UDA(A)P
Managing Third-Party Vendors: Regulatory and Compliance Considerations for New Payment Models

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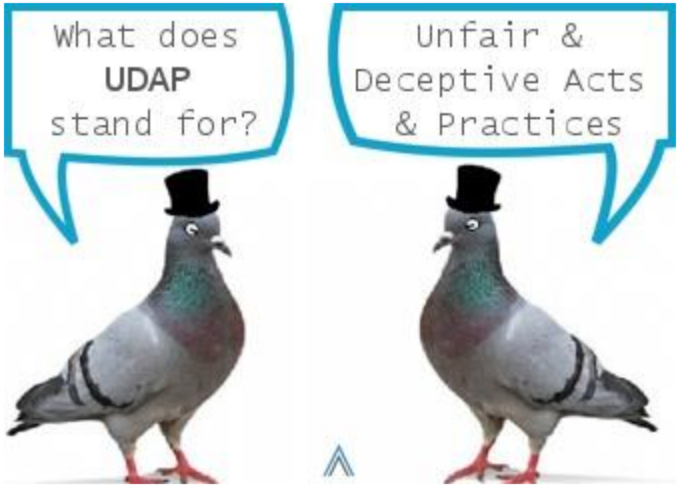
Unfair, Deceptive and Abusive Acts and Practices: There's a New Sheriff in Town



UDAP:
Statutory Authority in the Dark Ages
(Prior to Dodd Frank)

- Section 5 of FTC Act (15 U.S.C. 45) prohibits "unfair or deceptive acts or practices in or affecting commerce."
- FTC enforces this provision against non-financial institutions
- Federal prudential regulators (OCC, FDIC, Fed, NCUA, as applicable) enforced this provision against financial institutions

UDAAP:
Statutory Authority
Dodd Frank Act

- DFA established the Consumer Financial Protection Bureau
- CFPB given authority over a wide range of consumer protection statutes and regulations
  - TILA, EFTA, ECOA, FDCPA, GLBA (privacy), RESPA, and others
- Sections 1031 and 1036 of the DFA give the CFPB authority to prohibit "unfair, deceptive, **or abusive**" acts and practices

UDAAP Authority

- CFPB has authority to write UDAAP rules: UDAAP rules applicable to any person that engages in offering or providing a consumer financial product or service (covered person) and any service provider

- CFPB also has supervision and enforcement authority for:
  - Depository institutions with assets over $10B
  - Non-bank entities

- Federal prudential regulators have supervision and enforcement authority for depository institutions with assets less than $10B.

CFPB: The New Sheriff in Town

- 2015 Budget projection: $582 million
- 2015 projection: 1,537 employees
- Not dependent on Congress for funding (funded by the Federal Reserve)
- Authority to impose penalties, restitution, and corporate governance remedies is greater than SEC’s
- Encourages consumers to e-mail complaints and uses them as the starting point for investigations
- Has issued some guidance, but generally only after related ***enforcement action(s)*** with respect to the particular area
- Statute of choice for enforcement actions: DFA Secs. 1031 and 1036 = **UDAAP** (at least 25 to date)

"Unfair"
An Act or Practice is Unfair if:

- It causes or is likely to cause **substantial injury** to consumers
  - Generally monetary harm
  - May include other subjective harm
  - Does not typically include emotional or other intangible harm; however, per the CFPB (July 10, 2013 bulletin), in some cases, emotional impacts may amount or contribute to substantial injury.
- Consumers cannot **reasonably avoid** the injury. Considerations include whether the act or practice:
  - Interferes with or hinders the consumer's ability to make informed decisions or take action to avoid the injury
  - Takes place without the consumer's knowledge or consent
  - Subjects consumers to undue influence or coercion

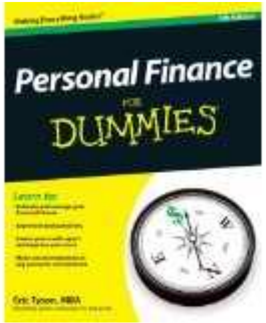
"Unfair"
An Act or Practice is Unfair if:

- The injury is not outweighed by **countervailing benefits** to consumers or to competition. Considerations include whether the act or practice:
  - Results in lower prices
  - Results in wider availability of goods and services
  - Promotes innovation
  - Would be costly to replace or remediate
  - Does not typically include emotional or other intangible harm; however, per the CFPB,
- Regulators sometimes consider **public policy**, but that cannot be the primary basis for the determination

“Deceptive”
An Act or Practice is Deceptive if:

- A representation (act or omission) **misleads or is likely to mislead** consumers.
  - Actual deception is *not* required
- The consumer’s interpretation of the representation is **reasonable** under the circumstances
  - Banking regulators state that they use a “reasonable consumer standard”
  - In practice, regulators (particularly the CFPB) probably use a “less sophisticated consumer” standard
    - CFPB emphasizes target audience
    - Only a “significant minority” must be misled or likely to be misled)
- Misleading representation must be **material** (likely to affect a consumer’s decision)

"Abusive"
An Act or Practice is Abusive if:

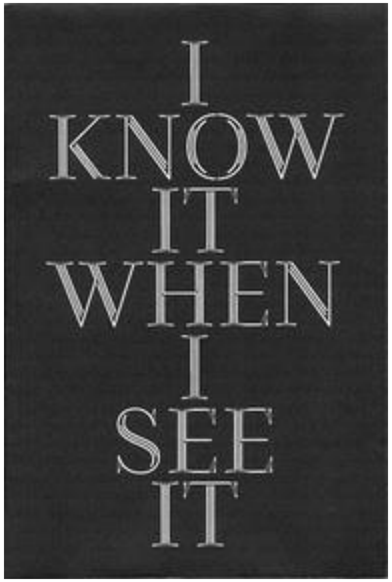


- It **materially interferes** with the consumer's ability to understand a term or condition of a financial product / service; OR
- It takes **unreasonable advantage** of a consumer's
  - **Lack of understanding** of the risks, costs, or conditions of the product or service
  - **Inability to protect their interests** in selecting a product / service
  - Reasonable **reliance on the covered person** to protect them.

A very nebulous standard, with no court rulings or agency rules for guidance:

"Abusive"
A Nebulous Standard:

- Director Cordray seems to favor an ***"I know it when I see it"*** test:



  - "It's a facts and circumstances test. [M]ost good businesses know it when they see it."
  - "[Companies] should be thinking carefully about whether they're taking unreasonable advantage of their consumers."
  - "A prong [of the test for abusiveness] is to take unreasonable advantage of people [who] don't have an opportunity to choose their provider, so they can't shop [and] they can't leave."
  - So far, the CFPBs approach to "abusive" is very similar to state "unconscionability" standards

UDAAP
Marketing "Best Practices"

UDAP / UDAAP Laws: Marketing “Best Practices”

- Legal Implications are primarily based on these considerations:
  - **Target Market**
  - **Marketing Channel**
  - **Information Received**
  - **Marketing Content**

UDAP / UDAAP Laws: Marketing "Best Practices"

Consider your Target Market: Much higher risk when marketing to vulnerable groups, such as:

- Elderly
- Students / young adults
- Racial / ethnic minorities
- Immigrants
- Consumers of specific national origins
- Members of specific religious denominations
- Current or former servicemembers
- Consumers with limited education
- Consumers with limited English proficiency
- Low-income or fixed-income consumers
- Consumers receiving public assistance
- Financially unsophisticated consumers
- Consumers with low credit scores
- Consumers in or who have recently experienced financial distress

UDAP / UDAAP Laws: Marketing "Best Practices"

Target Market

- Reasons for relevance:
  - Deception is determined on the basis of a consumer's reasonable interpretation
  - Whether a consumer's interpretation is reasonable depends on his or her background and circumstances
- Is your product / service appropriate for the target market?
  - Although UDAAP is determined on the basis of objective factors, the analysis is often applied based on a subjective impression of the value received by the consumer
  - You can avoid a lot of UDAAP scrutiny by ensuring your customer base is made up of people who receive commensurate value
- Non-English Marketing:
  - If you market your product or service in another language, you <u>must</u> deliver in that language as well

UDAP / UDAAP Laws: Marketing "Best Practices"

Consider your Marketing Channel

- Multitude of channels now available:
  - Print
  - Telephone
  - Web page, banner, pop-up
  - E-mail
  - SMS text
  - Mobile app
  - Social media
- What works well in one channel may not be appropriate for another
- Telephone channel considerations:
  - Make sure incentives do not encourage sale of high-cost products regardless of consumer's request or situation
  - Do not base compensation or performance evaluation of sales staff (telephone, face-to-face, chat, etc) on sales volume without consideration of product outcomes or performance (for example, default or attrition rates) and of compliance

UDAP / UDAAP Laws: Marketing "Best Practices"

Consider the Information you Receive

- Adopt reasonable data security practices
  - Reasonable based on the information received
  - Reasonable based on network security – does your app run on insecure connections?
  - Reasonable based on platform
    - Different mobile platforms utilize different security features and handle permissions in their own way

UDAP / UDAAP Laws:
Marketing "Best Practices"

Information you Receive

- Understand the limitations of the available platforms
  - Implement their security features properly
  - If you make it available, it is your responsibility to assure that it is secure
- Encrypt sensitive information
  - Mobile devices often rely on unsecure Wi-Fi access points at coffee shops, airports, and the like
  - Transit encryption helps to prevent interception
  - Utilize HTTPS or another appropriate method
  - Update as technology changes
- Protect the data you store on a user's device (*e.g.,* by encrypting it)

UDAP / UDAAP Laws: Marketing “Best Practices”

Consider your Marketing Content

- **All forms of advertising should be reviewed for UDAP/UDAAP compliance, *including materials from third parties***
- Sensitive areas include:
  - Use of the word “free” and its equivalents
  - Rewards programs
  - Affiliate and multi-level marketing
  - Add-on features
  - Comparisons
  - Fee disclosures and descriptions
  - High pricing

UDAP / UDAAP Laws: Marketing "Best Practices"

Consider your Marketing Content

- Marketing content includes more than just prepared advertising:
  - Telemarketing
  - E-mail and text message
  - Internet chat
  - Social media posts
- Particularly for telemarketing, should employ:
  - Training
  - Scripts
  - Rebuttal scripts
  - Monitoring / Recording

UDAP / UDAAP Laws – Marketing “Best Practices”: Marketing Content – Disclaimers

- Must always explain all material costs and limitations clearly and conspicuously
- The question isn’t “Is it readable?” The question is “Is it read?”
- Remember the 4 Ps:
  - **Prominence**: is it big enough for consumers to notice and read?
  - **Presentation**: is wording and format easy for consumers to understand?
  - **Placement**: is it where consumers will look?
  - **Proximity**: Is it near the claim that it qualifies?

UDAP / UDAAP Laws – Marketing "Best Practices": Marketing Content – Disclaimers

- Must consider the **marketing channel**; what is clear and conspicuous on paper might not work well in other environments

- March 2013: FTC issued revised version of its ".com Disclosures" guide to account for mobile devices in addition to web ads:

  - If a required disclosure can't be made clearly and conspicuously on a particular device, then the ad shouldn't run on that platform

  - Place disclaimers as close as possible to the triggering claim

  - Avoid using pop-ups for disclosures since they are often blocked

  - Use hyperlinks and scrolling cautiously

UDAP / UDAAP Laws – Marketing "Best Practices": Marketing Content – Disclaimers

- Disclosures that are necessary to prevent deception or unfairness should not be relegated to cardholder agreements or other terms of use
- Space-constrained ads are not exempt from the disclosure requirements contained in the Guidance
  - When a space-constrained ad requires a disclosure, incorporate the disclosure into the ad whenever possible
  - When it is not possible to make a disclosure in a space-constrained ad, it may, under some circumstances, be acceptable to make the disclosure clearly and conspicuously on the page to which the ad links

CFPB UDAAP Enforcement – "Deceptive": Credit Card Add-on Products

Consumer Financial Protection Bureau

- CFPB has focused on UDAP / UDAAP in the marketing of credit card add-on products (credit protection, identity protection, and the like). Many huge fines / restitution payments.
- Allegations are always pretty much the same:
  - Making claims that are not true
  - Failing to disclosure material limitations and conditions
  - Enrolling customers in products / programs without their specific consent to do so (especially with "Free Trial" promotions that convert to a membership)
  - Enrolling customers in products that they don't understand
  - Billing customers for a product for which they can't receive the full benefit
- More on this in post-conference Master Class

CFPB Enforcement: "Abusive"

- **The Debt Assistance Cases: Enrolling Customers in Inappropriate Debt Relief Programs**
  - *American Debt Settlement Solutions* settlement (June 7, 2013)
  - *College Education Services* (CES) complaint (filed Dec. 11, 2014)
    - ➢ Both collected "advance fees" (fees for debt settlement services before settling any debt)
    - ➢ Both knew or should have known that many of its customers could not complete or were not eligible for the programs they were offered and thus would pay fees without receiving benefit. Thus, both companies took advantage of consumers' <u>lack of understanding</u> of the product (an abusive practice)
    - ➢ Both created the illusion of expertise to induce consumers to rely on them. Consumers <u>reasonably relied</u> on these companies to enroll them in appropriate programs that they could complete, and ADSS / CES committed an abusive practice by not doing so.

CFPB Enforcement: "Abusive"

- **The Payday Lending Cases**
  - *CashCall* Complaint (filed Dec. 16, 2013): **attempting to collect debt the consumer did not owe**
    - CashCall allegedly purchased, serviced, and collected a variety of consumer loans from Western Sky Financial that state usury and/or licensing laws either rendered void or else limited the consumer's obligation to repay
    - Since consumers didn't know that state law barred collection of their debt, trying to collect it took advantage of consumers' <u>lack of understanding</u> and was therefore abusive

CFPB Enforcement: “Abusive”

- **The Payday Lending Cases (cont)**
  - *ACE Cash Express* consent order (July 10, 2014): **inducing borrower to pay fees for loan they won’t be able to repay**
    - ACE made two-week payday loans
    - If a borrower couldn’t repay the loan on time, in-house and third-party debt collectors created a false sense of urgency and / or made various threats or false statements in order to convince the borrower to pay off the old loan by taking out a new one and paying a new set of fees)
    - By leveraging an artificial sense of urgency to induce delinquent borrowers with a demonstrated inability to repay their existing loan to take out a new loan and pay more fees, ACE took unreasonable advantage of the borrowers’ inability to protect their own interests in selecting a financial product or service

CFPB Enforcement: "Abusive"

- **The Servicemember Cases:**

  - *Colfax Capital / Rome Finance* consent order (July 19, 2014): **attempting to collect money consumers didn't owe**
    - Much like CashCall, Colfax attempted to collect consumer debt that was void under applicable state law (usury or licensing laws)
    - Since consumers didn't know that state law barred collection of their debt, trying to collect it was abusive, because it took advantage of consumers' <u>lack of understanding</u>

FREEDOM
FURNITURE & ELECTRONICS

  - *Freedom Stores* settlement (filed Dec. 18, 2014): **filing debt collection suits in distant forum**
    - Freedom Stores and Freedom Acceptance Corp sells and finances furniture and electronic goods; located near military bases
    - Freedom and its co-defendants filed debt collection suits in Norfolk, VA against consumers who resided far away
    - Consumers were unaware that the contract with Freedom included a forum-selection clause and would have been powerless to negotiate it
    - Freedom's practices were abusive, because they took unreasonable advantage of the consumers' <u>inability to protect their interests</u>

CFPB Enforcement: "Abusive"

- **The For-Profit College Case:**

ITT Technical Institute ITT

  - *ITT Educational Services* law suit (Feb. 26, 2014): **structuring financial aid to force students into oppressive loans**
    - ➢ ITT recruited students with misleading claims about graduations rates and salaries of graduates
    - ➢ ITT personnel were actively involved in completing students' applications for financial aid and encouraged them to believe ITT was doing so in the students' best interests
    - ➢ ITT provided temporary credits for the first year (with no interest) but then demanded they be repaid in full; students often had no choice other than to take out ITT Private Loans with high f rates that ITT had helped to design
    - ➢ Students ended up with loans they could neither understand nor afford
    - ➢ Via its temporary credit / Private Loan design, ITT committed an abusive practice by taking unreasonable advantage of students' inability to protect their interests in selecting a product
    - ➢ By pushing students into high-rate loans, ITT also took unreasonable advantage of students' reasonable reliance on ITT to act in their interest (also an abusive practice)
    - ➢ Mar. 6, 2015: Court denied ITTs motion for summary judgment on the UDAAP claims

Practical UDA(A)P Considerations for New Products and Services

Practical UDA(A)P Considerations for New Products and Services

- Institutions that have low risk profiles for potential UDA(A)P violations:
  - Do not offer high-risk products
  - Have not introduced new products
  - Have no consumer complaints

    ***FDIC Compliance Manual —June 2014* (VII–1.6)**

  - Social media

  “The recent crisis demonstrated that unregulated financial innovation can impose an unacceptably high price on society and, especially, on its poorest members”

  Saule T. Omarova, License to Deal: Mandatory Approval of Complex Financial Products, 90 Wash. U. L. Rev. 064 (2012)

Practical UDA(A)P Considerations for New Products and Services

Big Picture Design Considerations

- Demonstrate that new products and services provide customers with benefits that exceed their costs
  - Evaluate target customer
  - Assess benefit to customer
  - Assess true costs to customer
    - Is the product confusing or complicated?
    - Is the product appropriate for the targeted customer?
- **Retain documentation!**

Practical UDA(A)P Considerations for New Products and Services

Substantial Regulatory Uncertainty

- Proposed CFPB No-Action Letter Policy
  - **Threshold Question**: Products or services must hold the promise for significant consumer benefit
  - **Availability:** "We anticipate that No-Action Letters would be issued <u>infrequently</u> and they would be issued in the staff's sole discretion <u>only after the applicant makes a thorough and persuasive demonstration that all the policy's criteria, including the likely provision of consumer benefit, are met</u>."

Operationalizing UDA(A)P

Operationalizing UDA(A)P

- What are your employees telling your customers?
  - Phone
  - Email
  - Social media
- Training, call monitoring, standard operating procedures
- Applying consistent standards
- First line of defense testing
- How are you reviewing your processes?
- Complaint intake: internal and external sources
- Using data wisely
- Governance and documentation

Third-Party Risk Management

Regulatory Guidance

- **OCC**
  - "A Bank's use of third parties does not diminish the responsibility of the board of directors and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws" (OCC Bulletin 2013-29)
- **CFPB**
  - "The mere fact that a supervised bank or nonbank enters into a business relationship with a service provider does not absolve the supervised bank or nonbank with responsibility for complying with federal consumer financial law to avoid consumer harm" (CFPB Bulletin 2012-03)

Regulatory Guidance

- **CFPB**
  - "Depending upon the circumstances, legal responsibility may lie with the supervised bank or nonbank as well as the supervised service provider." (CFPB Bulletin 2012-03)
- **FDIC**
  - "Financial Institutions that fail to adequately mange these relationships may be viewed as facilitating a payment processor's or merchant client's fraudulent or unlawful activity and, thus, may be liable for such acts or practices." (FIL-3-2012)

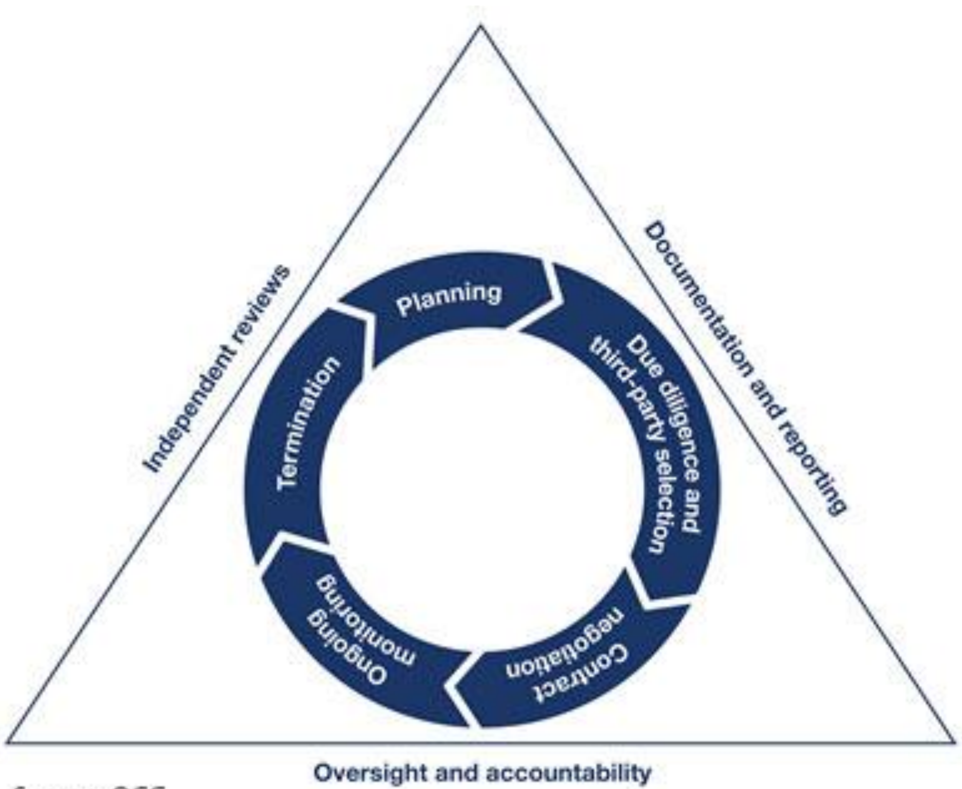
Managing Third-Party Relationships

- FI is responsible for actions of Third Parties
  - CFPB – Bulletin 2012-03
  - FDIC – FIL 44-2008; FIL 3-2013
  - OCC – Bulletin 2013-29
- Third Party Risk Management Program-OCC
  - Risk Management Life Cycle
    - Planning
    - Due diligence
    - Written Contracts
    - Ongoing Monitoring
    - Termination

Managing Third-Party Relationships

- **Critical Activities**
  - Significant risk if the third party fails to perform
  - Significant customer impacts
  - Require significant investment to implement the third party relationship and manage the risk
  - Could have a major impact on operations if bank has to find an alternate or substitute or brought in house
- **Oversight of Subcontractors**
  - Bank is responsible

Third-Party Risk Management



Source: OCC

Managing Third-Party Relationships

- **Planning**
  - Risk assessment, strategic purpose, compliance and legal aspects, goals and objectives
- **Due Diligence and Selection**
  - Financial reviews, compliance, policies, training, personnel, business experience and reputation, information security
- **Contract Structuring**
  - Scope, performance, reporting, audits, compliance, default and termination, indemnification, limitation of liability, subcontracting

Managing Third-Party Relationships

- **Ongoing Monitoring**
  - Audit, compliance review, performance, complaints, ability to manage risk, reliance on subcontractors, financial condition, personnel changes, training
- **Termination**
  - Terminate efficiently – expiration, breach, convenience
  - Transition to another provider
  - Bring activity in-house

Managing Third-Party Relationships

- **Implementation Challenges**
  - Due diligence
  - Monitoring
- **Impact and Lessons Learned**
  - Cost of compliance
  - Collaboration with third parties
  - Collaboration with regulator(s)

QUESTIONS AND COMMENTS?