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Fifth Circuit Vacates Fiduciary Rule

Last week, a three-judge panel of the Fifth Circuit Court of Appeals issued a 2-1 decision vacating the DOL Fiduciary Rule. The decision is sweeping: it rejects the regulation re-defining fiduciary investment advice, as well as the new prohibited transaction exemptions and modifications to old exemptions adopted along with the regulation. The majority decision refers to all of these as the “Fiduciary Rule,” and we adopt that term in this alert.

The effect of the decision, if it becomes final, will be to revert to the regulatory definition of fiduciary advice adopted in 1975 and to the pre-2016 prohibited transaction exemptions. We discuss the timing and implications of the decision later.

What did the court say?

The court majority opinion includes two key rulings: that the DOL did not have the authority to adopt the new fiduciary advice definition (“the Fiduciary Rule...is inconsistent with the entirety of ERISA’s ‘fiduciary’ definition”); and, in adopting the Fiduciary Rule, it acted arbitrarily and capriciously (“the Rule fails to pass the tests of reasonableness or the [Administrative Procedures Act]”). Based on these rulings, the court decided to “**VACATE** the Fiduciary Rule *in toto*.” [Emphasis in the original.] In other words, the court struck down both the new fiduciary advice definition and the package of exemptions that came with it.

In issuing the ruling, the court emphasized that “trust and confidence” are at the heart of the fiduciary definition, not mere sales activities:

“...agencies are not free to adopt unreasonable interpretations of statutory provisions and then edit other statutory provisions to mitigate the unreasonableness... This is the vice in BICE, which exploits DOL’s narrow exemptive power in order to ‘cure’ the Rule’s overbroad interpretation of the ‘investment advice fiduciary’ provision.”

Does the ruling apply nationwide?

Yes.

When is the ruling effective?

Not until May 7, 2018, at the earliest. The DOL has 45 days from entry of the judgment to request that all the Fifth Circuit judges re-hear the case. (We note that the dissenting judge was the Chief Judge of the court.) If the DOL doesn’t take additional steps, we revert to the old “five-part” fiduciary advice definition¹ and the pre-2016 prohibited transaction exemptions. The Best Interest and other Impartial Conduct Standards

will go away. If a request for re-hearing is granted, it seems likely the court will grant a “stay,” *i.e.*, the decision will not apply until a decision by the full Fifth Circuit.

The DOL could also ask the Supreme Court for permission to appeal the decision. In so doing, the DOL could ask that the Fifth Circuit’s ruling be stayed pending the resolution of the request or the ultimate decision by the Supreme Court. During the period of the stay, the Fiduciary Rule will remain in effect.

What’s next?

That depends. A number of commentators have suggested the DOL will not ask for a rehearing by the Fifth Circuit, or seek permission to appeal to the Supreme Court, and will let the Fiduciary Rule die. We believe there is a fair chance that the DOL will seek to have the decision overruled even as it continues its regulatory process to review and likely amend the rule.

If the process is fully stretched out, the stays could be in effect for a year or more. In that case, we think the DOL will propose a new regulation and exemptions during that time, which will start an entirely new process. The SEC might also propose its own fiduciary rule during that period.

The Fifth Circuit decision could also motivate more states to adopt their own fiduciary rules.

What should financial firms and advisors do now?

For the short term – until May 7 at least – the Fiduciary Rule remains in effect. Therefore, firms must still comply to avoid possible regulatory action or private litigation. If the DOL seeks to overturn the Fifth Circuit ruling, we think a stay of the ruling is likely, which means that firms would need to continue complying with the Fiduciary Rule until a final judgment is issued.

Regardless of what happens in the courts, from a risk-management perspective, to the extent that firms have adopted internal policies or made communications with clients that implement the Fiduciary Rule, they will need to continue complying with their policies and procedures and communications made to clients until they make changes. Otherwise, they could face regulatory problems with the SEC, FINRA or state regulators (similar to the Massachusetts complaint against Scotttrade).

Even if the Fifth Circuit decision becomes effective on May 7, there is another possible trap for the unwary arising out of the ruling that the Fiduciary Rule is “vacated.” The general rule seems to be that when a rule is “vacated,” it means the rule was never valid to begin with. This may be good news to firms that

¹ Under the 1975 regulation, fiduciary advice is (1) individualized, (2) regularly provided, (3) related to securities or other property, and (4) subject to a mutual understanding that the advice (5) will be a primary basis for the recipient’s decision-making.

became fiduciaries effective June 9, 2017, but were not before then. It's not such good news for firms and advisors that were fiduciaries before June 9 and continue to be thereafter. If they have received "conflicted compensation" (e.g., revenue sharing or other variable compensation) in reliance on the Best Interest Contract Exemption (BICE) since June 9, they'll have a problem. The BICE would also be "vacated" effective on that date, so they would no longer have an exemption for the conflicted compensation they received. This is just one example of the complexities that need to be resolved once the fate of the Fiduciary Rule is finally decided.

In any case, it isn't clear whether it is advisable to begin changing policies and procedures now, as we do not know what the DOL's response to the Fifth Circuit decision will be.

The implications of the Fifth Circuit decision are complex and will require more analysis. We will share more thoughts shortly.

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