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Fiduciary Financial Advisers and the Incoherence of a “High-Quality Low-Fee” Safe Harbor

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Abstract

Americans now hold trillions of dollars in individual retirement savings accounts. Concerned about conflicts of interest among financial advisers who provide advice to retirement savers, the Department of Labor has proposed imposing fiduciary status and a “best interest” standard on such advisers. To ameliorate the resulting compliance costs, the DOL has also raised the possibility of a safe harbor for certain “high-quality low-fee investments.” However, the notion of a “high-quality” investment is in irreconcilable tension with the highly individualized assessment of risk and return that is required by modern portfolio theory, the well-accepted concept from financial economics that has been codified in the “prudent investor rule” as the standard of care for fiduciary investment. This policy incoherence is worrisome because of the potential for the safe harbor to swallow the best interest standard.

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Introduction

Today the bulk of retirement saving by American workers, 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 navigating the vast and complicated array of investment options in today's financial markets. Some of these advisers are compensated by commissions or service fees from the providers of products the adviser sells, raising conflict of interest concerns.

To protect the integrity of financial advice to retirement savers, the Department of Labor (DOL) has proposed a new regulation that would impose "fiduciary" status on any person who provides "investment advice or recommendations" to an IRA owner or to a retirement plan beneficiary.¹ Under the proposal, financial advisers to retirement savers, including IRA holders, would be subject to "trust law standards of care [i.e., prudence] and undivided loyalty."² The aim of the proposal is to ensure that all retirement savers receive advice that is in the best interest of the saver, that is, advice that is both competent and unaffected by a conflict of interest.

The centerpiece of the DOL proposal is a "Best Interest Contract" exemption that in implementation of the duty of loyalty would regulate conflicted compensation arrangements.³ Under this exemption, an adviser could receive conflicted compensation if the adviser's recommendations were nonetheless in the "best interest" of the client (a substantive safeguard) and if the adviser adopted protocols to mitigate conflicts of interest (a process safeguard). As regards the duty of care or prudence, the DOL's expectation is that the "best interest" standard would "be interpreted in light of forty years of judicial experience with ERISA's fiduciary standards and hundreds more with the duties imposed on trustees under the common law of trusts."⁴

In light of the potential compliance costs from the "best interest" fiduciary standard, the DOL has also raised the possibility of a safe harbor for certain "high-quality low-fee investments."⁵ As framed by the materials released by the DOL thus far, any investment falling within the "high-quality low-fee" safe harbor would be per se permissible. In effect, an investment deemed "high quality" and "low cost" would be conclusively presumed to be in the "best interest" of the retirement saver. The assumption underlying the safe harbor is "that certain high-quality investments are provided pursuant to fee structures in which the payments are sufficiently low that they do not present serious potential material conflicts of interest."⁶

¹ Definition of the Term "Fiduciary"; Conflict of Interest Rule— Retirement Investment Advice, 80 Fed. Reg. 21928 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509–2510).

² Id. at 21928.

³ See Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21960 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550).

⁴ Id. at 21970.

⁵ Definition of the Term "Fiduciary," 80 Fed. Reg. at 21929.

⁶ Proposed Best Interest Contract Exemption, 80 Fed. Reg. at 21978.

The rationale for the safe harbor focuses almost exclusively on the problem of conflicts of interest, that is, the fiduciary duty of loyalty. But fiduciary status also includes a duty of care or prudence. And the DOL's analysis does not address whether a "high-quality low-fee" safe harbor is sensible with respect to portfolio construction under the fiduciary duty of prudence. In fact, the notion of a "high-quality" investment is in irreconcilable tension with the highly individualized assessment of risk and return that is required by modern portfolio theory and the "prudent investor rule" of fiduciary investment law. Given the uncertainty, litigation risk, and compliance costs of the best interest standard, there is good reason rooted in theory and prior empirical study to suppose that many advisers will opt for the safe harbor. It is critical, therefore, that the safe harbor be consistent with the controlling law and well-accepted economics of fiduciary investment.

The basic idea of modern portfolio theory is that an investor should undertake to maximize return and minimize risk, matching the risk and expected return of her overall investment portfolio to her particular circumstances. Accordingly, the prudent investor rule requires a fiduciary to evaluate the investor's risk tolerance and investment goals, choose a level of overall portfolio market risk and expected return that is commensurate with that risk tolerance and goals, and avoid wasteful diversifiable risk. 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 support – necessarily requires an investor-specific analysis that cannot be captured in a safe harbor. What is a "high-quality" investment for one investor may entail too much risk for another. And indeed, what is a "high-quality" investment for a given investor today will change as the investor's circumstances change. 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."⁷

There is much to commend in the DOL's effort to bring fiduciary investment principles to retirement saving. But the DOL's suggestion of a safe harbor for "high-quality low-fee" investments is misguided. Apart from the risk that the safe harbor will in effect displace the rule, a safe harbor for "high quality" investments is in irreconcilable tension with the law and economics of fiduciary investment. A core principle in both the controlling law and the well-accepted economics of fiduciary investment is that no type or kind of investment can be deemed categorically "high-quality" for all investors at all times.

Individual Responsibility for Managing Retirement Savings

Over the past four decades, the bulk of retirement saving by American workers, measuring in the trillions of dollars, has shifted from defined benefit plans to defined contribution plans and individual retirement accounts (IRAs).⁸ In consequence, much of

⁷ *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828 (2015).

⁸ See, e.g., Council of Econ. Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings* 5 (Feb. 2015), https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf

the responsibility for investment management of retirement savings has shifted from professional fiduciary managers of defined benefit plans to individual savers. 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,⁹ 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.

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 has expanded substantially, for example, and now includes a large number of index and exchange-traded funds.¹⁰ Devising a portfolio from this vast array of investment options that matches one's retirement goals and tolerance for risk is a challenge for even sophisticated investors. There is a growing body of evidence, moreover, that retail investors are not generally sophisticated. 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.¹¹

Toward Fiduciary Financial Advisers

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. "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, and many Americans turn to professional advisers for assistance."¹² Expert advice is key to choosing a diversified portfolio with an appropriate balance of risk and return given the retirement goals of the saver. But the benefit of financial advice will be attenuated or even lost if the advice is incompetent (i.e., imprudent) or is tainted by a conflict of interest (i.e., disloyal).¹³

[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.").

⁹ See Tibble, 135 S. Ct. at 1828–29.

¹⁰ See Investment Company Institute, 2015 Investment Company Fact Book (55th ed.), https://www.ici.org/pdf/2015_factbook.pdf.

¹¹ 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).

¹² CEA Report, supra note 8, at 2.

¹³ Formally this is 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

When one person reposes “trust and confidence” in another person at the other person’s invitation and in reasonable reliance on the other person’s expertise, the law commonly deems the other person a fiduciary subject to duties of loyalty and prudence (or care).¹⁴ Application of this principle to a financial adviser to a retirement saver is unsettled, however, owing to an inconsistent patchwork of state and federal law. The extent to which (if at all) the law currently imposes fiduciary status on a financial adviser to a retirement saver depends on whether under federal law the adviser is a registered financial adviser, a broker-dealer, or otherwise,¹⁵ and whether under state law the adviser is an agent of the client or otherwise has had special trust and confidence reposed in him.¹⁶

Against this backdrop of patchwork regulation of financial advisers to retirement savers, in April of 2015 the Department of Labor (DOL) proposed a sweeping new definition of “fiduciary” status under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (the tax code).¹⁷ In the words of the DOL: “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.”¹⁸

Under the DOL proposal, a person who provides “investment advice or recommendations” to an IRA owner or to a pension plan beneficiary would be deemed a fiduciary.¹⁹ Under the proposal, therefore, financial advisers to retirement savers,

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).

¹⁴ See, e.g., *Wiener v. Lazard Freres & Co.*, 672 N.Y.S.2d 8, 14 (App. Div. 1998) (noting that fiduciary obligation may arise if “a party reposed confidence in another and reasonably relied on the other’s superior expertise or knowledge”); Restatement (Third) of Agency § 8.01 cmt. c (Am. Law Inst. 2006) (noting imposition of fiduciary obligation “on the basis that one party to the relationship has in fact reposed trust and confidence in the other and has done so consistently with the other’s invitation”); see also Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisers Under the Law of Agency*, J. Fin. Plan., Feb. 2014, at 42.

¹⁵ See, e.g., Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 Bus. Law. 395 (2010).

¹⁶ 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.” *Id.*

¹⁷ See Definition of the Term “Fiduciary”; Conflict of Interest Rule – Retirement Investment Advice, 80 Fed. Reg. 21928 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509–2510).

¹⁸ *Id.* at 21935.

¹⁹ *Id.* at 21928. “Under the [proposal], a person renders investment advice by (1) providing investment or investment management recommendations or appraisals to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA owner or fiduciary, and (2) either (a) acknowledging the fiduciary nature of the advice, or (b) acting pursuant to an agreement, arrangement, or understanding with the advice recipient that the advice is individualized to, or specifically directed to, the recipient for consideration in making investment or management decisions regarding plan assets.” *Id.* at 21929.

including IRA holders, would be subject to “trust law standards of care [i.e., prudence] and undivided loyalty.”²⁰ The trust law duty of care or prudence imposes an objective standard of care.²¹ The trust law duty of undivided loyalty prohibits conflicts of interests.²²

Conflicts of Interest and Fiduciary Status

The DOL’s analysis of the proposal focuses almost exclusively on the problem of advisers’ financial conflicts of interest:

Today, individual retirement investors have much greater responsibility for directing their own investments, but they seldom have the training or specialized expertise necessary to prudently manage retirement assets on their own. As a result, they often depend on investment advice for guidance on how to manage their savings to achieve a secure retirement. In the current marketplace for retirement investment advice, however, advisers commonly have direct and substantial conflicts of interest, which encourage investment recommendations that generate higher fees for the advisers at the expense of their customers and often result in lower returns for customers even before fees.²³

In imposing a fiduciary standard on all advisers to retirement savers, the DOL aims to ensure that all retirement savers receive competent advice that is in the best interest of the saver without bias from the adviser’s personal benefit.²⁴

A fiduciary who receives compensation from an entity whose investment products the fiduciary recommends presumptively breaches the duty of loyalty. But conflicted advice is not always against the interests of the client. For example, the fact that a mutual fund pays 12b-1 fees should not, by itself, exclude that fund as a permissible investment for retirement savers, as the DOL’s proposal recognizes.²⁵ Indeed, the common law of trusts tolerates authorized conflicts of interests, provided that the trustee acts fairly and in good faith in pursuit of the beneficiary’s best interest.²⁶ That is, trust law regulates authorized conflicts of interest rather than categorically prohibiting them. For example, the Uniform Trust Code provides that an investment in a mutual fund that pays the trustee fees for services is not presumptively a breach of the

²⁰ Id. at 21928.

²¹ See Restatement (Third) of Trusts § 77 (Am. Law Inst. 2007).

²² See id. § 78.

²³ Definition of the Term “Fiduciary,” 80 Fed. Reg. at 21930.

²⁴ See id. at 21933 (“Even when plan sponsors, participants, beneficiaries, and IRA owners clearly rely on paid advisers for impartial guidance, the regulation allows many advisers to avoid fiduciary status and disregard ERISA’s fiduciary obligations of care and prohibitions on disloyal and conflicted transactions. As a consequence, these advisers can steer customers to investments based on their own self-interest (e.g., products that generate higher fees for the adviser even if there are identical lower-fee products available), give imprudent advice, and engage in transactions that would otherwise not be permitted by ERISA and the Code without fear of accountability under either ERISA or the Code.”).

²⁵ See Proposed Best Interest Contract Exemption, 80 Fed. Reg. at 21961.

²⁶ See Restatement (Third) of Trusts § 78 cmt. c(2); Jesse Dukeminier & Robert H. Sitkoff, *Wills, Trusts, and Estates* 591, 593 (9th ed. 2013).

duty of loyalty.²⁷ More generally, in an authorized conflict-of-interest situation, the trustee may act, but “the conduct of the trustee ... will be subject to especially careful scrutiny.”²⁸

The “Best Interest Contract” Exemption: Regulation Instead of Prohibition

In recognition of the over-inclusiveness of an absolute prohibition on conflicted compensation for advisers to retirement savers, the DOL has proposed several new prohibited transaction exemptions (PTEs) and revisions to existing PTEs that, taken together, are meant to regulate conflicted compensation arrangements rather than prohibit them categorically. The centerpiece is the “Best Interest Contract” exemption.²⁹ Under this exemption, a conflicted compensation arrangement would be permissible if the underlying investment is in the “best interest” of the client (a substantive safeguard) and if the adviser adopted protocols to mitigate conflicts of interest (a process safeguard).³⁰ To qualify, an adviser must

contractually acknowledge fiduciary status, commit to adhere to basic standards of impartial conduct, warrant that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and disclose basic information on their conflicts of interest and on the cost of their advice. The adviser and firm must commit to fundamental obligations of fair dealing and fiduciary conduct – to give advice that is in the customer’s *best interest*; avoid misleading statements; receive no more than reasonable compensation; and comply with applicable federal and state laws governing advice.³¹

²⁷ Uniform Trust Code § 802(f) (amended 2004) provides as follows:

An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the prudent investor rule of [Article] 9. In addition to its compensation for acting as trustee, the trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust. If the trustee receives compensation from the investment company or investment trust for providing investment advisory or investment management services, the trustee must at least annually notify the persons entitled under Section 813 to receive a copy of the trustee’s annual report of the rate and method by which that compensation was determined.

²⁸ Restatement (Third) of Trusts § 37 cmt. f(1); *see also* Dukeminier & Sitkoff, *supra* note 26, at 593.

²⁹ *See* Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21960 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550). Another important exception is for principal trades, *see* Proposed Class Exemption for Principal Transactions in Certain Debt Securities Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, 80 Fed. Reg. 21989 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550), which are common for government agency, municipal, and corporate debt; preferred securities; U.S. Treasuries; and brokered certificates of deposit.

³⁰ Definition of the Term “Fiduciary,” 80 Fed. Reg. at 21929–21930.

³¹ Proposed Best Interest Contract Exemption, 80 Fed. Reg. at 21961 (emphasis added).

Notice the italicized reference to the customer's "best interest." The Best Interest Contract exemption is different in structure from previous PTEs in that it is principles-based rather than prescriptive.³² The proposal defines best interest as follows:

Best interest is defined to mean that the Adviser and Financial Institution act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor, when providing investment advice to them. Further, under the best interest standard, the Adviser and Financial Institution must act without regard to the financial or other interests of the Adviser, Financial Institution or their Affiliates or any other party. Under this standard, the Adviser and Financial Institution must put the interests of the Retirement Investor ahead of the financial interests of the Adviser, Financial Institution or their Affiliate, Related Entities or any other party.³³

The proposal is express in linking this definition of "best interest" to "longstanding concepts derived from ERISA and the law of trusts."³⁴ The DOL's expectation, also stated expressly, is that the best interest standard will "be interpreted in light of forty years of judicial experience with ERISA's fiduciary standards and hundreds more with the duties imposed on trustees under the common law of trusts."³⁵

Because the DOL proposal aligns with existing trust and ERISA fiduciary law, likely its most significant practical effect will be on financial advisers to IRA holders, as they had not previously been subject to similar obligations.³⁶

New Compliance Burdens in the IRA Market

Under the DOL's two-step imposition of fiduciary status with a "best interest" standard, a financial adviser who recommended to an IRA account holder an investment product that compensated the adviser but was not in the client's best interest would be in breach of duty and subject to liability to the client. In each case, the question

³² See *id.* ("Rather than create a set of highly prescriptive transaction-specific exemptions, which has generally been the regulatory approach to date, the proposed exemption would flexibly accommodate a wide range of current business practices, while minimizing the harmful impact of conflicts of interest on the quality of advice. The Department has sought to preserve beneficial business models by taking a standards-based approach that will broadly permit firms to continue to rely on common fee practices, as long as they are willing to adhere to basic standards aimed at ensuring that their advice is in the best interest of their customers.").

³³ *Id.* at 21970.

³⁴ *Id.*

³⁵ *Id.*

³⁶ See Definition of the Term "Fiduciary," 80 Fed. Reg. at 21938 ("Advisers to ERISA-covered plans are already required to adhere to the fundamental standards of prudence and loyalty, and can be held accountable for violations of the standards. Rather, the primary impact of the "best interest" standard is on the IRA market. ... Incorporating the best interest standard in the proposed Best Interest Contract Exemption effectively requires advisers to comply with these basic fiduciary standards as a condition of engaging in transactions that would otherwise be prohibited because of the conflicts of interest they create.").

presented would be whether the given advice was in the best interest of the client. The purpose would be to deter disloyal and imprudent advice by the threat of after-the-fact liability.

The cost of the proposal, however, is an expanded compliance burden and increased litigation risk, which is the rationale for a safe harbor, as we discuss below. A particular worry raised by the DOL is that the additional compliance burden might push some advisers to discontinue advising clients with smaller account balances.³⁷ To qualify for the Best Interest Contract exemption, an adviser must adopt conflict-mitigating internal “policies and procedures.”³⁸ Moreover, following the trust law tradition, the DOL anticipates that review of a fiduciary adviser’s recommendation to an IRA account holder will “focus on the process the fiduciary used to reach its determination or recommendation.”³⁹ These additional safeguards will raise the cost of providing advice to an IRA account holder.

Another source of increased costs will be increased liability exposure and greater overall litigation risk. Relative to a prescriptive approach, a principles-based governance regime is more uncertain, which will invite defensive and precautionary practices. And the proposal preserves private rights of action and class actions. Even if an individual client’s damages are small, aggregated in a class action those damages can add up to substantial liability exposure from even small decisions. In a low-margin business dependent on volume, the chilling effect could be a significant.

All told, imposing fiduciary status on financial advisers to IRA account holders may well increase the price of that advice, and a higher price would likely cause some retirement savers to forgo professional financial advice. It is unclear whether providing less conflicted advice to fewer retirement savers would result in a net social welfare gain.

A Safe Harbor for “High-Quality Low-Fee” Investments?

In recognition of the increased compliance burden arising from the imposition of fiduciary status with a “best interest” standard, the DOL has also raised the possibility of issuing “a separate streamlined exemption that would allow advisers to receive otherwise prohibited compensation in connection with plan, participant and beneficiary accounts, and IRA investments in certain high-quality low-fee investments, subject to fewer conditions.”⁴⁰ The aim of this streamlined “high-quality low-fee” exemption would be to “minimiz[e] compliance burdens for advisers and financial institutions when they offer investment products with little potential for material conflicts of interest.”⁴¹

³⁷ See, e.g., Proposed Best Interest Contract Exemption, 80 Fed. Reg. at 21979.

³⁸ Id. at 21970.

³⁹ Id.

⁴⁰ Definition of the Term “Fiduciary,” 80 Fed. Reg. at 21929.

⁴¹ Id. at 21948.

Although the DOL has not proposed text for the “high-quality low-fee” exemption, owing to “difficulty in operationalizing [the] concept,”⁴² the DOL has clarified that “the streamlined exemption would not expressly contain a ‘best interest’ standard.”⁴³ Conceptually, therefore, the “high-quality low-fee” exemption would be a safe harbor. “The aim would be to design conditions with sufficient objectivity that Advisers and Financial Institutions could proceed with certainty in their business operations when recommending the investments.”⁴⁴

The critical assumption by the DOL is “that certain high-quality investments are provided pursuant to fee structures in which the payments are sufficiently low that they do not present serious potential material conflicts of interest.”⁴⁵ On this assumption, the DOL reasoned that “a streamlined exemption for high-quality low-fee investments could be subject to relatively few conditions, because the investments present minimal risk of abuse to plans, participants and beneficiaries, and IRA owners.”⁴⁶

The DOL’s rationale for the safe harbor focuses almost exclusively on the problem of conflicts of interest, that is, the duty of loyalty. The analysis does not address whether the exemption is sensible with respect to portfolio construction, that is, the duty of prudence. And as we shall see, a safe harbor for “high quality” investments is in irreconcilable tension with the highly individualized assessment of risk and return that is required by modern portfolio theory as codified by prevailing fiduciary investment law, including under ERISA and the law of trusts.

Would the Prescriptive Safe Harbor Swallow the Principles-Based Rule?

Before considering the conflict between portfolio theory and a “high-quality” safe harbor, it is worth pausing to consider the question posed by the DOL of whether “the availability of the streamlined exemption [would] discourage Advisers and Financial Institutions from offering other types of investments, including higher-cost mutual funds, even if the offering of such other investments would be in the best interest of the plan, participant or beneficiary, or IRA owner.”⁴⁷ There is good reason, rooted in both economic theory and in empirical study, to believe that the answer is yes.

As a matter of theory, a danger with any prescriptive safe harbor is that in practice it will displace the broader principles-based rule from which the safe harbor is derived. In particular, if the litigation risk of the principles-based rule is uncertain and potentially substantial, and if compensation is constrained (by rule, competition, or both), then a safe harbor that avoids the weakly compensated added litigation risk of the

⁴² Id.

⁴³ Proposed Best Interest Contract Exemption, 80 Fed. Reg. at 21978.

⁴⁴ Id.

⁴⁵ Id.

⁴⁶ Id.

⁴⁷ Id. at 21979.

principles-based rule will be highly attractive.⁴⁸ For the reasons already canvassed, these circumstances appear to be present in the context of the DOL's fiduciary status proposal. Others have offered similar analyses in other fiduciary investment contexts.⁴⁹

As a matter of empirical study, we have shown that in donative trusts the old "prudent man rule" of fiduciary investment, which in effect offered a safe harbor for government bonds, suppressed investment by bank and other institutional trustees in equity.⁵⁰ Upon repeal of the prudent man rule (that is, upon abrogation of the safe harbor), and its replacement with the new "prudent investor rule" rooted in modern portfolio theory, there was a statistically and economically significant shift from government bonds to equity.⁵¹ The safe harbor had skewed investment by professional bank and other institutional trustees, in particular in larger trusts for which risk tolerance would tend to be greater,⁵² even though the prudent man rule was nominally a default rule and trust instruments typically included boilerplate specifically authorizing investment in stocks.⁵³ The safe harbor for government bonds avoided the weakly compensated additional litigation risk of stock investment, but exposed investors to inflation risk and deprived them of the higher expected returns associated with a higher risk portfolio.⁵⁴

The Incoherence in Law and in Economics of a Safe Harbor for "High-Quality" Investments⁵⁵

As we have seen, the basis for the "high-quality low-fee" safe harbor is the assumption "that certain high-quality investments are provided pursuant to fee structures in which the payments are sufficiently low that they do not present serious potential material conflicts of interest."⁵⁶ In other words, the personal benefit to an adviser from recommending a low-fee investment will be too small to induce the adviser to recommend investments that are not in the best interest of the client. The focus of the safe harbor, therefore, is on conflicts of interest, that is, the duty of loyalty.

⁴⁸ See Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 *J. L. & Econ.* 681 (2007).

⁴⁹ Some have argued that ERISA fiduciaries have invested cautiously in part because the large size of ERISA funds gives rise to significant liability exposure. See Diane Del Guercio, *The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investments*, 40 *J. Fin. Econ.* 31 (1996); Bevis Longstreth, *Modern Trust Investment Management and the Prudent Man Rule* 232-66 (1986).

⁵⁰ Schanzenbach & Sitkoff, *supra* note 48, at 707.

⁵¹ *Id.* at 698; Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Market Risk: An Empirical Analysis* 8 (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Paper No. 816, 2015), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Sitkoff_816.pdf.

⁵² Schanzenbach & Sitkoff, *supra* note 51, at 17.

⁵³ Schanzenbach & Sitkoff, *supra* note 48, at 685; Schanzenbach & Sitkoff, *supra* note 51, at 7.

⁵⁴ Schanzenbach & Sitkoff, *supra* note 48, at 687-88.

⁵⁵ Portions of the ensuing analysis are derived without further citation from Schanzenbach & Sitkoff, *supra* note 51.

⁵⁶ Proposed Best Interest Contract Exemption, 80 *Fed. Reg.* at 21978.

But fiduciary status triggers also a duty of care or prudence in addition to a duty of loyalty. As the DOL has explained, fiduciary status under ERISA and the tax code for financial advisers to retirement savers would subject those advisers to “trust law standards of care [i.e., prudence] and undivided loyalty.”⁵⁷ For this reason, the DOL has stated that to qualify for the safe harbor an investment must be both “high quality” and “low fee.” Taking notice of the “prevailing ... view in the academic literature that” endorses a strategy of “buy[ing] and hold[ing] a diversified portfolio of assets calibrated to track the overall performance of financial markets,”⁵⁸ the DOL has suggested that “mutual funds with low all-in fees” would be most apt for inclusion within the “high-quality low-fee” safe harbor.⁵⁹

The error in this analysis is lack of context. As we shall see, the bedrock concept in both the law and the economics of fiduciary investment is modern portfolio theory. Yet the term “modern portfolio theory” does not appear even once across the hundreds of pages of analysis accompanying the DOL’s fiduciary proposal. The academic literature to which the DOL adverts focuses on the merits of active versus passive investment strategies. That literature does not suggest that the optimal balance of risk and expected return is the same for every investor, and that this universally optimal risk and expected return tradeoff points to a fund that tracks the overall market. To the contrary, there is broad consensus that the antecedent question of asset allocation within portfolio construction should be guided by modern portfolio theory.⁶⁰

The basic idea, operationalized by the “prudent investor rule” under ERISA and trust law, is that an investor should undertake to maximize return and minimize risk, matching the risk and expected return of her overall investment portfolio to her particular circumstances. For some investors, such as an older person with limited resources and immediate cash needs, a substantial investment in a fund that tracks the overall market might incur too much risk. For other investors, such as a younger person with strong job security and substantial savings, an investment with a higher risk and expected return tradeoff might be warranted.

In the ensuing analysis of the proposed “high-quality low-fee” safe harbor, we first review the basics of modern portfolio theory, the core concept from financial economics upon which the modern law of fiduciary investment is based. Second, we canvass the law of fiduciary investment, both under ERISA and under trust law, taking notice in particular of how the prudent investor rule codifies the basic elements of

⁵⁷ Definition of the Term “Fiduciary,” 80 Fed. Reg. at 21928.

⁵⁸ Proposed Best Interest Contract Exemption, 80 Fed. Reg. at 21978.

⁵⁹ *Id.*

⁶⁰ Although the DOL proposal does not address modern portfolio theory or prevailing fiduciary investment law, there is a brief suggestion in the proposal that “the streamlined exemption could require that the investment product be ‘broadly diversified to minimize risk for targeted return,’ or ‘calibrated to provide a balance of risk and return appropriate to the investor’s circumstances and preferences for the duration of the recommended holding period.’” *Id.* However, as noted by the DOL, adding such a condition would tend to undermine the nature of the exemption as a safe harbor, reducing its utility in minimizing compliance costs. *See id.* (noting that “adding conditions might undercut the usefulness of the streamlined exemption”). It bears repeating, moreover, that the DOL has also stated that “the streamlined exemption would not expressly contain a ‘best interest’ standard.” *Id.*

modern portfolio theory. Third, we consider the normal and customary way in which the law and economics of fiduciary investment come together in practice 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. Fourth, we note in particular 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.

Modern Portfolio Theory. The key insight of modern portfolio theory, for which Professor Harry M. Markowitz was awarded a Nobel Prize in 1990,⁶¹ 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. 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 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 the level of market risk and expected return that is commensurate with that individual risk tolerance and purpose; and (3) avoiding or at least minimizing to the extent feasible wasteful idiosyncratic risk (i.e., uncompensated risk). Moreover, prudent portfolio management requires ongoing reassessment of the investor's risk tolerance and investment purposes and periodic rebalancing of the overall portfolio for continuing alignment with the investor's evolving risk tolerance and purposes.

The Law of Fiduciary Investment: The Prudent Investor Rule. The centerpiece of the law of fiduciary investment, both under ERISA and under trust law, is the "prudent

⁶¹ Harry M. Markowitz - Facts, Nobel Prize, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1990/markowitz-facts.html (last visited Sep. 4, 2015).

investor rule.”⁶² As canonically stated by the Restatement (Third) of Trusts (1992)⁶³ 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.”⁶⁴ 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.”⁶⁵

As interpreted by the DOL and the United States Supreme Court, ERISA requires adherence 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.”⁶⁶ Moreover, in applying ERISA fiduciary law, including to matters of fiduciary investment, the Supreme Court has “often noted that an ERISA fiduciary’s duty is ‘derived from the common law of trusts.’”⁶⁷ Thus, in *Tibble v. Edison International*, decided in May 2015, 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.⁶⁸

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 level of overall portfolio market risk and expected return that is commensurate with that risk tolerance and goals, and avoid wasteful idiosyncratic risk.⁶⁹ At the outset of the fiduciary relationship, the fiduciary has a “reasonable time” to “make and implement” a compliant investment program.⁷⁰ What constitutes a reasonable time is context specific,

⁶² Uniform Prudent Management of Institutional Funds Act § 3 (Unif. Law Comm’n 2006), adopted in nearly every state, applies the prudent investor rule to charitable organizations in the management and investment of their endowment funds.

⁶³ The 1992 Restatement provision on the prudent investor rule was superseded without material changes by Restatement (Third) of Trusts § 90 (Am. Law Inst. 2007).

⁶⁴ Unif. Prudent Inv’r Act § 2(b) (Unif. Law Comm’n 1994); *see also* Restatement (Third) of Trusts § 90(a).

⁶⁵ Unif. Prudent Inv’r Act § 3; *see also* Restatement (Third) of Trusts § 90(b).

⁶⁶ *See* 29 U.S.C. § 1104(a) (2013), as interpreted in 29 C.F.R. § 2550.404a-1(b) (2014).

⁶⁷ *Tibble v. Edison Int’l*, 135 S. Ct. 1823, 1828 (2015); *see also* Comptroller of the Currency, Investment Management Services: Comptroller’s Handbook 116 (Aug. 2001), <http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/invmgt.pdf> [hereinafter Comptroller’s Handbook] (“ERISA’s statutory and regulatory standards for prudent investing, diversification, and delegation of pension plan fiduciaries are also reflected in the Restatement (Third).”).

⁶⁸ *See* *Tibble*, 135 S. Ct. at 1828.

⁶⁹ *Dukeminier and Sitkoff*, *supra* note 26, at 635, surveys examples of “special circumstances” that could justify not diversifying and so bearing idiosyncratic risk.

⁷⁰ 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).

depending on factors such as the liquidity of the inception portfolio assets and the tax and other transaction costs of reallocation.⁷¹

After the initial portfolio construction, a fiduciary remains under an “ongoing duty to monitor investments and to make portfolio adjustments if and as appropriate,”⁷² for example, by rebalancing the portfolio in light of actual investment performance and changes in the investor’s circumstances.⁷³ The 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.”⁷⁴

Application in Practice. 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.”⁷⁵ Choosing the “appropriate degree of risk” for an investment portfolio involves “quite subjective judgments that are essentially unavoidable in the process of asset management.”⁷⁶ Moreover, proper diversification requires an assessment of the portfolio as a whole, including the other assets of the investor.⁷⁷ Accordingly, assessing the proper amount of market risk and proper diversification strategies for a given investor 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 innate preferences for risk, 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.”⁷⁸ A safe harbor that would validate an investment of any amount – whether 5, 10, 50, 75, or even 100 percent – of an IRA or other investment account in any one fund determined to be “high quality” without regard for the individual retirement saver’s particular circumstances and tolerance for market risk is in irreconcilable tension with the settled

⁷¹ See Restatement (Third) of Trusts § 92 cmt. b.

⁷² Id. § 90 cmt. e(1).

⁷³ See Tibble, 135 S. Ct. at 1828–29 (“In short, under trust law, a fiduciary normally has a continuing duty of some kind to monitor investments and remove imprudent ones.”).

⁷⁴ Unif. Prudent Inv’r Act § 2 cmt.

⁷⁵ Id.

⁷⁶ Restatement (Third) of Trusts § 90 cmt. e(1).

⁷⁷ See Dukeminier & Sitkoff, *supra* note 26, 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.’”).

⁷⁸ Restatement (Third) of Trusts § 90 cmt. e(1).

law and well-accepted economics of fiduciary investment. Given the likely pull of the safe harbor, the resulting welfare losses from improper portfolio construction could be substantial.

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 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 technology stocks given the likely correlation between the performance of those stocks and the investor's own small business.

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."⁷⁹ 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.⁸⁰ An investment policy statement will also normally specify "asset allocation guidelines."⁸¹ 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."⁸² To the extent feasible, the "portfolio's assets must be viewed together with the client's other assets."⁸³ 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."⁸⁴

⁷⁹ Dukeminier and Sitkoff, *supra* note 26, at 634.

⁸⁰ Comptroller's Handbook, *supra* note 67, 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.").

⁸¹ Comptroller's Handbook, *supra* note 67, at 107.

⁸² *Id.*

⁸³ *Id.* at 106.

⁸⁴ *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).

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.”⁸⁵

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.⁸⁶

An investment policy statement also provides a “‘paper trail’ in the event of an audit, litigation, or a dispute,”⁸⁷ and it facilitates selection of “an appropriate performance benchmark” against which to compare the account’s performance.⁸⁸

The Investment Management Handbook published by the Comptroller of the Currency to give guidance for bank examiners 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.⁸⁹

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.⁹⁰

Conclusion

Motivated by concern over conflicts of interest among financial advisers to retirement savers, the DOL has proposed imposing fiduciary status and a “best interest” standard on such advisers. To ameliorate the resulting compliance costs, the DOL has also raised the possibility of a safe harbor for certain “high-quality low-fee investments.” However, the notion of a “high-quality” investment is in irreconcilable tension with the highly individualized assessment of risk and return that is required by modern portfolio theory, the well-accepted concept from financial economics that has been codified in the

⁸⁵ fi360, supra note 80, at 48.

⁸⁶ Comptroller’s Handbook, supra note 67, at 111.

⁸⁷ fi360, supra note 80, at 48.

⁸⁸ Comptroller’s Handbook, supra note 67, at 108-10.

⁸⁹ Id. at 110.

⁹⁰ Id. at 112.

“prudent investor rule” as the standard of care for fiduciary investment. This policy incoherence is worrisome because of the potential for the safe harbor to swallow the best interest rule.

Under the prudent investor rule, a fiduciary must evaluate the investor’s risk tolerance and investment goals, choose a level of overall portfolio market risk and expected return that is commensurate with that risk tolerance and goals, and avoid wasteful diversifiable risk. 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 support – necessarily requires an investor-specific analysis that cannot be captured in a safe harbor. What is a “high-quality” investment for one investor may entail too much risk for another, or even too much risk for the same investor at a later time.

There is much to commend in the DOL’s effort to bring fiduciary investment principles to retirement saving. But the notion of a safe harbor for “high-quality low-fee” investments is misguided. A core principle in both the law and the economics of fiduciary investment is that no investment can be deemed categorically “high-quality” for all investors at all times. Thus, a safe harbor for certain “high-quality” investments is in irreconcilable tension with both the controlling law and well-accepted economics of fiduciary investment.