IMPROVING RETIREMENT SAVINGS OPTIONS FOR EMPLOYEES

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Americans do not save enough for retirement. One reason is that our retirement savings accounts—whether employer-sponsored defined-contribution plans such as 401(k) plans or individual retirement accounts—are heavily invested in actively managed mutual funds that siphon off tens of billions of dollars in fees every year, yet deliver returns that trail the overall market. Under existing law, as interpreted by the courts, mutual funds may charge high fees to investors, and companies may offer expensive, active funds to their employees. This Article argues that the Employee Retirement Income Security Act should be reinterpreted, in light of basic principles of trust investment law and the underlying purpose of the statute, to strongly encourage employers to offer low-cost index funds in their pension plans. Existing Department of Labor regulations should be modified to clarify that the current safe harbor for participant-directed plans (in which participants select among investment options chosen by plan administrators) does not extend to plans that include expensive, actively managed funds. This would improve the investment options available to American workers and increase their chances of generating sufficient income in retirement.

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INTRODUCTION

America faces a looming retirement security crisis. Social Security Old-Age and Survivors Insurance, which has traditionally provided a basic stream of income to retired workers, is threatened both by the projected exhaustion of the Social Security trust funds (currently forecast for 2036),[1] and by the resulting calls from both Republicans and Democrats to reduce program benefits.[2] Traditional defined benefit pensions, in which

1. THE BD. OF TRS., FED. OLD-AGE & SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS ANN. REP. 3 (2011), *available at* http://www.ssa.gov/oact/tr/2011/tr2011.pdf. Technically speaking, there are two separate Social Security trust funds, but it is conventional to analyze them in the aggregate. Once the trust funds are exhausted, benefit payments will be limited to incoming payroll taxes, which will be insufficient to pay full scheduled benefits.

2. The bipartisan deficit commission formed by President Barack Obama in 2010, for example, recommended reducing the Social Security benefit formula for all but the lowest-income participants, increasing the full retirement age, and reducing cost-of-living adjustments. NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH 49–52 (2010), *available at* http://www.fiscalcommission.gov/sites/fiscalcommission.

employers promise their employees a guaranteed annual income in retirement, have largely made way for defined contribution pensions such as 401(k) plans, in which employees are responsible for setting aside money and investing it for retirement, generally choosing from a list of investment options selected by the employer.[3] In 2009, however, of all households with a head of household between the ages of 57 and 66, only 63% had any retirement accounts–and the median value of those accounts was less than $86,000.[4] Rising health care costs disproportionately affect the elderly because of their high consumption of health care and the significant cost sharing imposed by Medicare, and Medicare's increasingly precarious financial straits make it highly likely that tomorrow's retirees will face some combination of higher premiums and lower benefits.[5]

Accumulating enough money for retirement boils down to three things: putting aside money from your current income, generating investment returns from that money, and not dipping into your retirement savings prematurely. This Article focuses on the second element of this formula. A fundamental problem for many Americans is that they simply do not have good investment alternatives available in the employer-sponsored defined contribution plans that are their primary retirement savings vehicle. Decades of research have shown that, when investing in relatively liquid and efficient markets such as the U.S. stock market, most people are better off putting their money in low-cost index mutual funds, which attempt to track the overall market or a major market segment, rather

gov/files/documents/TheMomentofTruth12_1_2010.pdf (proposing Social Security reform); *see also* BIPARTISAN POL'Y CTR. DEBT REDUCTION TASK FORCE, RESTORING AMERICA'S FUTURE: REVIVING THE ECONOMY, CUTTING SPENDING AND DEBT, AND CREATING A SIMPLE, PRO-GROWTH TAX SYSTEM 75–78 (2010), *available at* http://bipartisanpolicy.org/library/report/restoring-americas-future (recommending lower benefits for higher-income beneficiaries, indexing the benefit formula to longevity, and changing the index used for cost-of-living adjustments).

3. The specific investment options may be selected by a separate plan administrator, but that administrator is itself selected by the employer.

4. Jesse Bricker et al., *Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009* (Fed. Reserve Bd., Divs. of Research & Statistics & Monetary Affairs, Working Paper No. 17, 2011) app. tbl.2A-B, *available at* http://www.federalreserve.gov/econresdata/scf/scf_2009p.htm.

5. President Obama's 2010 deficit commission, for example, recommended limiting growth in federal government health care spending to the rate of GDP growth plus one percentage point, which is well below historical and current increases in health care spending due to demographic changes and rising health care costs. NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, *supra* note 2, at 41–42; *see also* BIPARTISAN POL'Y CTR. DEBT REDUCTION TASK FORCE, *supra* note 2, at 51, 55–56 (recommending an increase in Medicare Part B premiums and shifting Medicare to a premium support model where growth in government spending is capped at the rate of GDP growth plus one percentage point).

than in more expensive, actively managed mutual funds, which attempt to beat the market by betting on particular stocks or groups of stocks. Yet many companies offer active funds in their 401(k) plans, and as of 2009, the average stock fund in a 401(k) plan had an expense ratio of 74 basis points, meaning that investors paid 0.74% of their assets every year for the privilege of investing in that fund,[6] while major domestic stock index funds are available for as little as six basis points.[7] In addition, active funds tend to underperform the market, so their investors' retirement savings are eroded by lower gross returns (before expenses) as well as by higher fees.

The problems of high mutual fund fees and poor fund selection are not new, but the traditional "solutions" have so far proven ineffective. Mutual funds are regulated by the Investment Company Act of 1940 (1940 Act),[8] which Congress amended in 1970 to impose on fund advisers (the companies that collect fees for managing mutual funds' money) "a fiduciary duty with respect to the receipt of compensation for services."[9] The courts have historically held that this requirement is met by any fee that is roughly consistent with industry practice, a position that was reaffirmed by the Supreme Court in 2010 in *Jones v. Harris Associates L.P.,* and that essentially blesses the status quo.[10] Employer-sponsored pension plans are regulated by the Employee Retirement Income Security Act (ERISA), which imposes various fiduciary duties on the trustees and administrators of those plans.[11] In exchange, employer-sponsored plans enjoy important tax preferences that help companies attract and retain workers. Although plan participants and beneficiaries can sue their employers for breach of those duties,[12] the courts have so far declined to hold that plan fiduciaries, including the plan's administrators, trustee, and

6. INV. CO. INST., 2011 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY 110 (51st ed. 2011), *available at* http://www.ici.org/pdf/2011_factbook.pdf. This is an asset-weighted average, meaning that the expense ratio for each fund is weighted by the number of dollars invested in that fund.

7. As of late 2012, the Vanguard Total Stock Market Index Fund had an expense ratio of six basis points for investments of at least $10,000. *Vanguard Total Stock Market Index Fund Admiral Shares*, VANGUARD GROUP, INC., https://personal.vanguard.com/us/funds/snapshot?FundId=0585&FundIntExt=INT (last visited Jan. 31, 2013).

8. Investment Company Act of 1940, 14 U.S.C. §§ 80a-1 to -64 (2006).

9. 14 U.S.C. §§ 80a-1 to -64, *amended by* 15 U.S.C. § 80a-35(b) (1970).

10. Jones v. Harris Assocs. L.P., 130 S. Ct. 1418, 1426 (2010).

11. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in 29 U.S.C. §§ 1001–1461 & scattered sections of 26 U.S.C.); 29 U.S.C. §§ 1101–1114 (2006) (containing fiduciary duty provisions of ERISA §§ 401–414).

12. "Participants" are employees or former employees who are eligible for or may become eligible for benefits because of their employment and "beneficiaries" are other people who are or may become eligible for benefits, typically because they have been designated by participants.

investment managers,[13] have a duty to protect participants from the higher costs and typically lower returns of active funds. The courts generally rely on ERISA section 404(c), which protects fiduciaries from liability for losses incurred as a result of participants' own investment decisions.[14]

In this Article, I make a new legal argument for strongly encouraging employer-sponsored defined contribution plans to offer only index funds (for market segments where low-cost indexing is available). ERISA, by construction and according to the interpretation of the Supreme Court, explicitly incorporates the principles of trust law. The core principles of trust investment law, as codified in the Restatement (Third) of Trusts—including the duty of diversification, the duty to avoid unreasonable costs, and the duty to avoid imprudent delegation—establish a presumption in favor of passive (index) investing and against active investing, at least in market segments that are relatively liquid and efficient. The key question is what this presumption implies for a situation where plan participants are allowed to exercise control over their accounts—control explicitly endorsed by ERISA. I argue that plan fiduciaries' duty to protect participants from poor investment choices does not simply evaporate in this context. Instead, while fiduciaries should offer a set of investment options that enable participants to tailor their portfolios to their individual risk-return preferences, the core duties of diversifying investments, avoiding unreasonable costs, and avoiding imprudent delegation, still apply where participants select from an array of investment options, and the duties still establish a presumption against active funds.

This argument is based on existing law, and a court that agrees with the argument could already hold that the inclusion of expensive, actively managed funds in an employer pension plan constitutes a breach of fiduciary duty. In defending against such claims, employers typically point to regulations written by the Department of Labor (as authorized by ERISA section 404(c)) that determine when plan fiduciaries are shielded from liability for losses caused by the participant's *exercise of control*. Those regulations can be satisfied by a plan that includes expensive active

13. In general,

> a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

§ 3(21)(A), 29 U.S.C. § 1002(21)(A) (2012).

14. § 404(c), 29 U.S.C. § 1104(c) (2006).

funds, but they admit two possible interpretations. The Department of Labor claims that this safe harbor only covers liability for bad investment decisions made by participants, not liability for poor selection of investment options in the first place. The courts have split on this question, with some holding that compliance with the regulations protects plan fiduciaries from both forms of liability.

To clarify this situation, the regulations should be modified in light of the interpretation of ERISA summarized above. The safe harbor provided by section 404(c) should be restricted to retirement plans that include only index funds. Plans including active funds would not necessarily violate ERISA-imposed fiduciary duties but would not benefit from the automatic safe harbor and would be susceptible to judicial review on a case-by-case basis. This would be more consistent with the principles of trust law as applied to ERISA and, most importantly, would improve the set of investment options available to workers in their retirement plans. A more modest alternative that could still have significant practical benefits would be granting the section 404(c) safe harbor to plans that make index funds the default investment allocation for plan participants but allow participants to opt into active funds. While this is far from a complete solution to our country's retirement security challenges, it would at least remove one significant drain on families' retirement accounts.

This Article proceeds as follows. Part I describes the policy problem: the importance of mutual funds to the overall retirement landscape, the superiority of index funds to active funds for ordinary investors, and the prevalence of active funds in the overall market and in retirement accounts. Part II surveys the historical attempts to prevent mutual funds from charging high fees and to encourage employers to offer good funds to their employees. Part III lays out the central argument of this Article—that the core principles of trust investment law, as applied to ERISA, establish a strong presumption against including active funds in employer-sponsored plans—and describes how this presumption could be implemented. Part IV addresses the relationship of public policy to legal doctrine and discusses whether the proposals in this Article are either too radical (not sufficiently supported by legal doctrine) or too modest (insufficient to solve the overall policy problem). Part V concludes by situating the Article's proposals within the history of America's public-private retirement system.

I. THE PROBLEM

A. The Retirement Security Challenge

Many Americans face the ominous prospect of not having enough money to live on in their old age.[15] Historically, retirees have depended on three main sources of income: Social Security, private pensions, and individual savings. Social Security is a pay-as-you-go system in which a payroll tax, levied on most wage earners and their employers, funds annuitized benefits paid to current and future retirees. Private pensions are tax-advantaged retirement plans created by private or public organizations in which employees or their employers set aside money that will ostensibly be used to provide income to those employees in retirement.[16] In this Article, "pensions" refers to both defined benefit and defined contribution plans. Individual savings are additional funds that people set aside for retirement, often through various types of Individual Retirement Accounts (IRAs), which also enjoy tax preferences.

Social Security currently promises modest benefits even to people who are now relatively young,[17] but whether the Social Security Administration will be able to pay those benefits is another question. In 2009, for the first time, the payroll taxes that finance Social Security were insufficient to pay current benefits, forcing the programs to draw on their accumulated trust funds.[18] As the baby boom generation retires, the imbalance between tax revenues and benefit payments will only get worse, leading to the exhaustion of the trust funds around 2036.[19] After that point, Social Security will only be able to pay about 77% of the benefits scheduled under current law.[20] This funding gap has created political pressure for a solution that will likely include a reduction in benefits to retirees.[21] In addition, Medicare—the federal program on which most retirees depend for health insurance—is in shakier financial condition, with spending projected to grow from 3.7% of GDP in 2011 to 6.7% of GDP in

15. *See, e.g.*, Stephen F. Befort, *The Perfect Storm of Retirement Insecurity: Fixing the Three-Legged Stool of Social Security, Pensions, and Personal Savings*, 91 MINN. L. REV. 938, 940–62 (2007) (anticipating, in 2007, a "perfect storm" caused by longer life expectancies and current workers not saving enough for retirement, threatening future retirees' financial well-being).

16. I say "ostensibly" because many such plans today allow participants to withdraw money before retirement.

17. *E.g.*, Andrew G. Biggs & Glenn R. Springstead, *Alternate Measures of Replacement Rates for Social Security Benefits and Retirement Income*, 68 SOC. SEC. BULL. (No. 2) 8, 14 (2008) (noting, in 2008, that a middle-income worker who is currently in her late thirties and retires in 2040 at age sixty-five could expect to receive benefits equal to fifty-five percent of her average income for the five years prior to retirement).

18. THE BD. OF TRS., *supra* note 1, at 42 (explaining that the Social Security trust funds invest surpluses earned in prior years and use those surpluses, as well as accumulated interest, to compensate for shortfalls in current and future years).

19. *Id.* at 3.

20. *Id.* at 9.

21. *See supra* note 2.

2035.[22] This has created the widespread belief that something must be done about Medicare: That something is likely to be either a reduction in benefits, which would increase costs for retirees, or the conversion of Medicare to a voucher program, which would increase costs for retirees and transfer the risk of health care cost inflation from the federal government to retirees.[23]

These likely reductions in already-modest government programs make private pensions and individual savings increasingly important components of retirement security. Yet American households today seem singularly unprepared for retirement. As of 2009, only 14% of middle-income households held any stocks, only 14% held any bonds (including savings bonds), and only 7% held any investment funds, including mutual funds (outside of retirement accounts).[24] Of middle-income households, only 58% had retirement accounts, and the median value of those accounts was only $26,000.[25] Even for households (of all incomes) headed by someone between the ages of 57 and 66, only 63% held any retirement accounts, with a median value of less than $86,000.[26]

The most important factor affecting a person's retirement assets is probably the amount she saves while working. But another important factor is how she invests that money. In the first decades after World War II, employer-sponsored pensions primarily followed the defined benefit model, where the employer promised to pay the employee a specific annual benefit upon retirement. The employer invested assets in the current period to fund those future benefits and bore the resulting investment risk. The past half-century, however, has seen a major shift from defined benefit to defined contribution pensions.[27] In the latter, the employer or the employee puts a specific amount of money in an individual account in the current period, and the employee receives that money (with investment gains) upon retirement. As a result, the employee bears the investment risk, not the employer.

It is theoretically possible for a defined contribution pension plan to be managed by the employer or by a professional investment adviser, but in

22. The 6.7% figure is from the "alternative fiscal scenario," which incorporates likely changes to current law. CONG. BUDGET OFFICE, CBO'S 2011 LONG-TERM BUDGET OUTLOOK 8 (2011).

23. *See supra* note 5.

24. Bricker et al., *supra* note 4, app. tbl.2A.

25. Bricker et al., *supra* note 4, app. tbl.2A-B.

26. Bricker et al., *supra* note 4, app. tbl.2A-B.

27. *See* Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 470 (2004) (noting that both the number of defined benefit plans and the number of participants in these plans have declined while the number of defined contribution plans has grown, signaling a "reversal of historic patterns").

practice most such plans are "participant-directed," meaning that the employee can choose from a list of investment options. The growth of the defined contribution plan has been accompanied by the growth of IRAs, which were created by ERISA to make pension benefits portable.[28] Instead of having to take a taxable distribution of her pension benefits upon leaving an employer, a departing employee could roll her distribution into an IRA, which would continue to generate tax-free investment returns until retirement. Current law also allows people who are not participants in employer-sponsored retirement plans to contribute pre-tax money to IRAs, thereby receiving the same tax benefits as those provided by defined contribution plans.[29]

In 2010, American households had $4.5 trillion invested in employer-sponsored defined contribution plans and $4.7 trillion in IRAs.[30] The large and growing importance of these plans means that an individual's retirement income increasingly depends in part on her investment choices. And today, more money in retirement accounts is invested in mutual funds than in any other investment vehicle—often, in the case of employer-sponsored plans, because employees have no other viable investment options.[31]

B. The Importance of Mutual Funds

In general, a mutual fund is a legal entity, organized either as a corporation or as a business trust, with the sole function of investing in other assets.[32] The fund issues shares that are bought by *fund investors* and that investors can sell back to the fund. Each share is a proportional claim on the assets in the fund and is priced based on the fund's net asset value; that is, fund shares never trade at a discount or a premium to the assets held by the fund. The assets of the fund are managed by the *fund adviser*, a company external to the fund itself, which is paid directly by the fund for its services. In other words, buying shares in a mutual fund is a way of hiring someone else to manage your money.

28. 26 U.S.C. §§ 402, 408 (2006) (amending the Internal Revenue Code); *see* Zelinsky, *supra* note 27, at 472–75, (discussing the creation of the IRA).

29. There are other flavors of tax-advantaged retirement savings, such as non-deductible (after-tax) IRAs and Roth IRAs.

30. INV. CO. INST., *supra* note 6, at 101.

31. INV. CO. INST., *supra* note 6, at 112; *see also* INV. CO. INST., 2010 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE INVESTMENT COMPANY INDUSTRY 103 (50th ed. 2010), *available at* http://www.ici.org/pdf/2010_factbook.pdf.

32. *See* Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421 (1988) (discussing the legal structure of mutual funds).

On balance, the existence of mutual funds is probably a good thing. Without mutual funds, people who wanted to invest in securities would be forced to buy individual stocks and bonds, incurring transaction and search costs. To obtain the benefits of diversification, they would have to buy large numbers of securities, which would be particularly inconvenient for small investors. Instead, an individual investor today can buy a small number of mutual funds or a single fund that provides a high degree of diversification at relatively low cost, making investing both simpler and cheaper. Mutual funds effectively allow small investors to pool their money and thereby gain some of the advantages of large investors.

Mutual funds are convenient and widely used, currently holding $11.8 trillion in investments in the United States.[33] They are also the building blocks out of which much of our country's retirement "system" is built. While Social Security does not invest in mutual funds, both defined contribution pensions and individual savings largely take the form of mutual fund investments. Mutual funds make up the largest single portion of the IRA market, with $2.2 trillion out of the total $4.7 trillion market.[34] And because mutual funds are the most popular investment options included in defined contribution pension plans, they claim $2.5 trillion of the $4.7 trillion in those plans.[35] For most households, a majority of their financial assets are invested in mutual funds,[36] and for 74% of households, retirement saving is the primary goal of their mutual fund investments.[37] The prevalence of mutual funds means that individuals' investment outcomes–and their retirement security–are largely in the hands of the mutual fund industry.

C. Good and Bad Funds

The biggest threat to investors posed by mutual funds is the expenses associated with actively managed funds.[38] Because a mutual fund is an

33. INV. CO. INST., *supra* note 6, at 9 (referring to "open-ended" mutual funds, which allow investors to redeem their shares at net asset value).

34. INV. CO. INST., *supra* note 6, at 112.

35. INV. CO. INST., *supra* note 6, at 118.

36. *Characteristics of Mutual Funds Investors, 2010*, 19 RES. FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Sept. 2010, at 5.

37. *Id.* at 7.

38. Mutual funds have also made headlines for illegal behavior, including late trading (allowing certain clients to place orders after the day's closing price has been calculated) and market timing (allowing certain clients to make frequent trades even in violation of a fund's official disclosure documents). *See, e.g.*, William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 75–78 (2010) (presenting multiple ways in which investment advisors might take

investment vehicle, the main characteristic customers should care about is the net investment returns that they will receive. Net investment returns equal gross investment returns (performance of the fund's investments) minus expenses (including sales loads, fund management fees, and administrative fees). Mutual funds can be divided into two categories: passively managed (index) funds and actively managed funds. Index funds attempt to replicate the performance of a market index, such as the S&P 500, sometimes simply by buying all the securities that make up the index. Therefore, they generally deliver gross investment returns that are very close to those of the market segment tracked by the index, and they usually have low expenses. In an active fund, the fund manager makes decisions to buy and sell securities with the intention of beating the market. Active funds generally have higher expenses than index funds for at least three reasons: higher costs of active stock-picking, the ability to charge higher prices because they offer a more differentiated product (stock-picking expertise), and higher transaction costs due to more frequent buying and selling.[39]

The attraction of actively managed funds is that they hold out the promise of beating the market. After all, if some fund manager is smart enough to beat the market by five percentage points per year, then it makes sense to pay one percentage point more in expenses to obtain her services. The problem is that there are very few, if any, fund managers smart enough to consistently beat the market in a meaningful sense—that is, managers whose *expected* gross returns, on a risk-adjusted basis,[40] are higher not only than those of an index fund, but high enough to compensate for higher costs. And since funds disclose their past returns, not their expected returns (which can be difficult to calculate with any accuracy), it is very hard, if not impossible, to identify those fund managers in advance. A large majority of investors would be better off simply buying index funds, pocketing the market return, and saving the expenses.

The superiority of index funds over active funds for the ordinary

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advantage of the current trading system); Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 PACE L. REV. 133 (2005) (detailing the evolution of the mutual fund industry and unscrupulous actions taken by those in the field); Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept That Deserves Serious Reconsideration*, 83 WASH. U. L.Q. 1045, 1061–79 (2005) (highlighting specific scandals among mutual fund groups during from 2003 to 2004).

39. Technically, transaction costs are already included in a fund's gross investment return (before deductions for fund expenses), so a fund's published expense ratio does not capture the full costs of active management; in some cases, transaction costs can exceed a fund's published expense ratios. *See* Hurst, *supra* note 38, at 146–47.

40. In general, asset classes with higher risk (higher variance of outcomes) have higher returns, so one way to increase expected returns is simply to invest in riskier assets.

investor is illustrated by the efficient market hypothesis—one of the central propositions of modern finance theory—but does not actually depend on it. That hypothesis, most closely associated with University of Chicago economist Eugene Fama,[41] holds, in short, that no one can beat the market. The basic principle is simple: In a highly liquid market, where investors can trade securities quickly and at low cost, prices will rapidly change to incorporate all available relevant information. Otherwise, traders would be able to make profits on new information, and their very activity would bring prices into line with that information. If no one can beat the market consistently, then there is no point in investing in active funds. Any fund that attempts to beat the market is at least as likely to fail as to succeed, so at best it will have the same expected gross returns as an index fund, but with higher expenses. The performance of funds that do beat the market year after year can be explained as the result of simple chance: In any universe including thousands of funds, many will beat the market in a given year, and some will beat the market for several years in succession.

The efficient market hypothesis is one of the most tested propositions in modern finance. Recent research indicates that there are probably some fund managers who can beat the market (that is, their superior results cannot be explained simply as the product of random chance).[42] Unfortunately, they are hard if not impossible to pick out from the legions of fund managers out there. In general, according to Mark Carhart:

> Persistence in mutual fund performance does not reflect superior stock-picking skill. Rather, common factors in stock returns and persistent differences in mutual fund expenses and transaction costs explain almost all of the predictability in mutual fund returns. Only the strong, persistent underperformance by the worst-return mutual funds remains anomalous.[43]

Eugene Fama and Kenneth French acknowledge that some fund

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41. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); *see also* JOHN CASSIDY, HOW MARKETS FAIL: THE LOGIC OF ECONOMIC CALAMITIES, 85–96 (2009) (examining the efficient market hypothesis through historical examples); JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET 89–107 (2009) (discussing Fama and the efficient market hypothesis).

42. *See, e.g.*, Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 80 (1997) (finding "very slight evidence" of mutual fund manager skill); Robert Kosowski et al., *Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis*, 61 J. FIN. 2551 (2006) (finding that the top mutual funds in recent years do have positive performance that persists at least one year into the future); Eugene F. Fama & Kenneth R. French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 1915 (2010) (finding that some managers have sufficient skill to cover their costs).

43. Carhart, *supra* note 42, at 57.

managers have market-beating skill, but nevertheless find that "true [alpha] in net returns to investors is negative for most if not all active funds . . . ."[44] Significantly for ordinary investors, "if many managers have sufficient skill to cover costs, they are hidden by the mass of managers with insufficient skill."[45] Since the mid-1960s, many studies have shown that active funds, in general, do worse than the market as a whole.[46] As of mid-2010, a majority of actively managed funds had lower returns than their relevant benchmark indexes in every single fund category over one, three, and five years.[47] Even if the efficient market hypothesis is not strictly true, it is true enough for the practical purposes of ordinary investors.

If stock-picking ability is impossible to identify, then the sole determinant of fund returns that investors can control is expenses. For those who think that stock picking is irrelevant, expenses are the main determinant of performance.[48] For those who believe in stock picking ability, much, if not all of it, is absorbed by expenses.[49] Even worse, expenses are negatively correlated with *gross* returns, not just net returns;

44. Fama & French, *supra* note 42, at 1916. "Alpha" is the conventional designation for returns that are due to fund manager skill, as opposed to beta, the designation for returns that are due to the performance of the overall market.

45. Fama & French, *supra* note 42, at 1916.

46. *E.g.*, William F. Sharpe, *Mutual Fund Performance*, 39 J. BUS. 119, 137 (1966) (finding that a sample of stock mutual funds underperformed the Dow Jones Industrial Average on a risk-adjusted basis); *see also* Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation Between Price and Performance in the Mutual Fund Industry*, 64 J. FIN. 2153 (2009) (finding underperformance of twenty-one to seventy-one basis points, depending on the set of controls); Martin J. Gruber, *Another Puzzle: The Growth in Actively Managed Funds*, 52 J. FIN. 783, 787 (1996) (finding that actively managed funds had annual returns that were sixty-five basis points below the applicable market indexes); Michael C. Jensen, *Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios*, 42 J. BUS. 167, 239 (1969) (finding that mutual funds, on a risk-adjusted basis, had lower net returns than the market as a whole); Russ Wermers, *Mutual Fund Performance: An Empirical Decomposition into Stock-Picking Talent, Style, Transactions Costs, and Expenses*, 55 J. FIN. 1655 (2000) (finding that actively managed funds hold stocks that outperform the market, but on a net basis underperform indexes by one percent). Note that both Gruber and Wermers argue that some fund managers do have superior stock-picking ability, but still recognize that funds as a whole do worse than the market.

47. *Standard & Poor's Indices Versus Active Funds Scorecard: Mid-Year 2010*, S&P INDICES: RESEARCH & DESIGN (S&P Indices, New York), 2010, at 3.

48. "In the absence of forecasting ability, all one need do is generate substantial expenses through time to insure inferior performance." Jensen, *supra* note 46, at 236; *see also* Sharpe, *supra* note 46, at 137 (finding that mutual funds do about as well as the Dow Jones index before expenses, but worse than the index after accounting for expenses).

49. Wermers, *supra* note 46, at 1690 (finding that expenses and transaction costs outweigh stock picking ability); *see also* Fama & French, *supra* note 42, at 1931–34 (finding that many managers have skill sufficient to cover their transaction costs, but few have skill sufficient to cover the other costs included in fund expense ratios).

that is, higher expenses are more likely to buy you a bad fund manager.[50] For the ordinary investor, then, the dominant strategy is simple: buy index funds with low expenses.[51]

Yet investors continue to invest in expensive, actively managed funds. Only 14.5% of stock mutual fund investments are in index funds.[52] While broad stock market index funds are available with expense ratios of 10 basis points or less,[53] in 2010, the average stock mutual fund charged 145 basis points for its efforts to beat the market. Even when funds were weighted by assets, the average stock mutual fund expense ratio was 84 basis points.[54] The average mutual fund also charged a 1% up-front "sales load," which is a fee to invest in the fund.[55] This boosted the effective annual cost of the average stock fund to 95 basis points.[56] People who buy mutual funds through their employer pension plans do little better. As of 2009, the asset-weighted average expense ratio for 401(k) plan investments in stock mutual funds was 74 basis points, while the comparable figure for all stock mutual funds was 86 basis points.[57] Given that asset-weighting increases the importance of large 401(k) plans, which should be able to exert the same influence on fund management fees as institutional investors, an advantage of 12 basis points is only a paltry improvement. In addition, investors in mutual funds receive returns that are considerably worse than the returns of those funds themselves because they buy and sell fund shares at the wrong time—buying into funds that have recently done well and selling out of funds that have done poorly.[58] From 1991 through 2010, investors in stock mutual funds earned an annual return of 3.83%, while the S&P 500 Index returned 9.14% annually.[59] Over that period,

50. Gil-Bazo & Ruiz-Verdú, *supra* note 46.

51. Although index funds should have lower expenses than actively managed funds, some index funds charge much higher fees than others.

52. INV. CO. INST., *supra* note 6, at 33.

53. *See Vanguard Total Stock Market Index Fund Admiral Shares, supra* note 7.

54. INV. CO. INST., *supra* note 6, at 66.

55. INV. CO. INST., *supra* note 6, at 65.

56. INV. CO. INST., *supra* note 6, at 64.

57. INV. CO. INST., *supra* note 6, at 110. The asset-weighted average expense ratio for stock funds was eighty-six basis points in 2009 and eighty-four basis points in 2010.

58. Christine Benz, *How Did Investors Really Do?*, MORNINGSTAR (Nov. 13, 2006, 6:00 AM), http://news.morningstar.com/articlenet/article.aspx?id=178504.

59. Press Release, Dalbar, Inc., Investors Can Manage Psyche to Capture Alpha: Dalbar Study of Investor Returns Offers Ways to Improve Investor's Alpha (Apr. 1, 2011), http://www.dalbar.com/Portals/dalbar/cache/News/PressReleases/pressrelease040111.pdf. After fund expenses, an investor in an S&P 500 index fund would have earned an annual return of about 9%. The period from 1991–2010 was not an unusual one: For the 20 years ending in 1998, the corresponding gap was 10.65%. Press Release, Dalbar, Inc., Investors Regain Footing: Dalbar Study Finds That Market Experience and Target Date Funds Lead to Success (Mar. 31, 2010), http://www.dalbar.com/Portals/dalbar/cache/News/PressRelease

$10,000 invested in the S&P 500 Index would have grown to $137,885; the same amount earning 3.83% per year would have grown to only $30,881. Expensive, actively managed funds are a major threat to the retirement security of millions of middle-class Americans.

People make bad decisions in general, particularly when it comes to investing. The behavioral economics literature is replete with examples of irrational investing choices.[60] The idea that it is difficult, if not impossible, to beat the market consistently is not intuitive; nor is the idea that repeated positive results are most often due to chance. Perhaps most difficult to accept is the idea that higher prices do not connote quality, but just the opposite. As a result, investors tend to chase returns, buying asset classes (e.g., stocks), certain types of funds (e.g., technology stock funds), and specific funds based on their past performance—all strategies that tend to have a negative impact on returns.

But we also have to ask who gains from the widespread belief that it is possible to beat the market. "Why do Congress and the SEC perpetuate these myths?" A.C. Pritchard asks. "Because the financial services industry requires these myths for its very existence. If investors were to switch en masse to index funds and other forms of passive investment, the Wall Street-industrial complex would crumble."[61] Mutual fund companies set out to exploit the human foibles that cause people to invest in active funds. Because fund companies make more money from high-expense funds than from low-expense funds, all other things being equal, they have an obvious incentive to create and market high-expense funds. Fund marketing centers on past performance. So, for example, a fund company can quietly launch several similar funds and wait a few years, after which some are likely (through luck if nothing else) to have beaten the market;[62] then it can shut down the losers and actively market the winners to a

s/pressrelease20100331.pdf.

60. For brief reviews of the major findings, see Birdthistle, *supra* note 38, at 80–84; Susan J. Stabile, *Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL'Y 361, 378–81 (2002).

61. A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1089 (2005).

62. From 1995 to 1997, the Van Kampen Growth Fund was a small fund that was closed to the public. It achieved stellar returns because its sponsor, Van Kampen Funds, gave it allocations in thirty-one hot initial public offerings. Van Kampen Funds then began marketing the Growth Fund to the public. Van Kampen Inv. Advisory Corp., Investment Company Act Release No. 23,996, Investment Advisers Act Release No. 1819, 70 SEC Docket 1213 (Sept. 8, 1999); *see also* Dreyfus Corp., Securities Act Release No. 7857, Investment Company Act Release No. 24,450, Investment Advisers Act Release No. 1870, 72 SEC Docket 946 (May 10, 2000) (imposing sanctions on Dreyfus for failing to disclose the "large impact of the IPOs on the fund's performance").

largely unsuspecting public. Fund companies also advertise the track records and pedigrees of their fund managers, using celebrity to attract investors who believe that some people must be better at stock picking than other people.

Although people make bad choices, perhaps we should allow them to do so. On one theory, summarized by Judge Frank Easterbrook in the Seventh Circuit's opinion in *Jones v. Harris Associates L.P.*, mutual funds compete in a free market, so people can look out for their own interests and we should let the chips fall where they may:

> New entry is common, and funds can attract money only by offering a combination of service and management that investors value, at a price they are willing to pay. Mutual funds come much closer to the model of atomistic competition than do most other markets. . . . A recent, careful study concludes that thousands of mutual funds are plenty, that investors can and do protect their interests by shopping, and that regulating advisory fees through litigation is unlikely to do more good than harm.[63]

According to Easterbrook, as long as there is sufficient competition, consumers will only buy into a fund if it provides sufficient "service and management." Therefore, when investors overpay for active funds, they are getting something for their money, even if it isn't superior investment returns. The study cited by Easterbrook is a 2007 article by John Coates and Glenn Hubbard that similarly focused on the existence of competition: Coates and Hubbard provided evidence that money tends to flow from mutual funds with high expenses to funds with low expenses, which implies that competition is working as it should.[64]

Even if we accept its premises, however, Easterbrook's argument constitutes a rather pallid defense of the status quo. He relies on the mere existence of competition rather than defending its substantive outcome: large investments in active funds with high fees. In their article, Coates and Hubbard actually show that funds with lower expenses do have higher

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63. Jones v. Harris Assocs. L.P., 527 F.3d 627, 634 (7th Cir. 2008), *vacated and remanded*, 130 S. Ct. 1418 (2010); *see also* M. Todd Henderson, *Justifying* Jones, 77 U. CHI. L. REV. 1027, 1035 (2010) ("The market for mutual funds is mature and competitive, so it strains credulity to claim that advisers can get away with charging supracompetitive fees, let alone to contend that courts are equipped to efficiently police abuses.").

64. John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 180–83 (2007). Coates and Hubbard's findings have been vigorously contested. *See, e.g.*, John P. Freeman et al, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83 (2008) ("The current system for evaluating mutual fund advisory fees is a failure. . . . [It has] allowed fund fees to float even higher, free from the competitive market's gravitational pull").

net returns, and this is, in fact, at the crux of their analysis: Cheaper funds perform better, which is why they grow in size, which is what proves that competition is working.[65] But competition does not prove that a market is efficient, let alone that it produces outcomes that are desirable either for individuals or for society as a whole.[66]

The fact that, in a competitive market, some people make poor choices that cause them to lose money may not in the abstract constitute a public policy concern, and this Article does not address the issue of what mutual funds people select for their taxable, non-retirement investments. When poor decisions are made in a market that enjoys tax preferences precisely because it is intended to further the public goal of expanding retirement security, however, it does raise a significant policy question. By providing valuable tax benefits to retirement accounts, the federal government is effectively a co-investor in those accounts; it hopes to gain "returns" in the form of lower poverty rates among elderly Americans. Even if some people are able to pick mutual funds that do beat the market, whether through luck or through skill, they are outnumbered by people whose fund investments trail the market. In the aggregate, then, active funds constitute a drain on Americans' retirement savings. The question becomes even more pressing in the context of employer-sponsored retirement plans, where employees cannot access the free market directly, but are instead restricted to the investment options prescribed by plan administrators.

II. SHORTCOMINGS OF EXISTING REGULATORY APPROACHES

The problem of high mutual fund fees is not new. This Part describes the two main approaches through which Congress and plaintiffs' attorneys

65. Coates & Hubbard, *supra* note 64, at 180.

66. Easterbrook also dismisses the argument that fund companies can prey on unsophisticated consumers: "The sophisticated investors who do shop create a competitive pressure that protects the rest." *Jones*, 527 F.3d at 634 (citing Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983)). Several economists, however, have argued that sophisticated and unsophisticated investors essentially shop in different markets, allowing fund companies to market expensive funds to the unsophisticated. *See, e.g.*, Susan E.K. Christoffersen & David K. Musto, *Demand Curves and the Pricing of Money Management*, 15 REV. FIN. STUD. 1499 (2002) (finding that if a fund performed poorly, its sophisticated investors would flee to other funds, leaving only price-insensitive customers and allowing the fund to charge high prices); Gil-Bazo & Ruiz-Verdú, *supra* note 46 (finding evidence to support Christoffersen and Musto's explanation and an alternative explanation: fund companies create funds they know will have lower expected performance and specifically target unsophisticated investors; Gruber, *supra* note 46, at 807 (arguing that bad funds exist because they collect money from unsophisticated investors and people restricted by their pension plans to underperforming funds).

have attempted to protect investors from expensive funds—regulation of mutual funds under the 1940 Act and of employer-sponsored pension plans under ERISA—and explains why they have generally failed.

A. Mutual Fund Regulation

As its supporters like to point out, the mutual fund industry is highly regulated.[67] Mutual funds and their relationship with fund advisers are subject to the 1940 Act and to the Investment Company Amendments Act of 1970 ("1970 Amendments"), which placed additional fee-related requirements on mutual funds.[68] Current law, however, has proven ineffective at limiting mutual fund expenses or driving bad funds from the market.

The 1940 Act dictated a corporation-like governance structure for all mutual funds, regardless of whether they were constituted as corporations or trusts. Each fund has a board of directors that is elected by shareholders (investors) in the fund; at least forty percent of those directors must be "disinterested" parties.[69] The board's responsibilities include approving the contract for investment services between the fund and the fund adviser.[70] Section 17(h) of the 1940 Act makes directors liable to fund shareholders for "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved . . . ."[71] Section 36 of the Act, in its original version, prohibited breaches of fiduciary duty involving "gross misconduct or gross

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67. *E.g.*, Coates & Hubbard, *supra* note 64, at 153 (arguing against additional regulation of mutual funds, "already the most heavily regulated sector of the financial services industry"). *See generally* Coates & Hubbard, *supra* note 64, at 160–63 (explaining how law and regulation promote competition in the mutual fund industry); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1967–83 (2010) (discussing the regulation of mutual funds, money market funds, exchange-traded funds, and 401(k) plans); Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1019–25 (2005) (discussing litigation as a remedy for fiduciary breaches by mutual fund directors); John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 92–98 (2010) (summarizing the regulation of mutual funds).

68. Investment Company Act of 1940, Pub. L. No. 91-547, 84 Stat. 1413 (1970) (codified as amended in scattered sections of 15 U.S.C.).

69. 15 U.S.C. § 80a-10(a) (2006). In practice, certain SEC rules make it attractive for mutual funds to have boards with a majority of disinterested members. Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 169 (2006).

70. 15 U.S.C. § 80a-15(c) (2006). The contract must be approved by a majority of the disinterested directors. For a summary of directors' duties in general, see Jones et al., *supra* note 32, at 435–38.

71. 15 U.S.C. § 80a-17(h) (2006).

abuse of trust"; this prohibition applied to fund advisers as well.[72] The 1970 Amendments lowered the section 36 standard from "gross misconduct or gross abuse of trust" to "personal misconduct."[73] The Amendments also introduced section 36(b), which imposes on fund advisers "a fiduciary duty with respect to the receipt of compensation for services" paid to the adviser or any of its affiliates, backed by a private right of action.[74] Approval of an investment services agreement by the fund's board of directors does not automatically shield a fund adviser from liability.[75]

This all sounds good: The board should negotiate with the fund adviser to ensure that the fund does not pay excessive fees, and the fund adviser also has a fiduciary duty to the fund and its shareholders. The structure set up by the 1940 Act, however, has not prevented the domination of the fund industry by expensive mutual funds for two major reasons. First, the corporate governance structure of mutual funds is deeply flawed.[76] In theory, the investment services contract must be approved at least once by a majority of the shareholders.[77] In practice, however, mutual funds are created by the fund advisers themselves and hence the contract can be approved before the fund is opened to the public; from that point it only needs to be approved annually by the disinterested members of the board.[78] And because the fund adviser creates the fund in the first place, the adviser is the only initial shareholder and can handpick the initial board. The statutory definition of a "disinterested" director is weaker than the common law definition of an independent director,[79] and therefore "disinterested" board members "are typically securities industry executives and professionals whose firms provide direct or indirect services to mutual funds."[80]

Second, the standards for breach of the board's or the fund adviser's fiduciary responsibilities have been set sufficiently high to protect mutual funds from claims of excessive fees. From 1940 to 1970:

72. 15 U.S.C. § 80a-35 (2006). For the original version of this section, see Langevoort, *supra* note 67, at 1021.

73. 15 U.S.C. § 80a-35(a) (2006).

74. *Id.* § 80a-35(b). Because section 36(b) only authorizes suits against an actual "recipient of such compensation or payments," it is targeted solely at fund advisers, not directors. *Id.* § 80a-35(b)(3) (2006).

75. *Id.* § 80a-35(b)(2) (2006).

76. *See, e.g.*, Palmiter, *supra* note 69, at 166 (explaining that the structure of the board is flawed because it is "composed of part-timers" who "operate without meaningful oversight").

77. 15 U.S.C. § 80a-15(a) (2006).

78. *Id.* §§ 80a-15(a)(2), 80a-15(c).

79. Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497 (2008).

80. Palmiter, *supra* note 69, at 170.

> [S]hareholders challenging investment adviser fees under state law were required to meet "common-law standards of corporate waste, under which an unreasonable or unfair fee might be approved unless the court deemed it 'unconscionable' or 'shocking,'" and "security holders challenging adviser fees under the [Investment Company Act] itself had been required to prove gross abuse of trust."[81]

The prevalence of expensive mutual funds motivated Congress to pass the 1970 Amendments.[82] But despite Congress's intentions, section 36(b) has done little to deter excessive fees, which is not particularly surprising. It is far from clear what it means that a fund adviser "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services,"[83] nor is it obvious whether this new fiduciary duty has substantive content or whether, as Easterbrook argued in *Jones*, it is simply procedural.[84] Because of these ambiguities, the application of section 36(b)–and hence the regulation of mutual fund fees—has rested largely in the hands of the courts, which have never granted a final judgment to plaintiffs under this section.[85]

Before the Supreme Court granted certiorari in *Jones*, the leading case on section 36(b) was *Gartenberg v. Merrill Lynch*, a Second Circuit case from 1982, which established a hurdle nearly as difficult for plaintiffs to overcome as the one that predated the 1970 Amendments.[86] The short reading of *Gartenberg* is that it allows any mutual fund fee that is not "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[87] On its face, this test provides judicial cover for any fee that is within shouting distance of industry averages, since a plaintiff must prove both that the fee is unreasonably high and that it *could not* have been negotiated fairly. As Donald Langevoort has written, "[t]his test resembles the state law test for corporate waste, even though the legislative history

81. Jones v. Harris Assocs. L.P., 130 S.Ct. 1418, 1423 (2010) (alteration in original) (quoting Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 540 n.12 (1984)); *see also* Sarah Cogan & Jonathan Youngwood, *Determining Breach of Duty on Fees Charged by Investment Advisers*, 243 N.Y.L.J., Jun. 18, 2010, at 4 (discussing the *Gartenberg* standard).

82. Fisch, *supra* note 67, at 1972.

83. Jones v. Harris Assocs. L.P., 527 F.3d 627, 630 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010) (quoting 15 U.S.C. § 80a-36(b) (2006)).

84. Justice Alito deemed the meaning of section 36(b) "hardly pellucid." *Jones*, 130 S.Ct. at 1426.

85. Henderson, *supra* note 63, at 1033.

86. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).

87. *Id.* at 928 (citing Fogel v. Chestnutt, 668 F.2d 100, 112 (2d Cir. 1981)).

behind section 36(b) explicitly wanted something more than a waste test."[88] Nevertheless, *Gartenberg* was recognized by most circuit courts of appeals as the predominant standard for mutual fund fee cases,[89] and its "disproportionately large" language played a major role in blunting challenges brought by fund shareholders.

In *Jones v. Harris Associates L.P.*, the Seventh Circuit attacked the *Gartenberg* standard,[90] essentially holding that section 36(b) challenges should be evaluated solely on procedural grounds. "A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."[91] The court also argued that the mutual fund market is competitive and that investors can protect their interests simply by moving their money from one fund to another.[92] The Supreme Court, however, upheld *Gartenberg*, specifically endorsing its "so disproportionately large" formulation.[93] Justice Alito's opinion defines a breach of fiduciary duty as a transaction that is "outside the range that arm's-length bargaining would produce,"[94] encourages "a measure of deference" to the decisions of disinterested directors on the fund's board,[95] and warns that "the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions."[96] Because it affirms the *Gartenberg* standard and defers to mutual fund boards, the Supreme Court's opinion is unlikely to change actual industry behavior.[97]

For some commentators, that is just fine. As discussed above,

88. Langevoort, *supra* note 67, at 1024. On closer reading, *Gartenberg* muddies its own waters, since it also states, "the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in light of all the surrounding circumstances," which is not quite the same thing. *Gartenberg*, 694 F.2d at 928.

89. *Jones*, 130 S. Ct. at 1425 ("[U]ntil the Seventh Circuit's decision below, something of a consensus had developed regarding the standard set forth over 25 years ago in *Gartenberg*.").

90. Jones v. Harris Assocs. L.P., 527 F.3d 627, 632 (7th Cir. 2008) ("[W]e are skeptical about *Gartenberg* because it relies too little on markets.").

91. *Id.* Although Judge Easterbrook recognized that "[i]t is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated," in that case, the disproportionately large fee is not itself the problem; the problem is the procedural flaw it implies. *Id.*

92. *Id.* at 634.

93. *Jones*, 130 S. Ct. at 1426.

94. *Id.* at 1427.

95. *Id.* at 1428.

96. *Id.* at 1430.

97. The Court did say that it was appropriate to compare a mutual fund's fees to the fees charged by the same fund adviser to its institutional clients. *Id.* at 1428–29. This comparison had been rejected by *Gartenberg*. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 n.3 (2nd Cir. 1982).

Easterbrook argued that high mutual fund fees are simply not a problem: If people are paying the fees in a competitive market, they must be getting their money's worth. "The trustees (and in the end investors, who vote with their feet and dollars) . . . determine how much advisory services are worth."[98] But the empirical evidence, as summarized above,[99] does not bear out this rosy view of the market: While a few fund managers may be able to beat stock indexes, in general, fund expenses are strongly and negatively correlated with gross returns, let alone net returns. Despite the existence of competition, many investors are paying whole percentage points or more in fees for services that provide them with negative value.[100]

Some analysts have proposed various ways to strengthen the existing governance model for mutual funds, whether by requiring that seventy-five percent of fund directors be disinterested,[101] mandating comparative disclosure of fund expenses to promote more effective board oversight,[102] holding disinterested directors to the standards required of independent directors in corporate law,[103] or asking courts to show less deference to disinterested directors.[104] Langevoort cautions, however, that "[i]n the absence of some means of forcing on the industry disinterested directors whose ideology is fiduciary rather than consumerist . . . the more reasonable legal reaction is to keep expectations in check."[105] Fund directors are not likely to be active defenders of investor interests, and that is unlikely to change, since investors can always sell their fund shares instead of expending effort in monitoring directors.[106] Given that a mutual

98. Jones v. Harris Assocs. L.P., 527 F.3d 627, 632 (7th Cir. 2008); *see also* Henderson, *supra* note 63, at 1038–48 (arguing that the real problem is not mutual fund fees but value-destroying strike suits over fund fees by plaintiffs and their attorneys).

99. *See supra* Part C.

100. There is also a curious conceptual tension in Easterbrook's argument. If the prices of mutual funds are efficient, it is hard to argue that the prices of stocks are inefficient. And if stock prices are efficient, then trying to beat the market is a fool's errand.

101. Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004). The SEC rules were effectively vacated by Chamber of Commerce of U.S. v. S.E.C., 443 F.3d 890 (D.C. Cir. 2006). There is some correlation between independent directors and better governance, but the causality could run either way. In Alan Palmiter's words: "[I]t seems more likely that investor-friendly management firms . . . are more likely to have truly independent directors . . . ." *Palmiter*, *supra* note 69, at 200.

102. James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 937 (2005).

103. Johnson, *supra* note 79, at 530–31.

104. Langevoort, *supra* note 67, at 1042.

105. Langevoort, *supra* note 67, at 1041.

106. Because investors can always sell their fund shares at net asset value, they are not locked into their investments and can simply sell out rather than engage in attempts at shareholder governance. Coates & Hubbard, *supra* note 64, at 162; *see also* Langevoort,

fund is typically the creature of its fund adviser and effectively captive to it since it has no independent operational existence, it is also debatable whether a fund's board has the negotiating power necessary to adequately represent shareholder interests.[107]

For these reasons, other commentators have argued that the current regulatory structure, based on the shareholder governance model, should be replaced with straightforward product regulation since investing in a mutual fund is more like buying an ordinary consumer product than it is like becoming a beneficiary of a trust or a shareholder in a corporation. "[M]utual fund investments are products," writes Langevoort, "no different, really, from health care, insurance, bank deposits, residential real estate, and other important settings where consumers are often less than diligent."[108] Jill Fisch proposes to replace the structure created by the 1940 Act with a new "conform or explain" model, in which a new federal agency would define standardized investment products and fund companies would have to explain how their products differed from those standards.[109] John Morley and Quinn Curtis propose ending shareholder voting and eliminating the role of boards in setting fund strategy and negotiating fees. If price regulation were necessary, they would prefer "an honest-to-goodness price cap enforceable by the government."[110]

Product-style regulation, however, would likely do little to protect ordinary investors from expensive active funds. Typical regulatory regimes (such as those imposed by the National Highway Traffic Safety Administration or the Food and Drug Administration) include minimum safety standards to protect the public from catastrophic harms and disclosure rules to further informed choice.[111] With mutual funds, however,

supra note 67 at 1031–32 (describing why corporate governance mechanisms do not work for mutual funds); Morley & Curtis, *supra* note 67, at 89 (explaining why investors prefer to simply sell their interests rather than invest effort in governance).

107. Palmiter, *supra* note 69, at 173 ("[The board] has no realistic option (or threat) to hire a new investment adviser or management firm."). In practice, funds virtually never fire their fund advisers. *See* Henderson, *supra* note 63, at 1032 (examining board practices, including an aversion to firing advisers); Morley & Curtis, *supra* note 67, at 95 ("As a practical matter, boards never fire management companies . . . .").

108. Langevoort, *supra* note 67, at 1037. Indeed, Langevoort argues that this mindset has become prevalent in the industry, including among mutual fund directors, and is one reason why directors do not play their appointed role effectively. Langevoort, *supra* note 67, at 1041; *see also* Johnson, *supra* note 79, at 504 ("This arrangement has led some, including former SEC Chairman Harvey Pitt, to describe mutual funds as 'products,' not companies.").

109. Fisch, *supra* note 67, at 1961, 1966.

110. Morley & Curtis, *supra* note 67, at 133, 139.

111. FDA Food Safety Modernization Act, Pub. L. No. 111-353 (2011) (revising food safety regulation); 49 C.F.R. §§ 571.100-500 (2011) (providing safety standards for

neither high fund expenses nor the risks of active investing qualify as a catastrophic outcome. This makes it difficult to envision a complete bar on active funds on traditional consumer protection grounds.[112] Mutual funds are already required to disclose their expenses, but this has not deterred many investors from investing in unnecessarily expensive funds. Disclosures could certainly be improved,[113] but even then they would be unlikely to blunt widespread investor enthusiasm for expensive funds because of the behavioral reasons described earlier.[114] Only a small amount of optimism bias or a small amount of successful marketing is required to make an expensive fund seem like a smart investment decision.[115] In summary, general mutual fund regulation is unlikely to shift the industry away from expensive, actively managed funds and toward low-cost index funds.

B. Employer-Sponsored Pension Plan Regulation

Employer-sponsored pensions have never been an entirely private affair. The system of employment-based pension plans that evolved in the wake of World War II was a publicly subsidized complement to the still-controversial Social Security system created in the New Deal.[116] Employer pensions were the private sector's preferred alternative to the prospect of Social Security becoming the nation's sole provider of retirement insurance. Employers both feared Social Security as an example of big government and wanted to use private pensions as a tool to attract workers, keep them loyal for long periods of time, and motivate them to retire when the time came. As a result, in the decades following World War II, many large American companies created defined benefit pension plans that promised fixed retirement benefits to employees based mainly on their

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automobiles); Jones v. Harris Assocs. L.P., 527 F.3d 627, 634 (7th Cir. 2008) (mentioning automobile regulation); Fisch, *supra* note 67, at 2029 (mentioning pharmaceutical regulation); Morley & Curtis, *supra* note 67, at 131–32 (mentioning tire regulation).

112. An absolute ban would also constitute a severe incursion into the free market for investment products and the freedom of the individual investor, which might be hard to justify given the evidence that at least some fund managers can deliver superior expected returns.

113. For example, fund expenses could be presented along with information about the expenses charged by other similar funds. Cox & Payne, *supra* note 102, at 936.

114. *See supra* Part C.

115. *See* Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647 (2011) (arguing that mandated disclosure is ineffective and counterproductive).

116. *See* JACOB S. HACKER, THE DIVIDED WELFARE STATE: THE BATTLE OVER PUBLIC AND PRIVATE SOCIAL BENEFITS IN THE UNITED STATES 85–173 (2002) (discussing the history of private pensions in the U.S.).

salaries and years of service.

Beginning in the 1960s, concerns about these plans created increasing pressure for greater federal regulation, culminating in the passage of ERISA in 1974. ERISA was largely concerned with problems specific to defined benefit plans, including underfunding of pensions, onerous vesting requirements that left many employees without benefits, and even outright theft.[117] These problems were due in part to conflicts between the short-term interests of employers and employees: Most crudely, every dollar not paid in benefits was a dollar the company could keep for its shareholders. The solution devised by ERISA was to apply the principles of trust law, both by requiring all employer plans to constitute themselves as trusts,[118] and by imposing specific fiduciary duties, derived from trust law, on various people involved in managing a plan.[119]

Retirement plan fiduciaries are defined to include anyone who "exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."[120] In a defined benefit plan, those fiduciaries are responsible for investing the assets of the plan to ensure that there will be enough money to meet future obligations to plan participants—a role similar to that of a trustee managing the assets of a trust for its beneficiaries. Like trustees, plan fiduciaries owe to plan participants and beneficiaries a duty of exclusive loyalty and a duty of care modeled on the "prudent man" standard,[121] a staple of trust investment law in the United States since the early nineteenth century.[122] In addition, ERISA imposes a duty of "diversifying the investments of the plan so as to minimize the risk of large losses,"[123] a duty recognized by trust law since the late nineteenth century, though not codified in the Restatement of

117. Stabile, *supra* note 60, at 366–67.

118. 29 U.S.C. § 1103(a) (2006); *see, e.g.*, Harris Trust & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000) ("The common law of trusts . . . offers a 'starting point for analysis [of ERISA]' . . . .") (alteration in original) (quoting Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 447 (1999)).

119. 29 U.S.C. § 1104(a) (2006).

120. 29 U.S.C. § 1002(21)(A)(i) (2006).

121. 29 U.S.C. § 1104(a)(1) (2006) ("[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan . . . . [A] fiduciary shall discharge his duties . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims . . . .").

122. John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 644-46 (1996).

123. 29 U.S.C. § 1104(a)(1)(C) (2006).

Trusts until the early 1990s.[124] These core fiduciary duties were intended to ensure that plan participants received the benefit of prudent, skilled investment management.

Again, as with mutual fund regulation, this sounds good in principle. Yet, as mentioned above, participants in employer-sponsored defined contribution plans are just as likely as anyone else to invest in expensive active funds. One underlying reason is that ERISA was written in a world of defined benefit plans, and many of its provisions only make sense in that context. Since 1974, however, the pension landscape has shifted towards defined contribution plans, particularly after the Internal Revenue Code was amended in 1978 to allow what are now known as 401(k) plans. The result is that employer-sponsored pensions are governed by a statute that was largely written for another age and another set of economic and legal challenges. Several of the protections that ERISA purports to provide to plan participants, such as its funding requirements,[125] are no longer relevant for defined contribution plans, while the protections that are necessary in a defined contribution world are absent.

In particular, ERISA partially weakens the fiduciary duties that apply in the context of defined contribution plans that allow participants to make their own investment decisions. ERISA section 404(c) relieves plan fiduciaries from liability for any losses resulting from the participant's "exercise of control" over her account.[126] This seems to imply that they can escape the duty of investing plan assets prudently simply by shifting that responsibility onto individual participants. Combined with section 401(k) of the Internal Revenue Code, section 404(c) is a major reason why employers today favor participant-directed defined contribution plans.[127]

Section 404(c) seems to make sense: It says that if a plan participant makes a bad investment decision, her employer should not be liable for her

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124. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(b) (2007); Langbein, *supra* note 122, at 646.

125. 29 U.S.C. §§1081–86 (2006).

126. 29 U.S.C. § 1104(c)(1)(A) (2006). On 29 U.S.C. § 1104(c)(1)(A) (2006) generally, see Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 33–38 (2000) (detailing section 404(c)'s implications for employers); C. Frederick Reish & Bruce L. Ashton, *ERISA Section 404(c): Shifting Fiduciary Liability in Participant-Directed Retirement Plans*, 5 J. TAX'N EMP. BENEFITS 175 (1997) (describing the requirements for transferring certain investment responsibilities to employees); Stabile, *supra* note 60, at 365–78 (describing the historical underpinnings of section 404(c) and its practical consequences for employers and employees).

127. *See* Stabile, *supra* note 60, at 366 (noting that "large numbers of employers have restructured their 401(k) plans" in order to reduce their liability for participants' losses); Zelinsky, *supra* note 27, at 478–79 (discussing section 404(c) as lessening employers' fiduciary burden).

losses. But in practice, it has often been interpreted to mean that an employer can include just about any investment options in its defined contribution plan, including expensive active funds, without worrying about ERISA's fiduciary duties. Section 404(c) requires the Department of Labor to define when a participant has exercised control over her account. Under the current regulations, to qualify for the safe harbor, a plan must give the participant the ability to "exercise control over assets in his individual account" and must provide "a broad range of investment alternatives."[128] To meet the latter criterion, the plan must allow the participant to (a) "materially affect the potential return . . . and the degree of risk" of her investments; (b) choose from at least three diversified, dissimilar investment alternatives that together allow her to increase diversification, reduce risk, and reach any point on the appropriate range of the risk-return spectrum; and (c) diversify her holdings to "minimize the risk of large losses."[129] These regulations can be met by offering at least three different, diversified mutual funds. In terms of relevant costs, the definition of a "broad range of investment alternatives" does not mention investment expenses, while the definition of "control" allows a plan to "impose[] charges for reasonable expenses."[130] A set of expensive, actively managed mutual funds would seem to comply with the regulations.

The courts have generally held that expensive mutual funds are compatible with the regulations and do not constitute a breach of fiduciary duty.[131] In *Hecker v. Deere & Co.*, the Seventh Circuit rejected an excessive fee claim because the plan in question offered more than twenty mutual funds, including some with low fees, and also allowed participants to select from over two thousand other funds through Fidelity's BrokerageLink service.[132] The court justified the funds' fees by appealing to the market,[133] a justification that applies to all fees charged by all funds open to retail investors. In other cases, district courts have endorsed plans because they included a few low-cost funds along with the allegedly

128. 29 C.F.R. § 2550.404c-1(b)(1).

129. *Id.* § 2550.404c-1(b)(3)(i).

130. *Id.* § 2550.404c-1(b)(2)(ii)(A). Given its context, however, this language should only apply to reasonable expenses for executing transactions. That would still leave the regulation silent on the topic of investment management expenses.

131. *See* Ellen M. Doyle & Stephen M. Pincus, *Restoring Retirement Nest Eggs*, TRIAL Apr. 2009, at 46, 46–47 (citing claims that made allegations of excessive fund fees).

132. Hecker v. Deere & Co., 556 F.3d 575, 586 (7th Cir. 2009) ("The fact that it is possible that some other funds might have had even lower ratios is beside the point . . . .").

133. *Id.* (noting that "all of these funds were also offered to investors in the general public, and so the expense ratios necessarily were set against the backdrop of market competition").

expensive ones,[134] because the funds in question were typical of those included in similar plans,[135] or, because the funds were selected through an adequately thorough process.[136]

Plaintiffs have had slightly more success when linking high fund expenses to failures of disclosure, arguing that a participant cannot exercise meaningful control over her account if she does not have adequate information. The regulations require that the participant receive "sufficient information to make informed investment decisions with regard to investment alternatives available under the plan."[137] Some courts have held that simply disclosing all applicable expenses[138] is sufficient to insulate a plan against challenge. In *Hecker*, for example, the complaint alleged that one Fidelity subsidiary, the trustee of the retirement plans, received payments from another Fidelity subsidiary that managed money for funds included in those plans; according to the allegation, the trustee used those payments to discount the administrative fee that it charged to the employer. In other words, the employer saved money by allowing the trustee to make money off of plan participants via the revenue-sharing arrangement.[139] The Seventh Circuit, however, held that there was no duty to disclose the revenue-sharing arrangement because it was not material.[140] In *Braden v. Wal-Mart Stores, Inc.*, by contrast, the plaintiffs alleged that mutual funds were included in their plans because the funds made payments to Merrill Lynch, the plan trustee and administrator.[141] The Eighth Circuit agreed that information about revenue sharing could be material because it "could influence a reasonable participant in evaluating his or her options under the

134. Renfro v. Unisys Corp., No. 07-2098, 2010 WL 1688540, at *6 (E.D. Pa. Apr. 26, 2010).

135. Kanawi v. Bechtel Corp., 590 F. Supp. 2d 1213, 1230 (N.D. Cal. 2008).

136. Taylor v. United Techs. Corp., No. 3:06cv1494 (WWE), 2009 WL 535779, at *10 (D. Conn. Mar. 3, 2009); *Kanawi*, 590 F. Supp. 2d at 1230.

137. 29 C.F.R. § 2550-404c-1(b)(2)(i)(B).

138. The regulations specifically require detailed disclosure of administrative expenses (charged at the plan level), individual expenses (charged at the individual account level), and fees and expenses associated with each investment alternative. 29 C.F.R. § 2550.404a-5(c)(2), (c)(3), and (d)(1).

139. *Hecker*, 556 F.3d at 578.

140. *Id.* at 585–86. Other courts have similarly ruled that revenue sharing agreements do not need to be disclosed to plan participants. *See* Renfro v. Unisys Corp., No. 07-2098, 2010 WL 1688540, at *7 (E.D. Pa. Apr. 26, 2010) (holding revenue sharing arrangement details to be irrelevant to proper execution of fiduciary duties); *Taylor*, 2009 WL at *12–13 (ruling that revenue sharing fees paid by participants through administrative fees, rather than by the employer, need not be disclosed); Tussey v. ABB, Inc., No. 06-04305-CV-NKL, 2008 WL 379666, at *2 (W.D. Mo. Feb. 11, 2008) (agreeing with Eighth Circuit precedent in holding that employers have no duty to disclose trustees' revenue sharing arrangements).

141. Braden v. Wal-Mart Stores, Inc., 588 F.3d 585, 589–90 (8th Cir. 2009).

Plan."[142]

Even in *Braden*, however, where the complaint attacked the plan's mutual funds on multiple substantive grounds (alleging that they charged unnecessarily high fees, underperformed available alternatives, offered expensive retail shares instead of cheaper institutional shares, and charged marketing fees that did not benefit participants),[143] the Eighth Circuit's reversal of the district court's motion to dismiss was based on the disclosure issue.[144] More generally, the court seemed to maintain that a fiduciary breach must be procedural in nature.[145] At best, it seems, the courts will require plan sponsors to avoid conflicts of interest (or at least disclose them) and do a thorough job of documenting their fund selection processes. This may eliminate one motivation for plan fiduciaries to offer high-fee funds in participant-directed plans, but it is unlikely to motivate those fiduciaries to seek out lower-cost mutual funds instead.

In summary, as currently interpreted by the courts, the law at most demands that plan fiduciaries select a menu of mutual funds that are not uniformly more expensive than industry norms. ERISA's explicit endorsement of participant-directed accounts seemingly makes it impossible to require employers to take more of an interest in their employees' retirement savings options. Given this situation, one logical proposal has been to amend ERISA to eliminate participant direction altogether,[146] or repeal section 404(c),[147] but this is, for political reasons, highly unlikely. Furthermore, this proposal would leave employees reliant on the managers of their pension funds, and there is little reason to believe that these managers are any more likely to beat the market than active mutual funds. Other proposals have included improved disclosures, better default options, and more and better financial education and advice for plan participants.[148] But while information, education, and advice might help

142. *Id.* at 600.

143. *Id.* at 599. The marketing (12b-1) fees are used to compensate brokers and other intermediaries who sell a mutual fund.

144. *Id.* ("A reasonable trier of fact could find that failure to disclose this information would mislead a reasonable participant in the process of making investment decisions under the Plan.").

145. *Id.* at 596 ("If these allegations are substantiated, the process by which appellees selected and managed the funds in the Plan would have been tainted by failure of effort, competence, or loyalty.").

146. Susan J. Stabile, *Paternalism Isn't Always a Dirty Word: Can the Law Better Protect Defined Contribution Plan Participants?*, 5 EMP. RTS. & EMP'T POL'Y J. 491, 513–14 (2001).

147. Stabile, *supra* note 60, at 397.

148. *E.g.*, Befort, *supra* note 15 at 976–78; Medill, *supra* note 126, at 75–77 (offering proposals to increase the education and advice offered to plan participants); James J. Choi et al., *Are Empowerment and Education Enough? Underdiversification in 401(k) Plans*, 36

solve some of the other problems with 401(k) and similar plans not addressed in this Article, these changes would do little on their own to improve the set of investment alternatives available to participants.

III. MAKING ERISA WORK

This Part argues for a different solution. Read in light of trust investment law and the context of ERISA, section 404(c) should not excuse plan sponsors and administrators from the duty to look out for participant interests when selecting investment options. Properly interpreted, that duty should imply a presumption against active managed mutual funds and in favor of low-cost index funds. The current Department of Labor regulations implementing section 404(c) are misleadingly broad, and the safe harbor they define should be restricted to plans that only offer low-cost index funds, at least for the segments of the market where indexing is available and inexpensive.

Before getting to the 404(c) safe harbor, it is first necessary to discuss modern trust investment law and how, through ERISA, it applies to pension plans.

A. *Trust Investment Law in a Nutshell*

In 1976, John Langbein and Richard Posner helped introduce index investing to the legal community in an article arguing that trustees could invest in index funds without violating the trust investment law of the time.[149] More importantly, they also argued that trustees *should* invest in index funds. After summarizing modern portfolio theory, they stated, "[t]he next question is how much picking and choosing the trustee should do within the class of publicly traded securities. . . . [O]ur real answer is 'none.'"[150] They then summarized the empirical evidence against active fund management before concluding:

> [T]he trustee's rational strategy . . . is to buy shares in a mutual fund or other investment vehicle that holds the market portfolio—a market fund—and then combine those shares either with borrowing, if he wants more "play" than the market portfolio, or with some relatively riskless asset such as Treasury

BROOKINGS PAPERS ON ECON. ACTIVITY 151, 193 (2005) (recommending that default options be changed to reduce participants' holdings of employer stock).

149. John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1 (1976).

150. *Id.* at 14.

notes if he wants less.[151]

Investing in index funds, they continued, was not just the economically rational thing to do; it was also consistent with the various precepts of trust investment law.[152] While they did not say that trustees had a *duty* to invest solely in index funds, they saw that possibility in the future:

> When market funds have become available in sufficient variety and their experience bears out their prospects, courts may one day conclude that it is imprudent for trustees to fail to use such vehicles. Their advantages seem decisive: at any given risk/return level, diversification is maximized and investment costs minimized. A trustee who declines to procure such advantages for the beneficiaries of his trust may in the future find his conduct difficult to justify.[153]

In the past thirty-five years, the empirical evidence has largely borne out the advantages of index funds, yet the courts have not recognized the duty to invest in them that Langbein and Posner foresaw. One contributing factor is perhaps that even the U.S. stock markets have turned out to be not quite as efficient as the proponents of the efficient markets hypothesis believed in the 1970s. But the studies reviewed above indicate that they are certainly efficient enough to make choosing among actively managed stock funds a losing proposition for most people.

Even though the courts have not adopted a duty to invest in index funds, the basic principles of modern trust investment law do dictate a strong presumption in their favor. This is apparent on a close reading of the Restatement (Third) of Trusts. The full Restatement (Third) was published in 2003, but sections 227 through 229, governing trust investment, were released in 1992 as sections 90 through 92 of the Restatement, Trusts (Prudent Investor Rule).

The "prudent investor" standard, as defined by the Restatement, "requires the exercise of reasonable care, skill, and caution,"[154] which implies that "[t]he trustee must give reasonably careful consideration to both the formulation and the implementation of an appropriate investment strategy . . . ."[155] Since many generally reasonable people invest in active funds, such investments might seem presumptively reasonable under the

151. *Id.* at 18. In practice, this means that the only risky investment an investor should hold is an index fund tracking the market as a whole; she can obtain more risk and return by leveraging this investment with borrowing or less risk and return by putting some of her money in Treasury bills.

152. *Id.* at 18–30.

153. *Id.* at 30.

154. RESTATEMENT (THIRD) OF TRUSTS § 90(a) (2007).

155. *Id.* § 90 cmt. d.

prudent investor standard. The Restatement does not necessarily authorize any investment behavior simply because many other people do it; instead, it recognizes that expert knowledge and skill may be required to meet the prudent investment standard.[156] But this is still not enough to derive a duty to avoid actively managed funds, since many people who might qualify as experts—including the managers of most mutual funds—engage in active management.[157]

In addition to the general requirement of care and skill, the prudent investor rule imposes several additional duties on trustees, including the duties to avoid unreasonable costs, to diversify the investments of the trust, and to avoid imprudent delegation of investment responsibilities.[158] While trust law had always required trustees to minimize costs,[159] the Restatement (Third) situates this duty in the context of modern finance. Section 90(c)(3) requires trustees to "incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship."[160] The Introductory Note to the chapter on trust investment gives additional meaning to this requirement:

> [T]he duty to avoid unwarranted costs is given increased emphasis in the prudent investor rule. This is done to reflect the importance of market-efficiency concepts and differences in the degrees of efficiency and inefficiency in various markets. . . . The duty to be cost conscious requires attention to such matters as the cumulation of fiduciary commissions with agent fees or the purchase and management charges associated with mutual funds and other pooled-investment vehicles. In addition, active management strategies involve investigation expenses and other transaction costs (including capital-gains taxation) that must be considered, realistically, in relation to the likelihood of increased return from such strategies.[161]

The more efficient a market is, the less reason to expend effort (and

156. *Id.* ("The duty to exercise both care and skill in investment management may require knowledge and experience greater than that of an individual of ordinary intelligence, depending on the investment strategy to be employed.").

157. Note that not all active asset management is created equal. In illiquid asset classes without widely available information, active management makes more sense. Having very large amounts of money can also make active management more attractive, as for Warren Buffett. However, the fact that some very smart and very successful investors invest actively in some asset classes does not imply that active management is a viable strategy for other investors in highly liquid asset classes such as U.S. stocks.

158. RESTATEMENT (THIRD) OF TRUSTS § 90 (2007).

159. Langbein, *supra* note 122, at 653.

160. RESTATEMENT (THIRD) OF TRUSTS § 90 (2007).

161. RESTATEMENT (THIRD) OF TRUSTS ch. 17, intro. note (2007).

costs) in making active investment decisions. Trustees are counseled specifically to consider the expenses deducted by mutual funds and are warned away from engaging in active management strategies unless those strategies can be justified by increased expected returns. The last point applies equally well to stock picking by trustees and to investing in actively managed funds, which pass their "investigation expenses and other transaction costs" through to fund investors.[162] On its own, this discussion of reasonable costs in the context of active investment strategies might create something of a presumption against actively managed mutual funds for market segments where cheaper index funds are available.

But there is more. The explicit duty of diversification, which the Restatement made part of the definition of prudent investing, is not simply based on the desire to avoid large losses, but derived from modern portfolio theory.[163] Investment risk can be separated into two categories: market risk (the variance of the returns of the market as a whole) and specific risk (the variance of the returns of an individual security that is not due to market risk). Investors can gain higher expected returns by taking on more market risk; specific risk, however, can be diversified away, and therefore does not provide higher returns.[164] This means that investors should only take on market risk.[165] The Restatement advised trustees to seek "the lowest level of risk and cost for a particular level of expected return,"[166] which implies eliminating specific risk through diversification.[167] The Restatement further states that "[t]he ultimate goal of diversification would be to achieve a portfolio with only the rewarded or 'market' element of

162. *Id.*

163. *Id.* § 90, reporter's general note on comments e–h; Langbein, *supra* note 122, at 647–49.

164. To illustrate this, assume that the market is composed of only two companies that are identical in all respects and have the same stock price today but whose stock prices are completely uncorrelated. Investing in only one of those companies is more risky than investing in both of them, but does not provide higher expected returns, since the expected returns of the two stocks are identical. This shows that taking on more specific risk is not compensated for by higher expected returns.

165. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. g (2007) ("[T]he expected return is not affected by the portfolio's reduced level of what is often called 'specific' or 'unique' risk—insofar as those terms are used to refer to risks that can be reduced by diversification. Other types of risk, however, are generally compensated through market pricing, so that the expected return from an investment or portfolio is directly affected by the level of these risks that cannot be diversified away—the so-called 'market' or 'systematic' risks."); *see also id.* § 90 cmt. e(1) ("[T]he requirement of caution ordinarily imposes a duty to use reasonable care and skill in an effort to minimize or at least reduce diversifiable risks.").

166. *Id.* § 90 cmt. f.

167. *Id.* § 90 cmt. g ("[A] trustee's duty of prudent investing normally calls for reasonable efforts to reduce diversifiable risks, while no such generalization can be made with respect to market risk.").

risk."[168] This degree of diversification can most easily by achieved by investing in index funds. It is possible to obtain virtually all of the benefits of diversification by buying about thirty stocks, but this depends on the degree of correlation between the returns of those stocks[169]

The discussions of passive and active investing in the comments to section 90 make a stronger case for index funds. The comments recommend index funds as a vehicle for investing in stocks.[170] More revealing, however, is the discussion of active strategies. While the relevant comment begins, "[p]rudent investment principles also allow the use of more active management strategies by trustees,"[171] the examples it provides are real estate and venture capital—relatively illiquid, inefficient markets where indexing is not available.[172] In general, the comment warns, "[i]f the extra costs and risks of an investment program are substantial, these added costs and risks must be justified by realistically evaluated return expectations."[173] In particular, it must be true that the "gains from the course of action in question can reasonably be expected to compensate for its additional costs and risks" and that "there is a credible basis for concluding that the trustee—or the manager of a particular activity—possesses or has access to the competence necessary to carry out the program."[174] Furthermore, although the Restatement recognized that trustees could sometimes delegate their investment responsibilities, the duty to avoid imprudent delegation—to "act with prudence in deciding whether and how to delegate authority"—means that a trustee must

168. *Id.*

169. According to the mutual fund separation theorem, under certain assumptions, all investors should hold risky assets in the same proportions; investors who want more risk and higher returns should hold less of the risk-free asset, while those who want less risk and lower returns should hold more of the risk-free asset. In other words, investors should all buy differing amounts of only two assets: (a) an index fund reflecting the entire market and (b) cash or Treasury bills. *See generally* Niko Canner et al., *An Asset Allocation Puzzle*, 87 AM. ECON. REV. 181, 182 (1997). The assumptions behind the theorem are not fully satisfied in practice, but the basic principle that there is no reason to take on specific risk holds in most circumstances.

170. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. h(1) (2007) ("Investing in index funds that track major stock exchanges or widely published listings of publicly traded stocks is illustrative of an essentially passive but practical investment alternative to be considered by trustees seeking to include corporate equity in their portfolios. It is one that offers the pricing security and economies of buying in essentially efficient markets."). The comment later allows for the "direct purchase of appropriate stocks," but only for purposes of "broadening . . . the portfolio's diversification." Now that index funds are available for the entire U.S. stock market, this rationale no longer applies.

171. *Id.* § 90 cmt. h(2).

172. *Id.*

173. *Id.*

174. *Id.*

seriously consider whether a fund manager has the ability to deliver superior returns before investing the trust's money in her mutual fund, which poses another barrier to investing in active funds.[175]

These hurdles are difficult to clear for a trustee who chooses to invest in domestic stocks through actively managed mutual funds rather than low-cost index funds. Both theory and empirical evidence argue strongly that there are no "gains from the course of action in question," let alone gains sufficient to compensate for the higher costs of active funds.[176] Nor is it likely that there could be a "credible basis" for concluding that a given fund manager has the ability to beat the market on a risk-adjusted basis.[177] These facts are acknowledged in the Reporter's comments, noting that "fiduciaries and other investors are confronted with potent evidence that the application of expertise, investigation, and diligence in efforts to 'beat the market' in these publicly traded securities ordinarily promises little or no payoff, in fact, often a negative payoff after taking account of research and transaction costs."[178]

The Restatement, then, argues strongly against incurring the additional costs of active management, at least in liquid markets such as U.S. stocks. Unlike *Gartenberg*, which presumptively allows mutual fund fees that are relatively close to those elsewhere in the industry, the Restatement does not license any investment strategy simply because other reasonable people are using it. Instead, both the duty to avoid unreasonable costs and the duty to diversify require trustees to specifically consider whether the additional costs and reduced diversification of active management are justified. And, in the abstract, the comments to the Restatement argue that they are not. This is almost as strong a position against actively managed stock funds as the Restatement could have taken, given its attempt to be flexible to the different circumstances of different trusts.[179] It is certainly possible to conceive of situations where a trustee might reasonably want to make active investments in domestic equities; for example, a trust with a significant, illiquid position in a private energy business might want to take a short position in public energy companies and a long position in the rest of the stock market. But the Restatement does imply that a trustee

175. *Id.* § 90(c)(2).
176. *Id.* § 90 cmt. (h)(2).
177. *Id.*
178. *Id.* § 90, reporter's general note on comments e–h.
179. *See, e.g.*, *id.* ch. 17, intro. note ("[T]he objectives of the 'prudent investor rule' of this Restatement Third range from that of liberating expert trustees to pursue challenging, rewarding, nontraditional strategies when appropriate to the particular trust, to that of providing other trustees with reasonably clear guidance to safe harbors that are practical, adaptable, readily identifiable, and expectedly rewarding.").

investing a liquid portfolio for a beneficiary with no particular special circumstances might face the burden of explaining to a court why she invested the trust's assets in actively managed domestic stock funds rather than index funds.

B. Trust Investment Law and ERISA

Trust law is relevant to ERISA because that statute expressly incorporated the law of trusts.[180] By requiring that the assets of any pension plan be held in trust—a requirement that has been imposed by the Internal Revenue Code since 1921[181]—the statute automatically invoked trust law.[182] ERISA's sections dealing with fiduciary duties were intended to "make[] applicable . . . the law of trusts,"[183] and the duties imposed by section 404(a) are also closely modeled on the common law of trusts.[184] In Langbein's words, "ERISA codifies the central principles of trust fiduciary law, and ERISA's legislative history makes clear that Congress meant to track the common law of trusts. Thus, agencies and courts interpreting and applying ERISA have inclined to rely upon the Restatement of Trusts and upon the major trust-law treatises."[185] Important Supreme Court opinions interpreting ERISA have recognized the central importance of trust law in understanding the statute.[186]

However, "trust law does not tell the entire story," as the Supreme Court has held:

> ERISA's standards and procedural protections partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection. And, even with respect to the trust-like fiduciary standards ERISA imposes,

180. *See* Michael J. Collins, *It's Common, But Is It Right? The Common Law of Trusts in ERISA Fiduciary Litigation*, 16 LAB. LAW. 391, 395–97 (2001) (citing legislative intent to have ERISA track traditional trust law's fiduciary conduct rules); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 168–70 (1997) (describing the conscious parallel between ERISA and conventional trust law).

181. 29 U.S.C. § 1103(a) (2006).

182. Langbein, *supra* note 180, at 169.

183. H.R. REP. NO. 93-533, at 11 (1973) (Conf. Rep.).

184. Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1108 (1988).

185. Langbein, *supra* note 180, at 169.

186. *See, e.g.*, Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110 (1989) ("ERISA abounds with the language and terminology of trust law. ERISA's legislative history confirms that the Act's fiduciary responsibility provisions 'codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.'" (alteration in original) (citations omitted) (quoting H.R. REP. NO. 93-533, pt. 11 (1973))).

> Congress "expect[ed] that the courts will interpret this prudent man rule (and the other fiduciary standards) bearing in mind the special nature and purpose of employee benefit plans," as they "develop a federal common law of rights and obligations under ERISA-regulated plans.[187]

In addition to trust law, courts must also consider the purposes of the statute, in particular, "Congress' desire to offer employees enhanced protection for their benefits, on the one hand, and, on the other, its desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place."[188] The "federal common law" referred to by the Supreme Court should build on the traditional common law but take into consideration the particular characteristics of employer-sponsored plans and the specific objectives of ERISA.

In fact, Congress in 1974 expanded upon existing trust investment law in order to keep abreast of contemporary investing theory and practice. In making the duty of diversification part of the prudent man standard, ERISA anticipated the treatment of diversification in the Restatement (Third) of Trusts.[189] ERISA also explicitly abrogated the traditional non-delegation rule of trust investing, which had limited the ability of trustees to hire external asset managers (such as mutual fund managers).[190] In expressly authorizing pension plans to use external management, ERISA again anticipated the Restatement, which allows trustees to delegate responsibilities where it is prudent to do so.[191]

The principles of trust investment law expressed in the Restatement, then, are relevant to the interpretation of ERISA for at least three reasons. First, since ERISA expressly incorporates key concepts of the common law of trusts, the meaning of those concepts continues to be governed, at least as a starting point, by the common law of trusts. This is the position of the Restatement itself: "The principles of this Restatement are generally

187. Varity Corp. v. Howe, 516 U.S. 489, 497 (1996) (alteration in original) (citations omitted) (quoting *Firestone*, 499 U.S. at 110).

188. *Id.*

189. *See* Langbein*, supra* note 122, at 646 (noting that "the trustee's duty to diversify has become more acute—for example, in ERISA, the 1974 federal pension legislation, a fiduciary must diversify the investments of participants and beneficiaries to minimize risk of loss unless doing so is clearly imprudent.").

190. 29 U.S.C. § 1102(c)(3) (2006); *see* Langbein, *supra* note 122, at 652 (noting a similar abrogation in the 1992 Restatement).

191. RESTATEMENT (THIRD) OF TRUSTS § 80(1) (2007); *see also id.* § 90 cmt. j ("In administering the trust's investment activities, the trustee has power, and may sometimes have a duty, to delegate such functions and in such manner as a prudent investor would delegate under the circumstances.").

appropriate to those statutory bodies of rules, both by analogy and insofar as those rules expressly or impliedly incorporate general principles of trust law."[192]

Second, insofar as trust investment law has changed since 1974, ERISA actually anticipated its future direction. Both ERISA's emphasis on diversification and its greater tolerance for delegation are consistent with the subsequent reformulation of trust investment law in keeping with modern financial theory and with the increasing specialization of the asset management industry.[193] By 1976, only two years after ERISA's passage, Langbein and Posner were able to argue that trustees should invest in index funds and might one day have a duty to do so. This indicates that applying the core principles of the Restatement to ERISA is not an anachronism that does violence to contemporary legislative intent.

Third, the implications of contemporary trust investment law promote one of the central purposes of ERISA, "offer[ing] employees enhanced protection for their benefits," while not affecting the other—encouraging employers to offer employee benefits plans in the first place.[194] The Restatement encourages trustees to identify the risk-return combination appropriate for a given trust and then to achieve that combination by investing in index funds, at least for asset classes where that is practical. The emphasis on minimizing risk and cost for a given level of expected returns is particularly suited for pension plans, which are intended to provide income security for employees after they retire. While an individual trust might have a valid reason to undertake an unorthodox investment strategy, this is unlikely to be true for an employer-sponsored pension plan. In addition, from a public policy standpoint, nothing is gained if some company pension plans beat the market spectacularly and others trail the market dismally. The former companies (or their employees) will enjoy a windfall while the latter will suffer losses or, worse, go bankrupt and shift their pension obligations to taxpayers (via the Pension Benefit Guaranty Corporation, the federal insurer of private pensions). Even if the gross gains of the one balance the gross losses of the other, the additional costs of their active investment strategies will be a net drain on the economy as a whole.

At the same time, there is no reason why holding employer-sponsored

192. *Id.* § 1 cmt. a(1).

193. *See id.* § 90, reporter's general note ("[ERISA] and its 1979 regulations also reveal, in still another context, a felt need for departures from traditional applications of the prudent-man rule of trust law. This is indicated in part through the U.S. Department of Labor regulations' recognition of modern portfolio theory and of more flexible concepts (for example, in delegation and in risk-return relationships).").

194. Variety Corp. v. Howe, 516 U.S. 489, 497 (1996).

pension plans to the requirements of current trust investment law would make employers less likely to offer such plans, so long as those requirements are clearly spelled out. From an administrative standpoint, it is no more difficult or expensive to invest plan assets in index funds than to invest them in actively managed funds. The important thing from the employer's standpoint is to avoid unnecessary litigation risk—the risk that a court will find that its investment strategy constitutes a breach of fiduciary duty. And litigation risk in this case depends less on the substance of the law than on how clear that law is and whether or not clearly defined safe harbors are available.

For these reasons, ERISA's requirements for the investment of plan assets should be informed by current trust investment law as expressed in the Restatement (Third). Trust law, in turn, strongly counsels ERISA plan fiduciaries to avoid active investing in liquid, efficient market segments where low-cost indexing is available. They can adopt active investing strategies in inefficient markets such as real estate or venture capital. They can also invest actively in liquid markets such as domestic stocks, but only if they can demonstrate that doing so complies with the standards of prudent investing.

C. ERISA and Participant-Directed Accounts

ERISA, however, allows for participant-directed accounts. The question, then, is what implications participant direction has for the duty of plan fiduciaries to invest plan assets prudently. To answer that question, we must first figure out the role of participant direction in a statute dedicated to protecting employee benefits under employer pension plans.

ERISA predated the 401(k) revolution, and its drafters most likely did not envision a world where people would be individually responsible for both funding and investing their retirement accounts. Individual accounts are a characteristic of defined contribution plans, not the defined benefit plans that were common in the 1960s and early 1970s. The defined contribution plans that existed at the time were mainly employee stock ownership plans and profit-sharing plans.[195] Since these were never intended to be the main source of an employee's retirement income, they presumably did not require as much protection as traditional pension plans.

More generally, however, participant direction has an important and positive role to play in a pension plan governed by trust investment law. A pension plan may be responsible for providing retirement income to thousands of participants of different ages, incomes, wealth categories,

195. Befort, *supra* note 15, at 959 n.131.

family situations, health statuses, and so on. Trust law requires trustees to avoid specific (uncompensated) risk, but it also recognizes that the appropriate degree of market (compensated) risk depends on the particular circumstances of the trust.[196] In other words, there is a spectrum of appropriate portfolios, each of which is fully diversified, differing only in their degree of market risk.[197] In a defined contribution plan, centralized management of all plan assets would place every participant at the same point on this risk-return spectrum, regardless of her individual situation. Participant direction solves this problem by allowing each individual to select the risk-return profile that best suits her individual situation, in effect tailoring the trust's investment strategy to the needs of each beneficiary.

Allowing each participant to select her preferred location on the spectrum of appropriate portfolios is an improvement over centralized asset management and is consistent with the principles of prudent investing contained in trust law. Allowing each participant to construct an inappropriate portfolio by selecting from investment options that violate those principles, however, cannot possibly be prudent. When a participant can choose from a menu of expensive, actively managed mutual funds (which, in *Hecker*, contained more than two thousand funds), participant direction allows her to deviate far from the optimal frontier of investment portfolios recommended by trust investment law. For example, even if a 401(k) plan offers a few low-cost index funds, if it also includes high-cost, actively managed, sector-specific funds, it enables participants to create portfolios that contain large amounts of specific risk, violating a fundamental principle of the Restatement.[198] Although these active funds may be riskier than index funds, in the sense that there is greater variance in the distribution of their expected returns, this higher risk is not justified by higher return expectations (because it is specific risk that could be diversified away), and so participants could obtain better risk-return combinations by investing in index funds.

While assembling undiversified portfolios made up of expensive active funds may not be a wise investment strategy, in the abstract it does not violate any particular legal principles. Doing so in the context of a trust

196. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e(1) (2007) ("Decisions concerning a prudent or suitable level of market risk for a particular trust can be reached only after thoughtful consideration of its purposes and all of the relevant trust and beneficiary circumstances.").

197. These portfolios are constructed by buying the market portfolio and combining it either with risk-free assets (to reduce risk) or with borrowing (to increase risk).

198. *See* RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. h (2007) ("Diversification is a common theme of modern investment concepts, and it ordinarily applies at all different levels of risk-return preference.") (citations omitted).

and, in particular, a pension plan that is dedicated to providing retirement income and governed by a statute that places demanding fiduciary duties on plan administrators, does raise issues. A trustee begins with an obligation to diversify the trust's assets so far as practical in order to maximize expected returns for any level of risk, and to do so at a reasonable cost. If the trustee gives participants control over their individual accounts, that fundamental obligation does not go away. Allowing each participant to determine and act on her own risk tolerance is consistent with trust investment law; allowing her to bet her account on the roulette wheel is not, nor are other investment strategies that violate the basic principles of diversification and avoiding unreasonable costs.

In addition, even if there might be good reasons for an individual to invest in active funds, giving *any* plan participant the option of buying actively managed funds constitutes an improper delegation of investment authority, since the plan sponsor cannot assume that every employee has the expertise necessary to choose among those funds. While modern trust law recognizes the need for delegation, that delegation must itself be prudent,[199] and the trustee must take into account "the knowledge, skill, facilities, and compensation of both the trustee and the prospective agents."[200] Given that a participant-directed plan may delegate important decisions to thousands of people, it would be dangerous to assume that every one of them possesses the capabilities required to invest prudently. Even if an individual employee may not perfectly assess her own financial situation in deciding how much risk to take on, she can plausibly do a better job than the plan trustee could do for her. But there is no reason to believe that the typical employee will be able to pick out the few actively managed mutual funds that can be expected to beat the market.

To be consistent with trust investment law and with ERISA, then, participant direction-the delegation of investment decisions to plan participants-in employer pension plans should be limited to allowing each participant to select the level of risk and expected return appropriate to her circumstances. This could be done by offering a set of low-cost index funds covering the major market segments and allowing participants to decide how to allocate their accounts across those funds.[201] Plan fiduciaries that give participants the ability to spend more money (in the form of

199. *Id.* § 90 cmt. j ("In deciding what as well as whether to delegate and in selecting, instructing, and supervising or monitoring agents, the trustee has a duty to the beneficiaries to act as a prudent investor would act under the circumstances.").

200. *Id.*

201. Alternatively, the plan could offer a single, "balanced" index fund-approximating the performance of all of the global securities markets aggregated together-alongside an option to invest in short-term Treasury bills.

higher fund expenses) on less-diversified mutual funds with lower expected returns should be prepared to explain themselves in court.

D. The Current Safe Harbor

But wait: What about section 404(c) and the exemption from liability for losses caused by a participant's investment decisions? The section 404(c) regulations say that a plan need only provide at least three diversified investment alternatives (which do not have to be index funds) that together make possible a wide range of risk-return choices; beyond that, plans can include any other investments. If the investment options included in a plan together comply with the regulations,[202] various courts have held that any duty to select those options prudently is either satisfied or, in the alternative, unenforceable by plan participants.[203]

But this is not what ERISA actually says. Section 404(c) authorizes the Department of Labor to determine the meaning of the phrase, "if a participant or beneficiary exercises control over the assets in his account."[204] Even if that condition is met, however, the safe harbor only applies to losses that "result[] from such participant's or beneficiary's exercise of control . . . ."[205] The key question in any case is whether a participant's losses are caused by her exercise of control or by some other factor for which plan fiduciaries may remain liable.

The plain meaning of "exercise of control" extends only to the actual investment decisions made by the participant. Assume, for example, that a plan offers a stock index fund and a bond index fund, a participant puts all of her money in the stock index fund, and the stock market loses fifty

202. On close examination, a plan that only includes actively managed mutual funds may not even comply with the regulations. According to the regulations, a plan must offer "at least three investment alternatives" that must "in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary . . . ." 29 C.F.R. § 2550.404c-1(b)(3)(i)(B)(3). Three different, diversified active funds would allow participants to construct portfolios having different aggregate risk and return characteristics. But arguably none of these portfolios are "within the range normally appropriate for the participant or beneficiary," at least not according to modern trust investment law, for which a risk-return combination is only appropriate if it minimizes risk for that level of expected return. Even if this is correct, however, the specific requirements of paragraph (b)(3)(i)(B) do not apply to all investment alternatives, but only to the three or more necessary to comply with that paragraph, and therefore a plan that uses index funds to clear that hurdle could also include any number of expensive, actively managed funds.

203. *See supra* Part B.

204. 29 U.S.C. § 1104(c)(1)(A) (2006).

205. 29 U.S.C. § 1104(c)(1)(A)(ii) (2006).

percent of its value (as happened in the panic of 2008–09): Then, the participant's losses clearly result from her "exercise of control" and the plan fiduciaries should not be liable for those losses.[206] By contrast, assume that a plan includes at least three index funds that together satisfy the "broad range" requirement, but that these funds charge expense ratios of two percentage points, rather than the ten to twenty basis points charged by similar funds. Decades later, a participant could argue that her lower account value due to those higher fees constitutes a loss. If the court agrees that it is a loss, then it was clearly caused by the plan fiduciaries' poor selection of investment options and not by her own exercise of control.[207] Under the wording of the statute, such a loss should be charged to the plan fiduciaries, despite the fact that the plan's investment options fit within the Department's regulations.

In other words, fiduciaries are not liable for the consequences of participant choices among investment alternatives, but they remain liable for losses that result from their selection of those investment alternatives in the first place. This is the position that the Department of Labor took in issuing its final regulation: "[T]he act of designating investment alternatives . . . in an ERISA section 404(c) plan is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable."[208] So in selecting investment options, plan fiduciaries remain bound by the duties of loyalty, care, and diversification[209] and are also barred from paying more than "reasonable compensation" for services.[210]

In most interesting cases, the participant's losses will be due to both investment selection by plan fiduciaries and exercise of control by the

206. The participant might argue that her losses resulted from the existence of the stock fund as an alternative and that the plan should only have offered the bond fund, but such a limited set of options would violate not only the "broad range" requirement, but also the basic principles of trust investment law.

207. For a similar example, see Angela Hayden Magary, *Pitfalls of an ERISA 404(c) Defense—Employers' Potential Liability for Employee-Directed Retirement Plans*, 11.2 PIABA B.J. 59, 64 (2004).

208. Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 57 Fed. Reg. 46922 (Oct. 13, 1992); *see also* Paul J. Donahue, *Plan Sponsor Fiduciary Duty for the Selection of Options in Participant-Directed Defined Contribution Plans and the Choice between Stable Value and Money Market*, 39 AKRON L. REV. 9, 15–17 (2006) (citing the preamble to the Final Regulations and the Department's amicus brief in the Enron litigation in which the Department reiterated its view that fiduciaries cannot escape their obligation to prudently select investment options).

209. 29 U.S.C. § 1104(a) (2006).

210. 29 U.S.C. § 1108(b)(2) (2006). 29 U.S.C. § 1106(a)(1) prohibits transactions between a plan and a "party in interest," which is defined by section 1002(14) to include a person who provides services to a plan; and section 1108(b)(2) provides an exemption to section 1106 for "reasonable arrangements with a party in interest" for necessary services, "if no more than reasonable compensation is paid therefor." *Id.* § 1108.

participant. In *In re Unisys Savings Plan Litigation*, the plaintiffs lost money they had invested in guaranteed investment contracts issued by an insurance company that later collapsed.[211] Unisys, the plan sponsor, argued that even if the inclusion of that investment alternative was imprudent, plan fiduciaries were shielded from liability by section 404(c) because the plaintiffs' losses resulted from their "informed choice" to invest in that alternative.[212] The Third Circuit agreed in principle with *Unisys*:

> [A] fiduciary may call upon section 1104(c)'s protection where a causal nexus between a participant's or a beneficiary's exercise of control and the claimed loss is demonstrated. This requisite causal connection is, in our view, established with proof that a participant's or a beneficiary's control was a cause-in-fact, as well as a substantial contributing factor in bringing about the loss incurred.[213]

In general, if a plan offers some good investment options and some bad ones, even if the inclusion of the bad ones constitutes a fiduciary breach, a participant's decision to invest in one or more of the bad ones will easily qualify as both a cause-in-fact of and a substantial contributing factor to the loss, and the plan fiduciaries will not face liability.[214]

Either *Unisys* is wrong or its implications are absurd. Assume that a plan includes diversified investment options that together satisfy the "broad range" requirement but also allows participants to place their money on zero on the roulette wheel (and discloses that playing roulette is risky). If a participant does the latter and loses her entire account, her losses result from both her own rashness and the plan sponsor's blatant irresponsibility, yet the *Unisys* standard would absolve the sponsor of liability. It is

211. *In re Unisys Savs. Plan Litig.*, 74 F.3d 420, 425 (3d Cir. 1996).

212. *Id.* at 444–45.

213. *Id.* at 445. 29 U.S.C. § 1104(c) (2006) is the codified version of ERISA § 404(c). However, the court reversed the district court's grant of summary judgment to Unisys on the grounds that Unisys had not proven that it had provided sufficient information to plan participants to give them effective control. Assuming sufficient disclosure, the inclusion of the guaranteed investment contracts would not have prevented Unisys from invoking section 404(c).

214. On *Unisys*, see Stabile, *supra* note 60, at 377–78 (explaining that the *Unisys* decision excuses a fiduciary from liability when there is a causal relationship between the participant's exercise of control and the loss). *But see* Donahue, *supra* note 208, at 15–16 n.34 (calling Stabile's reading of *Unisys* "flawed" and arguing that it is possible to hold a fiduciary liable when a participant's losses result from his or her selection). Donahue claims that *Unisys* "actually supports the assertion that damages from the Plan Sponsor can be obtained as a result of option selection decisions," but the passage he quotes states that liability could arise "if the Plans did not offer an acceptable alternative to GIC investments." *Id.* By implication, if they did offer an acceptable alternative, the plan fiduciaries would be shielded from liability.

difficult to imagine that Congress intended to protect plan fiduciaries in cases where their own imprudence was a major and avoidable cause of participant losses.

Unisys was based on events that occurred before the current regulations were issued. Several courts have since deferred to the Department of Labor's position that the selection of investment options is itself subject to fiduciary duties, including the Fourth Circuit in *DiFelice v. U.S. Airways, Inc.*[215] Recently, however, two other courts of appeals have rejected the Department's position. In *Hecker*, the Seventh Circuit held that the safe harbor "does protect a fiduciary that satisfies the criteria of § 1104(c) and includes a sufficient range of options so that the participants have control over the risk of loss."[216] The court essentially asserted that any plan that complies with the regulations is shielded from claims of fiduciary breach.[217] The opinion quotes from the "broad range" criterion of the regulations, then describes how the plan in question met that requirement, and concludes: "If particular participants lost money or did not earn as much as they would have liked, that disappointing outcome was attributable to their individual choices."[218] In short, if a plan provides sufficient choice, as defined by the regulations, its fiduciaries are not liable if participants invest in the bad funds. This argument, however, does not seriously address the Department of Labor's position that imprudent fund selection remains a fiduciary breach, even if the resulting investment menu technically complies with the regulations. Instead, *Hecker* asserts that complying with the regulations and giving participants "control over the risk of loss" is enough to earn a complete exemption from liability.[219]

In *Langbecker v. Electronic Data Systems Corp.*, the Fifth Circuit rejected the Department's position on different grounds.[220] The court argued that the Department's position was an unreasonable interpretation of section 404(c) because it "would render the § 404(c) defense applicable only where plan managers breached no fiduciary duty, and thus only where

215. 497 F.3d 410, 418 n.3 (4th Cir. 2007); *see, e.g.*, Kanawi v. Bechtel Corp., 590 F. Supp. 2d 1213, 1232 (N.D. Cal. 2008) (accepting the Department of Labor's position that a fiduciary has a "continuing duty to monitor the prudence of investment options in a plan regardless of the scope of a participant's control"); Bendaoud v. Hodgson, 578 F. Supp. 2d 257, 271 (D. Mass. 2008) (asserting that fiduciaries can be liable for providing unwise investment choices even if plan participants direct their own investments).

216. 556 F.3d 575, 589 (7th Cir. 2009). 29 U.S.C. § 1104(c) is the codified version of ERISA § 404(c).

217. *Id.* at 589–90.

218. *Id.* at 590.

219. *Id.* at 589.

220. 476 F.3d 299, 311 (5th Cir. 2007).

it is unnecessary."[221] In other words, if a plan can comply with the "broad range" requirement, yet its fiduciaries can still be liable for imprudent selection of investment options, then that component of the regulations might as well not exist. Put another way, if a plan fiduciary can demonstrate prudence in its choice of investment options, then it has already met its fiduciary duties, and whether it complies with the regulations is irrelevant.

The court in *Langbecker* has a valid point, but it is ultimately too cute. The point is that the current regulations are not very helpful. They show employers how to fulfill the statutory requirement that participants be permitted to exercise control over their accounts, which shields them from liability for losses resulting from participant investment decisions. But compliance with the regulations does not provide an automatic exemption from liability for imprudent selection of investment options. From an employer's perspective, this safe harbor is deeply flawed, since complying with the details of the regulations still does not provide watertight protection from lawsuits.

Even if the safe harbor is flawed, however, that does not authorize courts to change the meaning of the statute. The statute still exempts plan fiduciaries only for losses resulting from the participant's "exercise of control," which plainly does not encompass the prior selection of investment alternatives. If plan sponsors and administrators are excused from their fiduciary duties whenever a participant's investment choices played some role in causing her losses, as in *Unisys*, the simple, predictable, and all-too-frequent fact of poor individual decision-making would absolve fiduciaries of even the most blatantly irresponsible and indefensible decisions. This seems incompatible with the basic principles of trust law, which require trustees to be loyal to the interests of their beneficiaries, and with ERISA's fiduciary duty structure, which demands care, skill, and prudence from plan sponsors and administrators. Such a powerful get-out-of-jail-free card would also undermine a statute designed to protect employee retirement savings from unscrupulous or incompetent employers.

For these reasons, simply complying with the letter of the Department of Labor's regulations—for example, by offering three dissimilar, diversified mutual funds—is not enough to escape trust investment law's presumption in favor of indexing and against active management. A plan may comply with the "broad range" requirement of the regulations, but if it enables participants to create suboptimal portfolios that a trustee would not be allowed to invest in, it violates the duties of diversification, avoiding

221. *Id.*

unreasonable costs, and prudent delegation. This does not automatically mean that any plan that includes active funds represents a breach of fiduciary duty. It only means that, to defend against a claim of breach, the plan sponsor and administrator have to explain why the inclusion of those funds was consistent with their fiduciary duties. Given the empirical evidence against active fund management, however, this may be a difficult case to make.

E. A Better Safe Harbor

My previous argument that employers remain liable for imprudent fund selection, despite section 404(c) and its enabling regulations, has two practical shortcomings. First, while it is quite plausible that some courts will agree with the Department of Labor that the section 404(c) exemption does not apply to the selection of investment alternatives, it is unlikely that they will suddenly rule that actively managed mutual funds are imprudent and that including such funds in a pension plan constitutes a breach of fiduciary duty; such a ruling would immediately expose the fiduciaries of thousands of 401(k) plans to potential liability for the losses suffered by their participants. Second, it leaves employers in limbo, unable to rely on the existing regulations and unsure how to protect themselves from liability for imprudent fund selection.

For these reasons, a better and more realistic solution is for the Department of Labor to modify the section 404(c) regulations, as it is authorized to do by the statute.[222] To be useful, a safe harbor should define, as clearly as possible, those objective conditions that, if met, will shield a party from liability. In this case, it should be narrower (covering fewer plans), but safer (minimizing the chances that those plans might create liability).

The current section 404(c) regulations are too broad because they encompass pension plans that contravene the principles of trust investing and therefore violate ERISA's fiduciary duties. Instead, to provide a meaningful safe harbor, the regulations should only permit plans with investment menus that are consistent with trust law and ERISA, interpreted conservatively (from the fiduciary's point of view)–that is, the definition of a "broad range of investment alternatives" should exclude plans that plausibly constitute a violation of fiduciary duties. Then employers could be confident that they were not only complying with the Department of

222. The section 404(c) exemption from liability applies "if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)." 29 U.S.C. § 1104(c)(1)(A) (2006).

Labor's definition of "exercise of control" but also satisfying the underlying fiduciary duty to select investment alternatives prudently.

As argued above, the only investment strategy that unequivocally complies with trust investment law is to diversify away specific risk as much as possible at the lowest cost possible. This means that for assets traded in liquid, efficient markets, trustees should invest solely through low-cost index funds, where those funds are available. Although pension plan participants should be allowed to make asset allocation decisions that reflect their risk preferences, within each asset class they should invest in low-cost index funds wherever possible. Therefore, the "broad range" component of the section 404(c) regulations should be limited to plans that only include low-cost index funds,[223] each covering a major segment of the securities markets—such as U.S. stocks, international (non-U.S. stocks), U.S. bonds, Treasury bonds, or Treasury inflation-indexed bonds—as well as a money market fund or similar low-risk investment option. A plan could not include additional investment options beyond those specified by the regulations, and therefore could not include less diversified, more expensive, actively managed funds.[224]

This proposal may seem like a return to the restrictive "legal lists" of investments that trustees were allowed to invest in, which were used in some jurisdictions into the early twentieth century.[225] But the proposal concerns a safe harbor, not an exclusive list. Just as the Restatement says that active management may be suitable under certain circumstances, it may be prudent for a plan to include active funds, especially in asset classes where low-cost index funds are not available. But trust law establishes a presumption against such investments: Recall that their "added costs and risks must be justified by realistically evaluated return expectations."[226] Therefore, actively managed funds should not receive the automatic protection of the regulatory safe harbor.

Such a narrowly drawn safe harbor will motivate most employers to conform their plans to its requirements. This will have two salutary policy

223. Index funds that attempt to follow the same indexes have varying expenses and varying levels of tracking error—the difference between the fund's gross returns and the actual returns of the index itself. Exchange-traded funds that track particular indexes may also have advantages over traditional index mutual funds. Determining exactly what investment options qualify as "low-cost index funds" for the purposes of the regulations is beyond the scope of this Article.

224. Ideally, the regulatory safe harbor would exclude plans that include company stock as an investment option. An argument might be made, however, that ERISA's exemption of company stock from its general diversification requirement implies that such plans are eligible for safe harbor. *See* 29 U.S.C. § 1104(a)(2) (2006).

225. Langbein, *supra* note 122, at 643–44.

226. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. h(2) (2007).

effects. First, it will improve plan participants' investment outcomes by reducing the amount of their assets that is drained away by fund management fees (saving them on the order of fifteen billion dollars each year)[227] and by steering them away from less diversified investment options that are likely to underperform the market, even before taking fees into account. With a restricted set of investment options, participants are more likely to invest on the efficient risk-return spectrum and more likely to consider where they should be on that spectrum.

Second, this reshaping of pension plans could have spillover effects on the mutual fund market as a whole. Defined contribution plans are a major source of demand for mutual funds, with $2.5 trillion out of the total $11.8 trillion invested in U.S. mutual funds, and shifting that money into low-cost index funds will itself significantly lower the industry's weighted average expense ratio. In addition, many people's introduction to investing is through 401(k) plans: Of households that first purchased mutual funds between 2005 and 2010, seventy-two percent were introduced to mutual funds by their employer-sponsored retirement plans.[228] Since the simplest way to continue investing one's plan balance after leaving a company is to convert it into an IRA with the same fund company, investing patterns set in a defined contribution plan persist, at least to some extent, into individual investing. Therefore, a policy change that shifts assets in employer pension plans from active funds to index funds is likely to cause a similar shift in IRAs, potentially doing far more than section 36(b) of the 1940 Act to solve the problem of high fund fees.

While narrowing the section 404(c) safe harbor offers employees

227. The weighted average expense ratio for stock mutual funds in 401(k) plans was 74 basis points in 2009. INV. CO. INST., *supra* note 6, at 110. A reduction in the average expense ratio by 60 basis points on $2.5 trillion in assets would reduce aggregate fees by $15 billion. This estimate excludes the higher transaction costs of active funds, which are not reflected in their expense ratios. It is theoretically possible that a major shift from active funds in index funds could cause those index funds to become more expensive. This assumes that low-cost index funds currently serve as loss leaders that are cross-subsidized by high-cost active funds, which is a possible equilibrium in a market with sophisticated and unsophisticated consumers. *See* Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505 (2006) (demonstrating that informational shrouding is present even in highly competitive markets). Even in this case, there should still be a large reduction in aggregate fees because index funds have lower costs than active funds. It is also not clear that the cheapest index funds are being sold as loss leaders. The Vanguard 500 Index Fund, for example, has an expense ratio as low as 6 basis points, but it also has more than $100 billion under management, providing more than $60 million in annual revenues to cover its costs. *Vanguard Fund Profile: Vanguard 500 Index Fund Admiral Shares*, VANGUARD GROUP, INC., https://personal.vanguard.com/us/funds/snapshot?FundId=0540&FundIntExt=INT (last visited Feb. 1, 2013).

228. INV. CO. INST., *supra* note 6, at 85.

enhanced protection for their benefits, it does not discourage employers from offering pension plans. The two major reasons why an employer would not offer a pension plan are administrative cost and litigation risk. A plan including a handful of index funds is no more expensive to administer than a plan including a large menu of actively managed funds. More likely, every large fund family would create an off-the-shelf plan that meets the requirements of the safe harbor, and since the plans would be substantively similar, they would be likely to compete on price. More importantly, this narrower safe harbor should reduce litigation risk for employers and plan fiduciaries. Because the safe harbor is defined to encompass only plans that are consistent with the principles of trust investment law and ERISA, the fact that a plan fits within the safe harbor should imply that its investment alternatives were selected prudently. This could only reduce liability risk from the current state of affairs where a plan fiduciary must first ensure that the plan's investment options comply with the many details of the "broad range" requirement, and then might still be liable for participant losses.

There is a more modest alternative that could still have a significant impact on plan participants' investments and hence the security of their retirement savings. Instead of restricting the safe harbor to plans that only offer low-cost index funds, the regulations could grant protection to plans that make low-cost indexing the default allocation of participant investments; that is, money contributed to employees' accounts would be invested in one or more index funds unless the employee affirmatively opted for a different investment strategy. The general idea of using default options to increase retirement savings has received considerable attention recently. This type of approach has proven attractive to many legal scholars because it preserves individuals' freedom of choice while encouraging them to make choices that are in their own interests.[229] The best-known example is automatically enrolling new employees in 401(k) plans unless they opt out, which results in much higher participation rates than if employees are not enrolled by default.[230] Default options also have

229. In many cases, the people making these choices recognize that they are acting in their own interests. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008) (demonstrating how to structure social policies to encourage individuals to make what they themselves consider the best decisions).

230. *See* THALER & SUNSTEIN, *supra* note 229, at 103–17 (summarizing retirement savings behavior and default options); John Beshears et al., *The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States*, *in* SOCIAL SECURITY POLICY IN A CHANGING ENVIRONMENT 167 (Jeffrey Brown et al. eds., 2009) (examining empirical evidence to conclude that defaults strongly impact savings outcomes); James J. Choi et al., *For Better or For Worse: Default Effects and 401(k) Savings Behavior*,

a significant effect on the amount of money that plan participants put aside[231] and on how participants allocate their money among various investment options.[232]

The Department of Labor could modify its regulations to require a default allocation to one or more low-cost index funds for any plan seeking to benefit from the section 404(c) safe harbor. Under these rules, employees could still affirmatively choose to move their money to other investment options. Since defaults seem to be at least somewhat "sticky," this would probably increase the amount of retirement plan money invested in low-cost index funds. There are at least two reasons why it is far from a perfect solution, however. First, default asset allocations seem to be less sticky than default participation. At one company where employees were automatically enrolled in a 401(k) plan with a default allocation, fewer than half of them had all of their money in the default fund after fifteen to twenty-four months.[233] In this case, the default allocation was to a money market fund (with very low returns), which could explain why so many people shifted away from it. More generally, however, most people agree in principle that they should be saving for retirement, so relatively few opt out of a plan with automatic enrollment; there is less popular consensus about particular investment strategies, so we would expect more people to opt out of the default allocation. Second, once employees have enrolled in a 401(k) plan, it is not in anyone's interests for them to opt out. By contrast, if employees are being defaulted into low-cost index funds, it is in the interests of the companies that offer the other available funds—or even of the plan administrator itself, which is often a mutual fund company—to convince them to switch into higher-cost funds. We can expect those fund companies to actively market their higher-cost funds to participants, reducing the stickiness of the default option and eroding the share of investments allocated to index funds.

Whether the safe harbor excludes plans that offer active funds or is simply restricted to funds that make index funds the default investment option, employees would benefit from lower investment costs and higher

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in PERSPECTIVES IN THE ECONOMICS OF AGING 81 (David Wise ed., 2004) (finding that automatic enrollment increases 401(k) participation and that a majority of new plan participants save at the default contribution rate); Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. ECON. 1149 (2001) (finding that 401(k) participation is higher with automatic enrollment and that a substantial share of those who enroll under automatic enrollment retain the default fund allocation and contribution rate).

231. Beshears et al., *supra* note 230, at 173–75.

232. Beshears et al., *supra* note 230, at 175–76.

233. Beshears et al., *supra* note 230, at 175 (examining employees who were hired after automatic enrollment began).

expected net returns, while employers would benefit from lower litigation risk. The big loser, of course, would be the asset management industry. Fund companies would no longer be able to pocket one percent of their customers' assets every year for providing products that, on average and in the aggregate, underperform the market. But that is precisely the point.

IV. POLICY GOALS AND DOCTRINAL CONSTRAINTS

This Article makes a legal argument to achieve a public policy goal. As such, it faces at least two serious issues. First, even if the policy goal is desirable, is it absolutely required by current law, or are there other interpretations of trust investment law and ERISA that dictate a different outcome? And second, what should we do about parts of the overall retirement savings landscape where the same policy goal applies but the legal argument is not available, such as IRAs?

A. Trust Law, the Restatement, and Department of Labor Regulations

The central doctrinal argument of this Article—that contemporary trust investment law contains a presumption against active investment management, at least for asset categories where low-cost indexing is feasible—rests heavily on the Restatement (Third) of Trusts, especially its comments. A Restatement, however, is not the law, but merely an authority of indeterminate persuasiveness. In addition, despite the comments to the Restatement that discuss the merits of passive investing, the common law of trusts has not recognized a duty to index.[234] Nor does it seem likely that the law will independently evolve in that direction. In the wake of the recent financial crisis, the strong form of the efficient markets hypothesis (which holds that market prices always incorporate all relevant information, private or public) has been widely left for dead; the influence of modern portfolio theory (the conceptual underpinning to the prudent investor rule as expressed in the Restatement) may well have passed its peak. In this context, one particular reading of the Restatement may seem too fragile a foundation for a significant change in the law governing defined contribution pensions.

I am not arguing for a blanket prohibition on active investing by trustees—only for the presumption against active funds that is already implied by the comments to the Restatement. I do not expect that courts

234. *See, e.g.*, CHARLES E. ROUNDS, JR. & CHARLES E. ROUNDS, III, LORING AND ROUNDS: A TRUSTEE'S HANDBOOK § 6.2.2.1, at 488–93 (2009) (discussing arguments for and against indexing in general and for trusts).

would use that presumption to immediately find that any trustee who has invested in active funds has breached her fiduciary duties. Instead, they should use it to ask trustees to explain their conduct in light of the principles of the Restatement.[235] For example, a trustee who delegates investment responsibility to a fund manager need only explain why that manager "possesses or has access to the competence necessary to carry out the [investment] program";[236] a trustee who can give a reasonable response to that question is unlikely to have breached her fiduciary duty. The Restatement recognizes that each trustee must take into account the particular circumstances of the trust and its beneficiaries, providing ample latitude for trustees to adopt appropriate investment strategies.

This flexibility afforded to individual trustees is less applicable to the world of defined contribution pension plans, all of which have the same objective (retirement saving) and each of which is responsible for large numbers of employees in differing financial circumstances. These factors imply that there should be less tolerance for investment strategies that take on risk that could be diversified away and incur expenses that could be avoided. Even so, this Article argues only for a presumption: Plan sponsors would still have the opportunity to explain why they chose to offer active funds in their pension plans. A fiduciary who could provide convincing evidence of why she believed, after a reasonable investigation, that a particular active fund promised net expected returns higher than those of an index fund would be unlikely to face liability.

Finally, my recommended solution is a regulatory change by the Department of Labor, not a sudden change in the way that courts interpret trust investment law. The fundamental reason why the Department should make that change is not simply that it is dictated by the Restatement of Trusts, but that it is good policy: Encouraging companies to shift their 401(k) plan offerings from active funds to low-cost index funds will, in the aggregate, reduce the fees paid by plan participants and increase the amount of money eventually available to them in retirement. This Article shows that changing the section 404(c) regulations to favor index funds is, at the very least, consistent with a plausible reading of trust law and ERISA, even if other readings are possible. In other words, the interpretation presented here provides the doctrinal support necessary for the Department to make a regulatory change that is desirable on policy grounds—which, in the end, is what matters to ordinary Americans.

235. *See* Meyer v. Berkshire Life Co., 250 F. Supp. 2d 544, 566 (D. Md. 2003) (asking defendants to explain their conduct in light of modern portfolio theory).

236. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. h(2) (2007).

B. Other Retirement Savings Vehicles

The proposals of this Article only address one component of the American retirement savings system: employer-sponsored defined contribution plans. As described above, in addition to the $2.5 trillion invested in mutual funds through such plans, another $2.2 trillion is invested in mutual funds through the various types of individual retirement accounts. The policy arguments against active funds in 401(k) plans apply equally well against active funds in IRAs. Why not change the rules for IRAs as well? And why stop there? Why not change the rules for all mutual funds?

The short answer is that the legal basis for the policy change recommended in this Article does not apply to IRAs. My argument is based on trust investment law as made applicable to employer-sponsored pension plans through ERISA. ERISA does not apply to IRAs, and there is no equivalent to section 404(c) and its enabling regulations that sets substantive criteria for IRA investments.[237] Banning active funds or otherwise restricting the types of investments that can be made in an IRA would require a new statute.

There is also a more interesting substantive difference between employer-sponsored pension plans and IRAs. An IRA provides a more direct relationship between the investor and the asset management industry than does a pension plan. An individual can open an IRA directly with an asset management company, a bank, or another financial intermediary. The intermediary can decide what investment options are available, but in some cases this includes virtually the entire universe of individual securities, mutual funds, and exchange-traded funds.[238] Since an individual can choose any intermediary for her IRA, this means that she has an essentially unrestricted choice of investment alternatives. Contrast this with an employer-sponsored pension plan, where the plan sponsor determines what investments the employee can make and on what terms.

One could argue that IRA investors are more vulnerable than pension plan participants because they are dealing directly with the asset management industry, without the expert protection provided by

237. An IRA can include almost any type of investment, with the exception of collectibles (artworks, antiques, etc.). *Retirement Plans FAQs Regarding IRAs*, INTERNAL REVENUE SERV., http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-IRAs (last visited Feb. 1, 2013).

238. Fidelity, for example, allows IRA investments in "Fidelity and non-Fidelity funds, stocks, bonds/U.S. Treasuries, FDIC-insured CDs, annuities, and ETFs." *Choosing Investments for Your IRA*, FIDELITY INVS., https://www.fidelity.com/retirement/learn-about-iras/choosing-investments (last visited Feb. 1, 2013).

sophisticated employers. This argument, however, is premised on the assumption that those sophisticated employers are actually doing a good job of looking out for employee interests, which is currently not the case. Instead, in a practical sense, many plan participants are worse off than IRA investors, who at least have the opportunity (whether or not they take it) to seek out low-cost index funds for their retirement savings.

The problem with employer-sponsored pensions is the failure of plan sponsors to live up to their fiduciary duties. This is precisely the kind of problem that trust law and ERISA are intended to solve. Fiduciary duties are typically imposed in situations where one party is vulnerable to another party, whether through asymmetric information, unequal bargaining power, or some other imbalance that cannot be redressed directly. With pension plans, employees cannot access the free market directly and are dependent on their employers to negotiate for them, yet those employers are not complying with their existing fiduciary duties. This Article simply proposes to enforce those duties.

By contrast, the problem with IRAs is one not of negligent fiduciaries but of market failure. Since consumers effectively have access to the entire market, the legal response, if any, should be to increase consumer protection, not to enforce fiduciary duties. The traditional mechanisms for consumer protection, as discussed above, are product regulation and disclosure. Given the known failings of disclosure in the context of financial products, perhaps the best solution from a policy standpoint would be to exclude active funds from IRAs. But this would be a particularly draconian solution. It would have to be a categorical ban. There is no practical way to create a presumption against active funds because IRA custodians do not play the investment-selection role played by pension plan administrators. To be coherent, it would have to extend to investments in individual securities as well, since they are, by definition, much less diversified than the typical active fund. And because this policy would restrict individual choice in a free (although tax-preferred) market—as opposed to restricting the choices of plan sponsors with fiduciary responsibilities to participants—it has to be balanced against the value of individual autonomy. Although I believe that restrictions on IRA investments would make ordinary investors, in the aggregate, better off,[239]

239. One concern raised occasionally is that if everyone were to invest in index funds, no one would try to pick stocks anymore, so the market would lose the ability to set prices. *See, e.g.*, Rounds & Rounds, *supra* note 234, § 6.2.2.1, at 491. Even if active funds were barred from employer-sponsored pension plans and from IRAs, however, many people would continue to pick stocks, including hedge fund managers, defined benefit pension funds, active fund managers (investing funds from people's non-retirement accounts), and individuals (in their own non-retirement accounts).

the legal case for it is ultimately more difficult to make.

What this discussion reveals, perhaps more than anything else, is the fragmented, patchwork nature of our retirement system and the laws that define it. This Article has argued that ERISA can be used to give employees better investment options and increase their retirement security. It is still true, however, that substantive changes to the world of defined contribution pensions have to be fit through a statutory window designed for a defined benefit world that is slowly fading into history—and once people leave their employers and roll over their account balances into IRAs, they enter a new world with its own legal rules. What we really need is a new, comprehensive legal structure for retirement savings, which could even be integrated with Social Security. But that is a subject for another time.

CONCLUSION

The retirement security of ordinary American workers has been a major concern of public policy since at least the 1930s, when it led to the establishment of Social Security. In the United States, however, insuring workers against destitution in their old age has never been left solely to the federal government. Instead, from the 1930s through the 1950s, the federal government and the private sector, through both collaboration and conflict, established a system of both public and private retirement benefits. Generally speaking, business leaders were opposed to the complete federalization of retirement insurance (and the higher payroll taxes it would entail), both because they opposed government expansion and because they used pension plans to pursue private ends—notably, attracting workers and later inducing them to retire. They favored employer-provided pensions as a complement to Social Security and as an alternative to the further expansion of Social Security.

Both the federal government and the business community got something out of this grand bargain, which was worked out in rough fashion over the decades. The government provided tax benefits to private employers in order to increase coverage of workers by private pension plans. In exchange for the tax benefits, the assets in those plans had to be held in trust for their participants and beneficiaries. The expansion of private pensions also relieved the federal government of some of the responsibility for supporting the elderly, albeit in a haphazard fashion, since not all workers have access to pensions. Finally, the passage of ERISA in 1974 imposed sweeping regulation on private pension plans, confirming their public importance as a major pillar of America's retirement system.[240]

Since 1974, employers have not kept up their end of the bargain. The replacement of defined benefit plans by defined contribution plans has shifted funding and investment risk from employers onto employees.[241] As a result, while most pension plans today offer a tax-advantaged way to save for retirement, they do not provide retirement insurance in any meaningful sense. The advantages for a company of shifting risk onto its employees are so great and so obvious (and individual accounts are so attractive to many people) that there is no way of going back to the world of defined benefit plans, and there is nothing any reading of ERISA can do about that. But participant-directed defined contribution plans are governed by ERISA, and hence by its fiduciary duty provisions, themselves rooted in trust law. The key question is what those provisions mean in the context of participant direction. This Article has argued that ERISA does have something important to say about such plans: The protection of section 404(c) should extend only to plans that, through the prudent selection of investment alternatives, ensure that participant assets are invested in conformity with the basic principles of trust law and sound investing. This implies that the section 404(c) safe harbor is not available to plans that include actively managed mutual funds; to make this clear, its implementing regulations should be rewritten to exclude such plans.

Such a strong presumption against active fund management would be difficult to maintain in the realm of ordinary investing, especially given the current dominance of the paradigm of investor sovereignty. But this presumption makes legal, political, and historical sense in the context of pension plans, which are governed by ERISA in the name of retirement security. Again, this interpretation of ERISA would not ensure retirement security for plan participants; they would still need to save enough money while working and not withdraw it prematurely, and they would still be subject to investment risk. But for any level of expected return, they would be subject to less investment risk, and they would lose significantly less money due to fees along the way. This result is entirely consistent with the basic purpose of ERISA's regulation of pension plans (and of the tax preferences granted to those plans): increasing the number of people who enjoy a decent income in retirement. It is also consistent with the history of

240. *See* 29 U.S.C. § 1001 (2006) ("The Congress finds . . . that the continued well-being and security of millions of employees and their dependents are directly affected by these [employee benefit] plans; that they are affected with a national public interest; that they have become an important factor affecting the stability of employment and the successful development of industrial relations . . . .").

241. *See* JACOB S. HACKER, THE GREAT RISK SHIFT: THE NEW ECONOMIC INSECURITY AND THE DECLINE OF THE AMERICAN DREAM 109–35 (2008).

employer pension plans, which have always had the public purpose of improving retirement security for ordinary Americans.