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Expected Retirement Law Changes May Spark ERISA Suits

By **Jennifer Neilsson, Darren Shuler and Benjamin Watson**
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Collective investment trusts, or CITs, and 403(b) plans have played recurring — though separate — roles in the surge of excessive fee lawsuits that have been filed against retirement plan fiduciaries over the past decade and a half.

Jennifer Neilsson

Congress is poised to pass bipartisan retirement legislation that could bring these two currents together to form a new wave of litigation under the Employee Retirement Security Act of 1974.

To understand how this new legislation — currently referred to as the Enhancing American Retirement Now Act, or EARN Act, and the Securing a Strong Retirement Act of 2022, or SECURE Act 2.0 — could generate additional litigation, it is helpful to review the important roles that CITs and 403(b) plans have played in prior waves of ERISA excessive fee cases.

Darren Shuler

The Rise of Collective Investment Trusts

CITs, like regulated investment companies — which include mutual funds — are pooled investment funds that are professionally managed. However, unlike a mutual fund, a CIT is excluded from the definition of "investment company" under the Investment Company Act of 1940 if the CIT is maintained by a bank and the assets consist solely of assets of retirement plans.

Further, under the Securities Exchange Act of 1934, CITs are not required to be registered.[1] Instead, CITs are regulated by the Office of the Comptroller of the Currency. The OCC regulations are generally less rigorous than the regulations that govern mutual funds.

Benjamin Watson

A CIT is subject to ERISA to the extent it holds plan assets, whereas mutual funds are specifically excluded from the plan asset rules.[2] As such, CITs are regulated by the U.S. Department of Labor and subject to the fiduciary rules, prohibited transaction prohibitions, and fee disclosure and reporting requirements.

Also, a CIT, like a retirement plan, is exempt from U.S. federal income tax because CITs are taxed as group trusts if specified requirements are met under Internal

Revenue Service guidance.[3] This guidance broadly allows most retirement plans to invest in CITs.

However, Sections 403(b)(1) and (7) of the Internal Revenue Code specifically limit 403(b) plan investments to annuities and regulated investment companies, excluding the possibility of offering CITs within the menu of investment options available to plan participants.

CITs create an investment experience similar to that of mutual funds for participants in individual account retirement plans — like 401(k) plans. Plan fiduciaries can take comfort in the fact that the trustee and/or investment manager of a CIT is subject to the heightened ERISA fiduciary standards of care when adding CITs to 401(k) plan investment menus.

The lack of retail investors and reduced securities law regulatory and reporting requirements allow CITs greater flexibility than mutual funds, and this generally has meant lower fees for CIT investors.

These lower fees and other benefits have led to the increased popularity of CITs. According to a recent MFS Investment Management paper titled "Retirement Plan Investment Vehicles: The Increasing Use of CITs," total CIT assets increased from $1.88 trillion in 2011 to over $3 trillion in 2018.[4] By 2020, CIT assets climbed to about $4.5 trillion, and comprised 30% of total 401(k) plan assets.[5]

CITs' lower fees have also attracted the attention of the ERISA class action bar. During the initial wave of excessive fee litigation targeting retirement plans in the mid-2000s, plaintiffs often claimed that fiduciaries breached their duties by offering higher-cost versions of mutual funds when cheaper share classes of those same funds were available.[6]

This theory of liability was refined in subsequent waves of litigation to claims that plan fiduciaries were imprudent for offering mutual funds at all, where equivalent CITs were available for a lower fee. Though courts have not adopted a categorical rule that CITs are superior to mutual funds, they have generally permitted such claims to proceed to discovery.

Litigation Targeting 403(b) Plans to Date

Similar to the relationship between CITs and mutual funds, 403(b) plans are substantively similar, though not identical, to their more well-known counterpart: the 401(k) plan. Specifically, 403(b) plans are defined contribution retirement plans available to employees of public schools and other tax-exempt organizations, including universities, charitable organizations, religious institutions and some hospitals.

While operating in fundamentally the same way as 401(k) plans — participants may invest a portion of their income in an individual account while enjoying certain tax benefits — 403(b) plans differ in several important respects.

For example, 403(b) plans have historically been more likely to use multiple record-keepers and offer a wider array of investment options. 403(b) plans are currently prohibited from offering a more diversified type of investment options, like CITs.

403(b) plans were not a target of the first wave of excessive fee litigation targeting individual account retirement plans. That changed in 2016, when the law firm Schlichter Bogard & Denton LLP began suing the fiduciaries of the nation's largest university 403(b) plans.

These lawsuits kicked off a new wave of 403(b) plan litigation that has shown no signs of letting up, and — in a parallel to trends in cases targeting 401(k) plans — has recently moved to smaller university retirement plans.

While the more recent cases targeting 403(b) plans have doubled down on the main theories of liability that were previously used to take aim at 401(k) plans — claims that individual investments performed poorly or were too expensive — the new cases have also included novel claims based on the unique features of 403(b) plans.

For example, 403(b) plaintiffs have alleged that fiduciaries of university retirement plans have breached their ERISA duties by offering more expensive retail share classes of investment funds when cheaper institutional class shares were available, charging participants higher fees for multiple record-keepers and offering participants an allegedly confusing number of different investment options.

Passage of SECURE Act 2.0 and EARN Act Could Make Way for New Wave of Fee Litigation

Notably absent from 403(b) plan litigation have been claims that plan fiduciaries should have offered CITs as investment options — claims that are now commonplace in cases filed against 401(k) plans.

This is because, unlike 401(k) plans, 403(b) plans are not permitted to include CITs in the menu of investment options, as described above. However, legislation is expected to be passed that would amend the law so that 403(b) plans would be permitted to include CITs in the investment menu.

The U.S. Senate Committee on Finance advanced a retirement legislation package, the EARN Act, at the end of June. It has many similar provisions to the U.S. House of Representatives' SECURE Act 2.0, which passed by a 414-5 vote on March 29.

The EARN Act is expected to be merged with another Senate bill and will then be reconciled with SECURE Act 2.0, and it is expected to be passed by both chambers and signed into law by President Joe Biden.

Both the EARN Act and SECURE Act 2.0 include provisions that would for the first time permit 403(b) custodial accounts to invest in CITs — recognizing that CITs can help to diversify investment options and lower costs to plans.[7]

If the proposed legislation becomes law and allows 403(b) plans to offer CITs as investment options, 403(b) plan fiduciaries should expect to be challenged by plaintiffs if they fail to examine the costs and benefits of offering CITs, instead of annuities and mutual funds — just as hundreds of 401(k) plans have been.

Plan fiduciaries, such as investment committees, can lessen potential fiduciary liability by taking steps to demonstrate procedural prudence. This may start by an investment committee engaging with its investment consultants and experts to prepare for this important change in the investment options that 403(b) plans may offer.

For example, the investment committee may seek education from independent consultants to better understand the differences between mutual funds and CITs, and to weigh the costs and benefits offered by each.

The plan's investment committee may also want to confirm that its investment consultant will be prepared to make recommendations regarding whether any CITs should be offered as an investment option and/or replace any existing investment options in the likely event that the legislation is signed into law.

Should the plan committee determine that CITs may be appropriate for their plan, further steps could include conducting a market survey of CITs that are comparable to the plan's existing investment options or speaking with existing fund managers about their CIT offerings. To the extent an investment committee takes these preliminary steps, it should take care to document the fiduciary process in minutes or other documentation.

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[1] See Securities Exchange Act of 1934 § 3(a)(2), (12).

[2] See 29 C.F.R. § 2510.3-101.

[3] See Rev. Rul. 81-100, 1981-1 C.B. 326 (modified and clarified by Rev. Rul. 2004-67, Rev. Rul. 2011-1 and IRS Notice 2012-6, Rev. Rul. 2014-24).

[4] See The Coalition of Collective Investment Trusts, Collective Investment Trusts (2021), available at https://www.ctfcoalition.com/portalresource/CollectiveInvestmentTrustsWhitePaper.pdf.

[5] See Jessica Sclafani & Craig McKenna, Retirement Plan Investment Vehicles: The Increasing Use of CITs (February 2022), available at https://www.mfs.com/en-us/investment-professional/insights/retirement-solutions/retirement-plan-investment-vehicles-the-increasing-use-of-cits.html.

[6] See Amanda Ernst, Plaintiffs Firms Put More 401(k) Fee Lawsuits in Motion, Law360 (Dec. 14, 2006), available at https://www.law360.com/articles/15129/plaintiffs-firms-put-more-401-k-fee-lawsuits-in-motion.

[7] See Senate Finance Committee Summary of Enhancing American Retirement Now (EARN) Act, available at https://www.finance.senate.gov/imo/media/doc/EARN%20Act%20section%20by%20section%20summary1.pdf.