



## Alerts

### Life Insurance Industry Loses Challenge to Department of Labor Fiduciary Liability Rules

**November 10, 2016**

*Lawyers for the Profession®*

*The National Association for Fixed Annuities v. Perez*, Civ. 16-1035 (RDM), United States District Court for the District of Columbia, November 4, 2016

In a widely anticipated ruling, the National Association for Fixed Annuities (NAFA) a life insurance industry trade association, lost a constitutional and statutory challenge to the Department of Labor's April 2016 Fiduciary Rules. The Rules extend ERISA fiduciary liability standards to individual life insurance agents selling investment products to Individual Retirement Account (IRA) customers.

#### Question Before the Court

The new Fiduciary Rules are designed to bring uniformity in the fiduciary standards governing pension and defined contribution plan managers and those governing securities and life insurance professionals that establish IRA accounts. The most controversial element of the rule is the placement of rigid controls on purportedly conflicted advice traceable to commissioned sales of IRA investments. The decision specifically focused on the impact on the sale of two life investment products — variable annuities and equity indexed annuities.

NAFA challenged the Department's authority to enact the new rule under ERISA and the rulemaking process. It argued further that the net effect of the rule was that the agency had essentially created a new investor cause of action without the requisite Congressional authority. Finally, NAFA argued the rule was unconstitutionally void for vagueness.

Judge Randolph Moss considered and rejected each of the various legal challenges to the Fiduciary Rules raised by NAFA. In challenging the Department's authority under ERISA, NAFA argued that the Department of Labor had ignored an historic bright line between pension and plan administrators fully dedicated to managing large pools of retirement assets and commissioned salespersons that sell IRAs to individual retirees.

In granting summary judgment for the Department the court painstakingly reviewed the legislative history of ERISA and the Department's rulemaking to establish that the existing exemptions of commissioned life agents were not based on any statutory or regulatory entitlement.

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The court ruled that, the Department's decision to hold those responsible for IRA sales to consistent fiduciary standards had been reasonable given the growth of IRAs as a future source of retirement income. IRAs were first introduced under ERISA in 1974 when defined benefit pensions accounted for the vast majority of retirement assets. Assets under management in IRAs remained relatively low before the pension buyout and 401(k) rollover boom that began in the 1980s.

The court took judicial notice of the fact that trillions of dollars of assets were estimated to be destined for investment in IRAs in the next five years without the traditional fiduciary /regulatory oversight that applied to pensions and 401(k) plans under ERISA. The court cited projections that individual investors could lose from 6% to 23% in avoidable investment costs, potentially in commissions, without standards similar to those applicable under Title I of ERISA. Thus, the court found the regulations were authorized under ERISA.

There are unresolved issues on how the Rules will be applied in practice that will likely be closely scrutinized on appeal. Normally regulations provide more formulaic and precise guidelines than the so-called "Best Interests Contract Exemption" and the standard for "reasonable compensation" of the Rules both of which are very general. The court drew analogies from other judicially sustained regulations, particularly those involving standards specifying "reasonable" conduct or standards to uphold the Rules.

The court closely analyzed the future mandate of the Rules that commissioned salespersons and firms execute contracts of adhesion with rote contractual warranties that investment professionals recommending IRAs will provide non-conflicted truthful advice. The new fiduciary standards require that recommendations be made without regard to the financial interests of the adviser. NAFA argued that this was an unauthorized exercise in creating a private cause of action by a regulatory agency. The court relied on regulations that had been sustained which required that certain contracts with a regulated business be in place and/or that certain terms be standard.

Judge Moss ultimately ruled that, notwithstanding the future burden and uncertainties placed on commissioned based IRA salespersons by the Rules, the court could find no legal obstacle to their enforceability. The court stated: "This may not be the pleasant one, but it is real".

### **What the Decision Means for Practitioners**

Lawyers will be called on to provide both transaction and risk management advice on how to best draft the disclosure documents and Best Interests Contracts called for by the Rules. In its commentary on the final rule, the Department noted that the final Best Interest Contract exemption does not chiefly rely on disclosure as a means of investor protection. However, disclosure above and beyond that required by the Rules coupled with a service commitment that justifies the recommendation of commissioned based products may in fact be the best risk management tool to avoid future liability under the Rules.

There was an empirically unsupported assumption in enacting the Rules that compensation received by level fee advisors are necessarily less conflicted and more cost effective to individual investors. Thus, fee based advisors are not affected by the Rules except in cases where they advise an investor to switch from a managed retirement plan to an IRA under their guidance.

However, many commission based advisers commit to a long-term advisory assistance in managing the investment without additional charge. For example, variable annuities and equity indexed annuities should be actively managed to optimize investment performance and ensure that allocations are changed as the investor nears retirement. Amortized over time, a long-term commitment to provide such active management free of charge could be considerably more valuable and cost effective than the net cost of paying level advisory fees over the same period.

Thus, the risk that the Best Interest Contract warranties can be used as a sword in future litigation can be mitigated. Commissioned based salespersons would be well advised to provide individualized written disclosures which provides reasonable detail regarding the adviser's anticipated compensation and also establishes and sets forth a service package that justifies that compensation.

Finally, practitioners should keep apprised of future regulatory or legislative developments. President Obama vetoed a Congressional resolution to overturn the Rules last summer. The Rules do not become effective until April and may face another Congressional challenge.



For more information, please contact [Edward F. Donohue III](#).

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