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Fifth Circuit Court of Appeals Invalidates the 2016 Final Department of Labor Fiduciary Rule and Related Prohibited Transaction Exemptions

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What's a financial advisor to do? On March 15, 2018, the Fifth Circuit Court of Appeals in *Chamber of Commerce of the U.S. v. U.S. Dep't. of Labor*, No. 17-10238, 2018 U.S. App. LEXIS 6472 (5th Cir. Mar. 15, 2018) vacated – thereby invalidating – a series of seven rules (which we collectively refer to in this post as the "fiduciary rule") issued in April 2016 by the Department of Labor (DOL). The fiduciary rule vastly expanded the reach of the ERISA fiduciary standards that apply to individuals and entities providing investment advice. This post first explains the state of the law prior to the fiduciary rule; it then discusses the impact of the rule on the arguments that the Court grappled with; and it concludes by handicapping the options available to regulated financial advisors and institutions as they endeavor to respond.

A majority of the Fifth Circuit held that the DOL acted in an arbitrary and capricious manner when, among other things, it expanded the class of advisors regulated as "investment advice fiduciaries," and created a new broad-based ERISA prohibited transaction class exemption known and referred to as the "Best Interest Contract Exemption." In a dissenting opinion, the Court's chief judge demurred, expressing the view that the DOL acted well within its authority in issuing the fiduciary rule. This decision calls the fate of the fiduciary rule into question. (The DOL has announced that it will suspend enforcement of the fiduciary rule). It also leaves investment advisors and the firms that employ them in a quandary as to how best to proceed.

To say that the fiduciary rule is contentious is an understatement. Proponents claim that the fiduciary rule is essential to protect retirement savings, particularly of rank-and-file, retail investors. Opponents argue that the rule is contrary to law and, if allowed to remain in place, would serve only to drive up costs unnecessarily and have the effect of reducing the range of retirement services and advice that broker-dealers make available to retail investors. Given the amounts held in U.S. retirement accounts – $27.9 trillion as of December 31, 2017 according to the Investment Company Institute – the stakes are enormous.

The Law in Effect Before the Fiduciary Rule

Fiduciary standards are a cornerstone of ERISA's regulatory edifice. Fiduciaries are required to adhere to basic norms of prudence and loyalty, and they are obligated to take appropriate measures to protect plan participants and beneficiaries from the potential harm caused by conflicts of interest. ERISA defines the term “fiduciary” with respect to a “plan” to include any individual who:

- Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so.

These individuals are generally referred to as “investment advice fiduciaries.” In 1975, the DOL promulgated a five-part test for determining who is an investment-advice fiduciary. Under that test, an investment-advice fiduciary is a person who:

(1) Renders advice…or makes recommendation[s] as to the advisability of investing in, purchasing, or selling securities or other property;

(2) On a regular basis;

(3) Pursuant to a mutual agreement . . . between such person and the plan; and

(4) Serve[s] as a primary basis for investment decisions with respect to plan assets;” and

(5) Is individualized . . . based on the particular needs of the plan.”

The DOL’s 1975 approach was generally consistent with the framework in federal and state securities laws. The Investment Advisers Act of 1940, a line of federal cases following *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), and similar state statutes and case law impose fiduciary duties on investment advisers who manage securities portfolios or render investment advice, but not on broker-dealer representatives whose only investment advice is uncompensated and incidental to performing securities transactions for or with their customers.

In the preamble to the fiduciary rule, the DOL claimed that the 1975 definition of “fiduciary” is no longer adequate in light of changes to investment landscape, particularly the growth of assets held in individual retirement accounts (IRAs). The DOL was concerned that individual investors might lack the sophistication and understanding of the financial marketplace possessed by investment professionals who manage retirement assets. According to the DOL, under the 1975 rule, “individuals may be persuaded to engage in transactions not in their best interests because advisers like brokers and dealers and insurance professionals, who sell products to them, have ‘conflicts of interest.’” The DOL concluded that “the regulation of those providing investment options and services to IRA holders is insufficient.” Hence the need to expand the class of individuals who qualify as investment advice fiduciaries.

But the DOL’s concern with IRAs is complicated by the statute itself. IRAs are generally creatures of the Internal Revenue Code and, as such, they are beyond the regulatory reach of the DOL. ERISA’s statutory fiduciary obligations of prudence and loyalty do <u>not</u> apply to IRAs and other plans not covered by ERISA. These fiduciary obligations are, however, subject to parallel Code-based conflict of interest or “prohibited transaction rules” that are like those imposed on ERISA-covered plans. Owing to a 1976 Presidential Order, the DOL has the authority to grant administrative exemptions under the Internal Revenue Code’s prohibited transaction rules, if the DOL finds the exemption to be in the interests of plan participants, protective of their rights, and administratively feasible. Even in this context, however, the only statutory sanction for engaging in illegal transactions is the assessment of an excise tax, which is enforced by the Internal Revenue Service.

Another feature of the fiduciary rule worth noting in the context of the Fifth Circuit's decision is the rule's disparate treatment of fixed versus variable annuities. While fixed annuities are regulated as insurance contracts, variable annuities are regulated as securities. The distinction is important, since sellers of insurance products are free to operate under a more favorable prohibited transaction exemption that predated, but which was modified by, the fiduciary rule. As a result, the fiduciary rule's regulation of variable annuity products is far more burdensome than its regulation of fixed annuity products.

The Fifth Circuit Decision

The Fifth Circuit held that the DOL's expansion of the term "fiduciary" conflicted with the statutory text of ERISA. In so holding, the majority focused on the distinction between the sale of investment products and investment advice, which the Court viewed as something about which Congress was aware. Applying long-standing rules governing judicial review of agency rule, the Court found that the fiduciary rule was inconsistent with ERISA. The Court also expressed concern that the fiduciary rule infringed on the regulatory authority of the Securities and Exchange Commission (SEC) which "has the expertise and authority to regulate brokers and dealers." In contrast, the dissent found that the DOL acted reasonably under its power to fashion administrative exemptions in response to changing circumstances.

Both the Fifth Circuit's majority opinion and the dissent are well-reasoned and compelling. They cannot be reconciled, mainly due to the unusual regulatory conundrum here. It is unusual for Congress, as it has with ERISA, to withhold authority from an agency to enforce certain prohibitions while granting authority to the agency to create exemptions to those same prohibitions. At what point does the permissibly asserted authority to narrow the exemptions to the prohibitions become misappropriated authority to define the prohibitions? Because the DOL does not have the statutory authority to regulate IRAs, the majority was of the view that the fiduciary rule endeavored to do something that the statute does not allow. The DOL's response, which the majority found unpersuasive, is that it is merely imposing fiduciary-like requirements on investment advice advisors as a condition of qualifying for an exemption – something that is well within the DOL's authority in the dissent's view. Other Federal courts have agreed with the DOL's position in the matter.

What's Next?

The fiduciary rule's fate is currently unclear. The Fifth Circuit's decision applies nationally, and not just in the jurisdictions that it covers (much of Louisiana and Mississippi and the Eastern District of Texas). By vacating the fiduciary rule in its entirety, the Fifth Circuit appears to have reversed the DOL's replacement of the existing five-part fiduciary definition and modification of existing exemptions, which were embedded in the fiduciary rule, thus reinstating prior law.

What happens next is up to the DOL. It could appeal the Fifth Circuit's decision to the Supreme Court. Given the split in the circuit courts and the significance of the rule, the Supreme Court would likely agree to hear the case. Alternatively, the DOL could petition for rehearing in front of the entire Fifth Circuit bench. If done timely, this would stay the Court's decision. Despite the changing political environment, the DOL has not abandoned enforcement of the fiduciary rule, it has merely delayed certain of its formal requirements. So one might expect the DOL to pursue an appeal. This is by no means certain, however. The DOL could decide to use the decision as a reason to abandon the fiduciary rule altogether or to reconsider anew the regulation of financial advisors by launching a new rulemaking process.

This uncertainty leaves financial advisors and institutions in something of a quandary. The fiduciary rule does not operate in a vacuum. Both the SEC and the many state regulators are moving ahead with their own regulation of the conduct of financial advisors. Thus, a return to the pre-April 2016 law is unlikely. Even in the absence of the fiduciary rule, there has been a shift in favor of imposing some higher standard of care on fiduciary advisors of all stripes than was required by prior law. Currently, investment advice fiduciaries are allowed to operate under a watered-down version of the Best Interest Contract Exemption, under which they must adhere to impartial conduct standards (receiving only reasonable compensation for services, providing advice in the best interests of retirement investors, and making no materially misleading statements), but they are not required to comply with its other formal requirements, including entering into a written contract. This allows fiduciary financial advisors to receive commission compensation, including sales loads, 12b-1 fees, revenue sharing or other payments from third parties that would otherwise give rise to a prohibited transaction.

Not all fiduciary financial advisors are equally affected by the Fifth Circuit’s decision and the DOL’s suspension of enforcement of the fiduciary rule. Sellers of variable annuities may use these developments to operate under the prior law’s prohibited transaction exemption, which is far more favorable to them. While this approach is certainly attractive, it is not without risk, since there is no assurance that the fiduciary rule will not be resurrected.

There are, however, forces larger than just the fiduciary rule at work. The trend toward imposing fiduciary status on financial advisors began with, but is not confined to, the fiduciary rule. A large swath of the retail financial services industry was (and still is) based on a sales-oriented culture to which the fiduciary rule is largely antithetical. The question is whether the absence of the fiduciary rule means a return to that ethic. Based on the action of the SEC and the states, we think not. The challenge instead is to strike the proper balance between sales and advice.

While the Fifth Circuit’s decision will be generally welcomed by the financial services industry, it strikes us as risky to assume that the fiduciary rule no longer applies to them. The immediate questions facing many firms are what to do regarding the use of customer agreements, disclosures, and forms that have been developed or revised to address the fiduciary rule during the interim legal uncertainty of a duration that remains unclear. At a minimum, it would be wise to make no changes until the DOL has shown its hand. The DOL has 45 days from entry of the judgment – May 7 – to request rehearing by the full Fifth Circuit.

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