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Is Bitcoin Prudent? Is Art Diversified? Offering Alternative Investments to 401(k) Participants

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Whether 401(k) plans' investment menus should feature "alternative" investments is a fact-driven inquiry applying ERISA's fiduciary standards of prudence, loyalty, and diversification. Central to this fact-driven inquiry is whether the alternative investment class in question is broadly accepted by investors in general and by professional defined benefit trustees in particular. A similarly salient concern when making this inquiry is the financial unsophistication of many, perhaps most, 401(k) participants. Accounting for these considerations, this Article concludes that REITs, private equity funds, and hedge funds can, with limits, today be offered as investment choices to 401(k) participants, but that cryptocurrencies (including Bitcoin), art, and environmental-social-governance (ESG) funds cannot. These latter investment categories have yet to achieve acceptance among professional defined benefit trustees and thus are not yet prudent to offer to 401(k) participants—if they ever will be.

This Article explores each of these five categories as a class. Even if 401(k) participants should be offered choices within any (or all) of these classes of alternative investments, particular investments within each class must still be scrutinized individually for their compliance with ERISA's fiduciary standards. The threshold, fact-intensive question that this Article addresses is whether, before considering specific investments, any generic category of alternative investments ought to be considered for the menu of choices offered to 401(k) participants.

Answering this question under ERISA's legal tests of prudence, diversification, and loyalty requires such fact-driven inquiries as the general acceptability of a particular category of investments, the trustee's motivation for embracing such investments, and the diversification achievable through such investments. While investment vehicles such as REITs pass these tests, art funds, Bitcoin, other cryptocurrencies, and ESG funds are not prudent to offer to 401(k) participants given such investments' novelty and the failure to date of defined benefit trustees to widely embrace such investments.

Hedge funds and private equity funds are, as a factual matter, closer to REITs in light of the widespread acceptance of these funds by defined benefit trustees. Consequently, as a class, such funds qualify as prudent for 401(k) menus even if the trustee would not deploy his personal resources to such funds and even if some (perhaps many) hedge and private equity funds examined individually fail ERISA's fiduciary standards. However, in light of the financial unsophistication of many 401(k) participants, the 401(k) fiduciary who makes hedge and private equity funds available to participants should limit participants' ability to make such alternative investments to protect participants from making undiversified choices.

These determinations may change over time with new factual circumstances, e.g., a greater acceptance of a particular asset class by investors, including professional defined benefit trustees as gatekeepers for the 401(k) universe, and the emergence of robust markets that provide more experience with particular investment categories. But, the approach is ultimately what counts, as the norms of prudence, loyalty, and diversification, applied to current facts, govern the construction of 401(k) investment menus.

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EDWARD A. ZELINSKY *

INTRODUCTION

Today, pension[1] assets are primarily invested in stocks, bonds, cash, cash equivalents such as money market and stable value funds, and investment funds including mutual funds, exchange traded funds (ETFs), passive index funds, and target date funds. In the parlance of the investing community, other assets are "alternative investments."[2]

The question this Article confronts is whether 401(k) participants[3] ought to be offered such alternative investments for their respective retirement accounts. In particular, this Article explores the legal propriety of making available to 401(k) investors five categories of alternative investments: (a) real estate, (b) art, (c) Bitcoin and other cryptocurrencies, (d) environmental-social-governance (ESG) funds, and (e) hedge and private equity funds.[4]

Whether 401(k) plans' investment menus should feature these (and other) "alternative" investment categories is a fact-driven inquiry applying

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[1] While the Internal Revenue Code distinguishes between pension plans and profit-sharing plans (including 401(k) arrangements), the labor provisions of the Employee Retirement Income Security Act of 1974 (ERISA) label both kinds of retirement savings plans as pensions. *Compare* I.R.C. § 401(a) (discussing "a stock bonus, pension, or profit-sharing plan"), *with* Employee Retirement Income Security Act of 1974 (ERISA) § 3(2), 29 U.S.C. § 1002(2)(A) (labeling as a "pension plan" any arrangement "provid[ing] retirement income" or "result[ing] in a deferral of income"). In this Article, I use the term "pension" in its broader, ERISA sense to capture all forms of retirement savings arrangements including profit-sharing plans with 401(k) salary reduction features.

[2] *See, e.g.*, Anna Hirtenstein, *Stock Rally in 2020 Outpaced Luxury Items*, WALL ST. J., Jan. 5, 2021, at B10 (The "asset class" of "alternative investments. . . . includes hedge funds, private equity and more exotic investments such as classic cars and other luxury goods."); Tyler Gallagher, *How Alternative Investing Can Improve Your Portfolio*, FORBES (Jan. 31, 2020, 8:00 AM), https://www.forbes.com/sites/theyec/2020/01/31/how-alternative-investing-can-improve-your-portfolio/?sh=66dc482b54aa.

[3] For ease of exposition, I use the term "participants" to include participants' beneficiaries who can direct the investment of 401(k) assets that they inherit or receive in divorce cases.

[4] Other investment categories could be added to this list, including commodities and derivatives. I chose to discuss these five classes of alternative investments to keep this Article to a manageable length and to examine alternative investment categories that generate much interest today in the investment community. The methodology I use in this Article is applicable to other alternative investment categories as they are considered for 401(k) investment menus.

ERISA's fiduciary standards of prudence, loyalty, and diversification.[5] Central to this fact-driven inquiry is whether the alternative investment class in question is broadly accepted by investors in general and by professional defined benefit trustees in particular. A similarly salient concern for this inquiry is the financial unsophistication of many, perhaps most, 401(k) participants. Considering these factors, I conclude that real estate investment trusts (REITs), hedge funds, and private equity funds can, with limits, today be offered as investment choices to 401(k) participants, but that cryptocurrencies (including Bitcoin), art, and ESG funds cannot. These latter investment categories have yet to achieve broad acceptance among professional defined benefit trustees and thus are today not prudent to offer to 401(k) participants.

This Article explores each of these five categories as a class. Even if 401(k) participants can be offered choices within any (or all) of these classes of alternative investments, particular investments within each class must still be individually scrutinized for their compliance with ERISA's fiduciary standards. The threshold, fact-intensive question that this Article addresses is whether, before considering specific investments, any generic category of alternative investments ought to be considered for the menu of choices offered to 401(k) participants.

In this context, ERISA's legal tests of prudence, diversification, and loyalty require such fact-driven inquiries as the general acceptability of a particular category of investments, the trustee's motivation for embracing such investments, and the diversification achievable through such investments. Investment vehicles such as REITs pass these tests as a category because REITs have a considerable track record compiled over sixty years and have achieved broad acceptance, both among general investors and in the world of defined benefit pensions. In light of this history and wide acceptance, REITs as a class qualify under ERISA's fiduciary standards as objectively prudent and diversifiable investments, which a loyal fiduciary may, within limits, offer to 401(k) participants.

In contrast, art funds, Bitcoin, and other cryptocurrencies are not prudent to offer to 401(k) participants given such investments' novelty and the failure to date of defined benefit trustees to widely embrace such investments. That failure indicates that Bitcoin, other cryptocurrencies, and art have yet to achieve sufficiently broad acceptance to be objectively prudent under ERISA for 401(k) purposes.

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[5] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1). ERISA is codified both in the Internal Revenue Code, Title 26 of the United States Code, and in Title 29 of the United States Code, pertaining to labor laws. Following conventional practice, I provide for each labor provision of ERISA both its ERISA designation and its corresponding United States Code designation. *See* JOHN H. LANGBEIN ET AL., PENSION AND EMPLOYEE BENEFIT LAW 77–79 (6th ed. 2015); LAWRENCE A. FROLIK & KATHRYN L. MOORE, LAW OF EMPLOYEE PENSION AND WELFARE BENEFITS 19–20 (3d ed. 2012).

ESG funds, like art and Bitcoin, are not objectively prudent under present circumstances and therefore are not appropriate as a class for 401(k) investment menus. Defined benefit trustees have not embraced ESG investments as an asset category. Insofar as ESG advocates promote ESG investments to generate social objectives or third-party benefits, such ESG investments fail ERISA's fiduciary test of loyalty, which commands an exclusive focus upon the economic welfare of plan participants. Department of Labor (DOL) regulations[6] reiterate the U.S. Supreme Court's teaching that ERISA-regulated funds should only seek "pecuniary" benefits for plan participants.[7] While a particular investment embracing ESG considerations might generate such financial benefits, ESG investments as such are not sufficiently accepted in the defined benefit context to be an objectively prudent investment class for 401(k) purposes. If a particular ESG fund or investment is an economically appropriate choice for a 401(k) menu, that propriety is in spite of, not because of, the fund's or investment's pursuit of broader social goals.

Finally, hedge funds and private equity funds are, as a factual matter, closer to REITs in light of the widespread acceptance of these funds by defined benefit trustees.[8] Consequently, as a class, such funds qualify as prudent for 401(k) menus even if the trustee would not deploy his personal resources to such funds and even if some (perhaps many) hedge and private equity funds examined individually fail ERISA's fiduciary standards. However, in light of the financial unsophistication of many 401(k) participants, the 401(k) fiduciary who makes hedge and private equity funds available to participants should limit participants' ability to make such alternative investments to protect participants from making undiversified choices.

With changed factual circumstances over time, some types of alternative investments that are today imprudent may become more conventional and thus prudent, just as today's prudent investments were once new and alternative.[9] But, there is no guarantee that any particular alternative investment category will necessarily evolve over time into the arena of prudence. After four centuries, tulips are still tulips.[10]

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[6] 29 C.F.R. § 2550.404a-1 (2021). The Biden administration has proposed major revisions to these regulations. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57,272 (Oct. 14, 2021) (to be codified at 29 C.F.R. pt. 2550). However, as of today, these regulations remain on the books.

[7] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014) (explaining that "[t]he term does not cover nonpecuniary benefits").

[8] Gallagher, *supra* note 2.

[9] On the origins and history of the mutual fund industry, see generally MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW (2d ed. 2011).

[10] However, some dissent from the conventional understanding of the tulip craze. *See, e.g.*, Christian C. Day, *Risky Business: Popular Images and Reality of Capital Markets Handling Risk—From the Tulip Craze to the Decade of Greed*, 133 PENN. ST. L. REV. 461, 463–74 (2008). *Cf.* Shan Li, *Forget the Stock Market. The Rare-Plant Market Has Gone Bonkers.*, WALL ST. J. (Sept. 18, 2020, 9:54 AM),

Central to my fact-intensive analysis under ERISA's fiduciary standards is the relationship of defined benefit pensions to participant-invested 401(k) plans. In important respects, these are "like"[11] "enterprise[s]"[12] as they both accumulate retirement resources for ultimate distribution to participants. In other respects, however, they are materially different enterprises. Defined benefit pensions are typically large agglomerations of capital, managed by professional fiduciaries for large groups of participants over a long-term horizon.[13] Participant-invested 401(k) plans, by contrast, entail investment control by rank-and-file employees who are often unsophisticated investors with shorter time horizons and small accounts to manage.

These similarities and differences indicate that it is imprudent to offer a particular class of alternative investments to 401(k) participants until that class has first been widely accepted in the defined benefit universe by professional trustees as appropriate vehicles for retirement savings. However, because 401(k) participants are often unskilled investors managing small accounts, acceptance by defined benefit trustees, while necessary, is not a sufficient condition for concluding that an investment class is prudent in the 401(k) context. In particular, it may be necessary to limit alternative investments in the 401(k) context, given the danger that unsophisticated 401(k) participants will direct too much of their small retirement accounts to these alternative investments.

The distinction between defined benefit pensions and 401(k) arrangements is also relevant to another important issue: whether each particular fund offered to a 401(k) participant must be internally diversified or whether single stock (or equivalently undiversified) offerings are prudent because the 401(k) participant can diversify her account as a whole. The possibility of poor diversification performance by unsophisticated 401(k) participants is too great a risk to permit single stock investments (or similarly undiversified funds) for them, though we can have confidence in the ability

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https://www.wsj.com/articles/forget-the-stock-market-the-rare-plant-market-has-gone-bonkers-11600437284 (explaining that "[t]he 1600s had the Dutch tulip market bubble").

[11] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[12] *Id.*

[13] Though defined benefit plans are not exclusively so. Some smaller defined benefit plans are established by personal services practices and other small businesses, but, today, the world of defined benefit plans is one of large, professionally-managed pensions. *See* Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 55,219, 55,230 (Sept. 4, 2020). "In 2017, there were 39,000 small defined benefit plans" defined as "plans with fewer than 100 participants." *Id.* at 55,237. However, the vast majority of defined benefit assets are held by a relatively small number of large defined benefit plans. "In 2017, there were 1,391 plans with more than $1 billion in assets each. These plans together represented just 0.2 percent of all pension plans, but held $5.3 trillion in assets, representing more than one-half of ERISA-covered pension assets." *Id.* at 55,234; *see also* CONSTANTIJN W.A. PANIS & MICHAEL J. BRIEN, ASSET ALLOCATION OF DEFINED BENEFIT PENSION PLANS 1 (2015), https://www.dol.gov/sites/dolgov/files/EBSA/researchers/analysis/retirement/asset-allocation-of-defined-benefit-pension-plans.pdf (providing that, in 2012, ninety-five percent of all defined benefit plan participants "[were] in a plan covering more than 1,000 participants").

of professional defined benefit trustees to diversify their overall portfolios using such single stock funds as part of their holdings.

One more introductory observation: A 401(k) trustee might find it prudent to place investments on a 401(k)-participant menu that the trustee would personally eschew for her own nonpension portfolio. The task of a trustee constructing a 401(k) menu is to give participants choices that have achieved general acceptance and thus are objectively prudent, even if the trustee would not make such investments for her own personal portfolio. For example, someone who eschews REITs for his personal investments might nevertheless, in his capacity as a 401(k) trustee, find it prudent to offer such funds for a 401(k) investment menu given the broad acceptance of real estate investments by defined benefit trustees. By the same token, someone who personally speculates in cryptocurrencies with his own funds should not, in his capacity as a 401(k) fiduciary, offer such currencies to plan participants, given the novelty of cryptocurrencies and the failure to date of defined benefit trustees to embrace them as an investment category.

In the last section of this Article, I address several questions which arise from my analysis. Among other conclusions, it is not necessary for a 401(k) trustee to include an investment choice from each prudent asset class, provided that the options offered to the participants are sufficiently broad and diversified. A 401(k) fiduciary may, with appropriate limits, make available alternative investments like REITs and hedge funds, but it is not mandatory to do so. Moreover, in light of the Internal Revenue Code's rules on nondiscrimination, it is legally possible, but not easy, for a 401(k) trustee to make available alternative investment choices to some more financially sophisticated participants, but not to other less knowledgeable participants.

In the final analysis, I argue less for the particular classification of certain asset classes than for the legally correct approach to determining which asset classes are (or are not) appropriate for 401(k) investment menus. These determinations may change over time with new factual circumstances, e.g., a greater acceptance of a particular asset class by investors, including professional defined benefit trustees as gatekeepers for the 401(k) universe, and the emergence of robust markets that provide more experience with particular investment categories. But, the approach is ultimately what counts, as the norms of prudence, loyalty, and diversification, applied to current facts, govern the construction of 401(k) investment menus.

I. BACKGROUND

In this Section, I discuss the background against which a fiduciary decides whether particular categories of alternative investments are appropriate for a 401(k) investment menu. In legal terms, this background includes ERISA's fiduciary duties and ERISA's authorization of participant-directed investing. This background also includes the similarities and differences between professional defined benefit trustees and often unsophisticated 401(k) participants. Finally, this background includes the different ways in which pension trusts may hold assets, for example, by direct ownership of a particular asset, by ownership through diversified holding devices such as mutual funds, and by ownership through financial intermediaries that bundle assets from among different investment categories.

A. *ERISA's Duties of Prudence, Loyalty, and Diversification*

ERISA fiduciaries are bound by the duties of prudence, loyalty, and diversification, derived from the common law obligations of trustees.[14] In particular, the trustee of a 401(k) plan, which permits participants to invest the assets of their respective retirement accounts, must ensure that the menu of investments offered to the participants for their accounts is prudent, is diversified, and loyally pursues the participants' interests. These fiduciary duties apply whether the employer sponsoring the 401(k) plan itself establishes the menu of investments available to the plan's participants or whether the trustee or another plan fiduciary is tasked with selecting that investment menu.

An employer sponsoring a 401(k) plan with participant-directed investing can, as part of the employer's "settlor" functions,[15] specify in the plan document the investments to which the participants can direct their account balances. In this context, a trustee's fiduciary duties require her to continually monitor and evaluate those employer-selected investment choices. If, during the course of ongoing monitoring, any of those choices

[14] Tibble v. Edison Int'l, 575 U.S. 523, 528–29 (2015) ("[A]n ERISA fiduciary's duty is derived from the common law of trusts. In determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts.") (internal quotations omitted) (internal citations omitted); *see also* JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 556 (4th ed. 2006) (explaining that "ERISA fiduciary law is derived from and patterned on the Anglo-American law of trusts"). For an overview of the common law fiduciary duties in the context of trusts and estates, see STEWART E. STERK & MELANIE B. LESLIE, ESTATES AND TRUSTS: CASES AND MATERIALS 673–733 (Saul Levmore et al. eds., 6th ed. 2019); Robert H. Sitkoff, *Fiduciary Principles in Trust Law*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 41, 41–57 (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019).

[15] Cigna Corp. v. Amara, 563 U.S. 421, 437 (2011) (stating that the employer is "like a trust's settlor" when it "creates the basic terms and conditions of the plan"); Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 444 (1999) (describing an employer "acting as the Plan's settlor" when it decides upon "the composition or design of the plan itself"); Lockheed Corp. v. Spink, 517 U.S. 882, 890 (1996) (providing that when employers "alter the terms of a plan," they "are analogous to the settlors of a trust"). While embraced by the courts, the notion of employers' settlor functions has been controversial. *See, e.g.*, Natalya Shnitser, *The New Fiduciaries*, 88 U. CIN. L. REV. 685, 691 (2020); Dana M. Muir, *The Limited Role of Fiduciary Obligation in Employee Benefit Plans*, *in* 2020 NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 2.03[1] (David Pratt ed.) (discussing "the plan settlor doctrine").

prove imprudent, the trustee is required to disregard the plan document designating those investments and terminate those investments.[16]

A fiduciary's obligations are substantively the same vis-à-vis 401(k) investment choices if the employer-approved plan document delegates the choice of investments to a trustee or another fiduciary, such as an investment committee, rather than identifies the investments offered to the participants for their respective 401(k) accounts. In that case, the duties of prudence, loyalty, and diversification also govern the selection and retention of the investment menu. Either way, the trustee (or other responsible fiduciary) must monitor and ensure a menu of investments that is prudent, diversified, and loyal to the interests of the 401(k) participants.[17]

In terms of prudence, ERISA requires a fiduciary to:

> [D]ischarge his duties with respect to a plan . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims[.][18]

In important measure, DOL's regulations[19] cast the fiduciary duty of prudence in procedural terms. According to these regulations, in discharging his investment duties, a prudent ERISA fiduciary is one who "give[s] appropriate consideration" to appropriate "facts and circumstances," including "the risk of loss and the opportunity for gain."[20]

The Restatement of Trusts similarly highlights the procedural aspects of a fiduciary's obligation of prudence.[21] Courts have, in this vein,

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[16] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 421 (2014) ("[T]he duty of prudence trumps the instructions of a plan document . . . ."); ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) ("[A] fiduciary shall discharge his duties with respect to a plan . . . in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III.").

[17] Hughes v. Northwestern Univ., 142 S. Ct. 737, 740 (2022) (discussing the "duty to monitor all plan investments and remove any imprudent ones"); 29 C.F.R. § 2550.404c-1(d)(2)(iv) (2021) (confirming a "fiduciary['s] . . . duty to prudently select and monitor any service provider or designated investment alternative offered" under any plan providing for participant-directed investing); *id.* § 2550.404c-5(b)(2) (confirming a fiduciary's duty "to prudently select and monitor any qualified default investment alternative under the plan" in the context of qualified default investment alternatives).

[18] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1)(B); *see also* LANGBEIN, STABILE & WOLK, *supra* note 14, at 556–57 (discussing ERISA's duty of prudence); Bernard S. Sharfman, *The Conflict Between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*, 71 CASE W. RSRV. L. REV. 1241, 1258–59 (2021) (discussing the same).

[19] 29 C.F.R. § 2550.404a-1(a), (e)(2)(ii)(F) (2021).

[20] *Id.* § 2550.404a-1(b).

[21] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. b (AM. L. INST. 2007) ("The trustee's compliance with these fiduciary standards is to be judged as of the time the investment decision in question was made, not with the benefit of hindsight or by taking account of developments that occurred after the time of a decision to make, retain, or sell an investment. The question of whether a breach of trust has occurred

characterized a plan trustee's ERISA-based duty of prudence as an obligation about process ex ante, not a guarantee of results ex post.[22]

However, buttressing its procedural elements, the law of prudence also has an objective quality. Courts have analyzed the choice of 401(k) investments by asking whether such choice was "objectively prudent" when made.[23] Even if a fiduciary's decision making process fails the procedural test of prudence, a decision is objectively prudent "if a hypothetical prudent fiduciary would have made the same decision anyway."[24] As a corollary, an investment subject to extensive scrutiny will fail the test of objective prudence if, on the merits, the investment falls outside accepted parameters for fiduciary decision making.

The fact-intensive notion of "objective prudence" is bolstered by the Restatement of Trusts, which notes that a trustee's duty of prudence has "substantive content"[25] and impels "caution"[26] and "conservatism"[27] when a trustee makes investments. This substantive emphasis on cautious and conservative investments is reflected in the DOL regulations, which condone participant-directed investing. An important theme of those regulations is that prudent investments for 401(k) plan participants are investments reflecting "generally accepted investment theories."[28] From this vantage, even if a fiduciary has proceeded in a careful and deliberate fashion, her choices are imprudent if they fall outside the parameters of generally accepted conventions. A key touchstone for objective prudence is whether the investment comes from a category that is generally accepted, i.e., whether, as a matter of fact, the form of the investment is long-standing and is widely embraced.

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turns on the prudence and propriety of the trustee's conduct, not on the eventual results of investment decisions. The trustee is not a guarantor of the trust's investment performance.").

[22] Bunch v. W.R. Grace & Co., 555 F.3d 1, 7 (1st Cir. 2009) ("[T]he test of prudence—the Prudent Man Rule—is one of *conduct*, and not a test of the result of performance of the investment. Whether a fiduciary's actions are prudent cannot be measured in hindsight. . . . The test is how the fiduciary acted viewed from the perspective of the time of the challenged decision rather than from the vantage point of hindsight.") (internal quotation marks omitted) (internal citations omitted).

[23] Brotherston v. Putnam Invs., LLC, 907 F.3d 17, 39 (1st Cir. 2018); Renfro v. Unisys Corp., 671 F.3d 314, 322 (3d Cir. 2011); Ramos v. Banner Health, 461 F. Supp. 3d 1067, 1129 (D. Colo. 2020); Acosta v. Reliance Tr. Co., No. 17-cv-4540 (SRN/ECW), 2019 WL 3766379, at *10 (D. Minn. Aug. 9, 2019) ("[T]he duty of prudence is based on an 'objective' reasonableness standard . . . .").

[24] Tatum v. RJR Pension Inv. Comm., 761 F.3d 346, 363 (4th Cir. 2014) (internal quotation marks omitted) (internal citations omitted) (quoting Plasterers' Loc. Union No. 96 Pension Plan v. Pepper, 663 F.3d 210, 218 (4th Cir. 2011)); *see also* Wildman v. Am. Century Servs., LLC, 362 F. Supp. 3d 685, 700 (W.D. Mo. 2019) ("Even if a trustee failed to conduct an investigation before making a decision, he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway.") (internal quotation marks omitted) (quoting Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 919 (8th Cir. 1994)).

[25] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. f (AM. L. INST. 2007)

[26] *Id.* § 90 cmt. e.

[27] *Id.* § 90 cmt. e(1).

[28] 29 C.F.R. § 2550.404c-5(e)(4)(i) (2021).

Thus, in the 401(k) menu context, the objective prudence inquiry should focus upon the history and acceptance of the investment category under consideration. If, as a factual matter, an investment category is well-established and broadly accepted, particularly by professional defined benefit trustees, that category has become cautious and conservative, i.e., objectively prudent for 401(k) purposes. In contrast, new and novel investments, whatever their attractiveness in other contexts, are not prudent for 401(k) investment menus.

Reinforcing the objective aspects of prudence is the acceptance of modern portfolio theory as a benchmark of prudent investing.[29] Under that theory, the prudence of any particular investment is assessed in the context of the overall portfolio of which that investment is a part. Again, this indicates that a prudent fiduciary's decisions are subject not just to procedural tests of care, but to standards of substantive propriety, as well. In their critique of high fee funds in 401(k) investment menus, Professors Ayres and Curtis implicitly invoke the test of objective prudence when they highlight the "distinction between investment decisions that, as a matter of market risk, turn out poorly and investment decisions that ex ante can be expected to underperform."[30] The former may have been prudent; the latter likely was not.

Under the test of fiduciary prudence, a 401(k) trustee or other ERISA fiduciary may select for the participants' investment menu choices that the trustee, in making her private investing decisions, would eschew for herself. The test of objective prudence is not that an investment satisfies the trustee's personal preferences. The test is whether the investment is substantively sound, that is, whether the investment is generally accepted[31] and therefore deemed cautious[32] and conservative.[33]

The fiduciary duty of diversification is both an extension of the duty of prudence and an independent duty in its own right. ERISA captures the overlapping nature of a fiduciary's duty to diversify. In statutory terms, an ERISA fiduciary must "diversify[] the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[34]

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[29] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e(1) (AM. L. INST. 2007) ("What has come to be called 'modern portfolio theory' offers an instructive conceptual framework for understanding and attempting to cope with nonmarket risk.").

[30] Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans*, 124 YALE L.J. 1476, 1510–11 (2015).

[31] 29 C.F.R. § 2550.404c-5(e)(4)(i) (2021).

[32] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e (AM. L. INST. 2007).

[33] *Id.* § 90 cmt. e(1).

[34] ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). *See also* LANGBEIN ET AL., *supra* note 14, at 555–57 (discussing ERISA's duty of diversification); Sitkoff, *supra* note 14, at 48 (discussing diversification as an aspect of prudence); CAL. PROB. CODE § 16048 (West 2021) ("[T]he trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."). The overlap between the rule of prudence and the requirement of diversification proves important in the

ERISA's statutory authorization of investments in "qualifying employer real property" and in "qualifying employer securities" similarly reflects that diversification is both a facet of prudence and an independent fiduciary obligation in its own right.[35] As to such employer-related investments, ERISA suspends "the diversification requirement," as well as "the prudence requirement," but "only to the extent that" the duty of prudence "requires diversification."[36]

The courts have been divided as to whether each individual investment choice in a 401(k) menu should itself be diversified or whether diversification should be assessed by looking at the entire menu of investments offered to a 401(k) participant.[37] This is an area where the distinction between defined benefit pensions and 401(k) plans is telling: We can be reasonably confident that a professional defined benefit trustee, confronted with a single stock fund or an equivalently nondiversified investment choice, will diversify her overall portfolio with other investments. We can be less certain that unsophisticated 401(k) participants, when confronted with the same nondiversified investment alternative, will build overall properly diversified portfolios for their respective retirement assets. Given the lack of investment savvy among many such participants, they may embrace too heavily a single stock or a similarly nondiversified investment fund. Thus, it is more convincing to understand the fiduciary requirement of diversification in the 401(k) context as applying to each choice offered to a 401(k) participant.

ERISA's duty of loyalty to the plan's participants is embodied in the statutory mandate that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."[38] The Internal Revenue Code earlier embraced the duty of loyalty when it required that qualified plans be operated for "the exclusive benefit

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context of my conclusion that prudent 401(k) trustees should limit participants' ability to invest in certain alternative investments to prevent such participants from concentrating their assets too heavily in such alternative investments. *See infra* pp. 546–47.

[35] ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).

[36] *Id.*

[37] *Compare* Stegemann v. Gannett Co., 970 F.3d 465, 478 (4th Cir. 2020) ("[A] single fund on a menu . . . can be scrutinized for imprudence for want of diversification . . . .") *with id.* at 487 (Niemeyer, J., dissenting) ("[T]he ERISA duty of diversification requires that a plan's investments be diversified but not that each investment be diversified."). *See also* 29 C.F.R. § 2550.404c-1(b)(3)(i)(B)(1) (2021) (explaining that a participant must be offered "at least three investment alternatives . . . [e]ach of which is diversified"). *See also* Schweitzer v. Inv. Comm. of the Phillips 66 Sav. Plan, 960 F.3d 190, 197–98 (5th Cir. 2020), *cert. denied* 142 S. Ct. 706 (2021).

[38] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A); *see also* LANGBEIN ET AL., *supra* note 14, at 508–09 (discussing ERISA's duty of loyalty); Sharfman, *supra* note 18, at 1256–58 (discussing ERISA's duty of loyalty).

of [the employer's] employees or their beneficiaries."[39] This statement of loyalty remains in the Code today.

Construing ERISA's "exclusive purpose" terminology in *Dudenhoeffer*, the U.S. Supreme Court declared that that purpose, which must "be pursued by all ERISA fiduciaries," entails the search for "the sort of *financial* benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries."[40] Thus, a loyal ERISA fiduciary does not seek "nonpecuniary benefits"[41] or the welfare of third parties.[42] "The duty of loyalty is analyzed under a subjective standard where 'what matters is why the defendant acted as he did.'"[43]

In light of the foregoing, ERISA's legal duties—prudence, loyalty, and diversification—require fact-intensive[44] inquiries: Is a particular investment option cautious? Conservative? Generally accepted? Have professional defined benefit trustees widely embraced this investment category? Is a fund internally diversified or not? Is a particular investment category novel, or does it have an established track record? Does a particular investment pursue the participant's interests or a third party's welfare? Answering these fact-based questions will tell us whether any particular category of alternative investments is appropriate for a 401(k) investment menu.

B. *ERISA Section 404(c) and Participant-Directed Investing*

ERISA section 404(c) provides the statutory underpinning for participant-directed investing of participants' respective 401(k) accounts.[45] Section 404(c) acknowledges that defined contribution plans with their individual investment accounts may "permit[] a participant or beneficiary to exercise control over the assets in his account."[46] If a plan provides for such participant-directed investing and "if a participant or beneficiary exercises

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[39] I.R.C. § 401(a).

[40] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014).

[41] *Id.* at 421.

[42] *See also* Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 405 (2020) (concluding that "ERISA forbids collateral benefits ESG investing by a pension trustee").

[43] Wildman v. Am. Century Servs., LLC, 362 F. Supp. 3d 685, 700 (W.D. Mo. 2019) (quoting *In re* Wells Fargo ERISA 401(k) Litig., 331 F. Supp. 3d 868, 875 (D. Minn. 2018)).

[44] *See* Schanzenbach & Sitkoff, *supra* note 42, at 427 (stating that "the prudent investor rule is a facts-and-circumstances standard"); *id.* at 448 (stating that prudence "is a contextual and fact-driven question"). *See also* Letter from Louis J. Campagna, Chief, Div. of Fiduciary Interpretations, U.S. Dep't of Labor, to Jon W. Breyfogle (June 3, 2020), at 3 [hereinafter Campagna Letter] (stating that compliance with ERISA fiduciary standards "is an inherently factual question").

[45] ERISA § 404(c), 29 U.S.C. § 1104(c). On the role of ERISA § 404(c) in the evolution of defined contribution retirement plans, see EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA 45–47, 51 (2007).

[46] ERISA § 404(c)(1)(A), 29 U.S.C. § 1104(c)(1)(A).

control over the assets in his account,"[47] the plan's trustees (and other fiduciaries) have no liability "for any loss" resulting from such participant's decisions about his account's investments.[48] The DOL regulations under section 404(c) establish that the trustee or other fiduciary is responsible for ensuring that the menu of investment options available to the plan's participants is "prudently select[ed]."[49] Thus, a fiduciary is immunized from liability only for losses which derive from the participant's choices within an acceptable menu, not for the imprudent design of the menu itself.

ERISA section 404(c)(5) extends trustees' immunity from fiduciary liability if a 401(k) participant can invest her account but takes no affirmative action to do so.[50] In that case, there is no fiduciary liability if the retirement assets of the participant automatically go to a "qualified default investment alternative."[51] Central to the regulatory definition of such a qualified default investment alternative is compliance with "generally accepted investment theories."[52] While it raises important interpretative issues (e.g., How widespread must acceptance be to be "general"?), the regulation's emphasis on implementing "generally accepted investment theories" reinforces a fact-based, objective view of prudence. As the Restatement of Trusts observes, "an inferred, general duty to invest conservatively is a traditional and accepted feature of trust law."[53]

C. *Like Enterprise: Comparing Defined Benefit with 401(k) Plans*

ERISA defines prudence in the context of "an enterprise of a like character and with like aims."[54] For these purposes, defined benefit pensions and 401(k) plans have both important similarities and material differences. On the one hand, they are "like" enterprises insofar as both defined benefit plans and 401(k) arrangements accumulate and invest resources for participants' retirements. On the other hand, there is a material distinction between a professional trustee investing large quantities of defined benefit pension funds over a long time horizon for a sizable and age-diverse community of pension participants and an employer or trustee constructing

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[47] *Id.*

[48] ERISA § 404(c)(1)(A)(ii), 29 U.S.C. § 1104(c)(1)(A)(ii).

[49] 29 C.F.R. § 2550.404c-1(d)(2)(iv) (2021). The DOL adopted this regulation in 2010. Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 75 Fed. Reg. 64,910, 64,910 (Oct. 20, 2010) (to be codified at 29 C.F.R. pt. 2550). The Ninth Circuit declined to apply this regulation in *Tibble v. Edison International* because the events involved in that case predated the adoption of the regulation. Tibble v. Edison Int'l, 729 F.3d 1110, 1122 (9th Cir. 2013).

[50] ERISA § 404(c)(5), 29 U.S.C. § 1104(c)(5).

[51] 29 C.F.R. § 2550.404c-5(e) (2021).

[52] *Id.* § 2550.404c-5(e)(4)(i)–(iii).

[53] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e(1) (AM. L. INST. 2007). *See id.* § 90 cmts. e–e(1) ("[A] generally conservative predisposition should continue to prevail in trust investing.").

[54] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

a 401(k) investment menu from which often unsophisticated participants will make the investment decisions for their own small accounts. What may be prudent for the former may not be prudent for the latter, given the differing investment expertise of defined benefit trustees and of 401(k) participants, as well as the different goals each must pursue.[55]

A professional trustee for a defined benefit pension might prudently invest a discrete percentage of the trust funds she controls in alternative investments in order to provide diversification. Given its longer time horizon, a defined benefit plan might properly invest in novel, thinly-traded assets for the long run. At the same time, it would be imprudent to offer these alternative investments to less sophisticated 401(k) participants since they may invest too heavily and exclusively in these alternative investments. Illiquid investments may be particularly inappropriate for an older 401(k) participant who is relatively close to retirement and therefore in need of liquid funds to pay his 401(k) distribution.

Consequently, acceptance by defined benefit trustees is a threshold criterion, which an investment must surmount before being considered prudent for 401(k) participants. If defined benefit trustees (typically investment professionals) have not embraced a particular category of investments for retirement savings purposes, a fortiori that category is not yet prudent to offer to less sophisticated 401(k) participants who are also investing for retirement savings purposes. However, even if a specific class of investments has achieved widespread acceptability among defined benefit fiduciaries, that class may still not yet pass muster for participant-directed investing in light of participants' often minimal investment skills, shorter time horizons, and the small amounts they invest. At the most basic level, it may be necessary to limit 401(k) participants' access to alternative investments to preclude their overconcentration in those investment categories, or it may be necessary to bundle those alternative investments with more conventional assets to ensure the diversification of 401(k) participants' portfolios.

D. *The Unsophisticated Nature of Many 401(k) Participants*

Central to this analysis is the financial unsophistication of many, perhaps most, 401(k) participants, in contrast to the professionalism of most defined benefit trustees. Considerations of prudence suggest that defined benefit trustees should be the gatekeepers for the 401(k) world. An investment is not generally accepted, and thus not prudent in the retirement savings setting, until it has been widely adopted in the defined benefit

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[55] On the differences between defined benefit pensions and 401(k) plans, see ZELINSKY, *supra* note 45, at 1–2. *See also* Campagna Letter, *supra* note 44, at 3 (noting the "important differences between a fiduciary's decision to include private equity investments in the portfolio of a professionally managed defined benefit plan, and the decision to include an asset allocation fund with a private equity component as part of the investment lineup for a participant-directed individual account plan").

universe. However, such adoption, while necessary, is not a sufficient condition for prudence in the 401(k) context. An investment may be a prudent choice for professional defined benefit trustees, but not yet conventional enough and diverse enough for unsophisticated 401(k) participants. Such participants, not appreciating the benefits of diversification, may overinvest in alternative assets unless their access to such assets is limited.

David F. Swensen was among those arguing that rank and file investors are invariably poor investors.[56] "Even with a massive educational effort," he warned, "the likelihood of producing a nation of effective investors seems small."[57] In a similar vein, Professors Ayres and Curtis focused on the "naïve diversification" pursuant to which many unsophisticated 401(k) participants direct their respective retirement funds irrationally, e.g., by dividing assets among similar funds even though one of these funds has significantly lower fees.[58] The consensus among commentators follows these lines: Many, if not most, 401(k) participants invest poorly.[59]

These concerns are buttressed by research indicating that many persons can be paralyzed when they are presented with too much choice.[60] This makes me skeptical of brokerage windows as a means to improve participant-directed 401(k) investing. Pursuant to such brokerage windows, the participant is permitted to invest his 401(k) funds in a very broad array of investments, rather than to invest within a limited menu of choices selected by the employer or plan fiduciary.[61] While some 401(k) participants may benefit from having myriad investment choices, many, perhaps most, may choose less wisely when confronted with more choices.

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[56] DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 145 (2005).

[57] *Id.* at 4.

[58] *See* Ayres & Curtis, *supra* note 30, at 1507.

[59] *See* ZELINSKY, *supra* note 45, at 8–12; *see also* Jeff Schwartz, *Rethinking 401(k)s*, 49 HARV. J. ON LEGIS. 53, 59–62 (2012).

[60] *See, e.g.*, Adi Ayal, *Harmful Freedom of Choice: Lessons from the Cellphone Market*, 74 LAW & CONTEMP. PROBS. 91, 99 (2011) (explaining that, in the context of 401(k) participant investing, "complexity of choice harmed the quality of choices made as well as willingness to make a choice at all"). *See, e.g.*, Mark Miller, *When Medicare Choices Get 'Pretty Crazy,' Many Seniors Avert Their Eyes*, N.Y. TIMES, https://www.nytimes.com/2020/11/13/business/medicare-advantage-retirement.html (Sept. 15, 2021) (describing the popular recognition that many individuals can be paralyzed from decision making in the face of too much choice).

[61] *See* Hecker v. Deere & Co., 556 F.3d 575, 578 (7th Cir. 2009) (discussing a brokerage window "which gave participants access to some 2,500 additional funds managed by different companies"); *see also* Schwartz, *supra* note 59, at 57 (discussing "brokerage window[s]"); Ayres & Curtis, *supra* note 30, at 1524 (explaining how a brokerage window "provides access to hundreds or thousands of funds and even individual stocks that investors can opt to hold"); Albert Feuer, *Ethics, Earnings, and ERISA: Ethical-Factor Investing of Savings and Retirement Benefits*, *in* 2020 NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION, *supra* note 15, § 6.07 (discussing the "brokerage option").

E. *The Different Ways in Which Pension Trusts Hold Assets*

Pension trusts can invest in different asset categories in a variety of ways. These different methods of investing have divergent implications for 401(k) investment menus under ERISA's test of diversification.

At its simplest, a pension trust may invest directly in an individual asset. The prototypical direct investment of an individual asset is a pension trust's ownership of the stock of a particular company. A pension trust may also invest in an asset class through an intermediary holding device, often resulting in a degree of diversification within the holding device. For example, a trust can invest in a mutual fund holding a group of stocks. Such a fund facilitates diversification—i.e., ownership of many corporations' stocks—unlike an investment in a single asset—e.g., ownership of a particular company's stock. It is, however, possible for a single stock fund to hold only the shares of a particular corporation.[62]

A pension trust may also invest in a vehicle which bundles items from different asset classes. An example of such a bundled investment vehicle is a target date fund that invests in different asset categories—e.g., stocks, bonds, and cash equivalents—thereby changing the composition of the fund's holdings from more aggressive to more conservative as the target date approaches.[63]

In the interests of diversification, a pension trust will often establish limits on the percentage of the trust's assets which will be allocated to any particular investment class or to any particular investment. A pension trustee may, for example, decide that it wants no more than a particular percentage of its holdings in any one company's stock or may limit to a particular percentage its holdings' common stocks as a group.[64]

In the context of a defined benefit trust, it is the professional investment fiduciary who chooses from among these approaches to investing. In the 401(k) context, the fiduciary considering alternative investments for a participant investment menu is required to choose more diversified methods of investments and to limit particular investment categories to prevent unsophisticated participants from making undiversified investments in alternative assets.[65] Indeed, as to most alternative investments that pass the test of prudence, the 401(k) menu offering such alternative investments

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[62] *See* Stegemann v. Gannett Co., 970 F.3d 465, 470, 475 (4th Cir. 2020) (discussing a single stock fund).

[63] Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 2022 (2010) ("[T]arget date funds offer investors professional allocation of their assets by shifting from an equity portfolio in the early years toward an increasing percentage of fixed income securities both leading up to and following the target date, a shift that is termed the fund's 'glide path.' As a result, the funds purport to meet the increasingly conservative investment needs of consumers as they age and approach retirement.") (footnote omitted).

[64] *See* Russell Galer, *"Prudent Person Rule" Standard for the Investment of Pension Fund Assets*, 83 FIN. MKT. TRENDS 43, 55 (2002).

[65] *See* U.S. DEP'T OF LAB., EMP. BENEFITS SEC. ADMIN., MEETING YOUR FIDUCIARY RESPONSIBILITIES 3 (2020) (noting that the DOL regulations require three different investment options and sufficient information regarding those options to participants).

should offer these in limited, bundled, and mediated forms to prevent participants from overinvesting in particular assets and asset categories.

II. ANALYZING SPECIFIC ASSET CATEGORIES

A. *Real Estate vs. Bitcoin and Art*

Against this background, I first analyze and contrast real estate, Bitcoin, and art funds as potential 401(k) investments under ERISA's fiduciary standards. Under this fact-intensive inquiry, real estate, cryptocurrencies, and art today represent the opposite ends of the prudence spectrum. Real estate, in particular REITs, are now long-established, actively-traded, and widely-accepted investments.[66] Defined benefit trustees invest extensively in real estate. REITs can be diversified devices that resemble traditional mutual funds. Today, as a class, REITs are conservative and conventional and therefore are objectively prudent to offer to 401(k) participants. To guard against overconcentration by unsophisticated investors, REITs should appear in 401(k) investment menus with limits and/or in internally diversified forms, e.g., diversified funds of REITs or REITs bundled with other investments in other asset categories. When so limited and diversified, REITs are prudent investments to offer to 401(k) participants for their respective retirement accounts.

In contrast, Bitcoin and art funds are new, thinly-traded investments that have not achieved wide acceptance in the investment community in general or among defined benefit trustees in particular. Bitcoin, other cryptocurrencies, and art funds thus represent the opposite end of the prudence spectrum in that they are too novel to offer to 401(k) participants today.

At one level, the history of real estate investments can be traced back to the Bible[67] or perhaps to the real estate speculation that was central to American colonial history.[68] More prosaically, the fact-based prudence inquiry for 401(k) purposes should start with Congress's authorization of the REIT in 1960.[69]

The Internal Revenue Code's pass-through taxation of REITs is modeled on the pass-through taxation of mutual funds.[70] Over the years,

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[66] *See* I.R.C. § 856 (governing REITs). For background information on REITs, see Bradley T. Borden, *Reforming REIT Taxation (Or Not)*, 53 HOUS. L. REV. 1, 13 (2015).

[67] My ancestors, for example, built Pithom and Ramses for the Pharaoh of Egypt, one of the ancient world's most aggressive real estate developers. For a recent analysis of this much-told tale, see LEON R. KASS, FOUNDING GOD'S NATION: READING EXODUS 454 (2021).

[68] *See, e.g.*, DAVID MCCULLOUGH, THE PIONEERS: THE HEROIC STORY OF THE SETTLERS WHO BROUGHT THE AMERICAN IDEAL WEST 42 (2019) (discussing George Washington's real estate speculation in Ohio).

[69] Act of September 14, 1960, Pub. L. No. 86-779, § 856(a)–(c), 74 Stat. 998, 1004–05 (1960) (adding the provisions pertaining to REITs to the Internal Revenue Code).

[70] Borden, *supra* note 66, at 18 ("REIT taxation is modeled after the [mutual fund] tax regime.").

REITs have emerged as widely-accepted, heavily-traded investment vehicles resembling mutual funds. Nareit, a trade association of REITs, calculates that all REITs today own about $3 trillion in assets, of which roughly two-thirds is held by publicly-traded REITs.[71] For 2014, Professor Borden put "REIT market capitalization" at "more than $907 billion."[72] Confirming the prudence of real estate investments for retirement savings, the average defined benefit plan today holds two to three percent of its assets in real estate.[73]

A REIT can achieve a measure of internal diversification.[74] A REIT can, for example, hold different kinds of real estate, including commercial structures, residential structures, office buildings, and apartment buildings.[75] A single REIT can also be diversified geographically, holding structures in different locations.[76] Moreover, a REIT can diversify by owning real estate-related mortgage loans in addition to or in lieu of actual buildings.[77] In the interests of diversification, groups of REITs can be aggregated or bundled with investments in other asset categories.

For all these reasons, real estate and REITs in particular, widely accepted by defined benefit trustees, are today prudent as an asset class to offer to 401(k) participants. Within the category of real estate, particular investments may still be more or less prudent depending upon their particular features. A REIT with excessive fees or owning a single structure is not a prudent offering for a 401(k) menu since it lacks internal diversification. But, as a generic category, REITs today pass the objective test of prudence. They are conventional, widely embraced, readily traded in active markets, and reflect the acceptance of real estate as an investment category by defined benefit trustees.[78]

REITs are not the only device available for making real estate investments available to 401(k) participants. Real estate mortgage investment conduits (REMICs), for example, are another way of holding interests in real estate.[79] But, for 401(k) menus, REITs today are the most well-established, broadly accepted, diversifiable, and readily available way

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[71] *REITs by the Numbers*, NAREIT, https://www.reit.com/data-research/data/reits-numbers#:~:text=REITs%20own%20approximately%20%243%20trillion,Americans%20all%20across%20the%20country (Nov. 2021).

[72] Borden, *supra* note 66, at 6.

[73] PANIS & BRIEN, *supra* note 13, at 6.

[74] Though, among economists, the benefits of REIT diversification are a controversial topic. *See, e.g.*, Zhilan Feng et al., *Geographic Diversification in Real Estate Investment Trusts*, 49 REAL EST. ECON. 267, 270–71 (2021).

[75] *Id.* at 271.

[76] *Id.* at 271, 274, 274 tbl.1.

[77] I.R.C. § 856(c)(5)(B) (defining, for REIT taxation, "real estate assets" to include "interests in mortgages on real property").

[78] *See supra* text accompanying notes 70–73.

[79] *See* I.R.C. §§ 860A–860D (establishing tax arrangements of REMICs).

to make real estate investments available to 401(k) participants for their retirement savings accounts.[80]

Once it is decided that, because of their broad acceptance, REITs can prudently be placed on a 401(k) investment menu, the focus shifts from prudence to diversification. At this point, the unsophisticated nature of many 401(k) investors becomes a concern. While professional defined benefit trustees widely invest in real estate,[81] we can be confident that they will not overconcentrate in real property as a class or in any single real estate investment. In contrast, there is a significant danger that some 401(k) participants will underdiversify by directing too much of their respective accounts to real estate as a class or by investing in a particular piece of real property.

Consequently, the most prudent way to offer real estate to 401(k) investors is as groups of REITs or as part of bundled funds that include REITs among other asset categories. In addition, or instead, it is also prudent to limit the percentage of a participant's account that can be directed to REITs. Looking at the investment patterns of defined benefit trustees, I would limit REITs to ten percent of any participant's account, though I acknowledge that the exact ceiling is a matter about which reasonable trustees might disagree. If the portion of any particular account invested in REITs exceeds the plan's limit, no further real estate investment should be permitted until other asset categories in the participant's account have appreciated sufficiently to reduce real estate back below the limit.

Besides precluding overconcentration, such a limit also signals to the participant that, while real estate is a prudent investment, she should diversify and hold assets from other investment categories, as well.

In contrast to REITs with their sixty-year history, Bitcoin did not exist before 2009.[82] The volume of Bitcoin investments is relatively small,[83] and

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[80] PANIS & BRIEN, *supra* note 13, at 6.

[81] *Id.*

[82] Eric D. Chason, *A Tax on the Clones: The Strange Case of Bitcoin Cash*, 39 VA. TAX REV. 1, 4 (2019). For the background and history of Bitcoin, see PRIMAVERA DE FILIPPI & AARON WRIGHT, BLOCKCHAIN AND THE LAW: THE RULE OF CODE 20–22 (2018).

[83] CoinMarketCap is a widely used website that reports cryptocurrency trading and values. On October 4, 2020, it reported that Bitcoin's total value was slightly more than $196 billion worldwide, while Bitcoin's daily trading value was slightly less than $55 billion. *Historical Snapshot - 04 October 2020*, COINMARKETCAP, https://coinmarketcap.com/historical/20201004 (last visited Feb. 2, 2022). *See also* Paul Vigna, *Bitcoin Is Back Trading Near Three-Year Highs*, WALL ST. J. (Nov. 1, 2020, 12:00 PM), https://www.wsj.com/articles/bitcoin-is-back-trading-near-three-year-highs-11604250000 ("[Bitcoin] has been around for only about 11 years, and for most of that time, it has been ignored by the mainstream and viewed a curiosity for risk takers. It has no record as a wide-scale asset class.").

Bitcoin prices are volatile,[84] trading in thin markets.[85] Prominent voices caution about the speculative nature of Bitcoin.[86] New York's Attorney General warns that "[v]irtual currency is a high-risk and unstable investment. Even if you purchase a well-established virtual currency from a more reputable trading platform, the price could crash in an instant."[87] SEC Chairman Gary Gensler characterizes cryptocurrency markets as "like the Wild West."[88]

Internal diversification by bundling Bitcoin with other cryptocurrencies is an unpromising prospect since other cryptocurrencies are even smaller, newer, and less liquid than Bitcoin.[89] Combining other cryptocurrencies with Bitcoin would produce an even less cautious and conservative package than Bitcoin standing by itself. Today, rank-and-file U.S. investors must hold Bitcoin (or any other cryptocurrencies) directly. There is as of yet no

[84] Chason, *supra* note 82, at 2 (recording how the market price of Bitcoin climbed from approximately $1,000 per unit in January 2017 "to almost $20,000" in December 2017, then went back down); Tressie McMillan Cottom, *Crypto and the Power of Folk Economics*, N.Y. TIMES (Feb. 7, 2022), https://www.nytimes.com/2022/02/07/opinion/crypto-nfts-folk-economics.html ("[C]rypto is volatile."); Vigna, *supra* note 83 ("The price of the digital currency has surged about 90% in 2020 . . . ."). *See* Megan McDermott, *The Crypto Quandary: Is Bankruptcy Ready?*, 115 NW. U. L. REV. 1921, 1945 (2021) (discussing the "extreme volatility in the price of Bitcoin"); *id.* at 1946 (discussing "the high volatility of crypto assets"); Paul Vigna, *Bitcoin Surges Into 2021, Rose Nearly 20% over Weekend*, WALL. ST. J., https://www.wsj.com/articles/bitcoin-surges-into-2021-rose-nearly-20-over-weekend-11609779024 (Jan. 4, 2021, 6:14 PM) ("A correction of sorts did occur, again illustrating the volatility of the asset class. After bitcoin hit its new high, the price fell 15% . . . .").

[85] McDermott, *supra* note 84, at 1940 ("[C]rypto assets . . . often present an illusionary facade of liquidity.").

[86] Ryan Browne, *Crypto Investors 'Should Be Prepared to Lose All Their Money,' Top UK Regulator Warns*, CNBC, https://www.cnbc.com/2021/01/11/crypto-investors-risk-losing-all-their-money-uks-fca-warns.html (Jan. 11, 2021, 12:14 PM) ("That's the message from the U.K.'s Financial Conduct Authority, which on Monday warned investments and lending products related to crypto come with 'very high risks.' . . . 'If consumers invest in these types of product, they should be prepared to lose all their money.'"); Tom Wilson, Anna Irrera & Jessica DiNapoli, *Rush to Bitcoin? Not So Fast, Say Keepers of Corporate Coffers*, REUTERS, https://www.reuters.com/article/us-crypto-currency-bitcoin-treasury-insi/rush-to-bitcoin-not-so-fast-say-keepers-of-corporate-coffers-idUSKBN2B00FY (Mar. 8, 2021, 1:09 AM) ("[M]any finance executives and accountants loath to risk balance sheets and reputations on a highly volatile and unpredictable asset that confounds convention.").

[87] *Investor Alert: Virtual Currency Risks*, OFF. OF N.Y. STATE ATT'Y GEN., https://ag.ny.gov/sites/default/files/crypto-investor-notice.pdf (last visited Oct. 6, 2021).

[88] Paul Kiernan, *SEC Calls for Tools to Rein In Crypto Markets*, WALL ST. J., Aug. 4, 2021, at A1.

[89] After Bitcoin, both the aggregate value and the daily trading volume of other cryptocurrencies dropped significantly. For example, Tether, on October 4, 2020, had a market capitalization somewhat greater than $15 billion with a daily trading volume of slightly over $29 billion. *Historical Snapshot - 04 October 2020*, *supra* note 83. *See* David Segal, *Going for Broke in Cryptoland*, N.Y. TIMES, Aug. 8, 2021, at BU1 (discussing "hype coins").

SEC-compliant mutual fund or similar device which permits grass roots investors[90] to hold or aggregate cryptocurrencies.[91]

In light of Bitcoin's novelty, it comes as no surprise that there is no cognizable investment in cryptocurrency by the professional managers of defined benefit plans.[92] Given the similarities of defined benefit arrangements and 401(k) plans as retirement savings accumulation devices, significant investment by professional defined benefit trustees is a minimum threshold of general acceptability that an investment category must pass before it can be offered prudently to 401(k) participants. Bitcoin and other cryptocurrencies today do not meet that threshold.

Cryptocurrency advocates suggest that defined benefit plans are starting to invest in Bitcoin, at least as part of bundled funds.[93] However, the fiduciary rule of prudence requires extensive experience and acceptance before an investment can be deemed objectively prudent.

Until defined benefit plans widely embrace Bitcoin and other cryptocurrencies for a significant period of time and in significant volume (as such plans have adopted real estate investments, hedge funds, and private equity investments), 401(k) plans should avoid offering Bitcoin and cryptocurrencies to 401(k) participants. It is possible, though not inevitable, that Bitcoin and cryptocurrencies will, at some point in the future, cross the threshold to prudence by establishing a sufficient track record and by

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[90] *See, e.g.*, SEC Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, Release No. 34-88284 (Feb. 26, 2020), https://www.sec.gov/rules/sro/nysearca/2020/34-88284.pdf (denying permission to list and trade the United States Bitcoin and Treasury Investment Trust). There are hedge funds that invest in Bitcoin and other cryptocurrencies, but these funds are restricted to accredited investors and are not available to rank-and-file investors. *See, e.g.*, Morgan Creek Blockchain Opportunities Fund II, LP, Notice of Exempt Offering of Securities (Form D) (Oct. 18, 2019), https://sec.report/Document/0000919574-19-006488. *See also The Digital Asset Index Fund*, MORGAN CREEK DIGIT. ASSETS WITH BITWISE, https://digitalassetindexfund.com (last visited Oct. 6, 2021) ("Investors must be accredited and U.S.-based."); Michael Wursthorn, *Another Bitcoin Futures ETF Bites the Dust*, WALL STREET J., (Nov. 11, 2021, 3:48 PM), https://www.wsj.com/articles/another-bitcoin-futures-etf-bites-the-dust-11636663692.

[91] Leah McGrath Goodman, *Wall Street's Crypto Cold War*, INSTITUTIONAL INV. (July 24, 2020), https://www.institutionalinvestor.com/article/b1mmvg200ctlr0/Wall-Street-s-Crypto-Cold-War. *See also* SEC Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, Release No. 34-83723 (July 26, 2018), https://www.sec.gov/rules/other/2018/34-83723.pdfhttps://www.sec.gov/rules/other/2018/34-83723.pdf (rejecting the rule change "to list and trade shares of the Winklevoss Bitcoin Trust"); Kate Rooney & Bob Pisani, *Winklevoss Twins Bitcoin ETF Rejected by SEC*, CNBC, https://www.cnbc.com/2018/07/26/winklevoss-twins-bitcoin-etf-rejected-by-sec.html (July 27, 2018, 7:53 AM).

[92] *See* Michael del Castillo, *Police Pension Backs Morgan Creek's $40 Million Blockchain Venture Capital Fund*, FORBES (Feb. 12, 2019, 6:00 AM), https://www.forbes.com/sites/michaeldelcastillo/2019/02/12/police-pensions-back-40-million--blockchain-venture-capital-fund/?sh=681927d911ae (noting that, when two public pensions invested in a bitcoin hedge fund, it was considered newsworthy and "unusual").

[93] Sam Bourgi, *Pension Funds Are Getting in on Bitcoin, According to Grayscale*, COINTELEGRAPH (Jan. 8, 2021), https://cointelegraph.com/news/pension-funds-are-getting-in-on-bitcoin-according-to-grayscale.

achieving broad enough acceptance to be deemed conventional in the defined benefit universe. But, that has not yet happened, and there is no guarantee that it will.

Some investors have made and will continue to make money trading Bitcoin. Some investors made money on tulips also. The fact-based inquiry for objective prudence is whether Bitcoin and other cryptocurrencies have today achieved general acceptance[94] as conservative[95] and cautious[96] investments. For 401(k) participants, Bitcoin and other cryptocurrencies are today, as a factual matter, not objectively prudent as an investment class.

This conclusion reinforces my concerns about brokerage windows[97] for rank-and-file 401(k) participants, as such windows may permit and sometimes encourage cryptocurrency investments. Robinhood.com, for example, proclaims cryptocurrency investments as one of its core products.[98] A brokerage window through this or any similar site could result in unsophisticated 401(k) participants making overconcentrated investments in cryptocurrencies.

Art has long been a traditional holding of the wealthy and powerful, and it remains so today.[99] Important contemporary voices call for broader embrace of art as an investment category.[100] However, funds facilitating art investment are, like Bitcoin, a new phenomenon. There is no publicly traded device by which investors can hold art. There are a relative handful of illiquid, privately held art funds organized as limited partnerships and limited liability companies.[101] By one account, there exist "fewer than [sixty]" such art funds, with assets worth \$830 million.[102] There is no evidence of professional defined benefit trustees investing in art.

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[94] 29 C.F.R. § 2550.404c–5(e)(4)(i) (2021).

[95] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e(1) (AM. L. INST. 2007).

[96] *Id.* § 90 cmt. e.

[97] *See supra* text accompanying notes 60–61.

[98] ROBINHOOD, https://robinhood.com/us/en/ (last visited Sept. 17, 2021) (listing "Our Products" as cash management, stocks and funds, options, gold, and crypto).

[99] *See, e.g.*, Emma Snover, Note, *Casting Light on the Shade: Using Securities Laws to Draw New Contours in Art Investment Regulation*, 88 FORDHAM L. REV. 1509, 1511 (2020) (discussing the size of the global and domestic U.S. art market).

[100] Adriano Picinati di Torcello, *Why Should Art Be Considered as an Asset Class?*, DELOITTE, https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/artandfinance/lu-art-asset-class-122012.pdf (last visited Feb. 2, 2022). Even if art does become a prudent investment class for 401(k) menus, Internal Revenue Code section 408(m) will discourage participants from investing their accounts directly in art since such direct investments will constitute taxable distributions. Arguably, section 408(m) would not be triggered by indirect art investments made via bundled investment arrangements or similar holding devices.

[101] Karen Hube, *Future Returns: Art Funds Draw Few Investors, but Some Are Worth a Look*, BARRON'S: PENTA (Apr. 23, 2019, 11:44 AM), https://www.barrons.com/articles/art-funds-draw-few-investors-but-some-are-worth-a-look-01556034302.

[102] *Id.*

In short, no prudent fiduciary could today view art funds as sufficiently accepted to be cautious and conservative investments for 401(k) menus.

B. *ESG Funds*

Like Bitcoin and art, ESG investments do not, as a class, qualify as prudent for 401(k) investment menus, in light of the failure of defined benefit trustees to embrace ESG investments as an asset category and in light of the fiduciary duty of loyalty, which precludes the use of trust funds to obtain benefits for third parties. A particular investment touted as an ESG asset may be financially prudent despite its ESG label. But, ESG assets as a class are not an objectively prudent category for 401(k) investment menus, given the failure of defined benefit trustees to embrace such investments as a class for retirement savings purposes. An asset packaged as an ESG investment may, as an economic matter, qualify for a 401(k) menu. If so, it is despite, not because of, the asset's ESG imprimatur.

The forerunners in the pension-setting of ESG investments were "economically targeted investments" (ETIs).[103] The proponents of ETIs argued that pension assets achieving market rates of return can be deployed to generate positive economic externalities, such as jobs or community development, that would otherwise not occur.[104] The opponents of ETIs[105] retorted that deploying pension assets to benefit third parties violates the fiduciary duty of loyalty to the pension participants whose retirement is the "exclusive purpose"[106] for which plan assets should be invested. To permit consideration of alleged ETI benefits for third parties threatens the integrity of the fiduciary decision-making process by introducing into that process concerns other than the welfare of the pension participants.[107]

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[103] Edward A. Zelinsky, *Economically Targeted Investments: A Critical Analysis*, 6 KAN. J.L. & PUB. POL'Y 39, 39 (1997); Edward A. Zelinsky, *ETI, Phone the Department of Labor: Economically Targeted Investments, IB 94-1 and the Reincarnation of Industrial Policy*, 16 BERKELEY J. EMP. & LAB. L. 333, 334–36 (1995); Edward A. Zelinsky, *The Continuing Battle over Economically Targeted Investments: An Analysis of the Department of Labor's Interpretative Bulletin 2015-01*, 2016 CARDOZO L. REV. DE NOVO 197, 197–98, *reprinted in* 2017 NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 4 (Kathryn J. Kennedy ed.) [hereinafter Zelinsky, *Continuing Battle*]; Jean-Pierre Aubry et al., *ESG Investing and Public Pensions: An Update*, 74 CTR. FOR RET. RSCH., Oct. 2020, at 1, 2, (discussing "economically targeted investments" by pensions as an early form of "social investing"); Feuer, *supra* note 61, § 6.03[4] (discussing economically targeted investments).

[104] Aubry et al., *supra* note 103, at 2. *See also* Paul Sullivan, *Jon Bon Jovi, the Jersey Shore and the Impact Investing Strategy*, N.Y. TIMES (Oct. 30, 2015), https://www.nytimes.com/2015/10/31/your-money/jon-bon-jovi-the-jersey-shore-and-the-impact-investing-strategy.html (describing interest in "investments [that] perform a social good—housing for displaced residents or financing for local businesses—while also earning a return close to the market rate").

[105] Of which I was one. *See generally* Zelinsky, *Continuing Battle*, *supra* note 103, at 197–98.

[106] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A).

[107] Bernard S. Sharfman, *ESG Investing Under ERISA*, 38 YALE J. ON REGUL. BULL. 112, 130–32 (2020).

Moreover, the critique continued, ETIs cannot alter the economy's allocation of resources, as promised.[108] If an externality-generating investment yields a market rate of return, another investor will make that investment even if the ETI-seeking investor does not.[109] The hallmark of a market-rate investment is that it is an investment the market will fund.[110] At the end of the day, the pursuit of ETIs is a game of musical chairs, which, while it shuffles ownership, does not alter the overall allocation of resources among investments that yield market-rate returns.[111]

In an apparent response to the critique that the ETI search for third party benefits violates the duty of loyalty to pension participants, ESG investing is, as Professors Schanzenbach and Sitkoff observe, today often promoted as generating higher returns for the investor.[112]

Other harbingers of ESG investing are mutual funds that reflect religious values. The GuideStone Funds, for example, eschew companies "whose products, services or activities are publicly recognized as being incompatible with the moral and ethical posture" of Christian values.[113] These companies to be avoided on religious grounds include firms "in the alcohol, tobacco, gambling, pornography or abortion industries."[114] The Timothy Plan is another organization which offers "[i]nvesting with [b]iblical [p]rinciples."[115]

Individuals investing their own nonpension funds are undoubtedly free to pursue whatever noneconomic goals are important to them.[116] It is their money they are investing. And, as we have just seen, what is more controversial is whether value-driven investing, pursued under the ESG label or under another rubric, actually alters market-based outcomes.[117]

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[108] Zelinsky, *Continuing Battle*, *supra* note 103, at 205–06.

[109] *Id.*

[110] *Id.*

[111] *Id.*

[112] Schanzenbach & Sitkoff, *supra* note 42, at 388–89 (explaining that proponents of ESG investing today assert "that ESG investing could improve risk-adjusted returns, thereby providing a direct benefit to investors"); *id.* at 454 ("[S]o much of the debate has centered on the claim that ESG investing can provide superior risk-adjusted returns."). *See also* Aubry et al., *supra* note 103, at 1 ("Proponents believe that, by integrating these ESG factors into existing methods of financial analysis, investors can both earn higher returns and promote socially beneficial practices and outcomes.").

[113] *How We Invest*, GUIDESTONE FUNDS, http://www.guidestonefunds.com/How-We-Invest (last visited Feb. 2, 2022).

[114] *Id.*

[115] *About Us*, TIMOTHY PLAN, https://timothyplan.com (last visited Feb. 2, 2022). *See also* Feuer, *supra* note 61, § 6.03[2] (discussing "faith-based" funds).

[116] *See, e.g.*, Feuer, *supra* note 61, § 6.02[1] ("[I]f the investor is an individual investing his or her funds, the only ethical-factor investing constraints are those that the individual chooses to follow.").

[117] *See, e.g.*, Schanzenbach & Sitkoff, *supra* note 42, at 433–53. *See also* Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. CORP. L. 205, 222 (2018) ("When one investor sells her stock in a publicly-traded company, tautologically another investor takes his place."); *id.* at 223 ("[T]he sale of publicly traded stock alone will have little direct economic consequences."); Zelinsky, *Continuing Battle*, *supra* note 103, at 199–206.

But, these issues, as important and interesting as they are, are not controlling in the context of ERISA's duties of prudence and loyalty. Under these legal tests, the fiduciary's focus must be whether an investment is generally accepted and therefore deemed cautious and conservative and whether an investment is pursued exclusively to provide retirement benefits for plan participants.

Here, the evidence is, at best, mixed. Many corporations, funds, and investment managers today proclaim their concern for ESG goals. While public sector pension plans have invested heavily in ESG funds as a result of political pressures, private sector defined benefit trustees have not embraced ESG investments as such.[118] There is, moreover, no real track record demonstrating that, for the long-run, ESG investing as a class outperforms investing based on traditional economic criteria.[119] As Professors Schanzenbach and Sitkoff observe, there is a serious prospect that ESG funds will be overvalued by ideologically-motivated purchasers bidding up the prices of such funds.[120] Such overvaluation makes ESG funds unattractive targets for those prudently investing for economic returns.[121]

A potential counterargument is that ESG funds are like target date funds,[122] incremental adaptations of conventional mutual funds. From this vantage, the historic experience of the mutual fund industry can be tacked onto ESG funds to give them a longer provenance and thus a greater claim to prudence.

There is, however, great tension between this defense of ESG investing as an incremental extension of long-standing mutual fund practice and the claims of ESG advocates that they are doing something new, indeed, revolutionary. Both claims cannot be true. It cannot be that ESG investing is objectively prudent because it is not greatly different from existing mutual funds, but that ESG investing is simultaneously compelling because it is a break with the past.

In short, under present circumstances, the ERISA-based duties of loyalty and prudence preclude the placement of ESG funds as a class onto 401(k) investment menus.

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[118] Aubry et al., *supra* note 103, at 3 ("[N]one of the institutional ESG assets are held by private sector defined benefit plans."); Staff, *Few U.S. Pension Plans Integrating ESG Into Investment Manager Selections: Survey*, BENEFITS CAN. (July 26, 2018, 5:00 PM), https://www.benefitscanada.com/news/few-u-s-pension-plans-integrating-esg-into-investment-manager-selections-survey/.

[119] Aubry et al., *supra* note 103, at 6 ("The fact that having an ESG policy is also negatively related to returns (with 10-percent significance) appears to contradict the assertion that focusing on social factors produces market or better returns.").

[120] Schanzenbach & Sitkoff, *supra* note 42, at 452.

[121] *Id.*

[122] *See* Fisch, *supra* note 63, at 2022–35.

This conclusion is reinforced by DOL regulations amplifying these fiduciary duties.[123] In three ways, these regulations discourage ESG investing for 401(k) purposes. These regulations prohibit the use of ERISA-regulated funds to pursue nonfinancial goals. In addition, these DOL rules limit the use of nonfinancial objectives as tie-breaking factors when investments are equally attractive in financial terms. Finally, these new regulations completely preclude from "qualified default investment alternatives" any fund or investment that styles itself as pursuing nonfinancial goals, such as ESG objectives.

While the earlier proposed version of these regulations explicitly addressed ESG investing in the pension context,[124] the final regulations as adopted drop any overt reference to ESG investing and instead differentiate "pecuniary"[125] from "non-pecuniary"[126] factors. Despite this change, the final regulations discourage pension plans from ESG investing by barring such plans from pursuing social benefits in the selection of 401(k) investment menus. Under the regulations, any investment, including an ESG investment, must be justified solely by financial benefits to the plan participants.

The final DOL regulations follow *Dudenhoeffer*[127] and declare that an ERISA "fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors."[128] Reinforcing this admonition, the regulations further warn that "[a] fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals."[129] These provisions preclude consideration of ESG or similar factors when investing ERISA-regulated assets except when such factors generate financial benefits (as ESG advocates contend they do and as ESG skeptics deny they can).

The regulations confirm the DOL's long-standing position that "non-pecuniary factors" may serve as tie-breaking "deciding factor[s]" when "investment alternatives" cannot be "distinguish[ed] on the basis of pecuniary factors alone."[130] However, the regulations further provide that, in such a tie-breaking situation, the "the chosen non-pecuniary factor or factors [must

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[123] *See generally* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39,113 (proposed June 30, 2020) (to be codified at 29 C.F.R. pt. 2550).

[124] *Id.* at 39,114.

[125] 29 C.F.R. § 2550.404a-1(c)(1) (2021).

[126] *Id.*

[127] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014).

[128] 29 C.F.R. § 2550.404a-1(c)(1) (2021).

[129] *Id.*

[130] *Id.* § 2550.404a-1(c)(2); *see also* Zelinsky, *Continuing Battle, supra* note 103, at 201–05.

be] consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan."[131]

This statement is not a model of clarity. However, it places additional, even if ambiguous, restraints on the use of nonfinancial considerations, such as ESG factors, for tie-breaking among otherwise perfectly balanced investments.

In a third constraint on ESG investing by ERISA plans, the DOL regulations explicitly bar participant-directed individual account plans from including in their "qualified default investment alternative[s]" any investment "if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors."[132]

Under these regulations, a mutual fund otherwise yielding appropriate economic benefits for participants can be added to a 401(k) menu even if the fund's manager considers ESG characteristics. However, those ESG characteristics themselves may not motivate the trustee's selection of an investment except in a tie-breaking situation. Even then, the 401(k) trustee must, inter alia, document how the tie-breaking "non-pecuniary factor or factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan."[133]

The proposed version of these regulations attracted the ire of ESG advocates. Attorney Albert Feuer, for example, criticized the proposed regulations as precluding ESG investing by ERISA-regulated plans and as lacking any legal basis.[134]

For those embracing the pro-ESG vantage, this criticism carries over to the final regulations since, under those regulations as adopted, consideration of "non-pecuniary factors," such as ESG concerns, can, at most, be used for tie-breaking and can never be used for qualified default investment alternatives.[135] While there is some play at the joints, on balance, 401(k) trustees, under the final version of the regulations, must carefully scrutinize investments packaged in or driven by ESG values to ensure that conventional economic benefits are advanced by those investments.[136] ESG considerations as such cannot motivate a trustee's decision to place or keep an investment on the 401(k) menu she constructs or monitors.[137] It is thus unlikely that the proponents of ESG investing will be happier about the final version of these DOL regulations than they were about the proposed version.

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[131] 29 C.F.R. § 2550.404a-1(c)(2)(iii) (2021).

[132] *Id.* § 2550.404a-1(d)(2)(ii).

[133] *Id.* § 2550.404a-1(c)(2)(iii).

[134] Albert Feuer, *INSIGHT: DOL Lacks a Convincing Legal Basis for Attempts to Discourage ESG/Sustainable Investing*, BLOOMBERG TAX (Sept. 18, 2020, 4:00 AM), https://news.bloombergtax.com/daily-tax-report/insight-dol-lacks-a-convincing-legal-basis-for-attempts-to-discourage-esg-sustainable-investing.

[135] 29 C.F.R. § 2550.404a-1(c)(2)(iii) (2021).

[136] *Id.* § 2550.404a-1(c)(1).

[137] *Id.*

Signaling its displeasure with these regulations, the Biden administration has proposed major revisions.[138] But, even if these regulations are ultimately withdrawn or modified, ESG funds as such are today not objectively prudent as an investment class, i.e., generally accepted and thus cautious and conservative.[139] Defined benefit trustees have so far eschewed ESG investments as a class.[140] Defined benefit plan trustees are the gatekeepers for 401(k) investing. The failure of defined benefit fiduciaries to accept ESG investing precludes the placement of ESG funds as a category onto 401(k) investment menus.

An ERISA-regulated trustee might find that a particular investment serves the financial interests of plan participants even though the investment considers ESG factors. But, third-party benefits cannot motivate trustees to place investments onto 401(k) investment menus since the duty of loyalty requires that the sole consideration for an ERISA plan's investment choices be the financial benefits for the participants' retirements.[141]

Here, again, it is necessary to distinguish between a trustee's personal investment decisions for his own portfolio and his obligations of loyalty and prudence as an ERISA fiduciary. The trustee can invest his own personal money however he chooses. But, as a 401(k) fiduciary, he must construct the participants' investment menu within the strictures of prudence, diversification, and loyalty.[142] As understood today, those strictures leave no room for ESG investments as an asset class, in light of the failure of defined benefit trustees to embrace ESG investments as a category and the impropriety under the duty of loyalty of using ERISA-regulated funds to benefit third parties.

C. *Hedge Funds and Private Equity Funds*

A "hedge fund" is an actively managed pool of capital that, by making relatively risky investments, promises purportedly sophisticated investors[143] higher returns than can be achieved by the more conventional investing

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[138] Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57,272 (Oct. 14, 2021) (to be codified at 29 C.F.R. pt. 2550). For my criticism of these proposed regulations, see Edward A. Zelinsky, *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3974783).

[139] *See supra* notes 25–28 and accompanying text.

[140] *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-18-398, RETIREMENT PLAN INVESTING: CLEARER INFORMATION ON CONSIDERATION OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS WOULD BE HELPFUL 13 (2018).

[141] *See supra* note 39 and accompanying text.

[142] *See supra* note 14 and accompanying text.

[143] Hedge funds generally accept investments only from "accredited investors" as defined in SEC Regulation D, 17 C.F.R. § 230.501(a) (2021). Among other criteria, an accredited investor can be an individual whose net worth (exclusive of her primary residence) exceeds $1,000,000; an individual whose annual income exceeds $200,000 yearly; or a trust with assets in excess of $5,000,000, provided that the trust is governed by "a sophisticated person." *Id.* § 230.501(a)(5)–(7).

strategies available to the general public.[144] Whereas a typical mutual fund or ETF buys and holds stocks and bonds, hedge funds often invest in more complicated financial transactions (e.g., short sales and leveraged transactions)[145] using less conventional instruments (e.g., options, derivatives, futures, total return swaps, and credit default swaps).[146] Hedge funds often operate opaquely in the belief that their proprietary investment strategies are best kept under wraps, even from the investors financing them.[147] Many hedge fund investors make their respective investments through "fund of funds" that purchase portfolios of different hedge funds.[148]

There is skepticism of hedge funds in important quarters. In 2007, Warren Buffett made a public bet that a passively-invested S&P 500 index fund would, over ten years, beat the performance of a group of hedge funds selected by his betting counterparty.[149] Buffett easily won the bet.[150] A consistent theme of hedge fund critics is that the fees paid to managers of these funds are inordinate, decreasing the net returns received by investors.[151] Among other contentions, the critique asserts that managers' fees, nominally tied to fund performance, are in fact a one-way street.[152] While hedge fund managers are amply compensated when hedge funds experience gains, these managers do not return this compensation if the funds subsequently decline in value.[153] So-called "high water mark" provisions prevent a manager from receiving further compensation until the now lower fund she manages returns to its previous high.[154] However, if the fund is liquidated below that high water mark or if the investor leaves the fund while its valuation is below that mark, the investor

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[144] *See* Kat Tretina & John Schmidt, *How Do You Invest in Hedge Funds?*, FORBES, https://www.forbes.com/advisor/investing/how-to-invest-in-hedge-funds (June 25, 2021, 12:59 PM) ("[Hedge funds] more often employ aggressive investment strategies, like leveraged, debt-based investing and short-selling, and they can purchase types of assets other funds can't invest in, like real estate, art and currency."); Joshua Hess, Note, *How Arbitrary Really Was the S.E.C.'s "Hedge Fund Rule"? The Future of Hedge Fund Regulation in Light of* Goldstein*, Amaranth Advisors, and Beyond*, 110 W. VA. L. REV. 913, 916–21 (2008) (discussing the organization and investing strategies of hedge funds).

[145] Tretina & Schmidt, *supra* note 144.

[146] Houman B. Shadab, *Hedge Fund Governance*, 19 STAN. J.L. BUS. & FIN. 141, 182 (2013).

[147] J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 814 (2007).

[148] *See, e.g.*, *Why Blackstone Alternative Multi-Strategy Fund*, BLACKSTONE, https://bxmix.blackstone.com/ (last visited Feb. 2, 2022).

[149] Nicole Friedman, *Buffett's Index Bet Pays Off for Charity*, WALL ST. J., Jan. 2, 2018, at B1.

[150] *Id.* ("Mr. Buffett's S&P 500 index fund returned 7.1% compounded annually. The competing basket of funds of hedge funds selected by asset manager Protege Partners returned an average of 2.2%.").

[151] *See generally* Itzhak Ben-David, Justin Birru & Andrea Rossi, *The Performance of Hedge Fund Performance Fees* (Ohio State Univ., Fisher Coll. of Bus., Working Paper No. 2020-03-014, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3630723 (analyzing "long-run outcomes associated with hedge funds' compensation structure," and finding "poor outcomes" for hedge fund investors). *See also* Shadab, *supra* note 146, at 168–69 (discussing the compensation of hedge fund managers).

[152] *See* Shadab, *supra* note 146, at 168–69.

[153] Ben-David, Birru & Rossi, *supra* note 151, at 13.

[154] Shadab, *supra* note 146, at 180; Ben-David, Birru & Rossi, *supra* note 151, at 4.

will have earlier paid management fees for investment performance she no longer possesses.[155]

The fee issue is compounded in the context of a fund of funds since a second set of fees is paid to the managers of the fund of funds on top of the fees paid to the managers of the underlying hedge funds.[156] Hedge funds may also pose liquidity issues for their investors as a result of "lock up" provisions which authorize the fund to block investors from withdrawing their investments.[157] The much-publicized losses incurred by hedge funds from their short-sales of GameStop and other stocks illustrated the risks associated with hedge funds' financial strategies.[158]

While Warren Buffett avoids hedge funds, many investors embrace them. Most importantly for 401(k) purposes, large defined benefit plans, on average, invest roughly ten percent of their respective portfolios in hedge funds and similar "alternative" investments such as private equity and derivatives.[159]

Hedge funds thus highlight again that a class of investments may be sufficiently accepted to be prudent for 401(k) menus even if the trustee herself would not invest in that class personally. Hedge funds also highlight the question of how general acceptance must be for prudence purposes: Are hedge funds "generally accepted" when America's iconic investor warns against them?

The liquidity, diversification, and secrecy issues raised by hedge funds are better handled by professional defined benefit trustees than by rank-and-file 401(k) investors. For a large, well-diversified defined benefit plan, a lock-up provision preventing the immediate withdrawal of funds may be a minor nuisance. For a small 401(k) investor on the verge of retirement, such a lock-up may be a financial disaster, particularly if the investor has made an overly large commitment to a fund and cannot currently liquidate his investment to meet his personal needs or to satisfy the Internal Revenue Code's required minimum distribution test.[160]

The minimum investments required by most hedge funds[161] pose another

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155 Ben-David, Birru & Rossi, *supra* note 151, at 4.

156 *Id.* at 56.

157 Shadab, *supra* note 146, at 154, 167; Tretina & Schmidt, *supra* note 144 ("Hedge funds are not as liquid as stocks or bonds either and may only allow you to withdraw your money after you've been invested for a certain amount of time or during set times of the year.").

158 Gunjan Banerji, Juliet Chung & Caitlin McCabe, *Individual Investors Rout Hedge Funds*, WALL ST. J., Jan. 28, 2021, at A1; James Mackintosh, *GameStop Shows Epitome of Bubble*, WALL ST. J., Jan. 28, 2021, at A1.

159 PANIS & BRIEN, *supra* note 13, at 6 ("On average, Alternative investments make up about 10% of the assets of large DB plans."). *See also National Data*, PUB. PLANS DATA, https://publicplansdata.org/quick-facts/national/ (Dec. 21, 2021) (discussing state and local pension plans, which, on average, invest 6.3% of their assets in hedge funds).

160 I.R.C. § 401(a)(9).

161 *See, e.g.*, Tretina & Schmidt, *supra* note 144 ("Minimum initial investment amounts for hedge funds range from $100,000 to upwards of $2 million.").

quandary for a 401(k) plan seeking to offer to its participants a hedge fund (or a fund of funds) as an investment option. It might require many participants to invest in the fund for their cumulative investments to satisfy such a minimum.

There is, at its core, a dilemma when assessing the prudence of hedge funds as 401(k) investments choices. Prudent investing is cautious and conservative.[162] A hedge fund promises greater returns precisely because it is not cautious and conservative, but rather embraces risky, often illiquid, and frequently secret investment strategies not available to the general public.[163] But, hedge funds have become so widely accepted in the defined benefit context as to be conventional in that context.[164]

The dilemma is mitigated if the particular investment offered to a 401(k) investor is a diversified fund of hedge funds or if the hedge fund is bundled into an investment package with assets from other investment categories.[165] There may also be more liquidity when a hedge fund (or a fund of funds) trades in a secondary market as they sometimes do.[166] On the other hand, a fund of funds involves a second set of management fees.

In the end, hedge funds represent a closer prudence call than does real estate. On balance, hedge funds, including funds of funds, have so penetrated the defined benefit universe as to be an acceptably prudent class of investments for 401(k) menus, so long as investments in such funds are limited to prevent unsophisticated participants from concentrating too heavily in them. Particular hedge fund investments offered to 401(k) participants must be selected with care and attention to the questions of fees, diversification, liquidity, and required minimum investments. But, as a class, hedge funds are generally accepted in the defined benefit world and thus constitute an asset class meeting the legal threshold of prudence, given their wide acceptance by defined benefit managers, as well as the possibility of investing diversely and with liquidity through funds of funds and through investments that bundle hedge funds with other asset classes.

Similar observations are to be made about private equity funds. The premise of private equity is that higher returns can be achieved by investing outside established markets.[167] Such an investment can be made as a direct investment in a private equity fund or by holding a fund of private equity funds. Prominent voices are skeptical of private equity as an investment

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[162] RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e (AM. L. INST. 2007).

[163] Tretina & Schmidt, *supra* note 144 .

[164] PANIS & BRIEN, *supra* note 13, at 6.

[165] *See generally* Campagna Letter, *supra* note 44, at 4 (discussing a bundled fund, which includes private equity as a component of diversified fund).

[166] Shadab, *supra* note 146, at 178.

[167] Gallagher, *supra* note 2.

class. Here, again, the Oracle of Omaha is among the outspoken.[168] But, defined benefit plans have embraced private equity as a now conventional investment category.[169] By virtue of that wide embrace, private equity today passes the prudence threshold as an investment class.[170]

A particular private equity investment choice, like any other 401(k) investment option, must be vetted individually for its fees, diversification, and liquidity before it is offered to 401(k) participants. Again, the 401(k) trustee who concludes that a private equity option may prudently be offered to the plan's participants may not find that choice appropriate for her own personal portfolio.

As was the case with REITs, there is a significant danger that unsophisticated 401(k) participants will overinvest in hedge and private equity funds. This possibility indicates that the ERISA fiduciary placing and keeping such funds in a 401(k) investment menu should, in the interests of diversification, limit the amount any participant may invest in such funds—just as defined benefit trustees invest limited amounts of their respective portfolios in these alternative investments. Diversification considerations also suggest that the best way to make hedge and private equity funds available to 401(k) participants may be as part of bundled investment packages that include more conventional investments as the bulk of the packages.

Instead of, or in addition to, such bundling, 401(k) plans should impose a reasonable limit (e.g., ten percent) on the percentage of the participant's account that she may hold as hedge and private equity funds. Besides protecting against overconcentration in hedge and private equity funds, such a limit would signal to the participant the importance of diversifying her retirement investments.

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[168] Hema Parmar & Sonali Basak, *Private Equity's Returns Questioned, This Time by Buffett*, BLOOMBERG L., https://www.bloomberg.com/news/articles/2019-05-05/private-equity-s-returns-questioned-again-this-time-by-buffett (May 6, 2019, 10:23 AM) ("'We have seen a number of proposals from private equity funds where the returns are really not calculated in a manner that I would regard as honest,' Buffett, 88, said Saturday[,] May 4 at Berkshire's annual shareholder meeting in Omaha, Neb. 'It's not as good as it looks.'").

[169] *See* PANIS & BRIEN, *supra* note 13, at 2, 6; *National Data*, *supra* note 159 (showing that state and local pension plans invest 9.3% of their assets in private equity); Mary Williams Walsh, *Marching Orders for the Next Investment Chief of CalPERS: More Private Equity*, N.Y. TIMES (Oct. 19, 2020), https://www.nytimes.com/2020/10/19/business/calpers-pension-private-equity.html.

[170] *See* Campagna Letter, *supra* note 44, at 5 (concluding that ERISA section 404 is not violated "solely because the fiduciary offers a professionally managed asset allocation fund with a private equity component"). *But see* U.S. DEP'T OF LAB., U.S. DEPARTMENT OF LABOR SUPPLEMENTAL STATEMENT ON PRIVATE EQUITY IN DEFINED CONTRIBUTION PLAN DESIGNATED INVESTMENT ALTERNATIVES 3 (Dec. 21, 2021), https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020-supplemental-statement.pdf ("The Department cautions against application of the [Campagna] Letter outside of that context.").

III. FURTHER ISSUES

The foregoing analysis suggests five additional questions a 401(k) trustee might confront when constructing for plan participants an investment menu which includes alternative investments. First, if a particular alternative asset class is prudent for 401(k) purposes (e.g., REITs), must an investment from that class be included in the plan's investment menu? Looking to the relevant DOL regulations and the more general duty of loyalty, the answer is a qualified "no."

To trigger the fiduciary protections of ERISA section 404(c),[171] a participant-directed 401(k) investment menu must offer to the plan's participants a "broad range of investment alternatives."[172] As few as three investments can satisfy this regulatory requirement of breadth, as long as, inter alia, each investment choice is itself internally "diversified" and "has materially different risk and return characteristics" from the other two choices.[173]

If these tests are met, there is no regulatory requirement that the entire universe of prudent asset classes be represented in any menu of investment choices. Thus, for example, an investment menu for 401(k) participants consisting of three different packages of mutual funds, ETFs, and cash equivalents could be diversified and could embody different risk and return characteristics without including real estate. This menu would satisfy the regulation's test of a "broad range" of investment choices even though this menu avoids real estate.

The qualification to this conclusion is that all decisions of an ERISA-regulated fiduciary must independently meet the statutory test of loyalty.[174] Thus, a trustee's decision to eschew real estate (or any other prudent investment class) must be exclusively motivated by the financial interests of the plan's participants in providing for their retirements. A trustee could not construct a 401(k) investment menu without a real estate option if the trustee was motivated, not by the participants' economic interests, but, for example, by animus toward a former spouse in the real estate industry.

With that qualification, a 401(k) investment menu can encompass a "broad range" of choices without offering an alternative from each and every prudent asset class. Including prudent alternative investments is a permitted choice, not a mandatory requirement.[175] If a trustee concludes that properly limited or bundled investments in REITs or in hedge and private equity funds will enhance 401(k) participants' retirement benefits, such investments can legitimately be included among the participants' options. But, such investments are not obligatory.

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[171] ERISA § 404(c), 29 U.S.C. § 1104(c).

[172] 29 C.F.R. § 2550.404c-1(b)(3) (2021).

[173] *Id.* § 2550.404c-1(b)(3)(i)(B)(1)–(2).

[174] *See supra* notes 38–43 and accompanying text.

[175] 29 C.F.R. § 2550.404c-1(b)(3)(i)(C).

Second, could a 401(k) plan make certain investments available to some, but not all, participants in the plan? Could, for example, a plan permit some participants to invest in hedge funds or through a brokerage window, only if these participants first pass a test establishing their financial sophistication? This kind of approach is possible, but it is not easily accomplished given the Internal Revenue Code's nondiscrimination rules governing qualified plans.[176]

Just as fiduciary duty is an overriding theme of the ERISA provisions governing pension plans,[177] nondiscrimination is a fundamental premise of the portions of the Internal Revenue Code regulating pensions.[178] For this purpose, the Code distinguishes between "highly compensated" and "nonhighly compensated" employees[179] and mandates that pensions may not discriminate in their "contributions or benefits . . . in favor" of the former.[180] In 2022, the dividing line between highly compensated employees and nonhighly compensated employees was an annual compensation of $135,000.[181]

Implementing the statute, the Treasury regulations mandate that, under a plan, "[t]he right to direct investments" and "[t]he right to a particular form of investment" cannot discriminate in favor of the sponsoring employer's highly compensated employees.[182] Impermissible discrimination is deemed to exist unless such right extends to a percentage of nonhighly compensated employees, which is at least seventy percent of the percentage of highly compensated employees enjoying such right.[183]

To see the practical challenges caused by this scheme, consider an employer that sponsors a 401(k) plan, covering all of the employer's personnel. Suppose that there are one hundred highly compensated employees and one hundred nonhighly compensated employees, all of whom participate in the 401(k) arrangement. Suppose further that the employer desires to offer a brokerage window only to financially sophisticated employees and administers a test for such sophistication. Let us further assume that fifty highly compensated employees pass the test for financial sophistication (and are thus offered the brokerage window) and that twenty nonhighly compensated employees pass.

On these assumptions, the plan fails the Internal Revenue Code's nondiscrimination standard; the percentage of nonhighly compensated employees qualifying for the brokerage window (twenty percent) is only forty percent of the percentage of highly compensated employees (fifty percent) qualifying as financially knowledgeable. If, however, thirty-five nonhighly compensated employees clear the test for financial sophistication,

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[176] LANGBEIN ET AL., *supra* note 5, at 77–79.

[177] *See supra* Part I.A.

[178] LANGBEIN ET AL., *supra* note 5, at 339–69 (discussing "[t]he Antidiscrimination Norm").

[179] *See* I.R.C. § 414(q) (defining who qualifies as a "highly compensated employee").

[180] *Id.* § 401(a)(4).

[181] I.R.S. Notice 2021-61, 2021-47 I.R.B. 738.

[182] Treas. Reg. § 1.401(a)(4)-4(b)(3)(iii)(B)–(C) (2001).

[183] *Id.* § 1.401(a)(4)-4(b)(1); Treas. Reg. § 1.410(b)-5 (1993).

the arrangement limiting the brokerage window to knowledgeable participants passes muster under the Code's nondiscrimination rules since thirty-five percent is seventy percent of the percentage of the highly compensated employees (fifty percent) clearing the test for financial knowledge and thus achieving access to the brokerage window.

From the employer's perspective, two problems emerge in this context. First, the employer contemplating this (or a similar) proposal—e.g., extending the right to invest in hedge funds only to employees who pass a test of financial sophistication—does not know in advance if enough nonhighly compensated employees will pass the test to qualify under the Code's nondiscrimination standard. Second, even if enough nonhighly compensated employees initially pass the test for financial sophistication, there is no guarantee that the Code's nondiscrimination standard will continue to be met on an ongoing basis in the future. If, for example, a nonhighly compensated but financially sophisticated employee quits and is replaced by a similarly low-paid employee who flunks the test of financial sophistication, then the policy will fail the Internal Revenue Code's nondiscrimination norm since thirty-four percent (the percentage of the nonhighly compensated employees demonstrating financial sophistication) falls just short of the necessary participation rate (thirty-five percent) for the nonhighly compensated employees.

An employer who accepts these vagaries of the Code's nondiscrimination rules could make some options available only to certain employees. However, this employer would need to continually monitor compliance with the Code's nondiscrimination standard and be prepared to change the policy if that standard is failed at some point in the future.

Third, is it possible that the limits on alternative investments I recommend impermissibly intrude upon the participants' control of the investments in their respective accounts?[184] As a statutory matter, section 404(c) protects a fiduciary from liability "for any loss"[185] that results if a participant exercises "control over the assets in his account."[186] The employee's control, the argument would go, is impaired by a ten percent (or similar) limit on investments in a particular class. Indeed, the purpose of such a limit is to constrain the participant's control to prevent her from overconcentrating her retirement investments in hedge funds or another prudent but alternative investment class.

From this vantage, once a 401(k) trustee determines that a particular investment category or a particular investment is, as a factual matter, sufficiently accepted to be prudent, the responsibility for diversification

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[184] *See supra* pp. 529–30 (recommending limits on REIT investments); *see also infra* pp. 541–43 (recommending limits on hedge and private equity investments).

[185] ERISA § 404(c)(1)(A)(ii), 29 U.S.C. § 1104(c)(1)(A)(ii).

[186] ERISA § 404(c)(1)(A), 29 U.S.C. § 1104(c)(1)(A).

shifts to the participant who "control[s]"[187] decisions within the prudent investment menu. One way of interpreting the relevant statutes and regulations is that an ERISA fiduciary is, as a matter of prudence, responsible for constructing the 401(k) menu and that the job of diversification is delegated solely to the participant via her control of her investment allocations within that menu. Under this reading of the statutes and regulations, a trustee who limits a participant's ability to invest more of her account in a particular asset class has, for section 404(c) purposes, unacceptably impaired the participant's control of her account.

However, this argument overlooks the overlapping legal relationship between the duties of prudence and diversification. The law does not dichotomize responsibility for these two duties. Rather, a prudent trustee, as part of her prudence duties, must concern herself with diversification as an aspect of prudence.

While ERISA recognizes diversification as a free-standing fiduciary mandate in its own right, diversification is also an element of the prudence requirement.[188] A prudent menu is one constructed considering diversification. A 401(k) trustee cannot relegate diversification concerns to the participants who control their accounts per section 404(c). It is imprudent to ignore the danger that unsophisticated 401(k) participants will overconcentrate their retirement savings in particular asset categories. A prudent trustee is necessarily sensitive to diversification concerns. Such concerns can be prudently addressed by the kinds of limits I have suggested for at least some alternative investment categories to prevent unsophisticated 401(k) participants from overconcentrating their investments in these categories.

Fourth, my analysis emphasizes the role of defined benefit trustees as gatekeepers for determining prudence for 401(k) purposes. Defined benefit plans and 401(k) plans are "like" each other insofar as both enterprises accumulate retirement savings.[189] Acceptance by professional defined benefit trustees of a particular investment category is a necessary condition for establishing the prudence of that category for 401(k) purposes.

But, defined benefit plans are in a long run decline.[190] Once, a majority of qualified plan participants were covered by defined benefit plans.[191] Today, 401(k) plans predominate.[192] At some point in the future, private sector defined benefit plans will be fossils. At that point, defined benefit

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[187] *Id.*

[188] *See supra* pp. 521–22.

[189] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[190] *See* ZELINSKY, *supra* note 45, at 31–34, 37, 44, 52, 57, 77, 91 (discussing the causes and consequences of the rise of the defined contribution paradigm and the concomitant decline of defined benefit pensions); John H. Langbein, *ERISA's Role in the Demise of Defined Benefit Pension Plans in the United States* (forthcoming).

[191] *See* ZELINSKY, *supra* note 45, at 31–34, 37, 44, 52, 57, 77, 91.

[192] *Id.*

trustees will no longer be prudence gatekeepers for 401(k) plans because defined benefit trustees will no longer exist in substantial numbers.

As a long-term prognosis, the defined contribution paradigm will prevail in the retirement savings universe, at least in the private sector.[193] But, for the short and intermediate runs, defined benefit plans will persist and will hold significant financial assets. Thus, for now and for the foreseeable future, professional trustees managing defined benefit funds serve as gatekeepers for 401(k) prudence purposes. At some point in the future, the continuing decline of defined benefit plans will make it necessary to revisit this question, but that point in time is not imminent.[194]

Finally, it can be argued that the world is speeding up and therefore that investments can meet the objective test of prudence in shorter time spans than they did before. I contrast the sixty-year history of REITs with the much shorter life of Bitcoins as part of my analysis that deems the former objectively prudent, but the latter not.[195] In contrast, the counterargument would go, from the vantage of 2022, Bitcoin's relatively short lifespan reflects a faster-moving world and should thus carry greater weight when assessing the prudence of Bitcoin as a 401(k) investment option.

Here, the tulip saga again raises a cautionary flag. No doubt, those in the midst of the tulip mania thought they too were in a precedent shattering world. Reflecting on their experience, I adhere to my conclusion: An objectively prudent investment is one which is generally accepted and therefore deemed cautious and conservative. More time should elapse and more experience should occur before 401(k) trustees let participants invest their retirement savings in Bitcoin and other cryptocurrencies, if that should ever occur.

CONCLUSION

Whether any category of alternative investments ought to be considered for the menus offered to 401(k) participants is a fact-intensive question. Central to this inquiry are ERISA's legal tests of prudence, diversification, and loyalty.[196] These tests require such fact-driven inquiries as the acceptability of a particular category of investments to investors in general and to professional defined benefit trustees in particular, as well as the trustee's motivation for embracing such investments. Another important concern when making this inquiry is the financial unsophistication of many, perhaps most, 401(k) participants.

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[193] *Id.* at 137–46.

[194] *See* Stewart E. Sterk, *ERISA Defined Benefit Plans Are Not "Trust"worthy*, 62 WM. & MARY L. REV. ONLINE 25, 46, 48–49 (2021) ("Defined benefit plans sponsored by private employers may be a dying breed, but their death will be a slow one . . . .").

[195] *See supra* p. 530–31.

[196] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

REITs pass ERISA's fiduciary tests because REITs now have a considerable track record amassed over six decades and have achieved broad acceptance, both among general investors and in the world of defined benefit pensions. In contrast, art funds, Bitcoin, and other cryptocurrencies are today not prudent to offer to 401(k) participants in light of such investments' novelty and the failure to date of defined benefit trustees to embrace such investments.

ESG funds are like art funds and Bitcoin in that they are not objectively prudent under present circumstances and therefore are not appropriate as a class for 401(k) investment menus. Hedge funds and private equity funds are closer to REITs in light of the widespread acceptance of these funds by defined benefit trustees. Consequently, as a class, such funds, if appropriately limited, qualify as prudent for 401(k) menus even if the trustee would not deploy his personal resources to such funds and even if some (perhaps many) such funds examined individually fail ERISA's fiduciary standards.

These determinations may change over time with new factual circumstances, e.g., a greater acceptance of a particular asset class by investors, including professional defined benefit trustees as gatekeepers for the 401(k) universe, and the emergence of robust markets that provide more experience with particular investment categories. But, the approach is ultimately what counts, as the norms of prudence, loyalty, and diversification, applied to current facts, govern the construction of 401(k) investment menus.