

# Investor education

## Understanding collective investment trusts



Collective Investment Trusts (CITs) offer similar benefits to mutual funds at generally lower costs, making them an attractive option for plan sponsors to consider in carrying out their fiduciary responsibilities.

Not FDIC Insured | No Bank Guarantee | May Lose Value

# The basics

A **CIT** is a tax-exempt, pooled investment vehicle maintained by a bank or trust company.

CITs were historically designed as investment vehicles for defined benefit plans. But they have evolved over the years. Today, CITs have become a popular choice of defined contribution (DC) plan sponsors. They are available for investment only by ERISA retirement plans and certain other types of governmental retirement plans.

**The primary reason why CITs have become popular: CITs are generally less expensive than mutual funds.**

Because investment-related fees and expenses are generally the most significant costs for many retirement plans, plan sponsors recognize that cost-effective investment vehicles such as CITs can mean sizable savings for their plans and their plan participants.

**Total assets in CITs are now at approximately \$6.3 trillion.<sup>1</sup>**

## Why do CITs have lower costs?

### CITs can have lower:

Overhead



Potential trading costs through cross-trading securities among a manager's investment strategies



Retail marketing expenses



### CITs also:

Are typically exempt from SEC registration and ongoing SEC requirements

Have potential tax treatment advantages for international funds due to a qualified investor base

Provide the opportunity for customized pricing arrangements based on plan size

**Lower costs and fees are the top advantage of CITs over mutual funds, with over three quarters finding it the most significant benefit.<sup>1</sup>**

1. The Cerulli Report "U.S. Defined Contribution Distribution 2024."

# Comparisons

**CITs** share some similarities with mutual funds but are also different in several meaningful ways that may be important considerations for a plan sponsor when deciding whether to choose a CIT or a mutual fund for its plan’s menu of investment options.

	CITs	Mutual Funds
<b>Operating Costs</b>	Generally lower operating costs (regulatory, administrative, distribution, marketing fees)	Generally higher operating costs (regulatory, administrative, distribution, marketing fees)
<b>Fee Structure</b>	Flexible unit class fee structures (investment management fees can be different for different unit classes of the same CIT)	Many funds have shares classes with different fee and expense structures but investment management fees must be the same across different share classes of the same fund
<b>Investment Options</b>	Wide range of investment choices	Wide range of investment choices
<b>Sponsor</b>	Offered by bank or trust company to qualified retirement plans; not available for investment by general public (retail)	Offered directly or through financial intermediaries (i.e., broker-dealers, insurance companies, banks, etc.) to public (retail), as well as institutions
<b>Eligible Investors</b>	Eligible trusts: tax-qualified plans under Internal Revenue Code of 1986 (Code), Section 401 (corporate, Keogh [Rule 180], Taft-Hartley); eligible government plans described in Code and Securities Act of 1933, Section 3 (a)(2); other group trusts or insurance company separate accounts that consist solely of Code Section 401 plans and eligible governmental plans Generally not eligible to participate: IRAs, 403(b) plans, Church plans not qualified under Code Section 401	No limitations, subject to prospectus criteria and requirements
<b>Investment Management Governance</b>	Managed by investment managers retained by CIT trustee, subject to such trustee’s supervision and oversight	Managed by investment managers approved by a fund’s board of directors, subject to the board of directors’ supervision and oversight
<b>Regulatory Oversight</b>	Subject to ERISA and Department of Labor (DOL) regulations and state or federal banking regulations	Subject to securities laws and regulations, including registration with the SEC
<b>Application of ERISA</b>	Fund assets considered “plan assets” under ERISA—subject to transaction provisions of IRC Section 4975	Fund assets not “plan assets” under ERISA
<b>Trade Settlement</b>	FUND/SERV	FUND/SERV
<b>Marketing Limitations</b>	Not registered under Securities Act of 1933; anti-fraud restrictions apply; marketing to eligible plan sponsors	Registered under the Securities Act of 1933; Marketing and distribution subject to FINRA requirements
<b>Regulatory Documents</b>	Declaration of Trust and Investment Policy Statement or similar trust documentation that govern the operations and investments of a CIT; no obligation to file with a banking regulator on a regular basis	Prospectus and Statement of Additional Information (SAI), which are updated and filed with the SEC on a regular basis, govern the operations and investments of a mutual fund
<b>Holdings Information</b>	Performance and holdings information available to plan sponsors and, in many cases, publicly on a periodic basis through website postings	Performance and holdings information publicly available and filed with the SEC, typically on a periodic basis depending on the type of fund

# Potential costs and benefits

Typically, the fees and expenses of a CIT are lower than those of comparable mutual funds, making it an attractive alternative for plan investors.

## Example of mutual fund fees vs. CIT fees

When a large plan and a small retail investor invest in the same mutual fund, they are typically subject to different investment management fees due to varying share classes. Large plans often access institutional share classes with lower expense ratios, while retail investors generally invest in share classes with higher fees for the same underlying fund.<sup>4</sup>

However, a CIT can offer multiple classes of unit ownership<sup>5</sup> subject to different investment management fees. This means that a retirement plan that is eligible to invest in a less expensive unit class—such as a large plan that is able to satisfy the investment minimum for a less expensive unit class—may be able to take advantage of lower CIT expense ratios.

## One can easily see why CITs are generally more cost-effective than mutual funds.

CITs' regulatory costs are lower, because they are not subject to the extensive registration, operational, disclosure and reporting requirements of federal and state securities laws and regulations or oversight by the SEC.

Unlike mutual funds, CITs and their trustees are subject to the oversight of state banking regulators or the Office of the Comptroller of the Currency (OCC), with substantially less burdensome regulatory, operational, reporting and disclosure requirements and obligations than those applicable to mutual funds.<sup>2</sup>

Administrative, distribution and marketing costs are typically lower, too. Since CITs are offered only to retirement plans and cannot be sold to individual retail investors, they are subjected to fairly limited advertising or distribution expenses in comparison to certain classes of mutual funds.

## Fees are more flexible

Simply put, CITs have greater fee flexibility than mutual funds. When a mutual fund offers multiple share classes, SEC rules dictate that the same investment management fee be charged with respect to all share classes of the fund.<sup>3</sup>

Not so with CITs. Many CITs offer unit classes with different investment management fees associated with each unit class typically based on the investment amount. This allows CITs to offer different pricing to retirement plans on the basis of the amount of assets that such plans invest or plan to invest in the CIT.

2. Under Section 9.18 of OCC regulations, national banks must prepare annual reports for their CITs based on audited financial statements. State-chartered banks are subject to similar reporting requirements under state law.

3. Rule 18f-3 under the Investment Company Act of 1940.

4. Although the management fee generally must be the same, different mutual fund share classes may be paying different amounts for class-specific distribution- and service-related expenses as provided under Rule 18f-3.

5. Ownership interests in CITs are customarily referred to as "units," rather than "shares."

**In addition to the CITs' operating expenses, you will indirectly bear the operating expenses of the underlying funds in which certain of the CITs may invest. The CITs and any underlying fund may engage in active and frequent trading, resulting in higher portfolio turnover and transaction costs. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on CIT performance.**

# Investment choices

Like mutual funds, CITs may invest in a wide range of instruments and securities.

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CITs may invest in the same types of instruments and securities as mutual funds, subject to their stated mandates and requirements and limitations in the governing documents. They can invest in multiple types of assets—including stocks, bonds, actively and passively managed funds, and ETFs, REITs, derivatives, etc.—often as a family of CITs that offers different investment strategies and styles for investment.

CITs combine assets from eligible retirement plan investors into a single investment pool (or “fund”) with a specific investment strategy. These assets may be managed by multiple managers, who act as subadvisors to the CITs’ trustees, who have been chosen based on their specialized investment expertise. In managing the CITs, subject to some limited exceptions, such as investments that may generate Unrelated Business Taxable Income (UBTI), investment managers do not need to be concerned with the tax consequences of the CITs’ trading activities, because CITs are tax-exempt.

**Valued and traded on a daily basis, CITs are accessible through 401(k) record-keeping platforms.**

# Exploring fiduciary responsibilities

Plan sponsors have an ERISA-dictated fiduciary obligation to offer reasonably priced investment alternatives. Exploring the possibility of including CITs on a plan's menu of investment options may help satisfy this requirement.

## Important note

**CITs must follow ERISA regulations and are subject to the DOL rules. Under ERISA, plans must disclose their investments in CITs on their form 5500s and participants must receive, at least quarterly, statements and information about their investments, including their investments in the CITs, if any.**

Since CITs are generally less expensive than mutual funds and typically offer unit classes with different pricing options depending on the amount of investment, plan sponsors may be able to significantly reduce and mitigate their fiduciary risk by exploring the possibility of including CITs on their plan's menu of investment options.

Under ERISA rules, plan sponsors must offer investors reasonably priced investment alternatives. A plan sponsor who prudently looks into CITs as a potential investment option for plan participants can help demonstrate that it is acting with the appropriate level of care. That can offer valuable protection from a fiduciary liability perspective, even if the plan sponsor ultimately decides against making the CITs available in its plan.

Of course, while CITs may offer attractive pricing, plan sponsors should consider a wide range of other factors in addition to fees and expenses in deciding what types of vehicles to make available for investment by their plan participants.

### **Available only from banks and trust companies**

Only banks and trust companies may sponsor and maintain CITs and, as such, act as CIT trustees, including choosing and monitoring the CIT's subadvisors. Each CIT is managed and operated according to its trust's governing documents.

# Important notes

Although CITs offer many advantages over mutual funds, plan sponsors should also consider the potential advantages of mutual funds over CITs.

Because CITs are not subject to the numerous reporting and disclosure requirements applicable to mutual funds, more public information is generally available for mutual funds, resulting in greater transparency for mutual fund investors.

Plan participants may also be less familiar with CITs, which are not available for investment by individual retail investors.

Furthermore, plan participants who take rollover distributions generally lose access to the plan's CITs, because CITs are not available to retail investors, including those investing through rollover IRAs. However, their rollover IRAs may be able to access mutual funds that are advised by the same investment managers.

In light of these potential comparative advantages for mutual funds, when evaluating CITs, plan sponsors may wish to consider CITs advised by investment managers that also advise well-established mutual funds.

Because mutual funds managed by these managers would be subject to SEC reporting and disclosure requirements, additional information about the funds and their investments and operations as well as the managers themselves would be publicly available, increasing transparency.

## **What plan sponsors may want to consider**

**If a retirement plan is currently using mutual funds as an investment option, consider whether more favorably priced CITs with comparable investment strategies are available.**

**When considering different CITs, consider choosing those that are advised by investment managers that also manage well-established mutual funds.**

**If plan sponsors need assistance with this type of due diligence, it may benefit them to work with a qualified financial professional to help them make an informed decision.**

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(800) 342-5236  
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