LEGAL UPDATE

Modern Portfolio Theory and Efficient Markets

Marcia S. Wagner, Esq.

When the DOL issued its regulations in June of 1979 defining prudence under ERISA, it chose to rely upon modern portfolio theory, which, rather than view investments in isolation, takes into account their role as part of an investment portfolio. In 2017, the modern portfolio theory is perhaps not so highly regarded as it was in 1979. The rationality upon which it was premised has been challenged by behavioral finance, and some empirical studies, which have the advantage of being able to make computations that would have been extremely difficult to make in 1952, have called into question whether it can accurately predict real-world developments. However, the Supreme Court in cases such as *Halliburton v. Erica P John Fund* (a non-ERISA securities fraud case) and *Fifth Third Bank v. Dudenhoeffer,* have reaffirmed the court's commitment to modern portfolio theory and the efficient capital market theory. What is the significance of that continued reliance for investment advisors, particularly as plans look to alternative investments, which are frequently illiquid?

Modern portfolio theory assumes liquid markets, and does not allow for illiquidity and informational problems. Modern portfolio theory rests on the assumption that organized securities markets are so efficient at discounting securities prices that the current market price of a security is highly likely already to impound the information that is known or knowable about the future prospect of that security. However, "special circumstances" including illicit forces such as fraud, improper accounting, and illegal conduct, or other evidence could indicate that a market is inefficient. Consistent with that analysis, courts have concluded that the active dissemination of knowingly false information or the concealing and misrepresentation of material information indicate that there is not an efficient capital market. In such cases, modern portfolio theory cannot be a defense to allegations of breach of fiduciary duty.

In *Coburn v. Evercore Trust Company,* the Court of Appeals for the District of Columbia Circuit noted in a footnote that an inefficient market, by definition, does not incorporate into its price all of the available information about the value of a security. The Court also noted in *Dudenhoeffer* that the Supreme Court stated that market efficiency is a matter of degree and accordingly a matter of proof. The Court of Appeals for the DC Circuit left open the question as to the degree to which a market must be inefficient to meet the "special circumstances" (circumstances to which the market price does not accurately reflect the value of the stock, such as fraud or corporate malfeasance) test specified in *Dudenhoeffer*. However, while not specified in *Dudenhoeffer*, other courts have identified as factors to be taken into account in determining the degree to which a market is efficient: (i) the average weekly trading volume; (ii) the number of analysts who follow the stock; (iii) the existence of market makers and arbitrageurs; (iv) the ability of the company to file a Form S-3 with the Securities and Exchange Commission; (v) evidence of share price responsiveness to unexpected events; (vi) the degree of market capitalizations—stocks with higher market capitalizations tend to be more efficient; (vii) small bid-ask spread; (viii) percentage of shares available to the public; and (ix) listing on the New York Stock Exchange or other national market. Note, however, that if such an analysis is performed, the Supreme Court's decision in *Dudenhoeffer* provides no guidance to lower courts as to the degree that there is a variation from an efficient market to constitute "special circumstances."

Furthermore, advisers need to be aware that modern portfolio theory cannot provide a complete defense to breach of fiduciary duty claims, at least at the pleadings stage, where ideally advisers would like to have them dismissed. That is, while the prudence of a particular challenged investment will ultimately be judged only after considering the role the investment played in the entire portfolio, at the pleading stage, a plaintiff may be able to allege more than the mere possibility of misconduct. Finally, advisers should be aware that while the DOL's views on modern portfolio theory as expressed in the regulations defining prudence with respect to investments are equally applicable to defined benefit and defined contribution plans.

Marcia S. Wagner *is the Managing Director of The Wagner Law Group. She can be reached at 617-357-5200 or* Marcia@WagnerLawGroup.com.