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Financial Advisers Can't Overlook the Prudent Investor Rule

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To protect the integrity of financial advice to retirement savers, in April 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.[1] 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, obligating those advisers to give financial advice that is unaffected by the personal financial interests of the adviser.

Tellingly, the DOL rulemaking is titled "Conflict of Interest Rule" for "retirement investment advice."[2] 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."[3] With respect to investment management, the standard of care under trust fiduciary law is prescribed by the prudent investor rule.

The purpose of this article 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. In brief, the prudent investor rule codifies the essence of modern portfolio theory. The core teaching of portfolio theory is that an 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.[4] 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.

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.[5]

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.

ERISA Fiduciary Law Derives From Trust Fiduciary Law

Under controlling U.S. Supreme Court precedent, the particulars of ERISA fiduciary law derive from the law of trusts. Accordingly, under the DOL rule, financial advisers to retirement savers will now be subject to "trust law standards of care and undivided loyalty."[6]

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."[7] However, a "transaction that would otherwise violate a trustee's duty of loyalty may be authorized by consent properly obtained from … the trust beneficiaries."[8] In accordance with these trust law principles, the DOL rulemaking that imposes ERISA fiduciary status on 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.[9]

But fiduciary status under ERISA also imposes a trust law duty of care in addition to a duty of loyalty. This fiduciary 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."[10]

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."

The Prudent Investor Rule

Our review of the prudent investor rule is organized in four parts. First, we review the basics of modern portfolio theory, the 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.

Modern portfolio theory. The key insight of modern portfolio theory, for which Harry Markowitz was awarded a Nobel Prize in 1990, is to differentiate between two kinds of investment risk in portfolio construction: market risk and idiosyncratic risk. Market risk is inherent to participating in the market, reflecting the tendency to some extent for the market as a whole to move together. A portfolio's market risk can be reduced by replacing more volatile investments (such as stocks) with less volatile investments (such as bonds). But market risk can be avoided only by avoiding the market by holding cash or cash equivalents. 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 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 diversifying across different investments with imperfectly correlated idiosyncratic risks, an investor can minimize 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.

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)[11] 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."[12] 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."[13]

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) requires an ERISA fiduciary to consider each investment "as part of the portfolio" and "with regard to diversification."[14] 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.'"[15] 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.[16]

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.[17] At the outset of the fiduciary relationship, the fiduciary has a "reasonable time" to "make and implement" a compliant investment program.[18] 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.[19]

After the initial portfolio construction, a fiduciary remains under an "ongoing duty to monitor investments and to make portfolio adjustments if and as appropriate,"[20] 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."[21] The prudent investor rule thus governs a fiduciary's "continuing responsibility for oversight of the suitability of investments already made as well as … decisions respecting new investments."[22]

Crucially, however, the rule permits a wide variety of investment techniques, including active investment strategies,[23] provided that the result is an overall portfolio 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.[24] Instead, the question is the reasonableness of the overall portfolio in light of the investor's risk and return objectives. The prudent investor rule, in other words, is principles-based rather than prescriptive.

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."[25] Choosing the "appropriate degree of risk" for an investment portfolio involves "quite subjective judgments that are essentially unavoidable in the process of asset management."[26] Moreover, proper diversification requires an assessment of the portfolio as a whole, including the other assets of the investor.[27]

Assessing the proper amount of market risk and proper diversification strategies for a given investor thus requires a highly individualized consideration. Time to retirement and an investor's overall wealth are among the more obvious of the many relevant factors. Given the multiplicity of relevant considerations, the law recognizes that "no objective, general legal standard can be set for a degree of risk that is or is not prudent."[28]

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 the investor's overall portfolio efficiency.

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 "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."[29] 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.[30] An investment policy statement will also normally specify "asset allocation guidelines."[31] 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."[32] To the extent feasible, the "portfolio's assets must be viewed together with the client's other assets."[33]

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."[34] The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* for investment management services explains:

> 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.[35]

An investment policy statement also provides a paper trail in the event of an audit, litigation, or a dispute,[36] and it facilitates selection of "an appropriate performance benchmark" against which to compare the account's performance.[37]

The OCC's *Comptroller's Handbook* 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.[38]

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.[39]

Conclusion

The ERISA fiduciary standard of care as applied to investment management is prescribed by trust law's 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 particular risk tolerance and investment goals, choose a commensurate level of overall portfolio market risk and expected return, and avoid wasteful diversifiable risk. Although the prudent investor rule permits a wide variety of investment techniques, the result must be an overall portfolio with risk and return objectives reasonably suited to the investor.

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 ensuring compliance with the rule is feasible with the tools, such as the investment policy statement, that are already used by other fiduciaries. ■

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Endnotes

1. "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice" (81 Fed. Reg. at 20946, 20946 [April 8, 2016] to be codified at 29 C.F.R. pts. 2509–2510, and 2550).
2. Id.
3. Id.
4. See *Unif. Prudent Inv'r Act* §§ 2-3 (Unif. Law Comm'n 1994); *Restatement (Third) of Trusts* § 90 (Am. Law Inst. 2007).
5. 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).
6. 81 Fed. Reg. at 20946.
7. *Restatement (Third) of Trusts* § 78(1)-(2) (Am. Law Inst. 2007).
8. Id. cmt. c(3).
9. 81 Fed. Reg. 21002, 21002 (April 8, 2016) (to be codified at 29 C.F.R. pt. 2550); see also 81 Fed. Reg. 21089 (April 8, 2016) (to be codified at 29 CFR Pt. 2550).
10. *Restatement (Third) of Trusts* § 77(1), (3).
11. The 1992 restatement provision on the prudent investor rule was superseded without material changes by *Restatement (Third) of Trusts* § 90 (Am. Law Inst. 2007).
12. *Unif. Prudent Inv'r Act* § 2(b) (Unif. Law Comm'n 1994); see also *Restatement (Third) of Trusts* § 90(a).
13. *Unif. Prudent Inv'r Act* § 3; see also *Restatement (Third) of Trusts* § 90(b).
14. 29 U.S.C. § 1104(a) (2013), as interpreted in 29 C.F.R. § 2550.404a-1(b) (2014).
15. *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828 (2015).
16. See id.
17. For a survey of special circumstances that could justify not diversifying and so bearing idiosyncratic risk, see the 2013 text *Wills, Trusts, and Estates, 9th edition* by Jesse Dukeminier and Robert H. Sitkoff.
18. *Unif. Prudent Inv'r Act* § 4; *Restatement (Third) of Trusts* § 92.
19. *Restatement (Third) of Trusts* § 92 cmt. b.
20. Id. § 90 cmt. e(1).
21. *Tibble*, 135 S. Ct. at 1828–29.
22. *Unif. Prudent Inv'r Act* § 2 cmt.
23. *Restatement (Third) of Trusts* § 90 cmt. h(2).
24. See *Unif. Prudent Inv'r Act* § 2(e); *Restatement (Third) of Trusts* § 90 cmt. f.
25. Id.
26. *Restatement (Third) of Trusts* § 90 cmt. e(1).
27. Dukeminier and Sitkoff, supra note 17, at 635.
28. *Restatement (Third) of Trusts* § 90 cmt. e(1).
29. Dukeminier and Sitkoff, supra note 17, at 634.
30. *Investment Management Services: Comptroller's Handbook* (Aug. 2001) 106–107; see also fi360's *Prudent Practices for Investment Advisors* (2013) 47.
31. *Comptroller's Handbook*, supra note 30, at 107.
32. Id.
33. Id. at 106.
34. fi360, supra note 30, at 48.
35. *Comptroller's Handbook*, supra note 30, at 111.
36. fi360, supra note 30, at 48.
37. *Comptroller's Handbook*, supra note 30, at 108–10.
38. Id. at 110.
39. Id. at 112.

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