Collective Investment Trusts

Prepared by the Coalition of Collective Investment Trusts

THE COALITION OF COLLECTIVE INVESTMENT TRUSTS

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Overview

Collective investment trusts (CITs), also known as commingled funds, collective investment funds or collective trust funds, are growing in number and assets. Long a popular choice of defined benefit (DB) plans, in recent years CITs increasingly have become a choice of defined contribution (DC) plan sponsors. CITs continue to grow in popularity for a variety of reasons, including recordkeeper acceptance, consultant familiarity, pricing flexibility, daily valuation, National Securities Clearing Corporation (NSCC) Fund/SERV® compatibility, and improved reporting and transparency as a result of compliance with Department of Labor (DOL) disclosure requirements under the Employee Retirement Income Security Act (ERISA). Plan sponsors also appreciate that CIT trustees are subject to ERISA fiduciary standards with respect to ERISA plan assets invested in CITs.

Formed in 2012, the Coalition of Collective Investment Trusts (CCIT) brings together collective trust fund sponsors, money managers and related service providers active in the collective trust fund industry. With approximately 40 member companies, the Coalition represents a sizeable portion of the rapidly growing collective trust fund market, which includes $1.2 trillion in assets as of December 31, 2013, according to Morningstar.

For more information about the CCIT, visit www.ctfcoalition.com.

The CCIT hopes this white paper provides those who invest in, research and recommend CITs a better understanding of how the funds operate, their structure and when they might be appropriate investment vehicles for eligible retirement plans.

Collective Investment Trusts Defined

CITs in general are pooled investment vehicles organized as trusts and maintained by a bank or trust company. CITs are designed to facilitate investment management by combining assets from eligible investors into a single investment portfolio (or "fund") with a specific investment strategy. By commingling, or pooling, assets, sponsors of CITs may take advantage of economies of scale to offer lower overall expenses, enhanced risk management, and more diverse and innovative investment opportunities for the participating investors than such investors could achieve by investing these assets on their own. Each fund is managed and operated in accordance with the applicable trust's governing documents, which generally include a declaration of trust (or plan document) and the fund's statement of characteristics.

Two Broad Types of Collective Trusts

Collective trusts generally fall into two types:

- A1 funds (also referred to as common trust funds); and
- A2 funds (also referred to as collective investment funds or collective investment trusts).

The terms "A1 funds" and "A2 funds" refer to the specific sections of the Office of the Comptroller of the Currency (OCC) regulations that established these two types of vehicles, as further described in the Regulatory Oversight section of this paper.

A1 funds involve the pooling of assets of various trust accounts held by a bank in its capacity as trustee, executor, administrator, or guardian. Participants in A1 funds do not have to be tax-exempt entities (although tax-exempt trusts can participate in these funds). Common trust funds can qualify for tax exemption under Section 584 of the Internal Revenue Code of 1986 if they comply with IRS regulations. Typical investors (or grantors in a trust relationship) include foundations, corporations, endowments, trusts and other entities that are exempt from federal income tax. Some A1 funds accept investment from certain taxable investors, including high net worth individuals and asset aggregators. A bank or trust company should be cognizant of the impact of accepting individuals and certain other types of investors under securities laws, tax laws and banking laws.

In this white paper, the CCIT focuses on **A2 funds** and uses the term collective investment trust (CIT). Generally speaking, only certain retirement plans – such as 401(k) plans, other defined contribution or defined benefit retirement plans that are qualified under Internal Revenue Code Section 401(a), and government 457(b) plans – may invest in CITs. Under certain circumstances, CITs may permit investment by qualified plans that include self-employed persons (often referred to as "HR 10 plans") and church plans. Retirement plans qualified under Puerto Rico tax laws and covering only Puerto Rico residents may also invest in a CIT, in accordance with a series of IRS Revenue Rulings. Generally, CITs may not hold assets of 403(b) plans, individual retirement accounts (IRAs), or health savings accounts. The rules governing who can invest in a CIT are contained in statutes, related regulations, and rulings under banking, securities and tax law. See the Regulatory Oversight section of this document for more information about the regulatory framework applicable to CITs.

The Investment Option Selection Process

Today, the retirement plan marketplace generally revolves around outcome-oriented strategies designed to position participants for a comfortable retirement. As plan sponsors, intermediaries and other service providers consider investment strategies, they will want to compare the available vehicles for a given approach. Plan fiduciaries should make all decisions, particularly those concerning the plan's investment menu, utilizing a prudent and well-documented decision making process.

Because investment platforms offer several types of investment vehicles for retirement plans, including mutual funds, CITs, separate accounts and annuities, it is both more difficult and more important than ever for plan fiduciaries to understand the various vehicles and make informed choices. Plan fiduciaries must evaluate many factors, including cost, to determine which options will best serve the plan's needs. For example, the provider's available investment universe, the plan's own investment policy statement (IPS), trading and operational considerations, current market trends, the demographic makeup of the plan's participants, and the current regulatory environment should all play roles in the fiduciary's decision making.

Given the many variables, no single option will necessarily provide the best fit for all the plan fiduciary's criteria. As with all decisions, plan fiduciaries should select investment vehicles based on what is in the best interest of the plan participants and their beneficiaries. Each plan's unique situation will inform which investment vehicles might be appropriate.

Some of the key questions a plan fiduciary should consider when selecting an investment vehicle for his or her plan's investment lineup might include:

- Is the plan provider's current investment universe appropriate?
- Is the cost structure appropriate given the plan size, services provided and the scope of desired investment options?
- Is there an opportunity to customize fees based on plan needs?
- How experienced is the asset manager, and what is his or her reputation in the marketplace?
- What type of data and/or reporting will be supplied to the plan?
- Are there any liquidity boundaries, trading issues or operational considerations?
- Given all available information, is the investment vehicle the best fit for the plan participants and their beneficiaries?

The Evolution of CITs

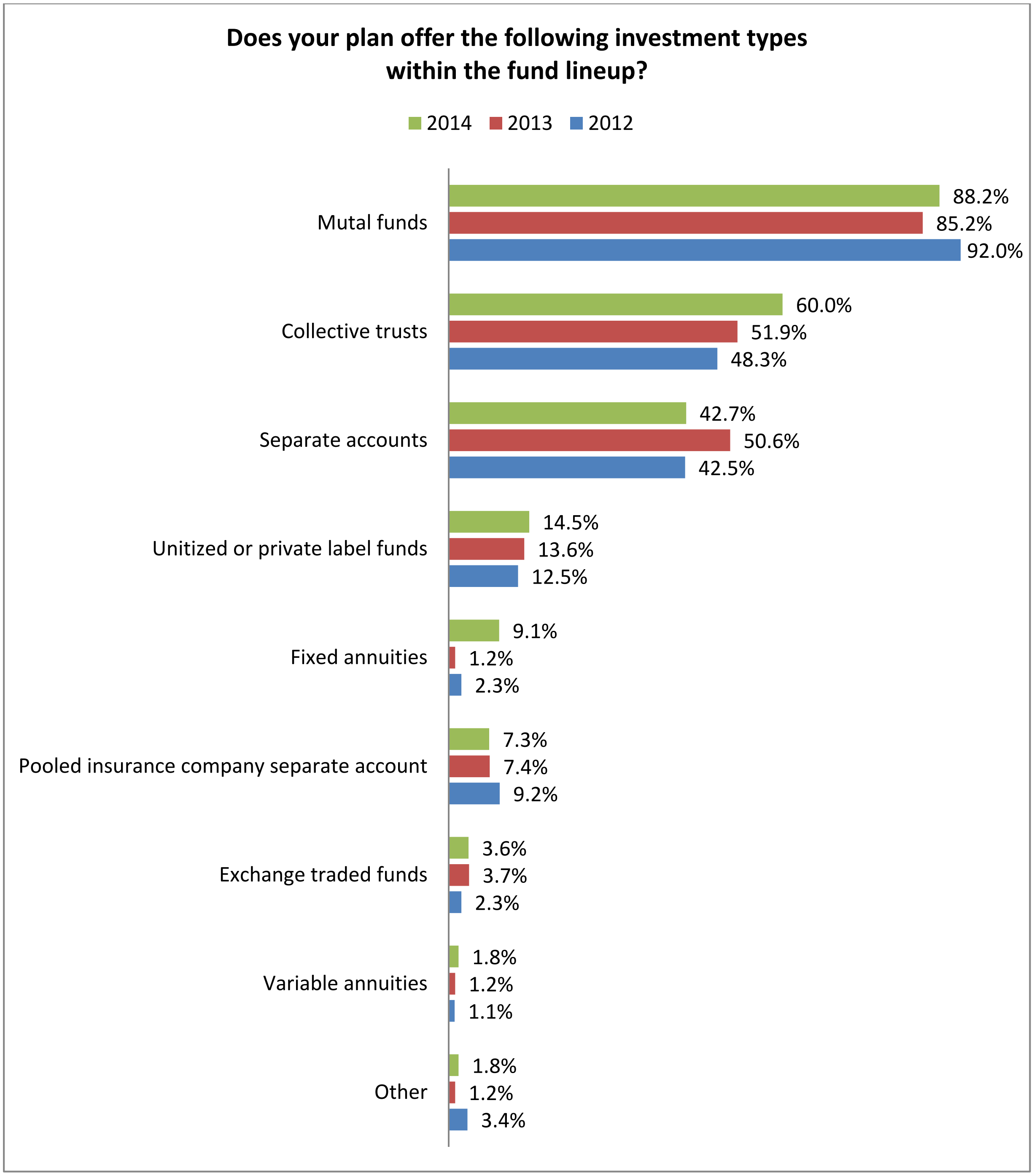
Collective investment trusts have been around for more than 75 years. Below is a brief timeline of the milestones associated with the evolution of this investment vehicle.

- 1927 – CITs first introduced
- 1936 – CIT use expanded in DB plans when Congress amended the Internal Revenue Code to provide tax-exempt status to certain bank-maintained CITs
- 1955 – CIT use expanded further with the Federal Reserve authorization for banks to combine funds from pensions, profit sharing and stock bonus plans, and the IRS determination that such CITs could be tax-exempt
- 2000 – CITs began trading on the NSCC's Fund/SERV® platform
- 2012 – To facilitate comparisons across DC investment alternatives, the DOL required plan administrators to standardize strategy, risk, performance and expense disclosures for plan participants

Early versions of CITs required investor purchases and withdrawals to be processed manually and were valued infrequently, typically only once per calendar quarter. These first CITs, unique to each bank and money management firm, provided investors little access to portfolio and performance data. As 401(k) plans developed in the 1980s, and DC plans became the primary employer-sponsored retirement savings vehicles, employers began considering a broader universe of investment options, including various legal structures such as mutual funds, CITs and other vehicles. Mutual funds, with daily valuations and greater portfolio data transparency, especially performance information, quickly overshadowed CITs and other vehicles, becoming the preferred vehicle of choice for most DC plans.

When CITs were included in the NSCC mutual fund trading platform, Fund/SERV®, in 2000, order placement methods for CITs began to operate more similarly to mutual funds. CITs could now offer automated subscription and withdrawal transactions for DC plans with standardized transaction processing in a daily valuation environment, like mutual funds. As a result, the usage of CITs has increased notably.

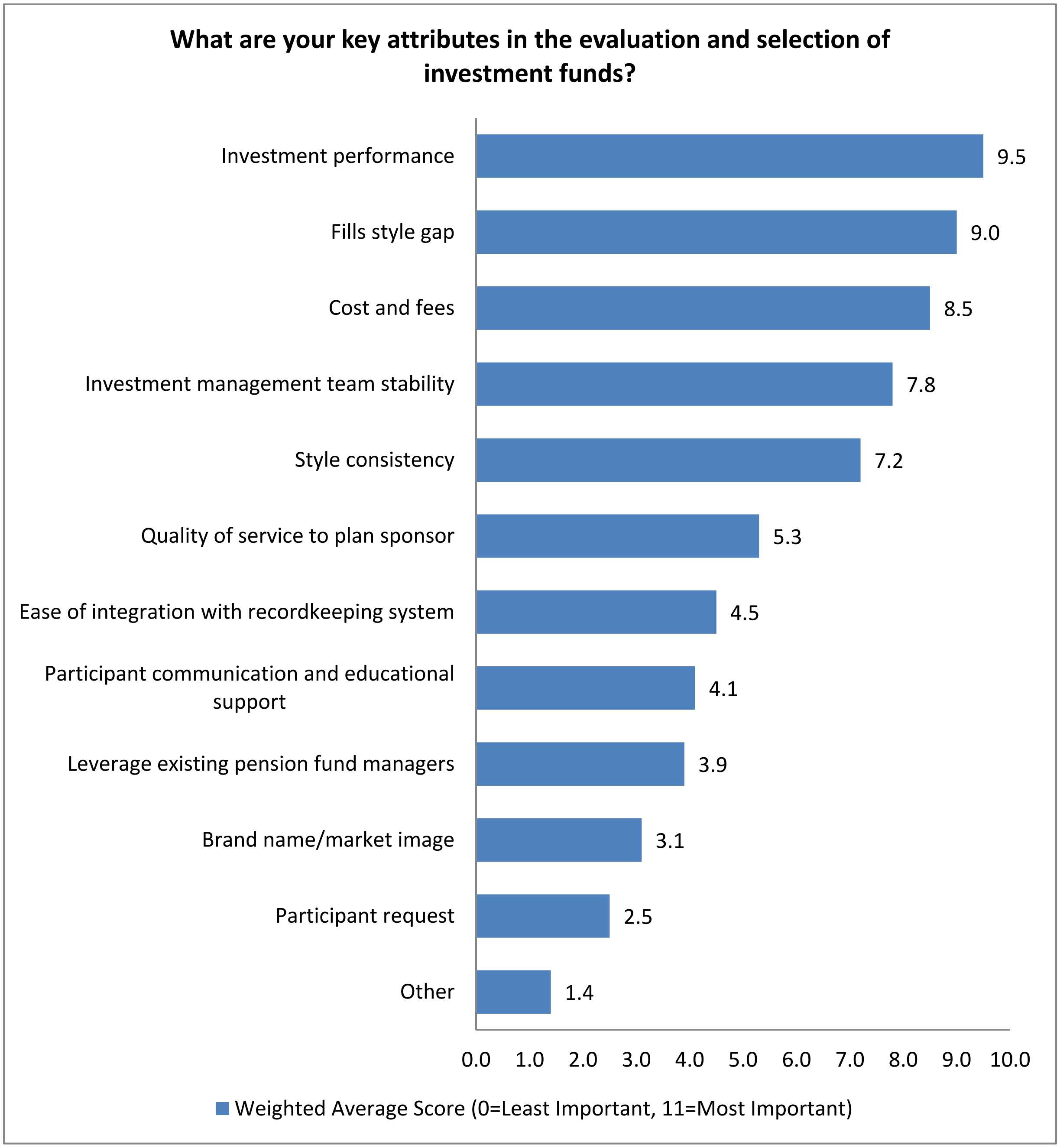
Until recently, widespread sharing of CIT information with database vendors has been limited, both in terms of the number of CITs publishing data and the breadth thereof. However, by both measures, there has been marked improvement. Data aggregators, such as Morningstar, provide coverage of CITs and continue to expand and improve their institutional subscription databases (available to plan sponsors and other service providers) with the support of CIT sponsors. In fact, Morningstar's coverage has increased to more than 1,748 CITs representing 3,358 share classes as of December 31, 2013.



Callan 2015 *Defined Contribution Trends 2015.*

Lack of detailed expense information has traditionally posed a headwind to broader use of CITs. Today, plan sponsors benefit from greater transparency on pricing practices in the DC market as a result of recent DOL regulations governing fee disclosures to plan sponsors and participants. The DOL believes this greater transparency will lead plan sponsors to carefully reevaluate the fees that they are paying for the investment options offered in their retirement plans. Scrutiny of plan costs and DOL-mandated disclosure of plan fees may help to further increase the popularity of CITs. Investment expense is generally the largest single expense associated with a retirement plan; lower-cost vehicles, including

CITs, provide plan fiduciaries and participants the potential for considerable savings as the industry becomes more focused on driving down plan costs to enhance performance. The potential pricing flexibility and cost advantages that CITs offer when compared to other investment vehicles may translate into greater demand.



Callan 2015 *Defined Contribution Trends 2015.*

Median Fee Comparison for Select Institutional Strategies, 2014

(basis points)

Source: eVestment

Analyst Note: This data is specific for a mandate size of $25 million and includes active and passive products. Fees are generally subject to a sliding scale.

	Large-Cap Equity	U.S. Fixed Income	Emerging Markets Equity	Alternatives
Vehicle Type	**Median**	**Median**	**Median**	**Median**
Mutual fund	83.0	55.0	125.0	105.0
Collective trust fund	60.0	35.0	100.0	80.0
Separate account	63.0	30.0	95.0	60.0

Cerulli Associates, *Institutional Markets 2014: Gaining Marketshare as Shifting Portfolio Construction Presents New Opportunities and Challenges.*

Early CITs	Modern CITs
Lack of pricing flexibility at the plan level	Plan-level pricing flexibility often available
Limited product offerings	Expanded universe of investment objectives
Quarterly valuation	Daily valuation
Manual processing of investor contributions and withdrawals	Potential for more standardized and automated daily processing
Limited performance calculations based on quarterly valuations	Performance generally available due to daily valuations
Limited availability of fund data	Fund fact sheets and enhanced data reporting
Used almost exclusively in DB plans	Used in both DB and DC plans

Features of CITs

CITs operate like other pooled investments in that investors with similar objectives merge their assets into a single portfolio. Although offered by banks and trust companies, CITs assume the same investment risk as other investments, with no guarantee from the bank or any regulatory authority such as the FDIC.

Governing Documents

Declarations of Trust (also referred to as plan documents) establish and govern CITs, creating a framework of operational and legal terms and conditions pertaining to the trust and the funds established and maintained under it. Terms regarding investor eligibility, subscriptions, redemptions and valuations, for example, may be found in the Declaration of Trust. In some cases, CITs may also have disclosure documents that provide additional information regarding their material terms and conditions, policies and procedures applicable to investment, and risk disclosures relevant to the investment strategy.

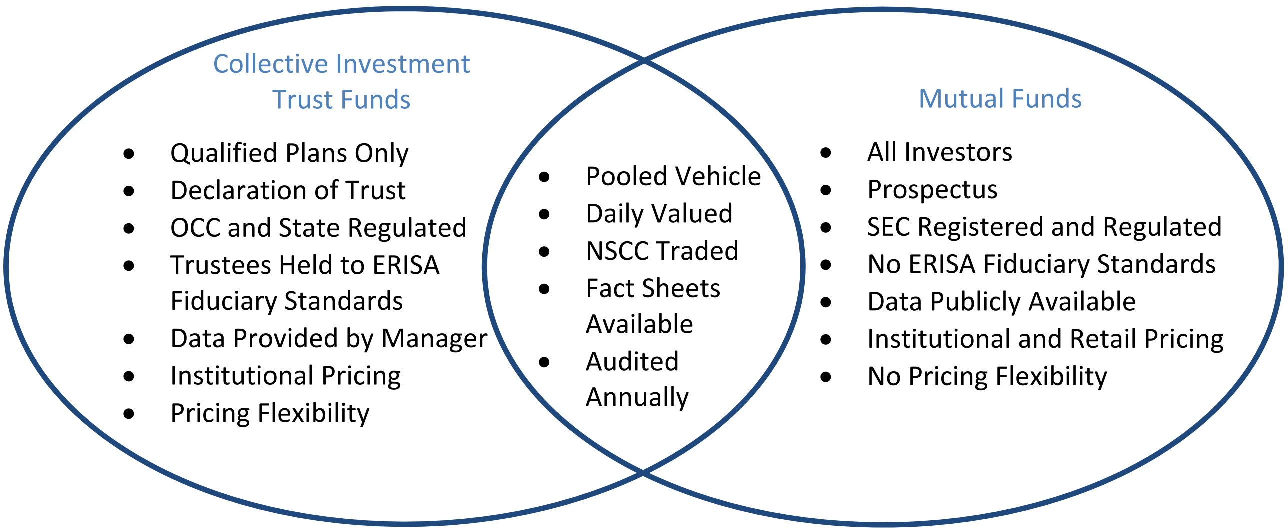
Descriptions of the individual CITs established under a Declaration of Trust exist in a document, which may be called a **Fund Description, a Supplemental Declaration, Statement of Characteristics** or an **Investment Guideline**, and is normally included as part of or accompanies the Declaration of Trust. This document typically contains the fund's investment objective, strategy, fees, sub-adviser's identity and other applicable terms that are material to a plan fiduciary's decision to invest in the fund. A participating plan should not expect to negotiate the terms of the Declaration of Trust or the investment guidelines of CITs any more than they would negotiate the terms of a mutual fund prospectus. If individual plans could change the terms under which the CIT operates, the CIT sponsor would find it difficult to meet its fiduciary duty to the fund and all its investors. Plans that require a great deal of flexibility in the terms and conditions under which their plan assets are managed are generally better suited to invest through separate accounts.

Plans invest in a CIT through an agreement between the trust company and the plan fiduciary, which is often called an **Investment Management Agreement, Custody Agreement, Participation Agreement, Adoption Agreement or Joinder Agreement.** This agreement typically requires the plan's fiduciary to make certain representations with respect to the plan's eligibility and to agree to the fee terms and conditions applicable to the CIT investment. In some cases, this agreement also provides information regarding the CIT's investment strategy and other material terms.

Banking regulators allow CITs to offer variations in pricing to different classes of investors, provided that the fees are reasonable and commensurate with the level of services provided. CIT fees are sometimes more negotiable than fees available in other regulated pooled investment vehicles. CIT trustees recognize that ERISA plan fiduciaries have a fiduciary duty to ensure that the fees charged for a plan investment option are reasonably related to the services provided.

Because CITs may accept investments from only certain retirement plans or other eligible investors in order to maintain their securities and tax exemptions, their marketing and distribution efforts are more targeted than other pooled investment vehicles. Reduced marketing and distribution costs contribute to the generally lower cost profile for CITs, when compared to other vehicles. Also contributing to the generally lower cost profile, CITs may be quicker and less expensive to launch. Additionally, CITs are not registered with the Securities and Exchange Commission (SEC), eliminating costly registration fees and extensive public disclosure requirements.

Of note, CIT trustees serve as ERISA fiduciaries to the plan assets invested in CITs and thus manage each CIT under ERISA fiduciary standards to the extent ERISA assets are invested in the CIT. ERISA fiduciary standards require the bank, as trustee, and any sub-advisers it may employ to assist in the management of the CIT, to act solely in the best interests of plan participants and their beneficiaries as a whole, avoiding conflicts of interest such as making decisions that may be in the bank's best interests.



Regulatory Oversight of CITs

CITs are subject to many laws and regulations, including those administered by:

- State and federal bank regulatory agencies (particularly the OCC);
- The DOL;
- The IRS;
- The SEC;
- The Financial Industry Regulatory Authority (FINRA), to the extent the CITs are marketed by a broker-dealer; and
- The Commodities Futures Trading Commission (CFTC), to the extent the CITs invest in commodity interests, such as futures or swaps.

Federal and State Banking Laws

The OCC's collective investment funds regulations are a primary source of banking regulations relevant to CITs. The OCC's collective investment funds regulations apply to CITs sponsored by national banks and trust companies. While CITs sponsored by state-chartered institutions are not directly subject to OCC regulation, many states apply the OCC's rules either by statute, rule, other guidance or as best practices in examining state bank collective trust activities.

The OCC's collective investment funds regulations are codified at Title 12: Banks & Banking (12 CFR 9.18). A1 funds are established under 12 CFR 9.18(a)(1), and A2 funds are established under 12 CFR

9.18(a)(2). These Title 12 regulations require, among other things, that:

- The bank sponsoring a CIT has “exclusive management” of the CIT, subject to prudent delegation;
- CITs are valued at least quarterly (illiquid assets may be valued annually), subject to market/fair valuation;
- Management fees satisfy the requirements set forth in the regulations; and
- The CITs are subject to risk management requirements.

DOL

As referenced earlier, CITs are subject to ERISA to the extent there are ERISA plan assets invested in the CIT and therefore are subject to DOL scrutiny. Because CITs are typically deemed to hold ERISA “plan assets,” the trustee and any sub-adviser of a CIT generally serve as ERISA fiduciaries and must comply with ERISA fiduciary standards in managing the CIT. In addition, all transactions, including those between the CIT and any “parties of interest” as well as the CIT’s fiduciaries, must comply with ERISA’s prohibited transaction rules. Lastly, the CIT sponsor is also subject to various reporting and disclosure requirements. These include service provider fee disclosures required under 29 CFR 2550.408(b)(2), which include certain investment-related disclosures required under 29 CFR 2550.404(a)(5). Technically, production of participant fee disclosures is the responsibility of the plan administrator of each of the CIT’s investing plans, but the CIT sponsor is required to provide the plan administrator or its agent (often the plan’s recordkeeper) extensive information about the CIT to enable plan administrators to comply with the regulation. In addition, Form 5500 reporting requirements apply if the CIT itself files a Form 5500 as a direct filing entity, and Form 5500 Schedule C disclosures must be provided to participating plans that are subject to the ERISA Form 5500 filing requirement.

IRS

Most CITs qualify as exempt from U.S. tax because they are “group trusts” under IRS Revenue Ruling 2011-01 (formerly 81-100). Certain requirements apply to qualify for this treatment, including that each investing plan must adopt the terms of the group trust as part of its trust.

Federal Securities Laws

Interests in CITs typically qualify as “exempt securities” under Section 3(a)(2) of the Securities Act of 1933 (Securities Act) and therefore are exempt from registration under the Securities Act so long as the CIT is “maintained by a bank” and participation in the fund is limited to certain investors, such as a pension or profit-sharing plan qualified under Internal Revenue Code Section 401(a) or a governmental plan as defined in Internal Revenue Code Section 414(d) .

Most CITs avoid registration as investment companies under the Investment Company Act of 1940 (1940 Act) by relying on an exclusion from the definition of an investment company found in Section 3(c)(11) of the 1940 Act, which is substantially similar to the Securities Act exemption described above. In a series of no-action letters, the SEC staff has stated that the bank must exercise substantial investment authority over the assets of the trust to satisfy the exclusion under Section 3(c)(11). A bank that functions in a mere custodial or similar capacity will not satisfy this requirement. At the same time, the SEC has long accepted that a bank may hire a sub-adviser to assist it in its exercise of investment discretion as long as the bank retains ultimate authority over the investments of the CIT.

CIT interests also typically qualify as "exempted securities" under Section 3(a)(12) of the Securities Exchange Act of 1934 (Exchange Act) and therefore enjoy broad exemptions from the requirements of that Act.

FINRA

To the extent that a CIT sponsor uses the services of a broker-dealer with respect to the sale of its CITs, the broker-dealer's representatives must comply with FINRA rules applying to member firm sales of exempt securities. FINRA Rule 0150 sets forth those rules, which are applicable to transactions in and business activities relating to exempt securities (other than municipal securities), such as interests in CITs, conducted by member firms.

CFTC

To the extent that a CIT invests in commodity interests, the CIT's sponsor and sub-adviser (if any) would have to comply with applicable CFTC rules and regulations. Exemptions most often used are under CTFC Regulation 4.5.

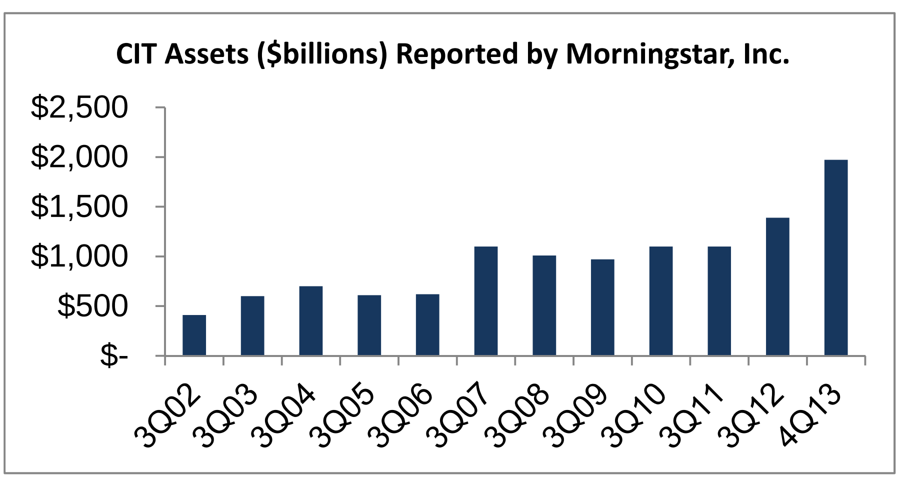
Growth in CITs

Technological advances, regulatory reforms and other changes in the retirement plan investment landscape have helped to increase the popularity of CITs in today's market. Traditionally adopted only by larger plans on a case-by-case basis, this comparatively low-cost investment vehicle continues to gain acceptance in the broader DC market. The CIT universe, historically dominated by indexed and stable value investment options, today offers a much broader array of investment strategies to meet these demands.

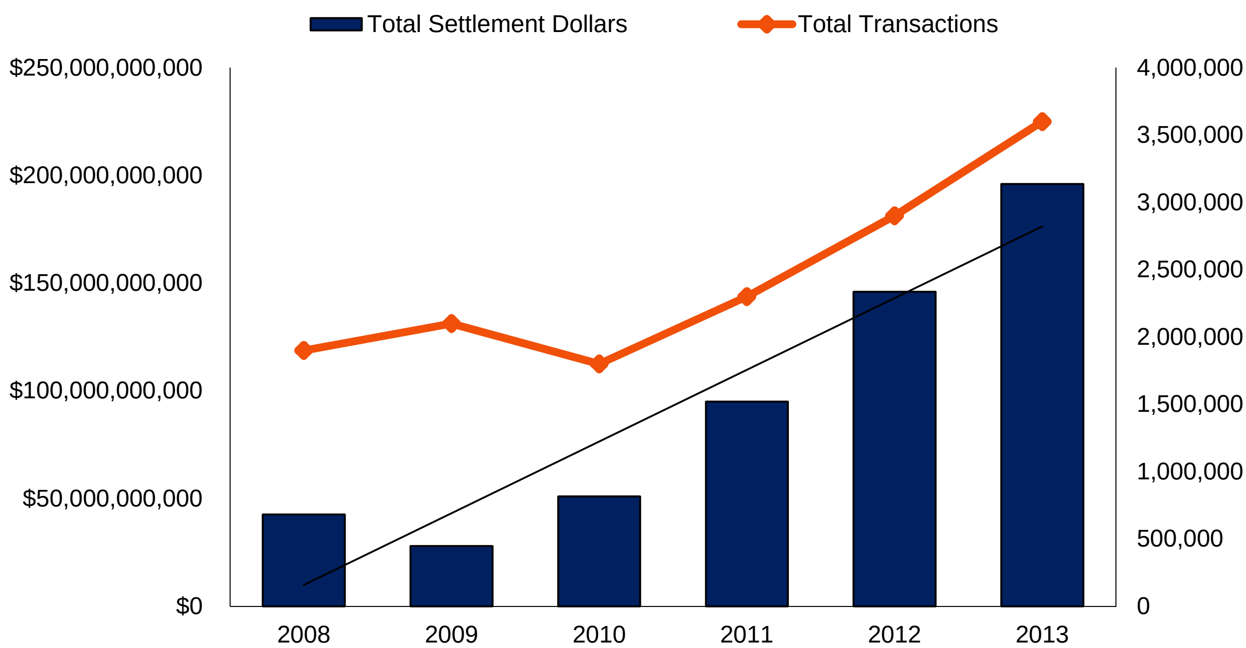
Broad Asset Class	Sum of Assets
Allocation	$ 246,867,938,181.00
Alternative	$ 3,163,666,130.00
Commodities	$ 1,567,171,532.00
International Equity	$ 194,798,638,933.00
Money Market	$ 23,570,264,938.00
Municipal Bond	$ 135,560,000.00
Sector Equity	$ 20,081,761,826.00
Taxable Bond	$ 353,848,959,606.00
U.S. Equity	$ 371,484,615,981.00
Grand Total	**$ 1,215,518,577,127.00**

Morningstar; As of 4Q 2013.

Although there is no centralized regulatory or industry database available that serves as a complete resource for measuring the universe of CIT assets, Morningstar, Inc., and DTCC provide statistical data that demonstrates the growth trend in CITs. Many bank sponsors of CITs voluntarily populate Morningstar's institutional subscription database with their bank's CIT fund data. In 2013, Morningstar reported on 181 provider companies.



CIT flows through DTCC/NSCC continue to grow



In the end, retirement plan fiduciaries must prudently select appropriate investments for their retirement plans, including both an appropriate number and suitable mix of investment options in the case of participant-directed plans. In that selection process, all types of investment vehicles should be considered.

Conclusion

When retirement plan decision-makers consider CITs, they should remember three things:

1. Bank sponsors of CITs serve as ERISA fiduciaries to the plans invested therein, under similar requirements as the plan fiduciaries themselves;
2. CITs include only retirement plans as investors, so all CIT investors share a long-term investment perspective that is not often found in other investment vehicles; and
3. The range of investment strategies available in CIT vehicles rivals the scope of any other type of vehicle, at generally comparable if not lower cost to the plan.

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