

Can DOL's Fiduciary Rule Resolve the Conflicts of Interest in Defined Contribution Plans?*

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Abstract: Americans have a tough time saving for their retirement. To make matters worse, the move from defined benefit to defined contribution retirement plans over the years has required greater investor sophistication, discipline, and sound investment advice. Furthermore, past rules did not require investment advisers to consider investors' best interest when providing investment advice. To address this serious and growing problem, the Department of Labor (DOL) has recently instituted a new fiduciary standard for investment advisers in retirement accounts. In this article, we present evidence that by failing to address the multiple-principals problem and lack of transparency, DOL's fiduciary standard is unlikely to succeed in improving investment advice or encouraging American families to save more. First, we show that the fiduciary standard alone is not sufficient to prevent conflicts of interest. Second, we also document that lack of transparency that come with proprietary investments products helps hide poor performance and confounds the uninformed investors' choice problems. We propose that one-principal standard be instituted along with strict transparency requirements to control the conflicts of interest.

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Introduction

Since 1975, a structural shift has occurred in our private retirement system away from defined benefit plans (DB) and into defined contribution plans (DC) which include self-directed Keogh and IRAs, and employer-sponsored 401(k) and 403(b) plans. DC plans provide tax-advantaged, retirement savings vehicles for individuals and they typically represent a large portion of the individual's savings. In 2015, IRAs alone accounted for \$7.6 trillion in assets.¹ This massive shift from DB plans to DC plans has increased the urgency and importance of both transparency and sound investment advice regarding retirement savings.

In spite of the fact that retirement vehicles constitute the bulk of their savings, most American families struggle with the management of DC plans and consequently do not save enough. According to a recent report, 56% of Americans have less than \$10,000 in their retirement accounts. One in three Americans reported that they had no retirement savings.² Clearly, the current DC plans for retirement savings are not working very well for the typical American.

The most important impediment for inadequate retirement savings in DC plans is the poor performance of trillions of dollars of investments in DC plans. The poor performance itself is a consequence of the lack of investor sophistication, discipline, as well as the complexity of the investment instruments and investment concepts. Another factor that compounds the problem is that the current rules do not require investment advice to be in the best interest of the plan beneficiaries.

¹ See Nick Thornton, *Total Retirement Assets Near \$25 Trillion Mark*, BENEFITS PRO (Jun. 30, 2015), <http://www.benefitspro.com/2015/06/30/total-retirement-assets-near-25-trillion-mark>.

² Elyssa Kirkham, *1 in 3 Americans Have Saved \$0 for Retirement*, Time (Mar. 14, 2016), <http://time.com/money/4258451/retirement-savings-survey/>.

To address these serious and growing problems, policy makers have targeted the ‘suitability rule’ in providing investment advice. Under Department of Labor’s (DOL) recently instituted new rule,³ investment advisers for retirement accounts would be subject to a higher fiduciary standard and investment advisers must recommend investment products with the “best interest” of the beneficiaries in mind. The new rule is prima facie laudable. However, there are two provisions in the recently instituted standard that undermine its primary intent of ensuring that investors get unbiased investment advice at a reasonable cost. The first one allows investment advisers to receive compensation such as commissions from financial institutions whose products they recommend for inclusion in the investors’ retirement portfolio. By allowing advisers to receive compensation from both the buyer (investor) and the seller (financial institutions), this provision creates an obvious conflict of interest between the investor and the adviser.

The second provision of concern allows advisers to include proprietary products in the retirement portfolio. These products suffer from greater informational asymmetry with the seller holding an informational advantage, and have complex features that are difficult for the average investor to understand and analyze. There is considerable

³ Under the DOL's definition, any individual receiving compensation for providing advice that is *individualized or specifically directed* to a particular plan sponsor (e.g., an employer with a retirement plan), plan participant, or IRA owner for consideration in making a retirement investment decision is a fiduciary. Such decisions can include, but are not limited to, what assets to purchase or sell and whether to rollover from an employer-based plan to an IRA. The fiduciary can be a broker, registered investment adviser, insurance agent, or other type of adviser (together referred to as "advisers" here). Some of these advisers are subject to federal securities laws and some are not. Being a fiduciary simply means that the adviser must provide impartial advice in their client's best interest and cannot accept any payments creating conflicts of interest unless they qualify for an exemption intended to assure that the customer is adequately protected. DOL's regulatory impact analysis estimates that the rule and related exemptions would save investors over \$40 billion over ten years, even if one focuses on just one subset of transactions that have been the most studied. The real savings from this new rule are likely much larger as conflicts and their effects are both pervasive and well hidden. *See Department of Labor Proposes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle-Class Families Billions of Dollars Every Year*, U.S. DEP'T OF LABOR, <https://www.dol.gov/ebsa/newsroom/fsconflictsofinterest.html>.

evidence that the average investor is not as financially sophisticated as she needs to be to manage substantial retirement assets. Furthermore, proprietary investment products are also likely to involve higher transaction costs. While either of the two issues of informational asymmetry and complexity is sufficient to put the investor at a significant disadvantage, the combination compounds the problem. Furthermore, the above two provisions in combination exacerbate the concern that investors' might not get sound advice: advisers who receive compensation from institutions have a greater incentive to recommend costly proprietary products that earn them greater commissions. In summary, the provisions that create potential conflicts of interest between advisers and investors are further compounded by allowing proprietary products.

The relevant policy question is how significant these issues are. That is, are these potential conflicts of interest likely to result in significant losses to investors due to poor advice? And does the lack of transparency in proprietary products have adverse consequences to investors? In this paper we provide evidence that the answer is "yes" to both questions.

To answer the first question on the effect of conflict of interest, we turn to the performance of DB pension funds which were already subject to the fiduciary standard. In DB pension funds the fiduciary is often an executive of the firm that employs the beneficiary. Such a set up creates a conflict of interest with the fiduciary-executive required to serve two principals: the beneficiaries of the DB fund and the shareholders of the firm. Our evidence indicates that a simple requirement that investment advisers be subject to the fiduciary standard does not by itself address the conflict of interest issue in DB pension funds: in funds with conflict of interest beneficiaries are short-changed for

the benefit of the shareholders. Based on the experience of DB pension funds with conflicts of interest, we can conclude that the effect of conflict of interest is real and significant and will very likely be to the detriment of the beneficiaries of the DC plans. Therefore, without addressing the conflict of interest issue, the DOL's fiduciary rule for DC plans is not likely to be successful in addressing the issue of inadequate retirement savings.

To address the second question regarding proprietary products, we consider two representative products that would continue to be allowed as appropriate retirement investments. We simulate the performance of these products and find that, on a risk-adjusted basis, the performance is inferior to relevant benchmarks. Hence our evidence suggests that without also addressing the transparency problem, the fiduciary standard rule for DC plans is not likely to be successful.

Our conclusion is that the DOL's fiduciary rule is flawed. On the one hand, it requires that investment advisers act in the best interest of the beneficiaries, yet it allows the advisers to receive income from third parties. In addition, by allowing opaque, proprietary products, the fiduciary rule compounds the problem. These proprietary products are often inferior to publicly traded off-the-shelf assets in terms of investment returns, partly because of higher fees, a fact that is not obvious to most investors because of their lack of financial sophistication. The higher fees can be used by financial institutions sponsoring the proprietary products to offer higher compensation to investment advisers (as allowed by the first provision), who in turn recommend the products to unsuspecting and under-informed investors. In fact, DOL's new rule is likely to lead to continued conflicted investment advice, confusion, and wide-spread litigation

to sort out these internal conflicts. We offer two policy recommendations to remedy these problems.

Based on the empirical evidence presented in this paper, our first policy recommendation addresses the rule that allows advisers to receive income both from the investor as well as the sponsor of the investment product. Any serious reform in retirement investment area must address the conflict of interest problem caused by this income exemption rule. The key to eliminating conflicts of interest involves insuring that the investment advisers serve, and therefore receive income from, only one principal, namely the investor. Unfortunately, the recent DOL rule and the associated exemptions simply fail to address the multiple-masters problem.

Second, any reform aimed at investor protection must eliminate the lack of transparency inherent in proprietary investment vehicles. In this paper, we show that by using proprietary products in IRA accounts, certain wealthy taxpayers invested private equity or hedge funds can avoid paying any taxes on their income. Thus, from a public policy perspective allowing proprietary products into IRA accounts does not make any sense. In addition, we show that without transparency, retirement beneficiaries will be unable to make informed decisions about their choice of retirement vehicles. The lack of transparency is often used to charge higher fees and use a portion of fees to induce investment advisers to recommend these products. Once again, on this key issue, the DOL rule falls significantly short by exempting the previous ban on proprietary products in IRA accounts. We recommend a very strict transparency rule in order for any investment to qualify as a retirement asset. Overall, we conclude that simply requiring a

fiduciary standard by itself is not going to solve retirement savings problems. Instead, it is likely to lead to additional problems by creating a conflicted set of rules.

The remainder of our paper is organized as follows: Section 1 provides the historical context in which the shift from DB to DC plans took place and provides a comparison of the two types of plans. Section 2 describes the fiduciary standard and analyzes conflict of interest problem in the context of corporate-sponsored pension funds. In Section 3 we use the evidence of conflict of interest in DB plans to provide an insight to the likely effect of the potential conflict of interest in DC plans. Section 4 explains the problems with allowing proprietary products in pension funds and provides evidence of the harm it can cause investors. Section 5 describes the policy recommendations to resolve the potential conflicts of interest in individual retirement accounts. In Section 6, we present the paper's conclusion.

1. The Shift from Defined Benefit to Defined Contribution plans

In this section we review the factors that caused the shift from DB to DC plans and the pros and cons of each type of plan.

a. Historical Background

For decades, Americans saved for their retirement using employer-sponsored pension plans.⁴ Under this system, the employers bore the burden of managing the assets prudently because the employers promised the employee specific benefits. The beneficiaries did not need to be financially savvy and yet they enjoyed the stability and security of retirement income.

⁴ See, Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 460-62 (2004).

After World War II, employers began to offer pension plans in order to compete for the best employees.⁵ As they become increasingly popular, Americans began to expect these benefits.⁶ Older Americans remember retirement plans where they received a fixed income after retirement, but only if they stayed with an employer for many decades.⁷ The plans used by the majority of Americans in previous generations were defined benefit (DB) plans, that is, the money paid out as pension is set by a tenure/salary calculation.

While secure and convenient, the old system eventually came under pressure. One issue was that employers were burdened with future retirement liabilities that were beyond their control and that created significant uncertainty in the marketplace. Also some firms deliberately underfunded their pension plans or they went bankrupt. To deal with firms that failed, U.S. Government created the Pension Benefit Guarantee Corporation (PBGC) that took over the pension liabilities for failed firms, thus transferring the risk and responsibility of the retirement plans to the U.S. taxpayers. The second issue was that Americans began changing jobs frequently. Consequently, shorter work tenure often meant that the employee did not qualify for any retirement benefits at all. Finally, shorter tenures also meant that Americans were burdened with the task of having to keep track of multiple streams of benefits.⁸

To deal with these problems, the Employee Retirement Income Security Act (ERISA) of 1974 popularized defined contribution (DC) pension plans and changed the

⁵ See Dennis Triplett, *The Great Shift: Moving from Defined Benefit to Defined Contribution*, THE INSTITUTE FOR HEALTHCARE CONSUMERISM (2016).

⁶ *Id.* at A1.

⁷ See, e.g., Leora Friedberg, *Not Your Father's Pension Plan*, THE FEDERAL RESERVE BANK OF ST. LOUIS (Jan. 2002), <https://research.stlouisfed.org/publications/review/02/01/23-34Friedberg.pdf>.

⁸ See, e.g., Quentin Fottrell, *Typical U.S. Worker Now Lasts 4.6 Years on the Job* (Jan. 12, 2014 7:58 AM), <http://http://www.marketwatch.com/story/americans-less-likely-to-change-jobs-now-than-in-1980s-2014-01-10> (arguing that Americans are no longer tied to a single employer for long periods of time).

landscape of the American retirement system permanently.⁹ Following the passage of ERISA, employers moved employees from the traditional defined-benefit pension plans (DB) to the employer-sponsored 401(k) and 403(b) plans,¹⁰ or DC plans, in which the money going into the retirement account was set in advance, but the ultimate value at the time of retirement depended on the performance of the assets held in the plan. Therein lay the danger with DC plans. Unless the retirement savings and investments were managed competently, most Americans could end up in their old age with little savings and at the mercy of various social safety-net programs, such as Social Security or Medicaid, which are only meant to be supplementary retirement vehicles.

ERISA also created the modern Individual Retirement Account (IRA), which played a key role in allowing individuals to access to tax favored defined contribution plans.¹¹ ERISA further added additional regulatory burdens to the DB plans, making the DC options even more appealing to employers. Specifically, the fiduciary obligations inherent in ERISA for the DB plans favored DC plans by shifting these fiduciary burdens to the employees.¹² In addition, under ERISA, DC plans could hold more of an employer's stock than a defined benefit arrangement if chosen by the employees.¹³ Once DC plans became available, more assets shifted to these vehicles.¹⁴

⁹ See Monique Morrissey, *Private-sector Pension Coverage Fell by Half Over Two Decades*, ECONOMIC POLICY INSTITUTE (Jan. 11, 2013, 9:27 AM), <http://www.epi.org/blog/private-sector-pension-coverage-decline/> (describing the decline of private-sector pension plans).

¹⁰ A 401(k) plan is an employer-sponsored, defined-contribution plan that allows employees to save for retirement as a deduction from their paychecks before taxation. Sometimes employees' contributions are matched by the employer. As of 2015, the maximum pre-tax contribution is \$18,000. 403(b) plans are available for employees of certain tax exempt institutions such as public schools.

¹¹ An IRA account allows an individual to save for retirement on a tax-free or tax-deferred basis to supplement employer sponsored plans. There are limits to how much individuals can save to take advantage of tax benefits.

¹² For DB plans, investment advisers are subject to the fiduciary standard meaning that any investment options must be in the "best interest" of the plan beneficiaries.

¹³ See, e.g., Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 460-62 (2004).

¹⁴ *Id.* at 474.

Following ERISA, the total value of assets in private DC plans jumped from \$104 billion in 1978 to \$2.5 trillion in 2000.¹⁵ Evidence shows that Americans have increasingly accepted DC plans, which gave them more control over their retirement assets.¹⁶ Regulatory framework further favored DC plans.¹⁷ While trade unions have favored DB plans (especially when managed by the unions), the erosion of unions' power and membership as well as shift from manufacturing to the service sectors have also contributed to the decline of DB plans.¹⁸ It is important to note that some Americans (U.S. and state government employees being the biggest group) are still DB plan participants.¹⁹ Nevertheless, over 100,000 DB plans with over 7 million plan participants have terminated since the early 1980s.²⁰ Furthermore, the shift from DB pension plans to DC plans appears to be accelerating.²¹

Overall, Americans like the fact that they exercise personal control over their own assets in their DC plans. Every person has different attitudes about risk and will have different investments needs that they feel comfortable with. DC plans do give employees more flexibility to pick the retirement plans that works for them.²²

¹⁵ See e.g., *Facts from EBRI*, EMPLOYEE BENEFIT RESEARCH INSTITUTE (Feb. 2005), [http://https://www.ebri.org/pdf/publications/facts/0205fact.a.pdf](https://www.ebri.org/pdf/publications/facts/0205fact.a.pdf).

¹⁶ Friedberg, *supra* note 8, at 1.

¹⁷ Robert Clark, et al., *The Choice of Pension Plans in the Changing Regulatory Environment*, AEI PRESS, 1990.

¹⁸ Daniel Beller and Helen Lawrence, *Trends in Private Pension Plan Coverage*, U.S. DEP'T OF LABOR, 1992.

¹⁹ Zelinsky, *supra* note 10 at 460-62.

²⁰ *Funding Challenge: Keeping Defined Benefit Plan Pension Plans Afloat: Hearing Before the Senate Comm. On Fin.*, 108th Cong. 57 (2003).

²¹ See Dennis Triplett, *The Great Shift: Moving From Defined Benefit to Defined Contribution*, THE INSTITUTE FOR HEALTHCARE CONSUMERISM, http://http://www.theihcc.com/en/communities/hsa_hra_fsa_admin_finance/the-great-shift-moving-from-defined-benefit-to-def_hzohzk89.html.

²² *Id.* at 1.

b. Investors' Financial Sophistication

While DC plans provide investors control over their retirement portfolio in terms of its risk profile, timing of trades, etc., it also imposes on them the responsibility of managing the portfolio. Therefore, a key question is whether investors have the education, skills and self-discipline to manage their own financial assets. According to a recent White House report, many participants in these new DC plans struggle to understand the basic financial concepts, costs, risks/reward, and diversification.²³ According to the report, many individuals also do not understand the most fundamental concepts and terminology in investing. The report additionally documents cognitive biases such as over-confidence, over-optimism, and loss aversion. These deficiencies often lead to lower investment returns, because they lead households to: 1) trade too much by seeking active management or chasing returns, 2) sell sound investments and hold risky, undiversified, underperforming assets based on recent performance, 3) overweight past returns, or 4) under-diversify.²⁴ Jill Fisch and Tess Wilkinson-Ryan document that the majority of American investors also do not understand the basic ideas like diversification, investment costs, inflation, and compound interest.²⁵ They also conclude that most Americans lack the requisite knowledge to protect them from outright financial fraud.²⁶

The Congress also asked the S.E.C. to investigate whether investors were financially literate as part of the Dodd-Frank Act. Similar results were found by the SEC

²³ Jason Furman & Betsy Stevenson, *The Effects of Conflicted Investment Advice on Retirement Savings*, THE WHITE HOUSE (Feb. 23, 2015), <https://www.whitehouse.gov/blog/2015/02/23/effects-conflicted-investment-advice-retirement-savings>.

²⁴ *Id.* at A1.

²⁵ See Jill E Fisch, and Tess Wilkinson-Ryan, "Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice" (2014). *Faculty Scholarship*. Paper 415.

²⁶ *Id.* at 23.

study that investors had many fundamental financial misconceptions that were leading to important investment mistakes.²⁷ The study also documents that most Americans are not even aware of how much they pay in fees and other costs.²⁸

c. Relative performance of DC and DB plans

Another approach to evaluate the appropriateness of different retirement plans is to compare the performance of the DC plans with DB plans. Given the lack of appropriate education, financial skills, and self-discipline to management their financial assets, coupled with the inability to evaluate conflicted advice, one would expect DC plans to underperform DB plans. DB plans spell out what benefit the enrollee will get upon retirement age, which is often calculated using a set formula and hence do not depend on the skill set of the beneficiary. In contrast, the value of the DC plans at the time of retirement depends on how those assets are managed by the beneficiaries.

Conceptually, traditional DB pension plans provide not only more professional management but also a better balance of risks and rewards.²⁹ This is because the DB plans place almost all of the risk of performance on the shoulders of the employers. If the DB assets outperform, the employer is able to reduce their contributions. If the plan underperforms, the employer has to increase its contributions to the plan. Because the employer has the ability to hire competent professional staff to assist with employee benefits planning or has business experience, the system works reasonably well, achieving both cost efficiencies and economies of scale.³⁰ Nevertheless, it is possible that financially-educated beneficiaries can benefit from DC plans which offer them the

²⁷ *Id.* at 608.

²⁸ *Id.* at 620.

²⁹ Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 Yale L.J. 451, 468 (2004).

³⁰ *Id.* at 8.

flexibility to control risk better.³¹ Furthermore, some beneficiaries can custom tailor risk-reward tradeoff to their own particular needs.³²

Evidence shows that DB plans significantly outperform defined contribution plans. By design, DB plans handle inflation risk by computing benefits as a fraction of the beneficiaries' salaries during the last few years of their working years.³³ In contrast, in DC plans, the employees are expected make financial decisions that help protect against inflation risk. In one study, DB plans outperformed DC plans by 76 basis points between 1995 and 2011.³⁴ Another study found that DB plans outperformed DC plans during 1990-2012 by about 70 basis points.³⁵ Given that there is over \$7.6 trillion invested in IRA accounts alone, a 70 basis point underperformance translates into a cost of over \$50 billion per year. Once again, the lagging performance of the DC plans adds an additional burden on the American worker to increase their future contributions as well as to take higher levels of risk.

d. Conflicts of interest in investment advice

Given their lack of financial education or even basic familiarity of investments, the American public needs professional investment advice. For investors who seek professional advice, there are additional hurdles. Since most investors cannot evaluate the appropriateness of the investment advice, at times, they receive conflicted advice. In its

³¹ *Id.* at 8.

³² *Id.* at 10.

³³ ZVI BODIE ET AL, PENSIONS IN THE U.S. ECONOMY 158 (Nat'l Bureau of Econ. Research ed., 1988), available at <http://www.nber.org/chapters/c6047.pdf>.

³⁴ See, e.g., *Defined Benefit Plans Outperform Defined Contribution Plans Again*, WILLIS TOWERS WATSON (July 2013), <https://www.towerswatson.com/en-US/Insights/Newsletters/Americas/us-finance-matters/2013/Defined-Benefit-Plans-Outperform-Defined-Contribution-Plans-Again>.

³⁵ See Alicia H. Munnell, *Investment Returns: Defined Benefit vs. Defined Contribution Plans*, BOSTON COLLEGE CENTER FOR RETIREMENT RESEARCH (Dec. 2015), http://crr.bc.edu/wp-content/uploads/2015/12/IB_15-211.pdf (finding that defined benefit plans did better by .7 percent).

most basic form, conflicted advice promotes investment options that are profitable for the brokerage firms (and thus the advisers) which tend to be weak, underperforming, overly-costly and undiversified from the employees' perspective. Hence, it should come as no surprise that conflicted advice should have a negative effect on the performance of retirement assets.

Estimates indicate that the aggregate annual cost of conflicted advice is about \$17 billion each year.³⁶ Retirees who received conflicted advice when rolling over their 401(k) balance to an IRA retirement will lose approximately 12% of the value of his or her savings if drawn down over 30 years. The average IRA rollover for those ages 55 to 64 in 2012 was \$100,000, hence losing 12% to fees is the equivalent to losing \$12,000. This is a significant sum, exceeding the total savings of a typical American family for many years. This evidence corroborates the initiative by DOL that reducing conflicted advice will improve lives to typical Americans.

2. Investment Advisory Standards

This section outlines the evolution and main features of the DOL's proposed fiduciary standard and the reaction to it, followed by the key concerns with the new standard.

a. Evolution of the Current Standard

Various government agencies have been floating the idea of a new fiduciary standard for years. For instance, the 2010 Dodd-Frank law reforming Wall Street required

³⁶ See, e.g., Jason Furman & Betsy Stevenson, *The Effects of Conflicted Investment Advice on Retirement Savings*, THE WHITE HOUSE (Feb. 23, 2015), <https://www.whitehouse.gov/blog/2015/02/23/effects-conflicted-investment-advice-retirement-savings>.

the fiduciary standard for all investment advisers.³⁷ The proposed fiduciary standard included both a duty of care and a duty of loyalty. These duties require the fiduciary to act in the best interest of the consumer and to provide full and fair disclosure of material facts and conflicts of interest. In 2011, such a fiduciary standard was withdrawn due to Wall Street criticism.³⁸

Before the change, even financial advisers were governed by different standards. The current system, established in the 1940s, left it to states to develop separate definitions of what the fiduciary standard should be, which often lead to confusion. The federal standard is also meant to address standardizing the care that investors get across jurisdictions.³⁹

Prior to 2016, investors who sought professional advice could receive advice both from broker-dealers and investment advisers, who were subject to different standards. Investment advisers are fiduciaries governed by the Advisers Act, which is based on principles of fiduciary duty. The fiduciary duty includes the duty of loyalty and the duty of care. If an adviser has a material conflict of interest, they must either eliminate the conflict or make a full disclosure. In contrast, an anti-trust authority such as the Securities and Exchange Commission governs broker-dealers.⁴⁰

The Obama administration's Department of Labor (DOL) has proposed stricter standards for financial professionals paid to give retirement advice. Under the new rules, brokers will also be subject to the fiduciary standard and thereby must put client interests

³⁷ Pub. L. No. 111-2013, 124 Stat. 1376 (2010).

³⁸ See <http://www.wagnerlawgroup.com/documents/A0050716.PDF>

³⁹ *Fiduciary Standard Resource Center*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, <http://www.sifma.org/issues/private-client/fiduciary-standard/overview/> (last visited May 3, 2016).

⁴⁰ *Fiduciary Standard Resource Center*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, <http://www.sifma.org/about/> (last visited May 3, 2016).

ahead of their own when offering investment advice for 401(k) plans. The DOL believes these rules would help working families by allowing them to receive advice that is in their best interests.⁴¹

The Office of Management and Budget received DOL's final rule on January 28, 2016.⁴² The rule includes changes to the definition of fiduciary investment advice for purposes of the ERISA standards of fiduciary conduct and the prohibited transaction rules of section 4975 of the Internal Revenue Code. The new rules include the "Best contract exemption," which the DOL indicated was intended to preserve common compensation practices while requiring those who provide fiduciary investment advice to adhere to the "best interest" standard of care. The "best interest" exception requires that investment advisers: 1) provide advice in the client's best interest; 2) create policies that deal with any potential conflict of interest; 3) clearly disclose any conflict of interest (an example of this would be hidden fees); and 4) enter into a written agreement contractually committed to these requirements.

While the "final" proposal itself went through multiple iterations, there are two critical changes in the final rule that are important for our purposes.⁴³

1. Advisers can include proprietary products.
2. Advisers can receive compensation such as brokerage or insurance commissions, 12b-1 fees, revenue-sharing payments.

Unfortunately for the retirement beneficiaries, these two exemptions that DOL provided in response to last-minute industry pressure in fact recreate the problems of opacity and

⁴¹ *Id.*

⁴² Daniel R. Kleinman et al., *Department of Labor Sends Fiduciary Rule to OMB for Review*, THE NATIONAL LAW REVIEW (2016).

⁴³ *Fact Sheet*, U.S. Dep't of Labor, [http:// https://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html](http://https://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html) (last visited May 4, 2016).

multiple-principals or masters, respectively, and they can completely undermine the entire intent of the new rule.

b. Commentary on the Pros and Cons of the New Standard

Some commentators have argued that there is a moral case for the new fiduciary standard. People who invest other's money should be providing advice and guidance that are in the best interest of the clients who might not have the necessary expertise to evaluate the services. The fiduciary standard is in line with this moral view because it requires financial professionals to make decisions based on the question "Is this really in the client's best interests?" Clearly, the suitability standard falls short of this requirement because it 1) creates conflicts of interest and 2) leads to more expensive and less appropriate services.⁴⁴

Others have pointed to the potential adverse impacts of the new rule.⁴⁵ One drawback may be that the fiduciary rule will be costly for financial firms to implement. Stephen Ellis has stated:

"We think that the investors and analysts looking at the more studied implementation costs of the rule are vastly underestimating the rule's potential impact on the financial sector. Current government and financial industry reports have a high-end annual cost of \$1.1 billion, but even our low-end prohibited transaction revenue estimate is \$2.4 billion."⁴⁶

⁴⁴ See Barry Ritholtz, *Find a Financial Adviser who Will Put Your Interests First*, WASHINGTON POST (Oct. 25, 2014), https://www.washingtonpost.com/business/get-there/find-a-financial-adviser-who-will-put-your-interests-first/2014/10/23/21f3a898-596f-11e4-bd61-346aee66ba29_story.html.

⁴⁵ Bloomberg, *Inside the Pros and Cons of a New Fiduciary Rule*, YOUTUBE (Apr. 7, 2016), <http://www.bloomberg.com/news/videos/2016-04-07/inside-the-pros-and-cons-of-a-new-fiduciary-rule>.

⁴⁶ *DOL to Continue Fiduciary Fight in 2016*, BANKRATE, (Jan. 12, 2016, 12:00 PM), <http://www.bankrate.com/financing/investing/dol-to-continue-fiduciary-fight-in-2016/>.

Clearly, higher costs of implementation of the new rule for financial firms are undesirable burden on the entire economy.

Some commentators have argued that the new rule may also lead to political fallout for the Government and a decline in trust of government agencies by increasing costs and reducing investors' choices. In the last few weeks, House Speaker Paul Ryan has become the most vocal opponent of the new fiduciary rule.⁴⁷ Mr. Ryan has called the new rule "Obamacare for financial planning." His main contention is that the new rule will lead to higher costs for the beneficiaries as well as financial firms. The House has introduced two bills that were designed to reduce by half the implementation costs of the new rule, but it is unclear whether these bills will marshal the necessary support. In a public statement, Mr. Ryan has argued: "When this rule comes down, we will be ready to do what we can to protect the savings of hardworking Americans."⁴⁸

Mr. Ryan's concerns are also expressed by the financial services industry. Some are concerned that the new rule could increase litigation costs for financial firms. Some argue that the rule will encourage clients to sue and the threat of litigation may lead advisers to leave the business.⁴⁹ Some experts predict that financial services firms will move more assets to fee-based performance which could limit choice for investors.⁵⁰

⁴⁷ Mark Schoeff, *House Speaker Paul Ryan Becomes Leading Opponent of DOL Fiduciary Rule*, INVESTMENT NEWS (Mar. 8, 2016, 1:46 PM), <http://www.investmentnews.com/article/20160308/FREE/160309931/house-speaker-paul-ryan-becomes-leading-opponent-of-dol-fiduciary>.

⁴⁸ *Id.* at 1.

⁴⁹ Andrew Welsch, *Will Fiduciary Rules Spur New Lawsuits Against Advisers?* ONWALLSTREET (Apr. 19, 2016, 6:22 PM), <http://www.onwallstreet.com/news/will-fiduciary-rule-spur-new-lawsuits-against-advisers-IAG2696400>.

⁵⁰ *Id.* at A1. A fixed fee such as \$50 per year management fee or consultation fee may be too heavy burden for many small investors.

As a result of the opposition from the financial services industry, the final rule has been diluted significantly.⁵¹ The final rule did not include some previously proposed regulatory requirements, including annual investment projections, disclosures, and 401(k) plan contract requirements. The rule also contains exceptions that allow financial firms and advisers to market themselves to consumers. For example, advisers can engage in marketing and public relations without violating the new rule. Public comments, press release, and marketing materials are exempt.⁵² The Obama administration spent a lot of time discussing the urgent need for the new rule, yet some of the provisions have been delayed until 2017 or 2018. The delay in implementation means that a subsequent administration could further modify or nullify the new rule through the political process.

In this paper, we argue that the two most important deficiencies of the new rule in response to industry pressure, is the fact that DOL has allowed exemptions for proprietary investments and multiple sources of income for the advisers. These two provisions together can undermine the foundation of the fiduciary rule, namely enabling the retirement beneficiaries to receive the best investment advice. Consequently, without transparency and single-principal requirements, we do not expect investors to be the main beneficiaries of the new fiduciary rules, because investors will continue to get conflicted advice.⁵³ The next two sub-sections provide an overview of these two deficiencies.

⁵¹ Ashlea Ebeling, *DOL Issues Final Fiduciary Rule: Does it Fall Short?* FORBES (Apr. 7, 2016, 4:28 PM), <http://www.forbes.com/sites/ashleaebeling/2016/04/07/dol-issues-final-fiduciary-rule-does-it-fall-short/#3664cd75548e>.

⁵² *Id.* at A1.

⁵³ See *What it Means for Investors: Rules for Financial Advisers are Changing*, USA TODAY (Apr. 6, 2016 11:41 AM), <http://www.usatoday.com/story/money/personalfinance/2016/04/05/fiduciary-ruling-investor-adviser-adviser/82655312/>.

c. Multiple-principals problem

The first major problem with the new DOL rule (called Best Interest Contract Exemption Rule) is allowing investment advisers to receive income both from investors as well as financial institutions such as brokerage firms whose products the adviser may recommend.⁵⁴ This exemption has created potential conflict of interest as it allows an agent (investment adviser) to serve multiple principals (investors and financial institutions) whose interests diverge. Benefiting one principal necessarily means hurting the other. In effect the potential conflict of interest caused by this exemption potentially undermines the entire basis of the fiduciary rule and sets the stage for continued potential conflicts of interest. The conflict of interest caused by this exemption is exacerbated by the exemption for proprietary products as explained below.

d. The Problem with Proprietary Investment Products

Proprietary investment products are specialized investment portfolios created by brokerage firms. These products can include combinations of stocks, bonds, and derivative assets. They can also include investments in start-ups and other private investment vehicles. The key feature of proprietary products is that they are unique to the

⁵⁴ “The provisions at issue generally prohibit fiduciaries with respect to employee benefit plans and individual retirement accounts (IRAs) from engaging in self-dealing and receiving compensation from third parties in connection with transactions involving the plans and IRAs. The exemption allows entities such as registered investment advisers, broker-dealers and insurance companies, and their agents and representatives, that are ERISA or Code fiduciaries by reason of the provision of investment advice, to receive compensation that may otherwise give rise to prohibited transactions as a result of their advice to plan participants and beneficiaries, IRA owners and certain plan fiduciaries (including small plan sponsors). The exemption is subject to protective conditions to safeguard the interests of the plans, participants and beneficiaries and IRA owners. The exemption affects participants and beneficiaries of plans, IRA owners and fiduciaries with respect to such plans and IRAs.” See, *Best Interest Contract Exemption*, U.S. DEP’T OF LABOR, <http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=28807&AgencyId=8&DocumentType=2>

financial institution offering them. Consequently, there is little or no historical performance data and the information about them is limited to what the sponsor provides. In addition, fees and expenses can be built into the product parameters and are typically much higher than for investing in mutual funds and other publicly listed securities. Given the lack of historical data, brokerage firms typically advertise the hypothetical returns for these products rather than actual historical performance.⁵⁵ Given the lack of full information and hidden fees, it is very likely that these products are highly profitable to the financial institutions offering them. Given that financial products are a zero-sum game, these profits will come at the expense of investors. Because of the DOL rule's exemption about receiving compensation from third-parties, financial institutions can share some of the excess profits with investment advisers. As a result, investment advisers are more likely to recommend proprietary products over publicly available mutual funds to investors, to the the latter's detriment.

Structured products are a common type of proprietary products. Structured products provide investors with modified income streams using options, leverage, and other derivatives. For instance, a structured product can increase in value when the overall market goes down, volatility increases, or when interest rates increase or oil prices decline. By their very nature, structured products constitute a black-box. They do not provide investors a full and complete picture of how they work, what the costs are, and what the future returns may be.⁵⁶ As a result, structured products can be characterized as offering poor transparency.

⁵⁵ See, <http://dealbook.nytimes.com/2012/07/02/ex-brokers-say-jpmorgan-favored-selling-banks-own-funds-over-others/?ref=susannecraig>

⁵⁶ Katrina Lamb, *An Introduction to Structured Products*, INVESTOPEDIA (2016), http://www.investopedia.com/articles/optioninvestor/07/structured_products.asp.

An extreme example of an inappropriate proprietary product is a dominated asset. A dominated asset is one that offers lower returns for the same level of risk or higher risk for the same level of return as another asset (typically publicly traded funds). Therefore, investing in a dominated asset is not in the best interest of any rational investor who prefers higher returns and lower risk. The most common reason a particular proprietary product would be dominated is the high expenses associated with it, which is simply income for the financial institution that created the proprietary product.

Evidence shows that on average, dominated proprietary products had returns at least sixty basis points worse than funds with similar risk.⁵⁷ Furthermore, dominated assets are recommended even though they are not in the best interest of the retirement beneficiaries. Given the lack of transparency about the proprietary investment products, investors are unable to judge what product is being recommended, what the expected returns are, sometimes even what the fees are, and whether the product is dominated.

Dominated assets can exist in employer sponsored DC plans also. Employers may insert high-fee assets into retirement plan menus presumably to increase employees' choices. In return, employers may receive direct and indirect benefits from financial institutions sponsoring these products. In extreme cases, some of these high-cost products can become dominated assets. Over half of plans have menus with at least one dominated fund. For such plans, dominated funds have over 10% of plan assets. While it is up to the employees to choose what they believe is the best product for them, their choice is influenced by the options presented to them in the retirement plan. Financial advisers clearly have the incentive to advise clients to invest more in dominated assets in return for payments from the sponsoring institutions. As discussed earlier, investors' relative

⁵⁷ *Id.* at 1346.

lack of financial sophistication combined with the opacity of proprietary products makes it difficult for them to critically evaluate the advice they receive from their financial advisers.

Unfortunately, regulations tend to be weaker when the issue is the cost of the investment products. ERISA was focused mainly on diversification, and the regulators have sidestepped their obligation to make sure that fund costs are appropriate. In the case of *Hecker vs. Deer & Co.*, the 7th circuit held it “untenable to suggest that all of the more than 2500 publicly available investment options had excessive expense ratios.”⁵⁸ Thus, courts have granted legal immunity to providers that offer investors the choice of dominated funds that are bad for investors.

Under a fiduciary standard, investment advisers could be tasked with ensuring the plans do not contain dominated funds. Revenue sharing is an additional issue. Plan fiduciaries may move assets to higher-cost funds because of benefits they receive from the product sponsors. Unfortunately, the Department of Labor guidelines do not explicitly deal with mapping, if mapping can be argued to be in a client’s “best interest.”⁵⁹

3. Evidence of Conflicts of Interest

While the exemption for investment advisers to receive compensation from third parties has the potential to harm investors due to conflicts of interest, the relevant question for policy makers is how real and significant the adverse effects are. Since the new fiduciary standard is not yet in effect, for evidence we need to look at historical settings where such potential conflicts of interest existed and find out how they played

⁵⁸ *Hecker v. Deere & Co.*, 556 F.3d 575, 577-592 (7th Cir. 2009).

⁵⁹ Ian Ayres, *The Problem of 401(k) Mapping to Dominated Funds*, FORBES (Mar. 29, 2014, 10:48 AM), <http://www.forbes.com/sites/whynot/2014/03/29/the-problem-of-401k-mapping-to-dominated-funds/#5a3595cc7702>.

out. In this section we offer such a setting and provide evidence of conflict of interest in that setting.

a. Fiduciary Standard and Performance of Corporate Pension Funds

We can gain insights into the likely effects of the conflict of interest built into the new fiduciary standard on the performance of DC retirement accounts by examining the performance of DB corporate pension funds which are already subject to the fiduciary standard yet attempt to serve two principals. Conflicts of interest arise in the case of DB pension funds whenever corporate executives serve as pension fund fiduciaries (fiduciary-executives). These fiduciary-executives are subject to potential conflicts of interest since they also attempt to serve two principals: their shareholders and their beneficiaries. Such conflicts of interest might affect the performance of DB pension funds.

The performance of DB corporate pension funds has been of great concern to fund beneficiaries, corporate management, and regulatory agencies. These concerns have been triggered by the record aggregate deficit of private pension plans, greater than \$330 billion in 2004 compared to less than \$100 billion in 1995. Moreover, the number of pension plans that are under the trusteeship of the Pension Benefit Guarantee Corporation has dramatically increased resulting in a seven-fold increase in the benefits paid out by PBGC between 1995 and 2015.⁶⁰

While part of this problem can be traced to the dismal stock market performance during the latter part of this period, it has brought to the forefront the concern that corporate managers may also be responsible for the deficits of their companies' pension

⁶⁰ The Pension Benefit Guarantee Corporation Annual report states that it paid \$5.6 billion in benefits in 2015 compared to \$761 million in 1995. See, <http://www.pb.gc.gov/Documents/2015-annual-report.pdf>

funds. The popular press has been rife with accusations of corporate theft of pension funds⁶¹ Some of the wealth transfer tactics that corporations are accused of are: a) projecting an unrealistically high return, claiming the pension plan is overfunded, and reducing contributions to the plan and diverting them to other uses; b) converting from conventional plans to cash balance plans which reduces payouts but does not trigger a tax for termination;⁶² c) declaring bankruptcy which typically entails losses to employee pension plans while setting up pension plans for senior management that are protected (example Enron & American Airlines); and d) siphoning pension plan surpluses to pay termination benefits and retirees' medical benefits.⁶³

We can also gain insights into the likely effects of the conflicts of interest of fiduciary-executives of DB pension funds by examining the performance of the fund trading decisions involving their own companies' stock since such decisions often involve trading off the interests of shareholders against that of pension beneficiaries. Consider for instance, the private and confidential corporate information fiduciary-executives possess routinely as part of their managerial engagement with the firm. If they ignore this confidential information, or use it to trade shares in pension funds to benefit their shareholders (to temporarily influence the stock price to obtain a favorable price in an acquisition, for example), then they fail in their fiduciary responsibility to the pension beneficiaries. If they use this information to benefit their pensioners, then they violate insider trading laws, which is illegal and, in addition, fail in their fiduciary responsibility

⁶¹ See, e.g., Robert Kuttner, *The Great American Pension Fund Robbery*, BLOOMBERG (Sept. 8, 2003 12:00 AM), <http://www.bloomberg.com/news/articles/2003-09-07/the-great-american-pension-fund-robbery>.

⁶² This tactic was pioneered by Bank of America in 1985. Nevertheless, on July 31, 2003, in response to a lawsuit by IBM workers, a federal judge ruled that such conversions are illegal.

⁶³ Lucent Technologies, Inc., Dupont Co. and SBC Communications, Inc. are some of the companies that used this tactic. See Ellen Schultz, *Coming up Short: Firms had a Hand in Pension Flight They Now Bemoan*, THE WALL STREET JOURNAL (July 10, 2003) at A1.

to their own shareholders.⁶⁴ This is the conundrum facing fiduciary-executives when the serve two masters.

To provide a concrete example assume that the executive-fiduciaries possess some positive non-public information regarding a possible takeover of their own firm. Based on this positive, non-public information, should the fiduciary-executives buy shares from the market place for the pension fund, do nothing or sell shares from the pension fund to their favored third parties? If they buy shares in the marketplace, they would be acting in the best interest of the pension beneficiaries but clearly against the best interest of their shareholders. If they do nothing, they are not actively helping either of their masters. If they sell shares out of the pension assets, they are clearly acting against the best interest of the pension beneficiaries.

Evidence indicates that the potential conflicts are real and not just of academic interest. The fact that pension plan beneficiaries have filed several lawsuits accusing fiduciary-executives of breaching their fiduciary duty by not selling the company stock held by their pension plans in time before the stock prices dropped is a clear indication of conflict of interest.⁶⁵ The conflict of interest also results in suboptimal diversification of pension plans: more than 27% of all employees hold at least half of their 401(k) balances in company stock and nearly 7% have their entire account in company stock. In response to the concern that fiduciary-executives may not always act in the interest of fund

⁶⁴ Interestingly, the recent fair disclosure regulation (Regulation FD) has exacerbated this conflict of interest. While ERISA requires fiduciary-managers to act in the best interests of pension fund beneficiaries, Regulation FD forbids them from favoring one investor over another.

⁶⁵ See Jeff Opdyke, *Retirement Plans Get New Safeguards*, THE WALL STREET JOURNAL (June 21, 2005, 12:01 AM), <http://www.wsj.com/articles/SB111930752257264546>. Some of the companies against whom lawsuits have been filed in 2005 are American Insurance Group, Delphi, General Motors, Krispy Kreme Doughnuts, and Merck.

beneficiaries, some corporations have hired independent fiduciaries to handle the trading of company stock in their own employee pension funds.⁶⁶

In order to provide formal evidence of conflict of interest of fiduciary-executives of DB pension funds, we analyze the performance of pension fund trades in which the fund attains insider status. A pension fund attains insider status either by acquiring more than 10% of the outstanding shares in a given firm (typically this is the sponsoring firm's shares), or by appointing a top level executive (an insider) as the fiduciary. In these instances, the pension fund acquires a legal-insider status and must report all subsequent transactions to the SEC.⁶⁷

It is well-documented that insiders as a group earn abnormal positive returns from trading in their own companies' stocks, presumably taking advantage of their privileged access to information.⁶⁸ Top executives typically earn a higher rate of return than officers and directors, who also earn a higher rate of return than outside large shareholders.⁶⁹ Consequently, access to privileged information directly arises as a result of day-to-day activities of the top executives. Another strand of literature ties the profitability of insider

⁶⁶ Jeff Opdyke, *Retirement Plans Get New Safeguards*, WALL STREET JOURNAL (June 21, 2005, 12:01 AM), <http://www.wsj.com/articles/SB111930752257264546>.

⁶⁷ Legal-insider status ends if the fiduciary is a lower-level executive or a non-executive and/or the pension fund reduces its equity investment to 10% or under.

⁶⁸ See Nejat Seyhun, *Investment Intelligence from Insider Trading* (MIT Press 1998).

⁶⁹ See, e.g., H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 210 (1986); Arturo Bris, *Do Insider Trading Laws Work?* 23 (Yale ICF Working Paper No. 00-19, 2010); H. Nejat Seyhun, *The Information Content of Aggregate Insider Trading*, 61 J. BUS. 1-22 (1988); H. Nejat Seyhun, *Why Does Aggregate Insider Trading Predict Future Stock Returns?* Quarterly J. Econ. 1302, 1329(1992); Bin Ke et al., *What Insiders Know About Future Earnings and How They Use It: Evidence from Insiders' Trade*, 35 J. ACCT. & ECON. 315, 315 (2003); John E. Core et al., *Stock Market Anomalies: What Can We Learn from Repurchases and Insider Trading?* 25 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=533323, 2005); Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315, 1315 (1985); H. Nejat Seyhun & Michael Bradley, *Corporate Bankruptcy and Insider Trading*, 70 J. BUS. 189, 203, 214 (1997).

trading to corporate governance and internal control mechanisms.⁷⁰ In the case of insider-pension funds, however, the presence of conflicts of interest can result in positive or negative abnormal returns. If the concerns of the proponents of fiduciary independence are valid, insider trades by pension funds will favor shareholders and executives at the expense of the beneficiaries, resulting in negative abnormal returns.

b. Data and Performance Measures

The insider trading data in the study is obtained from a compilation by Securities and Exchange Commission (SEC) and made available for sale. The data contains all open market insider trading in publicly traded firms between January 1975 and December 2014.⁷¹ For the purposes of this study, only open market purchases and sales are included. Private transactions, shares acquired through exercise of options, and trades with corporations are excluded. The data on stock market returns are obtained from

⁷⁰ Taylan Mavruk & H. Nejat Seyhun, Do SEC's 10b5-1 Safe Harbor Rules need to be rewritten, 2016 Colum. Bus. L. Rev. 153 (2016); Cindy A. Schipani and H. Nejat Seyhun, *Defining "Material, Nonpublic": What Should Constitute Illegal Insider Information?*, 21 FORDHAM J. CORP. & FIN. L. 327 (2016); S. Burcu Avci, Cindy A. Schipani and H. Nejat Seyhun, Ending Executive manipulations of incentive compensation, J. CORP. L. 2016; S. Burcu Avci, Cindy A. Schipani and H. Nejat Seyhun, Manipulative games of gifts by corporate executives, U. PENN. J. BUS. L., 18, 2016, Hollis A.Skaife et al., *Internal Control over Financial Reporting and Managerial Rent Extraction: Evidence from the Profitability of Insider Trading*, 55 J. Acct. & Econ. 91, 107 (2013); Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 68 J L. & ECON. 371, 403 (2005); Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 Acct. Rev. 131, 144 (1998); Enrichetta Ravina & Paola Sapienza, *What Do Independent Directors Know? Evidence from Their Trading*, 23 REV. FIN. STUD. 962, 1001 (2010).

⁷¹ For most of the sample period analyzed here, Section 16(a) of the Securities and Exchange Act requires that insider transactions be disclosed within the first 10 days of the month following the month of the trade. Section 16(b) prohibits insiders from profiting from short-term price movements defined as profitable offsetting pairs of transactions within 6 months of each other, while Section 16(c) prohibits profiting from short-sales. Sarbanes-Oxley Act of 2002 (effective August 29, 2002) has modified insider trading regulations in many significant ways. First, the new reporting requirement states that insider transactions must be reported electronically by the end of the second business day following the day on which the transaction is executed both through EDGAR and corporate public websites. Sarbanes-Oxley also prohibits purchase and sale of securities during black-out periods. Any profit made from these prohibited transactions shall inure to and are recoverable by the corporation.

CRSP. The final sample contains all insider trades between January 1975 and December 2014 in firms for which stock return data is available in CRSP.

From this sample we extract trades by insiders identified as pension funds. To be included in this sample, an insider's name (name of trader) in the database must contain the word "pension." For a pension fund to be classified as an insider to a company, either it must hold more than 10% of any equity class of security of the firm, or the fiduciary of the pension fund must be a top-level executive. An insider relation code indicates whether the insider status for the pension fund arises as a result of the large shareholdings or interlocking executives.

Table 1 provides the summary statistics of insider trades by pension funds. As shown in Panel A, the sample contains 60 pension funds that have acquired insider status while trading the shares of 94 firms during our sample period. The number of firms exceeds the number of pension funds since some professionally managed pension funds acquire insider status in more than one firm. This situation can result when the pension fund holds more than 10% of the outstanding shares of more than one firm. Purchases and sales as insiders are evenly distributed across firms as well pension funds. The trades are evenly distributed between purchases and sales.

As Panel B of the table indicates, there are a total of 2,049 trades by all pension funds during the sample period. About two-thirds of these trades are by pension funds classified as shareholders (10% or more equity holding). Approximately 30% of the trades are by pension funds whose trustees are classified as insiders. The remaining trades are by pension funds whose officers or directors are classified as insiders and by funds that are classified as affiliated persons. The number of sales is about a third of the number

of purchases for all pension fund trades and the predominance of purchases holds across all subsamples.

Panel C of Table 1 classifies pension fund insider transactions based on whether the fund assets are managed in separate accounts or commingled with pension assets of other firms.⁷² A separate account is a pension fund held for employees of a single firm. A commingled fund, on the other hand, holds the pension investments of two or more firms' employees. We use two criteria to identify separate accounts and commingled funds. First, if a pension fund traded in shares of more than one firm with insider status we identified this fund as a commingled fund. Second, if the pension fund's name contained only the name of a fund management firm and did not include the name of the client firm whose pension money is being managed (e.g. Morgan Guarantee Trust Pension Fund) we classified the fund as a commingled fund.⁷³ Panel C indicates that separate account transactions outnumber commingled fund transactions by a two-to-one margin: the number of transactions in separate accounts equals 1,411, while the number in commingled funds equals 638.

For all our reported results, we measure abnormal returns as holding period returns (HPR) computed in the following manner:

$$HPR_{i,T} = (r_{i,T} - r_{m,T})h,$$

where $r_{i,T}$ is the with-dividend holding period return to stock i for the horizon T , $r_{m,T}$ is the with-dividend return to an equally weighted portfolio of all New York Stock

⁷² We argue later that these two types of funds differ in the extent of conflicts of interest.

⁷³ To the extent our classification is not perfect, we would tend to blur the distinction between separate and commingled categories and we would bias our results toward the inability to distinguish between these two.

Exchange, American Stock Exchange, and NASDAQ stocks for the same horizon T .⁷⁴ The parameter h is equal to 1 if the insider trade is a purchase and -1 if it is a sale. Therefore, a negative reported market-adjusted stock return implies that the return following a purchase is negative or the return following a sale is positive. The holding period starts from the beginning of the month following the trade date and the HPR is measured over four horizons: 6 months, 12 months, 18 months, and 24 months, i.e., for $T = 6, 12, 18, \text{ and } 24$. We report results using alternative measures in Section d below.

c. Performance of Pension Funds when Trading as Insiders

In this section we report the performance of insider trades of DB pension funds when a corporate executive also serves as the fiduciary for the fund. We then compare the performance of insider trades of the fund to the performance of all insiders. Given that corporate executives are attempting to serve two masters (shareholders and fund beneficiaries), we would expect potential conflicts of interest.

Panel A of Table 2 reports mean holding period returns (HPR) of the stocks for each of the four horizons following trades by pension funds. The HPR is reported for all pension fund insider trades as well as for the different classes of insider relationship of the funds (Shareholder, Officer, Trustee, and Other). Availability of return information for different horizons somewhat reduces our sample size. The total sample varies between 1,979 trades for the 6-month horizon and 1,869 for the 24-month horizon. For the entire sample in which pension funds acquire insider status, it can be seen that the mean HPR are negative for all but the 6-month horizon and are statistically significant at the 10% level or better (p -values are 0.053 for the 12-month horizon and less than 0.0001

⁷⁴ We measured abnormal return using the cumulative abnormal return measure and obtain similar results.

for the two longer horizons). Thus, there is strong evidence that pension fund trades in stocks where they acquire insider status result in losses over one to two-year horizons. In addition, the monotonically increasing losses for each of the three horizons starting from the 12-month horizon (mean HPR of -3.4% , -13.6% , and -21.6% for 12, 18, and 24-month horizons, respectively) indicate that, on average, pension fund trades incur losses in each of the last three time horizons.

In about 65% of the trades, the pension funds' insider relationship is that of a shareholder. In these cases, the pension fund has acquired more than 10% of the underlying firms' shares. These pension funds are unlikely to be well-diversified as a result (unless they trade on privileged information), are likely to contain suboptimal levels of unique risk, and present greater opportunities for conflicts of interest. For this subsample with valid return data, the pattern of losses for the overall pension fund sample is repeated, with the pension fund trades showing significant losses over all horizons except the six-month horizon (for which the mean HPR is also negative but not significantly different from zero) and the losses increasing sharply with the holding period. The mean HPR for the 12, 18, and 24-month periods are -11.8% , -22.9% , and -33.4% , respectively.

The other categories of insider status arise from interlocking executives. When the pension fiduciary is an officer-director or a trustee of the sponsoring corporation, once again, the pension acquires a legal-insider status. For the other three categories of relationships, namely, Officer-Director, Trustee, and Other, the results are muted: abnormal profits are positive over some horizons, negative over some horizons, and zero

over others. The number of pension fund trades by the Officer-director and Other categories is, however, relatively small, representing less than 5% of all trades.

Overall, Panel A of Table 2 shows that the main problem occurs when the pension fund acquires a large equity stake in the sponsoring firm. It is possible to argue that holding a large equity stake in the shares of the sponsoring firm could never be optimal for the pensioners in the first place. Given that their human capital is already tied up in the fortunes of the sponsor, the optimal holding in their own company stock should be very small or nil. Consequently, acquiring these large equity stakes serves as a clear signal of the potential conflicts of interest, which is confirmed by the evidence. In the case of interlocking executives, the evidence is not clear cut. Given the small number of observations when a high-level executive is appointed as the fiduciary, it is hard to make a case either way.

Panel B of Table 2 reports the abnormal returns for sub samples of sales and purchases by pension funds. Purchases dominate sales by a factor of about three. The mean HPR are negative and significant ($p < 0.02$) for the two longest horizons in both the purchases and the sales subsamples. The 18 and 24-month mean HPR are -9.7% and -15.1% , respectively, for purchases, and -25.7% and -42% , respectively, for sales. For the purchase subsample, the 12-month return is not significantly different from zero while the 6-month return is positive and significant. For the sales subsample, the 12-month return is negative and significant at the 10% level while the 6-month return is not significantly different from zero.

To adjust for the possibility that trades by a few pension funds in a few firms may account for the bulk of the sample, we averaged all insider trades by a pension fund in a

given firm and treated it as a single observation. This reduced the observations to 117. The results, however, are essentially the same. Pension fund insider trades earned negative mean HPR over all but the 6-month horizon. The 12, 18, and 24-month mean HPR were -8.34% , -17.1% , and -18.1% , respectively, with p values (adjusted for heteroskedasticity) less than 0.08. The 6-month mean HPR was not significantly different from zero.

The conclusion from the above results is that pension funds earn negative market-adjusted returns when they acquire a large equity stake in the underlying firms. This contrast is even more evident when compared to the performance of other insider trades. Table 4 provides the performance of all insiders. In contrast to the results in Panel A of Table 2, we find that mean market-adjusted HPR of the trades of all other insiders for all four horizons are positive and statistically significant (p -values less than 0.001). Thus it is clear that the poor performance of pension fund trades when they trade as insiders is an exception to the performance of overall insider trades. This result is consistent with the finding of noted academics that defined-benefit pension funds that invest in equity underperform the *S&P 500* index.⁷⁵

d. Comparison of Separate Accounts and Commingled Funds

While the poor performance of insider trades of pension funds as whole provides preliminary support for the proponents of independent pension fund fiduciaries, the case for independent fiduciaries will be stronger if we find that the degree of independence is positively related to fund performance. We propose the following methodology to test

⁷⁵ Josef Lakonishok, *The Structure and Performance of the Money Management Industry*, BROOKINGS PAPERS: MICROECONOMICS 339, 339-91 (1992).

this relationship. Pension funds can be categorized as separate accounts or commingled funds. As explained earlier, separate accounts are pension funds that are created exclusively for a sponsoring company's employees, while commingled funds mingle the pension investments of multiple companies. If one is concerned about conflicts of interest of the fiduciary-executive, an argument can be made that the conflicts of interest are worse in the case of separate accounts. Recall that pension funds can obtain insider status in one of two ways: either by an interlocking executive structure (senior company executives serving as fiduciaries of their own firm's pension fund, for example) or by holding 10% or more of the company's stock. In separate accounts under an interlocking executive structure, insiders can use pension fund assets either to benefit themselves or their shareholders directly without having to co-ordinate their decisions with anyone else. They can do so by using the pension funds' assets to prop up their stock prices temporarily (by directing the pension fund to buy the shares of their firm prior to exercise of their executive stock options or prior to an acquisition), or push their stock prices down temporarily (by directing the pension fund to sell shares of their firm prior to granting of executive stock options). These actions would hurt the beneficiaries of pension funds and benefit the insiders themselves or the firm's stockholders. In contrast, such actions require co-ordination and collusion with the outside managers of commingled funds. Such coordination and collusion is likely to be difficult to achieve and costly for several reasons. First, the interests of the commingled pension fund manager and the firm's executives and/or shareholders may not be congruent. For instance, the timing of key events relating to the compensation contracts of firm's executives (granting and exercise of executive stock options) and that of pension fund

managers (evaluation dates of pension fund performance) need not be the same. Second, for commingled fund managers, the performance of one of the stocks in their portfolio is less critical than for the firm's executives and shareholders. Third, benefiting the insiders might require quid-pro-quo, payment of which is likely to increase the probability of detection. And finally, outside professional pension fund managers have more to lose in terms of their reputation by engaging in these types of manipulations in a given pension fund. Consequently, we expect conflicts of interest to be less prevalent in outside managed commingled funds. Therefore, if conflicts of interest are present, we expect insider trades of commingled funds to outperform that of separate accounts.

Table 3 presents the performance of insider trades of separate accounts and commingled funds. The mean HPR of separate accounts is negative (between -4.6% and -34.0%) and significant ($p < 0.0001$) for all four holding periods. By contrast, the mean HPR for commingled funds is positive (between $+8.3\%$ and $+10.0\%$) and significant ($p \leq 0.001$) for all four horizons. Thus, the evidence is consistent with the hypothesis that there is a conflict of interest between fund managers and fund beneficiaries with the fund managers acting in the interest of the firm's shareholders or themselves at the expense of the fund beneficiaries.

e. Investigation of Alternative Explanations for Poor Performance of Pension Fund Insider Trades

In this section we investigate three alternative explanations for the poor performance of insider trades of pension funds relative to insider trades as a whole. Specifically, we investigate if the performance is the result of some unknown bias in the subsample of firms in our data with pension fund insider trades; if it is due to liquidity

constraints resulting from unexpected outflows; and finally, if it is due to the difference in trading strategies of pension funds. The tests that follow rule out all three alternative explanations for the poor relative performance of pension fund insider trades.

1. *Sample bias*

To test if the subsample of firms with pension fund insider trades has any special characteristics that result in the poor performance of these trades, we analyze the trading performance of other insiders in the same sub sample of firms with pension fund insider trades. These tests help us check the possibility that there is something unique about these particular set of firms that leads to trading losses. Perhaps, all other insiders (in addition to pension funds) suffer trading losses in these set of firms due to some unspecified chain of events.

Table 4 reports the results. It can be seen from the table that the mean HPR for all other insiders is positive and significant for ($p < 0.0001$) for all horizons. Hence, while pension funds suffer trading losses, the other insiders in the same set of firms are trading profitably. These results contrast sharply with the performance of pension fund insider trades reported in Table 2. In summary, we find that pension funds do systematically worse than other insiders in the same firms, thus providing no evidence of any bias in the sample of firms with pension fund insider trades.

2. *Liquidity constraints*

It is possible that the relatively poor performance of pension fund insider trades is due to forced liquidation of assets to meet pension payments to beneficiaries. Open-end mutual funds and ESOP face similar liquidity constraints. One can reasonably argue that mutual funds face greater risk of liquidity constraints than pension funds since flows in

and out of mutual funds are less predictable than the flows in and out of pension funds. To test this hypothesis, we compared the performance of pension fund insider trades with that of mutual fund and ESOP insider trades.⁷⁶

To identify mutual fund trades we searched the names of traders in the insider trading database for words that identify them as a mutual fund. Our algorithm searched for the following specific words: ‘Fund’, ‘Principal’, ‘Venture Capital’ ‘Euroventure’, ‘Capital Corporation’, ‘Partner’, ‘Trust’, ‘Investment’, and ‘Asset Management’. We also ensured that the name of the insider did not contain the word ‘Pension’. ESOP firms were identified by searching for key words ‘employee stock ownership’ and ‘ESOP’.

The performance of mutual fund insider trades is reported in Table 4. The mean HPR is positive 8.14% by 24-months, and significant for the sample of mutual fund insider trades, ($p < 0.0001$) for all horizons. In addition, the monotonic relation between the mean HPR and the horizon indicates that mutual fund insider trades yield positive returns in each of the periods.

A similar result holds for ESOP insider trades. The mean HPR is positive and significant for the sample of mutual fund insider trades, ($p < 0.0001$) for all horizons and monotonically increasing with the horizon. By 24 months, ESOP-insiders’ profits rise to 7.36%. These figures are comparable to the profits for all insiders containing between 1.7 million and 2.3 million observations. Our evidence indicates that liquidity constraints are unlikely to explain the poor relative performance of pension fund insider trades. Trades

⁷⁶ Similar to pension funds, fiduciaries of ESOPs also face conflicts of interest situations. They might trade-off private benefits of employees against stock price performance. ESOPs are strong deterrents to takeovers and that changes in ownership due to ESOPs are associated with negative stock price reactions. See Susan Chaplinsky & Greg Niehaus, *The Role of ESOPs in Takeover Cases*, 49 THE JOURNAL OF FINANCE, 1451, 1451-70 (1994).

by mutual funds (which face potentially even greater liquidity constraints) and ESOP profit from insider trades just like other insiders.

3. *Trading strategies*

We investigate whether the differences between the performance of pension fund insider trades and that of all insider trades can be explained by differences in investment styles. We analyze two investment styles: momentum and mean-reversion.⁷⁷ A trade is classified as a momentum trade if a purchase (sale) is made after a positive (negative) HPR over the six-month period ending in the month preceding the trade date. A trade is classified as a mean-reversion trade if a purchase (sale) is made after a negative (positive) HPR over the six-month period ending in the month preceding the trade date.⁷⁸ Seyhun finds that insiders tend to follow a mean-reversion strategy for both short horizons of up to one year as well as long horizons up to five years. The evidence in Panel A of Table 5 supports this finding. For the entire sample of insider trades, about 63% of the trades are consistent with a mean-reversion strategy (selling winners and buying losers). Similarly, when we limit the sample to insider trades in firms in which pension fund insider trades occur, about 60% of the trades are consistent with a mean reversion strategy as reported in Panel B. In contrast, the percentage of pension funds trades that can be classified as mean-reversion is much lower (50 – 52%), as reported in Panel C.

⁷⁷ Momentum refers the finding that recent performance of stocks continues in the same direction for about 12 months. Mean-reversion refers to the reversal of these patterns over the next three to five year horizons. Jegadeesh and Titman report that past six-month winners on NYSE-AMEX continue to outperform past six-month losers by about 1% per month over the next 6 months. See Narasimhan Jegadeesh, *Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency*, 48 *Journal of Finance* 65-91 (DeBontd and Thaler document mean-reversions over longer holding periods. They show that a strategy of buying long-term losers and selling long-term winners would have earned about 25% over the subsequent three-year period. See Werner De Bondt & Richard Thaler, *Further Evidence on Investor Over-reaction and Stock Market Sensationality*, 42 *JOURNAL OF FINANCE* 557-81 (1987).

⁷⁸ Nejat Seyhun, *Investment Intelligence from Insider Trading* (MIT Press 1998).

While there appears to be evidence that pension fund insider trades follow on average a different trading strategy than other insider trades, the difference in performance cannot be explained by the difference in trading strategy. To see this, compare the performance of pension fund insider trades that follow a mean-reversion strategy with trades of non-pension fund insiders in firms traded by pension funds since both groups seem to follow the same pattern in their investment style (Panels B & C, Table 5). The mean HPR for pension fund trades are significantly negative for mean-reversion trades for all horizons ($p < 0.0001$). By contrast, the mean-reversion trades of other insiders in the same firms (Panel B) earn a significant positive return for all horizons except the 12-month horizon in which they earn returns not significantly different from zero. Therefore, the evidence does not provide support to the hypothesis that trading strategies are the cause of the lower profit of pension fund insider trades.⁷⁹

⁷⁹ We also ran the various tests we conducted to check the robustness of our results. For the sake of brevity, we summarize the results of our tests, rather than provide detailed tables.

a. Performance measured by style adjusted returns

Style adjusted returns are computed by taking into account size and book-to-market ratios.⁷⁹ First, at the beginning of each year, we classified all firms in the CRSP universe into ten size groups (using NYSE market capitalization decile cutoffs) and five book-to-market groups (using book-to-market values computed at the beginning of the preceding July). For each month between January 1975 and December 2003, we compute the equally-weighted average returns for each of these 50 benchmark portfolios. We then assign the firms in our sample into one of these 50 portfolios based on their size and book-to-market ratios. Abnormal returns are computed as the difference in returns between the firms in our sample and the matched size and book-to-market benchmark groups.

Using this approach, we find that the mean HPR of pension fund insider trades is still negative and significant for the two longer horizons (mean HPR of -7.2% and -11.9% with p -values less than or equal to 0.002). The mean HPR for the 12-month horizon is not significantly different from zero while the mean 6-month HPR is positive and significant (mean HPR of 3% with p -value of 0.000). This is in contrast to the performance of all insiders in the same firms with pension fund insider trades; the trades of these insiders still earn significant positive HPR consistently over all four horizons.

The results using the style-adjusted model for the trades of separate accounts and commingled funds are qualitatively similar to the results reported earlier. The mean HPR for the trades of separate accounts are significantly negative for all four horizons and monotonically increasing with the horizon; they vary from -3.2% for the 6-month horizon to -23.9% for the 24-month horizon. By contrast the mean HPR for the trades of commingled funds are significantly positive for all four horizons ($p < 0.0001$); they vary from 15.6% for the 6-month horizon to 17.1% for the 24-month horizon. Thus, using the style-adjusted model confirms our finding that the conflict of interest hurts the beneficiaries of pension funds.

4. Evidence that Proprietary Products are not in the Best Interest of Beneficiaries or the Taxpayers

Proprietary products can be any investment vehicle that the investment sponsor creates. They can include a bundle of securities that already trade on public exchanges. They can also include structured products whose payoffs are modified using leverage, option, futures and other derivative products. Finally, they can include investments in start-ups and other private investment vehicles. The key feature of these products is that they do not trade on any public exchanges and the information about them is limited to what the sponsor provides.

There are multiple problems with allowing proprietary investment products in retirement accounts. One important problem is valuation. Since these products are unique and do not trade on the market, it is not possible to observe a market determined price or value for them. Instead, the valuation of the proprietary product is made privately by the owner of the product. This private valuation creates problems both for the taxpayers as

b. Performance measured using cumulative abnormal returns

In addition to HPR, we also used cumulative market-adjusted abnormal monthly returns of the stock (CAR) starting from the month that follows the trade computed as:

$$CAR_{i,T} = \sum_{t=1}^T (r_{i,t} - r_{m,t})h,$$

where $r_{i,t}$ is the with-dividend return to stock i for month t , and $r_{m,t}$ is the with-dividend return to equally weighted portfolio of all New York Stock Exchange, American Stock Exchange and NASDAQ stocks for month t . The parameter h is defined as before as equal to 1 if the insider trade is a purchase and -1 if it is a sale.

The results using CAR are qualitatively similar to those obtained using HPR. The CAR of overall pension fund insider trades is negative and significant for all horizons. In addition, CAR of insider trades by separate accounts are negative and significant while that by commingled funds are positive and significant.

c. Volume of trades and performance

In order to check if the performance of pension fund insider trades is related to the volume of trade, the sample was divided into four volume groups based on the number of shares traded: less than 100 shares (sample size = 3 trades), 100 to 1000 shares (224 trades), 1000 to 10,000 (1028 trades) shares, and greater than 10,000 shares (794 trades). The mean HPR for the top three volume sub-groups are negative (and significant at the 5% level or better) for the 18 and 24-month horizons. There was no clear relationship between the trade volume and the HPR.

well as the retirement investors. From the taxpayers' perspective, these products can be used to create unfair tax shelters. For the small investor, these products constitute black boxes with no way to peer inside and understand the structure, costs, risks and expected returns.

Some examples would be helpful to illustrate the problems associated with the proprietary products in retirement accounts. First, we illustrate the conflicts created for the U.S. taxpayers. Suppose that an entrepreneur creates a start-up with an expected market value of \$20 million. A proprietary investment vehicle is then created using the start-up assets, and 20 billion shares are issued against it. Suppose the fair market value of these private shares is be \$0.001. However, since is no market for this product, the entrepreneur can attach any private valuation on this investment. Assume that the entrepreneur makes a small valuation error (in absolute value) and privately values each proprietary share at \$0.0000001 instead of \$0.001. At this price, the entire startup is now valued at \$2,000. The entrepreneur then simply uses \$2,000 to put all 20 billion shares in his IRA account.

At a later date, when some or all the proprietary investment is offered to the public at the fair market price of \$0.001 per share, the IRA account balance will suddenly grow from \$2,000 to \$20 million. In effect, the value increase has taken place in a tax sheltered account, thereby free from taxation. This tax-free wealth can now be consumed or passed to future generations.⁸⁰ If sufficient time passes between when the

⁸⁰ See the report of the U.S. General Accounting Office, which reports that in 2011 there were over 600,000 individuals with estimated IRA balances over \$1 million, more than 1,000 individuals with an estimated IRA balances more than \$10 million and over 300 individuals with an estimated IRA balances that exceeded \$25 million. The aggregate estimated dollar balance of the \$25 million + group is \$81 billion, which means this group could be generating significant tax loss for the U.S Government. See <http://www.gao.gov/products/GAO-15-16>, "IRS Could Bolster Enforcement on Multimillion Dollar Accounts, but More Direction from Congress is Needed."

investment was purchased by the IRA account and when the initial public offering took place, it would be difficult if not impossible to determine whether the value increase is due to subsequent improvements in the start-up or the initial misvaluation.⁸¹ Since these private equity or carried-interest investments typically takes years to develop, while Internal Revenue Service can only audit the last three years, exacerbates the conflicts of interest.

A recent GAO study has found that there are more than 300 taxpayers who own IRA accounts with an aggregate value of about \$81 billion.⁸² Thus, the average balance in these accounts is over \$250 million each. While all of the IRA balances are fully taxed as ordinary income when distributed to the taxpayer, there is an easy way of getting around this taxation as well. After contributing \$2,000 to an ordinary IRA account and purchasing privately-valued proprietary product, the taxpayer can simply convert this IRA into a Roth-IRA, pay taxes on extra \$2,000 of income and after the valuation step-up, they can enjoy the \$20 million wealth increase completely tax-free.⁸³

Another problem with the proprietary products arising from private valuation is the lack of information regarding their risks and expected returns for the retirement beneficiary. While a complete analysis of the various types of proprietary products is beyond the scope of this paper, we examine the potential performance of a representative

⁸¹ The GAO Report states "A small number of taxpayers has accumulated larger IRA balances, likely by investing in assets unavailable to most investors—initially valued very low and offering disproportionately high potential investment returns if successful. Individuals who invest in these assets using certain types of IRAs can escape taxation on investment gains. For example, founders of companies who use IRAs to invest in nonpublicly traded shares of their newly formed companies can realize many millions of dollars in tax-favored gains on their investment if the company is successful. With no total limit on IRA accumulations, the government forgoes millions in tax revenue. The accumulation of these large IRA balances by a small number of investors stands in contrast to Congress's aim to prevent the tax-favored accumulation of balances exceeding what is needed for retirement." *See Id.*

⁸² *Supra* note 80.

⁸³ An ordinary IRA account allows the taxpayer to contribute using pre-tax dollars but pay full income taxes upon distribution. In contrast, a Roth IRA allows the taxpayer to contribute from after-tax income, but then enjoy all distributions without taxation upon reaching retirement age.

example of these products. A common feature of these proprietary products is to limit downside risk and retain upside potential. One representative retirement investment vehicle we analyze, offers the following features:

- a. Protects the principal from market downturns
- b. Grows retirement assets
- c. Guarantees rising income for the first 10 years of the contract
- d. Doubles retirement income potential if no withdrawals are taken for the first ten years.
- e. Limits the upside gains to the investor.

Sometimes these products also explicitly state that there are no fees or commissions charged. In this case, the benefits to the brokerage firm are not zero but they are hidden in the terms of product specifying how much the investors participate in the upside. While exactly how these objectives are achieved are not disclosed to the investor, the payout structure is disclosed as detailed below.⁸⁴

- a. Annual accounting: Interest is earned based on annual changes in S&P 500 index. If S&P is up at the end of the year, interest is credited up to 4% cap. If S&P 500 index is down for the year, no interest is earned.

- b. Monthly accounting: Interest is based on monthly changes in S&P 500 index. If S&P is up at the end of the month, interest is credited up to 2% cap. If S&P 500 index is down for the month, negative interest is earned with no cap. Interest earned at the end of the year is the sum of twelve monthly interest credits with a floor of zero.

⁸⁴ These specific parameter values are taken from a specific product offered by an anonymous insurance company.

A typical investor is completely unprepared to evaluate a complex financial investment such as this. It is not at all obvious whether these are either good investments or bad investments. It is also not at all obvious whether annual or monthly accounting is better.

To analyze the potential performance of these structured products, we ran a simulation analysis with one million repeated experiments. We simulate the S&P 500 returns using a normal distribution with an annual arithmetic mean of 8% and annual standard deviation of 16%, in line with the observed characteristics of S&P 500 returns. In the case of the monthly accounting product, we use the corresponding monthly arithmetic mean of 0.67% and monthly standard deviation of 4.7%. We analyze the performance of these structured products over a ten year investment horizon.

The simulated performance of both these products is shown in Table 6. An investment of \$100,000 in the S&P 500 index grew to a mean value of \$215,113 in ten years, thus producing a mean geometric return of 6.92% per year. The same amount invested in the structured product grew to \$129,113 in ten years, corresponding to a mean geometric return of 2.57% per year. In other words, investors who put their money in the structured product for ten years will, on average, end up with 60% of what they would have had if they had invested in the S&P 500 index. They are of course giving up the 40% upside in order to buy downside protection: recall that the structured product guarantees the principal amount. The question therefore is whether investors are paying a fair premium for the insurance of downside protection. In this case they are giving up on average 3.35% return per year to get downside protection.

One way to answer this question is to compare the average annual return of the structured product to that of the ten-year Treasury bond. Both the structured product and the bond guarantee the principal amount. The buy and hold return of the bond is fixed while that of the structured product is variable as it depends on the return of the S&P 500 index. Given that the structured product is risky, its expected return should be greater than that of the bond. During 1962-2015, only during the last four years has the ten-year Treasury bond yield been lower than 2.57%, the average forecasted return of the structured product. Therefore, it is difficult to make the case that the investor is better off with the structured product.

The sub-optimality of the structured product is starker when we considered the monthly accounting case. In this case, an investment of \$100,000 in the S&P 500 index grew to a mean value of \$221,716 in ten years, producing a mean geometric return of 7.02% per year. The same amount invested in the structured product grew to \$115,993 in ten years, corresponding to a mean geometric return of 1.44% per year. In other words, investors who put their money in the structured product for ten years will, on average, end up with 52% of what they would have had if they had invested in the S&P 500 index. The average annual return of the structured product is lower than the Treasury bond yield in any of the years during 1962-2015. In other words, the monthly accounting structured product is a dominated asset: the Treasury bond dominates it by providing better return at lower risk. Thus investors would have been better off investing in Treasury bonds which is much simpler investment than being induced to purchase the complicated structured product they do not fully understand. It is important to note that the superiority of the bond over the structured product is before we take into account transaction costs. The

buying and selling of Treasury bonds involves minimal transaction costs in contrast to the fees and commissions normally associated with the structured proprietary product.

Overall, when all the facts have been considered, it is difficult to argue that such a product would be in the best interest of any retiree. Yet, the new DOL rule would continue to allow these types of products in being offered as suitable retirement investments. What is never reported is the expected annual returns and risks from this products. This is an important piece of information that can help investors in deciding whether to invest in this structured product. However, under the current DOL rules, such disclosures are not mandated.

5. Policy Recommendations

The DOL's fiduciary rule suffers from internal conflicts. It requires that investment adviser act in the best interest of the beneficiaries, yet it allows the advisers to receive income from third parties. Additionally, it does not outlaw opaque, proprietary products, which can lead to taxpayer exploitation and uninformed investment decisions. Overall, DOL's new rule is likely to lead to continued conflicted investment advice, confusion, and wide-spread litigation to sort out these internal conflicts.

We make two policy recommendations to resolve these issues. Our first recommendation is to outlaw proprietary products in retirement accounts. By their very nature, these proprietary products do not trade in the market and thus they require private valuation. Private valuation in turn creates multiple problems both for the taxpayers and for the retirement beneficiaries.

From the taxpayers' perspective, private valuation creates potential conflicts. It is easy to undervalue these products, include them in tax-sheltered IRA accounts and then

enjoy the capital gains without taxation after the market values are established. These potential conflicts can and should be avoided by banning proprietary products in IRA accounts and requiring that all investments must trade on U.S. exchanges.

From retirement beneficiaries' perspective, private valuation also creates potential conflicts. When it comes to proprietary products, retirement investors are simply pitted against financially sophisticated investment advisers and brokers, and they are at a significant informational disadvantage. These proprietary products are complex yet there is no information to evaluate them. Furthermore, current rule do not even require the disclosure of basic information such as hidden costs, comparison to publicly available alternatives or simulated expected returns. Without such basic information, informed investment decisions are impossible. Second, even if some information is provided, the average investor is not financially savvy to be able to value these products. Instead, if only publicly traded investments are allowed, investors would be protected to some extent by relying on the wisdom of the public markets which have been shown to be informally efficient.⁸⁵ Consequently, we propose that only publicly-traded securities should be allowed to be included in retirement accounts.

⁸⁵ Market efficiency means that price of publicly traded assets fully reflect all available information. See Fama (1970). The evidence in the finance literature generally supports the concept of the semistrong form of market efficiency. The 2013 Nobel Prize winning economist for his path-breaking work on market efficiency, Eugene Fama often regarded as the father of the efficient market hypothesis, wrote in 1970, "We shall conclude that, with but a few exceptions, the efficient markets model stands up well," and "[i]n short, the evidence in support of the efficient markets model is extensive, and (somewhat uniquely in economics) contradictory evidence is sparse." See Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," *Journal of Finance*, 25 (1970), pp. 383-417. In 1991, Fama updated his analysis and wrote, "The empirical literature on efficiency and asset-pricing models passes the acid test of scientific usefulness." Eugene F. Fama, "Efficient Capital Markets: II," *Journal of Finance*, 46 (1991), p. 1576.7 Eugene F. Fama, "Efficient Capital Markets: II," *Journal of Finance*, 46 (1991), p. 1576. Although some recent studies have uncovered some evidence of anomalous price behavior, numerous peer-reviewed academic studies by leading financial economists have largely concluded that these anomalies have alternative explanations that are consistent with and support market efficiency. There are a number of such surveys. See: Eugene F. Fama, "Market Efficiency, Long-Term Returns, and Behavioral Finance," *Journal of Financial Economics* 49 (1998), pp. 283-306; G. William Schwert, "Anomalies and Market Efficiency,"

Our second policy recommendation is for the DOL to reinstitute the rule that require investor advisers to be paid only by the retirement beneficiaries. This rule change is necessary to ensure that the advisers have only one master they serve and thereby avoid the conflicts. With multiple masters, investors' advisers will be tempted to recommend products that are most profitable for themselves as well as the investment sponsors instead of those products that are best suited for the beneficiaries. The likely result is vastly expanded litigation that will be necessary to sort out the conflicts within the DOL's rule.

6. Conclusions

As it stands, DOL's fiduciary rule is deeply flawed. It suffers from internal conflicts since it requires that investment adviser act in the best interest of the beneficiaries, yet it allows the advisers to receive income from third parties. Additionally, it does not outlaw opaque, proprietary products, which would lead to costly and uninformed investment decisions. In fact, DOL's new rule is likely to lead to continued conflicted investment advice, confusion, and wide-spread litigation to sort out these internal conflicts. We offer policy two recommendations to remedy these problems.

Based on our empirical evidence, our first policy recommendation addresses the income exemption rule. Any serious reform in retirement investment area must address the multiple-master problem caused by the income exemption rule. The key to eliminating conflicts of interest involves insuring that the investment advisers serve only one master and therefore receive income only from one master. Unfortunately, the recent

in Handbook of the Economics of Finance. G. Constantinides et al., eds. (Amsterdam: North Holland, 2001).

DOL rule and the associated exemptions have completely failed to address the multiple-masters problem.

Second, any serious reform must eliminate the total lack of transparency in proprietary investment vehicles. Without transparency, retirement beneficiaries will be unable to make informed decisions about their choice of retirement vehicles. Once again, on this key issue, the DOL rule falls significantly short by exempting proprietary products in IRA accounts. Overall, we conclude that simply requiring a fiduciary standard by itself is not only going to resolve potential conflicts of interest, but in fact lead to additional problems by creating a conflicted set of rules.

This paper also provides direct evidence that supports having independent fiduciaries that serve only one master. The support is based on the profitability of company-supported pension funds' transactions in firms in which they acquire insider status. Pension funds are considered as insiders if the pension fund holds more than 10% of the shares of the underlying firm or if there is an overlap among the executives of the underlying firm and the pension fund. As an insider, the pension fund has to report every transaction in the shares of the underlying company to the Securities and Exchange Commission.

Insider status presumably provides managers of pension funds private, confidential information, which could be used to improve the fund performance for the beneficiaries. Since executives most often serve as the fiduciary of the sponsoring firm's pension fund, insider-status could lead to conflicts of interest since pension fund assets can also be used to benefit the executives themselves or the firm's shareholders. Our objective in this paper was to determine whether the insider-status of the pension funds

leads to improved fund performance for the beneficiaries or results in relatively poor fund performance due to conflicts of interest.

Our findings indicate that when the pension fund acquires an insider status by acquiring more than 10% of the underlying firm's shares, beneficiaries of the pension funds suffer. In fact, pension fund managers exhibit bad timing in the trades of the underlying firm's shares. Stock prices tend to underperform after being purchased by the pension fund, and outperform after being sold. The magnitude of the abnormal losses for the beneficiaries of the pension funds is large: 3.4% after one year and 21.6% after two years. These losses are both statistically and economically significant. These results support the case for independent fiduciaries.

Table 1**Summary statistics of insider trades by pension funds**

The table provides the summary statistics of trades by pension funds that are classified as insider trades. Panel A provides the number of firms and pension funds in the sample. Panel B provides pension fund trades classified by insider type: Shareholder, Officer-Director, Trustee, and Other. Panel C provides the break of pension fund insider trades by separate accounts (pension fund held for employees of a single firm) and commingled funds (a fund that holds the pension investments of employees of multiple firms).

Panel A: Insider transactions by pension funds and underlying firms

	Total	With purchases	With sales	Average shares bought	Average shares sold
Number of firms	94	53	55	48,963	79,630
Number of pension funds	60	35	41	54,388	39,624

Panel B: Insider transactions in pension funds by insider relationship

Insider type	Number of trades	Number of purchases	Number of sales	Average shares bought	Average shares sold
Shareholder	1,324	925	399	50,529	52,951
Officer-Director	41	25	16	17,765	18,001
Trustee	579	498	81	16,481	21,288
Affiliated persons & others	105	89	16	19,334	68,020
Total	2,049	1,537	512	37,158	47,320

Panel C: Insider transactions by type of pension fund

Fund type	Number of trades	Number of purchases	Number of sales	Average shares bought	Average shares sold
Separate account	1,411	1,103	308	41,310	37,831
Commingled fund	638	434	204	26,605	61,647

Table 2**Performance of pension fund insider trades**

The table provides the mean market-adjusted holding period returns (HPR) of pension fund trades in which the fund is classified as an insider. The holding period return for each trade is computed as

$$HPR_{i,T} = (r_{i,T} - r_{m,T})h,$$

where $r_{i,T}$ is the holding period with-dividend return to stock i for the horizon T , $r_{m,T}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks for the same horizon T . The parameter h is equal to one if the insider trade is a purchase and negative one if it is a sale. The holding period returns are computed for four horizons: 6, 12, 18, and 24 months, starting from the month following the trade date. Panel A reports the mean HPR for four classes of insiders, Shareholder, Officer-Director, Trustee, and Other. Panel B reports the mean HPR for sales and purchases separately. p values are in parentheses. The sample size is provided at the bottom of each result.

Panel A: Performance of insider transactions by pension funds grouped by insider relationship

Relationship	Mean Holding Period Return			
	(1,6)	(1,12)	(1,18)	(1,24)
All	0.017 (0.040) 1,979	-0.034 (0.053) 1,941	-0.136 (0.000) 1,909	-0.216 (0.000) 1,869
Shareholder	-0.012 (0.182) 1,303	-0.118 (0.000) 1,265	-0.229 (0.000) 1,233	-0.334 (0.000) 1,193
Officer-Director	0.139 (0.005) 39	0.043 (0.499) 39	0.022 (0.859) 39	0.048 (0.644) 39
Trustee	0.080 (0.000) 575	0.150 (0.000) 575	0.043 (0.062) 575	-0.009 (0.681) 575
Other	-0.044 (0.050) 62	-0.081 (0.033) 62	-0.031 (0.530) 62	-0.049 (0.296) 62

Table 2 (continued)

Panel B: Performance of insider transactions by pension funds grouped by type of transaction:
sale or purchase.

Transaction type	Mean Holding Period Return			
	(1,6)	(1,12)	(1,18)	(1,24)
Purchases	0.031	-0.008	-0.097	-0.151
	(0.000)	(0.486)	(0.000)	(0.000)
	1,484	1,458	1,446	1,417
Sales	-0.025	-0.114	-0.257	-0.420
	(0.219)	(0.067)	(0.011)	(0.005)
	495	483	463	452

Table 3**Performance of pension fund insider trades grouped by type of fund:
Separate accounts vs. Commingled funds**

The table provides the mean market-adjusted holding period returns (HPR) of pension fund insider for two sub samples: separate accounts and commingled funds. A separate account is a pension fund held for employees of a single firm. A commingled fund holds the pension investments of employees of multiple firms. The holding period return for each trade is computed as

$$HPR_{i,T} = (r_{i,T} - r_{m,T})h,$$

where $r_{i,T}$ is the holding period with-dividend return to stock i for the horizon T , $r_{m,T}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks for the same horizon T . The parameter h is equal to one if the insider trade is a purchase and negative one if it is a sale. The holding period returns are computed for four horizons: 6, 12, 18, and 24 months, starting from the month following the trade date. p values are in parentheses. The sample size is provided at the bottom of each result.

Relationship	Mean Holding Period Return			
	(1,6)	(1,12)	(1,18)	(1,24)
Separate accounts	-0.046	-0.111	-0.228	-0.340
	(0.000)	(0.000)	(0.000)	(0.000)
	1,349	1,346	1,343	1,343
Commingled funds	0.152	0.138	0.083	0.100
	(0.000)	(0.000)	(0.001)	(0.000)
	630	595	566	526

Table 4**Performance of trades by insiders other than pension funds**

The table provides the mean market-adjusted holding period returns (HPR) of trades by insiders other than pension funds. HPR for four types of insiders are included: All insiders, Other insiders in firms with pension fund insider trades, Mutual funds, and Employee Stock Ownership Plans (ESOP). p values are in parentheses. The holding period return for each trade is computed as

$$HPR_{i,T} = (r_{i,T} - r_{m,T})h,$$

where $r_{i,T}$ is the holding period with-dividend return to stock i for the horizon T , $r_{m,T}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks for the same horizon T . The parameter h is equal to one if the insider trade is a purchase and negative one if it is a sale. The holding period returns are computed for four horizons: 6, 12, 18, and 24 months, starting from the month following the trade date. p values are in parentheses. The sample size is provided at the bottom of each result.

Type of insider	Mean Holding Period Return			
	(1,6)	(1,12)	(1,18)	(1,24)
All insiders	0.0240	0.0390	0.0609	0.0635
	(0.000)	(0.000)	(0.000)	(0.000)
	2,205,681	2,133,895	1,931,550	1,779,879
Other insiders in firms with pension fund trades	0.0361	0.0462	0.0608	0.0706
	(0.000)	(0.000)	(0.000)	(0.000)
	30,488	29,901	28,586	27,313
Mutual funds	0.0342	0.0472	0.0578	0.0814
	(0.000)	(0.000)	(0.000)	(0.000)
	63,298	60,870	55,627	51,746
ESOP	0.0127	0.0265	0.0404	0.0736
	(0.000)	(0.000)	(0.000)	(0.000)
	5,907	5,832	5,702	5,619

Table 5

Trading strategies and performance of insider trades

The table provides the mean market-adjusted holding period returns (HPR) of insider trades of various groups based on their trading strategy: All insiders (Panel A), Other insiders in firms with pension fund insider trading (Panel B), and pension fund insiders (Panel C). A trade is classified as a momentum trade if a purchase (sale) is made after a positive (negative) HPR over the six-month period ending in the month preceding the trade date. A trade is classified as a mean-reversion trade if a purchase (sale) is made after a negative (positive) HPR over the six-month period ending in the month preceding the trade date. The holding period return for each trade is computed as

$$HPR_{i,T} = (r_{i,T} - r_{m,T})h,$$

where $r_{i,T}$ is the holding period with-dividend return to stock i for the horizon T , $r_{m,T}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks for the same horizon T . The parameter h is equal to one if the insider trade is a purchase and negative one if it is a sale. The holding period returns are computed for four horizons: 6, 12, 18, and 24 months, starting from the month following the trade date. p values are in parentheses. The sample size is provided at the bottom of each result.

<u>Panel A: Performance of all insider trades grouped by trading strategy</u>				
Trading strategy	Mean Holding Period Return			
	(1,6)	(1,12)	(1,18)	(1,24)
Momentum	0.055	0.081	0.084	0.086
	(0.000)	(0.000)	(0.000)	(0.000)
	821,550	797,135	720,977	666,044
Mean reversion	0.005	0.014	0.047	0.050
	(0.000)	(0.000)	(0.000)	(0.000)
	1,384,131	1,342,760	1,210,573	1,113,835
<u>Panel B: Performance of non-pension fund insider trades in firms with pension fund insider trades, grouped by trading strategy</u>				
Trading strategy	Mean Holding Period Return			
	(1,6)	(1,12)	(1,18)	(1,24)
Momentum	0.083	0.115	0.108	0.150
	(0.000)	(0.000)	(0.000)	(0.000)
	12,279	11,973	11,639	11,096
Mean reversion	0.005	0.000	0.028	0.017
	(0.078)	(0.945)	(0.001)	(0.039)
	18,209	17,928	16,947	16,217

Table 5 (continued)

Panel C: Performance of pension fund insider trades, grouped by trading strategy				
Trading strategy	Mean Holding Period Return			
	(1,6)	(1,12)	(1,18)	(1,24)
Momentum	0.074	0.078	-0.046	-0.126
	(0.000)	(0.000)	(0.083)	(0.001)
	997	984	974	970
Mean reversion	-0.042	-0.150	-0.229	-0.314
	(0.000)	(0.000)	(0.000)	(0.000)
	982	957	935	899

Table 6**Simulated performance of structured products**

The table provides the simulated results of two structured products described in the paper. We ran a simulation analysis with one million repeated experiments. We simulate the S&P 500 returns using a normal distribution with an annual arithmetic mean of 8% and annual standard deviation of 16%, in line with the observed characteristics of S&P 500 returns. In the case of the monthly accounting product, we use the corresponding monthly arithmetic mean of 0.67% and monthly standard deviation of 4.7%. We analyze the performance of these structured products over a ten year investment horizon for an investment of \$100,000. We report the mean, maximum and minimum terminal values of each product and its annual mean geometric return.

Panel A: Annual Accounting

Invest \$100,000 in	Terminal value			Annual mean geometric return
	Mean	Min	Max	
S&P 500 index	\$215,113	\$13,178	\$1,630,151	6.92%
Structured product	\$129,113	\$100,000	\$148,024	2.57%

Panel B: Monthly Accounting

Invest \$100,000 in	Terminal value			Annual mean geometric return
	Mean	Min	Max	
S&P 500 index	\$227,716	\$17,476	\$2,287,489	7.02%
Structured product	\$115,993	\$100,000	\$264,421	1.44%