Circuit Courts of Appeal Reach Different Conclusions on the Department of Labor's Fiduciary Rule

In a March 15, 2018 decision in *Chamber of Commerce of the United States* v. *United States Department of Labor*, the United States Court of Appeals for the Fifth Circuit vacated in its entirety the so-called "Fiduciary Rule" promulgated by the Department of Labor ("DOL") in 2016, holding that the rule is inconsistent with the Employee Retirement Income Security Act ("ERISA") and that the DOL lacked statutory authority to impose the restrictions and requirements the rule created.[1] Two days earlier, in *Market Synergy Group, Inc.* v. *United States Department of Labor*, the United States Court of Appeals for the Tenth Circuit had reached a different conclusion in a decision that addressed only part of the Fiduciary Rule, holding that the rule's treatment of fixed indexed annuities ("FIAs") was not arbitrary and capricious, and is therefore valid.[2] The two decisions create uncertainty about the viability of some elements of the Fiduciary Rule that ultimately may need to be resolved by the Supreme Court.

I. Overview

At a high level, the Fifth and Tenth Circuit decisions are similar in that both concern the meaning of the term "fiduciary" as used in ERISA and the Internal Revenue Code, and the "arbitrary and capricious" standard established by the Administrative Procedures Act ("APA") to evaluate the propriety of federal agency rulemaking.[3] Congress enacted ERISA to "promote the interests of employees and their beneficiaries in employee benefit plans."[4] Title I of ERISA confers upon the DOL broad regulatory authority over employer- or union-sponsored retirement and welfare benefit plans,[5] whereas Title II created tax-deferred personal IRAs and other similar accounts under the Internal Revenue Code.[6] Under Title I, fiduciaries are subject to regulation by the DOL, whereas under Title II fiduciaries are subject to certain prohibited transactions provisions. These prohibited transactions involve fiduciaries of both ERISA plans and IRAs, and although the DOL is not granted the comprehensive oversight it enjoys under Title I, it is permitted to grant exemptions to penalties imposed under Title II for engaging in prohibited transactions. In April 2016, the DOL announced (i) a change to the "investment advice fiduciary" definition found in Titles I and II; (ii) amendments to the scope of six existing exemptions found in Titles I and II; and (iii) two new exemptions to the prohibited transaction provision in Title II. The various components of this comprehensive overhaul are known collectively as the Fiduciary Rule.

In general, the Fiduciary Rule provides that an "investment advice fiduciary" is an individual who "renders investment advice for a fee."[7] Among the amendments to this definition in the Fiduciary Rule is a proposal to adopt a "Best Interest Contract Exemption" ("BICE"),[8] which would permit investment advice

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[1] *U.S. Chamber of Commerce* v. *U.S. Dep't. of Labor*, 885 F.3d 360, 388 (5th Cir. 2018).

[2] *Market Synergy Group, Inc.* v. *U.S. Dep't. of Labor*, 885 F.3d 676, 686 (10th Cir. 2018).

[3] *See* 29 U.S.C. § 1001 et seq. (ERISA); 26 U.S.C. § 4975 (Internal Revenue Code); 5 U.S.C. § 706(2)(A) (APA) (authorizing a court to "set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law").

[4] *Shaw* v. *Delta Air Lines, Inc.*, 463 U.S. 85, 90 (1983).

[5] 29 U.S.C. §§ 1108(a)-(b), 1135.

[6] 26 U.S.C. § 4975(e)(1)(B).

[7] 29 C.F.R. § 2510.3-21(a)(1) (2017).

[8] 81 Fed. Reg. 21002 (Apr. 8, 2016), *corrected at* 81 Fed. Reg. 44773 (July 11, 2016), *and amended by* 82 Fed. Reg. 16902 (Apr. 7, 2017).

fiduciaries to avoid penalties currently imposed for engaging in certain prohibited transactions. The Fiduciary Rule also includes a proposed amendment to the existing "Prohibited Transaction Exemption 84-24" ("PTE 84-24"), which previously applied to sales of insurance and annuity contracts and authorized permissible commissions for certain transactions.[9] Both the BICE and the amended PTE 84-24 impose new "Impartial Conduct Standards" including duties of loyalty and prudence, standards relating to compensation, and a prohibition against misstatements.[10] Importantly, the Fiduciary Rule leaves Fixed-Rate Annuities within the scope of PTE 84-24, but transitions FIAs to the BICE.

II. The Fifth Circuit's Decision

In *Chamber of Commerce of the United States* v. *United States Department of Labor*, the Fifth Circuit considered a number of challenges to the proposed Fiduciary Rule, including whether the DOL had "overreach[ed] to regulate services and providers beyond its authority," and "the Rule's arbitrary and capricious treatment of variable and fixed indexed annuities," and ultimately vacated the rule in its entirety.[11]

The Fifth Circuit considered as a threshold matter the expanded scope of DOL regulation under the Fiduciary Rule and "whether the new definition of an investment advice fiduciary comports with ERISA Titles I and II."[12] The court explained that "the touchstone of common law fiduciary status" is "the parties' underlying relationship of trust and confidence,"[13] and that the "contemporary understanding of 'investment advice for a fee'" contemplates "an intimate relationship between adviser and client beyond ordinary buyer-seller interactions."[14] The court reasoned, "whether one looks at DOL's original regulation, the SEC, federal and state legislation governing investment adviser fiduciary status vis-à-vis broker-dealers, or case law tying investment advice for a fee to ongoing relationships between adviser and client, the answer is the same: 'investment advice for a fee' [is] widely interpreted hand in hand with the relationship of trust and confidence that characterizes fiduciary status."[15] The court also concluded that the Fiduciary Rule was unreasonable pursuant to the Supreme Court's guidance in *Chevron, U.S.A., Inc.* v. *N.R.D.C., Inc.*,[16] as well as arbitrary and capricious under the APA.[17]

Specifically, the court held that the amended definition of "investment advice fiduciary" in the rule was inconsistent with ERISA Titles I and II, and that the DOL "lacked statutory authority to promulgate the Rule":[18]

> [T]he Fiduciary Rule conflicts with the plain text of the "investment advice fiduciary" provision as interpreted in light of contemporary understandings, and it is inconsistent with the entirety of ERISA's "fiduciary" definition. DOL therefore lacked statutory authority to promulgate the Rule

[9] 81 Fed. Reg. 21147 (Apr. 8, 2016), *corrected at* 81 Fed. Reg. 44786 (July 11, 2016), *and amended by* 82 Fed. Reg. 16902 (Apr. 7, 2017).

[10] *See supra* notes 8, 9.

[11] *Chamber of Commerce*, 885 F.3d at 363.

[12] *Id.* at 368.

[13] *Id.* at 369.

[14] *Id.* at 374.

[15] *Id.* at 376.

[16] 467 U.S. 837, 843 (1984) ("[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.").

[17] 5 U.S.C. § 706(2)(A).

[18] *Chamber of Commerce*, 885 F.3d at 379.

> with its overreaching definition of "investment advice fiduciary."[19] [Furthermore,] [t]he Fiduciary Rule . . . bears hallmarks of "unreasonableness" [under the *Chevron* deference test] and arbitrary and capricious exercises of administrative power.[20]

The Fifth Circuit provided several subsidiary bases for its holding, including that (i) "the Rule ignores that ERISA Titles I and II distinguish between DOL's authority over ERISA employer-sponsored plans and individual IRA accounts;"[21] (ii) the definition of "investment advice fiduciary" is too broad and "comprises nearly any broker or insurance salesperson who deals with IRA clients";[22] and (iii) "the BICE does not adequately narrow the Rule's overbreadth" but instead "extends far beyond creating 'conditional' 'exemptions' to ERISA's prohibited transactions provisions."[23]

III. The Tenth Circuit's Decision

The Tenth Circuit's decision in *Market Synergy Group, Inc.* v. *United States Department of Labor* also considered the legality of the DOL Fiduciary Rule but, unlike the Fifth Circuit's broad decision, focused narrowly on whether the treatment of FIAs was arbitrary compared to other fixed annuities under the Fiduciary Rule. Also unlike the Fifth Circuit, the Tenth Circuit held that the DOL's treatment of FIAs was not arbitrary and capricious.[24]

Specifically, the court held that the DOL (i) provided "adequate notice of its intention to exclude transactions involving FIAs from PTE 84-24"; (ii) did not "arbitrarily treat FIAs different from other fixed annuities by excluding FIAs from PTE 84-24"; and (iii) "adequately consider[ed] the . . . economic impact of its exclusion of FIAs from PTE 84-24."[25] The court rejected arguments from appellant Market Synergy Group ("MSG") that the DOL failed to provide sufficient notice of its intention to remove FIAs from PTE 84-24, because the proposed rule, as originally drafted, kept FIAs within the scope of PTE 84-24. During the notice and comment period preceding enactment of the Fiduciary Rule, the DOL requested comments on "whether the proposal to revoke relief for securities transactions involving IRAs . . . but leave in place relief for IRA transactions involving . . . fixed rate annuities and FIAs . . . strikes the appropriate balance."[26] In the court's view, this notice to the public and invitation to comment on the proposed rule was sufficient.

The Tenth Circuit rejected MSG's argument that the treatment of FIAs was arbitrary and capricious because "'[FIAs] fall between fixed-rate annuities and variable annuities in terms of the extent to which insurers bear investment risks.'"[27] The court reasoned that, based on industry comments and publications from FINRA and the SEC, the DOL appropriately determined that "'the complexity, risk, and conflicts of interest associated with . . . indexed annuity contracts' demonstrated that [FIAs] were more akin to variable annuities and should therefore be treated as such."[28] Finally, the court determined that the DOL had surveyed applicable state

[19] *Id.*

[20] *Id.* at 388.

[21] *Id.* at 381.

[22] *Id.* at 382.

[23] *Id.* at 383.

[24] *Market Synergy Group*, 885 F.3d at 686.

[25] *Id.* at 681.

[26] *Id.* at 682.

[27] *Id.* at 683 (citing MSG's appellate brief).

[28] *Id.* (quoting PTE 84-24, 81 Fed. Reg. at 21, 157-58).

regulations and conducted a Regulatory Impact Analysis, and therefore properly considered "the effect implementation of the BICE would have on the insurance market."[29]

IV. Significance of the Decisions

The ultimate fate of the Fiduciary Rule may have far-reaching implications for some individuals and firms offering the products and services encompassed by the rule, while in the near-term "[c]onfusion abounds."[30] As the Fifth Circuit observed, "Throughout the financial services industry, thousands of brokers and insurance agents who deal with IRA investors must either forgo commission-based transactions and move to fees for account management or accept . . . burdensome regulations and heightened lawsuit exposure . . . . It is likely that many financial service providers will exit the market for retirement investors rather than accept the new regulatory regime."[31] The DOL stated that it does not intend to enforce the Fiduciary Rule in light of the Fifth Circuit's decision, but added that it intends to review the rule, possibly paving the way for a revised rule, another round of court challenges and further uncertainty.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email Helene R. Banks at 212.701.3439 or hbanks@cahill.com; Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; David S. Slovick at 212.701.3978 or dslovick@cahill.com; or Courtney B. LaHaie at clahaie@cahill.com.

[29] *Id.* at 685.

[30] *Chamber of Commerce*, 885 F.3d at 368.

[31] *Id.*