Prudent Risks for Anxious Workers

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As worker-directed pensions become the norm, American workers must increasingly make complex investment decisions. In this Article, we argue that the current system of pension regulation offers little protection to the significant group of workers who are financially unsophisticated. The applicable fiduciary rules, found in ERISA, leave beneficiaries unnecessarily exposed to unique risk by allowing trustees to make investments that are undiversified as long as those investments are individually low in risk.

We propose a two-part reform of the current rules governing pension fiduciaries. First, the basic standard governing all fiduciaries should be revised to require fiduciaries to attempt to eliminate unique risk. Second, small plan administrators need guidance about investment strategy in the form of a system of safe harbor rules. Indeed, small plans should be encouraged to contract out the administration of their funds. With adequate fiduciary rules, an expanded system of worker-directed plans might have many advantages over the current system of defined benefit plans, which have proven tremendously difficult to regulate, and Social Security, whose unfunded benefit structure reduces national savings and threatens the financial security of the system.
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I. INTRODUCTION

Most people have trouble managing money. A few are tempted to squander their savings on high risk schemes that promise outrageous returns. The average investor, however, is so anxious to preserve his nest egg that he often places it in conservative investments that run only minimal risks.

Yet a strategy of low-risk investment contravenes the most fundamental lessons of modern finance: diversification minimizes risk and maximizes return. To reap the highest return for the lowest risk, an investor should select a diversified portfolio of investments whose risks are not individually low, but are complementary, partially offsetting each other.

The average American worker is increasingly asked to bear the risks of his own financial decisions. The typical worker’s most important financial asset is a pension, and worker-directed pension investment is rapidly becoming the norm. In this Article, we argue that the current legal system offers the average worker no real protection against his own financial naiveté. Pension investments are, in theory, regulated by the fiduciary rules of the Employee Retirement Income Security Act (ERISA). These fiduciary rules acknowledge portfolio theory, but almost wholly fail to incorporate the insights of modern portfolio theory. Current law allows pension trustees to make undiversified investments as long as those investments are individually low in risk, thus leaving pension beneficiaries unnecessarily exposed to significant risks that could be readily eliminated through diversification. In this Article, we propose reforming the current fiduciary rules. We begin by examining why these rules are now so inadequate. The problem starts with a fact to which a generation of students will eagerly attest: modern finance is a difficult field. It is difficult to understand and more difficult yet to reduce to a set of simple rules.

The current statutory rules and the regulations implementing them do little to clear up the mystery of prudent investing. Their lack of a well-specified standard has led in turn to three further problems. First, even courts that conscientiously attempt to apply portfolio theory often misunderstand its principles. Second, some courts are hostile to portfolio theory, and the current vagueness of ERISA’s text and the Regulations under it permits them to undermine ERISA’s objectives. Finally, courts hesitate to hold pension trustees to an investment standard with contents so difficult to discern.

As a result, pension fiduciaries now have, in practice, no obligation to follow one of the most basic principles of portfolio theory: a portfolio is adequately diversified only if it eliminates all unique risk. To address
this problem, we propose a series of reforms. First, courts and the
United States Department of Labor must clearly enunciate a fiduciary
obligation to eliminate unique risk. Such a standard would increase the
chance that courts would find poorly managed funds in violation of
ERISA. Second, we believe that this obligation must clearly extend to the
unique risk in holdings of employer stock.

Third, we propose to augment the new legal standard with a revision
of the present regulatory regime. The Department of Labor has
steadfastly refused to provide any pre-litigation guidance to fund managers
on the adequacy of their diversification. This position, we argue, has
exposed many beneficiaries to unnecessary risks. The pension system
cannot depend primarily on litigation to ensure compliance. Many
pension plans are not managed by Wall Street fund managers, but instead
by smaller investment professionals and small business owners whose
employees the plans cover. These individuals will often be judgment
proof, at least for the sums at stake in pension cases. Courts, moreover,
are understandably reluctant to impose liability on fiduciaries who have
violated a rule with contents which unclear to the fiduciary and perhaps
even to the court.

A regulatory system which expects pension trustees to follow the
principles of modern portfolio theory must provide detailed, concrete
guidance about what those principles require. Such an enterprise,
however, must be undertaken cautiously. The fact that finance theory is
hard to master also implies that it cannot easily be translated into
regulatory guidelines. Any attempt to regulate investment strategy creates
a risk of hampering the efficient operation of capital markets. We
therefore propose a system of safe harbor rules targeted at the small funds
that are most likely to find themselves in trouble. These safe harbor rules
would make use of investment decisions made by larger funds, which
have in the past performed fairly well. Moreover, the investment policies
of large funds can be effectively policed by an improved version of the
prudent investor rule. Unlike small investors and employers, large funds
are seldom judgment proof and are unlikely objects of judicial solicitude.
These new regulatory mechanisms, in combination with a fiduciary duty
to eliminate unique risk, will substantially improve the financial security
of worker pensions. Since the regulations would be market-based, we
believe that they would be unlikely to interfere with the operation of the
market for capital.

Finally, we believe that workers who participate in self-directed plans
should be given substantially more protection than at present from their
own tendency to underdiversify. This protection can be achieved while
still permitting choice by requiring each investment vehicle to be
diversified.
Part II of this Article describes how workers bear an increasing share of investment risk. Part III examines two approaches to hedging against risk: traditional trust doctrine and modern portfolio theory. Part IV explores how the current pension regime arrived at a rule that affords workers less protection than either traditional trust law or modern portfolio theory. Part V presents our proposed reforms.

II. WORKERS AND INVESTMENT RISK

Many workers lack financial sophistication. Their resulting difficulty in making investment decisions is often cited as the reason for a central feature of our traditional system of retirement income security: the principal components of that system take investment decisions out of the hands of workers. In the last few years, this central feature of our retirement system has eroded as government and market forces both have shifted investment risk to the less financially astute.

The United States provides retirement income through two mechanisms, Social Security and the system of tax subsidies for retirement savings. The Social Security system, the larger of the two programs, eliminates the need for workers to make investment decisions by eliminating investment. In other words, the Social Security system is an unfunded regime in which current receipts are used to pay current benefits.


2. Recent data suggests that Social Security income represents about 38% of the income of the average person 55 years or older. Sylvia Nasar, *Pensions Covering Lower Percentage of U.S. Workforce*, N.Y. TIMES, Apr. 13, 1992, at A1, D4. This number seems to suggest a decline from earlier estimates, which were as high as 54%. See generally Michael J. Boskin & John B. Shoven, *Concepts and Measures of Earning Replacement During Retirement*, in *ISSUES IN PENSION ECONOMICS* (Zvi Bodie et al. eds., 1987).

3. To the individual worker, the Social Security system resembles a compulsory savings scheme. In return for a tax payment now, the worker receives an annuity after retirement. In a more fundamental sense, however, Social Security is not a form of savings. Savings, in the economic sense, occurs when resources that could have been consumed today are set aside and used to produce new output that can be consumed tomorrow. In principle, a system like Social Security could be used to finance savings. Social Security payroll taxes could be loaned to the private sector in the form of capital investments. The return on this fund could be used to pay the annuities of retirees. Such a system would be called funded social security. As the system accrued obligations to current workers, it would accumulate funds to meet those obligations.
Tax subsidized retirement savings have historically provided a significant share of retirement income, though less than Social Security. Like Social Security, these plans traditionally have not required workers to choose among investments. For several decades, the most common tax subsidized savings vehicle has been the employer-sponsored defined benefit plan. Defined benefit plans guarantee a fixed level of benefits to plan members. Unlike Social Security, these plans are at least partially funded. Contributions on behalf of current workers are invested to finance future retirement benefits to those workers. The employer controls investment policy and also bears the consequences of its choices. If the plan falls short of its goals, the employer must make additional contributions to comply with ERISA's elaborate funding rules. Employers must also pay premiums to the federal pension insurance program, the Pension Benefit Guarantee Corporation (the PBGC). If an employer cannot make the required funding contribution, the PBGC insures that employees will receive a specified percentage of their expected benefits upon retirement.

In recent years the relative importance of defined benefit plans has been declining. Defined contribution plans are emerging as a critical source of retirement income. In a defined contribution plan, as in a defined benefit plan, the employer, sometimes matched by the employee, makes contributions to a pension fund that is invested on behalf of current employees in a set of investment vehicles. Defined contribution plans may or may not permit workers to choose among these investment vehicles. The employee's pension is contingent upon the success of the selected investment vehicles. If the fund provides a lower return than


5. For a general discussion and comparison of defined benefit and defined contribution plans see generally BARBARA J. COLEMAN, PRIMER ON EMPLOYEE RETIREMENT INCOME SECURITY ACT 17-18 (2d ed. 1987); RICHARD A. IPPOLITO, PENSIONS, ECONOMICS AND PUBLIC POLICY 96 (1986); DAN McGILL & DONALD S. GRUBBS JR., FUNDAMENTALS OF PRIVATE PENSIONS 105-12 (6th ed. 1989); RICHARD M. STEINBERG ET AL., PENSIONS AND OTHER EMPLOYEE BENEFITS: A FINANCIAL REPORTING AND ERISA COMPLIANCE GUIDE 6 (4th ed. 1993); Leon E. Irish, Twenty Years of Employee Benefits, J. PENSION PLAN. & COMPLIANCE, Fall 1993, at 1, 15-16.

6. According to one recent article, the number of traditional defined benefit plans has fallen by 40% in the last four years, while the number of defined contribution plans has grown by 12%. Leslie Wayne, Pension Changes Raising Concerns, N.Y. TIMES, Aug. 29, 1994, at A1, D3.
expected, the employee receives a smaller than anticipated pension. If the fund provides a higher return, the employee enjoys a larger pension.\(^7\)

The trend towards shifting investment risk to workers is likely to accelerate in the current period of legislative reform. For example, Individual Retirement Accounts (IRAs), which are by nature defined contribution plans, have been relatively unimportant in the past, but many members of the new Congress advocate the expansion of IRAs.\(^8\)

In response to the perennial fiscal crisis of the Social Security system, Congress has begun to consider some radical alternatives. Privatized Social Security, a notion which once appealed to the same constituency as plans to block fluoridation of the water supply, has recently attracted substantial support among moderates. These privatization plans essentially would replace the current unfunded scheme with a broad-based set of defined contribution plans.\(^9\)

The increased assumption of investment risk by workers has raised concern about the retirement income security of the current generation.\(^10\)

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8. For example, the Roth-Breaux Super IRA bill would restore the full deductibility of all contributions to IRAs and would let nonworking spouses contribute $2000 a year to their own IRAs. It would also create a back-ended IRA where contributions would be made from after-tax income, but investment earnings would continue to grow tax-free and distributions would not be taxed. S. 12, 104th Cong., 1st Sess. §§ 101, 103, 111 (1995); see also Vineeta Anand, Roth Sets For Expanded IRAs, PENSIONS & INVESTMENTS, Sept. 18, 1995, at 1, 33.
9. The 13-member Advisory Council on Social Security has considered several proposals. For example, the Kerrey-Simpson proposal would raise the age at which older Americans can claim Social Security retirement benefits, let workers divert one-third of their Social Security taxes into an individual investment account, and allow part of the Social Security trust funds to be invested in stocks instead of the special Treasury bonds in which the assets are now invested. See S. 824, 104th Cong., 1st Sess. §§ 2(a), 257 (1995). Similarly, the “Grimlich Plan” would allow individuals to voluntarily contribute an additional one to four percent of their earnings to Social Security to finance annuities to bridge a gap between age 62 and an extended early retirement age. Finally, the “Ball Plan” would gradually shift up to 40% of the Social Security trust funds into private capital market investments. See Vineeta Anand, Social Security Shake Up: Panel to Present Two Approaches, PENSIONS & INVESTMENTS, May 29, 1995, at 2; see also Robert Pear, Plan Would Have Social Security Put Some Money in Stock Market, N.Y. TIMES, Feb. 17, 1996, at A1.
10. Simon weighs the paternalistic and social welfare concerns against excessive risk-bearing and believes that some fraction of a retired worker’s income should include relatively riskless benefits similar to those provided by Social Security and defined benefit plans. William M. Simon, The Prospects of Pension Fund Socialism, 14 BERKELEY J. EMPLOYMENT & LAB. L. 251, 256 (1993). Moreover, even the more financially sophisticated employees often fall into behavioral investing traps. For example, investors tend to look at upside and downside positions in separate frames of reference which leads to phenomena such as unnecessary risk-taking and overpriced downside protection. Hersh Shefrin & Meir Statman, Behavioral Portfolio Theory (Sept. 29, 1994) (unpublished...
Most observers and policymakers believe that defined benefit plans provide the best protection for financially unsophisticated employees. Defined benefit plans, however, are not without problems. Defined benefit plans by definition promise to provide specified benefit levels. Determining the current contribution levels required to fulfill such promises requires extremely complex financial and actuarial computations. ERISA's funding and insurance provisions have greatly increased the security of defined benefit pension promises, but employers have found compliance with these rules enormously expensive. As a result, the number of defined benefit plans in operation is currently shrinking. Fewer new plans are put into effect, and many firms have terminated their defined benefit plans, sometimes leaving workers with no pension coverage and sometimes replacing defined benefit plans with defined contribution plans. Moreover, the PBGC insurance program is in dubious financial condition, and is widely regarded as the next potential savings and loan crisis. Defined benefit plans may also have some indirect ill effects. With a defined benefit plan, employers may have difficulty reconciling differences among beneficiaries. Some employees, for example, may wish to engage in social investing, while others wish to maximize their financial returns. The use of defined benefit plans also may impede the
internal governance of American corporations. The characteristically American dispersion of shareholders has long been recognized as the source of many of the most vexing problems in corporate governance. By aggregating small holdings, pension funds should have provided a powerful curb to the abuses of corporate management. Yet pension funds run by corporate managers are unlikely to challenge the incumbent management of other corporations.15

Finally, the use of defined benefit plans may have blunted the political impact of pension funds. The post-war growth of pension funds has greatly diminished wealth inequality, giving rise to what has been called “pension fund socialism.”16 The diffusion of ownership, several political theorists argue, should have promoted the diffusion of political power. Yet it has not, at least in part because defined benefit plans give employers the functional ownership of pension fund assets.17 Workers pay a steep price for a return that is not subject to investment risk. A broad-based pension system cannot insure against the risk of a decline in the prevailing return to investment.18 Someone must bear the cost of economy-wide downturns, and whoever bears the cost will demand compensation in the form of control over investment.19

The trend toward defined contribution plans should in many ways be welcomed. The pension system can, however, attempt to provide some protection against returns that are substantially below the market return. In the next Part we evaluate the present rules which attempt to protect pension beneficiaries.


17. Simon, supra note 10, at 255; Alexander, supra note 1, at 112, 118.

18. One scholar proposed that the government should interfere to control market and economic volatility, in part because of an increasing reliance on “savings funds.” Tamar Frankel, What Can Be Done About Stock Market Volatility, 69 B.U. L. Rev. 991, 992-94 (1989). Simon weighed the paternalistic and social welfare concerns against excess risk-bearing and believes that some fraction of a retired worker’s income should include relatively riskless benefits similar to those provided by Social Security and defined benefit plans. Simon, supra note 10, at 256.

III. TRUST LAW AND MODERN FINANCIAL THEORY

The fiduciary rules of ERISA regulate the pension investments made on behalf of American workers. These rules have their doctrinal roots in the law of trusts. To understand why ERISA takes the form it does, this Part explores traditional trust law and the recent evolution of trust law to incorporate modern financial theory.

A. Traditional Trust Law

The fiduciary principles of ERISA have their foundation in the common law of trusts. Traditional trust principles imposed two requirements on trust investments: those investments must be individually prudent, and they must be diversified.

The individual prudence requirement of trust law was embodied in the so-called prudent man rule. This rule focused on the risk of a given investment, examined in isolation. The traditional prudent man rule, as stated in Section 227 of the Second Restatement of Trusts, required the trustee "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate . . . ."20

The prudent man rule can be illustrated on a diagram that later financial analysts used to illustrate portfolio theory. Consider the investment decision facing a risk-averse trust. Each point on the diagram corresponds to an asset in which the trust might invest. Suppose for the moment that the trust is planning to hold only one asset. The desirability of each asset depends on its mean return and the variance in the return. The higher the asset's mean, the more desirable it is; the higher the asset's variance, the less desirable it is. Since the trust is risk-averse, it will accept an increase in the variance of a portfolio only if compensated with a higher mean return. These preferences can be represented by a graph with mean and variance on the axis. The arrow indicates the direction in which assets are becoming more desirable.

21. Strictly speaking, this analysis assumes that the investor's utility depends only on the mean and variance of the portfolio it holds.
The traditional prudent man rule prohibited the trust from making certain kinds of investments. The rule prohibited fiduciaries from making investments with a risk above a threshold level, often described as having a significant chance of losing principal. In the diagram, the shaded region indicates assets with the acceptable level of risk. Under traditional principles, investment $B$ was barred.

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22. Traditional trust law not only specified a ceiling on permitted risk, but deemed certain types of investment to be generally prudent or imprudent. Investments that were usually prudent included government securities, first mortgages on land, and corporate bonds. Imprudent investments include dead securities purchased for "speculation," shares in new and untried enterprises, the carrying on of a trade or business, or the purchase of assets for resale. 

23. *Id.* § 227 cmt. e. This provision can be varied by the terms of the trust. *Id.* § 227(a). Traditional rules distinguished, in theory, among various prudent risks. The most conservative investment was not necessarily deemed to be the most prudent, since "an investment can ordinarily be made which will yield a higher income and as to which there is no reason to anticipate a loss of principal." *Id.* If a prudent man had to hold only one of two prudent assets with the same risk, he would be obligated to choose the one with the higher mean return. In practice, however, these principles were seldom invoked. *See, e.g.*, In re Newhoff, 435 N.Y.S.2d 632, 637 (Sur. Ct. 1980), *aff'd*, 486 N.Y.S.2d 956, 963 (App. Div. 1985); Estate of Knipp, 414 A.2d 1007, 1009 (Pa. 1980).
Traditional trust law supplemented the duty of prudence with a duty to "distribute the risk of loss by a reasonable diversification of investments."24 This requirement was, in theory, entirely independent of the prudence requirement,25 so that trust investments were required to be both diversified and individually prudent. The Second Restatement did provide a limited exception to the diversification requirement: a trustee was not required to diversify if "under the circumstances it is prudent not to do so."26 This exception, though, was carefully limited to unusual circumstances, such as widespread economic downturns or where trust funds were exceptionally small.27

The traditional trust rule that investments be both diversified and individually prudent reflected the prevailing financial wisdom of the nineteenth and early twentieth centuries. In the 1950s, the basic principles of finance were revolutionized by the approach that is now known as modern portfolio theory.

**B. Portfolio Theory**

Modern portfolio theory, like traditional trust law, starts from the assumption that a prudent investor is risk averse. The two investment theories, however, prescribe very different strategies for avoiding unnecessary risks. Traditional trust law required that each trust investment, taken in isolation, must be low in risk. Portfolio theory, in contrast, shows that an individual low risk investment, or even a portfolio composed of a number of low risk investments, is not the best way to produce the highest return for a low level of risk.

The central insight of portfolio theory is that risk is not additive. Two assets properly combined may have less risk than either asset alone. The key to reducing overall risk without reducing return is finding assets whose risks are negatively correlated with each other. For example, one asset might be a share in a company that made sunglasses while the other is a share in a company that manufactured umbrellas. No matter what the weather, one would prosper. The precise variance of a portfolio combining the two assets depends on the correlation between the assets comprised by the portfolio.28 The lower the correlation between two assets, the lower the potential variance of a joint portfolio. As long as the

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24. Restatement (Second) of Trusts § 228 (1959).
25. Id. § 228 cmt. a.
26. Id. § 228.
27. Id. § 228 cmt. c.
two assets are not perfectly correlated, combining them can reduce portfolio variance below the level of either separately.

The basic principles of portfolio theory are often illustrated by the following diagram.29

Consider a trust whose investment opportunities consisted of $A$ and $B$. The traditional prudent man rule would require the trust to invest only in asset $A$, and would bar the trust from holding asset $B$ on the grounds that it entailed too much risk. Modern portfolio theory takes an entirely different approach, focusing on the risk characteristics of each asset not separately, but as it interacts in the portfolio. Suppose that the trust was allowed to invest in both $A$ and $B$. By varying the shares of each asset in its portfolio, an investor could create an infinite variety of portfolios, as the shaded area in the diagram illustrates. This diagram illustrates the fact that any portfolio that combines $A$ and $B$ must have a mean that is between the mean of $A$ and the mean of $B$. For example, a portfolio

29. For a more detailed analysis, see generally HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (2d ed. 1991); William F. Sharpe, A Simplified Model for Portfolio Analysis, 9 MGMT. SCI. 277 (1963).
consisting of two assets which return five percent and seven percent must have a return no less than five percent but no greater than seven percent. Thus, the shaded area cannot extend higher than $B$.

The variance of a portfolio containing $A$ and $B$, however, may be lower than the variance of either $A$ or $B$ alone. The variance of the portfolio depends on the correlation between $A$ and $B$ and the proportion of each held in the portfolios. The lower the correlation between two assets, the lower the potential variance of a joint portfolio. As long as the two assets are not perfectly correlated, combining them can reduce portfolio variance below the level of either separately. The correlation between assets is not directly represented in the diagram, but is rather reflected indirectly in the shape of the area representing possible combined portfolios. By extending to the left of both $A$ and $B$, the shaded area reflects the fact that $A$ and $B$ are not perfectly correlated. Thus, some portfolios containing $A$ and $B$, such as $C$, have a lower variance than either $A$ or $B$. For any risk averse investor, $C$ is strictly preferable to $A$ because it provides a higher return and a lower risk.

Portfolio theory has an even more surprising result, the so-called Separation Theorem.\textsuperscript{30} The Separation Theorem suggests that there is a single portfolio, called the market portfolio, containing the optimal combination of risky assets for all investors, regardless of their risk preferences. In order to tailor their portfolio to their individual risk preferences, investors should vary the proportion of assets they hold in the market portfolio and in risk free assets, such as short-term Treasury bills. In other words, investors should not attempt to lower the risk of their portfolio by holding a risky portfolio containing few risky stocks.

The Separation Theorem is illustrated in the diagram by the line connecting point $E$, which represents a risk free asset, with point $C$, which represents an optimal unique risk-minimizing portfolio of risky securities. This line illustrates portfolios that combine holdings of $C$ with the risk-free asset $E$. The Separation Theorem shows that all investors, regardless of their risk preferences, should choose a portfolio on this line—that is, one that combines $C$ with the risk free asset $E$.

The crucial characteristic of the optimal risky portfolio is that it eliminates unique risk. Unique risk, also called specific risk, is due to factors which may be company or industry specific. These factors include the price of substitutes for the company's product, the prices of inputs and so on. Diversification mitigates the unique risk of one asset by offsetting that risk against the unique risk of another asset. For example, during a rainy season, the increased revenue earned by an umbrella company

offsets the low revenue generated by a sunglasses company. After unique risk has been diversified away, the remaining risk is called the market risk, otherwise known as beta. Market risk is the sum of each asset's covariance with the market.  

Note that the diversification implied by portfolio theory is more specific than the diversification of traditional trust law. The market portfolio $C$ depends on a very specific combination of $A$ and $B$ that takes into consideration the correlation between the two, as well as their risk and return. Portfolio $D$ is diversified, and would probably meet the traditional diversification rule of the Second Restatement of Trusts. It would not, however, be as efficiently diversified as portfolio $C$.

From these observations follow the basic principles of modern investing. Because unique risk can be diversified away, no asset's price should reflect the asset's unique risk. Because market risk cannot be eliminated through diversification, it is reflected in the price of the stock. Since unique risk is not compensated, no rational investor should ever bear unique risk. Even a low risk asset such as $A$ usually has some unique risk, and any rational investor should diversify that risk away by holding at least some other asset such as $B$. The best way to avoid unique risk is not to make low risk investments but to choose a properly diversified portfolio.

The basic principles of portfolio theory were developed in the 1950s and 1960s. Starting in the 1970s, legal commentators began to criticize the traditional prudent man rule on the grounds that ruling out high risk investments per se was inconsistent with modern portfolio theory. These criticisms were reflected in the 1990 Third Restatement of Trusts which replaced the traditional prudent man rule with a new prudent investor rule. Notwithstanding some occasional hedging in the comments, the Third Restatement essentially requires fiduciaries of private trusts to follow the principles of modern finance. The next Part will examine the development of the law of pension trusts. In striking contrast to private

31. BREALEY & MYERS, supra note 28, at 163.
33. "[The prudent investor] standard . . . is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy." RESTATEMENT (THIRD) OF TRUSTS § 227 (1990). The Reporter’s comments clearly endorse the central principle of modern portfolio theory: any rational investor should eliminate unique risks. See id. §227 cmt. e. Courts have not yet had the opportunity to apply this most recent Restatement standard.
trust law, we argue, the law governing pensions has actually regressed in the last several decades.

IV. OUR PERMISSIVE PENSION REGIME

Under traditional fiduciary law, a trust investment was required both to be individually prudent and to be part of a diversified portfolio. ERISA’s fiduciary rules were originally designed to follow traditional trust law, but today they permit a pension trustee to fulfill its fiduciary obligations either by diversifying or by choosing individually prudent investments. This Part will examine how ERISA’s fiduciary doctrine devolved while the law of private trusts evolved toward the principles of modern financial theory.

A. ERISA’s Diversification Standard

ERISA was enacted in 1974. Its principal aims were to prevent default on pension obligations and to end the widespread self-dealing by pension fiduciaries. It accomplished these objectives by a comprehensive scheme of pension regulation, and as part of this scheme provided general principles governing pension investments.

Congress wanted ERISA’s fiduciary rules to follow the rules governing private trusts. ERISA therefore imposed two basic duties on pension fiduciaries: invest prudently and diversify. The statutory language of both elements of ERISA’s basic fiduciary standard parallels the language of the then-current Second Restatement of Trusts. Under ERISA’s version of the prudent investor rule, a fiduciary must act “with the care, skill, prudence, and diligence that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

Thus, ERISA enacted the then-current Second Restatement principles requiring individually prudent investments that were also diversified.


36. The legislative history of ERISA clearly shows that Congress intended to federalize the common law of trusts. See 120 CONG. REC. 15,737 (1974) (statement of Senator Harrison A. Williams Jr.) (citing goals of ERISA as “to make applicable the law of trusts . . . to establish uniform fiduciary standards to prevent transactions which dissipate or endanger plan assets and to provide effective remedies for breaches of trust”). Thus, ERISA enacted the then-current Second Restatement principles requiring individually prudent investments that were also diversified.

investments; as in the Second Restatement, this diversification requirement is waived when undiversified holdings would clearly be prudent.

In the twenty years since ERISA's passage, however, ERISA fiduciary standards and the law of private trusts have taken sharply divergent paths. The law of private trusts, reflected in the Third Restatement, has moved toward principles of modern portfolio theory. ERISA has moved away from even the nascent portfolio theory of the Second Restatement. The Second Restatement did require diversification, although of a less sophisticated type than that required by portfolio theory. Current ERISA doctrine effectively eliminates any duty to diversify. The doctrinal basis for this evolution has been the principle that no diversification is required when nondiversification would be prudent. In the law of private trusts, this rule has remained a narrow exception for small trusts and times of emergency. In contrast, courts interpreting ERISA have expanded this small exception into an important rule of law. Under ERISA case law, courts have held this waiver to mean that a fund must be diversified unless the investments are individually prudent. In other words, current ERISA doctrine permits a fund to consist entirely of asset C, which is prudent but not risk-free.

ERISA case law therefore permits trustees either to diversify or to choose individually prudent investments. This rule, permitting

38. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). In general, no more than 10% of plan assets may consist of employer securities or real property. ERISA § 407(a)(2) (1991), 29 U.S.C. § 1107(a)(2) (1994). However, the ten percent restriction on holdings of employer securities does not apply to "eligible individual account plans," though these holdings must satisfy the prudence requirement. ERISA § 407(b), 29 U.S.C. § 1107(b). The term "eligible individual account plan" includes any individual account plan which is a profit-sharing, stock bonus, thrift, or savings plan, and which explicitly provides for holding employer securities and property. ERISA § 407(d)(3)(A), 29 U.S.C. § 1107(d)(3)(A).


40. For example, in instances where the fiduciary fails to diversify the assets, the defendant can establish that the investments were individually prudent and avoid liability. See Etter v. J. Pease Constr. Co., Inc., 963 F.2d 1005, 1009 (7th Cir. 1992) (holding that the fund was undiversified because 88% of it was invested in one real estate venture, but "[the plan obviously did not suffer a loss, and Etter has not identified a more profitable, prudent, alternative investment"); Reich v. King, 867 F. Supp 341 (D. Md. 1994) (holding that the plan was not diversified with 70% of plan assets invested in loans secured by real estate located in Frederick County, but the investments were individually prudent); Lanka v. O'Higgins, 810 F. Supp. 379 (N.D.N.Y. 1992) (holding that the plan's investment portfolio, consisting of only three stocks, was prudent because of the contrarian investment strategy and the selection of the three particular stocks); Jones v. O'Higgins, 11 Employee Benefits Cas. (BNA) 1660, 1667 (N.D.N.Y. 1989) (holding that the fund was not diversified because over 90% of the funds assets were invested in three
portfolios consisting entirely of a single asset like \( C \), conforms neither to modern portfolio theory nor to traditional trust law. In modern portfolio theory, the requirement of diversification, properly understood as the duty to eliminate unique risk, entirely supersedes the requirement that investments be individually prudent. Even investments which are individually low in risk may contain some unique risk that any rational investor should diversify away. ERISA's standard is worse even than the traditional rules, in which the diversification requirement supplemented the prudence requirement: an investment was required to be both individually prudent and part of a diversified portfolio, and the exception to non-diversification applied only in highly unusual circumstances or to very small trusts.\(^4\) A trust would not satisfy this standard by holding a single asset like \( C \), but would satisfy the standard by holding a number of assets that individually looked like \( C \). Unless these assets were perfectly correlated, the resulting portfolio would be better than \( C \) alone, although only by chance would it fall on the line representing optimal portfolios.

Under ERISA case law, a fiduciary has no obligation to diversify individually prudent investments even where those associated risks could be reduced through diversification. To compound the problem, courts have applied the already lenient prudent-or-diversified standard in a surprisingly lax way. Most fiduciaries who have been found to violate ERISA's investment standards have not merely failed to diversify, but have engaged in self-dealing of some kind.\(^2\) Absent a conflict of interest, courts have found inadequate diversification only if the fiduciary

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41. The Second Restatement states as follows:

Since the rule stated in this Section is an application of the general rule stated in § 227, there may be special circumstances in which the trustee is excused from diversifying investments. Thus, where the trust estate is very small it may be proper for the trustee to invest the whole or substantially the whole of it in one security or type of security. . . . So also, in times of crisis and general financial instability, it may be proper to invest a large portion or even the whole of the trust estate in a single type of security such as government securities.

RESTATEMENT (SECOND) OF TRUSTS § 228 cmt. c.

has placed a large percentage of the plan assets in a single investment. For example, in *Jones v. O'Higgins*,[44] the court held that the investment of ninety percent of a plan’s assets in three stocks did not violate the diversification requirement because the investments were clearly prudent.[45] Courts have found the diversification requirement violated by individually prudent investments in only one narrow set of circumstances—when investments are concentrated in a limited geographic area.[46] Even this rule is not applied consistently. In a recent case, the District Court in Maryland considered a pension fund which had invested seventy percent of all the plan’s investments in loans secured by real estate located in a single county.[47] The court found that this investment strategy did not meet the diversification requirement, but declined to impose liability on the grounds that the investments were individually prudent.

The reluctance of courts to impose liability for mere non-diversification has several causes. ERISA contains no general explanation of the diversification standard.[48] This lack of statutory guidance has

43. GIW Indus. v. Trevor, 895 F.2d 729, 733 (11th Cir. 1990) (holding that investment of 70% of plan assets in government bonds with a single maturity date and 15% of plan assets in zero coupon bonds with a different maturity date violates § 404 by exposing plan to risks if the need to liquidate investments arises); Marshall v. Glass/Metal Ass'n, 507 F. Supp. 378, 384 (D. Haw. 1980) (reviewing a proposal in which 23% of plan assets would be invested in a loan to redevelop foreclosed condominium property); Marshall v. Teamsters Local 282 Pension Trust Fund, 458 F. Supp. 986, 991-92 (E.D. N.Y. 1978) (reviewing a proposal in which 30% of plan assets would be invested in a risky loan to build a hotel-casino); see also Brock v. Citizens Bank of Clovis, 841 F.2d 344, 346 (10th Cir. 1988), *cert. denied*, 488 U.S. 829 (holding that the diversification requirements of ERISA § 404 are violated by investing 65% of plan assets in commercial real estate first mortgages); Marshall v. Mercer, 4 Employee Benefits Cas. (BNA) 1523 (N.D. Tex. 1983) (holding that duty to diversify is violated by investment of 85% to 90% of plan assets in loans to companies owned by the trustee); Rausch v. Damon, Nos. 83-1161-CV-W-8, 84-0506-CV-W-8 (consolidated) 1984 WL 3648 (W.D. Mo. Sept. 5, 1985) (reviewing an investment proposal in which nearly 100% of plan assets are invested in a peso-denominated CD).

44. 11 Employee Benefits Cas. (BNA) 1660 (N.D.N.Y. 1989).

45. *Id.* In a less extreme example, a court found diversification satisfied when the trustee invested between three and 13% of plan assets in individual stocks. Sandoval v. Simmons, 622 F. Supp. 1174, 1211 (C.D. Ill. 1985).

46. *Brock*, 841 F.2d 344 at 345-46 (reviewing investment in which high proportion of plan assets are invested in mortgage loans within a limited area of New Mexico); Donovan v. Guaranty Nat'l Bank, 4 Employee Benefits Cas. (BNA) 1686 (S.D. W. Va. 1983) (reviewing investment in which greater than 80% of plan assets invested in mortgage loans secured by property in and near Huntington, West Virginia).


compounded the inevitable difficulties that courts have had in applying the standard. Like everyone else (including generations of economists), courts do not find portfolio theory intuitively obvious. They have accordingly struggled to discern what Congress intended. In this effort, courts have looked to the statutory text and the legislative history of ERISA, but both have proven misleading. Like the Second Restatement, ERISA provides that the objective of diversification is "to minimize the risk of large losses."\(^{49}\) Large losses, courts seem to have reasoned, were unlikely to result from low risk investments. This is probably true, but large losses are even less likely to result from a diversified portfolio.

This mistake was reinforced by a passage in the legislative history. According to the House Conference Report, the rule permitting prudent departures from the diversification requirement implied a proof allocation system:

\[
\text{[T]he plaintiff's initial burden will be to demonstrate that there has been a failure to diversify. The defendant then is to have the burden of demonstrating that this failure to diversify was prudent.}^{50}\]

This burden shifting mechanism, which had no analogue in the Second Restatement or the common law of trusts,\(^{51}\) may have led courts to believe that prudent nondiversification was more common than it in fact is.

A few courts are even actively hostile to portfolio theory. This hostility is strikingly illustrated by the opinion of the court which recently permitted a pension fund to hold seventy percent of its investments in mortgages in a single county.\(^{52}\) The Secretary provided a sophisticated explanation of the problems that would result from such a policy.\(^{53}\) The

\[\text{§§ 1002, 1104 (1994).}\]

51. The prudent man rule adopted by the First and Second Restatements includes the diversification standard. The circumstances in which it would be prudent to depart from this standard were limited to when the trust estate is very small or there is a period of financial crisis and instability. \textit{See Restatement (First) of Trusts} § 228 cmt. e (1935); \textit{Restatement (Second) of Trusts} § 228 cmt. e (1959).
52. \textit{Reich}, 867 F. Supp. at 344.
53. The Secretary of Labor's chief expert was Richard Hinz, a Department of Labor economist. The court discussed Hinz' testimony as follows:

[T]he Plan's lack of diversification was imprudent. Hinz [sic] conclusion was based on the premise that the Plan's returns could have been realized with a more diversified portfolio facing fewer risks, and that the Plan was not com-
defendant plan argued, in effect, that its investments had met the traditional prudence requirement, in the sense of being low risk. The court relied heavily on the defendant’s expert testimony, dismissing the testimony of the Secretary’s expert as based “on textbook-type theories that appeared far removed from the actual realities of mortgages in Frederick County.”

Finally, judges often seem troubled by the difficult position in which the law places trustees. Many pension fund managers are eager to comply with the law, but are at present unsure of what it requires. Courts seem unwilling to impose liability on defendants who have made a good faith effort, however much that effort may have fallen short. An extreme case is Bisceglia v. Bisceglia. Joseph Bisceglia established a pension plan for the employees of his business, Joe’s Plumbing. Since he had very little education or investment experience, his accountant advised him to hire Frank Pirtle as an investment advisor. Following Pirtle’s advice, the plan invested over ninety percent of its assets in real estate and mortgages, and thirty-six percent of its assets in one real estate partnership. This investment program produced high returns for a few years, but eventually two of these real estate deals collapsed. Subsequently, the value of employee Frank Bisceglia’s interest in the plan dropped from $28,634 in 1986 to $2,075 in 1989. Frank Bisceglia brought suit against his brother for violation of fiduciary duty under

pensated for the significant risks that it faced. Hinz testified that the Plan could suffer large losses due to the following risks: default risk, interest rate risk, inflation risk, and liquidity risk.

Id.

54. Defendant’s experts included David Brock, a local bank president: Mr. Brock analyzed each of the loans in the Plan’s portfolio. In many instances Brock personally visited the properties that served as collateral for the loans. Brock concluded that there is no risk of large losses due to the Plan’s heavy concentration in residential mortgages, and that the loans were made in a prudent manner. Brock based his opinion on the loans’ low loan to value ratios, their status as 5 year “balloons,” the good payment histories of the borrowers, and Walter King’s knowledge of the local real estate market.

Id.

55. Id. at 345. Similar sentiments were expressed in the court’s description of the Secretary’s chief expert witness:

On cross-examination Hinz stated, however, that he had not investigated any of the particular loans in the Plan’s portfolio. Rather, his analysis was based on general economic and investment theories. In addition, Hinz admitted that he had never managed an investment portfolio, and that his only experience with residential mortgages resulted from one purchase of his own home.

Id. at 344.

ERISA. The Ninth Circuit found that the trust was plainly undiversified, but refused to find Joseph Bisceglia liable:

Clearly, Joseph Bisceglia was prudent, at least without hindsight, in his selection of Pirtle as an investment adviser. Pirtle was recommended by Bisceglia's well-trusted accountant . . . . Normally a trustee cannot rely simply on an expert's advice, but must independently satisfy the demands of the prudent investor. However, in this case any investigation by Joseph Bisceglia would have been totally fruitless. He had no sophistication in the business world, nor any personal knowledge of investments. The analysis of whether a trustee has functioned as a prudent person must be done on a case-by-case basis.57

The Bisceglia case starkly illustrates a key problem with the current system. On the one hand, Joseph Bisceglia was an immensely sympathetic defendant, who had tried to the best of his ability to provide a responsibly managed pension plan. On the other hand, Frank Bisceglia lost his entire retirement savings.

B. Self-Directed Accounts

The rules discussed in the preceding Parts apply to all funds, whether or not they allow workers to choose among investment vehicles. ERISA currently permits fund managers to relieve themselves of much of their fiduciary obligation by providing participants with a range of choices that meet specified criteria.

The evidence suggests that participants in these self-directed accounts unintentionally take on unique risk. In particular, many investors, apparently seeking a maximally risk-averse course, inadvertently assume unnecessary unique risk by investing heavily in guaranteed insurance contracts (GICs), which are fixed income assets that include no equity component.58 These choices are permitted by the current rules that permit participants to choose among vehicles, Section 404(c) and the corresponding Regulations. The Regulations relieve a self-directed plan of liability for poor employee investment decisions if it makes available investment choices that, among other things, tend "to minimize through

diversification the overall risk of a participant’s or beneficiary’s portfolio.” The plan must provide participants with a broad range of investment alternatives.\(^{59}\) At least three of these alternatives must be diversified,\(^{60}\) and all must in the aggregate enable the participant to eliminate unique risk.\(^{61}\) However, each of these three in isolation need not eliminate unique risk and participants can easily choose an underdiversified portfolio.\(^{62}\)

C. Employer Securities

The basic fiduciary principles of ERISA have been eroded to the point of extinction by judicial interpretation. As if this problem was not enough, Congress chose to exempt defined contribution plans from one of the principal limits on employer self-dealing. Defined benefit plans may not invest more than ten percent of their assets in employer securities,\(^{63}\) but defined contribution plans are exempt from this limit.\(^{64}\) In principle, this exemption does not exempt funds from the general prudence requirement.\(^{65}\) In practice, though, many defined contribution plans hold large amounts of employer stock. For example, holdings of employer stock among the 1000 largest defined contribution plans average 28.3% of fund assets.\(^{66}\) The top eight plans average 39.8%, and one fund holds 91%.\(^{67}\) Such large holdings have led to a number of major lawsuits after the employer stock declined precipitously in value.\(^{68}\)

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60. § 2550.404c-1(b)(3)(B)(1).
62. § 2550.404c-1(i)(5).
65. Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982) (referring to the application of the prudence requirement with respect to company stock).
67. Id. at 42.
68. See, e.g., Kuper v. Iovenko, 66 F.3d 1447 (6th Cir. 1995); Moench v. Robertson, 62 F.3d 553 (3rd Cir. 1995).
D. Summary

The current system of pension regulation suffers from three serious defects. It has, de facto, no general diversification requirement; it does not protect participants in self directed plans from foolish choices; and it permits excessive investment in employer securities. In the next Parts we will discuss how the current system of pension regulation might be revised. We begin by proposing a revised fiduciary standard that would require both prudence and diversification, and incorporate a modern conception of prudence.

V. SOME REFORMS

A. A Revised Fiduciary Standard

Courts have construed ERISA to impose a fiduciary standard of "diversified or prudent," and they have applied this standard with such hesitation as to prohibit only the most extreme investment policies. This rule, we have argued, is intolerably lax. From a policy perspective, pension investment rules should embody the approach to investing endorsed by the Third Restatement. Investments should be diversified, and should be prudent in the sense that they eliminate unique risk, but not in the sense that they are necessarily low in risk.

We believe that this standard can be adopted without new legislation. Congress intended ERISA to embody the common law of trusts. Of course, if Congress wanted ERISA's standards to freeze the common law rules in force at the time of enactment, then new legislation might be needed. Under the common law in 1974, trust investments had to be both diversified and prudent in the sense of being individually low in risk. This approach would help some pension beneficiaries, but not others. Beneficiaries of undiversified but "prudent" plans would be helped, since their plans would be required to hold more diversified portfolios. However, beneficiaries of efficiently diversified plans would be hurt, since the traditional prudence requirement would prevent plan trustees from making high-risk but properly diversified investments.

However, when Congress modeled ERISA on the common law, it presumably envisioned fiduciary rules that would incorporate contemporary trust doctrine and evolve with that doctrine. This evolutionary approach to fiduciary standards is supported by 1979 Department of Labor Regulations. These Regulations took a significant

step towards endorsing modern portfolio theory by explicitly authorizing the fiduciary to examine the investment in the context of the aggregate risk and return characteristics of the portfolio. The Regulations do not, however, require the fiduciary to eliminate unique risk.

The next step in the evolution of ERISA's investment rules should be the adoption of the principle that fiduciaries must make all reasonable efforts to eliminate diversifiable risk. To do this, courts and the Department of Labor can begin by looking to the Third Restatement of Trusts. The Third Restatement correctly states the basic principles of portfolio theory and represents a dramatic advance over earlier law. However, as a model for courts and regulators, the Third Restatement has an important shortcoming. Even though the black letter of the Third Restatement rejects the requirement of individual prudence, noting that investments must be evaluated in the context of the portfolio as a whole, the rule itself does not mention the elimination of unique risk as the basis for evaluating the overall portfolio. The Reporter's comments to the Third Restatement lucidly describe the principle of eliminating unique risks, but the Comments are comically reluctant to make a commitment.

70. A fiduciary must give "appropriate consideration" to those facts and circumstances that... the fiduciary knows or should know are relevant to the... investment... involved, including the role the investment... plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties." 29 C.F.R. § 2550.404a-1(b)(i)(1994) (emphasis added). The Regulation defines "appropriate consideration" as follows:

The term "appropriate consideration" includes, but is not necessarily limited to, a determination by the fiduciary that the particular investment... is reasonably designed, as part of the portfolio... to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain... and consideration of the following actors as they relate to such portion of the portfolio: (A) The composition of the portfolio with regard to diversification; (B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; (C) The projected return of the portfolio relative to the funding objectives of the plan.

29 C.F.R. § 2550.404a-1(b)(2). These regulations, though, seem to have had little effect on ERISA litigation.

71. The Third Restatement states: "[The prudent investor] standard... is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy." RESTATEMENT (THIRD) OF TRUSTS § 227(a) (1990).

72. RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. e. The Restatement shares with the Regulations and legal critics of the traditional prudent man rule this emphasis on rejecting individual prudence rather than requiring the elimination of unique risk. See Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. REV. 52 (1987) (focusing on eliminating the individually prudent requirement); Paul G. Haskell, The Prudent Person Rule For Trustee Investment And Modern Portfolio Theory, 69 N.C. L. REV. 87, 108-10 (1990) (proposing that eliminating the individually prudent requirement should be conditioned on the suitability of such a strategy given the
to any particular rule of investing.73

We believe that standards under ERISA require something more explicit, since ERISA standards must provide clear guidance for the perplexed. The standard would apply to all funds, whether employer managed or available to employees in a system of self-directed accounts. Each fund should be required “to minimize through diversification the unique, or diversifiable, risk of a participant’s or beneficiary’s portfolio.”74 The requirement would impose an ex ante rather than an ex post duty to eliminate unique risk. Such an approach would be similar to that of the prudent investor standard and its associated duties pursuant to trust law and ERISA.75

B. Employer Securities

A pension fund’s obligation to eliminate unique risk should extend to holdings of employer stock. The current levels of such holdings—around thirty percent for large plans—are indefensible. Giving employees a stake in the success of the employer can advance many important goals, such as improving productivity, decreasing information costs between managers and employees, and increasing trust between and

73. At one point the comments state that the Restatement rules “are intended to reflect the lessons derived from modern experience and research, without either endorsing or excluding any particular theories of economics or investments.” RESTATEMENT (THIRD) OF TRUSTS § 227 introduction cmt.

74. Again, this is perfectly consistent with requiring self-directed plans to provide investments that offer a variety of choices.

75. The Third Restatement explicitly provides that the trustee’s compliance with its fiduciary standards is to be judged as of the time the investment decision in question was made, not with the benefit of hindsight or by taking account of developments that occurred after the time of a decision to make, retain, or sell an investment. RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. b. ERISA provides a similar standard under which the fiduciary must act “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (emphasis added). For an application of the prudent investor standard, see, e.g., GIW Indus. v. Trevor, 895 F.2d 729, 731 (11th Cir. 1990); Reich v. King, 867 F. Supp. 341, 343 (D. Md. 1994); Lanka v. O’Higgins, 810 F. Supp. 379, 387 (N.D.N.Y. 1992); Freund v. Marshall & Ilsley Bank, 485 F. Supp. 629, 635 (W.D. Wis. 1979).
among employees and managers. Pension plans, however, are not the appropriate vehicle for worker ownership. The pension system receives an enormous tax subsidy, and this subsidy is intended to provide retirement security, not to subsidize personnel management policies. Holdings of employer stock do not cost-effectively advance the goal of retirement security, since they unnecessarily augment unique investment risk.

Moreover, holding employer stocks in pension plans frustrates the objectives of both pension policy and worker ownership. Most workers do not have the time or resources to examine carefully the investment decisions of their pension funds, and they are likely to be unaware of how much employer stock the fund holds. This creates two problems. First, in planning for retirement, workers will fail to consider the excess unique risk resulting from employer securities. Second, holding employer securities in a large portfolio with other investments obscures the return to employer securities. This blunts the incentive effects of employee ownership, since the employee will be less likely to effectively assess or appreciate his company's performance.

Indeed, the best approaches to making employees into stakeholders may not involve equity holdings at all. We share the views of the many observers who believe that the best balance between retirement security and the risks inherent in stakeholding will probably be achieved by combining a diversified pension plan with some type of profit sharing or option arrangement.

From a doctrinal point of view, using ERISA's prudence requirement to reduce holdings of employer securities is slightly more difficult than imposing a general obligation to eliminate unique risk, since ERISA explicitly permits defined contribution funds to hold more than ten percent of their assets in employer securities. However, courts have held that the rules regarding employer stock do not eliminate the separate requirement of prudence. Few if any firms have so little unique risk that fund managers could meet a true prudence requirement with large holdings of employer stock, and the ten percent exemption could be interpreted to mean that if such a fund exists it should be permitted to hold more than ten percent employer securities.

77. For an excellent discussion of these issues, see Richard L. Doernberg & Jonathan R. Macey, ESOPs and Economic Distortion, 23 HARV. J. ON LEGIS. 103 (1986).
78. Hansmann, supra note 76.
79. Kuper v. Iovenko, 66 F.3d 1447 (6th Cir. 1995); Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995); Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982) (referring to the application of the prudence requirement with respect to company stock).
Workers would enjoy more secure retirement savings if ERISA provided an explicit duty to eliminate diversifiable risk. However, we believe that an improved standard of liability is not enough. In the next Part we suggest a revision of the current regulatory framework for pensions.

**C. Guidance for Small Plans**

Most defects in current ERISA investment standards can be traced to the vagueness of the statute and current Regulations. Imposing an explicit duty to eliminate diversifiable risk would improve matters, but we believe that the fiduciaries of many pension funds need more guidance to prevent situations such as the *Bisceglia* case, in which workers lose their entire retirement savings because of non-diversification. At the same time, regulators must approach the task of prescribing investment policy with humility. The history of securities regulation is filled with examples of well-meaning rules that had unintended ill-effects.  

Comprehensive regulations governing pension investment would be unwise. No set of regulations can provide rules to beat the market average return, since that return has already incorporated the efforts of the most sophisticated financial analysts. Indeed, it seems unlikely that any set of regulations could even provide rules for duplicating the market return, at least through an active investment strategy. The key issue in managing any portfolio is long-term asset allocation, in which the investor seeks a long-term "normal" asset mix that represents an ideal blend of

controlled risk and enhanced return. Suppose the Department of Labor attempted to prescribe asset allocation strategy. To do so, it would need to make a complex calculation that considered which asset classes were appropriate; the expected return from the various asset classes; the standard deviation of the return from the various asset classes; the appropriate time horizon for pension plans; the covariance between asset classes; and the risk tolerance of the plan participants. Moreover, the principles used to predict future returns and the theories that investors use to construct optimal portfolios are continually revised. The principles of sound investing evolve too quickly and are too complex to be codified in the Federal Register.

An alternative regulatory method would prescribe various passive investment strategies such as index funds. This approach would eliminate the need for the Department of Labor to draw up investment strategies. However, encouraging most funds to invest passively would create other serious problems. Pension funds are among the largest accumulations

81. For our purposes, the proposed safe harbor standard would only need to focus on the initial policy asset allocation strategy. Investment managers may diverge from policy asset allocation based on continuous objective evaluations of the performance of the plan's assets. For example, if long term bonds do not fare well, the investor may move the assets out of this investment class. This strategy is known as tactical asset allocation. Finally, the investment manager may employ dynamic strategies such as portfolio insurance which results in mechanistic shifts in response to market changes. See ROBERT D. ARNOTT & FRANK J. FABOZZI, ACTIVE ASSET ALLOCATION: STATE-OF-THE-ART PORTFOLIO POLICIES, STRATEGIES & TACTICS 4-6 (1992).

82. The scenario we describe might be somewhat less implausible if the Securities and Exchange Commission rather than the Department of Labor were drafting the regulations. However, the two agencies long disputed who had jurisdiction over pension investments, and the Department of Labor won. See Daniel v. Int'l Bhd. of Teamsters, 439 U.S. 551 (1979).


84. MARK P. KRITZMAN, ASSET ALLOCATION FOR INSTITUTIONAL INVESTORS 129-44 (1990).

85. Some commentators may argue that such regulatory intervention would contradict the theory of "relational investing" in which institutions see themselves as long term investors in the firm. Ian Ayres & Peter Cramton, Relational Investing and Agency
of wealth in the American economy. Many observers have long predicted that, because of their size, funds would become an increasingly important force in American economic and political life.\textsuperscript{86} In fact, however, pension funds have remained relatively passive, both politically and in the governance of corporations whose stocks they own. Many observers believe that this tendency already has been exacerbated by the regulatory regime, and encouraging more passive investment would make a bad situation worse.\textsuperscript{87}

An explicit obligation to eliminate unique risk would, we believe, provide adequate protection for employees covered by relatively large funds. These funds are run reasonably competently. Large plans hire experienced consultants and investment managers to suggest appropriate asset allocation strategies. Their principal problem at present seems to be an excessive concentration in employer stock, which results from a conflict of interest rather than from an inability to understand investment theory. Given a clearer legal standard, courts would not hesitate to impose liability on a large plan which had inadequately diversified.

Small funds, however, face an entirely different set of problems. Often, the less experienced fiduciary decides upon an asset allocation strategy with little guidance. As Bisceglia illustrates, even when fiduciaries of smaller plans consult experienced consultants and investment managers, they may choose unwisely. In particular, they often make fundamental mistakes in their allocation of assets between debt equity and other classes of investment. A significant number of plans seem to invest primarily in real estate. Smaller pension plans allocate significantly less of their assets to equity securities than the larger plans, while allocating


86. \textit{See generally} Drucker, \textit{Unseen Revolution} supra note 16.

87. Alexander, \textit{supra} note 1, at 124 (discussing how modern fiduciary law has extended equity's tradition of constructing ownership as passive through the corporate pension system); \textit{see also} Adolf A. Berle \& Gardiner C. Means, \textit{The Modern Corporation and Private Property} (1932). On the other hand, several authors perceive institutional investor activism as a realistic alternative mechanism of corporate governance. \textit{See}, e.g., Black, \textit{supra} note 15, at 575-91 (arguing that institutional investors have the ability to effect changes in corporate policy); \textit{see also} Black, \textit{supra} note 80, at 873-88; Coffee, \textit{Liquidity Versus Control}, \textit{supra} note 80, at 1366-38; Ronald J. Gilson \& Reinier Kraakman, \textit{Reinventing the Outside Director: An Agenda for Institutional Investors}, 43 \textit{Stan. L. Rev.} 863, 882-92 (1991); Roe, \textit{supra} note 15, at 53-65. However, public pension plan activism may be constrained by distinctive investment conflicts. \textit{See} Kathleen Paisley, \textit{Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions}, 4 \textit{Yale L. \\& Pol'y Rev.} 188, 196-206 (1985); Roberta Romano, \textit{Public Pension Fund Activism in Corporate Governance Reconsidered}, 93 \textit{Colum. L. Rev.} 795 (1993).
more of their assets to cash and cash equivalent assets. The average return to small plans is slightly less than, but comparable to, the return to larger plans. A significant number of small plans, however, have seriously imbalanced portfolios. The smallest plans can be regulated without impeding the operation of the capital markets.

The system of pension regulation must address the problem of small plans with a separate set of rules. The objective of these rules would be not to fine-tune the administration of funds, but to prevent disasters such as Bisceglia from occurring. To reconcile the need for some guidelines with the difficulty of providing them, we propose a system of safe harbor rules that would rely on the behavior of large pension fund managers and upon rules set forth in another regulatory regime, the Investment Company Act. A fiduciary who followed these rules would be insulated from liability. At the same time, a fiduciary who did not meet the safe harbor rule would be permitted to try to show that his investments were nonetheless prudent in the sense of eliminating unique risk.

The simplest definition of a small plan would simply incorporate the definition ERISA already uses for filing and registration purposes, a plan with fewer than one hundred participants. The first tier of the safe harbor rules would provide guidelines for appropriate asset allocations based on the market decisions of large investors, which present a fair representation of the asset allocation philosophies of the most sophisticated investors.

The principle component of this plan would be asset allocation guidelines based on the decisions of large investors. Using the decisions of more sophisticated market participants to help less sophisticated ones is a well-accepted technique in other areas of public policy.

88. See infra tbl. II.A, app. II. Small plans, defined as those with under 100 employees, constitute approximately 83% of the total number of existing pension plans. See infra tbl. III.A, app. III. However, only 14% of all pension plan assets are held by small plans and only 11% of all participants are covered by small plans. In other words, even though there are over 500,000 more small pension plans than large plans, the small pension plans only maintain about $261,928 million in total assets whereas the larger plans maintain over $1.5 billion in total assets. See infra tbl. III.B, app. III. Similarly, the small pension plans provide for 8,441,000 participants, whereas the large plans provide for 69,221,000 participants. See infra tbl. III.C, app. III.

89. See infra tbls. I.B & I.C, app. I.

90. See infra notes 98-102 and accompanying text.


92. Our proposed approach is similar to proxy shopping, a mechanism that has been suggested to ensure the quality of social services:

Direct regulation has proven expensive and has often been ineffective.
difficult aspect of devising these rules is choosing the appropriate pool of large investors. No potential comparison is entirely satisfactory. In principle, large defined contribution plans are the appropriate comparison. These plans fall into two groups, self-directed and employer-directed. Unfortunately, both types of plans have disadvantages. The managers of employer funds do not always face the ideal incentives to manage funds wisely, since they shift the plans' investment risk to a captive clientele. Employees who direct their own accounts, however, often make the same mistake as traditional trust law and small fund fiduciaries: they choose undiversified portfolios of lower risk assets such as GICs.93

Defined benefit plans have some advantages over defined contribution plans as a benchmark, since the employers who manage these funds bear significant investment risk. However, the PBGC partially insures defined benefit plans, and the portfolio choice problem for firms is very different than the choice for individuals. Safe harbor recommendations could also be based on the asset allocation decisions of lead investment managers. These managers are probably subject to the most desirable set of market pressures. However, their optimal asset allocation decision may differ from the optimum for pension funds because of their different tax treatment.

The theoretical difficulties in choosing among benchmarks may, however, be moot. The average asset allocation of all three types of funds is remarkably similar.

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93. Berton, supra note 58, at C1; Damato, supra note 58, at C1; Rowland, supra note 58, at 37.
**Average Recommended Asset Blends**
**By Large Pension Funds and Lead Investment Managers**

<table>
<thead>
<tr>
<th>Equity</th>
<th>Fixed Income&lt;sup&gt;94&lt;/sup&gt;</th>
<th>Cash</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment managers&lt;sup&gt;95&lt;/sup&gt;</strong></td>
<td>56.00</td>
<td>32.00</td>
<td>11.00</td>
</tr>
<tr>
<td><strong>Defined benefit funds&lt;sup&gt;96&lt;/sup&gt;</strong></td>
<td>56.80</td>
<td>32.40</td>
<td>3.80</td>
</tr>
<tr>
<td><strong>Defined contribution funds&lt;sup&gt;97&lt;/sup&gt;</strong></td>
<td>51.70</td>
<td>38.00</td>
<td>5.30</td>
</tr>
</tbody>
</table>

Safe harbor regulations, of course, must propose a range of acceptable asset allocations. These ranges, we believe, should be set to permit small funds wide latitude in their investment decisions. We cannot emphasize too strongly that we are trying to prevent extreme strategies, such as investing seventy percent of a fund in mortgages in one county. We are not suggesting that the Department of Labor divine a single ideal portfolio in which small funds must invest. A broad range of acceptable allocations can be derived from the maximum and minimum levels chosen by large investors. The ranges of these levels for investment managers are narrow enough to rule out extreme allocations, while still permitting considerable discretion.

**Maximum and Minimum Asset Allocations Recommended by Lead Investment Managers**

<table>
<thead>
<tr>
<th>Stocks</th>
<th>Bonds</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average</strong></td>
<td>56.00</td>
<td>32.00</td>
</tr>
<tr>
<td><strong>Maximum</strong></td>
<td>65.00</td>
<td>50.00</td>
</tr>
<tr>
<td><strong>Minimum</strong></td>
<td>45.00</td>
<td>20.00</td>
</tr>
</tbody>
</table>

For example, forty-five to sixty-five percent may be a safe harbor allocation range for equity, and up to twenty-five percent may be an acceptable investment level for cash. The comparable figures for defined

---

<sup>94</sup> The fixed income category includes bonds and guaranteed insurance contracts. GICs provide returns similar to other fixed income securities.

<sup>95</sup> See infra tbl. II.E, app. II.

<sup>96</sup> See infra tbl. II.B, app. II.

<sup>97</sup> See infra tbl. II.C, app. II.
contribution plans have a considerably wider range. However, the outlying values among these plans seem to consist predominantly of GICs and employer securities. These anomalies would be reduced or eliminated by the improved standard of diversification outlined in Part V.A.

We therefore propose safe harbor guidelines based on the maximum and minimum allocations chosen by the managers of the largest investment and pension funds. These figures should be revised regularly, just as the Treasury revises the discount rate used in tax calculations. We believe that these guidelines will permit such a wide variety of investment policies that they have no serious chance of interfering with the operation of the capital market.

An adequately diversified portfolio requires not only a reasonably acceptable asset allocation, but also adequate diversification within each asset class. Unfortunately, diversification standards are harder to establish than asset allocation standards. Because we are concerned about overregulation we propose a very modest approach. A minimal model for a diversification standard already exists in the current law governing mutual funds. To qualify as diversified, no more than five percent of a mutual fund’s assets may be invested in the securities of any one issuer. This rule of thumb is surprisingly consistent with the empirical finding of some economists that holding as few as twenty randomly chosen stocks can yield ninety-four percent of the benefits of equity diversification.

The safe harbor rules for small funds should adopt some version of this five percent restriction, which provides some protection from an undiversified portfolio. Indeed, this principle seems so

98. See infra tbl. II.D, app. II.
99. 15 U.S.C. § 80a-5(b)(1) (1994). To qualify for pass-through tax treatment, the investment company must meet a roughly similar diversification requirement provided in the Internal Revenue Code. First, with respect to 50% of the assets, no more than five percent of these assets may be invested in securities of any one issuer I.R.C. § 851(b)(4)(A) (1994). Second, no more than 25% of the value of the fund’s total assets may be invested in securities of any one issuer. I.R.C. § 851(b)(4)(B). Pass-through tax treatment is essential for a mutual fund. Otherwise the taxpayer’s investment faces triple taxation: (1) tax on corporate income; (2) tax on distributions received by the fund; (3) tax on distributions to investors from the mutual fund. See Mark J. Roe, Political Elements in the Creation of a Mutual Fund Industry, 139 U. PA. L. REV. 1469, 1480 (1991).
uncontroversial that it might well be extended to all funds regardless of their size.\footnote{102}

A five percent limit would increase the diversification of pension funds, but would not ensure that pension investments were properly diversified. The full benefits of diversification result from the elimination of unique risk through the covariance of each security against other securities in the portfolio. Because the five percent rule does not take covariance into consideration, a fund may invest much of its assets in stock from one industry and still meet the diversification standards.\footnote{103}

Even though a fund is “diversified” pursuant to the regulations, the assets may still be exposed to extensive unique risks due to a concentration of assets in a particular industry.

The Department of Labor could take two approaches to regulating diversification. One approach would directly set diversification standards. This could be accomplished by adopting a particular theory of portfolio management and examining the risk of thousands of stocks. We are not enthusiastic about this method. Alternatively, the Regulations could take a market-based approach. A properly diversified portfolio can be described in terms of the proportion it invests in various industries and sectors of the economy. The Department of Labor would use the allocation within asset classes of the largest funds to set value-weighting guidelines for medium and small funds. This process, however, will be harder than the basic asset allocation procedure, since it would require

\footnote{102. The most serious potential legal obstacle to this proposal is its application to employer securities. Defined contribution plans are exempt from the 10% limit on holdings of employer securities. ERISA § 407 (1991), 29 U.S.C. § 1107 (1994). Such holdings represent a serious problem, with one major fund holding 91% of its assets in employer stock. See infra tbl. II.D, app. II. On the one hand, courts have held that the rules regarding employer stock do not eliminate the separate requirement of prudence. Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982). On the other hand, a five percent rule would arguably make the explicit permission surplusage. We believe, however, that a five percent rule that merely provides a safe harbor can answer this objection. In any event, Congress could always amend ERISA, preferably, in our opinion, to forbid investment in any employer securities at all.}

\footnote{103. For instance, the nation’s “diversified” mutual funds are 16% invested in technology stocks according to a Morningstar Mutual Funds survey. Sara Callian, Many ‘Diversified’ Stock Funds Are Packed With Technology, WALL ST. J., Mar. 30, 1995, at C1. However, the investment company must disclose such a concentration of assets to the investor. 15 U.S.C. § 80a-8(b)(1) (1994).}
Regulations which set forth difficult decisions about which assets to group together.

An entirely different approach would, rather than set diversification guidelines, require or encourage small plans to delegate investment decisions. Current ERISA rules already provide for such delegation. The named fiduciary of a plan is generally responsible for the management and control of the plan assets. The named fiduciary, however, can limit this responsibility by delegating the authority to manage and control plan assets to a qualified investment manager.104 The investment manager must expressly acknowledge that he is a fiduciary with respect to the plan and must be either an investment adviser registered under the Investment Advisers Act of 1940, a bank, a trust company, or a qualified insurance company.105 The named fiduciary must act prudently and in the interests of the participants and beneficiaries in selecting and continuing the use of the investment manager. However, once the named fiduciary has delegated this authority, he is not liable for the acts or omissions of the investment manager.106

The fact that a delegation mechanism already exists raises a puzzling question: Why do more small firms not already delegate? A few perhaps, may actually wish to manage their own investments. In the past, cost may have been a factor. However, today many financial intermediaries offer off-the-shelf plans for a modest cost. Bisceglia suggests that lack of information is the most important cause of non-delegation. Bisceglia actively sought advice and would presumably have been delighted to delegate all investment responsibility. In all likelihood he simply did not know that such delegation was possible. We therefore propose that the administrative process for small plans make it easy for named trustees to delegate and hard, though not impossible, for them to assume control of their own investments. The current informational filings should be supplemented to require trustees either to provide proof of delegation, or to sign an informed waiver explicitly assuming liability for investment decisions.

Encouraging delegation may have one cost. Delegating investment decisions may reduce the political and economic influence of small pension funds. These costs, however, are less significant than they might at first appear to be. First, nothing in the delegation process would prevent the financial intermediaries to which small plans would delegate

104. ERISA § 402(a), (c)(3), 29 U.S.C. § 1102(a), (c)(3); see also ERISA §§ 405(b)(3)(B), (c)(1), (d)(1), 3(38), 29 U.S.C. §§ 1002(38), 1105(b)(3)(B), (c)(1), (d)(1).
105. ERISA § 3(38) (1991); see also 29 C.F.R. § 2510.3-21(c) (1995).
from exerting economic influence. Second, although small plans are numerous, they represent a relatively small fraction of total pension assets. Ultimately, even if delegation does in part tie the hands of small funds, we believe this cost is worth bearing. The active involvement of pension funds in the American economy is in general to be encouraged, but small plans cannot be active participants without seriously underdiversifying their investments.

The safe harbor rules we propose would vastly improve the pre-litigation guidance that pension funds now receive. However, we also suggest one additional reform. At present, the Department of Labor takes a very strong position that diversification is a matter of fact, and it refuses to issue opinion letters even in extreme cases. For example, it refused to comment on the desirability of a proposal to place an entire pension fund in a single fixed income asset. Issuing such opinion letters, we believe, would make the task of small plan administrators much easier, and with safe harbor rules in place, the Department would presumably find the task of issuing such letters less difficult.

The Department of Labor should also make it as easy as possible for small firms to locate investment advisors to whom they can delegate investment responsibility. This would probably require no more than a listing of acceptable advisors in a given geographic area.

An improved system of pre-litigation guidance, we believe, would serve several purposes. First, both opinion letters and safe harbor rules would provide guidance to the very large class of pension fund managers who are willing and eager to comply with the law, but who are at present unsure of what it requires. This would of course be desirable in itself. It would also make courts more sympathetic to plaintiffs who did bring diversification claims. At present, courts seem unwilling to impose liability on defendants who have made a good faith effort to invest responsibly, however much that effort may have fallen short. Under current law, their reluctance is understandable, since fiduciaries receive so little guidance. With more freely issued opinion letters and safe harbor rules, fiduciaries could not claim that they had no notice of the governing rules.

Second, safe harbor rules would enable the Department to take a more active role in monitoring plan compliance with the diversification requirement. At present, the principal compliance filing, Form 5500, contains essentially no information that would help the Department

107. See infra app. III.
ascertain how diversified a fund is. A plan need only report the amount of assets invested in various broad classes of assets such as equity. For example, a fund which holds an S&P 500 index looks no different from one whose only asset is an interest in a firm on the verge of bankruptcy.

Finally, safe harbor rules would greatly simplify the litigation of diversification cases. Courts at present flatly refuse to dispose of diversification questions on summary judgment, even in extreme cases. Courts have adopted the view that diversification is a matter of fact that must be decided by the trier of fact. Safe harbor rules would at least enable courts to find certain plans in compliance as a matter of law.

D. Self-Directed Accounts

Unique risk is not the only risk that fiduciary rules must consider. No rational investor would assume unique risk, but different rational investors do choose different levels of market risk; that is, they make different tradeoffs between risk and return. The pension system might adopt a number of stances towards market risk. Pension regulators might make a paternalistic choice about the appropriate level of market risk for retirement savings. Except perhaps for barring extremely high levels of risk, we are disinclined to adopt such an approach. Instead, pension funds should be permitted to allow workers to choose the level of rational risk they wish to bear.

The pension system must also decide whether to regulate the choices that pension funds give to participants. Even if the government does not specify a permitted level of market risk, it might permit fund managers to make this decision by offering participants a single fund with a fixed, albeit rational, level of investment risk. This fund-level paternalism is clearly permitted under current law.

There is, however, a trend toward permitting beneficiaries to choose among various investment vehicles. We approve of this trend, and indeed believe it should be encouraged. Funds that permit choice, however, should, not be immune from the obligation to reduce unique risks. Evidence suggests that many workers unintentionally take on unique risk by investing heavily in GICs, which are fixed income assets that include

Prudent Risks for Anxious Workers

no equity component. Under current law, the sponsor of a self-directed plan has no liability for poor employee investment decisions if at least three of the investment alternatives it makes available are diversified, and if all the alternatives in the aggregate enable the participant to eliminate unique risk. Not all alternatives, in isolation, though, must eliminate unique risk, so that participants can easily choose an underdiversified portfolio.

We therefore propose a mild sort of paternalism under which pension funds that give workers some investment choice make it difficult for workers unintentionally to take on unique risks. To accomplish this, all funds available to participants should be required to minimize unique risk. However, funds that permit investment choices should be required to provide participants with a risk-free alternative. Since the optimal unique-risk minimizing portfolio of risky securities is the same for all investors, participants could achieve optimal differences in risks by varying the proportion of this optimal risky portfolio with a risk-free asset. This principle should be not merely a safe harbor rule, as it seems to be at present, but a generally applicable requirement.

Plans should not necessarily offer participants only two choices, an optimal risky portfolio and a risk-free asset. Choosing an optimal risky portfolio is a difficult matter. Allowing participants to choose among different providers of risky portfolios introduces a highly desirable element of market pressure on fund managers. However, there is no reason why any of these funds should be permitted deliberately to assume unique risk.

110. Berton, supra note 58, at C1; Damato, supra note 58, at C1; Rowland, supra note 58, at 37.
113. § 2550.404c-1(f)(5).
114. The emphasis on choice in the Regulations seems intended to deal with the fact that different participants will wish to make different trade-offs between risk and return. See 29 C.F.R. § 2550.404c-1(b)(3)(A), (3)(B)(3).
115. If the employer fails to meet the safe harbor requirements, it may attempt to meet the diversification standards pursuant to ERISA § 404(a). See 29 C.F.R. § 2550.404c-1(a)(2). Most observers interpret this provision as the default rule. See William B. McClure, Jr. & Ladonna Griffith Lesesne, Important Issues in Participant-Directed Investments, in ALI-ABA: ADVANCED LAW OF PENSIONS AND DEFERRED COMPENSATION 721 (1993); Roberta Casper Watson, Final Regulations Under ERISA Section 404(c), in ALI-ABA QUALIFIED PLANS, PCS, AND WELFARE BENEFITS 339 (1993). In either case, plan fiduciaries will remain liable for the prudent selection and monitoring of any designated investment vehicles and designated investment managers provided for under the plan. See 29 C.F.R. § 2550.404c-1(b); see also Howard S. Denburg & Donald P. Carleen, Rules on Participant Directed Individual Plans, BENEFITS TODAY, Oct. 29, 1992, at 3.
On purely libertarian grounds, the pension system should perhaps permit beneficiaries to purposely assume unique risk. Our concern here is the many who unintentionally assume unique risk through GICs. We would therefore require those who wished to assume high levels of unique risk to sign elaborate consent or assumption of risk forms. Undiversified investments should not be part of the normal menu of choices. Portfolio theory implies that allowing some participants to choose rational risks does not require letting others take foolish ones.

VI. CONCLUSION

The American system of retirement income is gradually shifting to savings vehicles that place investment risk on beneficiaries. Many observers have expressed concerns that this shift places an unrealistic burden on the financial skills of the average employee. Under the current system of fiduciary rules, these concerns are well-founded. Pension trustees may satisfy their obligations by investments that are either individually prudent or diversified. This permissive standard provides pension beneficiaries with little protection from incompetent administrators.

In this Article, we propose a two-part reform of the current fiduciary rules. First, we believe that the basic fiduciary standard should be revised to require both prudence and diversification while incorporating a modern conception of prudence. Second, we propose a system of safe harbor rules to guide small plan administrators.

With adequate fiduciary rules, the current trend toward defined contribution plans should not threaten the retirement income of the American worker. Indeed, a shift to defined contribution plans might have many advantages over the current pattern of defined benefit pensions and Social Security. The current Social Security system is not funded.¹¹⁶ Many economists believe that this unfunded approach has a deleterious effect on our national savings rate¹¹⁷ and on the financial security of the system.¹¹⁸ A properly regulated system of defined

¹¹⁶. Instead, each year's payroll tax receipts are paid out to current retirees. As obligations to current workers mount, they are not funded by accumulated savings. This is subject to some qualifications: for example, the fund at present runs a temporary surplus because of the large size of the current working cohort.

¹¹⁷. To the extent that workers are promised annuities from future tax receipts, they are less likely to save for their retirement. See, e.g., Martin Feldstein & Anthony Pellechio, Social Security and Household Wealth Accumulation: New Microeconometric Evidence, 61 REV. ECON. & STAT. 361 (1979); Martin Feldstein, Social Security, Induced Retirement, and Aggregate Capital Accumulation, 82 J. POL. ECON. 95 (1974).

¹¹⁸. In particular, it threatens the system with bankruptcy during periods in which
contribution plans would increase both savings and financial security.

Defined benefit plans, moreover, have proven tremendously difficult to regulate. The elaborate set of defined plan regulations seems to have created a rise in plan terminations, and many observers fear that the PBGC insurance program is in precarious financial condition. Our proposed regulatory structure is considerably simpler than the funding rules now in use for defined benefit plans.

Finally, a shift to defined contribution plans may have some desirable consequences for the American political economy. Pension funds are among the largest accumulations of wealth in the United States. Many observers have long predicted that, because of their size, funds would become an increasingly important force in American economic and political life. In fact, however, pension funds have remained relatively passive both politically and in the governance of corporations whose stocks they own. This passivity may have resulted, in part, from the prevalence of defined benefit plans that are in effect owned by employers. Worker managed funds may be a small step in the direction of, if not pension fund socialism, a more democratic capitalism.

the retired cohort is large relative to the work force as a whole.
Appendix I: Rates of Return

**TABLE I.A**
AVERAGE RATES OF RETURN FOR LARGE PLANS

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate of Return</th>
<th>S&amp;P Index</th>
<th>Salomon Bros. Bond Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>21.90%</td>
<td>32.40%</td>
<td>-2.60%</td>
</tr>
<tr>
<td>1981</td>
<td>5.40</td>
<td>-4.90</td>
<td>-1.00</td>
</tr>
<tr>
<td>1982</td>
<td>18.20</td>
<td>21.40</td>
<td>43.80</td>
</tr>
<tr>
<td>1983</td>
<td>9.40</td>
<td>22.50</td>
<td>4.70</td>
</tr>
<tr>
<td>1984</td>
<td>9.90</td>
<td>6.30</td>
<td>16.40</td>
</tr>
<tr>
<td>1985</td>
<td>20.00</td>
<td>32.20</td>
<td>30.90</td>
</tr>
<tr>
<td>1986</td>
<td>14.10</td>
<td>18.50</td>
<td>19.80</td>
</tr>
<tr>
<td>Average</td>
<td>14.13</td>
<td>18.34</td>
<td>16.00</td>
</tr>
</tbody>
</table>


**TABLE I.B**
AVERAGE RATES OF RETURN FOR PLANS BY PLAN SIZE

<table>
<thead>
<tr>
<th>Year</th>
<th>Plan Size</th>
<th>Small Plan</th>
<th>Medium</th>
<th>Large Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>1.90%</td>
<td>1.10%</td>
<td>-0.10%</td>
<td></td>
</tr>
<tr>
<td>1978</td>
<td>6.00</td>
<td>6.00</td>
<td>6.50</td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>9.30</td>
<td>10.30</td>
<td>11.90</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>21.60</td>
<td>21.90</td>
<td>22.50</td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td>7.60</td>
<td>5.70</td>
<td>3.80</td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>14.50</td>
<td>16.20</td>
<td>17.70</td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>5.50</td>
<td>12.20</td>
<td>14.00</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>10.40</td>
<td>10.20</td>
<td>9.00</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>19.10</td>
<td>21.00</td>
<td>22.00</td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>13.70</td>
<td>14.50</td>
<td>15.10</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>10.96</td>
<td>11.91</td>
<td>12.24</td>
<td></td>
</tr>
</tbody>
</table>

Source: David D. McCarthy & John A. Turner, *Pension Rates of Return in Large and Small Plans*, in *TRENDS IN PENSIONS* 263 (1992). A small plan involves less than $5 million; a medium plan, between $5 and $20 million; a large plan, greater than $20 million.
## TABLE 1.C
**RATES OF RETURN FOR SMALL PRIVATE PENSIONS BY NUMBER OF PARTICIPANTS**

<table>
<thead>
<tr>
<th>Year</th>
<th>All Plans</th>
<th>1 to 9</th>
<th>10 to 24</th>
<th>25 to 99</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>5.70%</td>
<td>5.90%</td>
<td>5.40%</td>
<td>5.10%</td>
</tr>
<tr>
<td>1978</td>
<td>7.10</td>
<td>7.10</td>
<td>7.00</td>
<td>7.40</td>
</tr>
<tr>
<td>1981</td>
<td>11.00</td>
<td>11.10</td>
<td>11.30</td>
<td>10.30</td>
</tr>
<tr>
<td>1982</td>
<td>16.50</td>
<td>16.30</td>
<td>16.70</td>
<td>17.50</td>
</tr>
<tr>
<td>1983</td>
<td>7.70</td>
<td>7.40</td>
<td>8.00</td>
<td>9.00</td>
</tr>
<tr>
<td>Average</td>
<td>9.6</td>
<td>9.56</td>
<td>9.68</td>
<td>9.86</td>
</tr>
</tbody>
</table>

Appendix II: Asset Allocations

**TABLE II.A**
**ASSET ALLOCATION BY PLAN SIZE**

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>$5-25 Million</th>
<th>$25-100 Million</th>
<th>$100-500 Million</th>
<th>Greater than $500 Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>22.95%</td>
<td>21.24%</td>
<td>21.42%</td>
<td>21.82%</td>
</tr>
<tr>
<td>Cash</td>
<td>10.17</td>
<td>8.5</td>
<td>5.62</td>
<td>4.12</td>
</tr>
<tr>
<td>Equity</td>
<td>29.39</td>
<td>32.45</td>
<td>36.77</td>
<td>44.44</td>
</tr>
<tr>
<td>GICs/BICs</td>
<td>14.97</td>
<td>15.67</td>
<td>15.28</td>
<td>9.18</td>
</tr>
<tr>
<td>Real Estate Equity</td>
<td>0.87</td>
<td>0.65</td>
<td>1.2</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Source: **DIRECTORY OF PENSION FUNDS AND THEIR INVESTMENT MANAGERS (1996).**

**TABLE II.B.**
**TOP CORPORATE DEFINED BENEFIT AVERAGE ASSET MIX AMONG 1,000 LARGEST PLANS**

<table>
<thead>
<tr>
<th>Asset</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks</td>
<td>56.8%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>32.4</td>
</tr>
<tr>
<td>Bonds</td>
<td>30.8</td>
</tr>
<tr>
<td>BICs/GICs</td>
<td>1.4</td>
</tr>
<tr>
<td>Annuities</td>
<td>0.2</td>
</tr>
<tr>
<td>Cash</td>
<td>3.8</td>
</tr>
<tr>
<td>Total Other</td>
<td>7.0</td>
</tr>
<tr>
<td>Real Estate</td>
<td>3.4</td>
</tr>
<tr>
<td>Mortgages</td>
<td>0.6</td>
</tr>
<tr>
<td>Other</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: **Special Report: The 1,000 Largest Pension Funds, PENSIONS & INVESTMENTS, Jan. 23, 1995, at 38.**
### Table II.C.
#### Top Corporate Defined Contribution Average Asset Mix Among 1,000 Largest Plans

<table>
<thead>
<tr>
<th>Asset</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>51.7%</td>
</tr>
<tr>
<td>Company Stock</td>
<td>28.3</td>
</tr>
<tr>
<td>Other Stock</td>
<td>23.4</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>38</td>
</tr>
<tr>
<td>BICs/GICs</td>
<td>27.2</td>
</tr>
<tr>
<td>Other Fixed Income</td>
<td>10.8</td>
</tr>
<tr>
<td>Annuities</td>
<td>0</td>
</tr>
<tr>
<td>Cash</td>
<td>5.3</td>
</tr>
<tr>
<td>Other</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Special Report: The 1,000 Largest Pension Funds, PENSIONS & INVESTMENTS, Jan. 23, 1995, at 38.

### Table II.D
#### Top Defined Contribution Corporate Funds

<table>
<thead>
<tr>
<th>Company</th>
<th>DC Fund Size</th>
<th>Total</th>
<th>GICs/BICs</th>
<th>Other Fixed Income</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT&amp;T</td>
<td>13,454,000</td>
<td>67%</td>
<td>8%</td>
<td>30%</td>
<td>2.5%</td>
</tr>
<tr>
<td>General Motors</td>
<td>11,500,000</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>DuPont</td>
<td>7,312,000</td>
<td>15%</td>
<td>9%</td>
<td>35%</td>
<td>3%</td>
</tr>
<tr>
<td>General Electric (401k)</td>
<td>8,489,000</td>
<td>46%</td>
<td>11%</td>
<td>35%</td>
<td>9%</td>
</tr>
<tr>
<td>Boeing</td>
<td>8,168,000</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>8164</td>
<td>92%</td>
<td>2%</td>
<td>2%</td>
<td>3%</td>
</tr>
<tr>
<td>IBM</td>
<td>7,228,000</td>
<td>4%</td>
<td>39%</td>
<td>45%</td>
<td>4%</td>
</tr>
</tbody>
</table>

Average: 8,022,797.71
Maximum: 13,454,000
Minimum: 8164

Source: Special Report: The 1,000 Largest Pension Funds, PENSIONS & INVESTMENTS, Jan. 23, 1995, at 42.
**Table II.E**

**Performance and Recommendation of Asset-Allocation Blends by Brokerage House**

<table>
<thead>
<tr>
<th>INVESTMENT MANAGER</th>
<th>PERFORMANCE</th>
<th>RECOMMENDATION</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3 Months</td>
<td>1 Year</td>
</tr>
<tr>
<td>Dean Witter</td>
<td>5.70</td>
<td>23.40</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>5.90</td>
<td>22.90</td>
</tr>
<tr>
<td>Paine Webber</td>
<td>5.60</td>
<td>21.80</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>5.30</td>
<td>21.70</td>
</tr>
<tr>
<td>Smith Barney</td>
<td>5.60</td>
<td>21.40</td>
</tr>
<tr>
<td>Prudential</td>
<td>5.40</td>
<td>21.30</td>
</tr>
<tr>
<td>Edward D. Jones</td>
<td>5.50</td>
<td>21.10</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>5.40</td>
<td>21.10</td>
</tr>
<tr>
<td>Everen</td>
<td>4.90</td>
<td>20.10</td>
</tr>
<tr>
<td>Lehman Brothers</td>
<td>5.50</td>
<td>20.00</td>
</tr>
<tr>
<td>CS First Boston</td>
<td>5.70</td>
<td>19.90</td>
</tr>
<tr>
<td>A.G. Edwards</td>
<td>5.00</td>
<td>19.90</td>
</tr>
<tr>
<td>Salomon Brothers</td>
<td>4.70</td>
<td>19.00</td>
</tr>
<tr>
<td>Raymond James</td>
<td>5.10</td>
<td>17.50</td>
</tr>
<tr>
<td>Average</td>
<td>5.40</td>
<td>20.80</td>
</tr>
<tr>
<td>Maximum*</td>
<td>5.90</td>
<td>23.40</td>
</tr>
<tr>
<td>Minimum*</td>
<td>4.70</td>
<td>17.50</td>
</tr>
<tr>
<td>Fixed Blend</td>
<td>5.40</td>
<td>21.90</td>
</tr>
<tr>
<td>Stocks</td>
<td>8.40</td>
<td>30.20</td>
</tr>
<tr>
<td>Bonds</td>
<td>1.80</td>
<td>14.10</td>
</tr>
<tr>
<td>Cash</td>
<td>1.50</td>
<td>6.00</td>
</tr>
</tbody>
</table>

* Calculations by authors.
N.A. = Not in study for full period.
### Appendix III: Plan Size

#### TABLE III.A
**DISTRIBUTION OF PLAN SIZE**

<table>
<thead>
<tr>
<th>No. of Plans</th>
<th>% of Total No.</th>
<th>Number of Plans</th>
<th>% of Total Plans</th>
<th>Defined Contribution</th>
<th>% of Total Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;100 Participants</td>
<td>582,773</td>
<td>83.34%</td>
<td>69,858</td>
<td>68.66%</td>
<td>512,915</td>
</tr>
<tr>
<td>&gt;100 Participants</td>
<td>53,777</td>
<td>7.69%</td>
<td>18,454</td>
<td>18.14%</td>
<td>35,322</td>
</tr>
<tr>
<td>Unreported Plans</td>
<td>62,744</td>
<td>8.97%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


#### TABLE III.B
**DISTRIBUTION OF ASSETS**

<table>
<thead>
<tr>
<th>Total (Millions)</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate Assets</td>
<td>% of Total Assets</td>
<td>Aggregate Assets</td>
</tr>
<tr>
<td>&lt;100 Participants</td>
<td>261,928</td>
<td>13.53%</td>
</tr>
<tr>
<td>&gt;100 Participants</td>
<td>1,672,856</td>
<td>86.40%</td>
</tr>
</tbody>
</table>


#### TABLE III.C
**PARTICIPANT DISTRIBUTION**

<table>
<thead>
<tr>
<th>Total (Thousands)</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. Participants</td>
<td>% of Participants</td>
<td>No. Participants</td>
</tr>
<tr>
<td>&lt;100 Participants</td>
<td>8441</td>
<td>10.87%</td>
</tr>
<tr>
<td>&gt;100 Participants</td>
<td>69,221</td>
<td>89.13%</td>
</tr>
</tbody>
</table>
