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THE SEPARATION OF INTELLIGENCE AND CONTROL: RETIREMENT SAVINGS AND THE LIMITS OF SOFT PATERNALISM

JACOB HALE RUSSELL*

ABSTRACT

“Soft paternalism” is in vogue among academics and lawmakers, but too much is being asked of it. This Article studies soft paternalist techniques—including nudging and disclosure—which have been used in the employer-sponsored retirement system. Defined-contribution retirement plans represent an ideal test case for libertarian paternalism: there has been extensive experimentation, and nudge advocates have often held up such plans as successes. In particular, this Article focuses on investment allocation decisions in retirement portfolios, and suggests that we should be skeptical of the ability of soft paternalism to improve those decisions. When a domain is rife with conflicts of interest—as in the allocation context—soft-touch strategies fare poorly. Since our tax-incentivized retirement system has paternalistic roots, we should more readily consider direct regulation of investment options available to retirement accounts.

The migration of American retirement savings from centralized, risk-pooling structures (Social Security and pensions) toward individual retirement plans (401(k) plans and other tax-favored, individually managed accounts) had collateral consequences. In particular, the responsibility for making complicated financial choices was redistributed to the individual saver—who typically lacks the knowledge and sophistication to make such choices. The result has been that many savers make costly mistakes in investing their portfolios. In response, academics and policymakers, most formally through the Pension Protection Act of 2006, have turned to a variety of typical “soft” remedies, including nudges designed to improve

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investment decisions by allowing employers to automatically direct employee savings into certain default mutual funds.

This Article argues that nudges have failed and will continue to fail in improving the allocation of retirement portfolios, because of problems that are common in many nudge programs. First, nudges rarely consider the ability of third parties to counter-nudge or to weaken nudge outcomes. Conflicts of interest are pervasive in the mutual fund and retirement industry, and those who accept the nudges are being pushed into a category of funds of dubious merit, and which appear to be worsening as institutions seek to exploit the default. Second, nudges are often loosely connected, or not connected at all, to the cognitive problems they seek to remedy. In the retirement allocation context, the nudge acts as a weak mandate for a substantive preference, rather than as a corrective for investors' cognitive biases. Finally, nudging often asserts autonomy—taking an agent's preferences seriously—as its central goal. But the claim that the retirement allocation nudges respect savers' preferences is problematic as a descriptive matter, and illogical as a normative matter, in a domain that is already a government-sponsored, tax-advantaged, paternalistic means to encourage retirement savings.

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INTRODUCTION

Nudging is in vogue. As interest in behavioral economics has grown among legal scholars, and as nudges have demonstrated potential in certain domains to reduce the role cognitive errors play in our decision making, academics have gone nudge-happy.¹ The very phrase “libertarian paternalism” or “soft paternalism” suggests the satisfying promise of a third way in politics.

However, critics are beginning to raise questions.² This Article focuses on the U.S. retirement system as a domain for exploring when nudges and other “soft paternalist” solutions are likely to succeed.³ Many policymakers and academics have been optimistic about a series of “soft paternalist” techniques—nudges and disclosure—that could improve the outcomes of defined-contribution plans, like 401(k) plans. Retirement provides an ideal test case for nudges: it is a domain full of well-documented cognitive biases, soft paternalists have claimed it as a domain of significant success for their project, and its legal architecture employs a series of nudges. In particular, the Pension Protection Act of 2006 (PPA) included a number of “soft” reforms that attempted to influence decisions about whether to enroll, how much to contribute, and how to invest savings.⁴

¹ The vast literature on nudging and soft paternalism is reviewed *infra* in Part I.B. For the best-known example for a popular audience, see generally CASS SUNSTEIN & RICHARD THALER, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (Yale Univ. Press, 2008). See also Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003) for an earlier, more academic version of their argument. While Thaler and Sunstein’s many articles on nudging have gotten the most popular and scholarly attention, other scholars have proposed similar broad strategies under phrases like “asymmetric paternalism”—nudges that help the boundedly rational while doing little harm to the “rational”—and “cautious paternalism.” See, e.g., Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O’Donoghue & Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism,”* 151 U. PA. L. REV. 1211 (2003).

² See *infra* notes 45–52 and accompanying text for a discussion of soft paternalism’s critics. For an extended discussion of the role of behavioral economics in law more generally, and specifically noting that one of the main outcomes of the increased discussion has been policy proposals employing nudges, see MARK KELMAN, *THE HEURISTICS DEBATE* 152–78 and *passim* (Oxford Univ. Press 2011). In general, this Article is greatly influenced by that book and supports its skepticism that behavioral economics can solve regulatory problems in a neutral way, since we inevitably will wind up back at the question of whether subjects’ choices are substantively desirable.

³ Academics have often treated nudges as a separate category from other soft, non-regulatory approaches, but they pose related issues, and appear to satisfy the same underlying purpose (finding a “third way” that can satisfy pro- and anti-regulatory factions).

⁴ Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 821–33, 901–906, 120 Stat. 780, 782–83 (2006).

This Article argues that we should be more skeptical than nudge advocates suggest—both in the retirement context and more generally. Optimism about “soft” solutions is misplaced when it comes to decisions about how to invest retirement funds—that is, *allocation problems*—when nudging may provide little help and may even leave employees worse off. The defined-contribution system requires employees to make a series of distinct decisions: whether to enroll in a plan, how much to contribute to the plan, how to invest the funds in the plan, and (eventually) how to receive distributions of funds in retirement. Each decision poses a separate set of challenges, but too often they are conflated in discussions of nudges. The allocation step poses unique challenges because of the complexity of investment choices and because of the conflicts of interest involved. It is also potentially a very ripe domain for nudgers because of the well-documented cognitive biases involved when individuals make investment decisions. A series of nudges added by the PPA allows employers to automatically allocate employees’ contributions into particular default funds—most commonly target-date funds (TDFs), mutual funds designed for employees who intend to retire in a given cohort (for example, the Vanguard Target Retirement 2040 Fund) whose investment strategy changes (in general by reducing risk) over the course of an employee’s career.⁵ An employee can redirect his contributions elsewhere, but the nudge is sticky for a large percentage of employees.

This Article suggests that the libertarian paternalist project runs up against three problems in the allocation nudge context, which are also more broadly applicable to other nudge efforts. First, the allocation nudge is inattentive to the supply side, the retirement industry, which has responded to, and should be expected to respond to, the nudge in ways that undermine it. The investment decision is not made in a vacuum, and mistakes are made not just because of individual choices but also because of industry incentives to push more lucrative, higher-fee funds that diminish savers’ returns. Because the allocation decision involves misaligned incentives and conflicts of interest⁶ between savers and the retirement industry, this nudge fares worse than nudges designed to increase contributions by automatically opting savers into plans—a nudge that benefits the supply and demand side equally.

Second, although nudging developed as a response to insights in behavioral economics about biases that may consistently distort our decision making, the nudge seems entirely disconnected from its cognitive project.

⁵ See *infra* Part I for a more detailed description of both the PPA’s methodology and TDFs.

⁶ Lauren Willis highlights the destructive role of conflicts of interest in nudging attempts for checking accounts and overdraft protection; see *infra* note 52.

In other words, the default-fund nudge does nothing to help savers understand or overcome the types of cognitive mistakes that contribute to poor investment decisions—for instance, the gamblers’ fallacy or anchoring on inappropriate information. Instead, the nudge simply pushes a substantive outcome (somewhat weakly, because employees can opt out) that has no fundamental connection to the cognitive problem it seeks to solve, and may not even be the optimal substantive outcome if we were to simply mandate a single investment choice. Worse still, soft policies create feedback effects in which nudge-protected individuals feel safer and become more trusting, while regulated entities feel attacked and feel the need to respond more aggressively.

Third, preserving autonomy is a central value for the libertarian paternalist project, and this does not make much sense—either normatively or descriptively—in the retirement savings context. Retirement is a tax-subsidized, paternalistic program designed to push people to save more than they otherwise would. In other words, it is a domain in which autonomy is already constrained. It is not clear that most people want poor investment choices to be respected on autonomy grounds; most individual savers are unlikely to have meaningful conceptions of their own preferences with respect to their retirement investment choices. Nor is it clear that we should let them, both because the system serves a societal function, and because it is not clear that “autonomy” requires us to prioritize the ends of a young saver who wants to invest riskily over the ends of his later self, who might prefer to have built a safe nest egg.

The nudge program comes against the backdrop of a radically reformed retirement system that has separated intelligence about investment decisions from control over those investment decisions.⁷ Over the past four decades, the American retirement system has dramatically shifted risk onto the individual worker. A series of legal changes has diminished the role of centralized structures that pool risk across society, like employer-sponsored pensions and Social Security, and increased the use of 401(k) and other individual retirement plans that increase personal choice but also

⁷ The title is, of course, a reference to the famous concept of the separation of ownership (shareholders) and control (management) developed in ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Macmillan rev. ed. 1932). Needless to say, my reference to retirement savers’ “intelligence” is meant only in a very narrow (and kind) sense—that is, to refer to the results of a variety of problems prevalent among savers, caused by everything from financial illiteracy to cognitive biases, or from market manipulation and conflicts of interest to savers simply *choosing* to focus on problems in life more interesting to them than the optimal design of a retirement portfolio.

personal risk.⁸ This shift closely parallels the more general political drift since the 1970s that has moved risk away from “broad structures of insurance ... onto the fragile balance sheets of American families.”⁹

In doing so, individual employees have become the central decision makers and monitors for a host of complicated investment questions—including how much money to save, how to invest it, and how to draw down the money at retirement. Americans are asked to make the same kinds of decisions that an investment management committee composed of experienced, well-compensated professionals at a large endowment fund or pension plan would make. Individual savers now make those decisions with the assistance of financial services players who have deeply misaligned incentives. The result has been a panoply of pathologies—decisions contrary to any imaginably rational approach to growing one’s retirement savings.

These mistakes are well documented in the finance literature: many workers do not assign any investment options to their savings, leaving their retirement portfolio in cash or low-interest money market funds where it will decline relative to inflation; when leaving a job, many workers cash out their retirement plans and pay a tax penalty, instead of rolling over the funds into a continuing retirement account; investors choose high-fee funds despite overwhelming evidence that high-fee funds offer lower post-fee returns; employees fail to diversify and overinvest in employer stock; the average investor never rebalances their asset allocation, but overtrades individual stocks, which produces worse returns than simpler buying and holding strategies; savers use naïve portfolio allocation techniques, namely by allocating an equal weight—the “1/N heuristic”—to each fund offered by their plan, regardless of which funds are offered; and employees fail to take advantage of employer matching programs for contributions, which is tantamount to leaving cash on the floor.¹⁰

⁸ For a thorough analysis of this change in legal academia, see Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 470–71 (2004). For a political economy perspective on the related effects and the social underpinnings of this change, see JACOB S. HACKER, *THE GREAT RISK SHIFT: THE NEW ECONOMIC INSECURITY AND THE DECLINE OF THE AMERICAN DREAM* (Oxford Univ. Press 2008); for another account by Hacker, but focused more precisely on that risk shift in the retirement context, see Jacob S. Hacker, *Restoring Retirement Security: The Market Crisis, the “Great Risk Shift,” and the Challenge for Our Nation*, 19 ELDER L.J. 1, 1–48 (2011).

The legal changes are discussed *infra* in Part I.A, but refer primarily to the tax code and to the Employee Retirement Income Security Act (ERISA).

⁹ HACKER, *supra* note 8, at 6 (showing the risk shift in employment, health care, welfare, and other fields).

¹⁰ See, e.g., James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *For Better or Worse: Default Effects and 401(k) Savings Behavior*, in PERSPECTIVES ON THE ECONOMICS OF AGING 119 (David A. Wise ed., 2004) (leaving in cash); Leonard E. Burman, Norma B. Coe & William G. Gale, *What Happens When You Show Them the*

Meanwhile, a retirement savings crisis looms. As the baby boom generation retires, the average working household has next to nothing—\$3,000—in retirement savings, and only 8 percent of working households meet even conservative goals for retirement savings.¹¹ The source of the problem is complicated and larger than mistakes in defined-contribution retirement plans. But as those plans have grown in importance, those losses have grown in significance.¹²

Neither soft paternalists nor their libertarian critics have done much to explain why “autonomy” might be a relevant guiding principle for 401(k) allocation, or how their proposed strategies serve autonomy in any meaningful way. We lack consensus about why we have the employer-sponsored, defined-contribution system in the first place. Employer-sponsored retirement plans emerged as a recruitment and retention tool for firms. But the move from defined-benefit to defined-contribution plans was tied up in the opposite logic: an advantage of defined-contribution plans is that they are more portable and make it easier for workers to switch firms.¹³ The origins of the switch are murky and at least partly accidental: the 401(k)

Money?: Lump Sum Distributions, Retirement Income Security, and Public Policy, THE URBAN INST. (Nov. 1999), available at http://www.urban.org/UploadedPDF/LSD_Final.pdf (not rolling over); Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 57–82 (1997) (insufficient attention to fees); James J. Choi, David Laibson & Brigitte C. Madrian, *Are Empowerment and Education Enough? Underdiversification in 401(k) Plans*, in 2:2005 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 200, available at http://www.brookings.edu/~media/Projects/BPEA/Fall%202005/2005b_bpea_choi.pdf (overinvestment in employer stock); William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 26 (1988) (lack of rebalancing); Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773, 774 (2000) (overtrade individual stocks); Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Saving Plans*, 91 AM. ECON. REV. 79, 80 (2001) (1/N heuristic); Olivia S. Mitchell et al., *Turning Workers into Savers? Incentives, Liquidity, and Choice in 401(k) Plan Design* 1–2 (Nat’l Bureau of Econ. Research, Working Paper No. 11725, 2005), available at <http://www.nber.org/papers/w11725> (employer match); *infra* note 36 (literature identifying others).

¹¹ Nari Rhee, *The Retirement Savings Crisis: Is It Worse Than We Think?*, NAT’L INST. ON RET. SEC. 11, 15 (June 2013), available at http://www.nirsonline.org/storage/nirs/documents/Retirement%20Savings%20Crisis/retirementsavingscrisis_final.pdf (reporting that the average retirement account balance is only \$12,000 for near-retirement households.).

¹² One study found that the average household would spend roughly \$155,000 in 401(k) fees during the course of a lifetime, eating up a third of their potential returns. Robert Hiltonsmith, *The Retirement Savings Drain: The Hidden & Excessive Costs of 401(k)s*, DEMOS (May 29, 2012), <http://www.demos.org/publication/retirement-savings-drain-hidden-excessive-costs-401ks>; *see infra* notes 38, 125, 129.

¹³ Beyond literal portability (for which there are technical solutions), many defined-benefit plans’ calculations are related to firm tenure and seniority, providing a powerful incentive to stay with the same firm.

section was hardly debated when it was added to the Internal Revenue Code in 1978, and its widespread use was not anticipated.¹⁴

A number of motives are plausible, and each would dictate a distinct set of values to guide policy. Most importantly, it is not at all obvious that “autonomy” should be the central value guiding the system. Whatever its original purpose, employer-sponsored retirement benefits have grown in size to the point that we may imagine them serving primarily a societal function, adding to the safety net that helps prevent retirees from becoming financial wards of the state. In other words, a paternalist theory *already* underpins employer-sponsored plans: we provide tax incentives because we worry that Americans will save too little in a regime with no intervention.¹⁵ This theory does not answer every question facing a policymaker—for instance, whether we should worry more about maximizing total aggregate savings or about the distribution of those savings.¹⁶ But the current system seems weakly suited to serving either function. It is possible that the most compelling feature is serving as a lucrative subsidy to the retirement and financial services industry.

This Article first introduces the broad contours of the contemporary U.S. retirement system in Part I, with particular attention to the soft paternalism strategies added in 2006 by the PPA. That law employs nudges (a concept explored in Part I.B.1) both to increase employee enrollment and contribution rates (Part I.B.2) and to improve employees’ investment decisions and portfolio allocation (Part I.C). In Part II, this Article delves into the problems on the supply side, and the ways in which the mutual fund and retirement savings industry has responded to, and should be expected to respond to, nudges in ways that undermine their purpose. Part III focuses on the demand side of the equation, noting the gap between the problem addressed by the PPA’s nudges—cognitive biases—and its solutions. Part III.B criticizes the normative backdrop that underlies the nudging program, and questions whether autonomy is a meaningful value in the retirement savings context. Part III.C expresses skepticism of two other remedies that are short of direct product regulation—increased disclosure regimes, and a limited set of fiduciary duties supplied by ERISA.

¹⁴ Richard Rubin & Margaret Collins, *You Can Thank or Blame Richard Stanger for Writing 401(k)*, BLOOMBERG (Feb. 3, 2014), <http://www.bloomberg.com/news/print/2014-02-03/you-can-thank-or-blame-richard-stanger-for-writing-401-k-.html>.

¹⁵ See Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1280–83 (1991) (“Congress clearly supposes that people are unable to make wise savings decisions for themselves.”). It is not clear that the system of tax breaks works very well at increasing savings; see *infra* note 24.

¹⁶ See *infra* note 68 and accompanying text. In critiquing the role of nudging in contribution decisions, some scholars, I think quite problematically, assume that we should measure total aggregate savings, and thus discount possible relative gains from contribution nudging to the least-well-off employee.

I. THE SOFT PATERNALIST EXPERIMENT IN RETIREMENT SAVINGS

A. The U.S. Retirement System

Along with Social Security and private savings, employer-sponsored retirement accounts form the so-called “three-legged stool” of the American retirement savings system.¹⁷ Employer-sponsored retirement plans come in two primary flavors: defined-benefit plans (sometimes called “pensions,” although the term is also sometimes used to refer to all employer-sponsored retirement plans) and defined-contribution plans (of which 401(k) plans are the best-known example). As these names suggest, a defined-benefit plan pays out pre-specified, guaranteed benefits to an employee upon retirement, often defined as a percentage of an employee’s pre-retirement salary. In a defined-contribution plan, employees contribute a fixed amount of their salary, sometimes alongside an employer contribution,¹⁸ to an account that the employee intends to access after retirement. The employee typically has a variety of choices about how to invest those funds, and thus the exact level of benefits that will be available after retirement are typically uncertain *ex ante* to the employee.

The private retirement system¹⁹ is incentivized and regulated by a combination of tax laws and other statutes, most notably the Employee Retirement Income Security Act of 1974, as amended (ERISA).²⁰ ERISA regulates private retirement plans by imposing fiduciary duties, disclosure requirements, and substantive regulation (such as vesting rules and minimum funding requirements) on plan sponsors and a variety of administrators who support the plans. The tax code provides for a variety of advantages for money saved for retirement. The best known are “401(k)” plans,²¹ employer-sponsored defined-contribution plans that allow employees to

¹⁷ This metaphor, often mistakenly attributed to Franklin D. Roosevelt, has been in use since at least 1949, although its origins are murky. *See* SOC. SEC. ADMIN., RESEARCH NOTE #1: ORIGINS OF THE THREE-LEGGED STOOL METAPHOR FOR SOCIAL SECURITY (May 1996), available at <http://www.ssa.gov/history/stool.html>.

¹⁸ From an economic standpoint, the divide between employee and employer contribution is seen as largely irrelevant, because an employer contribution is simply part of the total compensation an employer allocates to an individual employee (the psychological effects of the labeling choice are less clear).

¹⁹ This Article focuses on employer-sponsored pension plans and largely sets aside issues related to public pensions, such as those run by state employers, which raise a variety of important but distinct and substantially unrelated policy issues.

²⁰ The most relevant provisions of ERISA are codified at 29 U.S.C.A. §§ 1001–1461 (West 2014).

²¹ Similar defined-contribution plans include 403(b) plans offered by non-profit institutions and 401(a) plans offered by certain state-affiliated employers. For the purposes of this Article, the distinctions matter little.

contribute money on a pre-tax basis that will be taxed at withdrawal, normally after retirement.

The 401(k) subsidy costs \$79.7 billion in tax spending—foregone tax revenues—for fiscal year 2014, third only to the employer-provided health insurance and home mortgage deductions.²² Tax breaks to defined-benefit plans cost another \$53.1 billion, and are ranked sixth on the list of tax expenditures.²³ Although these tax expenditures are widely assumed to encourage Americans to save more than they otherwise would, they may not be as productive as was hoped: one recent influential study suggested that the savings effect of a retirement tax break might be on the order of an extra penny saved for every dollar of tax code spending.²⁴

Over the past half century, a well-documented shift has taken place in the U.S. retirement savings system away from defined-benefit plans and toward defined-contribution plans.²⁵ In 1989, 42 percent of full-time workers in the private sector participated in defined-benefit plans; as of 2012, that number had fallen to 20 percent.²⁶ Over the same time period, the share of participants in defined-contribution plans increased from 40 percent to 51 percent.²⁷ Law has aided and abetted this shift in two ways. First, law defines the options available for retirement savings through tax code incentives, government programs, and direct regulation, and the legal regime can change the attractiveness of various options. Second, the legal regime, most notably in the form of ERISA, defines and allocates fiduciary duties and other forms of legal responsibility between parties.

²² Memorandum from the Members of the Fed. Accounting Standards Advisory Bd. to Wendy M. Payne, Executive Director of the Fed. Accounting Standards Advisory Bd. 4 (Oct. 18, 2013), *available at* http://www.fasab.gov/pdf/files/2013oct_tab_a_taxex.pdf.

²³ *Id.*

²⁴ Raj Chetty et al., *Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts: Evidence from Denmark* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 18565, 2012), *available at* <http://www.nber.org/papers/w18565>. Although the study was based in Denmark, where better data was available, it has been widely cited in U.S. economics and policymaking circles. *See, e.g.*, Annie Lowrey, *Study Questions Tax Breaks' Effect on Retirement Savings*, N.Y. TIMES ECONOMIX BLOG (Nov. 25, 2012, 10:43 PM), <http://economix.blogs.nytimes.com/2012/11/25/study-questions-tax-breaks-effect-on-retirement-savings/>.

For an argument that draws in part on the study to argue that nudging may outperform fines and taxation in social benefits, see Brian Galle, *Tax, Command ... or Nudge*, 92 TEX. L. REV. 837 (2014).

²⁵ *See supra* note 1.

²⁶ Barbara A. Butrica & Nadia S. Karamcheva, *Automatic Enrollment, Employee Compensation, and Retirement Security* 2 (Ctr. for Ret. Research at Bos. Coll., Working Paper No. CRR WP 2012-25, 2012), *available at* http://crr.bc.edu/wp-content/uploads/2012/11/wp_2012-25-508.pdf.

²⁷ *Id.*

The economic effects of the switch to defined-contribution plans are unclear. Given the relationship between risk and return, for some individuals, of course, defined-contribution plans will provide superior performance and result in more savings at retirement. That same principle also alters the distribution of outcomes—that is, a number of investors will produce poor returns, whether from outright mistakes or from “bad luck” despite “good decisions”—and creates considerable uncertainty about how much money an individual saver will have at retirement. Weighing those two requires a normative theory of the purpose of our retirement savings system, a point I return to in Part II.C.

The tradeoff between defined-benefit and defined-contribution plans is often seen as categorically favoring defined-contribution plans for overall returns, but some analysts have found otherwise. In a number of studies, and for non-trivial time periods, defined-benefit plans offered overall superior returns to 401(k) plans despite their lower risk profile to the individual employee.²⁸ As always, what you find depends on what you look at: for instance, tracking overall or average account balances, as a leading mutual fund industry trade group likes to do, is flawed because it does not show to what extent gains or losses are attributable to contributions and withdrawals versus investment performance.²⁹

Under ERISA, an employer has the fiduciary duties of prudence and of loyalty to plan participants in administering the plan.³⁰ Beyond the employer, other agents are covered by fiduciary duties if they exercise any discretionary authority or discretionary control in the management or administration of the plan or its assets.³¹ But ERISA makes significant exceptions to fiduciaries’ responsibility with respect to investors’ self-directed assets: under Section 404(c), when an individual participant “exercises control over the assets in his account ... no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such

²⁸ See, e.g., Linda Stern, *Why Pension Funds Are Eating Your 401(k)'s Lunch*, REUTERS (May 22, 2013), <http://www.reuters.com/assets/print?aid=USL2N0E31I220130522> (describing an ongoing study in which defined-benefit plans have outperformed defined-contribution plans repeatedly over the past several decades, especially during bear markets). But see Jack VanDerhei, *Reality Checks: A Comparative Analysis of Future Benefits from Private-Sector, Voluntary-Enrollment 401(k) Plans vs. Stylized, Final-Average-Pay Defined Benefit and Cash Balance Plans*, EMP. BENEFIT RESEARCH INST., Issue Brief No. 387, June 2013 at 1, available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_06-13.No387.K-DBs.pdf (noting that for stylized portfolios, 401(k)s outperformed defined-benefit plans over a twenty-seven-year period).

²⁹ Floyd Norris, *Misleading Numbers on 401(k)'s*, N.Y. TIMES ECONOMIX BLOG (Oct. 17, 2013, 4:34 PM), <http://economix.blogs.nytimes.com/2013/10/17/misleading-numbers-on-401ks/>.

³⁰ 29 U.S.C. § 1104 (2012).

³¹ § 1002(3)(21)(A); see also JOHN H. LANGBEIN, DAVID A. PRATT & SUSAN J. STABLE, PENSION AND EMPLOYEE BENEFIT LAW 543–47 (5th ed., Foundation Press 2010).

participant's or beneficiary's exercise of control."³² In other words, investors are responsible for their own mistakes. The duties of prudence and care still govern the fiduciaries' decisions about what investment choices to offer, but plaintiffs have rarely won (except in a string of recent settlements, discussed in Part III.C) under theories of poor menu design. In addition, ERISA exempts holdings in the employer's own stock from the statute's diversification requirements.³³

What is clear is that many individuals make poor decisions in investing their defined-contribution assets, mistakes cited in the Introduction, which have been exhaustively covered elsewhere.³⁴ This is hardly surprising given the voluminous evidence both on low financial literacy³⁵ and on behavioral and cognitive biases.³⁶ Employees face a dizzying array of choices, with the average 401(k) plan containing twenty investment options,³⁷ which employees may not even be interested in thinking about. It is also not surprising given the bad menus offered to many employees. In one recent study by Ian Ayres and Quinn Curtis, 10.2 percent of the optimal risk premium was consumed by plan expenses, fund fees, and menu design limitations; another 13.1 percent was eaten up by bad investor choices within those menus.³⁸ In another study, participant investment choices were shown to involve mistakes that could reduce retirement wealth by 20 percent over a twenty-year career.³⁹ In short, these mistakes are expensive and an inevitable result of the current defined-contribution system.

³² § 1104(c).

³³ *Id.* § 1104(a)(2).

³⁴ These are briefly cataloged in the Introduction, *supra* note 11. For a short literature review citing most of the relevant pieces, see NING TANG, OLIVIA S. MITCHELL, GARY MOTTOLA & STEVE UTKUS, UNIV. OF MICH. RET. RESEARCH CTR., THE EFFICIENCY OF PENSION MENUS AND INDIVIDUAL PORTFOLIO CHOICE IN 401(K) PENSIONS 2 (2009), available at <http://www.mrrc.isr.umich.edu/publications/briefs/pdf/rb203.pdf>. For a narrative overview, see Melissa A. Z. Knoll, *The Role of Behavioral Economics and Behavioral Decision Making in Americans' Retirement Savings Decisions*, 70 SOC. SEC. BULLETIN 1, 1 (2010), available at <http://www.ssa.gov/policy/docs/ssb/v70n4/v70n4p1.html>.

³⁵ See *infra* note 101. For an informed critique of why we should not rely on financial literacy education as a remedy, see Lauren E. Willis, *Against Financial Literacy Education*, 94 IOWA L. REV. 197, 198 (2008); Lauren E. Willis, *The Financial Education Fallacy*, 101 AMER. ECON. REV. 429, 429–34 (2011).

³⁶ See *infra* Part II.B. For a literature review, see LIBRARY OF CONG. FED. RESEARCH DIV., BEHAVIORAL PATTERNS AND PITFALLS OF U.S. INVESTORS (Aug. 2010), available at http://www.loc.gov/frd/frd/pdf-files/SEC_Investor-Behavior.pdf; see also TANG ET AL., *supra* note 34, and Knoll, *supra* note 34.

³⁷ DELOITTE, ANNUAL 401(K) SURVEY RETIREMENT READINESS 15 (2010), available at https://www.iscebs.org/Resources/Surveys/Documents/401%28k%29Survey_10.pdf.

³⁸ Quinn Curtis & Ian Ayres, *Measuring Fiduciary and Investor Losses in 401(k) Plans*, 7TH ANNUAL CONFERENCE ON EMPIRICAL LEGAL STUDIES 3 (2012), available at <http://ssrn.com/abstract=2107796>.

³⁹ TANG ET AL., *supra* note 34, at 15.

B. Enrollment and Nudging

1. The Rise and Allure of Nudging

Over the past few decades, the legal academy has become increasingly intrigued by behavioral research, largely originating within psychology and economics departments, on cognitive biases that distort individuals' choices. This research is causing us to deviate significantly from the behavior predicted by traditional rational-choice models of behavior.⁴⁰ In response to this recognition, nudging has come into vogue. The term, sometimes called “soft paternalism” or “libertarian paternalism,” refers to policy strategies that recognize the degree to which framing, defaults, and “choice architecture” affect decision making because of cognitive biases like anchoring, availability, or the herd mentality.⁴¹ By recognizing and refining those elements, policymakers can have their cake and eat it too: they can present choices to individuals in a way that “nudges” more of them into making a “better”⁴² decision, while still in theory respecting individual autonomy to make a different choice. The legal academy has followed the sets of nudges suggested by the best-known authors on nudging, Cass Sunstein and Richard Thaler—which range from requiring drivers to affirmatively make a decision whether to become organ donors during license renewal, a so-called “active choosing” strategy,⁴³ to requiring extra drivers' education to obtain a license to drive a motorcycle without a helmet⁴⁴—with numerous other suggestions.

Nudging is not without its critics. The predominant “anti-nudge” school comes from the libertarian right. It is focused on critiquing the concept of libertarian paternalism as an intellectually inconsistent “oxymoron”—essentially thinly veiled paternalism that is inconsistent with libertarian principles.⁴⁵ Nudgers have countered that the critique does not make sense

⁴⁰ The most accessible treatment by a leading developer of this field is DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* (Farrar, Straus & Giroux eds., 2011). A key early article that introduced these issues to the legal academy was Christine Jolls, Cass Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1471 (1998). For a book-length analysis of some of the limitations of this work that assesses its effects on the legal academy, as well as debates within cognitive psychology over which of several theories better explains the experimental results, see KELMAN, *supra* note 2.

⁴¹ See SUNSTEIN & THALER, *supra* note 1, at 252–53.

⁴² On whether nudges should be used to improve overall social welfare or to help each individual optimize his or her own personal choice, see Russell Korobkin, *Libertarian Welfarism*, 97 *CALIF. L. REV.* 1651, 1651–86 (2009).

⁴³ See SUNSTEIN & THALER, *supra* note 1, at 175–82.

⁴⁴ *Id.* at 232 (crediting *N.Y. Times* columnist John Tierney for the suggestion).

⁴⁵ See, most notably, Gregory Mitchell, *Libertarian Paternalism is an Oxymoron*, 99 *NW. U. L. REV.* 1245, 1246–48 (2005) (critiquing libertarian paternalism for failing to

given what we know about how these cognitive biases distort decisions.⁴⁶ In essence, it is hard to understand how libertarianism as a philosophical commitment would require letting people err unintentionally and unreflectively as to the *means* to their chosen end—to err even when the mistake committed is beyond the actor’s control and the actor, if given the information necessary to correct the error, would prefer to correct the error.

Other scholars have described specific limitations of nudges, either in particular applications or by identifying general scope conditions where nudges work best. Charles Sabel and William Simon define two approaches to administrative law, “minimalism”—which emphasizes market-based techniques, including nudging—and “experimentalism”—under which central institutions delegate authority to, and actively monitor, local regulators. They argue that although minimalism has dominated recent legal scholarship, experimentalism may be more effective, in part because it is more responsive and adaptive.⁴⁷ Using a formal model, other scholars argued that sticky defaults were most welfare-improving in situations where individuals were sufficiently homogenous. By contrast, in situations where needs are heterogeneous or individual information is otherwise generally valuable, default options may be damaging because they decrease incentives for individuals to acquire information about their choices.⁴⁸

In an empirical study, Dan Ho showed that whatever their theoretical benefits, nudges may suffer from flaws in implementation. In one common nudge—the use of prominent restaurant grades to encourage compliance with health codes—“jurisdictions fudge more than nudge,” with significant grade inflation and inconsistency between grading periods. In addition, public health inspectors spent valuable time on disputes over grades, rather than on more substantive efforts to improve restaurant safety.⁴⁹

Most recently, Ryan Bubb and Richard Pildes argued that nudgers in the legal academy too often conflate their social science agenda with their

justify its preference for welfare over liberty, for potentially redistributing from “rational” to “irrational” actors, and for being indistinguishable from typical attempts by central planners to intrude on personal autonomy). *See also* Douglas G. Whitman & Mario J. Rizzo, *Paternalist Slopes*, 2 N.Y.U. J.L. & LIBERTY 411, 413 (2007) (arguing that soft paternalism may lead us down the slippery slope to disastrous hard paternalism, so we should be wary of claims by “soft” paternalists that their intervention methods are modest).

⁴⁶ *See, e.g.*, Sunstein & Thaler, *Libertarian Paternalism*, *supra* note 1.

⁴⁷ Charles F. Sabel & William H. Simon, *Minimalism and Experimentalism in the Administrative State*, 100 GEO. L.J. 53, 93 (2011).

⁴⁸ *See* Bruce Ian Carlin et al., *Libertarian Paternalism, Information Sharing, and Financial Decision-Making 2–3* (Mar. 7, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1570158.

⁴⁹ Daniel E. Ho, *Fudging the Nudge: Information Disclosure and Restaurant Grading*, 122 YALE L.J. 574 (2012).

political agenda.⁵⁰ In particular, they argue, nudgers tend to ignore the fact that behavioral economics may actually point to harder paternalism than nudging allows. In addition, behavioral economics suggests that certain nudges will be limited in effect, and that nudges can be so sticky that wrongly calibrated nudges will badly misfire.⁵¹ Lauren Willis has noted that when firms oppose nudges, they may find other ways to counteract them. She points to evidence that banks have been successful in getting people to opt into so-called “overdraft protection,”⁵² undermining a change in law designed to protect people from the abusive practice by requiring affirmative opt-ins before banks could extend them the automatic high-interest, low-risk loans to cover transactions on overdrawn debit cards.⁵³ In the most direct assault on nudging and its philosophical underpinnings, philosopher Sarah Conly has used the same kind of findings from behavioral economics upon which the nudgers rely to argue that we should not be so afraid of a harder paternalism.⁵⁴

2. *Nudging to Increase Contribution to Retirement Plans*

In 2006, partly in order to address reforms in the funding of defined-benefit pension plans, Congress enacted the PPA.⁵⁵ The law took advantage of insights from behavioral economics; most notably, it encouraged the use of nudges to increase enrollment in and contributions to 401(k) plans. Automatic enrollment, which the PPA made easier,⁵⁶ is lauded among the chief successes of “nudging” in the real world, and its supposed success is

⁵⁰ See Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. 1593, 1594 (2014).

⁵¹ See *id.*

⁵² See Lauren E. Willis, *When Nudges Fail: Slippery Defaults*, 80 U. CHI. L. REV. 1155, 1174–207 (2013). I return to Willis’s excellent article in Part II, a section that makes a similar, though distinct, argument in the retirement allocation context.

⁵³ *Id.* at 1174.

⁵⁴ See generally SARAH CONLY, *AGAINST AUTONOMY: JUSTIFYING COERCIVE PATERNALISM* (2013) (arguing that autonomy is overrated, because of our false belief that we are more rational than we actually are).

⁵⁵ See *supra* note 4.

⁵⁶ For a thorough summary of the changes the PPA made to the auto-enrollment scheme (and changes made by the PPA more generally), see GROOM LAW GROUP, *SUMMARY COMPARISON OF CURRENT LAW AND THE PRINCIPAL PROVISIONS OF THE PENSION PROTECTION ACT OF 2006: CHANGES PRIMARILY AFFECTING DEFINED CONTRIBUTION PLANS, IRAS, GOVERNMENTAL AND TAX-EXEMPT EMPLOYER PLANS, AND INSURANCE PROGRAMS* 7–11 (2006), available at http://www.groom.com/assets/html/documents/PPADCAIRA_ReformsFINAL.pdf. Auto-enrollment had previously been possible under Department of Labor and IRS rulemaking. The PPA created safe harbors that would protect companies from possible violations of ERISA’s nondiscrimination provisions—which are designed to level the playing field in retirement savings between highly compensated and less compensated employees—that could arise as the result of auto-enrollment.

regularly cited as an argument for trying nudge-based tactics in other policy domains.

A major problem with defined-contribution plans has been encouraging employees to enroll and to contribute a portion of their paycheck. Fewer workers participate in defined-contribution plans when offered than in defined-benefit plans.⁵⁷ The PPA's strategy was inspired by academic studies⁵⁸ that showed huge increases in enrollment when companies switched to auto-enrolling employees, who could then choose to opt out, in 401(k) plans. Although purely rational employees would be expected to set their 401(k) contributions to their desired rate of savings (or a zero percent rate) regardless of the default enrollment, dramatic increases in enrollment and savings rates occurred when employers switched to "opt-out" auto-enrollment from "opt-in" systems.⁵⁹ In one influential study, participation went up 48 percent among newly hired employees, and 11 percent overall, in just fifteen months when one large U.S. company began using auto-enrollment.⁶⁰ In other words, simple tweaks to plan design could be very effective in overcoming inertia and other impediments to saving. Perhaps best of all, effects appeared particularly strong for populations that previously participated in the company's 401(k) plans at low rates, including young, lower-paid, Hispanic and Black employees.⁶¹

Since the PPA was adopted, the number of employers using auto-enrollment has soared by some estimates from 4 percent in 1999 to 24 percent in 2006 to 46 percent in 2011.⁶² At one employer, TIAA-CREF, participation jumped from 63 percent to 95 percent, with an average deferral rate of 7 percent, following the use of auto-enrollment.⁶³ The results for employees' long-term savings accumulation could be significant.⁶⁴

⁵⁷ In 2012, 89 percent of those employees in the private sector who were offered defined-benefit plans participated, compared to only seventy percent in defined-contribution plans. See Butrica & Karamcheva, *supra* note 26, at 2.

⁵⁸ See *id.* at 3.

⁵⁹ See, e.g., Choi et al., *supra* note 10, at 12.

⁶⁰ Brigitte Madrian & Dennis Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. ECON. 1149, 1149–88 (2001).

⁶¹ *Id.* at 1160–61.

⁶² Butrica & Karamcheva, *supra* note 26, at 5.

⁶³ See Press Release, TIAA-CREF Financial Services, TIAA-CREF Study Finds Automatic Enrollment in 401(k) Plans Boosts Employee Participation (Nov. 21, 2011), available at http://www1.tiaa-cref.org/public/about/press/about_us/releases/pressrelease405.html.

⁶⁴ Jack VanDerhei, *The Impact of Automatic Enrollment in 401(k) Plans on Future Retirement Accumulations: A Simulation Study Based on Plan Design Modifications of Large Plan Sponsors*, EMP. BENEFIT RESEARCH INST., Issue Brief No. 341, April 2010, at 5, available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_04-2010_No341_Auto-Enroll1.pdf.

While the benefits seem largely positive, there are some mixed effects as well. There is evidence that employer contributions are reduced when employers switch to auto-enrollment, which could mean that some employees who would have participated anyway save less.⁶⁵ A similar problem stems from the fact that the effects of inertia are strong, and employees typically stick with the savings rate set by their employer default. For most auto-enrollment employers, that rate is 2 percent or 3 percent, which may be too low and undercut accumulation, but trying to increase those default savings rates may increase opt-outs.⁶⁶ Clearly, that effect is worst for those who would have had the highest savings rates before the adoption of auto-enrollment, and thus it may primarily affect higher-income employers. There is also evidence of a plateau effect in the number of employers adopting auto-enrollment.⁶⁷

Bubb and Pildes use this negative evidence as a key example of their diagnosis of the problem in behavioral law and economics more generally. In particular, they note the troubling possibility that overall savings may have fallen as a result of auto-enrollment.⁶⁸ This particular critique seems overstated. As they acknowledge in a footnote, auto-enrollment may have improved the *distribution* of savings—that is, helping the most vulnerable savers at the expense of well-off savers.⁶⁹ It is quite plausible that increasing aggregate savings is a less important goal than improving savings outcomes at the lower end of the spectrum. Bubb and Pildes also express concern that we do not know much about the types of people who opt out, beyond some suggestive evidence.⁷⁰ As Sunstein and Peter Orszag have countered, such critiques mainly indicate that we should nudge smarter.⁷¹

⁶⁵ See Barbara A. Butrica & Nadia S. Karamcheva, *How Does 401(k) Auto-Enrollment Relate to the Employer Match and Total Compensation?* (Ctr. for Retirement Research at Bos. Coll. Issue Brief No. 13-14, 2013); see also Barbara A. Butrica & Mauricio Soto, *Will Automatic Enrollment Reduce Employer Contributions to 401(k) Plans?* (Urban Inst., Retirement Policy Program Discussion Paper No. 09-04, 2009), available at http://www.urban.org/uploadedpdf/411995_employer_contributions_paper.pdf.

⁶⁶ See Choi et al., *supra* note 10, at 4.

⁶⁷ See Anne Tergesen, *401(k) Auto-Enrollment Tapers Off*, MARKETWATCH (Mar. 15, 2013, 2:30 PM), <http://blogs.marketwatch.com/encore/2013/03/15/401k-auto-enrollment-tapers-off/tab/print/> (quoting a Vanguard researcher who believes that auto-enrollment is most appealing to large companies, which limits the room for future growth).

⁶⁸ Bubb & Pildes, *supra* note 50, at 1622 n.89. Problematically, it is not at all clear that a falling total average contribution rate between the pre-recession year of 2007 and the post-recession year of 2011 has mainly to do with the effects of auto-enrollment rather than broader macroeconomic trends.

⁶⁹ *Id.* at 1623.

⁷⁰ See *id.* at 1626 (noting the troubling evidence that opt-out decisions are correlated with lack of trust in financial institutions, which may not be a rational reason to opt out).

⁷¹ Peter Orszag & Cass Sunstein, *Give People Choices, Not Edicts*, BLOOMBERG NEWS (Dec. 5, 2013, 9:00 AM), <http://www.bloombergview.com/articles/2013-12-05/give-people-choices-not-edicts>.

Two other nudge-based strategies to improving enrollment have been tested and advocated. Under “Save More Tomorrow,” proposed by Thaler and Shlomo Benartzi, an individual’s contribution rate would escalate each year.⁷² Under “active decision,” participants are not automatically enrolled in a retirement plan, but are required to make an affirmative choice—to contribute or not to contribute—rather than having a sticky default.⁷³ One study found that active decision led to a 28 percent enrollment increase when compared to no auto-enrollment.⁷⁴ The authors argued that active decisions were preferable for decisions that involved tendencies to procrastinate and fairly heterogeneous preferences that ought to be respected, but that in fields characterized by widespread financial illiteracy, default enrollment was preferable.⁷⁵

C. Allocation and Nudging

The PPA’s authors hoped nudging could help solve not just the enrollment problem but also the portfolio allocation and investment problems documented in Part I.A. The PPA and a series of Department of Labor rules try to use soft strategies, such as nudges, increased disclosure,⁷⁶ and fiduciary duties,⁷⁷ to prevent some of the most egregious mistakes savers make in their investment decisions. Notably, the rules allow employers to make default investments for their participants, which, like auto-enrollment, can be overridden, but are likely to be sticky for many participants.⁷⁸ These default investments are nudges in two senses: first, by modifying fiduciary duty rules to provide safe harbors—providing certainty that is highly sought after in ERISA’s complex regulatory environment—they nudge employers toward using these optional default investment arrangements; second, the employers who use them nudge their participants into particular investments, but the employers always retain the right to opt out.

In 2007, using its authority under the PPA, the DoL issued rules making it easier for employers to invest their employees’ undirected assets in

⁷² Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow™: Using Behavioral Economics to Increase Employee Savings*, 112 J. POL. ECON. S164, S170–71 (Supp. 2004) (the proposed plan would again allow participants to opt-out).

⁷³ See Gabriel D. Carroll, James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *Optimal Defaults And Active Decisions*, 134 Q.J. ECON. 1403, 1639–40 (Nov. 2009).

⁷⁴ *Id.* at 1639.

⁷⁵ See *id.* at 1639–74.

⁷⁶ See *infra* Part III.C.1.

⁷⁷ See *infra* Part III.C.2.

⁷⁸ 26 U.S.C.A. § 414(w)(3) (West 2014).

Qualified Default Investment Alternatives (QDIAs).⁷⁹ The default investment rules solved a key concern of plan fiduciaries: whether they would be held responsible for investment losses if they allocated a participant's funds to a particular investment. Under the DoL's rules, they would not be liable, so long as the investments met the QDIA test and certain other rules.⁸⁰ Fiduciaries would still have a duty of prudence in choosing the QDIAs. QDIAs are defined extensively in the rule, but include many lifecycle or target-date funds, certain balanced funds, and certain managed accounts.⁸¹

Since the PPA, TDFs, a relatively recent invention, have exploded in popularity and emerged overwhelmingly as the primary QDIA.⁸² (Concerns about TDFs are the topic of Part II.C below.) TDFs are designed for employees retiring around a specific year—for instance, the Vanguard Target Retirement 2050 Fund is for employees who expect to retire around 2050—and change their investment strategy to become increasingly conservative as an employee approaches retirement (at the most rudimentary level, a high exposure to equities early on, shifting over time to a high exposure to bonds). Most of these products are “funds of funds,” which simply hold other funds run by the same mutual fund family and charge an additional fee. For instance, JPMorgan SmartRetirement 2050 Institutional Class held,

⁷⁹ Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452 (Oct. 24, 2007) (codified at 29 C.F.R. pt. 2550).

⁸⁰ *See id.* For an excellent description of the rule's operation, see GROOM LAW GROUP, DOL ISSUES FINAL DEFAULT REGULATIONS: MANY QUESTIONS ANSWERED, MANY QUESTIONS REMAIN 2–4 (2007), available at http://www.groom.com/media/publication/4_final_defaultregarticle.pdf.

⁸¹ *See* Default Investment Alternatives, 72 Fed. Reg. 60,479–80 (including, for instance, “an investment fund ... that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date...or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age.... An example of such a fund or portfolio may be a ‘life-cycle’ or ‘targeted-retirement-date’ fund.”).

Under very limited circumstances, largely having to do with certain situations where funds were already using such products before the rules, QDIAs may also include principal-preservation products, including stable value funds and money market funds—products that earn low, but almost always positive, returns. *Id.* at 60,480.

⁸² *See, e.g.,* Jean A. Young, *Target-Date Fund Adoption in 2012*, RESEARCH NOTE (Vanguard), Feb. 2013, at 1, available at https://pressroom.vanguard.com/content/nonindexed/2.11.2013_Target_Date_Fund_Adoption_in_2012.pdf (reporting that 27 percent of Vanguard retirement participants were invested *exclusively* in a single TDF in 2012, three times higher than in 2007; Vanguard estimates that by 2017, 55 percent of all plan participants and 80 percent of new plan participants will be in TDFs).

as of December 21, 2013, roughly two-dozen other JPMorgan funds.⁸³ The fund charged seventy-five basis points in annual expenses, of which seventy-one basis points came from “acquired fund fees,” which were the fees charged by the underlying funds, and thus passed through to owners of the 2050 lifecycle fund.⁸⁴

In addition, the DoL’s rules allowed an even stronger nudge—a shove—to move current employees’ existing allocations into QDIAs.⁸⁵ Called reenrollment or reset, the approach allows an employer to move all an employee’s funds out of his or her current investments and into the fund’s default investment vehicle.⁸⁶ Employers must provide their employees with the option to opt out of the switch and maintain their prior investment strategy, but as with auto-enrollment, few do.⁸⁷ Lawsuits that have challenged reenrollment have largely failed.⁸⁸

⁸³ JPMorgan SmartRetirement® 2050 Fund Institutional Shares Data (June 30, 2014), available at https://www.jpmorganfunds.com/blobcontent/216/297/1205478538503_FS-SR2050-I.PDF.

⁸⁴ See Summary Prospectus: JPMorgan SmartRetirement® 2050 Fund (Jan. 8, 2014), available at <https://www.jpmorganfunds.com/cm/Satellite?pagename=jpmfVanityWrapper&UserFriendlyURL=otherresourcesld&cusip=4812A4807&fileName=SPRO-SR2050-I.PDF>.

Fees are for the institutional class, and those fees are typically the cheapest. The seventy-five-basis-point fee reflects a fee waiver, which will expire unless it is renewed. The fund’s charge would have been 1.01 percent without the fee waiver. Rather than reducing the fees, mutual funds commonly give temporary fee waivers, possibly because they are more flexible and make rapid changes easier. See Susan E.K. Christoffersen, *Fee Waivers in Money Market Mutual Funds* 23 (Wharton Ctr. for Fin. Insts., Working Paper No. 97-46-B, 2000).

⁸⁵ See Default Investment Alternatives, 72 Fed. Reg. at 60,453 (noting that the QDIA rule and its related fiduciary-duty relief applies to situations other than auto-enrollment, including “the failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant to provide investment instruction. *Whenever a participant or beneficiary has the opportunity to direct the investment of assets in his or her account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided by this final regulation, so long as all of its conditions have been satisfied.*” (emphasis added)).

⁸⁶ See, e.g., *Improving Plan Diversification through Reenrollment in a QDIA*, VANGUARD COMMENTARY (Vanguard), Aug. 2012, at 4–5, available at <https://institutional.vanguard.com/iam/pdf/RENPPR.pdf?cbdForceDomain=false> (suggesting that plan sponsors may choose to reenroll employees because of concerns about underdiversification or to simplify administration when the employer wants to change its menu offerings dramatically).

⁸⁷ See Veronica Dagher, *Your Employer Knows Best. Perhaps.*, WALL ST. J. (Feb. 7, 2011) at R7 (noting that “among employers that shifted their 401(k) plans to T. Rowe Price and conducted a plan ‘reset,’ roughly 87% of all participants remain in the target-date fund 18

There is good evidence that, on aggregate, these nudges are quite sticky.⁸⁹ The popularity of lifecycle funds has exploded since the PPA.⁹⁰ T. Rowe Price reported that 96.3 percent of participants who defaulted into a QDIA remained invested there.⁹¹

II. FAILED NUDGES AND THE SUPPLY SIDE

This Part's argument proceeds in three sections. First, I introduce some background on the structure of the mutual fund and retirement savings industries to show the inherent conflicts of interest that prevail in allocation decisions, in striking contrast with the alignment of interests that prevails in enrollment and contribution decisions. The next two sections consider two competing ways in which mutual funds might counteract a nudge given these conflicts. In Part II.B, I consider the possibility that mutual funds would convince some savers to opt out of the nudge and into investment strategies that are worse for them but more lucrative to the industry. In Part II.C, I consider how, even for those individuals who stay in the nudge, the industry could weaken its products in order to take advantage of the nudge. There is already significant evidence of this trend.

In this and the next Section, I sometimes will refer to two hypothetical investors, "Adam" and "Ben," who represent useful archetypes.⁹² In the

months after the conversion," and that "57% of plans transferred to T. Rowe Price in 2009 conducted plan resets for their employees, compared with 14% in 2005").

⁸⁸ See, e.g., *Bidwell v. Univ. Med. Ctr.*, 685 F.3d 613, 616 (6th Cir. 2012) (rejecting, under the DoL safe harbor rule, a challenge by the plaintiff, who had invested funds in a stable value fund. The defendant reinvested those funds in a lifecycle fund after mailing notices and opt-out instructions to all plan participants. The plaintiff claimed never to have received notice.).

⁸⁹ See, e.g., Henrik Cronqvist & Richard Thaler, *Design Choices in Privatized Social-Security Systems: Learning from the Swedish Experience*, 94 AM. ECON. REV. (PAPERS & PROC.) 424, 425–27 (May 2004) (observing significant investment inertia after the initial enrollment period, which is when investors usually receive nudges).

⁹⁰ See *infra* Part III.C.2.

⁹¹ See *Getting Beyond Ordinary: Advances in Automatic Savings Program Design*, T. ROWE PRICE RETIREMENT INSIGHTS (T. Rowe Price), Feb. 2013, at 9, available at https://www2.troweprice.com/rms/rps/Marketing/Articles/AdvancesinAutomaticSavingsProgramDesign_whitepaper.pdf. T. Rowe Price did not report the time period to which this figure refers.

⁹² Far from caricatures, these archetypal investors should be understood as representative of characteristics affecting large swaths of the populations. Consider, for instance, the previously mentioned evidence on financial literacy. See *supra* notes 34–36. On the overconfidence side (Ben), see, e.g., Francesco D'Acunto, *Identity, Overconfidence and Investment Decisions* 21 (Nat'l Bureau of Econ. Research, Conference Paper, Oct. 2014), available at http://faculty.haas.berkeley.edu/francesco_dacunto/papers

absence of the PPA's nudges, Adam and Ben each allocated their savings to a number of relatively high fee funds and each trades funds within their retirement account relatively actively. These two traits are common and are typically costly compared to a passive, low-fee fund strategy.⁹³ Although their behavior is similar, their rationales are quite distinct. Adam is the prototypical "ignorant" investor: he neither knows nor wants to know anything about finance. Ben is highly knowledgeable about finance, he is familiar with the academic literature on various investment strategies and the efficient markets hypothesis, and he is a frequent consumer of business news and analysis.

Adam, in other words, has chosen a poor investment strategy because he has been told to do so. His decision could follow one of two stories about economies of influence. In the more direct form, Adam picks his funds with the help of some kind of advice-giver who is financially incentivized through (entirely legal) direct or indirect kickbacks⁹⁴ to push him into high-fee funds and frequent trading,⁹⁵ up until the adviser's suggestions cross a (fairly distant) regulatory line.⁹⁶ A softer variant is also possible: Adam's decisions have been influenced almost entirely by framing, marketing, and advertising, ranging from its most literal form (ads suggesting a particular fund) to its weakest form (everything from the menu

/genderTrade.pdf (providing experimental evidence on the role played by gender and identity in investment overconfidence and aggressive trading). Certain risk-taking characteristics of Ben also resemble the profile of investors who are most susceptible to fraud. *See, e.g.*, Applied Research & Consulting, Financial Fraud and Fraud Susceptibility in the United States (Sept. 2013) (FINRA research report) at 6, *available at* http://www.saveandinvest.org/web/groups/sai/@sai/documents/sai_original_content/p337731.pdf (finding that "susceptibility to investment fraud appears to be positively associated with one's ability and willingness to take on investment risk").

⁹³ *See supra* notes 38–39.

⁹⁴ One form these kickbacks take is known as revenue sharing, which involves payments from a mutual-fund to a broker. This practice raises complicated legal questions, and it has come under fire in recent years. For a good treatment of the legal issues, see John A. Haslem, The Many Faces of Mutual Fund Revenue Sharing 44–46 (Oct. 31, 2014) (unpublished manuscript), *available at* <http://ssrn.com/abstract=2136614>. There is a lot of ambiguity and very little transparency in the area.

⁹⁵ *See supra* note 84.

⁹⁶ The typical standard for brokers is suitability—the product must be suitable for the client's needs—which is generally seen as a relaxed standard. Registered investment advisers are held to a fiduciary standard, which is seen as stricter (though still often relaxed). *See infra* Part III.C.2; Benjamin P. Edwards, Fiduciary Duty and Investment Advice: Will a Uniform Fiduciary Duty Make a Material Difference? 2 (Mar. 2, 2014) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2469987.

of funds themselves, to fund names,⁹⁷ to subtle placement decisions on a trading platform).

By contrast, Ben trades frequently in and out of high-fee funds because, despite being well versed in efficient markets literature, he is highly confident—rightly or wrongly⁹⁸—that his own sophistication and abilities exceed that of the market. Ben’s rationale may also be quasi-expressive, a point I return to in Part III.B. In other words, he enjoys the *feeling* of active trading and trying to beat the market.

Nudging is a problematic public-policy strategy for helping either category of investor: Adam largely because of the conflict of interest problems explored in Part II, and Ben for reasons explored both in Part II.C and in Part III.B. At the outset, though, it is worth noting another problem: even if, as I suspect a libertarian paternalist would argue, we want Ben and Adam to be treated differently by nudges, it will be hard to tell them apart after our first round of nudging. In particular, some Adams and some Bens will likely have opted out of the nudge for reasons that are not discernable to policymakers or regulators on the basis of readily observable characteristics because their visible choices are identical.⁹⁹

Throughout this Article, I take for granted (and defend somewhat in Part II.A) some basic assumptions shared by most serious finance research—including the assumption that for most individual investors, active trading strategies are unlikely to beat the market, and that most individual investors are served by passive, index-based strategies that track the market.¹⁰⁰

A. Mutual Funds and Misaligned Incentives

Several characteristics of the allocation decision stand in contrast to the contribution decision and make nudging particularly problematic. This Section outlines those attributes. First, investment decisions involve problems for which there is some legitimate uncertainty, even among experts, about the correct answers to the problems. That uncertainty makes it hard to distinguish between real debates, for example, over broad asset allocation

⁹⁷ Fund names matter all too much. One study found that a fund name change to a “hot” style generates an average abnormal flow of 28 percent without any associated performance improvement. Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825, 2825–58 (Dec. 2005).

⁹⁸ There is an extensive literature on overconfidence. *See supra* note 92.

⁹⁹ Various authors have argued that nudging is rarely if ever theoretically wrong, just not always optimized correctly. *See, e.g.*, Orszag & Sunstein, *supra* note 71.

¹⁰⁰ *See infra* note 111.

strategies,¹⁰¹ and invented debates, like the choice between overactive and passive management strategies.¹⁰² That ambiguity, in turn, provides an opportunity for investment firms to exploit in their marketing and sales, which may overemphasize factors, like past performance, that should have little relevance to savers' decisions. Additionally, the ambiguity may make it easier for financial institutions to obscure the issues at hand in lobbying efforts before Congress and regulatory agencies.

Second, difficulties specific to many savers compound the inherent complexity of choosing an optimal allocation approach. In particular, Americans have very low levels of basic financial literacy. In a five-question survey testing basic everyday finance, 61 percent of recipients answered one or more questions wrong.¹⁰³ Financial literacy is especially low among young people¹⁰⁴ and among minority populations.¹⁰⁵ As a compounding factor, most Americans do not invest significant time in financial planning,

¹⁰¹ See, e.g., Gary P. Brinson, L. Randolph Hood & Gilbert L. Beebower, *Determinants of Portfolio Performance*, 42 FIN. ANALYSTS J. 44 n.4, 39–44 (1986).

¹⁰² This debate at times resembles the debate over climate change. Numerous empirical analyses have failed to find anyone who, over time, can beat the market by picking publicly-traded stocks. These findings are well supported by most versions of the efficient markets hypothesis. Empirical studies have also shown that any returns a mutual fund buyer could make from someone who could beat the market would be eaten up by the high fees of active management. See, e.g., Laurent Barras, Olivier Scaillet & Russ Wermers, *False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas*, 5 J. FIN. 179, 214–15 (Feb. 2010) (citing numerous others). The most outspoken, grumpy, and eloquent proponent of this view is Jack Bogle, the founder of Vanguard, which is known primarily for its index funds. See Jeff Sommer, *One Answer to the Index Fund: Build a Better Index*, N.Y. TIMES (Nov. 11, 2013, 11:10 AM), http://dealbook.nytimes.com/2013/11/11/one-answer-to-the-index-fund-build-a-better-index/?_r=0 (quoting Bogle's plainspoken advice on active managers: "The problem is that you don't know what will perform well in the future."). Whether there is doubt at the margins, for the average individual investor in the market, there is no debate over indexing versus active management.

Yet active managers continue to claim otherwise, and investors continue to chase past returns. See, e.g., Blake Phillips, Kuntara Pukthuanthong & P. Raghavendra Rau, *Limited Attention, Horizon Effects, and the Uninformative Persuasion of Mutual Fund Investors* (Oct. 29, 2013) (unpublished manuscript) at 1–2, available at <http://www.iimb.ernet.in/research/sites/default/files/Mutual%20Fund%20Stale%20returns.pdf> (finding that despite warnings in extremely small type, past performance does not guarantee future performance).

¹⁰³ FIN. INDUS. REGULATORY AUTH. INVESTOR EDUC. FOUND., *FINANCIAL CAPABILITY IN THE UNITED STATES: REPORT OF FINDINGS FROM THE 2012 NATIONAL FINANCIAL CAPABILITY STUDY* 31 (2013), available at http://www.usfinancialcapability.org/downloads/NFCS_2012_Report_Natl_Findings.pdf.

¹⁰⁴ See Annamaria Lusardi, Olivia S. Mitchell & Vilsa Curto, *Financial Literacy among the Young: Evidence and Implications for Consumer Policy* (Jan. 28, 2010) (unpublished manuscript) at 2, available at http://www.dartmouth.edu/~alusardi/Papers/Financial_literacy_young.pdf.

¹⁰⁵ See *supra* note 103, at 28.

with 39 percent of workers reporting spending “no time at all” planning for retirement.¹⁰⁶ It is possible that the topic of retirement is too confusing, seems too remote, or is simply uninteresting relative to other priorities (a possibility often forgotten by people who spend their days writing about retirement savings). This remains true even as staggeringly few Americans (14 percent) are “very confident” (and only another 38 percent “somewhat confident”) about their ability to retire comfortably.¹⁰⁷

Third, and most consequentially, allocation involves deep, intractable conflicts of interest between savers and retirement providers.¹⁰⁸ This is a sharp, key contrast with the contribution decisions discussed in Part I.B, which involve an *alignment* of interest because both investment managers (through fees) and individual savers (through having more money available at retirement) can benefit from increasing savings rates.

Not so in the allocation context. Fund advisers are not compensated based on performance, but rather based on fixed annual management fees charged on assets under management. These asset-based fees represent the vast bulk of fees—84 percent—earned by the retirement savings industry.¹⁰⁹ In many instances, financial boons to the fund industry and retirement service providers¹¹⁰ come at the detriment of the saver. First, because

¹⁰⁶ 2007 Minority Retirement Confidence Survey (Employee Benefit Research Institute Fact Sheet) at 1, *available at* http://www.ebri.org/files/MRCS07.FS1_Final.pdf. The percentages reporting spending “no time at all” are even higher among African Americans (48 percent) and Hispanics (50 percent). *Id.* 21 percent of workers report spending more than twenty hours a year (although it is hard to know how accurate such self-reported numbers are). *Id.*

¹⁰⁷ Ruth Helman, et al., *The 2012 Retirement Confidence Survey: Job Insecurity, Debt Weigh on Retirement Confidence, Savings*, 369 EMP. BENEFIT RESEARCH INST., Issue Brief No. 369, Mar. 2012, at 1, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_03-2012_No369_RCS2.pdf.

¹⁰⁸ In this Section, I lump together as “retirement providers” all entities that make money off their role in providing and managing defined-contribution plans (basically everyone except the participant and the employer), because they are largely the same despite specific differences in the role and legal regime governing each. Clearly, the conflicts I describe here may be significantly worse in some instances (for example, a single entity that both selects the fund menus and runs funds, and in doing so tends to over select its own funds for the menu) than in others (for instance, a record-keeper or trustee whose tasks are essentially administrative).

¹⁰⁹ Deloitte Consulting LLP, *Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of the ‘All-In’ Fee* 6 (Investment Company Institute Nov. 2011), *available at* http://www.ici.org/pdf/rpt_11_dc_401k_fee_study.pdf. Plan sponsors also charge per-participant and per-plan administration fees, which do not pose the same alignment issues. *Id.* at 36.

¹¹⁰ Who pays what fees to whom is a complicated and interesting question, both because retirement plans and mutual funds have complicated structures, but also because of features that tend to obscure a clear understanding of fee arrangements, such as revenue sharing, bundled services, and various indirect payments. However, the

the saver's contributions are diminished by the amount of any fees, the saver retires with fewer assets (a loss that grows each year, given the interest that could have been earned on the foregone savings). Second, many of the ways in which investment advisers earn those pennies are correlated with deleterious investment strategies. Most empirical and theoretical work within finance suggests that individual savers should generally be using inexpensive, passive, index-based funds, which are the cheapest and least lucrative to their advisers.¹¹¹

By contrast, many activities that *are* profitable for fund advisers damage individual investors' returns beyond the loss of the fees themselves. Fees tend to be higher for funds with active or complex trading strategies that, even before fees are taken into account, typically produce returns lower than passive strategies.¹¹² High rates of portfolio turnover and frequent trading, either by the retirement saver directly or within a fund held by the retirement saver, generate lucrative brokerage fees, but such churning damages returns.¹¹³ Mutual funds cross-subsidize the performance of their more lucrative high-fee funds at the expense of their low-fee funds.¹¹⁴

Fees charged on assets under management do not sufficiently align incentives for retail mutual funds. While good market performance obviously increases assets under management and is thus positive for both saver and fund manager, it is not the only way to increase assets and fees. Retail funds also engage in extensive marketing efforts, including revenue-sharing arrangements with brokers, to sell their mutual funds to new investors. Fund investors bear the costs, regardless of whether the costs are beneficial to the fund. Fund marketing and sales efforts, among the most significant and hard-to-unpack fees charged by funds, are at best a

distinctions are largely irrelevant to this Article's argument. For a good overview, see *supra* note 94.

¹¹¹ For the most famous and best, popular statement, see generally BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (W.W. Norton & Co., 1973).

¹¹² There are numerous studies in this vein. For a representative and recent work by two very well-known finance scholars, see Eugene Fama & Ken French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 5, 1915, 1916 (2010) (finding no evidence that we can distinguish any active managers who can beat the market from skill rather than luck, and that costs generally consume any possible outperformance).

¹¹³ See, e.g., Theodore Day, Yi Wang & Yexiao Xu, *Investigating Underperformance by Mutual Fund Portfolios at 14* (May 2001) (unpublished manuscript), available at <http://utd.edu/~yexiaoxu/Mfd.PDF> (finding significant excess turnover in mutual funds that diminishes returns).

¹¹⁴ See José-Miguel Gaspar, Massimo Massa & Pedro Matos, *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 1, 73, 74 (Feb. 2006).

deadweight loss to current fund shareholders. They may also damage fund investors in general because they are often used to sell bad funds and may make funds too large to be effective.¹¹⁵ Although these “12b-1 fees” have been heavily critiqued and do not perform the function for which they were originally intended, the retail fund industry has successfully lobbied to keep them.¹¹⁶

Clearly, there are good mutual funds out there, but there is good reason to suspect that bad mutual funds go unpunished and often find their way into the most vulnerable investors’ portfolios. Typical market correctives do not work well for retail mutual funds. The most striking empirical evidence of this is that funds that track the S&P 500 index charge sharply different fees.¹¹⁷ Yet many investors continue to choose more expensive ones, despite overwhelming evidence that fees are the most important—perhaps the only—salient characteristic in that decision.¹¹⁸ Funds have occasionally advanced the argument that individual select funds have comparable performance potential but higher fees because of other services bundled with the funds.¹¹⁹ However, outright mistake by investors is a better explanation. In an experiment asking Wharton MBA students and other elite subjects to choose between receiving returns from four S&P 500 index fund prospectuses, with fund services unbundled and therefore irrelevant, 80 percent of subjects fail to minimize fees *even after* experimenters gave them a simplified one-page fee disclosure.¹²⁰ The study’s

¹¹⁵ For an excellent account of the many ways in which 12b-1 fees for fund marketing and distribution have become a disaster for mutual fund investors (and undermining typical mutual fund arguments about the supposed benefits of such fees including economies of scale), see John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 J. CORP. L. 4, 740, 745, 748, 770, and *passim* (2007).

¹¹⁶ The SEC, which created the 12b-1 fee system in the late 1970s to deal with a specific problem faced by mutual funds at the time, has attempted to reform the system, but it has met heavy resistance. See Mutual Fund Distribution Fees; Confirmations, 75 Fed. Reg. 47,064, 47,064 (Aug. 4, 2010) (codified at 17 C.F.R. pts. 210, 239, 240, 249, 270).

¹¹⁷ Joe Light, *Don’t Pay High Fees for Index Funds*, WALL ST. J., May 4, 2013, at B9.

¹¹⁸ See, e.g., Edwin Elton, Martin Gruber & Jeffrey Busse, *Are Investors Rational? Choices Among Index Funds*, 59 J. FIN. 1, 261, 286 (2004). Index funds may use different underlying trading techniques to match an index’s return, but it is not clear that this should explain the fee differences, given that all of them advertise themselves as tracking the S&P 500.

¹¹⁹ Sean Collins, *Are S&P 500 Index Mutual Funds Commodities?*, 11 INV. CO. INST. PERSPECTIVE 9 (Aug. 2005), available at <http://www.directorscouncil.org/pdf/per11-03.pdf>. The most absurd explanation advanced by some funds for higher fees was toll-free telephone support (which is provided by most funds, including the lowest-fee funds at Vanguard).

¹²⁰ James J. Choi, Xavier Gabaix, David Laibson & Brigitte C. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds* 4, 27 (Nat’l Bureau of

lesson is clear: people—even financially literate people—simply do not understand the role fees play in returns, and instead focus on other, irrelevant information. Funds know this. In obtaining materials from Morgan Stanley, a research assistant to the same study reported the following quote from the Morgan Stanley representative about its S&P 500 fund offering:

There are better S&P 500 index funds out there There's no question that Vanguard's fund will outperform ours Do not buy our S&P 500 index fund. It will not accomplish anything. I wouldn't be able to look at myself in the mirror in the morning if I recommended that fund to you.¹²¹

The legal regime is not much help either. In lieu of direct regulations on, say, limits to mutual fund fees,¹²² the legal regime governing mutual funds takes a page from corporate governance. An independent board of directors reviews fund decisions to ensure they are in the best interest of fund shareholders.¹²³ But the system does not work well because mutual funds are fundamentally different from typical corporations: institutional investors in funds will walk, rather than vote in new board members, when funds underperform.¹²⁴ The risk of negative asset flows provides some market discipline, but it may also leave many individual investors abandoned—likely the most vulnerable investors who are least able to assess fund performance. In other words, intelligence walks, rather than fights for control.

Market correctives may be even worse in the retirement context, in which employees tend to have few fund options (often from a single family

Econ. Research, Working Paper No. 12,261, 2008), *available at* <http://www.nber.org/papers/w12261>.

¹²¹ *Id.* at 7 n.57.

¹²² Although the law requires that mutual fund fees be reasonable, courts have largely abandoned any role in assessing that reasonableness. *See* *Jones v. Harris*, 559 U.S. 335, 353 (2010); *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d, 923, 928 (2d Cir. 1982). In part, this is an institutional competence concern, but as an explicit matter, courts have (in a striking parallel of judicial interpretations of the various duties under corporate law, which are dwarfed by the business-judgment rule) chosen to focus on process and the role of the board of directors in reviewing mutual fund fees.

¹²³ 15 U.S.C. § 80a-15(c) (2012) (section of the Investment Company Act of 1940 that provides for review of mutual fund advisory contracts by independent board).

¹²⁴ John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 *YALE L.J.* 84, 102 (2010). A similar problem may be emerging for regular corporate governance as institutional investors come to dwarf the role of individual, dispersed shareholders, upending the longstanding Berle-Means view of corporate governance—although activist investors have stepped into that role. *See* Ron Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *COLUM. L. REV.* 863 (2013).

of funds) and little recourse (short of changing employers) if they do not like those options.¹²⁵ The mutual fund industry has taken advantage of this. When a mutual fund parent company owns an entity that serves as a plan trustee, that trustee strongly prefers to choose funds offered by its parent.¹²⁶ It will also tend to retain its own bad funds when they underperform; in fact, the worse the fund, the higher the comparative likelihood of retaining one's own funds versus other companies' funds. In other words, "it pays to set the menu."¹²⁷ Beyond menu design, retirement service providers have other ways to direct participants toward expensive, badly performing funds—for instance, through advice provided directly through their retirement service help-lines, through marketing materials, or more subtly, through design choices on the online retirement platform.¹²⁸

Financial advisers, including brokers (who have no fiduciary duty to their clients), make the problem worse. Most of them are compensated based on (entirely legal) kickbacks.¹²⁹ A study of the Oregon University System's retirement plan found that more vulnerable—less educated and less highly compensated—participants were more likely to use a broker provider, and that the resulting portfolios were substantially worse than non-broker-advised portfolios.¹³⁰ In a recent troubling (but unsurprising) audit study, financial advisers not only failed to de-bias auditors with bad portfolios, they actively reinforced bad biases and made portfolios

¹²⁵ Of course, fiduciary duties governing retirement plan menu design may compensate for this, but courts have largely bowed out of the role of reviewing employers' plan menu designs. See *infra* Part III.C.2. Moreover, retirement plan participants are likely to assume that employers have chosen good funds for them and may exercise less independent due diligence.

¹²⁶ Veronika K. Pool, Clemens Sialm & Irina Stefanescu, *It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans* 21 (Nat'l Bureau of Econ. Research, Working Paper No. 18764, 2013), available at <http://www.nber.org/papers/w18764>. The authors also tested the possibility that plan trustees had private information about their own family's funds that caused them to retain them, and found that future performance of the retained funds fared no better.

¹²⁷ *Id.*

¹²⁸ While legal academics have been very attuned to conflicts of interest in the mutual fund and investment advisory industry, they have paid too much attention to formal disclosure means—such as prospectus design—and essentially no attention to the way in which data is presented to someone about to purchase a mutual fund (i.e., the design of the retirement platform or "mutual fund supermarket").

¹²⁹ See, e.g., John Freeman, Stewart Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 61 OKLA. L. REV. 83, 84 (2008).

¹³⁰ See generally John Chalmers & Jonathan Reuter, *What Is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes* (Nat'l Bureau of Econ. Research, Working Paper No. 18158, 2012), available at <http://www.nber.org/papers/w18158>.

worse.¹³¹ The advisers pushed the auditors—including those who arrived with well-designed, low-fee portfolios—toward high-fee funds and encouraged clients to foolishly chase past returns.¹³² Nonetheless, in surveys, people show that they trust investment advisers and brokers to help them make good decisions.¹³³ Other experimental evidence has shown the significant degree to which actors “wrongly” trust advisers, finding that advisers who project confidence can maintain sway regardless of accuracy in situations in which assessing accuracy is difficult or costly.¹³⁴

B. Counter-Nudges and Vulnerable Savers

Nudgers seem to have forgotten their own lesson: all decisions are subject to subtle influences that can have profound consequences.¹³⁵ In particular, the retirement industry has a variety of ways to counter-nudge participants into alternative strategies. Investment decisions are typically made through retirement platforms in which subtle wording and design decisions can significantly affect decision making. On top of that, employees may seek advice through other means that leave them susceptible to subtle or overt pressure. That pressure need not even be deliberate on the part of industry actors, and can be an unconscious response to feeling that lucrative products are threatened. Experimental evidence in the disclosure context has demonstrated that parties may worsen their behavior in response to disclosure requirements.¹³⁶ Worse still, the savers who make the

¹³¹ See generally Sendhil Mullainathan, Markus Noeth & Antoinette Schoar, *The Market for Financial Advice: An Audit Study* (Nat’l Bureau of Econ. Research, Working Paper No. 17929, 2012), available at <http://www.nber.org/papers/w17929.pdf>.

¹³² *Id.*

¹³³ Two-thirds of respondents to one survey said they thought investment advisers would help them make better decisions. See RAND INSTITUTE FOR CIVIL JUSTICE, U.S. SEC. & EXCH. COMM’N, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 99 (2008), available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

¹³⁴ Sunita Sah, Don Moore & Robert MacCoun, *Cheap Talk and Credibility: The Consequences of Confidence and Accuracy on Advisor Credibility and Persuasiveness*, 121 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 246, 254 (2013) (providing experimental evidence that when it is difficult to assess adviser accuracy, the confidence heuristic—that an adviser’s confidence increases her credibility—trumps the calibration hypothesis that overconfidence will backfire).

¹³⁵ Similar issues have long been raised in the context of disclosure. See, e.g., Howard Beales, Richard Craswell & Steven Salop, *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 491 (1981) (pointing out that many information-based approaches “mask many of the complexities involved in the ways in which information is communicated to consumers and the ways that consumers (and the market) respond”).

¹³⁶ See *infra* note 180.

worst and least considered allocation decisions may be among those who are most likely to be susceptible to such counter-nudges—an “Adam” who does not want to consider his options extensively and is readily susceptible to pressure from third parties.¹³⁷

As suggested earlier, allocation nudging is fundamentally different, in this sense, from nudges designed to increase enrollment or contributions because of the intractable conflicts of interest in the former. When there are not direct adverse interests, we can expect the unnudged population to be composed largely of those whose preferences would be better satisfied by opting out.¹³⁸ In other words, in a situation without direct adverse interests between the party being nudged and the party implementing the nudge, the unnudged will consist largely of those who, in some sense, think they have a strong preference contrary to the default choice. There is reason to suspect that this is largely true in the contribution context: when contributions go up, retirement services providers win (in the form of more assets under management, resulting in higher fees), but the typical saver does, too.

But in a situation characterized by direct adverse interests, the entities implementing the nudges—the retirement services providers—will do their best to counteract the nudge. That response, entirely unsurprisingly, can take two forms: either they can seek to get people to opt out of the nudge (the subject of this Section) or they can accept the nudge and find other ways to undo its worst effects (the subject of Part II.C).

¹³⁷ An excellent, parallel argument is made with respect to overdraft protection on checking accounts by Willis, *supra* note 52 (arguing that banks used marketing and other tactics to successfully undermine the law requiring them to seek an individual’s opt-in consent for overdraft protection on her checking account, and suggesting—both based on logic and with the help of survey data—that opt-ins were particularly concentrated among those who overdraft frequently and may have most needed legal protections against the practice).

I agree substantially with Willis’s article; my argument diverges in two respects, beyond the focus on a different substantive domain from overdraft protection. First, in Parts II.C and II.D below, I focus in large part on describing other unintended consequences of nudges (i.e., that are not concentrated on vulnerable populations opting out). Second, I believe the distribution of various actors’ preferences in the retirement allocation context is slightly more nuanced and ambiguous than in the overdraft protection context, and may require refining or at least reinterpreting Willis’s framework to fit here. In fact, many in the financial-services industry supported the Pension Protection Act (for a number of obvious reasons, many discussed in Part I, *supra*), unlike banks who outright opposed the passage of limits on overdraft protection and then sought to undermine the legislative scheme. By contrast, the story here involves the possibility of retirement-services companies not only *undermining* the PPA’s nudges (the focus of this section) but also *taking advantage* of the PPA’s nudges (the focus of Part II.C). This distinction may, in large part, stem from the fact that overdraft protection is a binary decision, versus the continuous, complicated, and evolving set of choices presented in allocation.

¹³⁸ Whether that idea is remotely coherent in this context is the subject of the next section (the “Bens”).

A nudge advocate might object that we just need to make the nudge stronger. We could tell investors, for instance, in big, red type: “Don’t trust the advice you’re being given: they’re all lying to you, and you need to choose low-fee funds.” While that might push some Adams into low-fee funds, we are left with an ever-irreducible version of the same problem: some portion of the unnudged will be those who *still* did not get it—the *absolute weakest* of all savers, those who we should be *most* worried about and for whom the argument for government intervention is strongest. Some of the Adams will be unable to discount the false claims of firms that (implicitly or explicitly) promise them higher rewards. And again, on the basis of easily observable characteristics, we will not be able to identify or distinguish those opt-outs from the Bens who opt out.

While limited data is available, there is evidence that some of those who ultimately opt out of allocation defaults are making objectively bad decisions. A Vanguard study of reenrollment in a single large plan reported that 42 percent of participants who opted out created inappropriately diversified portfolios, including those with high concentrations of company stock.¹³⁹ In another domain, taxes, a study found that low-income filers opted out of a nudge designed specifically to target them.¹⁴⁰ Frequent overdrafters—the population targeted by overdraft protection nudges—were the most likely to opt back into the overdraft system.¹⁴¹

In addition, as nudges become increasingly strong and increasingly begin to resemble pure paternalism, the purely political rationale (the notion that we can split the difference) for nudging, instead of regulating, becomes increasingly weak. The light touch starts to look increasingly heavy-handed, even as it still fails to accomplish part of what it is meant to do—and even as those effects are concentrated among those who most warrant government intervention.

¹³⁹ Gary Mottola & Stephen Utkus, *Reenrollment and Target-Date Funds: A Case Study in Portfolio Reconstruction*, VANGUARD CTR. FOR RETIREMENT RESEARCH (Vanguard), Sept. 2009, at 13, available at https://pressroom.vanguard.com/content/non-indexed/Reenrollment_and_target_date_fund_a_case_study_in_portfolio_reconstruction.pdf (finding that men, older participants, and wealthier participants were more likely to opt out. However, the study did not report opt-out statistics for specific segments of more vulnerable populations, nor did it indicate whether the poor diversification strategies were concentrated among any particular demographics of opt-outs.).

¹⁴⁰ Erin Bronchetti, Thomas Dee, David Huffman & Ellen Magenheimer, *When a Nudge Isn’t Enough: Defaults and Saving Among Low-Income Tax Filers* 28 (Nat’l Bureau of Econ. Research, Working Paper No. 16887, 2011), available at <http://www.nber.org/papers/w16887>.

¹⁴¹ See *supra* note 137.

C. Incentives to Weaken Nudges

Even to those whose allocations are successfully nudged by the PPA, the actual benefits are highly ambiguous—and can be expected to become worse over time,¹⁴² given typical responses¹⁴³ to legal rules. So far, the primary effect of the PPA’s nudges with respect to portfolio allocation has been pushing significant numbers of employees into “lifecycle” or “target-date” funds,¹⁴⁴ funds whose asset allocation shifts from riskier to less risky funds as an employee approaches retirement. The popularity of these funds has exploded since the PPA, from \$71 billion in assets in 2005 to \$378 billion in 2011. It is estimated that more than half of all defined-contribution assets will be in lifecycle funds by 2020.¹⁴⁵ The switch to lifecycle funds as a default choice addressed an important problem: many plans previously defaulted savers into cash or money market funds that earn insignificant interest rates, resulting in stagnant retirement savings (actually declining in real dollars). Many savers stayed in such funds.¹⁴⁶ Improving that misallocation decision is undoubtedly a victory for the PPA.

But there are serious reasons to be hesitant about the overwhelming migration of savers into lifecycle funds, including relatively high fees, a short and mixed performance track record, difficulty for investors in understanding and monitoring the components of their fund (because they are funds-of-funds), and extreme heterogeneity among offerings with identical

¹⁴² For a general argument that behavioral economics forgets that its findings can also endogenously affect models—as firms seek to use behavioral economics to manipulate markets in their advantage—and a specific application to the domain of product liability in tort, see Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630 (1999).

¹⁴³ The notion that actors’ (sometimes unanticipated) responses to regime changes may have counterproductive effects is obviously commonplace in legal analysis. The critique is also familiar to all rules (as opposed to standards and case-by-case administration). They create a line that actors are tempted to walk right up to. *See, e.g.*, Cass Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953, 995 (1995) (rules allow evasion); MARK KELMAN, *A GUIDE TO CRITICAL STUDIES*, 41–42 (1987) (summarizing the typical anti-rule argument that “unjust outcomes will occur more often because people will actively attempt to arrange their affairs so that they are favored by the rules”). Rules can also become outdated as circumstances change. *See* Sunstein, *supra* note 1, at 993, though that is distinct from the argument that actors will actively change those circumstances so as to make the rules less effective.

¹⁴⁴ As mentioned in Part I.C, while other types of funds, including balanced funds, could meet the requirements to be a QDIA, plan administrators have overwhelmingly chosen lifecycle funds as their QDIAs (This is probably a good thing: the concerns discussed in this section are likely even worse for balanced funds, which have even more variation).

¹⁴⁵ Josh Charlson et al., *Target-Date Series Research Paper: 2012 Industry Survey*, MORNINGSTAR FUND RESEARCH, May 2012, at 3.

¹⁴⁶ Choi et al., *supra* note 10.

labeling. These suspicions can only be expected to increase as the funds become more popular. Nudging does not, of course, solve the problem that regulated entities will react to rules to minimize their fallout. Notably, fees for TDFs now vary quite widely, from 0.15 percent for Vanguard's Target Retirement Series all the way up to a staggering 1.47 percent for the Legg Mason Target Retirement Series.¹⁴⁷ Sixteen of the TDFs tracked by Morningstar have asset-weighted expense ratios above 1 percent, which is remarkably high when compared to the comparable offerings from Vanguard and Fidelity (0.19 percent).

TDFs offered for a particular retirement date by competing fund families are often viewed as comparable products, and most savers will be offered only one fund family's TDF series. But studies have found that TDFs exhibit significant heterogeneity: TDFs offered by different fund companies with the same target date have very different risk-return profiles.¹⁴⁸ More concerning is that heterogeneity appears to have increased significantly since the PPA came into force, as funds have sought to differentiate themselves on factors other than fees.¹⁴⁹ Put bluntly, some scholars have suggested that the growing deviation in TDF returns can be seen as a measure of obfuscation by the funds. Increased competition in the TDF market thus far has mainly created increased obfuscation.¹⁵⁰ Again, this is consistent with what we know about competition in the mutual fund industry, where most evidence suggests that competition does not do a good job reducing fees, and that independent boards have not solved the problem either.¹⁵¹

¹⁴⁷ Josh Charlson et al., *Target-Date Series Research Paper: 2013 Industry Survey*, MORNINGSTAR FUND RESEARCH, 2013, at 50, available at <http://corporate.morningstar.com/us/documents/ResearchPapers/2013TargetDate.pdf>.

¹⁴⁸ Pierluigi Balduzzi & Jonathan Reuter, Heterogeneity in Target-Date Funds and the Pension Protection Act of 2006 (Feb. 22, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=2022672>.

¹⁴⁹ *Id.* at 19.

¹⁵⁰ *Id.*

¹⁵¹ Morley & Curtis, *supra* note 124, at 98. A few scholars have asserted that the mutual fund industry has the hallmarks of a competitive marketplace. See John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy* (Harvard Law and Economics Discussion Paper No. 592, 151, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005426. For a representative critique, see John P. Freeman, *Working Paper Responding to the Advisory Fee Analysis in AEI Working Paper #127, June 2006*, 'Competition and Shareholder Fees in the Mutual Fund Industry: Evidence and Implications for Policy' by John C. Coates, IV, and R. Glenn Hubbard (Am. Enter. Inst., Working Paper, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984507.

Other studies have pointed to agency problems in TDFs.¹⁵² TDF managers have strong incentives to select their family's own funds—and perhaps especially their family's poorly performing funds, which are otherwise hard to sell. Inertia in the 401(k) context may reduce the likelihood that funds will be punished for this behavior in negative asset flows.¹⁵³ In fact, TDFs on average appear to underperform against balanced funds.¹⁵⁴ TDFs also tend to use active strategies, which are costly and may further reduce investor returns. Of the forty-five series of TDFs tracked by Morningstar, twenty-five have 89 percent or more assets invested with active strategies; only six consist of 90 percent or more passive, indexed strategies.¹⁵⁵ TDFs also charge additional fees for repackaging their constituent funds (and updating them according to the fund's glide path), and many predict those expenses will offset any gains from using TDFs.¹⁵⁶

Even as the possible risks of TDFs can be expected to get worse, the nudge is coupled with little regulation. The QDIA definition is relatively broad, requiring mainly that the fund follow a glide path that risk-adjusts allocations as retirement approaches.¹⁵⁷ DoL's regulatory oversight has consisted largely of proposing disclosure rules for TDFs.¹⁵⁸ The SEC began looking at TDFs in 2009,¹⁵⁹ but took no action; it seems unlikely that they will, given that the SEC's regulatory infrastructure for mutual funds is focused on disclosure.

Participants nudged into TDFs may be even less likely than the average fund investor to monitor their fund's fees, risk profile, performance, and other factors. For one, many of the nudged are those who paid no attention to the choice in the first place. For another, the nudge itself will be interpreted as implicit advice by the employer¹⁶⁰—a nod of confidence that will make participants even less likely to investigate independently.

¹⁵² Vallapuzvha V. Sandhya, Agency Problems in Target-Date Funds (Mar. 14, 2010) (unpublished manuscript), *draft available at* <http://ssrn.com/abstract=1570578>.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ Charlson, *supra* note 145, at 23.

¹⁵⁶ Mauricio Soto, Robert K. Triest, Alex Golub-Sass & Francesca Golub-Sass, *An Assessment of Lifecycle Funds* 17 (Bos. Coll. Ctr. for Ret. Research, Working Paper, 2008), *available at* http://crr.bc.edu/wp-content/uploads/2008/05/wp_2008-10-508.pdf.

¹⁵⁷ Fact Sheet, U.S. Dep't of Labor, Default Investment Alternatives Under Participant-Directed Individual Account Plans (September 2006), <http://www.dol.gov/ebsa/newsroom/fsdefaultoptionproposalrevision.html>.

¹⁵⁸ 75 Fed. Reg. 73,987 (Nov. 30, 2010) (The regulations have not been adopted.).

¹⁵⁹ Leslie Wayne, *Target-Date Mutual Funds May Miss Their Mark*, N.Y. TIMES, June 24, 2009, at 8; U.S. Sec. & Exch. Comm'n, U.S. Dep't of Labor, Public Hearing on Target Date Funds and Other Similar Investment Options (June 18, 2009) (transcript), *available at* <https://www.sec.gov/spotlight/targetdatefunds/targetdatefunds061809.pdf>.

¹⁶⁰ Madrian & Shea, *Power of Suggestion*, *supra* note 60, at 1182.

III. FAILED NUDGES AND THE DEMAND SIDE

A. *Gaps in the Nudging Program*

As the previous Part suggested, a problem with nudging is that it primarily addresses the demand side—here, the side of individual retirement savers making investment choices—while ignoring the supply side and its desire and ability to influence demand. Even on the demand side, there is a major disconnect between what nudges are supposed to “solve” and what the nudges are.¹⁶¹ Nudging developed out of insights into certain repeated cognitive mistakes, but many nudges do not seem designed to correct or draw attention to those mistakes. Instead, they simply substitute a weak means of pushing a substantive preference that is different from what would otherwise happen. This gap, I think, limits the potential for the nudging project to succeed.

Take the case of minimizing mutual fund fees, which is perhaps the most widely agreed-upon problem in consumer choice of mutual funds, and part of the backdrop of criticism that the PPA sought to address.¹⁶² The Wharton experiment (discussed in Part II.A) elegantly demonstrated this problem, in which MBAs failed to avoid the most funds, all designed identically to track the S&P 500.¹⁶³ In that experiment, some of the funds with higher fees were assigned higher past returns in particular periods. Especially in choosing among identical styles of funds, this data should have no impact on choice, as past returns do not predict future performance.

There are at least two readily plausible cognitive explanations for why those Wharton investors—like many investors—failed to minimize fees. For one, we are likely to *anchor* on returns in trying to figure out what investment will make the most money. In other words, if past returns are available, we may focus on those, and they crowd out our ability to comprehend and evaluate other, more relevant data such as fees. For another, we are subject to the *gambler’s fallacy*: we see winning streaks when luck is the better explanation.

The nudge into TDFs does not address either of these; indeed, it has no real visible connection to either. Instead, it substitutes a substantive goal of pushing a particular type of fund. As discussed in Part II.C, this fund may not even be the most desirable type, perhaps in part because the libertarian paternalist school is so intent on arguing that it is fixing cognitive problems, not substituting its own substantive judgment. Nowhere does this

¹⁶¹ This theme is also explored in KELMAN, *supra* note 2, which also exhaustively explores the intellectual history of the nudging school and the behavioral research that served as its precursor.

¹⁶² See *supra* notes 110–134.

¹⁶³ See *supra* note 120.

nudge help people understand the problem with anchoring on returns, or help them to focus more appropriately on fees.¹⁶⁴ This is equally true of other problems in the allocation context that we might want nudges to address—excessive frequency of trading in one’s account, or failing to diversify.

In other words, our strategies may inevitably do more to *counterbias* savers rather than *debias* them. Debiasing is difficult—perhaps impossible in the real world of constrained time, resources, and interest on the part of consumers. But in the context of retirement savings, counterbiasing requires policymakers to choose a particular outcome towards which to bias savers. In counterbiasing, we are simply substituting one lexical step in a decision making process for another, without making the decision making process itself any better. That may not be preferable to—and is almost certainly less transparent than—simply mandating that outcome, which at least has more certain distributional consequences on the types of savers whose outcomes are affected.

The use of counterbiasing instead of debiasing may also make conflicts of interest more intractable. Since people are still engaged in an inappropriate decision making process, it is easier for a third party to throw additional counterbiasing tactics at a consumer. Consider the so-called “Snackwell effect,” the nickname for the effect when consumers eat more low-calorie labeled cookies than normal cookies. Since low-calorie labeling has simply substituted another heuristic for choosing food products, rather than moving eaters into a more informed decision making process for those choices, results of this labeling policy may be unpredictable and undesirable.

The nutrition comparison raises another issue: although debiasing is difficult, if not impossible, it may be worth investing in expensive debiasing strategies in the nutrition context. It is a domain in which consumers make repeated decisions—multiple times a day—and it is not easily subject to third-party management. By contrast, retirement investment decisions may not be a good candidate for debiasing (if it were even possible), because they are decisions that can be made infrequently, easily managed by a third party (as in the days of defined-benefit plans), and arguably have fewer personal values at stake.

The problem of a gap between the problem and the remedy in nudging becomes even clearer by reference to a domain in which nudges seem to

¹⁶⁴ Although it would be more consistent with the nudging program, it is not clear this would be possible or desirable. If we know that the one piece of relevant data is fees, for instance, why do we not simply require investors to choose the lowest fund fee, or require employers to provide the lowest fund fee? Kelman echoes this point in his critique of nudging under the fast and frugal school. KELMAN, *supra* note 2, at 172. And investor literacy is an elusive goal. *See supra* note 35.

work well: the contribution part of the retirement decision. To the extent that a cognitive bias is responsible for low contribution rates, that bias has to do with inertia, procrastination, and time-framing issues (our inability to consider our future selves). The nudge directly counteracts that because it forces a choice; its methodology directly overcomes inertia either by choosing a default rule in an opt-in regime, or by forcing a decision in an active choice regime. In either instance, there is a close connection between the problem and the remedy.

B. The Problem with Taking Preferences Seriously

It is not clear that nudging makes normative sense, for reasons that are slightly different from the typical normative critiques levied against nudgers by the libertarian right.¹⁶⁵ In the context of a tax-subsidized paternalistic program designed to force people to save, the goal of giving people “autonomy” may not have much logic to it, either as a descriptive matter or as a normative matter.

Let us return to Adam and Ben, and assume both opt out of the contribution nudge—Adam because he is successfully counter-nudged into a more lucrative strategy, and Ben because he believes he has a trading strategy that will beat the market over time. The libertarian paternalist might perceive Ben’s decision to opt out of the nudge as a good outcome, because it respects his autonomy. By contrast, the libertarian paternalist would likely want to fix Adam’s problems: we believe that a series of cognitive problems has caused Adam to choose poor means to a presumably knowable end—maximizing his retirement wealth. Of course, we face the problem—a pooling equilibrium problem common in legal regimes¹⁶⁶—that there is no readily observable way to tell Adam and Ben apart in the group of people who have opted out of the nudge. Both will appear the same to any regulatory regime, even though some have left the default investments for “good” reasons, and others for “bad.”

At a deeper level, the libertarian paternalist’s desire to leave Ben alone to his errors seems flawed both descriptively and normatively. Their argument could take three forms, each of which either is not an accurate depiction of what Ben is really doing, or does not provide a compelling reason to value his autonomy above policymakers’ paternalistic judgment in this particular context.

¹⁶⁵ See *supra* Part I.B.1.

¹⁶⁶ For a discussion of pooling equilibrium problems in law, see DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDAL C. PICKER, *GAME THEORY AND THE LAW* (1998).

First, while we think Ben is probably making a mistake, there is, in fact, uncertainty about the correct means to achieving maximum retirement wealth.¹⁶⁷ Given the uncertainty, and given that these may be reasonably “well-considered” mistakes, our desire to protect Ben’s autonomy tips the scale enough that we should not override his decision to opt out.

Second, Ben is revealing a distinct risk preference from the median saver for whom we designed our nudge, which we should respect.

Third, Ben’s behaviors are not remotely “mistakes” at all: in fact, Ben’s ends are different from or more complicated than most savers’, and we are supposed to take an agent’s chosen ends seriously. Ben’s true ends may include not only maximizing his retirement wealth, but also a demonstration of his own ability to play the market, the expressive value of his making particular bets about the world, or the fun or adrenaline that he experiences in making trades in his portfolio and watching the results. In other words, we can almost always rewrite an agent’s means as their ends, in ways that I think most of us would find quite plausible and coherent, which perhaps points to an intrinsic flaw in libertarian paternalism. For instance, consider the two pictures we might paint of a gambler. She may gamble to make money, in which case, if we know she will lose money on average and over time, we might want to regulate her behavior. Or she may actually just enjoy aspects of the *experience* of gambling, whether or not it is financially profitable over time, in which case the libertarian paternalist might want to respect her autonomy.

None of these accounts justifies leaving Ben to his mistakes, in large part because of general problems with preference utilitarianism.¹⁶⁸ The

¹⁶⁷ A common critique of libertarian paternalism is that regulators themselves may be subject to cognitive biases, which may in fact make their nudges systematically flawed. A thoughtful discussion of biases that may affect policymakers, and some of the possible treatments, is Paul Brest, *Quis custodiet ipsos custodiet? Debiasing the policymakers themselves*, in *THE BEHAVIORAL FOUNDATIONS OF PUBLIC POLICY* 481, 481–493 (Eldar Shafir ed., Princeton U.P. 2013).

In that vein, Richard Posner has expressed concern with the idea that we ought to push retirement savers into equity-dominated portfolios. Noting that equity-driven portfolios were badly hit in the financial crisis, Posner argued that this push was the result of a series of cognitive biases on behalf of those designing policy, who gave “advice based on the kind of myopia that bases predictions about the future on naïve extrapolation from the past.” Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, *WALL ST. J.*, July 22, 2009 (It is worth noting that the market has substantially recovered since Posner’s complaint was written, although defending any particular approach to asset allocation strategies is somewhat beyond the scope of this paper—which largely accepts the conventional wisdom of modern finance as being, if not perfect, at least better than most other approaches. *See supra* note 102.)

¹⁶⁸ *See* Mark Kelman, *Hedonic Psychology, Political Theory and Law: Is Welfarism Possible?*, 52 *BUFF. L. REV.* 1, 81–82 (2004) (arguing that typical strategies used by welfarists are problematic: hedonic utilitarianism fails because there is no good reason to

first account—that even if Ben wants to maximize retirement savings and policymakers are 95 percent sure the best way for him to do that is to pursue a passive strategy, we should let Ben err for autonomy reasons—does not have a lot going for it. The notion that Ben is erring “better” than Adam in any meaningful way seems hard to defend (because Ben has read more finance literature? because Ben could or would defend his error more passionately than Adam?). In fact, to the extent Ben’s poor decision making stems from the powerful cognitive effect of overconfidence, the very theory that led to libertarian paternalism—that we should correct behavioral errors that we identify—would strongly suggest that we could assist Ben by “de-biasing” him.¹⁶⁹

The second account, arguing that Ben has a different set of risk preferences from the default saver for whom our policymaker designed the nudge, makes some analytical sense, but little practical sense. For one, there is empirical evidence that it is simply not true: recall the Vanguard evidence that many opt-outs are just making bad decisions and under-diversifying, not adjusting their risk profile. Moreover, there is no reason to think that many, if any, savers can meaningfully answer the question “How much risk do you want to take in your retirement savings?” in the abstract. The question has little meaning for most people, and it requires too much data that people either have little access to, or that is largely uncertain, such as future income and date of retirement. We also know that many workers who could have employed strategies on their own did not pursue them until TDFs were offered, a reminder that third parties define their preferences.¹⁷⁰ To

think that “pleasure” or “pain” (or equivalent but better modern measurements by hedonic psychologists) matter for a particular subject, given the many forms of happiness; but given what we know about behavioral psychology, preference utilitarianism also fails because we can only tell whether preferences are “correct” by reference back to hedonic utilitarianism).

That the problem of preference incoherence, so prominent in rational-choice theory, is not solved by behavioral law and economics stems from the fact that most of the latter school is simply a form of rational-choice theory, rather than a coherent or separate theory of its own. See Mark Kelman, *Behavioral Economics as Part of a Rhetorical Duet*, 50 STAN. L. REV. 1577, 1579 (1998).

For another type of challenge to the preference assumptions made in much of the behavioral law-and-econ literature, see Barbara Fried, *But Seriously, Folks, What Do People Want?*, 65 STAN. L. REV. 1249, 1250 (2013) (asking what happens to much of this work if we question the typical assumption that agents’ “true” preference is to maximize consumption, as opposed to “minimiz[ing] the time and mental energy spent on trades”—or, taken even further, that their preference is to not “go through life relating to their environment as a potential source of gains from trade”).

¹⁶⁹ Related arguments are made in a generalized form by CONLY, *supra* note 54, at 4.

¹⁷⁰ See Olivia S. Mitchell & Stephen P. Utkus, *Target-Date Funds in 401(k) Retirement Plans* (Wharton Pension Research Council, Working Paper 2012-02, Mar. 2012),

the extent we rely instead on their revealed preferences, behavioral economics again helps remind us that this is no help: the question is too sensitive to framing issues and other biases. Moreover, if the only form of autonomy we want to respect is a small amount of variation in individual risk preferences, there are narrower and safer ways to accomplish this than the current free-for-all.

The third argument a libertarian paternalist might make—that Ben’s true ends are something unique, and we have to take those seriously—is considerably more compelling, but ultimately just as unconvincing. For one, it is not clear we can ever coherently distinguish between means and ends without recursion. The libertarian paternalist might think the compulsive gambler who gambles because she enjoys the thrill of it all, rather than to make money, still holds an even “higher” end of wealth preservation, which she has simply forgotten because of a cognitive or physiological bias. In large part, this presents another version of the conventional time-framing problem that is pervasive across law, and to which there is no technical solution.¹⁷¹ In Ben’s instance, we can easily imagine that when Ben hits age sixty-five and finds that his retirement fund is inadequate and underperformed relative to those who followed the nudge, he may wish we had forced him to listen back when he was twenty-five. We do not have to imagine it: we know empirically that workers’ intentions towards and perceptions of their own retirement change considerably with age,¹⁷² and that confidence in retirement savings varies with age.¹⁷³ Which of the

available at <http://fic.wharton.upenn.edu/fic/papers/12/12-04.pdf>. Of course, this is in many ways the core insight of those who work on choice architecture.

¹⁷¹ Kelman, *supra* note 2, at 3 (pointing out that an agent “does not have a single evaluative perspective” and we have to defend our decision to privilege one of those perspectives); see also Mark Kelman, *Interpretive Construction in the Substantive Criminal Law*, 33 STAN. L. REV. 591, 594 (1981) (identifying the same problem as pervasive in criminal law in determinations of blameworthiness, which are inevitably dependent on how we choose to time-frame a defendant’s actions).

¹⁷² See David Ekerdt, Karl Kosloski & Stanley Deviney, *The Normative Anticipation of Retirement by Older Workers*, 22 RESEARCH ON AGING 1, 16 (2000) (explaining that the sense of proximity to retirement impacts behavior towards retirement planning); David Ekerdt, Karl Kosloski & Stanley Deviney, *Stability and Change in Plans for Retirement* (HRS/AHEAD Working Paper Series, No. 96-035, July 1996) (explaining how intentions of plans in retirement, e.g., whether to work part time, vary considerably).

¹⁷³ See, e.g., OneAmerica, *Plan Participant Survey* (Summer 2012), http://oneamerica.newshq.businesswire.com/sites/oneamerica.newshq.businesswire.com/files/publication/file/Participant_Web_Survey_Results_for_Web.pdf. Of course, some portion of this diminished confidence could also be due to more accurate information—but that information feeds inexorably into an agent’s self-conception of her preferences and ends, again rendering the notion of measuring those ends descriptively and normatively incoherent.

various versions of Ben are policymakers meant to respect in considering an agent's ends? There is, of course, no real answer in a descriptive sense.

Beyond the descriptive problem, there is also a normative question: Should we care? Setting aside deep philosophical debates about the value of autonomy,¹⁷⁴ the answer also depends on what we think our retirement system is supposed to accomplish. Grand libertarian rhetoric notwithstanding, there is absolutely nothing *obvious* or *inevitable* about the merits of autonomy in 401(k) allocation. In fact, our private retirement savings scheme is *already* deeply paternalistic¹⁷⁵ and coercive—in the form of the tax advantage we provide for defined-contribution savings. Why do we offer this scheme in the first place? Those who would say it serves a primarily societal function—creating a retirement safety net and preventing individuals from becoming wards of the state—should not be so hesitant about stating the obvious: we need to tell Adam and Ben how to invest their money. By contrast, one can imagine more individualistic conceptions of the subsidy—encouraging people to participate in the market and helping them develop financial literacy, in which case perhaps errors are valuable. Alternatively, perhaps the real function of the scheme is to provide a valuable subsidy to the mutual fund industry, although there may be more efficient ways of doing that.

This implies that the value of nudges and other “soft” approaches might be very different in the retirement context than in the general investment context, depending on one's theory of why we want individuals participating in either. In other words, it is totally plausible to think that we should mandate particular investment strategies in a tax-advantaged retirement scheme that is designed to lessen the burdens on the state to provide for people in old age, but at the same time to want to allow individual, self-directed participation in the stock market to allow a wider range of purposes, including self-expression. The point is that answering these questions cannot simply rely on some underdeveloped notion of revealed preferences—it has to rely instead on arguments about the rationale underlying an already pervasively regulated system created by government tax expenditure.

It can be difficult to understand the jump frequently made by those anti-paternalists who *understand* the role of cognitive biases and other framing choices, *accept* the inherent difficulty and incoherence of ever measuring a “true” preference, *worry* that government nudging will be incomplete or flawed because of further cognitive biases, and then *conclude* that the pre-nudged “state of nature” is thus somehow “neutral” or superior when measured on autonomy grounds.¹⁷⁶ In making that final jump, many of

¹⁷⁴ CONLY, *supra* note 54, at 2–3.

¹⁷⁵ Weiss, *supra* note 15, at 1279.

¹⁷⁶ See, e.g., MARK D. WHITE, THE MANIPULATION OF CHOICE: ETHICS AND LIBERTARIAN PATERNALISM 149 (2013). See also SUNSTEIN & THALER, *supra* note 1, at 252–53.

these authors seem to conflate normative philosophical arguments for the intrinsic worth of autonomy with positive “proof” that un-nudged preferences better respect autonomy.

Of course, it remains entirely plausible that once we accept that preferences will always be manipulated *somehow* by someone, the normative value of autonomy is better served, in a real-world positive sense, by a system in which preferences are manipulated “more” by democratic governments than by, say, big business and advertising firms. Even more likely, it may just be the case that autonomy, in a world where all our desires are contingent and subject to framing and manipulation, is just a vapid concept for describing policy choices.

C. The Limits of Other Remedies

1. Why Disclosure Won't Help

Remedies that seek to improve allocation decisions through improved disclosure or financial literacy are difficult to take seriously, given the overwhelming evidence on behavioral biases, investor literacy,¹⁷⁷ and the lack of incentives for typical corporate-governance remedies to work.¹⁷⁸ The problems with disclosure, a technique scholars and policymakers have often taken as a panacea, have been the subject of prominent academic critiques in recent years.¹⁷⁹ In the conflict-of-interest-rich environment of retirement savings, there is reason to suspect disclosure could be not just useless, but actually have negative consequences—a phenomenon of which there is growing evidence in related areas of law. On the demand side, disclosure may increase the trust individuals have without them focusing on the content of the disclosure; on the supply side, experiments have shown

¹⁷⁷ See *supra* Part I.A.

¹⁷⁸ While there are limits to disclosure in the public-company context as well, there are incentives for some investors to take advantage of informational advantages (for example, by analyzing disclosures) and effectively arbitrage corporate-governance rights. See, e.g., Ron Gilson & Jeffrey Gordon, *Agency Capitalism: Further Implications of Agency Capitalism* (European Corporate Governance Inst., Law Working Paper No. 239/2014, Feb. 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359690. The role of exit rights in the mutual fund context vastly diminishes those incentives. See *supra* note 124.

¹⁷⁹ See, e.g., Omri Ben-Shahar, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 665 (Feb. 2011); Matthew A. Edwards, *Empirical and Behavioral Critiques of Mandatory Disclosure: Socio-Economics and the Quest for Truth in Lending*, 14 CORNELL J.L. & PUB. POL'Y 199, 248 (2005); Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 511 (2007); Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059, 1105 (2011).

that advisers may give “worse” advice after disclosing, in an attempt to counteract possible effects of disclosure.¹⁸⁰

But the regulatory regime governing both retirement plans (through the DoL) and mutual funds (through the SEC) still relies primarily on disclosure. The DoL has recently modified fee disclosure rules to require plan administrators, usually employers, to collect and disseminate to participants information on fees charged by all providers involved in a retirement plan.¹⁸¹ It is hard to imagine that this will accomplish much. Even if employees were likely to read and comprehend the disclosure—a full eleven pages long in the DoL’s *simplified* model version¹⁸²—it is unclear how employees would know if fees were appropriate or not. It is even more unclear what an employee should do if the fees seemed inappropriately high, as the collective action problems are enormous,¹⁸³ and the notion that retirement plan fees play much role in employees’ choice of where to work is obviously suspect. The DoL’s guidance to employees on what to do with fee information—carefully written to avoid suggesting any stance by the agency—provides little help.¹⁸⁴

Even the best recent counter-critique of “notice skepticism” does not rehabilitate the possibilities for disclosure in the retirement savings realm.¹⁸⁵ With a particular focus on Internet privacy, Ryan Calo has eloquently argued that before we give up on notice-based strategies, we should experiment with more innovative forms of disclosure, such as “visceral notice” or “showing” rather than telling the results of a particular policy. Unlike nudges, he argues that notice does not attempt to “manipulate preferences but instead gives consumers the information they need to act upon preferences.”¹⁸⁶ But one of Calo’s key assumptions is “that consumers come to the web with preexisting privacy preferences,”¹⁸⁷ providing a good

¹⁸⁰ Daylian Cain, George Loewenstein & Don Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005).

¹⁸¹ 29 C.F.R. § 2550.404a-5 (2013).

¹⁸² U.S. Dep’t of Labor, *ABC Plan 401(k) Fee Disclosure Form*, available at <http://www.dol.gov/ebsa/pdf/401kfeform.pdf>.

¹⁸³ Plaintiffs’ firms can and do play some role in remedying these problems, but they are of little help in the retirement fund context because courts are reluctant to play a role in judging fees. *See supra* Part III.B.

¹⁸⁴ U.S. Dep’t of Labor, *Understanding Your Retirement Plan Fees*, <http://www.dol.gov/ebsa/publications/understandingretirementfees.html> (last visited Sept. 25, 2014).

¹⁸⁵ Ryan Calo, *Against Notice Skepticism in Privacy (and Elsewhere)*, 87 NOTRE DAME L. REV. 1027, 1057 (2012).

¹⁸⁶ *Id.* at 1046. Advocates of nudges, many of whom emphasize that they want to respect “ends” while only nudging “means,” might disagree with Calo’s characterization—whether or not their distinction makes coherent analytical sense.

¹⁸⁷ *Id.* at 1046 n.106.

reason to let individual consumers more precisely tailor their online behavior to their own personally desired optimal level of privacy.

As discussed in Part III.B, that assumption of heterogeneous preferences that are *known* to consumers is not meaningfully true in the retirement-allocation context. On one level, core preferences are likely to be fairly homogenous: maximize wealth for retirement. On the more fine-grained level, we may not trust individuals' assessments of their own heterogeneous preferences, again either because we think they are "wrong" and subject to some kind of cognitive bias that, if they recognized, or given the passage of time and changing preferences, they would want to have overridden, or because we do not care because we believe the retirement system serves a social rather than individual function.

Calo's article stems from the widespread sense that disclosure is, in his paraphrase of the Churchill quote, "the worst regulatory mechanism, except for all of the alternatives."¹⁸⁸ Direct regulation, so the typical argument goes, may have unintended consequences, including stifling innovation, and may be harder to enforce. Uncertainty of what the best result is warrants a light touch. However, as we increase and refine notice requirements to try to produce intended results, we are inevitably making the same judgment calls that direct regulation would require. For instance, the toughest proposal for disclosure elsewhere in financial products regulation—Jill Fisch's idea of "conform or explain"¹⁸⁹—would require regulators to decide what a "plain vanilla" product looks like. That call requires policymakers assessing the same kinds of data they would need to *require* all products to conform. If the only reason we choose disclosure is to accommodate a degree of uncertainty—a problem inevitable in all policy-making—we ensure that those who *most* need our advice, however uncertain it is, will be those who are *least* likely to get it. That is virtually ensured not only by financial illiteracy, but also because notice incentivizes regulated entities to take steps to counter-bias any potential consequences from disclosure.

2. *Limits of Fiduciary Duties*

Another approach has involved proposals to broaden the scope of fiduciary duties¹⁹⁰ that apply under ERISA to entities involved in retirement

¹⁸⁸ *Id.* at 1047.

¹⁸⁹ The most articulate proponent of this strategy is Jill Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 2028–35 (2010) (arguing for a "conform or explain" regime in the mutual fund context, since funds should be thought of as resembling financial products rather than corporations).

¹⁹⁰ There is a broader debate about expansion of fiduciary duties in the investment advice and broker-dealer context, and Dodd-Frank required the SEC to consider changes

plans. This approach may seem like a form of direct regulation, but in reality it tends to have so many safe harbors that it is more accurately described as a soft approach—a nudge, in a sense, directed at the retirement industry and employers by offering a menu of approaches likely to decrease possible liability. Such efforts at strengthening these duties include broadening the interpretations of the duties themselves,¹⁹¹ or expanding the group of people deemed fiduciaries.¹⁹² Once again, these strategies are unlikely to help much because of the pervasive conflicts of interest in the retirement and fund industries with respect to allocation decisions, and also because the party that would have to get involved to make them work well—the judiciary—is not likely to step up to the task.

In the most general sense, fiduciary duties seem like they could be helpful. Fiduciary duties serve as a legal tactic for institutional design, a

to the standards applicable to both (including possibly giving broker-dealers the same fiduciary duty as an investment adviser). For a good discussion, see Edwards, *supra* note 96. See also SEC, Study on Investment Advisers and Broker Dealers (Jan. 2011), <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>; SEC, Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty (2013), <http://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf>.

¹⁹¹ See, e.g., James Kwak, *Improving Retirement Savings Options for Employees*, 15 U. PA. J. BUS. L. 483, 487 (2013) (arguing that DoL should reinterpret ERISA to push employers to offer low-fee index funds). Following their study on losses caused by fiduciaries' menu designs, *supra* note 38, Ayres and Curtis sent letters to numerous companies who have high-cost plans reminding the companies of their fiduciary duties; the fund industry decried the letter. See, e.g., Kelly Greene, *Letters about 401(k) Plan Costs Stir Tempest*, WALL ST. J., July 24, 2013; Jo Ann Butler and Eric Paley, *Much Ado About Nothing...Or Is It?*, NIXON PEABODY BENEFITS ALERT (Nixon Peabody LLP), July 2013), available at http://www.nixonpeabody.com/files/157700_Benefits_Alert_07_18_13.pdf (calling the letter “condescending” and noting that Ayres “should not expect many dinner invitations from the plan sponsor community in the near future;” among its most incoherent explanations for that study is flawed and the letter should be disregarded: the data used in the study—the data reported by plan sponsors to the DoL—are not accurate in the first place because “sponsors do not accurately report fees on form 5500s!”).

Other scholars have similarly suggested that increased evidence on the effects of defaults could lead to new theories of fiduciary liability that previously might have failed. See James Poterba, Comment, *For Better or for Worse: Default Effects and 401(k) Savings Behavior*, in PERSPECTIVES ON THE ECONOMICS OF AGING 81, 122 (2004), available at <http://www.nber.org/chapters/c10341> (“[I]f the defaults that the firm chooses for its saving plan have significant consequences for worker wealth accumulation, then firms may face future court challenges if workers reach retirement with inadequate resources and their resource shortfall can plausibly be traced to the firm’s default policies.”).

¹⁹² The most prominent instance of this is a rule proposed by DoL to expand the definition of fiduciaries under ERISA. 75 Fed. Reg. 65263, 65272 (Oct. 22, 2010). The rule met with significant resistance from industry groups, and DoL tabled it but said it plans to re-propose a modified rule in the future.

technique by which law can affect the allocation of responsibility. Fiduciary duties can help to create “due influence” by realigning incentives between a party in need of protection, the principal, and a party more capable of providing that protection, such as the agent, who might otherwise make decisions adverse to the principal. They shift responsibility from the principal to the agent and, in their most extreme version, put the agent directly in the shoes of the principal.

There are a few key aspects of the fiduciary relationship in the retirement allocation context that limit its potential to help. For one, we often conceptually think of fiduciary duties as similar to nudges: they respect a principal’s given ends, while allowing a more expert party to choose the means to that end. Consider the familiar notion in legal ethics that the client chooses ends, and the lawyer chooses means. However, as discussed above in Part III.B, there is little reason to trust savers’ ability or need to choose desirable ends in the retirement context, nor to think they can intelligently monitor the agent’s choice of means.

ERISA, which encompasses many parties in its definition of fiduciary, may make that monitoring problem even worse. Essentially, we have thrown too many agents at the problem, each of whom has a financial conflict of interest with the saver regarding allocation decisions, and all of whom create an increasingly complicated web of connections that makes it hard for the principal to monitor. Consider the range of entities involved in a particular plan who may hold a fiduciary duty: the employer, the trustee, the company hired to administer the plan, various investment advisers, members of the plan’s investment committee, and others.

Fiduciaries do not act in a vacuum. Even applying the same vague legalistic fiduciary standard to, for example, an employer and to a mutual fund family will result in very different behavior. In other words, a fiduciary’s actor is not determined only from the design of its fiduciary incentives—which are, like all standards, necessarily vague, incomplete, and indeterminate—but by other incentives it faces. For instance, such companies also face a fiduciary responsibility to their shareholders to maximize profits.¹⁹³ As a result, other conflicts of interest—most notably that funds can earn lucrative fees through strategies that are detrimental to investors—will coexist with, and often trump, any vagueness in the fiduciary duty regime.

Perhaps most importantly, courts have chosen to and are likely to remain on the sidelines, largely because of perceptions of institutional com-

¹⁹³ The independent board requirement for mutual funds is supposed to be partly a solution to this problem, but as argued compellingly elsewhere, it fails in that function. See *supra* note 124; John A. Haslem, *Why Have Mutual Fund Independent Directors Failed as ‘Shareholder Watchdogs?’*, 19 J. INVEST. 7 (2012).

petence. ERISA's fiduciary duties, like most such duties, are subject to extensive exceptions and safe harbors to provide predictability for businesses involved in the retirement industry. Like the business judgment rule in corporate law, these exceptions have come to dwarf the rule. Likely due to concerns about their own institutional competence, courts have largely bowed out from any such role.¹⁹⁴ In the earlier days of defined-benefit arrangements, typical litigation concerned fraud and other straightforward misappropriation—cases to which the judiciary believes itself well suited. Recent defined-contribution litigation instead asks courts to weigh nebulous economic concepts over which courts have little institutional competence, such as whether plan provider fees are unreasonable. Courts have mostly rejected any role in such claims in the retirement context, or in mutual funds in general.¹⁹⁵ A recent batch of plaintiffs' suits alleging high fees and self-dealing against major employers has moved further along than in the past, producing several large settlements, but has shown no signs of breaking through into the judicial regime.¹⁹⁶

A possible "third way" approach, encouraged by the PPA,¹⁹⁷ involves programs that render advice from third parties, who receive a per-participant fee from the employer for providing allocation advice, but who accept no money from fund providers and thus do not have the same flawed incentives. This could theoretically solve the incentive misalignment problem created by the switch from defined-benefit to defined-contribution arrangements. At the same time, there are several possible concerns. First, unlike in a defined-benefit arrangement, in which employers bore direct financial obligations, the primary performance incentives on advice ar-

¹⁹⁴ Some scholars have noted that while there is a long-running debate on the role of courts in policy issues, the ERISA regime meant that cases for retirement savings losses following stock-market volatility were inevitable, and thus hoped that courts would at least grapple seriously with the policy issues. See Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 U. MICH. J.L. REFORM 469, 474 (2001).

¹⁹⁵ See *Jones v. Harris*, 559 U.S. 335 (2010) (putting a burden on plaintiffs arguing unreasonable fees that no plaintiff has ever successfully met). That decision explicitly rests on a view of the role of fund governance and independent directors that most scholars consider faulty. See *supra* note 124.

¹⁹⁶ See, e.g., *Beesley v. Int'l Paper*, 2009 U.S. Dist. LEXIS 7999, at *3 (S.D. Ill. Feb. 4, 2009); Linda Stern, *How 401(k) Lawsuits Are Bolstering Your Retirement Plan*, REUTERS, Nov. 5, 2013 (discussing the role of St. Louis plaintiffs' attorney Jerome Schlichter in bringing numerous such cases).

¹⁹⁷ 29 U.S.C. 1108(g) (2012) (defining an "eligible investment advice arrangement"—which receives exemptions from many ERISA requirements—as an entity gives advice under a fee structure that does "not vary depending on the basis of any investment option selected" or "uses a computer model" to generate the advice). The best known of these programs is Financial Engines, but others include GuidedChoice or an offering from Merrill Lynch.

rangements are in the form of competition. Second, they are not mandatory, so they may replicate many of the same opt-out problems discussed in Part II. The prevalence of opting out may not be evenly distributed among savers and may, once again, disproportionately affect those who most need interventions. Third, transparency is lacking: because the market is potentially quite lucrative and very competitive, companies have been tightly guarded about their algorithms and underlying allocation strategies. Finally, most obviously, the programs cost money that, even if technically paid by the employer, may reduce retirement savings, although by how much is an open question.

CONCLUSION

This Article does not conclude with an elaborate design for a more perfect retirement system.¹⁹⁸ Instead, its goal is to serve as a reminder to paternalism-shy regulators and scholars. In leaning on soft regulatory solutions, we too often forget the lessons of behavioral economics itself. In the retirement allocation system in particular, we think too little about the problems posed by the unique set of misaligned incentives in mutual funds and retirement services. In other words, readers can view this Article as a bit of a “nudge” itself—not a blanket decree that nudges should always be avoided, but an attempt to counter-bias those scholars who have developed overconfidence in nudge-based strategies. There is not a single policy option that stems from its argument, although those disappointed in the likely failure of allocation nudges would do well to consider direct regulation of the products available for investment in retirement plans. Such an approach would require funds to meet certain requirements with respect to fees and investment content in exchange for the chance to compete in the lucrative, taxpayer-subsidized retirement savings game.

Three basic implications for policy on 401(k) allocation flow from this account. First, what design interventions are optimal depends on *what purpose we want 401(k)s to serve*, and we lack a coherent narrative of their rationale. Too often we assert abstract values—like autonomy, which animates much of the libertarian paternalist instinct—without reference to the

¹⁹⁸ A good one (from outside the legal academy) is Teresa Ghilarducci, *Pension Reform in the United States: Guaranteed Pension Accounts are Key*, 2 *ROTMAN INT'L J. PENSION MGMT.* 58, 60 (2009). Another is Dana Muir, *Choice Architecture and the Locus of Fiduciary Obligation in Defined Contribution Plans* 19 (Ross Sch. of Bus. Working Paper No. 1183, Dec. 2012). Muir also provides some comparative analysis of Australia's “superannuation” retirement system, which may provide a useful model—unlike many European systems, Australia's provides for significant consumer choice and private competition, while at the same time entailing greater direct regulation.

higher-order purposes they do or do not serve in a given policy application. It seems clear that the retirement-savings system has a paternalistic foundation, in the form of a tax subsidy designed to encourage a specific outcome, and that should provide at least some basis for guiding policy choices.¹⁹⁹

Second, to the extent 401(k)s serve a societal purpose, we should be *skeptical of “soft” strategies*—disclosure and nudging—and more readily accepting of direct regulation *in domains that involve pervasive conflicts of interest*, like allocation. Direct regulation can take a variety of forms—including, in one basic version, regulating the quality and fee structure of those lifecycle funds that want to serve as default investment options.

Third, we should be *more aware of the alignment and misalignment of incentives*. While this Article does not advocate a return to the defined-benefit schemes of yesterday, it is worth recalling that defined-benefit schemes relied on a series of market-based incentive alignments between employer and employee,²⁰⁰ while allocation decisions in defined-contribution schemes are largely compromised because of a direct misalignment, or conflict, of interests.

¹⁹⁹ Other underlying purposes are obviously plausible. Employer-sponsored retirement plans, for instance, may continue to serve firms in recruiting and retaining qualified workers. On why employer costs might not equal employee value, see, e.g., Melissa Famulari & Marilyn Manser, *Employer-Provided Benefits: Employer Cost versus Employee Value* 112, MONTHLY LAB. REV. 24, 28 (1989).

We might also see inherent value in incentivizing widespread individual participation in the stock market. This purpose could help explain why some 401(k)s have a directed brokerage option that allows employees to pick individual stocks—an option whose existence is hard to explain under any understanding of academic finance, which pretty much uniformly would agree that individuals should not pick individual stocks in their retirement portfolio, if in any portfolio. Alternatively, a public-choice or capture theory could explain why brokerage windows—which charge higher fees and are more prone to lucrative churning—are allowed.

It might also be a way of ensuring that a portion of the overall retirement-savings mix allows individuals to control their own risk/reward tradeoffs. For a discussion of the notion that individuals have, understand, or can supply an individual risk/reward proposition in any meaningful sense, see *supra* Part II.C.

²⁰⁰ Those alignments could extend further, for example, to pension insurers, who had market incentives to monitor employers’ pension management. It should also be noted that another behavioral bias, availability, might be causing us to over-dramatize the problems faced by defined-benefit plans. Many people associate employer-sponsored defined-benefit plans with the numerous problems with underfunded state and local pensions, because the latter are in the news so much. But the analogy is fairly irrelevant: accounting rules and tighter standards under ERISA were able to fix most of the problems caused in the private-employer context, while pay-as-you-go accounting in the states poses an entirely unrelated set of problems.

The new MyRA “starter” accounts, announced in this year’s State of the Union address,²⁰¹ may suggest a possible path towards a more paternalistic allocation scheme. The accounts are available to anyone, whether or not they have a workplace savings plan, and are run for free by the government.²⁰² There is only one investment option: a government-run plan that pays the same variable interest rate as the Government Securities Investment Fund available to federal workers;²⁰³ participants face no risk of losing money. Since the goal of these plans is to get new participants into the retirement system, an interesting question is whether these new participants will become used to the single investment choice, and when they switch into the 401(k) system, react with alarm to the dizzying array of choices that retirement-plan sponsors normally push. The value people place on “choice” is not intrinsic but rather defined, in large part, by their expectations.²⁰⁴ Changed expectations could open the door to more paternalistic policy interventions.

Is nudging better than nothing? One response to this Article would hold that nudging reflects a feasible political compromise in an era of otherwise intractable partisanship, and the PPA’s nudges represent better regulation than simply leaving retirement savers as they were. That argument has some appeal, but it does not take nudgers at their word. Many nudgers have not been modest in their claims. Cass Sunstein has referred to nudges as “usually the best response ... in the face of behavioral market failures,” and believes that nudges can increase welfare “without compromising the legitimate claims of freedom of choice.”²⁰⁵ This Article suggests reasons for skepticism on both claims.

But this Article’s argument goes further than simply saying that nudging may not be the best of all possible worlds. Indeed, there are reasons to worry that the PPA has in fact left some savers worse off on investment allocations. TDFs are increasingly problematic in ways that could be entirely

²⁰¹ President Obama, State of the Union address (Jan. 28, 2014), available at <http://www.whitehouse.gov/the-press-office/2014/01/28/president-barack-obamas-state-union-address>.

²⁰² White House Office of the Press Secretary, *Fact Sheet: Opportunity for All: Securing a Dignified Retirement for All Americans* (Jan. 29, 2014), available at <http://www.whitehouse.gov/the-press-office/2014/01/28/fact-sheet-opportunity-all-securing-dignified-retirement-all-americans>. Contributions of up to \$5,500 a year can be made as long as the account balance is below \$15,000.

²⁰³ The fund is one of several offered as part of the U.S. government’s thrift savings plan, whose small range of investment options (six) all reflect passive investment strategies with extraordinarily low fees.

²⁰⁴ Projection—a cognitive bias in which we project our own desires onto others—might help explain why the financial professionals who oversee retirement plans assume that participants desire lots of complicated financial choices.

²⁰⁵ CASS R. SUNSTEIN, *WHY NUDGE? THE POLITICS OF LIBERTARIAN PATERNALISM* 17, 165 (Yale U.P. 2014).

predicted by attentiveness to supply side incentives. Opt-outs are making poor decisions, and the distribution of opt-in and opt-out decisions on particular types of savers may be correlated with financial vulnerability in problematic ways. On top of that, the sense that nudging has fixed the problem—and the creation of new industry players who have redefined expectations around the PPA and who will now have reasons to oppose anything that would weaken the incentives to push people into TDFs—has decreased regulatory will for additional reform.

Choice architecture is inevitable. Choices will always be contingent on framing and presentation, and behavioral economics has drawn valuable attention to that problem. But this observation does not let us escape from making fundamental policy choices—if anything, it only makes the need to make them more acute, since we have more reason to mistrust choices made without active intervention.

At a general level, this Article suggests that policymakers and academics should think carefully about which domains are susceptible to nudging. There are three lessons. First, we should consider not only the “nudged,” but also other sources—the suppliers and other third parties who may seek to either counter-nudge or otherwise undermine a successful nudge. Second, we should remember that the concept of nudging originated out of a growth in behavioral economics, and we should try to reserve nudges for situations in which we can closely connect them to the cognitive problems we seek to solve. Finally, we should carefully consider whether and how autonomy—a key value upheld by libertarian paternalists—matters in a given policy domain before simply assuming that a nudge provides the optimal solution. Use of nudges is too often an easy way out of a difficult policy problem, and, not surprisingly, easy solutions to thorny policy dilemmas are usually illusory.