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Max M. Schanzenbach
Robert H. Sitkoff

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Harvard Law School
Cambridge, MA 02138

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Fiduciary Financial Advice to Retirement Savers: Don't Overlook the Prudent Investor Rule

Max M. Schanzenbach[†]

Robert H. Sitkoff^{††}

Abstract

Americans now hold trillions of dollars in individual retirement savings accounts, raising concerns about conflicts of interest among financial advisers who provide advice to retirement savers. Prompted by these concerns, in April 2016 the Department of Labor promulgated a rule that imposes on financial advisers to retirement savers “fiduciary” status under the Employee Retirement Income Security Act. The Department reasoned that the fiduciary duty of loyalty would protect retirement savers from conflicted investment advice. But in addition to a duty of loyalty, fiduciary status also imposes a duty of care. With respect to investment management, the fiduciary standard of care is governed by the “prudent investor rule,” which is grounded in modern portfolio theory and requires an overall investment strategy having risk and return objectives reasonably suited to the purpose of the investment account. This essay calls attention to the regulatory imposition of the prudent investor rule on financial advisers to retirement savers. The essay also canvasses the basic tenets of the prudent investor rule, highlighting its nature as principles-based rather than prescriptive, and the customary role of an investment policy statement in compliance by professional fiduciaries.

[†] Seigle Family Professor of Law, Northwestern University, m-schanzenbach@law.northwestern.edu.

^{††} John L. Gray Professor of Law, Harvard University, rsitkoff@law.harvard.edu.

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INTRODUCTION

Today the bulk of American workers' retirement savings, worth trillions of dollars, is in self-directed individual retirement accounts (IRAs) and defined contribution pension plans. Understandably, many workers with self-directed accounts turn to financial advisers for help in matching the vast and complicated array of investment options in today's financial markets to the worker's particular circumstances. However, the manner by which financial advisers are compensated has long raised concerns about conflicts of interest. Some advisers are compensated by the providers of the financial products that the adviser sells, giving the adviser a financial incentive to recommend the products that provide the adviser with the most compensation. Some advisers also engage in principal trading, a form of self-dealing in which the adviser recommends that the client buy securities from the inventory of the adviser's firm.¹

To protect the integrity of financial advice to retirement savers, in April 2016 the Department of Labor (DOL) promulgated a rule that imposes fiduciary status under the Employee Retirement Income Security Act (ERISA) on any person who provides "investment advice or recommendations" to an IRA owner or to a retirement plan beneficiary.² This new test for fiduciary status under ERISA replaces the more complicated prior five-factor test under which many financial advisers to retirement savers were not ERISA fiduciaries.³

The DOL's main rationale for expanding the scope of ERISA fiduciary status was to impose the fiduciary duty of loyalty on financial advisers to retirement savers, thus ensuring that retirement savers receive financial advice that is unaffected by the personal financial interests of the adviser. Tellingly, the DOL rulemaking is entitled "conflict of interest rule" for "retirement investment advice."⁴ However, fiduciary status under ERISA imposes not only a trust law duty of loyalty but also a trust law duty of care. As the DOL acknowledged, a financial adviser to a retirement saver will now be subject to "trust law standards of care" in addition to "undivided loyalty."⁵

The purpose of this essay is to highlight the DOL's imposition of the trust law duty of care, and so the prudent investor rule, on financial advisers to retirement savers, and to explain the basics of that rule. In brief, the prudent investor rule codifies the essence of modern portfolio theory. The core teaching of portfolio theory is that an

¹ Securities typically involved in principal trades include government, municipal, or corporate debt, preferred securities, or brokered certificates of deposit as well as shares held by the firm as part of a firm-commitment initial public offering. *See* Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisers Under the Law of Agency*, J. Fin. Plan., Feb. 2014, at 45-46.

² Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 Fed. Reg. 20946, 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509–2510, and 2550).

³ *Id.* ("Today, as a result of the five-part test, many investment professionals, consultants, and advisers have no obligation to adhere to ERISA's fiduciary standards or to the prohibited transaction rules, despite the critical role they play in guiding plan and IRA investments.").

⁴ *Id.*

⁵ *Id.*

investor should maintain a well-diversified portfolio with a level of risk and return matched to her particular circumstances.

Under the prudent investor rule, a fiduciary must evaluate the principal's risk tolerance and investment goals, choose a commensurate level of overall portfolio market risk and expected return, and avoid wasteful diversifiable risk.⁶ Because of the multiplicity of relevant considerations – including the investor's risk preferences, age and health, career, family status and obligations, and other asset holdings and sources of income – application of the prudent investor rule is specific to an investor's particular circumstances. Crucially, however, the rule permits a wide variety of investment techniques, including active investment strategies,⁷ provided that the result is an overall portfolio with risk and return objectives reasonably suited to the investor. Under the prudent investor rule, which is principles-based rather than prescriptive, no type or kind of investment is categorically permissible or impermissible.⁸

In the wake of the DOL rulemaking, a financial advisory firm acts at its peril if it overlooks the prudent investor rule in updating its risk management and compliance protocols. By way of illustration, suppose that a firm were to accept management of a \$200 million retirement account concentrated in a single publicly traded security. If the firm fails to diversify the account portfolio within a reasonable time, the price of the concentrated security drops by half, and a diversified portfolio would have tripled, then the firm's liability exposure would be \$500 million.⁹

Application of the prudent investor rule to financial advisers to retirement savers creates new litigation risk for those advisers. But this risk is manageable with the compliance tools already in use by other fiduciaries, such as bank trust departments, that have long been subject to the prudent investor rule. The centerpiece of bank trust department compliance with the prudent investor rule is the "investment policy statement." Such a statement sets forth the individualized investment program created to match the account's purpose and risk tolerance with a diversified portfolio having an appropriate balance of risk and expected return. The Office of the Comptroller of the

⁶ See Unif. Prudent Inv'r Act §§ 2-3 (Unif. Law Comm'n 1994); Restatement (Third) of Trusts § 90 (Am. Law Inst. 2007).

⁷ "Prudent investment principles . . . allow the use of more active management strategies by trustees," if the costs are "justified" in comparison to "realistically evaluated return expectations." Restatement (Third) of Trusts § 90 cmt. h(2).

⁸ See Unif. Prudent Inv'r Act § 2(e) ("A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act]."); Restatement (Third) of Trusts § 90 cmt. f ("Specific investments or techniques are not per se prudent or imprudent.").

⁹ The \$500 million figure represents make-whole damages in the amount of the difference between the hypothetical prudent portfolio's value of \$600 million and the actual portfolio's value of \$100 million. See Restatement (Third) Trusts § 100 cmt. b(1) (Am. Law Inst. 2012) ("The recovery in such a case ordinarily would be the difference between (1) the value of those investments and their income and other product at the time of surcharge and (2) the amount of funds expended in making the improper investments, increased (or decreased) by a projected amount of total return (or negative total return) that would have accrued to the trust and its beneficiaries if the funds had been properly invested.").

Currency, the federal regulator that supervises bank trust departments, emphasizes the importance of an investment policy statement “in portfolio management risk control.”¹⁰

I. BACKGROUND

We begin by considering the background context for the DOL rulemaking, in particular (a) the rise of individual responsibility for managing retirement savings, (b) the prior patchwork fiduciary regulation of financial advisers to retirement savers, and (c) the DOL’s regulatory imposition of trust fiduciary law duties of loyalty and care on such advisers.

A. Individual Responsibility for Managing Retirement Savings

Over the past four decades, the bulk of retirement saving by American workers has shifted from defined benefit plans to defined contribution plans, such as 401(k) plans, and individual retirement accounts (IRAs).¹¹ In consequence, much of the responsibility for investment management of retirement savings has shifted from professional fiduciary managers of defined benefit plans to individual savers.¹²

The shift toward greater individual responsibility for investment management of retirement savings coincided with a proliferation of investment options. The variety of mutual funds available to investors, which now includes a large number of index and exchange-traded funds, has expanded substantially.¹³ There is a growing body of evidence, moreover, that retail investors are not well-equipped to make these choices. Many individual investors not only lack knowledge about finance but also face cognitive limits and behavioral quirks. When presented with a menu of mutual funds, for example, many retirement savers divide their investments equally across each of the offered funds, which is a kind of naïve diversification that is highly unlikely to achieve a portfolio appropriate to the saver’s circumstances.¹⁴ Even for sophisticated savers,

¹⁰ Comptroller of the Currency, Investment Management Services: Comptroller’s Handbook 1, 110 (Aug. 2001), <http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/invmgt.pdf> [hereinafter Comptroller’s Handbook].

¹¹ See, e.g., Council of Econ. Advisers, The Effects of Conflicted Investment Advice on Retirement Savings 1, 5 (Feb. 2015), https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf [hereinafter CEA Report] (“In 1978, traditional pensions accounted for nearly 70 percent of all retirement assets. Defined contribution plans accounted for less than 20 percent and IRAs accounted for only 2 percent. Annuities accounted for the remainder. By the end of 2013, traditional pensions accounted for only 35 percent of retirement assets, a decrease of 32 percentage points; defined contribution plans and IRAs accounted for more than half of all retirement assets.”).

¹² In the case of a defined contribution plan, the saver chooses from a menu of investment options provided by the plan sponsor. Although the sponsor has a fiduciary obligation in the creation and ongoing monitoring of the menu, see *Tibble v. Edison Int’l*, 135 S. Ct. 1823, 1828–29 (2015), the saver is on her own in allocating her account among the offered options. In the case of an IRA, almost all investment decisions are at the discretion of the saver. Rollovers from a defined contribution plan into an IRA are common.

¹³ See Investment Company Institute, 2015 Investment Company Fact Book (55th ed.), https://www.ici.org/pdf/2015_factbook.pdf.

¹⁴ See Shlomo Benartzi & Richard H. Thaler, Naïve Diversification Strategies in Defined Contribution Saving Plans, 91 Am. Econ. Rev. 79 (2001); Ning Tang et al., The Efficiency of Sponsor and Participant Portfolio Choices in 401(k) Plans, 94 J. Pub. Econ. 1073 (2010).

devising a portfolio from this vast array of investment options that matches one's retirement goals and tolerance for risk is a challenge.¹⁵

To cope with the bewildering array of investment alternatives, many retirement savers look to financial advisers for help in the management of their retirement savings. Expert advice is key to choosing a diversified portfolio with a balance of risk and return appropriate to the retirement goals of the saver. But the benefit of financial advice will be attenuated or even lost if the advice is tainted by a conflict of interest or is careless. The standard legal-regulatory solution to protect one party against another party's conflicts of interest or carelessness is fiduciary obligation.¹⁶

B. Patchwork Regulation of Financial Advisers

Prior to the DOL rulemaking, application of fiduciary principles to financial advisers to retirement savers was unsettled. To be sure, federal law imposed fiduciary status on some financial advisers under ERISA and under the Investment Advisers Act.¹⁷ But the prior five-factor test for ERISA fiduciary status excluded many forms of financial advice to a retirement saver,¹⁸ and the Investment Advisers Act applies only to a subset of financial advisers.¹⁹ Likewise, although state law imposes fiduciary status on an adviser who is an agent of the client,²⁰ and imposes fiduciary status on a non-agent adviser if the client justifiably reposes special trust and confidence on the adviser,²¹ these categories do not capture many kinds of financial advice to a retirement saver.

¹⁵ "Selecting and managing IRA investments can be a challenging and time-consuming task, frequently one of the most complex financial decisions in a person's life." CEA Report, *supra* note 11, at 2.

¹⁶ Formally these circumstances present a principal-agent or agency problem, with the divergence of interests between the adviser and the client giving rise to agency costs. *See, e.g.*, Robert H. Sitkoff, An Economic Theory of Fiduciary Law, in *Philosophical Foundations of Fiduciary Law* (Andrew S. Gold & Paul B. Miller, eds., 2014); Robert H. Sitkoff, The Economic Structure of Fiduciary Law, 91 B.U. L. Rev. 1039 (2011).

¹⁷ With respect to the latter, see 15 U.S.C. § 80b-6; *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) ("Congress recognized the investment advisor to be . . . a fiduciary.").

¹⁸ *See supra* note 3.

¹⁹ *See* 15 U.S.C. §§ 80b-2(11), 80b-3; *see also* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 Bus. Law. 395 (2010).

²⁰ *See, e.g.*, *O'Malley v. Boris*, 742 A.2d 845, 849 (Del. 1999) ("The relationship between a customer and stock broker is that of principal and agent. . . . [T]he broker must act in the customer's best interests and must refrain from self-dealing unless the customer consents, after full disclosure. These obligations at times are described as fiduciary duties of good faith, fair dealing, and loyalty. They are comparable to the fiduciary duties of corporate directors, and are limited only by the scope of the agency."); *see also* Sitkoff, *supra* note 1.

²¹ In *Burdett v. Miller*, 957 F.2d 1375 (7th Cir. 1992), for example, the court noted that "the relation between an investment advisor and the people he advises is not" a *per se* fiduciary category. *Id.* at 1381. But the court imposed fiduciary duties on the defendant investment adviser nonetheless. The plaintiff had "reposed trust and confidence" in the defendant, who had held himself out "to be expert as well as trustworthy." *Id.* The defendant had gained "influence and superiority over" the plaintiff by virtue of his claimed "expert knowledge the deployment of which the [plaintiff could not] monitor." *See also* *Patsos v. First Albany Corp.*, 741 N.E.2d 841, 849-50 (Mass. 2001) (similar); *Restatement (Third) of Agency* § 8.08 cmt. d (Am. Law Inst. 2006) ("[A] securities broker's duty may include the provision of advice and warnings when the broker's relationship with the client is one in which the client's trust and confidence are invited by the broker and given by the client.").

Against this backdrop of patchwork fiduciary regulation of financial advisers to retirement savers, in April 2016 the DOL promulgated an expansive new definition of fiduciary status under ERISA.²² The DOL expressly connected the increasing importance of self-directed retirement savings and the attendant reliance on advisers to the inadequacy of existing law as justification for the expansion of fiduciary status under ERISA: “The absence of adequate fiduciary protections and safeguards is especially problematic in light of the growth of participant-directed plans and self-directed IRAs, the gap in expertise and information between advisers and the customers who depend upon them for guidance, and the advisers’ significant conflicts of interest.”²³

Under the new DOL rule, which replaces the prior five-factor test for ERISA fiduciary status that had excluded many forms of financial advice to a retirement saver, any person who provides “investment advice or recommendations” to an IRA owner or to a pension plan beneficiary is an ERISA fiduciary.²⁴ Under controlling U.S. Supreme Court precedent, moreover, the particulars of ERISA fiduciary law derive from the law of trusts.²⁵ Accordingly, under the DOL rule financial advisers to retirement savers will now be subject to “trust law standards of care and undivided loyalty.”²⁶

C. Application of Trust Fiduciary Law

Under the trust law duty of loyalty, “a trustee has a duty to administer the trust solely in the interest of the beneficiaries. ... [T]he trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee’s fiduciary duties and personal interests.”²⁷ However, a “transaction that would otherwise violate a trustee’s duty of loyalty may be authorized by consent properly obtained from ... the trust beneficiaries.”²⁸ In accord with these trust law principles, the DOL rulemaking that imposes ERISA fiduciary status on

²² See Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509–2510, and 2550).

²³ Id. at 20956.

²⁴ Id. at 20946. The new rule covers a “recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA.” Id. at 20997. The rule also covers a “recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made.” Id. The term “‘recommendation’ means a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action. The determination of whether a ‘recommendation’ has been made is an objective rather than subjective inquiry.” Id.

²⁵ See *infra* notes 38–39 and text accompanying.

²⁶ 81 Fed. Reg. at 20946.

²⁷ Restatement (Third) of Trusts § 78(1)–(2) (Am. Law Inst. 2007).

²⁸ Id. cmt. c(3).

financial advisers to retirement savers also provides for a “Best Interest Contract Exemption” and a “Class Exemption for Principal Transactions” that “under conditions designed to safeguard the interests of these investors” allow for certain forms of conflicted compensation and principal trades if they are reasonable and fairly disclosed.²⁹

But fiduciary status under ERISA also imposes a duty of care in addition to a duty of loyalty. And this standard of care is objective. A trustee “has a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust.” Moreover, if a “trustee possesses, or procured appointment by purporting to possess, special facilities or greater skill than that of a person of ordinary prudence, the trustee has a duty to use such facilities or skill.”³⁰ Under controlling U.S. Supreme Court precedent as well as an earlier DOL rulemaking, the standard of care for an ERISA fiduciary in investment management is prescribed by the trust law “prudent investor rule.”³¹

II. THE PRUDENT INVESTOR RULE³²

We begin our review of the prudent investor rule with a look at the basics of modern portfolio theory, the Nobel Prize winning concept from financial economics upon which the prudent investor rule is based. Second, we canvass the particulars of the prudent investor rule, taking note of how the rule codifies the basic elements of modern portfolio theory. Third, we consider the principles-based nature of the prudent investor rule, and how it is applied toward a highly individualized investment program that matches the investor’s purpose and risk tolerance with a diversified portfolio having an appropriate balance of risk and expected return. Finally, we note the central role of an “investment policy statement” in sound fiduciary investment practice, and how the investment policy statement has been emphasized by another federal regulator, the Office of the Comptroller of the Currency, in its examinations of banks conducting fiduciary activities.

A. Modern Portfolio Theory

The key insight of modern portfolio theory, for which Professor Harry M. Markowitz was awarded a Nobel Prize in 1990,³³ is to differentiate between two kinds of investment risk in portfolio construction: market risk and idiosyncratic risk.

²⁹ Best Interest Contract Exemption, 81 Fed. Reg. 21002, 21002 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2550); *see also* Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, 81 Fed. Reg. 21089 (Apr. 8, 2016) (to be codified at 29 CFR Pt. 2550).

³⁰ Restatement (Third) of Trusts § 77(1), (3) (Am. Law Inst. 2007).

³¹ *See infra* notes 37-39 and text accompanying.

³² Portions of the ensuing analysis are derived without further citation from Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Market Risk: An Empirical Analysis*, ___ J. Emp. Legal Stud. ___ (forthcoming), available at <http://ssrn.com/abstract=2583775>.

Market risk is inherent to participating in the market, reflecting the tendency to some extent for the market as a whole to move together. Market risk can be avoided only by avoiding the market, such as by holding cash or short-term government bonds. Generally speaking, to obtain a greater expected return, an investor must take on additional market risk. Because an investor's expected return increases with added exposure to market risk, such risk is sometimes called "compensated risk."

Idiosyncratic risk, by contrast, is particular to a given investment, reflecting the fact that different investments react differently to certain changes in circumstances. A breakthrough in solar power, for example, would increase the value of an investment in an energy-dependent manufacturing company but would decrease the value of an investment in a coal company. By holding a diversified investment portfolio, that is, by holding many different investments with imperfectly correlated idiosyncratic risks, an investor can minimize or even eliminate overall idiosyncratic risk. It follows, therefore, that each individual investment must be evaluated in light of its contribution to overall portfolio risk and expected return.

Modern portfolio theory thus teaches that prudent portfolio construction requires: (1) assessing the individual investor's risk tolerance and investment purposes; (2) choosing a portfolio with a commensurate level of market risk and expected return; and (3) diversifying away to the extent feasible unnecessary idiosyncratic risk. Prudent portfolio management also requires ongoing monitoring and periodic rebalancing in light of changing circumstances.

B. The Prudent Investor Rule

The centerpiece of the law of fiduciary investment, both under ERISA and under trust law, is the prudent investor rule. As canonically stated by the Restatement (Third) of Trusts (1992)³⁴ and the Uniform Prudent Investor Act (1994), the prudent investor rule codifies the learning from modern portfolio theory about the distinction between market risk and idiosyncratic risk in two ways. First, "[a] trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust."³⁵ Second, a trustee must "diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."³⁶

As interpreted by the DOL and the U.S. Supreme Court, an ERISA fiduciary must adhere to the prudent investor rule. Under a 1979 DOL regulation, ERISA § 404(a)

³³ Harry M. Markowitz - Facts, Nobel Prize, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1990/markowitz-facts.html (last visited Sep. 4, 2015).

³⁴ The 1992 Restatement provision on the prudent investor rule was superseded without material changes by Restatement (Third) of Trusts § 90 (Am. Law Inst. 2007).

³⁵ Unif. Prudent Inv'r Act § 2(b) (Unif. Law Comm'n 1994); *see also* Restatement (Third) of Trusts § 90(a).

³⁶ Unif. Prudent Inv'r Act § 3; *see also* Restatement (Third) of Trusts § 90(b).

requires an ERISA fiduciary to consider each investment “as part of the portfolio” and “with regard to diversification.”³⁷ Moreover, in applying ERISA fiduciary law, the Supreme Court has “often noted that an ERISA fiduciary’s duty is ‘derived from the common law of trusts.’”³⁸ In *Tibble v. Edison International* (2015), for example, the Court relied extensively on the Restatement (Third) of Trusts and the Uniform Prudent Investor Act, treating both as authoritative expositions of the principles applicable under ERISA to fiduciary investment matters.³⁹

Accordingly, under both trust law and ERISA, the prudent investor rule requires a fiduciary to evaluate the investor’s risk tolerance and investment goals, choose a commensurate level of overall portfolio market risk and expected return, and avoid wasteful idiosyncratic risk.⁴⁰ At the outset of the fiduciary relationship, the fiduciary has a “reasonable time” to “make and implement” a compliant investment program.⁴¹ What constitutes a reasonable time is context-specific, depending on factors such as the liquidity of the inception portfolio assets and the tax and other transaction costs of reallocation.⁴²

After the initial portfolio construction, a fiduciary remains under an “ongoing duty to monitor investments and to make portfolio adjustments if and as appropriate,”⁴³ for example, by rebalancing the portfolio in light of actual investment performance and changes in the investor’s circumstances. In the words of the U.S. Supreme Court, “a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee’s duty to exercise prudence in selecting investments at the outset.”⁴⁴ The prudent investor rule thus governs the fiduciary’s “continuing responsibility for oversight of the suitability of investments already made” as well as the fiduciary’s “decisions respecting new investments.”⁴⁵

Crucially, however, the rule permits a wide variety of investment techniques, including active investment strategies,⁴⁶ provided that the result is an overall portfolio

³⁷ See 29 U.S.C. § 1104(a) (2013), as interpreted in 29 C.F.R. § 2550.404a-1(b) (2014).

³⁸ *Tibble v. Edison Int’l*, 135 S. Ct. 1823, 1828 (2015); see also Comptroller’s Handbook, supra note 10, at 116 (“ERISA’s statutory and regulatory standards for prudent investing, diversification, and delegation of pension plan fiduciaries are also reflected in the Restatement (Third).”).

³⁹ See *Tibble*, 135 S. Ct. at 1828.

⁴⁰ Jesse Dukeminier & Robert H. Sitkoff, *Wills, Trusts, and Estates* 635 (9th ed. 2013) surveys examples of “special circumstances” that could justify not diversifying and so bearing idiosyncratic risk.

⁴¹ Unif. Prudent Inv’r Act § 4; Restatement (Third) of Trusts § 92. Federal law likewise requires national banks, “[u]pon the acceptance of a fiduciary account for which [the bank] has investment discretion, . . . [to] conduct a prompt review of all assets of the account to evaluate whether they are appropriate for the account.” 12 C.F.R. § 9.6(b) (2014).

⁴² See Restatement (Third) of Trusts § 92 cmt. b.

⁴³ *Id.* § 90 cmt. e(1).

⁴⁴ *Tibble*, 135 S. Ct. at 1828–29.

⁴⁵ Unif. Prudent Inv’r Act § 2 cmt.

⁴⁶ “Prudent investment principles . . . allow the use of more active management strategies by trustees,” if the costs are “justified” in comparison to “realistically evaluated return expectations.” Restatement (Third) of Trusts § 90 cmt. h(2) (Am. Law Inst. 2007).

with risk and return objectives reasonably suited to the investor. Under the prudent investor rule, no type or kind of investment is categorically permissible or impermissible.⁴⁷ Instead, the question is the suitability of the overall portfolio with the investor's risk and return objectives. The prudent investor rule, in other words, is principles-based rather than prescriptive.

C. The Prudent Investor Rule is Principles-Based

Application of modern portfolio theory under the prudent investor rule is highly contextual. “[T]olerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries.”⁴⁸ Choosing the “appropriate degree of risk” for an investment portfolio involves “quite subjective judgments that are essentially unavoidable in the process of asset management.”⁴⁹ Moreover, proper diversification requires an assessment of the portfolio as a whole, including the other assets of the investor.⁵⁰ Assessing the proper amount of market risk and proper diversification strategies for a given investor thus requires a highly individualized consideration.

For example, time to retirement and an investor's overall wealth are important factors in determining risk tolerance for a retirement account. But they are not the only relevant factors. Even investors who are similar in age and wealth are nonetheless likely to have differences in risk preferences, health, and family circumstances that merit more or less risky portfolios. Unique financial circumstances, such as employment security and ownership of illiquid assets (e.g., homes or family businesses), also affect risk tolerance. Given the multiplicity of relevant factors, the law recognizes that “no objective, general legal standard can be set for a degree of risk that is or is not prudent.”⁵¹

Diversification to manage idiosyncratic risk must also be an individuated decision, even in the retirement context, because an IRA or other retirement account may not reflect the investor's entire wealth. Consider an investment in a mutual fund that holds foreign stocks. Adding this investment could improve overall portfolio efficiency for an investor who held only domestic issues. But for an investor who was already heavily exposed to foreign stock markets in other accounts (retirement or otherwise), the same investment would reduce portfolio efficiency. Likewise, an investment in a mutual fund focused on small cap stocks could benefit an investor whose overall portfolio was overweighted in large cap stocks. But the very same investment could injure an investor

⁴⁷ See Unif. Prudent Inv'r Act § 2(e) (“A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].”); Restatement (Third) of Trusts § 90 cmt. f (“Specific investments or techniques are not per se prudent or imprudent.”).

⁴⁸ Id.

⁴⁹ Restatement (Third) of Trusts § 90 cmt. e(1).

⁵⁰ See Dukeminier & Sitkoff, *supra* note 40, at 635 (“Diversification might not be necessary if the trust is but one piece of a larger program of wealth management such that the beneficiary's financial interests are diversified overall. [Uniform Prudent Investor Act] §2(c)(6) . . . lists ‘other resources of the beneficiaries’ as a relevant circumstance to be considered ‘in investing and managing trust assets.’”).

⁵¹ Restatement (Third) of Trusts § 90 cmt. e(1).

whose overall portfolio already contained small cap stocks. Generally speaking, portfolio efficiency is improved by exposure to a variety of industries. However, an investor whose wholly owned small business was a technology company should probably avoid heavy investment in other technology stocks given the likely correlation between the performance of those stocks and the investor's own small business.

D. The Investment Policy Statement

To ensure an orderly and rational process toward assessing the appropriate balance of risk and expected return in a fiduciary account, banks and other corporate fiduciaries typically require the preparation of "a written investment policy statement for each new trust account, reciting investment guidelines that reflect the purpose of the trust and the risk tolerance of the beneficiaries."⁵² An investment policy statement will normally specify "the account's risk tolerance" as well as its "investment goals and return requirements" in light of the particular circumstances of the account.⁵³ An investment policy statement will also normally specify "asset allocation guidelines."⁵⁴ The normal and customary practice, which reflects the requirements of the prudent investor rule, is to apply portfolio theory in "deciding how to allocate portfolio assets among the major asset categories."⁵⁵ To the extent feasible, the "portfolio's assets must be viewed together with the client's other assets."⁵⁶

Among other benefits, an investment policy statement facilitates "[r]ebalancing ... to maintain proper diversification," ensuring that the "portfolio avoids 'allocation drift' by not straying far from its targeted levels of risk and return."⁵⁷

Portfolio monitoring and revision is a continual and complicated process that requires extensive analysis and sound judgment. Asset categories may become over- or under-weighted in relation to the asset allocation guidelines because the returns on individual asset categories will vary over time. Portfolio re-balancing involves restoring the portfolio to appropriate percentage allocation ranges.⁵⁸

An investment policy statement also provides a "'paper trail' in the event of an audit, litigation, or a dispute,"⁵⁹ and it facilitates selection of "an appropriate performance benchmark" against which to compare the account's performance.⁶⁰

⁵² Dukeminier and Sitkoff, *supra* note 40, at 634. Consistent with the higher standard of care expected of a professional trustee, courts have rebuked bank trustees for failing in a timely manner to "establish an investment plan." *See, e.g.,* *In re Estate of Janes*, 681 N.E.2d 332, 338 (N.Y. 1997); *see also* *In re Hunter*, 955 N.Y.S.2d 163, 165 (App. Div. 2012).

⁵³ Comptroller's Handbook, *supra* note 10, at 106-07; *see also* fi360, Prudent Practices for Investment Advisors 47 (2013), http://www.fi360.com/main/pdf/handbook_advisor.pdf (An investment policy statement will normally specify "risk, return, and time horizon parameters" and will define "diversification and rebalancing guidelines.").

⁵⁴ Comptroller's Handbook, *supra* note 10, at 107.

⁵⁵ *Id.*

⁵⁶ *Id.* at 106.

⁵⁷ fi360, *supra* note 53, at 48.

⁵⁸ Comptroller's Handbook, *supra* note 10, at 111.

⁵⁹ fi360, *supra* note 53, at 48.

The Investment Management Handbook published by the Comptroller of the Currency summarizes thus:

The creation of an appropriate investment policy document, or statement, is the culmination of analyzing the investment assignment, identifying investment objectives, determining asset allocation guidelines, and establishing performance measurement benchmarks. The lack of an investment policy statement, or the existence of a poorly developed one, is a weakness in portfolio management risk control.⁶¹

Crucially, each investment policy statement is highly individualized to the circumstances of the particular account, matching the investor's purpose and risk tolerance with a diversified portfolio having an appropriate balance of risk and expected return in light of the circumstances. Moreover, because those circumstances will likely evolve over time, the normal fiduciary practice is to undertake a periodic "investment policy review to analyze performance and reaffirm or change the investment policy, including asset allocation guidelines," as warranted by changed circumstances.⁶²

Conclusion

Concerned about conflicts of interest among financial advisers to retirement savers, in April 2016 the DOL finalized a rulemaking that imposes ERISA fiduciary status on any person who provides "investment advice or recommendations" to an IRA owner or to a retirement plan beneficiary.⁶³ Tellingly, the rulemaking is entitled "conflict of interest rule" for "retirement investment advice."⁶⁴ However, fiduciary status under ERISA imposes not only a duty of loyalty but also a duty of care. As the DOL acknowledged, a financial adviser to a retirement saver will now be subject to "trust law standards of care" in addition to "undivided loyalty."⁶⁵

The trust law fiduciary standard of care as applied to investment management is prescribed by the prudent investor rule. Under the prudent investor rule, no type or kind of investment is categorically permissible or impermissible. Instead, a fiduciary must evaluate the principal's risk tolerance and investment goals, choose a commensurate level of overall portfolio market risk and expected return, and avoid wasteful diversifiable risk. Because of the multiplicity of relevant considerations – including the investor's risk preferences, age and health, family status and obligations, and other asset holdings and sources of income – application of the prudent investor rule is specific to an investor's particular circumstances. Accordingly, the rule permits a wide variety of investment techniques, including active investment strategies, provided

⁶⁰ Comptroller's Handbook, *supra* note 10, at 108-10.

⁶¹ *Id.* at 110.

⁶² *Id.* at 112.

⁶³ Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 Fed. Reg. 20946, 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509-2510, and 2550).

⁶⁴ *Id.*

⁶⁵ *Id.*

that the result is an overall portfolio with risk and return objectives reasonably suited to the investor. The rule is principles-based rather than prescriptive.

Application of the prudent investor rule to financial advisers to retirement savers creates new litigation risk for those advisers. In the wake of the DOL rulemaking, therefore, a financial advisory firm acts at its peril if it overlooks the prudent investor rule. But compliance with the rule is feasible with the tools already in use by other fiduciaries, such as bank trust departments, that have long been subject to the prudent investor rule. The centerpiece of bank trust department compliance with the prudent investor rule is the "investment policy statement." Such a statement sets forth the individualized investment program created to match the account's purpose and risk tolerance with a diversified portfolio having an appropriate balance of risk and expected return.