CLIENT ALERT

# Fifth Circuit Overturns DOL Fiduciary Rule

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On Thursday, in a decision that will likely cause continued uncertainty in the financial services industry about how to treat retirement account investors and clients, the U.S. Court of Appeals for the Fifth Circuit vacated the fiduciary rule and related exemptions (the "DOL Fiduciary Rule" or the "rule") that were issued by the Department of Labor (the "DOL") in 2016.[1] In a 2:1 decision, the court held that the DOL Fiduciary Rule was unreasonable, that the DOL lacked statutory authority to promulgate it, and that the DOL overreached its authority by doing so. The *Chamber of Commerce* decision comes just days after the Tenth Circuit affirmed a district court's judgment in *Market Synergy Group, Inc. v. U.S. Department of Labor*, which held that there was adequate notice to exclude transactions involving fixed index annuities from Prohibited Transaction Exemption 84-24 (which is the exemption generally used to exempt the receipt of commissions in connection with the sale of annuity products), that there was no arbitrary treatment of fixed indexed annuities compared to other fixed annuities, and that the DOL conducted an adequate economic impact analysis about the rule's impact on the fixed indexed annuity industry.[2] Importantly, a footnote in the *Market Synergy* opinion provided that "MSG does not challenge the DOL's authority to issue the rule nor does it challenge the DOL's new definition of 'fiduciary.'" While the *Market Synergy* decision is more limited in scope, the *Chamber of Commerce* decision is more broad and has nationwide effect: the rule has now been vacated in its entirety, including the provisions concerning the treatment of annuity products under the rule.

The DOL Fiduciary Rule, issued in April of 2016, expanded the definition of "investment advice fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA"), amended six existing prohibited transaction exemptions ("PTEs"), and created two new PTEs, including the Best Interest Contract Exemption (the "BIC Exemption"). The rule

[1] *See U.S. Chamber of Commerce v. U.S. Department of Labor*, No. 17-10238, 2018 WL 1325019 (5th Cir. Mar. 15, 2018).

[2] *See Market Synergy Group, Inc. v. U.S. Department of Labor,* No. 17-3038, 2018 WL 1279743 (10th Cir. Mar. 13, 2018).

expanded the circumstances in which broker-dealers, investment advisers, and other intermediaries would be treated as fiduciaries with respect to ERISA plans and individual retirement accounts ("IRAs"), including one-time sales recommendations. While the definition of "investment advice fiduciary" became final in June 2017, the related exemptions under the rule were delayed until July 1, 2019, except for certain exemption conditions, which required compliance with the so-called Impartial Conduct Standards. The Impartial Conduct Standards require fiduciaries to act in their clients' "best interests," receive no more than reasonable compensation, and make no misleading statements.

The U.S. Chamber of Commerce and several other trade organizations representing the financial services industry brought suit against the DOL in federal court, claiming among other things, that the rule was inconsistent with the governing statutes, that the DOL overstepped its authority in promulgating the rule, and that the rule's treatment of variable and fixed indexed annuities was arbitrary and capricious.

In reversing the lower court which upheld the rule, the Fifth Circuit held that the DOL overreached its authority by promulgating the rule, and that the rule itself was unreasonable. The DOL lacks the authority to enact such a rule, the court noted, which deviates unnecessarily from the common law interpretation of "fiduciary," is inconsistent with the statutory framework of ERISA, and fails to meet a statutory need under which the DOL derives the authority to implement regulations under ERISA. "A perceived 'need' does not empower the DOL to craft *de facto* statutory amendments or to act beyond its expressly defined authority," wrote Circuit Judge Edith H. Jones in the majority opinion.

The court's determination that the rule itself is unreasonable is based on the distinction between the DOL's authority over employer-sponsored plans under Title I of ERISA and over IRAs under Title II of ERISA. By statute, a fiduciary of a plan under Title I of ERISA "must adhere to the traditional common law duties of loyalty and prudence," pursuant to which the DOL has the authority to promulgate regulations to that effect. A fiduciary of a plan under Title II of ERISA, such as an IRA, is not subject to the same duties of loyalty and prudence, although IRAs are subject to the prohibited transaction provisions under the Internal Revenue Code, pursuant to which the DOL has authority to exempt certain transactions that would otherwise be prohibited. The rule is unreasonable, the court concluded, because it ignores this distinction.

In particular, the court observed that, without the BIC Exemption, the rule would be "independently indefensible" due to the overbroad determination of who is considered a fiduciary by virtue of the expanded definition of "investment advice fiduciary." The DOL abused its power to exempt prohibited transactions when the BIC Exemption, together with the fiduciary rule, in effect circumvented the DOL's regulatory authority between those plans that fall under Title I and those that fall under Title II. "[A]lthough lacking direct regulatory authority over IRA 'fiduciaries,'" the court wrote, "the DOL impermissibly bootstrapped what should have been safe harbor criteria into 'backdoor regulation.'"

The Fifth Circuit's decision leaves the future of the rule uncertain, and could pave the way for the Securities and Exchange Commission to become the primary regulator across retirement and nonretirement accounts. There is, however, no question that the DOL still retains significant authority and responsibility for the regulation of retirement

accounts and pension plans; the Fifth Circuit's decision simply identifies the limits of that regulatory authority and responsibility. It is expected that the SEC will issue its own guidance on the standards of conduct for investment advisers and broker-dealers during 2018.

In addition, the states may accelerate their efforts to fill the gap left in the wake of the *Chamber of Commerce* decision vacating the rule. Several states have already enacted consumer protection laws extending state law fiduciary requirements to financial planners, and a few others have considered doing the same. In New York, the Department of Financial Services proposed consumer protections in December 2017 that would adopt a "best interest" standard for those licensed to sell life insurance and annuity products – a new obligation that would require that the product that best reflects the customer's interest be offered ahead of what is most profitable to the seller. These state-based laws and regulations raise the prospect of a complex and potentially contradictory number of regulatory regimes.

We will continue to monitor developments that result from the *Chamber of Commerce* decision, as well as any regulations and laws at the state level that impact the sale or delivery of financial products applicable to retirement and nonretirement accounts.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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