

Locked In: The Competitive Disadvantage of Citizen Shareholders

Anne M. Tucker

INTRODUCTION

Indirect investors—especially mutual fund investors—are often low-dollar, low-incentive, rationally apathetic investors facing enormous information asymmetries and collective action problems. These traits raise difficult corporate governance questions about how indirect investors exercise or should exercise their right to vote in fund elections, obtain fund-related information, and pursue litigation against the fund. These questions are all the more important in light of how many indirect investors own mutual funds through employer-sponsored defined contribution retirement plans. On the one hand, these investors hold individually significant accounts that affect their financial stability. On the other hand, these individual accounts hold little value relative to the fund as a whole. The account owners do not have the power or incentive to try influencing fund governance through voting or litigation. This is true even when it would be in their best interests to try, such as when a mutual fund charges high fees. This is the conundrum of the indirect investor: they have risk associated with owning securities, and ownership rights associated with those securities, but little incentive to exercise those rights.

John Morley and Quinn Curtis's 2010 article, *Taking Exit Rights Seriously*,¹ offers a clear answer to this problem. They assert that the best solution for *all* mutual fund investors in an unsatisfactory high-fee fund is simply to exit. They argue that the mechanisms traditionally suggested for curbing fees—board meetings, shareholder votes, or 36(b) fee litigation²—are red herrings at best

1. John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84 (2010).

2. The Investment Advisers Act includes a private right of action in section 35(b) that redresses breaches of fiduciary duty, specifically involving advisers' compensation, limited to one-year statute of limitations where damages may be recouped for the excessive fees. 15 U.S.C. § 80a-35 (2012).

and expensive placebos at worst. They instead focus on the competition produced by exit, or the threat of exit, arguing that competition is the key to regulating the mutual fund market. Exit is, in their view, the remedy for *all* indirect investors who are paying high mutual fund fees. The corporate literature has accepted the exit option as a clean solution to a tricky problem, largely ignoring the conundrum of indirect ownership and the stress it places on traditional theories of shareholder governance.³

But what if *some* mutual fund investors are stuck and exit is, for them, an empty option? Such is the case for the fastest growing group of new securities investors: those who enter the securities market through self-directed, defined contribution retirement plans—such as a 401(k)—and who invest heavily in mutual funds and other securities. I call this group the citizen shareholders (CSHs).⁴ As an investor class, CSHs are often low-dollar (due to contribution limits); long-term (due to tax penalties on preretirement-age withdrawals); and unsophisticated in account allocation strategies and management. For these investors, exit is not a feasible option. Morley and Curtis’s original theory, elegantly simple, overlooks the unique constraints of CSHs.

This Essay considers the implications of Morley and Curtis’s theory for CSHs, drawing upon more recent scholarship by Ian Ayres and Quinn Curtis that shows the continuing problem of high mutual fund fees.⁵ Part I reviews the arguments advanced by Morley and Curtis, and Part II explains the flaws of their model as applied to CSHs. The Essay challenges the widely accepted view that exit is the best strategy for *all* mutual fund investors by showing that exit is not a viable option for CSHs and that the exit of *other* investors actually creates a competitive disadvantage for CSHs. Many CSHs, relative to other mutual fund investors, are locked into high fee funds and frozen out of the benefits that result from fee competition.

Thus, for CSHs—the fastest growing group of new securities holders—exit and competition are not the hoped-for panacea. This Essay redirects corporate law scholarship’s attention to these unsophisticated, passive, and apathetic, but also socially and financially important, investors. The elusiveness of exit for locked-in CSH investors suggests that the traditional mechanisms for countering high fees, such as litigation or voting, may actually be rational solutions for some investors and should be encouraged over an empty exit remedy.

-
3. See, e.g., Anita K. Krug, *Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm*, 86 S. CAL. L. REV. 263, 312 (2013).
 4. See Anne M. Tucker, *The Outside Investor: Citizen Shareholders & Corporate Alienation*, 11 U. ST. THOMAS L.J. 99, 101 (2013) (recognizing “citizen shareholders[] and their unique position in the governance and securities frameworks that regulate their investments”).
 5. Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and “Dominated Funds” in 401(k) Plans*, 124 YALE L.J. 1476, 1481 (2015).

Moreover, the collective action problems and information asymmetries facing CSHs suggest that the focus of proposed reforms should shift away from investor-reliant remedies (such as exit) towards regulation. The interdependence of mutual funds and retirement savings further supports this conclusion. Regulation is needed, and commonly used, to promote retirement savings. Possible regulatory solutions to the problems of passivity and information asymmetries in the CSH retirement mutual fund market include the Department of Labor (DOL) using fee caps and requiring enhanced fee transparency. Alternatively, courts could interpret ERISA fiduciary obligations to augment liability for plan sponsors, a door the Supreme Court recently opened in *Tibble v. Edison International*, regarding an ongoing duty to monitor defined contribution plan contents.⁶

Ironically, such regulatory solutions are often ignored because of the assumed competitiveness of mutual fund markets for all participants,⁷ a notion this Essay challenges.

I. THE DOMINANCE OF EXIT IN MUTUAL FUNDS

Professors Morley and Curtis concluded exit was the dominant strategy for mutual fund investors facing high fees.⁸ Exit leverages a key structural difference between investing in a mutual fund and investing in the stock of a publicly traded company (also referred to in this Essay as an operating company). Upon exit, a mutual fund investor redeems her investment for its present cash value, also known as the net asset value or NAV. The exiting mutual fund investor therefore extracts assets from the fund and reduces the overall size of the fund.⁹ An exiting investor of an operating company, on the other hand, sells her stock certificate for a price that reflects both the present value of the company and the future expected return.¹⁰ The underlying assets of the operating company remain unchanged, because the certificate only represents her stake in the company, not the underlying assets.

6. 135 S. Ct. 1823 (2015).

7. See, e.g., John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 173-177 (2007) (arguing that “[a]mong one important type of mutual fund, money market funds, evidence of price competition is clear”).

8. Morley and Curtis use the term “dominance” to articulate that exit is a superior strategy over all other options (for example, litigating, voting, or staying in a high-fee fund) in all scenarios and, accordingly, describe it in game theory terms as “dominant.” Morley & Curtis, *supra* note 1, at 102.

9. *Id.* at 89-90; U.S. Sec. & Exch. Comm’n, *Fast Answers: Net Asset Value*, SEC (July 9, 2013), <http://www.sec.gov/answers/nav.htm> [<http://perma.cc/R7WP-9HS3>].

10. Morley & Curtis, *supra* note 1, at 102-03.

These key economic differences between redemption in mutual funds versus sale in operating companies, make exit a cheaper and more attractive option for mutual fund investors than operating company investors.

An example illustrates this point. Consider two operating companies in the pharmaceutical industry that trade at the same share price: \$4/share. Both companies are testing a new drug. Company A announces negative results and Company B announces positive results. Since these trial results signal future FDA approval and potential earnings of the companies, we would expect the market to lower Company A's stock price below \$4 and raise Company B's above \$4. An investor in Company A can leave, but incurs a switching cost to do so. She may sell her shares in Company A at the decreased price of \$3.50/share to buy stock in Company B at an increased price, say \$4.50. Exiting an operating company investment can thus entail switching costs.

Switching costs are not present when one exits a mutual fund. Compare the above example with two S&P 500 index funds (a type of mutual fund). Imagine they have the same one-year return, the same NAV of \$4, and charge the same fees. Because both funds track the same index, both funds will have the same investment portfolio: the companies in the S&P 500. What if Fund A announces higher adviser fees and Fund B announces lower adviser fees for the coming year? Assuming the NAV for both remains the same, Fund A investors would likely earn less than Fund B investors, once fees are factored in. But while the fee change affects future returns, it does not affect the present redemption price. Fund A investors can therefore exit at \$4/share today and reinvest that money in Fund B at \$4/share in order to earn more over the year. Fund A investors incur no switching costs because redemption, as opposed to sale, focuses on present rather than future value (\$4 plus or minus fees). Because exit is relatively cheap, it is an attractive option in mutual funds, at least for those investors who can and know to do so.

Professors Morley and Curtis do not consider either litigation¹¹ or voting for management changes¹² superior strategies to exit in mutual funds, for two

11. Litigation specific arguments include the low success rate and the no-to-low success value of recovery and settlements due to the one-year marginal cost recovery cap. Litigation is subject to familiar party-in-interest criticisms suggesting that attorneys, not investors, are motivated to bring such suits. Additionally, recovery goes to current investors and not necessarily to those investors who overpaid in the past. See Quinn Curtis & John Morley, *An Empirical Study of Mutual Fund Excessive Fee Litigation: Do the Merits Matter?*, 30 J.L. ECON. & ORG. 1, 24-26, 47-50 tbls.5 & 6 (2014).

12. Shareholder voting rights in open-ended mutual funds is a symbolic fiction because (1) it is costly and inefficient, (2) fee arrangements are structured with built-in flexibility to avoid mutual fund shareholder votes, and (3) uncontested director elections do not require individual shareholder votes (approved by brokers who can vote shares of individuals). Inefficiency of voting is evidenced by lack of institutional investor activism or hedge fund arbitrage in mutual funds. See Morley & Curtis, *supra* note 1, at 113, 130 (arguing that while

reasons. First, the ease of exit erodes the pool of sophisticated, resourced and motivated investors who would litigate or stage management proxy contests. Those investors will simply move their money elsewhere.¹³

Second, both litigation and voting require investors to expend resources (namely, time and money) and confront the typical collective action problems in mutual funds, composed as they are of rationally apathetic investors.¹⁴ Collective action problems affect operating company investors, too. But with mutual funds, the future value of litigation or voting efforts is not reflected in the redemption price (which looks at present value only) until those efforts are completed. Even then, any gains are shared among all other investors in the fund. This will lead investors to prefer the immediately gratifying option of exiting and reinvesting. For operating companies, on the other hand, litigation or proxy contests remain attractive options for some investors. If such a strategy is expected to cause higher future returns for investors, it should increase the present price of the stock.¹⁵ For example, the \$4 stock of the pharmaceutical company should increase during the course of a shareholder derivative suit that eliminates management self-dealing or a proxy contest that removes an inefficient board, rewarding the investor who initiated the action even before it is completed.

But as we have seen, factoring future value into the present share price imposes switching costs that are not present in mutual fund investment. Returning to our investors in Funds A and B, assume that rather than exiting, a Fund A investor pursues 36(b) fee litigation or engages in a proxy fight to change Fund A's management. Even if the Fund A investor successfully reduces the fees, and therefore achieves a higher return on her investment, the reduced fees would not affect the NAV of the fund. Assuming the Fund's assets remain constant, the price at which she can redeem her shares stays the same before, during, and after her campaign to reduce fees: \$4.

There is little rational incentive to pursue a win on paper that has no immediate economic benefit. As a result, exit is more attractive as a cheap and effective remedy. The Fund A investor can redeem her shares and invest in Fund B for the same price without paying a premium for the lower fees and resulting higher expected return – and, importantly, without sharing profits

exit by sophisticated investors prevents free-riding on activism or litigation, exit should promote competition driving down fees across the board).

13. *See id.* at 107.

14. *See id.* at 106-07.

15. For example, when Starboard Value waged a successful proxy fight for control of the board of Darden, Darden's stock traded at \$48 on October 13th, the shareholder vote date, and \$52 on October 28th. *See* Leslie Patton, *Starboard Wins All Seats on Darden's Board*, BLOOMBERG BUS., Oct. 10, 2014, <http://www.bloomberg.com/news/2014-10-10/starboard-wins-all-12-seats-on-darden-s-board-after-proxy-fight.html> [<http://perma.cc/P84W-3GVH>].

among the other investors or expending time and money to litigate the fee issue or wage a proxy contest in Fund A.

II. EXIT AND CSHs

Professors Morley and Curtis concede that exit is an uncertain strategy for the least sophisticated investors, including CSHs, who are likely to have fewer monitoring and information resources. As the example above illustrates, exit rights benefit those with sufficient resources, motivation, and information to transfer their investments. Morley and Curtis argue, however, that robust exit rights for sophisticated investors should encourage competition that will correct fee disparity for *all* investors.¹⁶ Thus, while acknowledging that the 401(k) investor complicates their theory, they conclude that these investors are unlikely to pursue other remedies, like litigation or voting, because they are low-dollar and unsophisticated. Thus, exit, with its trickle down benefits, is their *only* viable strategy.¹⁷

This conclusion fails to appreciate the extent to which the constraints of retirement plan investment, and the added intermediaries it entails, distinguish CSHs from other indirect investors. These differences compromise exit as a viable strategy for CSHs. The more likely outcome is that CSHs will do nothing.

A. CSH Investment

Despite the dominance of exit options for *other* investors, the unique mechanics of investing in defined contribution plans lock CSHs into their investment and hinder exit. The structural design of retirement plans obfuscates fees, weakens liability standards, and bifurcates remedies by splitting liability between the mutual fund and the retirement plan. These features can effectively lock CSHs into high-fee mutual funds without viable alternatives.

At a basic level, the compensation and tax components of CSHs' investment discourage exit. CSHs are motivated to invest in a retirement plan like a 401(k) for several reasons: a desire to invest as a savings vehicle; the possibility of enhanced employment compensation, if an employer matches funds; and tax incentives such as tax-free contributions and growth. Plus, for many CSHs, investment (or, "enrollment") is automatic at the time of

16. Morley & Curtis, *supra* note 1, at 130.

17. *Id.* at 113 ("Exit still dominates . . . even for investors in 401(k) plans, however, because the costs of voting and litigating against funds held in 401(k) plans are particularly high and the benefits are particularly low. . . . These small individual investors are the least likely investors to become active.").

employment through an opt-out regime.¹⁸ Like other benefits, such as health care, retirement benefits are a component of overall employee compensation.¹⁹ Not investing in the plan—or withdrawing early, thereby incurring tax penalties and forfeiting tax-free growth²⁰—is like leaving earned money on the table or taking a voluntary salary reduction. Thus, the compensation and tax implications of their investment conspire against CSHs exiting mutual funds.

CSHs are also “stuck” in their mutual fund investments because they do not have the same options as other investors. Specifically, they suffer from: (1) limited menu options and constrained investment choice, (2) plan-level organization and costs, (3) the virtual lack of plan sponsor liability for plan design, and (4) bifurcated remedies under ERISA and securities laws.

The following illustration of two investors—one a retail investor and one a CSH—demonstrates how these structural differences impact exit rights. Consider first the investment chain for a retail investor, Rosy, who is described and best served by the Morley/Curtis model. Rosy selects one of 7,923 available U.S. mutual funds²¹ in which to invest. Rosy’s chosen fund is subject to regulations under the Investment Company Act,²² the Investment Advisers Act,²³ and certain SEC reporting and enforcement guidelines.²⁴ Rosy may be charged investment management and administrative fees by the fund.²⁵ Rosy

-
18. See, e.g., Emp. Benefits Sec. Admin., *Automatic Enrollment 401(k) Plans for Small Businesses*, U.S. DEP’T OF LABOR, <http://www.dol.gov/ebsa/publications/automaticenrollment401kplans.html> [<http://perma.cc/6RRN-KD42>].
 19. See Jonathan Gardner & Steve Nyce, *Attracting and Keeping Employees: The Strategic Value of Employee Benefits*, TOWERS WATSON (May 2014), <http://www.towerswatson.com/DownloadMedia.aspx?media={FD628608-2EBo-45C7-864D-F4617DEC5F54}> [<http://perma.cc/YSB5-CH7Q>].
 20. See Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978) (codified in various sections of 26 U.S.C.); 26 C.F.R. § 6a.103A (1981). Unless an exception applies, plan withdrawals before the age of fifty-nine and a half are subject to a ten percent penalty. See *Topic 424-401(k) Plans*, U.S. INTERNAL REVENUE SERV. (Aug. 31, 2015), <http://www.irs.gov/taxtopics/tc424.html> [<http://perma.cc/88CF-Z73A>].
 21. INV. CO. INST., 2015 INVESTMENT COMPANY FACT BOOK 173 tbl.1 (55th ed. 2015), http://www.icifactbook.org/pdf/2015_factbook_1.pdf [<http://perma.cc/2RKF-84D7>] (reporting year-end total for 2014).
 22. 15 U.S.C. §§ 80a-1 to 80a-64 (2012).
 23. *Id.* at §§ 80b-1 to 80b-21.
 24. Securities Act of 1933, 15 U.S.C. §§ 77a-77b (2012); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78o (2012); see also 17 C.F.R. §§ 270.0-1 to 270.60a-1 (2012) (providing guidelines for Investment Company Act of 1940); 17 C.F.R. §§ 275.0-2 to 275.222-1 (2012) (providing guidelines for Investment Advisers Act of 1940).
 25. Investment related fees include management fees, marketing and distribution fees often reported as 12b-1 fees, sub-transfer agent (sub-TA) fees, and trading or transaction costs. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-325, 401(K) PLANS: INCREASED EDUCATIONAL OUTREACH AND BROADER OVERSIGHT MAY HELP REDUCE PLAN FEES 9-10 (2012) [hereinafter

has limited voting rights in fund governance elections²⁶ and can only bring a private cause of action against fund managers under 36(b) for a breach of fiduciary duty, limiting her recoupment to the excess fees charged—subject to the one-year statute of limitations.²⁷ Rosy’s dominant strategy, when unhappy with the fund, is to exit.

Next consider Cara, a CSH who selects her investment from an average of fourteen options²⁸ in her employer-sponsored, self-directed, defined contribution plan. Mutual funds are the most common investment offered and selected in such plans.²⁹ The defined contribution plan is the first step in Cara’s investment chain diagram, and the portal to access the mutual fund, which is the second step in the diagram. Looking at box two on the diagram below, the fund in which Cara invests is subject to the same regulations as Rosy’s, and Cara also holds the same limited voting rights.³⁰ Like Rosy, Cara may be charged investment management and administrative fees. But unlike Rosy, Cara may also be charged retirement plan record-keeping fees associated with her 401(k) plan filings, record management, and other account fees at the defined-contribution-plan level.³¹ Remember that, for Cara, the defined contribution plan is a portal through which she accesses the mutual fund investment. The extra layer in Cara’s investment chain introduces third parties like employer sponsors, plan fiduciaries and service providers—along with their attendant interests and fees.

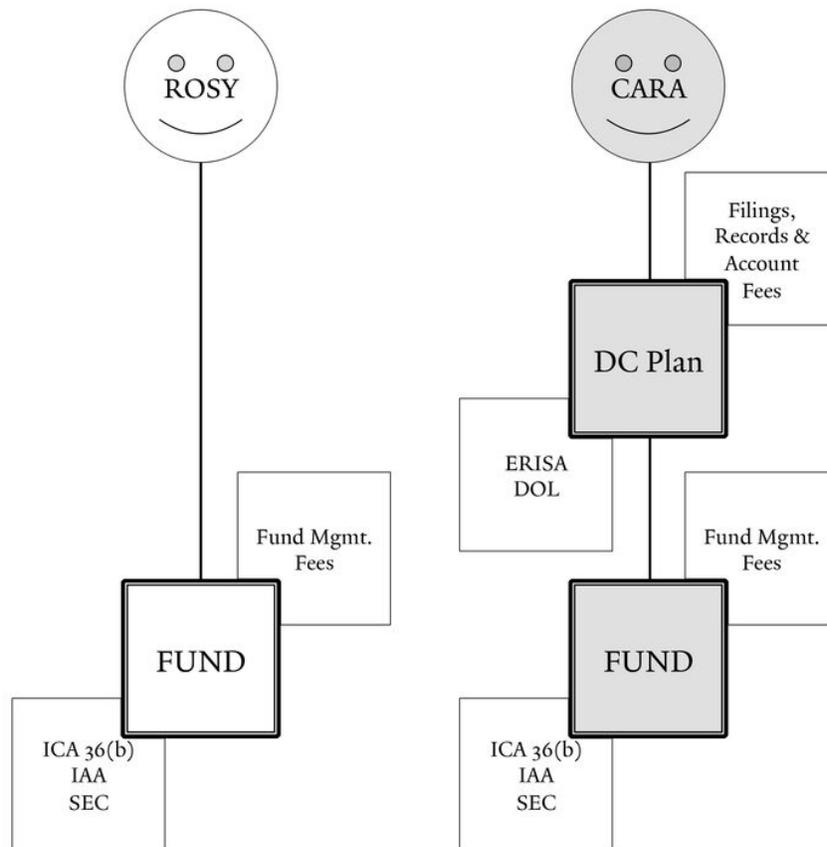
GAO, REDUCE PLAN FEES], <http://www.gao.gov/assets/600/590359.pdf> [<http://perma.cc/8G5X-FG9N>].

26. For a discussion of the limited role of corporate style governance, including voting, within mutual funds, see Anita K. Krug, *Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm*, 86 S. CAL. L. REV. 263, 278-83 (2013) (observing that the mutual fund “board of directors is unable to act as an independent voice on shareholders’ behalf and, importantly, foster[s] conflicts on the adviser’s part, as well as the board’s”).
27. 15 U.S.C. § 80a-35 (2012); see also *Jones v. Harris*, 130 S. Ct. 1418, 1429-30 (2010) (describing the *Gartenberg* standard of liability under 36(b) for excessive fees). The short one-year statute of limitations for excessive fees, as compared to longer statute of limitations in other areas of securities laws, demonstrates the narrowness of the excessive fee litigation remedy.
28. Ning Tang et al., *The Efficiency of Sponsor and Participant Portfolio Choices in 401(k) Plans*, 94 J. PUB. ECON. 1073, 1075 tbl.2 (2010).
29. INV. CO. INST., *Chapter 7: Retirement and Education Savings*, in 2014 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY, http://www.icifactbook.org/fb_ch7.html [<http://perma.cc/XQA4-DAUV>] (describing trends in mutual fund investment through defined contribution retirement accounts).
30. See *supra* note 25.
31. See Ayres & Curtis, *supra* note 5, at 1485-86 (discussing the “costly” administration of retirement plan assets as a result of filings and audited financial statements); see also Keith Clark, *THE DEFINED CONTRIBUTION HANDBOOK: AN INSIDE GUIDE TO SERVICE PROVIDERS & ADVISORS*, 45-51 (describing fees charged to plan participants) (2003).

Cara’s investment chain, because it includes a defined contribution retirement plan, is also subject to the Employee Retirement Income Security Act (ERISA).³² ERISA imposes additional fiduciary duties on any plan fiduciary who exercises discretion over Cara’s account,³³ subject to a three- or six-year statute of limitations under ERISA.³⁴ Cara may thus appear more protected than Rosy, given the overlapping ERISA fiduciary duties owed to her. However, note that Cara exercises choice when she allocates her investments within her defined contribution plan (control that is not present in defined benefit plans like pensions). For that reason, most of her ERISA fiduciary duty claims are barred because of the safe harbor provision that exempts fiduciaries from liability where an investor exercises choice.³⁵

This comparative diagram illustrates the structural differences between the two investment avenues:

-
32. See 29 U.S.C. §§ 1002(34), 1104 (2012).
 33. See *id.* § 1002(21)(A) (defining a fiduciary as anyone who exercises discretionary authority or control regarding the management or administration of a plan or disposition of assets, or renders investment advice for a fee); see also *Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co.*, 768 F.3d 284, 291-92 (3d Cir. 2014) (defining plan fiduciaries within a defined contribution retirement plan in a case alleging excessive fees).
 34. See 29 U.S.C. § 1113; see also *Tibble v. Edison Int’l*, 135 S. Ct. 1823, 1828-29 (2015) (finding that the duty to monitor is included within the six-year statute of limitations and remanding to the Ninth Circuit to determine the scope of the monitoring duty). The differing statutes of limitations for fee-based violations whether arising from ERISA (three to six years) or the Investment Adviser’s Act (one year) illustrate the bifurcation of remedies for excessive fees. Compare 29 U.S.C. § 1113, with 15 U.S.C. § 80a-35(b)(3) (2012).
 35. See 29 U.S.C. §§ 1104(c)(1)-(4); see also *Hecker v. Deere & Co.*, 556 F.3d 575, 587-89 (7th Cir. 2009) (discussing the criteria for exercising control and upholding dismissal on the basis of the “impenetrable” affirmative defense).



As the diagram shows, Cara, like all CSHs, is subject to an additional layer of fees at the 401(k)-plan level—a level at which there are no shareholder voting rights. Additionally, litigation rights under ERISA and 36(b) require CSHs to pursue remedies at both the fund and plan levels, making litigation bifurcated, more complicated, and costly. These same structural differences resulting from the defined contribution plan framework and the resulting third parties, interests, and fees also impact CSHs' exit remedies from mutual funds.

B. Exit and Intra-Plan Switching

The dominance of exit as *the* strategy for mutual fund investors depends on exit being cheap (i.e., little to no switching costs) and facilitated by robust market competition. These two assumptions break down for CSHs, who face unique structural obstacles to exiting their mutual funds because of the mechanics of their retirement-plan investment: the limited investment menu in

the retirement plan; the third-party intermediaries in the investment chain, with their own interests such as revenue sharing; and the competition silo effect of share classes. These factors isolate CSHs from the robust competition necessary to make exit a viable option. Additionally, locked-in investors fund the liquidity of the exiting investors, making exit not a cheap solution, but rather a costly proposition for CSHs overall.

As a result, CSHs are disadvantaged relative to other mutual fund investors. Rather than an easy solution, exit is an elusive remedy, making the “do nothing” alternative an obviously inferior, but also more likely, outcome. This Part shows how the structural design of defined contribution retirement plans frames CSHs’ investment context keeping them locked into high-fee mutual funds.

1. Fee Competition in the 401(k) Plan

The strength of Professor Morley and Curtis’s exit remedy relies upon robust competition in the mutual fund market, which requires both the threat of exit and other viable investment alternatives. There has been a legal debate over the competitiveness of mutual fund fees, as evident in the 2010 Supreme Court decision *Jones v. Harris Associates L.P.*³⁶ and the underlying disagreement in the Seventh Circuit between Judges Easterbrook³⁷ and Posner.³⁸ The drop in mutual fund fees charged to retail investors generally,³⁹ and the drop in 401(k) plans specifically, suggest that there is competition over these fees.⁴⁰

-
36. 559 U.S. 335 (2010). Justice Alito, writing the majority opinion, sidestepped the competition question directly, articulating a standard of review based, in part, on the process used to establish the fee: “The *Gartenberg* standard . . . accurately reflects the compromise that is embodied in § 36(b).” *Id.* at 353.
37. Chief Judge Easterbrook, writing the opinion in the Seventh Circuit case, touted the competitive features of the mutual fund market, such as the large number of funds, the low barriers to entry, and the fact that “investors can and do ‘fire’ advisers cheaply and easily by moving their money elsewhere.” *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 634 (7th Cir. 2008), *vacated and remanded*, 559 U.S. 335, 353 (2010).
38. 537 F.3d 728, 730-31 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc) (arguing that that competition cannot be “counted on to solve the problem” of high advisory fees, noting “rampant” abuses in the mutual fund arena, and questioning the robust role of competition to curtail such practices).
39. These fees fell from a weighted average of ninety-nine basis points in 2000 down to seventy-four basis points in 2013. See INV. CO. INST., *Chapter Five: Mutual Fund Expenses and Fees*, in 2015 INVESTMENT COMPANY FACT BOOK (2015), http://www.icifactbook.org/fb_ch5.html [<http://perma.cc/RT75-H2J8>].
40. These fees fell from a weighted average of seventy-seven basis points in 2000 to fifty-eight basis points in 2013. See Sean Collins et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 2013, 20 INV. CO. INST. RES. PERSP. 1, 12 (2014), <http://www.ici.org/pdf/per20-03.pdf> [<http://perma.cc/348K-FM3Z>].

But high fees continue in mutual funds, particularly among CSHs in defined contribution plans. Persistent and concentrated high-fee funds further undermine the exit rights of CSHs and demonstrate the problem of relying on competition to protect *all* mutual fund investors. How do high fees persist?

For one thing, the lower mutual fees more likely reflect general asset-class trends—such as the growing popularity of index funds⁴¹ over actively managed mutual funds⁴²—than they reflect per se fee competitiveness. For example, if Cara reallocates 50% of her investments in an index fund with 42 basis points (0.42%) fees charged away from an actively managed fund that charged 89 basis points (0.89%), her fee average decreases. But the decreased average fee does not confirm that the index fund fee is competitive, if for example, Rosy can purchase a similar index fund at 22 basis points (0.22%) fees. Including lower-fee options in defined contribution plans reduces fee averages, but does not necessarily verify fee competitiveness.

Additionally, funds do not universally adopt the Investment Company Institute (ICI)'s reported low average 401(k) fees. Critics point to small-plan fee averages at 189 basis points (1.89%) or more, which the ICI does not report because it may disproportionately samples large-asset and thousand-plus-participant plans with historically lower fees and because of exclusions in the reported all-in fee.⁴³

Averages also do not fully address the question of outliers—funds that charge higher fees than comparable alternatives. Ian Ayres and Quinn Curtis recently analyzed data from 3,500 401(k) plans in 2010 and found evidence of persistent and debilitating high fees in 401(k) plans. They observed a 43 basis

41. Index funds are a type of mutual fund that tracks the movement of a certain index like the S&P 500. *See, e.g.*, William Baldwin, *Mutual Fund Tax Guide*, FORBES (March 17, 2014, 12:15 PM), <http://www.forbes.com/sites/baldwin/2014/03/17/mutual-fund-tax-guide> [<http://perma.cc/96N6-WD9T>]. Compare passive index funds with actively managed funds, where managers “pick individual securities that they believe will outperform a relevant benchmark (*i.e.*, an index) over time.” Jim Cahn, *Active Versus Passive Investing: Are These Really the Only Two Options?*, FORBES (Apr. 22, 2015 12:06 PM), <http://www.forbes.com/sites/jamescahn/2015/04/22/active-versus-passive-investing-are-these-really-the-only-two-options> [<http://perma.cc/3QE5-FCHG>].

42. *See* INV. CO. INST., *Chapter Two: Recent Mutual Fund Trend*, in 2015 INVESTMENT COMPANY FACT BOOK (2015), http://www.icifactbook.org/fb_ch2.html [<http://perma.cc/M3JE-2RGZ>].

43. *Reconciling the 401k Fee Estimates of the ICI and Its Critics*, BRIGHTSCOPE, <http://blog.brightscope.com/2009/05/13/reconciling-the-401k-fee-estimates-of-the-ici-and-its-critics> [<http://perma.cc/VAP7-93HK>]. The all-in fee reflects the expense ratio, which may not capture additional fees such as options, brokerage commissions, and other transaction-related expenses like spread. *Id.*; *see also* Concept Release, Sec. & Exch. Comm’n, RIN 3235-A194, Request for Comments on Measures to Improve Disclosure of Mutual Fund Transactions Costs (Dec. 19, 2003), <http://www.sec.gov/rules/concept/33-8349.htm> [<http://perma.cc/84G9-4QHJ>] (providing a detailed summary of fee reporting problems for mutual funds).

point (0.43%) average premium paid by CSHs in an average plan, even when choosing the lowest-cost option available. More than 19% of plans pay excess expenses of more than 75 basis points (0.75%), and the top fee decile is 146 basis points (1.46%).⁴⁴ Although there is a relationship between the fees and plan size,⁴⁵ plan size alone cannot explain this spread of fees.⁴⁶

This prevalence of high-fee funds in defined contribution plans undermines fee competition and weakens exit rights for CSHs. The retail investors, the Rosys, who select high-fee funds may do so because they lack the time, money, expertise, or advice needed to identify a lower-fee fund.⁴⁷ This is likely the case with CSHs. But there is yet another reason the Caras of the world may find themselves in a high- or higher-fee fund: because a third party (their employers) select the investment options for their retirement plans. A plan may be littered with high-fee options acting as investment traps that lure CSHs to invest in them despite the fee consequences.⁴⁸ Alternatively, a high-fee fund might be the cheapest option available among the limited options included in the employer's plan. Indeed, Professors Ayres and Curtis show that for many CSHs, investing in the cheapest available options in their plans means they may still pay higher than average fees.⁴⁹ Their findings suggest that exit is not available for CSHs already in the lowest cost fund of their plans—they have nowhere to exit to. Nor is exit a strong remedy for CSHs, if switching within the plan still results in higher-than-average fees.

Thus, including higher-fee investment options in a defined contribution plan menu harms all participating investors, even if there are other lower-fee alternatives, because they restrict exit options and undermine competition. For example, imagine Investor A selects the higher-fee investment fund (HFF), following a flawed (or naïve) diversification strategy. Investor B is in the same plan, but avoids the HFF and allocates all assets to the lower-fee fund (LFF_a). Investor B is still harmed by the HFF in the plan, because it reduces spots for

44. Ayres & Curtis, *supra* note 5, at 1501.

45. INV. CO. INST., *supra* note 29; *see also* GAO, REDUCE PLAN FEES, *supra* note 25 (finding that small plan sponsors (fewer than 50 participants) paid an average of 1.33 percent of assets for recordkeeping and administrative fees, whereas larger plan sponsors (more than 500 participants) paid 0.15 percent for the same services); INV. CO. INST., *supra* note 39, at fig.5.11 (finding lower fees for larger plans reflecting economies of scale).

46. Ayres & Curtis, *supra* note 5, at 1503 (finding a spread of nearly 70 basis points in excess fees among plans of similar size leading to the conclusion that a “very pricey plan can be nearly twice as expensive as a plan of similar size with very low costs”).

47. *See* Jill E. Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PENN. L. REV. 605, 621-22 (2014).

48. Ayres & Curtis, *supra* note 5, at 1502-06 (describing the problem of dominated funds and stating that “empirical findings suggest that investors will tend to allocate their portfolios to low-quality choices”).

49. *Id.* at 1502-03 (documenting the wide variation in plan costs).

additional LFFs (LFF_b and LFF_c), to which B could exit and which would exert competitive pressure on LFF_a. Without suitable alternatives, so long as LFF_a charges at least one basis point less than the HFF, Investor B will choose LFF_a and not exit, even if LFF_a charges excessive fees compared to the market. Littering a plan with high-cost funds not only increases information costs for those who seek to switch,⁵⁰ but also erodes exit efficiency and ultimately undermines the exit strategy altogether.

2. *Third-Party Incentives*

Recall Cara's investment diagram. The additional defined-contribution level introduces third parties—employer sponsors, advisers, and administrators—into the CSH investment chain. They introduce problems of preferences, incentives and conflicts of interest in plan menu design, which complicate fee competition and weaken exit strategies for CSHs.

Although seventy-one percent of 401(k) plan participants believe they do not pay fees associated with their 401(k) plan,⁵¹ in fact investing through a retirement plan produces costs that the employer-sponsor, the employee-participant, or both must bear. Employers sponsoring defined contribution plans may delegate plan administration to a third-party service provider, such as an investment company, bank, or insurance company.⁵² These service providers, for a fee, manage investment options, provide financial advice to the plan, track individual account allocations (record keeping services), hold account assets in trust or as a custodian (custodial services), or provide participants with telephone- or web-based customer services.⁵³ Compensation for service providers varies between plans,⁵⁴ but they often recoup their fees through a practice known as revenue sharing,⁵⁵ where a service provider

50. The contained universe of defined contribution plan investment necessarily limits information costs, but for many unsophisticated investors it does not matter if they are searching for an alternative fund in one of one hundred or one thousand plans if the alternative is either not available or the investor does not know what alternative (i.e., competitive and lower fees) it should be seeking.

51. *401(k) Participants' Awareness and Understanding of Fees*, AARP 1 (Feb. 2011), <http://assets.aarp.org/rgcenter/econ/401k-fees-awareness-11.pdf> [<http://perma.cc/VLB4-97U3>].

52. See GAO, *REDUCE PLAN FEES*, *supra* note 25, at 7.

53. *Id.*

54. Fees may be a fixed percentage of total plan assets or may be based on the number of plan participants, or an itemized flat fee or some combination of the three. *Id.* at 8-9.

55. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-119, 401(K) PLANS: IMPROVED REGULATION COULD BETTER PROTECT PARTICIPANTS FROM CONFLICTS OF INTEREST 16 (2011), <http://www.gao.gov/assets/320/315363.pdf> [<http://perma.cc/W7EB-NGGM>]. Revenue sharing has generally been upheld by courts as permissible under ERISA. See, e.g., *Hecker v. Deere & Co.*, 556 F.3d 575, 590 (7th Cir. 2009); cf. *Tussey v. ABB*,

collects fees from participants and uses them to offset other plan fees for the employer sponsor. A 2013 survey found that eighty-seven percent of plans engaged in some form of revenue sharing,⁵⁶ which accounted for up to eleven basis points (0.11%) of fees charged.⁵⁷

Revenue sharing is not, on its face, a pernicious practice. But the incentives that underlie it are.⁵⁸ Employer sponsors, who historically have not fully understood the scope or impact of revenue sharing practices,⁵⁹ are responsible for selecting the final menu of funds offered to employee participants. Consider Fund A, which charges a higher fee and uses part of it to offset record-keeping fees, and Fund B, which charges a lower fee and offers no offset. The incentive for the employer sponsor—and the service provider that recommends funds to investors—is to choose Fund A, which generates revenue for administrative services. It passes the higher costs to participants, but lowers costs for the employer sponsor and ensures that service providers get paid. Of all the costs in the plan, the fees charged to participants have the greatest chance of impacting their investment returns. Yet the conflicting incentives at play in menu design subrogate CSH interests to third-party interests. This creates a tension between the long-term financial interests of the participants and the short-term financial interests of the third parties.

To show how these skewed incentives disturb competition, imagine you want to purchase a car. The car dealer receives a higher or lower commission depending on the model of car you purchase. To distort competition, imagine that you can only go to one car lot and that your employer requires a specific dealership—surgeons go to Lexus, professors go to Volvo, etc. Like the third parties in a defined contribution plan, the dealer has incentives to stock the lot with the highest commission-earning models while meeting whatever minimum standards apply. Your car purchase options, like CSHs' investment options, are determined in part by what best serves the third parties' interests. And like an imperfect investment option, choosing an imperfect, but best available, car—one with low fuel efficiency and too many extra amenities—extracts costs.

Choice matters whether you are buying a car or allocating retirement investments. Yet choice is limited for CSHs investing in defined contribution

Inc., 746 F.3d 327, 332-33 (8th Cir. 2014) (finding liability at trial for failure of the plan fiduciary to monitor revenue sharing fees).

56. See Chuck Epstein, *Is Revenue Sharing on its Way Out?*, TREASURY & RISK (July 9, 2014), <http://www.treasuryandrisk.com/2014/07/09/is-401k-revenue-sharing-on-its-way-out> [<http://perma.cc/LT5X-5APD>].

57. *Id.*

58. Ayres & Curtis, *supra* note 5, at 1509.

59. GAO, REDUCE PLAN FEES, *supra* note 25, at 24-28 (reporting that an estimated forty-eight percent of plan sponsors were unaware of whether their service providers had revenue sharing arrangements).

plans. In their 2015 empirical study of fees, Professors Ayres and Curtis found that fifty-two percent of the 401(k) plans surveyed offered one or more dominated funds—defining dominated funds as investment options that do not add to plan diversity and which charge higher-than-average fees. The presence of dominated funds reduced plan returns and increased plan costs as a whole.⁶⁰ Their findings challenge the rationale behind ERISA liability standards, which assume that investor choice is independent of third-party menu design.⁶¹ While open-brokerage windows are available, giving participants access to a range of investments outside of the plan, they do little to expand investor options given the small amounts invested in them: approximately one percent of plan assets.⁶²

It is insufficient for an employer to offer only a single or a few low-cost investment options. For exit rights to prove robust, CSHs require an alternative option to invest in a similar type of investment (mutual fund, bonds, etc.), in a similar asset class (index funds, alternative mutual funds, etc.), that charges similar or lower fees. The number of available alternatives shapes decisions, at the car lot and in retirement investing alike.

3. *The Price of Others' Exit*

Mutual funds must maintain liquidity—assets held in cash and not invested in the market—to pay the NAV of redeemed shares. Since mutual funds do not know how many investors will redeem or invest on a given day, they must maintain more liquidity than they might actually need. These uninvested assets impose a lost opportunity cost because they cannot earn a return in the market. This lost opportunity cost imposed by the threat of exit is small when evaluated for a single trade, but significant in the aggregate. Additionally, if a fund underestimates the number of investors that redeem on a given day, it may have to sell additional assets and may do so at a loss because the asset sale

60. Ayres & Curtis, *supra* note 5, at 1504-06.

61. *See id.* at 1502 (noting the empirical finding that an investor's propensity to invest in low-cost funds is related to the number of low-cost funds featured in the menu and suggesting a relationship between menu design and choice).

62. Collins et al., *supra* note 40, at 3, 17 n.10; *see also* Hecker v. Deere & Co., 556 F.3d 575, 586 (7th Cir. 2009) (“[T]here was a wide range of expense ratios among the twenty Fidelity mutual funds and the 2,500 other funds available through BrokerageLink.”).

price was lower than the asset price reflected in the NAV.⁶³ Trading and liquidity cost estimates range from \$10-17 billion annually.⁶⁴

These costs are borne exclusively by the investors who stay in the fund. Between Rosy, who has robust exit rights, and Cara, whose exit rights are weak, Rosy is more likely to exit and extract lost opportunity costs from Cara and other locked-in CSHs. In this sense, CSHs are subsidizing the exit strategy for other investors.

4. *The Silo Effect of Mutual Fund Share Classes*

Share classes are a widespread practice in the mutual fund industry. In 2014, there were over 24,000 total share classes⁶⁵ for the 7,923 U.S. mutual funds.⁶⁶ For each mutual fund there are usually multiple classes of retail shares available at different fee structures,⁶⁷ and many funds include institutional share classes.⁶⁸ Investors who own securities in the same mutual fund, but who own in different share classes, hold fundamentally different investments once fees are factored in. Importantly, these investors are isolated into their separate investment silos so that the competitive pressures of one share class do not affect others within the same mutual fund, but who invest in a separate share class. Share class silos isolate the competitive influence of sophisticated retail investors and even of large-asset or large-participant defined contribution plans within each share class. For CSHs, isolated competition reduces the trickle-down competitive pressure of exit by *other* investors, while still imposing liquidity costs on locked-in investments held by CSHs.

Consider a generic mutual fund that offers retail Class A shares (minimum investments with front-end load fees but no or low ongoing sales fees), retail Class B shares (deferred contingent sales load with ongoing sales fees where shares may be converted to Class A after a period of time), and retail Class C

63. Open-End Fund Liquidity Risk management Programs; Swing Pricing; Re-opening of Comment Period of Investment Company Reporting Modernization Release, 80 Fed. Reg. 62,273, 62,326-28 (proposed Oct. 15, 2015) (to be codified at 17 C.F.R. pts. 210, 270 & 274), <http://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf> [<http://perma.cc/BC8V-PTL7>].

64. Miles Livingston & David Rakowski, *Mutual Fund Liquidity and Conflicts of Interest*, 23 J. APPLIED FIN. 95, 95-103 (2013).

65. INV. CO. INST., *supra* note 21, at 173 tbl.1 (reporting year-end total for 2014).

66. *See id.*

67. *See Mutual Fund Classes*, SEC. & EXCHANGE COMM'N, <http://www.sec.gov/answers/mfclass.htm> [<http://perma.cc/P78V-GQP9>].

68. *See Mutual Funds and Institutional Accounts: A Comparison*, INV. CO. INST. 1 n.2 (2006), http://www.ici.org/pdf/ppr_o6_mf_inst_comparison.pdf [<http://perma.cc/LL9K-TST9>].

shares (no or low load sales with lower, permanent ongoing sales fees).⁶⁹ When retirement plan menus include retail share classes, they usually offer Class B or Class C shares, not Class A shares. But if Class A shares represent the lowest overall fees, then qualifying investors should self-select into Class A. Those investors would likely be the most well-resourced and the most sophisticated, and therefore more likely to exit Class A for an alternative fund with lower fees than a Class B or Class C investor. The frequent exit of Class A investors exerts competitive pressure on Class A shares. But the less sophisticated investors in Class B and Class C, which likely includes CSHs, do not benefit from the competition exerted by the Class A investors' exit or threat of exit. Share class silos reduce the collateral benefits to CSHs of other investors' exit rights.

Institutional shares of mutual funds are yet another type of share class, which might enhance CSHs' investment options. These shares are usually offered to high-volume investors such as defined contribution plans and individuals.⁷⁰ But not all defined contribution plans offer institutional class shares to participants – many only offer retail class shares. In 2009, the Seventh Circuit found in *Hecker v. Deere & Co.* that plan fiduciaries did not violate their ERISA duties by including “retail” class shares in a retirement plan,⁷¹ based on the assumption that the mutual fund market was competitive. But in *Tibble v. Edison International*,⁷² the Supreme Court found that the unexamined retention of retail class shares in a plan, when lower-fee institutional class shares were available, might violate a plan fiduciary's obligation of ongoing monitoring and management of plan assets. Thus, the type of share classes included in defined

69. See, e.g., *FINRA Investor Alert: Understanding Mutual Fund Classes*, FIN. INDUS. REGULATORY AUTH. (2011), <http://www.finra.org/web/groups/investors/@inv/@protect/@ia/documents/investors/p125866.pdf> [<http://perma.cc/UH8F-DHHY>].

70. Corrie Driebusch, *The New ABCs of Mutual Funds*, WALL STREET. J. (June 2, 2013), <http://www.wsj.com/articles/SB10001424127887323550604578413271356056276> [<http://perma.cc/C6LW-XJKY>]. Institutional share classes are available, often at the lowest fees to reflect the economies of scale reached by the limited number of accounts with high assets that require reduced advisory contract services. Such shares are not subject to the ICA or certain tax reporting obligations.

71. *Hecker v. Deere & Co.*, 556 F.3d 575, 590 (7th Cir. 2009); cf. *Braden v. Wal-Mart Stores Inc.*, 588 F.3d 585 (8th Cir. 2009) (finding that the inclusion of retail class shares where revenue sharing was not disclosed could give rise to a breach of fiduciary duty claim and rejecting the market competition assumption in *Hecker*).

72. 135 S. Ct. 1823, 1827-1829 (2015) (remanding the case to the Ninth Circuit to determine the scope of the monitoring duty). The lower court's unchallenged findings were that during the relevant time period (i) the funds in question offered institutional options in which the Edison 401(k) Savings Plan almost certainly could have participated (ii) those options were in the range of twenty-four to forty basis points cheaper than the retail class options the Plan did include, and—crucially—(iii) between the class profiles, there were no salient differences in the investment quality or management. *Tibble v. Edison Int'l*, 729 F.3d 1110, 1137 (9th Cir. 2013), *vacated and remanded*, 135 S. Ct. 1823 (2015).

contribution plans may come under increasing scrutiny, and more institutional share classes—along with their lower fees—may become available to CSHs.

Regardless of the share classes offered in their defined contribution plans, however, CSHs remain competitively disadvantaged relative to other retail investors investing in *any* class of shares. Whereas retail investors have exit options and the opportunity to exit, CSHs are locked in by constrained choice and withdrawal penalties, among other things.⁷³ For example, retail investors in Class C shares may thereafter choose to exit once they become better informed about fees and have sufficient investment money to opt into more competitive share classes. CSHs in Class C could not do the same. That some investors can easily leave uncompetitive fee share classes and others (CSHs) cannot means that over time, these high-fee, low-competition fund share classes would theoretically become comprised disproportionately of long-term, locked-in CSHs, who in turn subsidize the liquidity costs of others' exit.

CONCLUSION

High fees can consume up to thirty percent of an investor's return on a thirty-year investment.⁷⁴ CSHs invest with a competitive disadvantage, subsidize the exit of other investors, and can become locked into high-fee funds. This has a negative impact on individual retirement savings and on our national retirement policy.

This Essay has shown problems with Professor Morley and Curtis's claim that exit is the superior strategy for *all* investors. Actually, exit is only superior for some—namely, those with uninhibited exit rights, which CSHs do not have. And contrary to Professor Morley and Curtis's suggestion, the impact of exit on the least sophisticated investors is not uncertain. Exit disadvantages CSHs, who are locked in, shoulder other people's switching costs, and are siloed off from the benefits of competition. Preserving the illusion that all investors have robust exit rights does harm to CSHs, because it leads to neglecting or abandoning alternative strategies that CSHs might effectively use when stuck in an unsatisfactory high-fee fund.

If exit is not a dominant strategy for all investors and competition alone cannot rigorously regulate mutual fund fees charged in defined contribution retirement accounts, then litigation and voting should not be summarily dismissed as irrelevant and expensive distractions. While imperfect, they may

73. See *supra* notes 18-20 and accompanying text.

74. Susanna Kim, *401(k) Fees May Cut 30% from Retirement Balance*, ABC NEWS (May 30, 2012), <http://www.demos.org/news/401k-fees-may-cut-30-retirement-balance> [<http://perma.cc/4DRX-FWRT>] (reporting that average 401(k) fees can consume thirty percent of retirement savings).

be the only viable remedy for CSHs.⁷⁵ And once collective action problems, information asymmetries, and the limited utility of shareholder voting in mutual funds are taken into account, litigation offers the most practical path for CSHs. Congress and the DOL through interpretive guidelines and regulations could increase fiduciary duty liability standards by limiting the safe harbor that exculpates plan sponsors when participants exercise choice in allocating their retirement account investments. Additionally, Congress could amend section 36(b) of the ICA to capture a wider array of high fee practices or simply extend the statute of limitations beyond the restrictive one-year timeline.

But immediate regulatory change is unlikely in the current political environment, leaving the job of enhancing litigation solutions to courts. A judicial solution recently gained traction in *Tibble*, where the Court paid attention to the potential value of including institutional share classes and interpreted plan managers' fiduciary duties to include robust ongoing monitoring obligations for defined contribution plans. On remand, the Ninth Circuit may further define plan fiduciaries' monitoring obligations and provide additional remedies for plan participants seeking to redress excessive fees through means other than exit. Importantly, the U.S. Supreme Court reviewed only the timing question of menu-based fiduciary duty claims in *Tibble*⁷⁶ and did not review the Ninth Circuit's holding that liability could arise from plan menu design.⁷⁷ Circuit courts had disagreed over whether such claims are exculpated by ERISA's safe harbor.⁷⁸ After *Tibble*, courts should treat menu design decisions, which occur *before* participants can exercise choice that triggers ERISA's safe harbor, as a proper subject of liability claims.

Courts should also evaluate the competitiveness of defined contribution plan design in light of the effect that menu design has on participant allocation choices. Since Professors Ayres and Curtis have demonstrated that there are persistent and concentrated high fee funds in defined contribution plans, which negatively impact competition and exit rights for CSHs, courts should consider overall plan design when determining how much real choice a participant has exercised. Professors Ayres and Curtis rightly call for an augmented legal standard regarding plan menu design addressing dominated

75. For a further discussion of the imperfect solution that litigation presents, see Ayres & Curtis, *supra* note 5, at 1514, which notes that the highest fee plans are small plans with fewer participants decreasing the potential recovery pool and the likelihood of representation by plaintiffs' attorneys who recoup fees as a percentage of the recovery.

76. *Tibble v. Edison Int'l*, 135 S. Ct. 43 (2014) (granting petition for certiorari).

77. *Tibble v. Edison Int'l*, 729 F.3d 1110, 1125 (9th Cir. 2013).

78. *Id.* at 1122-25; *see also* Langbecker v. Elec. Data Sys. Corp., 476 F.3d 299, 310-12 (5th Cir. 2007) (refusing to apply *Chevron* deference to the Department of Labor's interpretation that menu design is excluded from the statutory safe harbor).

funds by asking whether the inclusion of a fund is prudent in light of other investment options available.⁷⁹ Similarly, courts should not consider competition defects in high-fee funds “cured” by the presence of open brokerage windows, given the low utilization rates of such options.

Aside from traditional remedies like litigation, regulation could also equalize exit opportunities and costs for all investors, CSHs included. Because exit imposes costs on the least sophisticated investors—who depend on their retirement savings for financial solvency and have the fewest resources to subsidize these costs—equalization is much-needed. One option involves shifting exit costs onto exiting investors, as with a switching fee.⁸⁰ Currently, funds may voluntarily levy an exit cost, although the practice is not widespread. Main streaming exit costs through industry best practices, consumer education, or amendments to the ICA to spread the practice would equalize the costs of exit. The SEC recently proposed rule 22c-1(a)(3) to amend the ICA allowing for partial swing pricing so that the daily NAV can more accurately reflect the value of portfolio assets taking into account transaction costs, like buying and selling assets to expand or shrink the size of the fund based on the number of investors entering or exiting a fund.⁸¹ The proposed rules allow, but would not mandate, funds to effectively shift these transaction costs onto the investors generating them and away from the long-time investors, like CSHs, who remain in the fund. If enacted and adopted by funds, partial swing pricing could reduce the costs of being locked into mutual funds.

Another powerful, but politically fraught, equalization option would involve capping mutual fund fees in defined contribution plans through ERISA and DOL regulatory changes. Setting a bright-line maximum fee for different types of mutual fund products offered in defined contribution plans—such as index funds, ETF funds, target date funds, and actively managed funds—would establish strong participant protection and foster ease of administration. But it would also create a host of ancillary problems of fee-setting and monitoring, not to mention garnering the necessary political buy-in of the mutual fund industry.

A more moderate approach would set plan composition benchmarks that require including certain types of low-fee funds in all defined contribution plans—for example, an index fund with a capped fee. Such funds could help

79. Ayres & Curtis, *supra* note 5, at 1509-10.

80. See, e.g., *The Sacks Equalization Model for Open-Ended Investments*, SACKS EQUALIZATION MODEL (2015), <http://www.sacksmodel.com> [<http://perma.cc/RL6F-TEWD>].

81. Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-opening of Comment Period of Investment Company Reporting Modernization Release, 80 Fed. Reg. 62,273, 62,326 (proposed Oct. 15, 2015) (to be codified at 17 C.F.R. pts. 210, 270 & 274), <http://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf> [<http://perma.cc/BC8V-PTL7>].

meet the diversification standards established under ERISA.⁸² Currently, diversification standards for defined contribution plans are evaluated per asset, rather than comprehensively as a plan.⁸³ Professors Ayres and Curtis proposed mandating the inclusion of a default retirement fund under the Qualified Default Investment Alternative rule and making that default fund subject to fee thresholds, which offers a promising blueprint.⁸⁴ Making the diversification focus more comprehensive, and combining it with fee-based benchmarks, would preserve plan independence while ensuring some level of participant protection.

Given the increasing number and importance of CSHs in the mutual fund investment market, relying exclusively on the exit strategy to monitor fees is untenable. Exit is an empty exit strategy for CSHs under the current framework when they are competitively disadvantaged relative to other investors and may be stuck in high-fee funds that erode their retirement security.⁸⁵ This Essay calls attention to the problem of CSHs and reminds corporate law scholars that our work is not done with regard to these tricky, but vitally important investors. Whether the solution lies in litigation, voting mechanisms, or regulatory changes is a matter to be debated beyond this Essay. What is required today is that corporate law scholars reinvest in the issue of retirement investors and acknowledge the limitations of exit for CSHs under the current framework.

Anne M. Tucker is an Associate Professor of Law at Georgia State University College of Law. In recognition of valuable contributions by way of comments and encouragement, she would like to thank Jennifer Taub, Donald Langevoort, Andrew Verstein, Anthony Casey, Anita Krug, and her colleagues at Georgia State College of Law including, but not limited to, Robert Weber, Paul Lombardo, and Nirej Sekhon.

Preferred Citation: Anne M. Tucker, *Locked In: The Competitive Disadvantage of Citizen Shareholders*, 125 YALE L.J. F. 163 (2015), <http://www.yalelawjournal.org/forum/locked-in-the-competitive-disadvantage-of-citizen-shareholders>.

82. Employee Retirement Income Security Act of 1974 § 404(a), 29 U.S.C. § 1104(a) (2012).

83. *In re State St. Bank & Trust Fixed Income Funds Litig.*, 842 F. Supp. 2d 614, 650–51 (S.D.N.Y. 2012) (quoting *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 438–40 (3d Cir. 1996)).

84. Ayres & Curtis, *supra* note 5, at 1515–17.

85. See *id.* at 1520–21 (proposing that participants in high cost plans be allowed to roll over their assets into alternative, low-cost plans).