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Collective Investment Trusts and 401(k) Plan Investments: Guidance for Fiduciaries and Employee Benefits Counsel

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May 11, 2022

Collective Investment Trusts and 401(k) Plan Investments: Guidance for Fiduciaries and Employee Benefits Counsel

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401(k) Plan Adoption of CITs

- CITs dominate the large plan market (i.e., plans with $1b or more in assets)
- CIT popularity is now rapidly growing in the mid to small plan space
  - In 2021, 78% of all 401(k) plans used CITs in their fund lineups, up from 44% in 2011*
  - 56% of plans use CITs as target date fund investment vehicles, vs. 29% that use mutual funds*

* Source: Callan 2022 Defined Contribution Funds Survey

Drivers Behind the Shift to CITs

Fees: Because CITs are not subject to registration under the '40 Act, they enjoy certain cost advantages over mutual fund counterparts

Flexibility: CITs can be quickly and readily customized to meet changing market environments/client needs

Plaintiffs' Bar Allegations

- Numerous 401(k) fee lawsuits in recent years allege the failure to consider use of CITs as low-cost alternatives to mutual funds gives rise to a breach of fiduciary duty. See, e.g., *Deering v. IQVIA, Inc.* M.D.N. C. No. 1:20-cv-00574 ("A clear indication of Defendants' lack of a prudent investment evaluation process was their failure to identify and select available collective trusts")

Plaintiffs' Bar Allegations (Cont'd.)

- District court rulings on the plausibility of such claims have been inconsistent
- Some find the allegations sufficiently plausible to survive motion to dismiss
- Others dismiss the allegations (see, e.g., *Tobias v. NVIDIA Corp*. 2021 BL 345322 N.D. Cal., No. 5:20-cv-06081 (Sept. 13, 2021) (CITs differ so much from mutual funds … in terms of their regulatory and transparency features as to make an apples to oranges comparison of the two impossible)

CIT Governing Documents

- Declaration of Trust
  - establishes and governs the CIT
  - frequently supplemented by Fund Declarations
  - contains investment guidelines
- Participation Agreement
  - affords the adopting plan access to the CIT
  - includes representations as to the adopting plan's eligibility
  - incorporates the provisions of the Declaration of Trust as part of the adopting plan's trust

CITs vs. Mutual Funds

Similarities

- Both are vehicles for pooled investment
- Both adhere to stated investment objectives and strategies
- Both typically engage the services of investment advisers to pursue objectives and strategies

Differences

- **CITs are ERISA "plan assets" vehicles**
  Mutual funds are not
- **Mutual funds are subject to '40 Act prospectus and financial reporting requirements (and expense)**
  CITs are not
- **CITs are available exclusively to qualified retirement plans and other classes of eligible investors**
  Mutual funds are available to the public

CITs Reflect a Number of Regulatory Influences

Tax Laws

- Rev. Rul. 81-100 *et seq.*

Federal and State Banking Laws

- OCC Reg. 9
- Exclusive management
- Prudent delegation and oversight
- Ongoing due diligence

CITs

The Federal Securities Laws

- CITs eligible for federal securities laws exemptions
- Must maintain clear governance practices
- Bank must maintain "substantial investment responsibility"

Employee Retirement Income Security Act of 1974

- ERISA fiduciary duties
- Duty to avoid prohibited transactions

IRS Rev. Rul. 81-100, et al

- Recognizes that CITs and certain other group trusts are not subject to federal income tax
- Limits participation in the CIT to certain types of plans (**note:** 81-100 more permissive than federal securities laws)
- Declaration of trust must prohibit use of trust assets other than for the exclusive benefit of participants and beneficiaries

Federal and State Banking Laws

Some historic background:

- Modern-day CITs evolved from "common trusts"
- Common trusts developed in the 1920's at the state level
- Common trusts permit bank and trust company co-mingling of bank funds managed for "true fiduciary purposes" (i.e., executorship, guardianship, conservatorship, etc.)
- Tension following the Depression era was to allow money management for true fiduciary purposes <u>without</u> opening bank pooled funds up to general public
- 1962: Supervisory authority over national banks transferred from Federal Reserve Board to OCC
- OCC adopts Reg. 9 allowing a second type of CIT – "a fund consisting solely of assets of retirement, pension, profit-sharing, stock bonus or other tax-exempt trusts." Reg. 9.18(a)(2)

Federal and State Banking Laws (Cont'd.)

- Office of the Comptroller of the Currency – 12 C.F.R. Part 9 (Reg. 9)
- Core Regulatory Principle: "A bank administering a collective investment fund shall have **exclusive management** thereof, **except as a prudent person might delegate** responsibilities to others"

Principles of Prudence

- Principles of prudence apply whenever a bank engages in determinations about whether and to whom CIT management authorities may be delegated

  "The trustee must act prudently in deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust. The trustee should consider all relevant circumstances in connection with the delegation of investment functions, including the knowledge, skills, capabilities, and compensation of both the trustee and agent. Other circumstances to be considered include the size of the trust, the nature and complexity of the trust assets, and the particular goals of the investment strategy"

  Comptrollers Handbook, Invest Management Services (Aug. 2021) at 120

- Duty of prudence is an ongoing one that continues following a decision to delegate: "The trustee is under a duty to supervise any agents to whom investment responsibilities are delegated."

Federal and State Banking Laws (Cont'd.)

Sub-Advisor Oversight

- The activities of the CIT sub-advisor remain subject to the oversight and ultimate authority of the bank
- Exclusive management requirement is not met if the Trustee simply out-sources its charter
- The OCC expects a national bank relying upon third parties, including CIT sub-advisors, to maintain risk management processes that are commensurate with the level of risk and complexity of the third-party relationship; with more comprehensive and rigorous oversight and management of third-party relationships that involve critical activities
- Accordingly, the OCC expects that banks utilizing the services of CIT sub-advisors will exercise periodic reviews of sub-advisor performance, style consistency, and investment of fund assets in a manner consistent with applicable investment guidelines

Federal and State Banking Laws (Cont'd.)

Written Policies and Procedures

- National banks are required to adopt and follow written policies and procedures that are adequate to maintain their fiduciary activities in compliance with applicable law
- A bank should be able to demonstrate control over the documents that afford clients access to CIT investment funds, including the maintenance of original documentation in a secure, centrally controlled location
- The bank also should maintain a system of internal controls, including an effective audit program for assuring that the bank is adhering to the terms and conditions of CIT instruments (i.e., declarations of trust and participation agreements)
- A national bank also is required to conduct a formal review of all of the assets for which it has investment discretion at least once per year

Federal and State Banking Laws (Cont'd.)

Summary of Reg. 9 and OCC Guidance

- Ongoing bank monitoring and oversight of CIT functions is critical
- The trustee of a CIT may not function as a mere custodian, but needs to undertake active, ongoing due diligence and inquiry as to whether the needs of the CIT are being met and whether the interests of the CIT are being properly served

The Federal Securities Laws

- Sections 3(c)(11) of the Investment Company Act of 1940 (the '40 Act) and 3(a)(2) of the Securities Act of 1933 (the '33 Act) make available to CITs counterpart exemptions from the registration and related disclosure and reporting requirements under each of those statutes
- In order to qualify for the exemptions, a CIT must **be "maintained by a bank"** and must consist solely of assets of one or more trusts of certain types of retirement plans—primarily those that meet qualification requirements under Code section 401(a), certain types of governmental plans or church plans
- Maintained by a bank = exercising substantial investment responsibility over CIT assets
- Functioning as a "mere custodian" insufficient

The Federal Securities Laws (Cont'd.)

SEC has brought enforcement proceedings against banks that fail to adequately "maintain" CITs through exercise of "substantial investment responsibility"

- *In Re Dunham Associates* (2006)

  A pooled trust fund serving as an intermediary vehicle to allow investors access to private funds unavailable for direct investment was not "maintained by" the bank

- *Great Plains Trust Company* (2020)

  Trust Company that completely out-sourced management of CIT to an affiliated investment adviser was not "maintained by" the bank. Trustee's oversight of advisor was "cursory," largely limited to passive receipt of information, and rarely resulted in changes or feedback

The Federal Securities Laws (Cont'd.)

- A bank relying upon the recommendations of third-party investment advisers for purposes of managing CIT assets would need to approve or authorize those investment decisions contemporaneously or in advance to demonstrate the exercise of substantial investment responsibility

ERISA
Definition of "Fiduciary"

- **A person is a "fiduciary" to a plan to the extent that person –**
  - Has any authority or control over the management of plan assets,
  - Has discretionary authority over plan administration, OR
  - Renders investment advice to the plan for a fee
- **"Named Fiduciaries"**
  - ERISA also requires that every plan have a "named fiduciary," which means that certain fiduciaries must be identified (or identifiable pursuant to a procedure described) in the plan document

ERISA (Cont'd.)
Who is a Fiduciary?

- Plan administrator
- Administrative and investment committees
- Trustee
- Investment managers and investment advisors
- Claims decision-makers
- *Functional fiduciaries:* Anyone who exercises discretion over plan investments or administration

ERISA (Cont'd.)
"Settlor" vs. Fiduciary Activities

- It is important to understand the distinction between "settlor" and fiduciary activities
- ***Importantly***, when acting as a settlor, ERISA's fiduciary standards do not apply
- "Settlor" activities (*e.g.*, employer/trustee business decisions relating to plan/trust establishment and design) are ***not fiduciary activities***
- But plan assets cannot be used to pay for "settlor" activities
- Moreover, there is a "fiduciary" exception to the attorney-client privilege for legal advice provided to fiduciaries

ERISA (Cont'd.)
"Settlor" vs. Fiduciary Activities

Settlor Activities

- Establishing the CIT
- Certain CIT amendments
- CIT termination
- **Importantly, plan assets cannot be used to pay settlor expenses**

Fiduciary Activities

- Appointing/monitoring CIT service providers (*e.g.*, sub-advisors)
- Selecting/monitoring CIT investments
- Monitoring CIT expenses
- Considering and deciding plan requests for admission/withdrawal
- Participating plan communications

ERISA (Cont'd.)
Overview of Fiduciary Duties

ERISA §404 requires fiduciaries to —

- Act prudently;
- Act solely in the interest of the plan's participants and beneficiaries (duty of loyalty);
- Use plan assets only to pay plan participants and beneficiaries and "reasonable" plan expenses;
- Diversify plan investments to avoid large losses; and
- Comply with governing plan documents

ERISA (Cont'd.)
Fiduciary Duties – Prudence

Process, process, process . . .

- Fiduciaries are not required to guarantee successful results—rather, they must employ a prudent decision-making process
- A prudent procedure is one employed by a "prudent expert" and not a "prudent layman"
- It is necessary to document procedural prudence

ERISA (Cont'd.)
Fiduciary Duties – Loyalty

- ERISA requires fiduciaries to act solely in the interest of participants and beneficiaries
- But committee members may "wear two hats"
  - "Settlor" hat
  - Fiduciary hat

ERISA (Cont'd.)
Fiduciary Duties
Prohibited Transactions

- ERISA's general fiduciary provisions are supplemented by "prohibited transaction" rules
  - ERISA and the Code prohibit certain transactions between a plan and "parties in interest" and "disqualified persons" to the plan
    - These include fiduciaries, the plan sponsor, service providers, and certain of their affiliates
  - ERISA prohibits self-dealing and other certain transactions involving fiduciary conflicts
  - But ERISA provides certain statutory exemptions and allows administrative exemptions to overcome these prohibitions

ERISA (Cont'd.)
Fiduciary Duties
Services and Fees

- Decisions about the disposition of plan assets, including whether to pay expenses are "fiduciary"
- Fiduciaries may only pay "reasonable" plan expenses –
  - For services that are appropriate and helpful to the plan, *e.g.*, administrative/investment expenses (but not for settlor expenses)
  - But fees must be "reasonable" in amount (compared to fees charged by other providers of similar services)
  - Reimbursement of reasonable fiduciary expenses (*e.g.*, travel, meetings) is permitted

ERISA (Cont'd.)
Fiduciary Liability

Remember –

- A fiduciary that breaches any of his/her fiduciary duties may be personally liable for plan losses
- A fiduciary may be liable for a breach of fiduciary duty by another fiduciary ("co-fiduciary")
- ERISA allows fiduciaries, participants, beneficiaries and the DOL authority to sue for violations of ERISA
- Participants can sue for benefit claims and equitable relief
- ERISA also provides for civil money penalties as well as criminal penalties
- ERISA generally preempts state lawsuits

ERISA (Cont'd.)
Identifying Plan Assets

A vehicle will not "hold plan assets" if –

- A mutual fund (registered investment company)
- A "Real Estate Operating Company"
- A "Venture Capital Operating Company"
- "Benefit Plan Investors" own less than 25% of every class of the vehicle's equity interests

Always "plan assets"

- Insurance company separate accounts (unregistered)
- Plan trust account
- Bank collective trust
- Wholly owned subsidiary of plan

ERISA (Cont'd.)
Prohibited Transactions

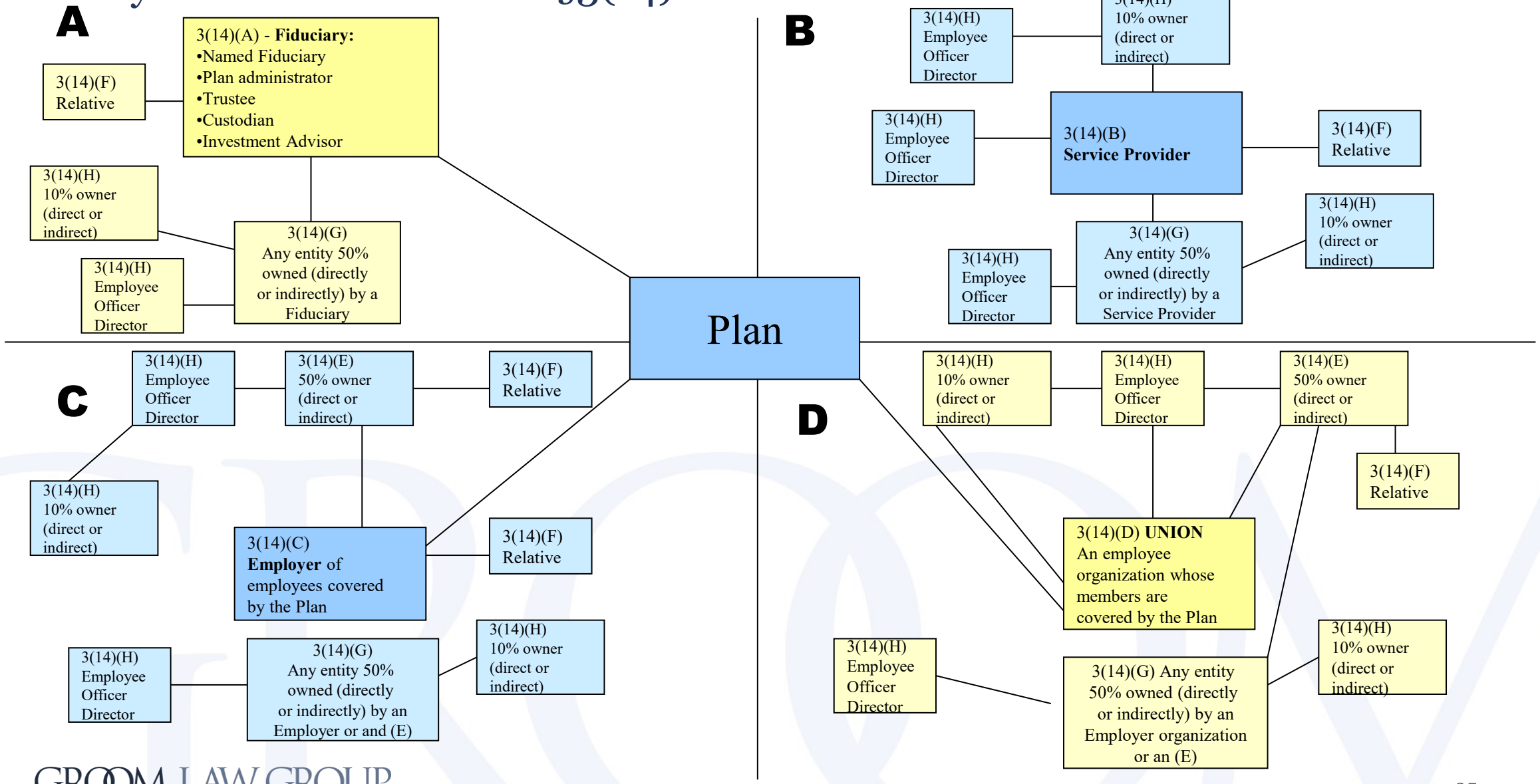
Two types of prohibitions

- Transactions between plan and a "party in interest" (related to the plan)
- Plan transactions "caused" by a fiduciary that has a conflict of interest

ERISA (Cont'd.)
Prohibited Transactions
"Party in Interest" Transactions

- **Section 406(a)** prohibits virtually any type of transaction between a plan and a "party in interest"
- "Party in Interest" = the employer, any plan service provider, or fiduciary, as well as numerous related parties
  - Every plan has a large set of parties in interest
  - It's not possible to identify all of these parties in interest for the purpose of avoiding transactions with them

ERISA (Cont'd.)
"Party In Interest" Status – §3(14)



ERISA (Cont'd.)
Prohibited Transactions
"Party in Interest" Exemptions

- Because it's not possible to identify all parties in interest, investment fiduciaries typically assume every counterparty is a party in interest and follow an exemption strategy
- Two types of exemptions
  - Global Exemptions
    - QPAM, section 408(b)(17), PTE 90-1/91-38
  - Transaction-Based Exemptions
    - E.g., principal transactions, FX

ERISA (Cont'd.)
Prohibited Transactions
"Real" Conflicts by Fiduciaries

- Self-Dealing
  - Fiduciary deals with plan assets "in own interest"
  - Intent not relevant
  - Ex: Plan's purchase of bond from investment manager's affiliate even if fair price
  - Ex: Fiduciary consultant recommends own service or product
- Representing Both Sides
  - Fiduciary represents both plan and counterparty in transaction between them.
  - Ex: a trade between two accounts managed by the same manager (or affiliated managers)
- "Kickbacks"
  - Fiduciary receives "consideration" from party involved in plan transaction
  - Ex: Fiduciary consultant receives a commission from insurer in connection with policy recommended by consultant

Key CIT Prohibited Transaction Exemption: ERISA §408(b)(8)

- *ERISA §408(b)(8) exempts investments in proprietary collective trusts and pooled separate accounts*
- Exemptive relief conditions include:
  - Compensation paid to the trust company/insurance company may not exceed "reasonable" amounts, and
  - Transaction must either be expressly permitted by the plan's governing documents or approved by an independent fiduciary

§404 Prudence and Loyalty Standards Always Apply

Compliance with the terms of a prohibited transaction exemption does not, in and of itself, satisfy ERISA §404 general fiduciary standards of prudence and loyalty!

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