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The Resurgence Of Collective Investment Trusts

Law360, New York (June 15, 2010) -- Bank collective investment trusts ("collective trusts"), a first cousin of the mutual fund, have been around for more than 70 years. Offered to both defined benefit and defined contribution plans, collective trusts today are vying to compete with mutual funds and other pooled investment vehicles as a mainstream product in the retirement plan marketplace.

Since the 1990s, mutual funds have overshadowed collective trusts as funding vehicles in the defined contribution plan marketplace for a number of reasons, including perceived advantages offered by mutual funds in the area of administration, pricing, record-keeping and performance advertising. However, collective trusts are now beginning to increase their share of the retirement plan market by competing successfully in terms of administration, pricing, record-keeping and overall cost.

But perhaps even more important, collective trusts have generally been able to weather the regulatory scrutiny of retirement plan fees and expenses. Collective trusts often have lower expense levels than comparable mutual funds. Collective trusts also are gaining attention as vehicles that arguably allow for more flexibility than mutual funds with respect to product design and the ability to avail themselves of certain alternative investments to a greater degree than mutual funds.

While the collective trust offers exciting possibilities to the investment manager, it also is fraught with certain traps for the unwary. In this piece, we briefly review the securities law framework applying to collective trusts and then discuss recent statements made by the U.S. Securities and Exchange Commission staff with respect to these vehicles.

The Regulatory Treatment Applying to Collective Trusts

Collective trusts are bank products and are overseen by the banking regulators.

Most collective trusts avoid registration as investment companies under the Investment Company Act of 1940 (the, "1940 Act") in reliance on an exclusion from the definition of an investment company found in Section 3(c)(11) of the act. Section 3(c)(11) excludes, among other entities, collective trusts maintained by a bank the assets of which consist solely of assets of two specific types of retirement plans derived from contributions under such plans.[1]

Section 3(c)(11) requires that a collective trust relying on the exclusion be maintained by its sponsoring bank. In a series of no-action letters, the SEC staff has required that in order for a bank to maintain a collective trust, the bank must exercise substantial investment authority over the assets of the trust.[2] A bank which functions in a mere custodial or similar capacity will not satisfy the "maintained" requirement. At the same time, the SEC has long held the position that a bank may hire a sub-adviser to assist it in its exercise of investment discretion.

The Recent Growth of Collective Trusts

As noted, a number of factors seem to be responsible for the resurgence of collective trusts. Lawsuits and regulatory scrutiny have put the spotlight on retirement plan fees and expenses, an area where the collective trust structure competes well.

Collective trusts have also responded to various operational challenges, in particular offering daily valuation and daily participant investment direction. In addition, living outside the 1940 Act allows collective trusts to more easily pursue investment strategies that entail, among other things, investment in illiquid derivative instruments and/or insurance guarantees.

Given this flexibility, the fact that assets in collective trusts exceed $1 trillion should come as no surprise.[3]

Recent SEC Staff Focus

As one may expect, the growth of collective trusts has caused regulators to examine them more closely. More specifically, in an April 8, 2010, speech to attendees of the Practicing Law Institute's 2010 Investment Management Conference, Andrew Donohue, director of the SEC's Division of Investment Management, revealed that members of his staff have begun looking into the activities of certain types of collective trusts that operate in a manner similar to mutual funds.

In particular, he indicated that his staff was looking at whether such trusts are properly relying on exclusion from regulation under the 1940 Act. This news surprised most industry observers, including lawyers who specialize in the 1940 Act, because neither the SEC nor its staff has made mention of, much less expressed an interest in, collective trusts over the past couple of decades.

Conclusion

Collective trust assets have increased considerably in recent years. In part, this may be because they offer some advantages to portfolio managers over mutual funds. For example, because they are not subject to regulation under the 1940 Act, collective trusts can more easily pursue investment strategies that entail, among other things, investment in illiquid derivative instruments and/or insurance guarantees.

However, investment managers interested in accessing the defined contribution plan marketplace through these vehicles should be aware of the increased SEC staff scrutiny and should carefully review guidance that the SEC staff has provided over the years with respect to reliance on the exclusion from 1940 Act regulation.

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[1] These are: (1) pension and profit-sharing plans which meet the requirements of Section 401 of the Internal Revenue Code (the “Code”) or the requirements for the deduction of the employer’s contribution under Section 404(a)(2) of the Code; and (2) governmental plans in connection with which interests, participations, or securities are exempted from the registration provisions of Section 5 of the Securities Act of 1933 (the “1933 Act”) under Section 2(a)(3) of that act. With certain exceptions, Section 3(a)(2) exempts any interest or participation in a Collective Trust issued in connection with: (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under Section 401 of the Code, (B) an annuity plan which meets the requirements for the deduction of the employer’s contributions under Section 404(a)(2) of the Code, (C) a governmental plan as defined in Section 414(d) of the Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries, or (D) a church plan, company, or account that is excluded from the definition of an investment company under Section 3(c)(14) of the 1940 Act.

[2] See e.g., The Provident Bank (SEC no-action letter dated Sept. 24, 1991).

[3] Ignites (“New Collective Fund Platform at Northern”) citing a Cerulli Associates estimates.