Baritz & Colman LLP

What's an Adviser to Do? Uncertainty in the Wake of the Fifth Circuit's Vacatur of DOL's Fiduciary Regulations

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"He who seeks to regulate everything by law is more likely to arouse vices than to reform them."

Benedict DeSpinoza (1632-1677)

FIDUCIARY STANDARDS PRE-F.R. (FIDUCIARY RULE)

For almost a half century, the financial services and insurance industries labored under fairly well-developed and (largely) workable concepts of when advisors or brokers were acting as fiduciaries – and when they were not. In 1975, the U.S. Department of Labor enacted regulation that defined a fiduciary for ERISA's investment advice provisions. The DOL definition pretty much adopted the common law concept of the special relationship of trust and confidence between a fiduciary and his or her client.

The DOL test defined an investment advice fiduciary as someone who (1) "renders advice…or makes recommendations 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 the advice (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." 29 C.F.R. § 2510.3-21(c)(1) (2015). (Emphasis ours.)

The regulation also reflected the traditional distinction drawn between an "investment adviser," who is a fiduciary regulated under the Investment Advisers Act, and a "broker-dealer" whose advice is "solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." 15 U.S.C. § 80b-2(a)(11)(C).

With the recent significant increase in the public investing through IRAs and other retirement plans, DOL became concerned about what it perceived to be an inherent "gap" in its 1975 regs: unless advisers are deemed fiduciaries charged with acting solely in the best interests of their clients, they faced a conflict of interest between their clients' best interests and their own pockets – or those of their firms.

Never mind that such a "gap" has existed for decades and has been dealt with, if not perfectly, at least reasonably (lawyer-speak for "the best we can do under the circumstances") through a combination of precedent and SEC and FINRA regulatory oversight. So the DOL sought to address the situation with the bureaucrat's weapon of choice. You guessed it -- yet an additional layer of DOL regulation.

BEHOLD: THE DAWN OF THE F.R.

The Fiduciary Rule provides that an individual "renders investment advice for a fee" whenever he is compensated in connection with a "recommendation as to the advisability of" buying, selling, or managing "investment property." 29 C.F.R. § 2510.3-21(a)(1) (2017). A fiduciary duty arises, moreover, when the "investment advice" is directed "to a specific advice recipient . . . regarding the advisability of a particular investment or management decision with respect to" the recipient's investment property. 29 C.F.R. § 2510.3-21(a)(2)(iii) 2017).

DOL's recent iteration dispenses with the "regular basis" and "primary basis" criteria used in the regulation for the past four-plus decades. Thus, it arguably applies to virtually all financial and insurance professionals who do business with ERISA plans and IRA holders – stockbrokers and insurance salespeople, for instance. These folks are thus barred from being paid whatever transaction based commissions and brokerage fees have long been standard in their industry because those types of compensation are now deemed to present a conflict of interest.

The Fiduciary Rule poses a monumental challenge to the financial services and insurance industries. The regulations and accompanying explanations span almost 275 pages in the Federal Register, and DOL itself estimates that compliance costs imposed on the regulated parties could reach $31.5 billion over the next decade.

CHAMBER OF COMMERCE V. U.S. DEPT. OF LABOR

On March 15, 2018, by a 2-1 vote, the Fifth Circuit Court of Appeals held that the DOL F.R. exceeded DOL's authority under ERISA. *Chamber of Commerce, et al. v. U.S. Dept. of Labor, et al.*, Case No. 17-10238, 2018 WL 1325019 (5th Cir. Mar. 15, 2018).The decision overruled a Dallas, Texas, Federal District Court decision upholding the F.R.

The Fifth Circuit decision held that DOL's expansion of the definition of a fiduciary was not "reasonable" (there's that word again) and essentially concluded that the DOL's 1975 definition more accurately reflected the distinction between a broker-dealer and an investment adviser. The Court ruled that "expanding the scope of DOL regulation in vast and novel ways" is properly left to Congress.

NOW WHAT?

Good question. To paraphrase Milton Friedman, are we all fiduciaries now? Since the Fifth Circuit decision was the result of a 2-1 vote, the DOL could seek re-argument "en banc" (*i.e.*, before a full Fifth Circuit Panel), or seek "certiorari" (Latin for "we wish to be informed") before the U.S. Supreme Court (*i.e.*, permission from SCOTUS to appeal). If DOL were successful, the F.R. would clearly be the standard – until other challengers emerge. (Or until Congress acts, which is unlikely in this political environment.)

What is unclear is: what standard applies to advisers and brokers – and their supervisors and compliance departments – as they deal with clients every day? Some say best practice for now is to toe the F.R. line; better safe than sorry. More to the point, many market participants, large and small, have already reacted to the Rule, and as a result, implemented broad new policies and procedures, at great expense. Thus the prospect of reverting to the 1975 standards may be moot. Moreover, many of the same players already consider themselves fiduciaries, regardless of any mandated status. In any event, going forward, we don't believe that this fight just fades quietly into the night. Excuse the bad pun and shopworn metaphor, but discretion may in fact be the better part of valor.

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