Legal Defenses

By Kerry Pechter *Mon, Feb 1, 2016*

Will the financial services industry sue the Department of Labor if it doesn't like the final wording of the fiduciary rule? And if it does, what happens next? Four attorneys--Bruce Ashton, Mercer Bullard, Tom Clark, and Steve Saxon, share their views.

The Department of Labor's proposed fiduciary rule is well-intended: the government wants to protect the millions of inexperienced investors who are rolling money from 401(k) plans to IRAs from exploitation by self-interested brokers and agents.

But, unless amended, the rule would also expose brokers and their firms to new legal liabilities, in the form of tougher arbitration hearings or perhaps an expensive wave of litigation in federal courts.

It's not clear if the DOL intended to terrorize broker-dealers with its proposal. But by explicitly granting investors new rights to sue advisors, it has. Greater legal liability isn't the only possible consequence of the rule that worries advisors—they also fear costly IT overhauls and a chill on sales of commissioned products—but it's high on the list.

Their fears are not unrealistic. Broker-dealers have seen what happened in the 401(k) space, where St. Louis plaintiffs' attorney Jerry Schlichter has won a series of big-ticket damage awards against 401(k) plan providers and sponsors for breaching their fiduciary duties to plan participants. The same, they fear, could happen to them and their businesses.

Here's the twist that really bugs the industry: The DOL will *rely on* plaintiffs' attorneys to enforce the rule by using it in federal class action suits against broker-dealers. Labor can regulate 401(k) and IRA advice, but it can't enforce the rules it issues (only the IRS can).

Efforts to derail the rule so far haven't worked. Bills filed by industry-friendly legislators (two more were marked up this week by the House Committee on Education and the Workforce) have gotten nowhere, and face a sure presidential veto if they did. A Trump or Cruz victory in November would certainly kill the rule, but no one seems to bank on it. The DOL itself might yet soften the wording of rule and make it less disruptive for the industry. But hopes for that are waning.

One defensive option is left: Sue the DOL and ask the U.S. District Court of Appeals to block the rule. This strategy worked when the indexed annuity industry sued the SEC and got Rule 151A annulled in 2010, and some think it could work again. ("Remember, 151A was a promulgated rule before we defeated it," boasted the fixed indexed group, **Americans for Annuity Protection**, in a January 11 e-mail blast.)

To learn more about a possible lawsuit, RIJ consulted several pension and securities law attorneys: Bruce Ashton of Drinker Biddle & Reath, Mercer Bullard of the University of Mississippi School of Law and PlanCorp, Tom Clark of Wagner Law Group, and Steve Saxon of Groom Law Group. Here are our questions and their answers.

A legal challenge? On what grounds?

There are hints that a financial industry trade group might file a lawsuit against the DOL this year if, as expected, the final rule still contains the Best Interest Contract Exemption. The BIC or BICE requires advisors to IRA owners to promise to act solely in their client's best interests. It's the same "fiduciary" standard that advisors to pensions and defined contribution plans have to meet.

Steve Saxon of the Groom Law Group in Washington, D.C., which represents industry clients, described a lawsuit as possible. "Generally speaking, and focusing just on various segments of the retirement services industry, there's a possibility that litigation will be brought. That's an arrow in the quiver that people are considering."

He's not alone. "The going thought is that a lawsuit is a long shot, but certain people are gung ho about it," said Tom Clark of the Boston-based Wagner Law Group and a blogger at **Fraplantools.com.**

Financial services firms might feel they have nothing to lose by creating a drawn-out legal battle, Clark said. "The industry might see the upside to a quagmire," he said, "and file even though they can't win it." Bruce Ashton (right) of Drinker Biddle & Reath agreed that "a challenge of the DOL's authority with respect to 'regulating' IRAs seems fairly likely."

What would be the grounds for such a lawsuit? Clark thinks that industry lawyers might accuse the DOL of violating protocol—in effect, to try to win on a technicality. They would question not what the DOL did, but how it did it.

"If there's a lawsuit, it would be a challenge that the DOL overstepped their regulatory bounds and messed up the rulemaking," he told *RIJ*. "They can't do it on substance; that would involve a bigger uphill battle than a challenge on procedure."

Saxon speculated that a suit might charge that the DOL made the definition of "an investment advice fiduciary" too broad. "It would allege that the department went too far and that their definition of a fiduciary is not supported by the statute or any other authority," he said.

"Secondly, it would say that the BIC exemption is an application of Title 1 of ERISA—in the fiduciary duty rules under Section 404—to IRAs," he added. "Congress made a decision, when it enacted ERISA [in 1974], not to do that. But the way in which the conditions of the BIC exemption work, that's where we end up. You could add that having the remedy [to a violation of the rule] be a class action lawsuit is problematic as well."

Says Bullard: "The first thing they did was to change the definition of a fiduciary. They are making more people subject to the prohibited transaction rules, and they are also extending the duty of loyalty to IRAs, which wasn't true before. That will be the primary focus of legal challenges to the rule, because Congress decided not to apply that duty, which is just a basic prudence standard, to IRAs.

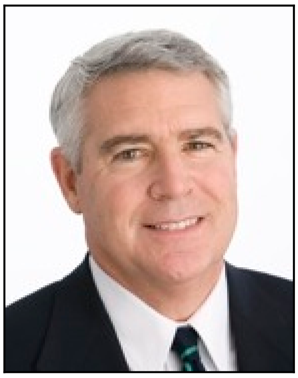
Concerns about the "Best Interest Contract"

Neither 401(k) plans or IRAs—let alone the possibility that the rollover IRA would become the largest single repository of retirement savings in the U.S., as they are today—were contemplated when ERISA was enacted.

Section 404 of Title I of ERISA gives the DOL authority over advisor conduct in employer-sponsored retirement plans like 401(k)s. But, as Saxon noted, the law says nothing about DOL jurisdiction over advisor conduct with respect to individual IRAs.

The "Best Interest Contract Exemption" would span the gap. It enables the DOL to exercising authority over IRA advisors without amending ERISA. If advisors want to sell products to IRA owners and receive third-party commissions from product manufacturers, they will commit a "prohibited transaction"—a punishable offense—unless they and their clients have signed the BIC and they have sworn to act in the sole interest of their clients, just as pension advisors do.

This puts brokers (or at least those brokers who mix the role of advisor with the role of sales agent) in an untenable position. They cannot safely take that oath, because, in the normal course of their jobs, they sometimes act in their own best interests. On the other hand, if they don't sign BIC contracts, they will commit a crime every time they sell a product and accept a third-party commission.



"Right now, IRAs are not subject to Title I of ERISA," Saxon explained. "An IRA holder can't sue a financial institution for imprudence under ERISA. This is what this whole BIC exemption is all about. If an IRA provider is a fiduciary, and if it is were found to have failed to meet what amounts to Section 404 under ERISA—as delineated in the BIC standard, which is based on Section 404—then, if that standard isn't satisfied, there's no exemption and you have a prohibited transaction. It's not actionable under ERISA, because they didn't change [ERISA]."

That's another twist in this tale. Even if the DOL can regulate advisor conduct with respect to IRAs, ERISA doesn't give it the power to enforce those rules. So the proposal specifies that IRA owners who feel wronged by their advisors have recourse to the federal courts, through private class action suits. They can't be limited to pursuing claims of misconduct in arbitration hearings, where brokers traditionally enjoy a kind of home-field advantage.

"The Department of Labor made it easier for class action lawsuits to be filed," Saxon said. "They've paved the way for plaintiffs attorneys to act as substitutes for DOL. It's a clever alternative, based on the application of a Title I-type standard of conduct to an IRA sales transaction. You broaden the definition of fiduciary to capture the advice-giver as a fiduciary, then apply Section 404 to the sales transaction. My view is that [the BIC standard] went beyond 404 and created some problems. That's a key point in evaluating where we end up."

Ashton told *RIJ*: "The BICE is structured as it is to create a private right of action for IRA holders that doesn't now exist, since there really isn't an effective enforcement mechanism. The prohibition against interfering with the right to participate in a class action is in there for the same reason."

"On the one hand, ERISA has the 'duty of loyalty' provision," noted Bullard. "It applies only to advisors to retirement plans. On the other hand there is a set of 'prohibited transaction' rules that apply to advisors to IRAs and to retirement plans. The latter apply to IRAs and retirement funds, but the duty of loyalty applies only to retirement plans. "[The BIC] is a clever way to apply that duty to IRAs," he added.

"They not only applied the [duty of prudence and loyalty] standard, which becomes actionable by government, they also made it *privately* actionable. There's no private access under ERISA, but the contract will give you private right of action through breach of contract."

As Clark put it, "For the rule to have teeth, [it requires the participation of the plaintiff's bar]. That's the linchpin." Of course, teeth for one adversary is a bite for the other.

If challenged, would the rule be stayed?

"It's complicated," Saxon said. "Is there a federal judge who would be willing to stay the implementation of the effective date of the regulations? Or would the federal courts say that the US Department of Labor has the right to move forward with the finalization of the regulation and the exemptions?"

If the case went to the US Supreme Court, Saxon said, "The question would be 'How long would that take and, in the meantime, would those of us in the retirement services space have to comply and deal with the terms of the regulation and the exemption'?

Bullard doesn't think the case is likely to go to the US Supreme Court, which hears only a small percentage of cases. While there is a lower federal court in Washington, "This will be decided by the US District Court of Appeals, DC circuit, and the three-judge panel would probably stay the rule," he said. "If you got a Republican panel, it would definitely be stayed. That's because the rule would revolutionize the way [the broker-dealer systems work]. So, if there's any risk of it *not* being legal, the smart thing would be not to go down that road in the first place. Once the industry implemented the necessary changes, it would be too expensive to go back."

But that wouldn't necessarily kill the rule, Bullard added. The DOL would likely appeal the initial panel's decision to all 11 judges of the DC circuit, where there's currently a seven-to-four Democratic majority, which would be more likely to uphold the rule. "But if a Republican gets elected president in the November, the rule is dead," Bullard told *RIJ*.

The future

Without a Republican victory next fall, the lawyers who spoke with *RIJ* were doubtful that the brokerage industry could defeat the fiduciary rule.

"Based on the law challenging an agency's ability to make rules, the law creates an uphill battle for challengers. Against that backdrop, it's fair to say they will have an uphill battle," said Clark (left).

"I'd be very surprised if a lawsuit in this area would get very far," Ashton said. "The DOL clearly has the authority to grant class exemptions and to structure the conditions for those exemptions that deal with both plans and IRAs. I also suspect that courts will find that they have the authority to regulate rollovers, since the assets are plan assets before they are rolled over. My suspicion is that DOL has vetted their legal authority pretty well. There will likely be lawsuits but I doubt very much whether they will be successful."

There's still a possibility that the DOL will change the language of the rule to make it less disruptive of the current brokerage business model, which relies on the flow of commissions from product manufacturers to advisors and allows advisors to manage their acknowledged conflicts-of-interest as they see fit.

For instance, the DOL could delete the section of the proposal that forces commission-paid sellers of variable annuities—but not other annuities—to take the BIC oath. Under current law, so-called "Prohibited Transaction Exemption 84-24" allows all annuity sellers to take commissions when selling to people with retirement accounts.

"The DOL could keep Prohibited Transaction Exemption 84-24 the way it is now. They could move all annuity transactions to PTE 84-24, or they could move all of them to the BIC. But no one really knows what might happen next," Saxon said.

"If anyone is telling you that they know what's been happening at the Department of Labor since September 24, when the last comment period ended, that would not be reliable," he said. "Even inside the government, things are still fluid, and they will be fluid until the regulation is finalized. In the meantime, they are not meeting with us or discussing anything with us."

Assuming that the final rule won't be different from the proposal, Bullard believes its biggest impact will be to empower clients in arbitration disputes with advisors, not to trigger a hail of class action suits against deep-pocketed brokerages. "There aren't going to be class action suits," he told *RIJ*. "No one believes there is significant class action exposure here.

"The single biggest effect will be an increased liability risk in arbitration," he added. "Plaintiffs will be able to put the BIC contract in front of an arbitration panel and show that the advisors were fiduciaries. This will mean that you can make a fiduciary breach claim in arbitration. The plaintiff will still face the hurdle of having to prove that the advisor failed to do what a fiduciary should do. But there will be a real increase of liability risk for advisors, and basic changes to [advisor] compensation."

Beyond that, the brokers will need to adapt their computer systems to new compensation regimes, compliance protocols and reporting requirements. "The costliest part for the financial firms will be changing all their systems. This will mean a total overhaul, Bullard said."

The broader view

There's a simple explanation for the complexity of all this. Gaps in the law engender ambiguities, and ambiguities get resolved in court. ERISA has big gaps. Its authors didn't envision IRAs or 401(k)s. The line between advisors and brokers and agents has blurred over the years. Most importantly, rollover IRAs are inherently ambiguous: they are private retail accounts and government-subsidized mini-pension funds at the same time.

Such ambiguities provide plenty of grist for the legal mills. But it's important to remember that the legal battle is just a sideshow to the main issue. At stake here is the $7 trillion rollover IRA market. The question is whether broker-dealers and other intermediaries will be able to serve—or exploit, in the Obama administration's skeptical view—that rich market in the manner to which they are accustomed.