No. 19-1401

In the Supreme Court of the United States

APRIL HUGHES, *et al.*,

Petitioners,

v.

NORTHWESTERN UNIVERSITY, *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF INVESTMENT LAW SCHOLARS AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTERESTS OF *AMICI CURIAE*[1]

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *amici* represent that they authored this brief in its entirety and that none of the parties or their counsel, nor any other person or entity other than *amici* or their counsel, made a monetary contribution intended to fund the preparation or submission of this brief. All parties have consented to the filing of this brief.

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Amici submit this brief to provide analysis regarding the problem of high costs in retirement plans and the harms that would result to investors if plans are not held accountable for including excessively costly funds in plan menus.

INTRODUCTION AND SUMMARY OF ARGUMENT

Defined contribution retirement plans currently hold almost ten trillion dollars in assets. The sponsors of those plans, typically employers, act as fiduciaries for participants in the plans. Participants construct portfolios by selecting a combination of investment options from lists of choices constructed by plan sponsors. Costs associated with retirement plan investments are important determinants of investor success and have long been an issue of concern to scholars and regulators. These costs vary widely from plan to plan. As a result of both conflicts of interest and simple fiduciary inattention, high fees are a problem in a substantial number of plans. Investors who incur excessive fees may lose tens of thousands of dollars in forgone returns, resulting in the need for those employees to spend additional years in the workforce prior to being able to retire.

Like other retail investors, participants in defined contribution plans often depend on fiduciaries to identify suitable investments and to exclude unsuitable investments from consideration. In a defined contribution plan, this advice takes the form of an array of investment options available to plan participants, usually referred to as the plan "menu."

The careful construction of plan menus is essential to investor welfare and perhaps the most important aspect of a plan sponsor's fiduciary obligations. Put simply, not every investment option is suitable for inclusion in the menu of a retirement plan, and one responsibility of the plan fiduciary is to ensure that unsuitable options are excluded or weeded out. A plan

sponsor has not constructed the menu prudently when it includes chronically underperforming funds, offers high-cost index funds when lower-cost funds track the same index, or includes high-cost share classes while otherwise identical low-cost share classes are available.

Poorly constructed plan menus cause foreseeable harm to plan investors. An extensive body of empirical research establishes that menus affect investor behavior, especially in the context of retirement plans. When menus include high-cost funds, investors reliably tend to include those funds in their portfolios and suffer reduced returns as a result. Indeed, the reason sponsors include high-cost funds in plan menus is often that those funds increase revenue to the service providers who simultaneously advise plan sponsors on menu construction and operate some of the funds included in the plan.

The lower court's approach to fiduciary duties would harm investors. A sponsor abdicates its fiduciary duty of prudence when it disregards the obligation to weed out unsuitable investments from the plan as long as it includes enough good options alongside the poor ones. And this approach would create an incentive to make menus worse. If omitting funds from a plan menu can serve as the basis for a fiduciary claim, but including them cannot, then fiduciaries would be encouraged to offer bloated menus and be affirmatively discouraged from pruning poor options. Allowing a "large menu defense" would effectively turn the fiduciary duty of plan sponsors on its head by encouraging them to adopt menus full of investment pitfalls.

Empirical studies of retirement plans, including a plan similar to the one at issue in this case, show that

employees are best served by concise, carefully constructed menus that exclude excessively expensive and underperforming fund options. Partly in response to lawsuits such as this one, as well as scholarly findings on menu effects, some portions of the retirement plan industry have begun to move away from overly long menus and high fees. The standard adopted by the court below creates a high risk of reversing this progress, leaving investors worse off and creating additional stress for the country's already strained retirement system.

Holding that plan sponsors breach their fiduciary duty by offering funds with excessive fees does not make plan sponsors responsible for every bad outcome an investor experiences. Even if each menu option is chosen with prudence, individual investors may still experience poor returns. Plan sponsors have fiduciary duties for the ex ante presentation of suitable options, not liability for market outcomes.

Defined contribution retirement accounts are among many U.S. households' most important assets. The fiduciary duty of plan sponsors is an essential legal bulwark in protecting the value of those assets. Plan sponsors must act with care and prudence in constructing the menu, and that duty includes ensuring that excessively expensive options are excluded.

ARGUMENT

I. INVESTORS ARE PREDICTABLY HARMED WHEN PLAN MENUS INCLUDE IMPRUDENTLY SELECTED INVESTMENT OPTIONS

A. The Fees Associated with Retirement Plan Investments Are a Significant Problem for Investors

Defined contribution retirement plans[2] are not free. While plan investors typically bear, directly or indirectly, the costs of operating the plan, plan sponsors have a fiduciary duty to operate plans with "care, skill, prudence, and diligence," 29 U.S.C. § 1104(a)(1)(B), including by incurring only reasonable expense, § 1104(a)(1)(A)(ii).

Because saving for retirement is a long-term proposition and fees are charged annually, fees can impose a significant drag on building wealth sufficient for retirement. The U.S. Department of Labor notes, for example, that over the course of a 35-year career, an increase in fees from 0.5% to 1.5% would lead to a 28% reduction in assets available for retirement.[3] The difference between an expensive plan and an inexpensive plan may substantially reduce retirement income or delay retirement.

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[2] Defined contribution plans are commonly called 403(b) plans when maintained by nonprofit entities and 401(k) plans when operated by for-profit companies. Unless a 403(b) plan falls within a regulatory safe harbor, 29 C.F.R. § 2510.3-2(f), the same ERISA fiduciary obligations apply as to 401(k) plans. *See* Pet. Br. 5.

[3] A LOOK AT 401(K) PLAN FEES, U.S. DEP'T LAB. 2 (Sept. 2019), https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/publications/a-look-at-401k-plan-fees.pdf.

Plan participants incur costs at two levels. First, plan-level fees are deducted annually from participant accounts. These fees include administrative expenses and record-keeping costs. Second, fund-level fees are assessed for each of the particular investment funds offered within the plan. Fees vary from fund to fund and are charged as a percentage of assets invested in the fund, so the plan participant experiences the fees as lower returns. This latter set of fund-level fees is the most significant component of total plan expenses for most investors, so ensuring that menus include fee-efficient options is critical to investor welfare.

Unfortunately, plan fiduciaries often harm investors by failing to construct fee-efficient menus. In a comprehensive study of retirement plan fees, Professors Ian Ayres and Quinn Curtis examined the costs associated with more than 3,500 defined contribution plans using plan data from 2010.[4] Looking at total plan costs, they found that investors paid, on average, 0.78% more in fees than participants in the lowest-cost plans did.[5] By way of comparison, the average fee associated with an equity mutual fund is now 0.50%,[6] meaning that the *excess* costs of retirement plans often exceed the typical cost of investing in mutual funds. Fees are so high in some plans that for a young worker, the excess costs incurred over time

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[4] Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and Dominated Funds in 401(k) Plans*, 124 YALE L.J. 1476 (2015).

[5] *Id.* at 1481.

[6] James Duvall, *Trends in the Expenses and Fees of Fund, 2020*, ICI RSCH. PERSP., Mar. 2021, at 1, 3–4.

would consume the entire tax benefit of saving in a 401(k).[7]

Importantly, a substantial portion of the excess cost results from the inclusion of high-cost funds in plan menus. Many menus include "dominated funds," defined as high-cost funds with close substitutes available at substantially lower costs, which do not meaningfully contribute to a more diversified menu.[8] Dominated funds predictably underperform their possible substitutes but nevertheless comprise about 11.5% of the asset base of plans that include them.[9]

High costs in retirement plans are avoidable. Diligent fiduciaries prune high-cost options and seek out low-cost replacements.[10] Indeed, the last several years have seen a downward trend in plan fees.[11] ERISA litigation, including cases that challenge the high cost of specific menu options and the inclusion of retail share classes, has been instrumental in encouraging these changes. Several federal courts have noted the salutary effect of fee litigation on plan costs.[12]

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[7] Ayres & Curtis, *supra* note 4, at 1501.

[8] *Id.* at 1504–05.

[9] *Id.* at 1506.

[10] DELOITTE, 2019 DEFINED CONTRIBUTION BENCHMARKING SURVEY REPORT 5, 25–26 (2019), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/human-capital/us-2019-defined-contribution-benchmarking.pdf (showing that 25% of plans replaced service providers because of fees).

[11] BRIGHTSCOPE & INV. CO. INST., THE BRIGHTSCOPE/ICI DEFINED CONTRIBUTION PLAN PROFILE: A CLOSE LOOK AT 401(K) PLANS, 2017, at 9, 56 (Aug. 2020), https://www.ici.org/system/files/attachments/20_ppr_dcplan_profile_401k.pdf.

[12] *See, e.g.*, *Marshall v. Northrop Grumman Corp.*, 2020 WL 5668935, at *4 (C.D. Cal. Sept. 18, 2020), *appeal dismissed per stipulation*, 20-56096, 2021 WL 1546069 (9th Cir. Feb. 16, 2021) ("This Court agrees that . . . [class counsel's] efforts have led to

In *Tibble v. Edison International*,[13] this Court stated that a fiduciary has a continuing duty to "monitor investments and remove imprudent ones."[14] In *Tibble*, as in this case, plaintiffs pointed to the plan fiduciary's inclusion of (and the failure to remove within the statute of limitations) needlessly costly mutual funds in its menu of options as a breach of duty.[15] What is at issue in this case is precisely the failure to remove (or exclude in the first instance) excessively costly funds.

The allegations about the plan in this case should also be sufficient to state a claim under ERISA for a fiduciary breach. The menu in this case is aberrant in both its length and the inclusion of retail share classes of mutual funds. While a typical retirement plan menu includes about twenty to thirty options,[16] the menu here offered more than 240.[17] Moreover, the menu included 129 retail share classes of mutual

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enormous fee savings for plan participants, and the firm has had a 'humongous' impact on the 401(k) industry."); *Kelly v. Johns Hopkins Univ.*, 2020 WL 434473, at *2 (D. Md. Jan. 28, 2020) ("As has been repeatedly recognized, [class counsel's] work on behalf of participants in large 401(k) and 403(b) plans has significantly improved these plans, brought to light fiduciary misconduct that has detrimentally impacted the retirement savings of American workers, and dramatically brought down fees in defined contribution plans."); *Tussey v. ABB, Inc.*, 2019 WL 3859763, at *3 (W.D. Mo. Aug. 16, 2019) ("[T]his kind of litigation has made a 'national contribution' in the clarification and refinement of a fiduciary's responsibilities and duties. Indeed, this litigation not only educated plan administrators throughout the country, it educated the Department of Labor.").

[13] 575 U.S. 523 (2015).

[14] *Id.* at 530.

[15] *Id.* at 525–26.

[16] BRIGHTSCOPE & INV. CO. INST., *supra* note 11, at 33.

[17] Pet. App. 3a.

funds.[18] As described below, these higher-fee retail share classes inherently underperform otherwise identical institutional share classes of the *same funds*. In retirement plan menus, more is not better. As described in Section II.A, lengthy menus full of high-cost options create pitfalls for investors rather than valuable flexibility.

B. Not All Investment Funds Are Prudent to Include in Plan Menus

Participants in defined contribution retirement plans select investments from menus constructed by the plan sponsor, which is typically an employer. Plan sponsors act in a fiduciary capacity when constructing the plan menu and are bound by law to act with prudence when selecting investment options.[19] Because thousands of investment funds are available and most retirement plans offer only twenty to thirty options, the plan sponsor necessarily exercises considerable discretion in selecting which funds to offer plan participants.

If the universe of funds consisted solely of investments with essentially similar price and performance characteristics, then little would turn on the specific investment products the sponsor chooses. As described below, a substantial body of research, however, suggests that the cost and quality of investment funds vary widely. A prudent fiduciary should choose funds carefully and with the interests of plan participants in mind.

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[18] Pet. Br. 10, 29 (citing JA100-16 (Am. Compl. ¶ 161)).

[19] 29 U.S.C § 1104(a)(1)(B). The U.S. Department of Labor has consistently interpreted this fiduciary obligation as applying to each fund included in the menu. 29 C.F.R. § 2550.404a-1(b)(1)(i).

As a threshold matter, certain fund options are presumptively inappropriate for inclusion in a professionally managed retirement plan. For example, many mutual funds offer both institutional share classes that carry lower fees and are marketed for use in retirement plans and similar large investment pools, and retail share classes sold to individual investors at a higher price, putatively to offset any higher overhead of serving individual investors. These two share classes are associated with the same portfolio of fund assets and will have the same pre-fee performance, but the retail shares will always deliver lower returns after deducting fees. Because the only difference between retail and institutional shares is their cost to the plan participant, the inclusion of retail shares by a plan that has sufficient assets to qualify for the institutional share class, strongly suggests that the plan sponsor is not constructing the menu prudently.

A similar dynamic arises with index funds, which seek only to track a market index, such as the Standard & Poor's 500 index, as accurately as possible, without trying to outperform it. Because all index funds tracking the same index seek to deliver the same performance, the primary basis for choosing between index funds is price. When a high-cost index fund is included in a plan menu over substantially less expensive options, that choice also raises questions as to whether the fiduciary is acting prudently in the interest of plan participants.

Fiduciary attention to fund selection is also important because research shows that the mutual fund market is subject to a number of frictions that ensure it is not perfectly competitive. When the mutual fund market does not weed out underperforming funds, it is

incumbent on fiduciaries to do so. A large body of evidence published in finance and economics journals identifies specific problems with the mutual fund market, including work that directly calls into question the industry's competitiveness.

In a prominent 1997 paper that has been cited thousands of times, then-Professor Mark Carhart published results that "do not support the existence of skilled or informed mutual fund portfolio managers."[20] More recently, in 2009, Professors Javier Gil-Bazo and Pablo Ruiz-Verdú generated a more strongly worded finding: "[T]here is a negative relation between funds' before-fee performance and the fees they charge to investors."[21]

Professors Jonathan Berk and Jules van Binsbergen, found evidence that some "managers are skilled" at "adding value" to mutual funds,[22] nevertheless "[t]he average net alpha across all funds is not significantly different from zero, so there is no evidence that investors share in the fruits of this skill."[23] More importantly, whatever the skill of specific managers might be, Berk and van Binsbergen write that "the conclusion of the literature is that . . . on average, mutual fund returns before fees show no evidence of outperformance."[24]

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[20] Mark Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 57 (1997).

[21] Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation between Price and Performance in the Mutual Fund Industry*, 64 J. FIN. 2153, 2178 (2009).

[22] *See* Jonathan B. Berk & Jules H. van Binsbergen, *Measuring Skill in the Mutual Fund Industry*, J. FIN. ECON., Oct. 2015, at 29, 35–36, https://repository.upenn.edu/fnce_papers/205/.

[23] *Id.* at 30–31.

[24] *Id.* at 5.

This evidence challenges the notion that there is sufficient competition in the mutual fund market to constrain fund fees. Indeed, Gil-Bazo and Ruiz-Verdú concluded, to the contrary, "it appears that mutual fund competition and regulation have not been sufficient to ensure that fees reflect the value that funds create for investors."[25]

The result is that not every mutual fund is a good deal, and some are very bad deals. As Professor Jill Fisch of the University of Pennsylvania Law School writes: "The mutual fund market offers extensive evidence of the long-term survival of funds that consistently underperform the market and simultaneously charge higher relative fees."[26]

Because not every mutual fund is a prudent option for retirement savers, the construction of the menu is a key, indeed *the* key, aspect of plan quality. Ensuring that high-cost, underperforming options are left off the menu is an essentially fiduciary task.

C. Including Imprudent Options in Plan Menus Predictably Harms Investors

Including high-fee, underperforming options in plan menus is not harmless. Overwhelming empirical evidence establishes that menu design influences participant choice. Plan fiduciaries know, or should know, at the time they design the menu, that if the menu contains inappropriate options, some employees will choose them. Indeed, conflicted plan service providers rely on this dynamic: Adding profitable, high-cost

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[25] Gil-Bazo & Ruiz-Verdú, *supra* note 21, at 2179.

[26] *See* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1994 (2010).

funds to a menu is a way to increase service providers' profits from operating the plan.

In an important study of defined contribution retirement plans, Professors Shlomo Benartzi and Richard Thaler show that when investors are offered multiple options with similar investment goals, they tend to allocate their money in proportion to their frequency within the menu through a process of "naïve diversification," suggesting that investors' asset allocations are influenced by the structure of the menu as opposed to optimal portfolio construction.[27] The phenomenon even extends to index funds that track the same index at different prices. Professors James Choi, David Laibson, and Brigitte Madrian examined allocations across index funds with different prices in a laboratory setting and found that Harvard staff members, Wharton MBA students, and Harvard college students paid, respectively, "201, 112, and 122 basis points more in fees than they needed to."[28] The scholars conclude that "mistakes driven by financial illiteracy are the primary source of the demand for high-fee index funds."[29]

When plan participants' behavioral tendency to follow the menu meets a fiduciary that fails to weed out needlessly high-cost funds, plan participants are harmed. One study examined asset allocation decisions

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[27] Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Saving Plans*, 91 AM. ECON. REV. 79 (2001).

[28] JAMES J. Choi, David Laibson & Brigitte C. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds*, 23 REV. FIN. STUDS. 1405, 1407 (2010).

[29] *Id.* at 1408; *see also* Edwin J. Elton, Martin J. Gruber & Jeffrey A. Busse, *Are Investors Rational? Choices Among Index Funds*, 59 J. FIN. 261 (2004).

in retirement plans and noted that most newly added options were high-cost, actively managed funds.[30] Investors predictably moved assets into these funds and experienced reduced returns as a result.[31] Similarly, Ayres and Curtis also find that investors held more assets in dominated funds than would be optimal,[32] and investors pay lower overall fees in plans that include more low-cost index fund options in the menu.[33]

More broadly, it is well understood that retail investors are prone to certain types of mistakes. Professors Richard Thaler and Cass Sunstein, for example, have published influential works attempting to guide investors through investment decisions in retirement plans.[34] Professors Ryan Bubb and Richard Pildes discuss the "[v]oluminous evidence of bounded rationality" in the field of retirement savings in the *Harvard Law Review*.[35] The evidence is also overwhelming that a well-crafted menu can help mitigate these problems.

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[30] Jeffrey R. Brown, Nellie Liang & Scott Weisbenner, *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans*, 91 J. PUB. ECON. 1992 (2007).

[31] *Id.* at 2007–11.

[32] Ayres & Curtis, *supra* note 4, at 1481, 1505–06.

[33] *Id.* at 1486, 1489, 1507, 1517.

[34] *See, e.g.*, RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 118–20 (2008) (discussing the "hard work" of picking mutual funds and making other investing decisions and noting that "investors are making all kinds of mistakes in this domain").

[35] Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. 1593, 1612–13 (2014). Bubb, along with Professors Patrick Corrigan and Patrick Warren explain the phrase "bounded rationality" as follows: Workers "have difficulty thinking through the complex set of problems that retirement planning entails, leading to a range of mistakes, such as choosing a retirement investment portfolio with excessive fees

The duty to avoid high-cost investment options is not unique to retirement plans. Investment fund managers, registered investment advisors, and brokers are all bound by obligations to their clients higher than those of arm's length bargaining.[36] These duties apply not only when one party manages assets for another, as in a trust, but also when a professional gives investment advice for compensation. For example, a broker recommending funds to a retail customer is obligated to understand the customer's investment needs and to make recommendations that are in the customer's best interest, including with respect to fees. All brokers have an obligation to sell only suitable products, and registered investment advisors are held to a full fiduciary standard when giving advice.

Retirement plan sponsors owe full-fledged fiduciary duties to plan participants, but unlike other financial professionals, their recommendations take the form of a menu. Building imprudent options into a menu breaches that fiduciary duty. When a menu imprudently includes investment choices that are plainly inferior to other options in the marketplace or includes higher cost share classes than were available to the plan, investors end up paying more as a result of the imprudent inclusions. A fiduciary acts in the interest of plan participants by building a menu that promotes

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or insufficient diversification." Ryan Bubb, Patrick Corrigan & Patrick L. Warren, *A Behavioral Contract Theory Perspective on Retirement Savings*, 47 CONN. L. REV. 1317, 1338 (2015).

[36] 15 U.S.C. §§ 80b-1 to -21; 15 U.S.C. §§ 77a-78pp; FIN. INDUS. REGULATORY AUTH., FINRA MANUAL § 2111 (2014); UNIF. PRUDENT INV. ACT §§ 2, 7 (1994); *see also* Ian Ayres & Edward Fox, *Alpha Duties: The Search for Excess Returns and Appropriate Fiduciary Duties*, 97 TEX. L. REV. 445 (2019).

success, not by providing a list of options fraught with pitfalls.

The law typically imposes duties to avoid foreseeable harm from commercial activity, even in the absence of a heightened fiduciary obligation. A manufacturer of consumer products is held to an ordinary duty of care, rather than a fiduciary duty. Nevertheless, that manufacturer may be held liable for the foreseeable misuse of its product.[37] Given a plan sponsor's more stringent duty, it likewise has a clear obligation to exclude poor options from the menu to avoid foreseeable harm.

D. Conflicts of Interest Infect the Menu Construction Process

Fee problems in retirement plans are not always the result of simple carelessness. The construction of plan menus is rife with conflicts of interest. Plan sponsors, particularly smaller employers, often lack the financial expertise to select an investment menu, and all plan sponsors engage financial firms to take custody of the assets and to keep plan records. Many of these service providers manage investment funds that are included in retirement plans. In many cases, sponsors rely on conflicted advice about menu options from plan service providers which benefit financially if their own investment products are included in the menu.

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[37] A manufacturer may face liability for foreseeable consumer misuse of a product. *See* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2 cmt. m (AM. L. INST. 1998). In instances where misuse is foreseeable, a manufacturer may be liable if a reasonable alternative design was available that might have avoided the harm. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 3 cmt. p (AM. L. INST. 1998).

Because plan fiduciaries—who do not directly bear the costs of high-fee investments—may rely on conflicted advice when constructing plan menus, low-quality options affiliated with service providers find their way into menus with disturbing frequency.

Another problematic practice is revenue sharing, whereby the costs of administering the plan are defrayed—not by direct, transparent fees to plan participants, but by diverting some of the fee revenue from plan funds to compensate recordkeepers. This practice makes it difficult for plan participants and sponsors to understand how much they are actually paying for plan administrative services. Revenue sharing can lead to overpayment for services, because "many service providers retain all revenue sharing, even if revenue sharing exceeds their fee arrangement. Retaining excess revenue sharing means that the plan sponsor is overpaying for services and is evidence of a breach of fiduciary duty."[38]

Revenue sharing creates incentives for service providers to recommend high-cost funds for inclusion in the menu. Service providers benefit when their inhouse investment funds are included in the plan menu, particularly when those funds are high-margin, actively managed funds. This conflict of interest makes low-cost options less likely to be recommended.[39]

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[38] Sheldon M. Geller, *401(k) Revenue Sharing Creates Employer Liability*, CPA J., Dec. 2015, at 3.

[39] David W. Arey, *A Duty to Act When 401(k) Plan Annual Operating Expenses Are Excessive*, 68 J. FIN. SERV. PROS. 69, 74 (2014) ("[T]he products that were best for advisors to sell were not necessarily the best products for clients to own. Low-cost trackers did not have sufficient fees to reward advisors, so tended not to be recommended.").

These conflicts of interest have measurable effects. A recent study by Professors Veronika Pool, Clemens Sialm, and Irina Stefanescu found that plan service providers who operate in-house mutual funds exhibit favoritism to their own funds in plans to which they provide services.[40] The authors found that plan advisors' own funds were more likely to stay in plan menus following periods of poor performance than were funds operated by other mutual fund companies. "[M]utual funds ranked in the lowest decile based on their prior three-year performance have a deletion rate of 25.5% per year if they are unaffiliated with the plan's trustee but a deletion rate of just 13.7% if they are affiliated with the trustee."[41] Importantly, investors did not correct for this favoritism by holding fewer of the offending funds in their own portfolios. By ensuring that the questionable funds remained in the menu, conflicted service providers were able to continue benefiting from fee income regenerate by the funds.

The plan sponsor's fiduciary duty is the only legal bulwark against these conflicts of interest. Third-party plan providers who provide services to retirement plans are typically not themselves fiduciaries and therefore face no bar to offering conflicted advice. Only the vigilance of plan sponsors acting as fiduciaries on behalf of plan participants can provide a counterweight to the inclusion of low-quality options in plan menus.

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[40] Veronika K. Pool, Clemens Sialm & Irina Stefanescu, *It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans*, 71 J. FIN. 1779 (2016).
[41] *Id.* at 1781.

II. THE COURT SHOULD NOT ALLOW A "LARGE MENU DEFENSE" TO FIDUCIARY BREACHES

A. Large Retirement Plan Menus Do More Harm than Good

When designing retirement plans, more choice is not always better. While menus need to be adequate to enable the creation of a diversified portfolio, this diversification can be accomplished with a modest selection of well-chosen funds. Compiling scores or even hundreds of funds is unnecessary and may harm investors, particularly when excessively costly funds are among those offered. Permitting sponsors to hide behind a "large menu defense" would be deleterious to investment savings.[42]

Diversification is key to investment success, and required of ERISA fiduciaries, 29 U.S.C. § 1104(a)(1)(C). Even financially unsophisticated investors understand that diversification reduces risk. The importance of diversification is underscored by modern portfolio theory, which maintains that the optimal portfolio, in terms of trading off risk and return, is to hold the entire market. This insight, in turn, is the basis for the growth of so-called index funds, which seek only to track the market by, essentially, allowing investors to hold the market portfolio at the lowest possible cost.

While holding a diverse portfolio of individual stocks is important to investment success, the same is not true when building a portfolio of mutual funds or

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[42] *See* Mercer Bullard, *The Social Costs of Choice, Free Market Ideology and the Empirical Consequences of the 401(k) Plan Large Menu Defense*, 20 CONN. INS. L.J. 335 (2014).

similar pooled investment vehicles. Because typical mutual funds already consist of diversified portfolios of individual stocks, there is no need to hold multiple mutual funds in order to diversify. Indeed, many mutual funds, including the popular target date funds, are designed to serve as the only asset an investor needs in order to save for retirement.

Because individual mutual funds are already diversified assets, a retirement plan menu need not provide a lengthy list of funds in order for plan participants to achieve diversification. Professors Ning Tang, Olivia Mitchell, Gary Mottola, and Stephen Utkus examined more than 1,000 retirement plans and found that most offered sufficient options in their menus to permit investors to adequately diversify,[43] even though the median number of investment options in the average menu was fewer than fourteen funds.[44] Increasing the number of funds in the plan did not meaningfully increase the ability of investors to diversify risk once the menu included a dozen funds.

There may be reasons to provide additional choices in a retirement plan menu. For example, a menu might provide additional options in order to accommodate investors with different time horizons or risk tolerances. But a typical menu consisting of twenty to thirty funds is more than adequate to serve this purpose.[45]

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[43] Ning Tang, Olivia S. Mitchell, Gary R. Mottola & Stephen P. Utkus, *The Efficiency of Sponsor and Participant Portfolio Choices in 401(k) Plans*, 94 J. PUB. ECON. 1073 (2010).

[44] *Id.* at 1075.

[45] The well-regarded defined contribution plan for federal employees, the Thrift Savings Plan, covers more than six million participants and seven hundred billion dollars in assets, and its menu

While long menus are not needed for investors to diversify, they do impose cognitive costs. Professors Julia Agnew and Lisa Szykman demonstrate experimentally that investors who are presented with additional mutual fund choices are more likely to report being overwhelmed when allocating a portfolio.[46] Professors Sheena Sethi-Iyengar, Gur Huberman, and Wei Jiang find evidence of this effect within real 401(k) plans: Adding ten funds to a plan menu is associated with a 1.5% to 2% drop in plan participation.[47]

Shortening lengthy menus can provide measurable benefits. Professors Donald Keim and Olivia Mitchell examine a setting particularly relevant to this case.[48] They study the redesign of a retirement plan menu from a large, nonprofit institution containing about ninety funds. The "streamlining" process involved the "elimination of 39 funds from the initial lineup, based on the funds' expense ratios, similarity of return and risk characteristics with retained funds, and the number of participants and aggregate amount invested in each fund."[49] Investors in eliminated funds

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offers just fifteen investment options. *See* FED. RET. THRIFT INV. BD., THRIFT SAVINGS FUND, FINANCIAL STATEMENTS, DECEMBER 31, 2020 AND 2019, at 6–7 (2021), https://www.frtib.gov/ReadingRoom/FinStmts/TSP-FS-Dec2020.pdf.

[46] Julie R. Agnew & Lisa R. Szykman, *Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience*, 6 J. BEHAV. FIN. 57 (2005).

[47] Sheena Sethi-Iyengar, Gur Huberman & Wei Jiang, *How Much Choice is Too Much? Contributions to 401(k) Retirement Plans*, *in* PENSION DESIGN AND STRUCTURE 83, 88–91 (Olivia S. Mitchell & Stephen P. Utkus eds., 2004).

[48] Donald B. Keim & Olivia S. Mitchell, *Simplifying Choices in Defined Contribution Retirement Plan Design: A Case Study*, 17 J. PENSION ECON. & FIN. 363 (2018).

[49] *Id.* at 367.

were either moved to similar funds or to target date funds with appropriate time horizons.

As a result of the streamlining, many investors ended up with improved portfolios. Investors in funds that were eliminated ended up holding lower cost portfolios with less risk exposure and continued to hold these portfolios once the menu redesign was complete. These results suggest that eliminating many of the options in a lengthy menu led to better outcomes to affected employees.

The point is not that short menus are a fiduciary requirement. Rather, these studies point out that lengthy menus, far from being a boon to investors, impose costs on plan participants that may leave them worse off.

B. The Decision Below Would Encourage Fiduciaries to Discount the Interests of Plan Participants When Designing Menus

Despite the risks of overlong menus, the decision below suggests that so long as a plan offers a reasonable number of good options to plan participants, then the plan sponsor should be immunized from fiduciary liability for including bad ones. The court wrote: "[T]he types of funds plaintiffs wanted (low-cost index funds) '*were and are* available to them,' eliminating any claim that plan participants were forced to stomach an unappetizing menu." Pet. App. 19a (citation omitted).

This language suggests that offering a menu that imprudently includes excessively expensive funds cannot be a breach of fiduciary duty so long as the menu also offers some reasonable options. Constructing the fiduciary duty this way would not only remove

liability for imprudent menu construction to investors' detriment; it would also give fiduciaries an affirmative incentive to reduce menu quality by including as many options as possible.

If all a fiduciary is required to do is to ensure that the menu contains a sufficiently large number of funds to construct a decent portfolio, but not to "monitor investments and remove imprudent ones," *Tibble v. Edison*, 575 U.S. at 530, then the plan sponsor will have a strong incentive to include as many funds as possible. By this rule, including a fund carries no legal risk but excluding a fund could lead a participant to argue that the menu provided inadequate options.

Creating an affirmative incentive to lengthen menus while insulating fiduciaries against liability for including imprudent options would turn the ERISA fiduciary duty on its head and weaken the entire defined contribution retirement system. As the foregoing review of the empirical literature makes clear, allowing large menus to shield fiduciaries from imprudent selections would be harmful to plan participants, reduce participation, increase costs, and allow conflicts of interest to go unchecked. These are all harms that a faithful fiduciary would seek to avoid.

While there is no single menu structure required by ERISA, a plan sponsor's duty should encourage, rather than undermine, sound menu design practices. Not every investment option has a fee structure or record of performance that merits inclusion in a large retirement plan. The legal obligation of the plan sponsor is to assemble a menu of options by selecting investments with an eye to cost and performance. When lower cost share classes or better performing funds with similar investment objectives are available, a

fiduciary should typically choose them absent a reason to the contrary.

CONCLUSION

The judgment of the court of appeals should be reversed.

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Respectfully submitted,

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