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THE CONSUMER FINANCIAL PROTECTION BUREAU:

A First Year Retrospective by K&L Gates

July 23, 2012

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Introduction

By: Laurence E. Platt, Steven M. Kaplan, Stephanie C. Robinson

As the Consumer Financial Protection Bureau celebrates its first birthday, financial service providers mark the occasion with solemnity. It has been quite a turbulent year with the Bureau, which has made the most of its new statutory authority to issue several final and proposed regulations, initiate its supervisory oversight of the previously unsupervised, and assume the supervisory function of the federal banking agencies for large banks. It has also laid the groundwork for what is expected to be an active enforcement environment.

Clearly, the Bureau spent the year between the enactment of the Dodd-Frank Act and the commencement of the Bureau's operations creating a robust, internal infrastructure to pursue its public purpose to protect consumers. The agency has issued new rules, examination procedures, and investigative procedures. It has issued bulletins opining on various topics, from a company's use of service providers to the use of the disparate impact test in lending. It has launched its own blog and created a portal to collect consumer complaints, and has made all kinds of information publicly available on its web site, including individual-level consumer complaint data. Its level of consumer outreach is unprecedented. If there is any theme to be gleaned from the Bureau's first year of activities, it is the sheer volume of newness.

This retrospective of the Bureau's first year of operations describes the Bureau's most consequential actions since its launch on July 21, 2011. Its wide-ranging activities over the past year reflect a mandate that spans numerous industries within the consumer financial services sphere, including some industries that previously went unregulated. Some of these updates appeared previously in our blog (www.consumerfinancialserviceswatch.com), others appeared as client alerts, but most are new analyses. Among the topics covered in our retrospective are rulemaking in the mortgage market and other markets such as prepaid cards, supervision and examination of banks and nonbanks, enforcement of federal consumer financial laws, and the debate over the agency's legitimacy.

As we previously did for several years with the many agencies whose functions the Bureau inherited, K&L Gates' Financial Services Practice Area is equipped to assist clients with virtually any legal issue relating to the Bureau's supervisory, rulemaking and enforcement activities. Moreover, the Bureau has borrowed heavily from the adjudicative procedures of the Securities and Exchange Commission and the Federal Trade Commission, and already our government enforcement lawyers have been able to leverage their skills to assist clients in this arena. We believe our large concentration of lawyers with direct and substantial experience in regulatory counseling, class action defense, internal investigations, and government enforcement equip us to help our clients keep up with what we expect to be the Bureau's aggressive pursuit of its statutory mission. We hope this retrospective will give you a flavor of the depth and breadth of our knowledge and experience.

If you have questions about any of the articles, or wish to obtain further information, please feel free to contact either the authors directly or other members of the Consumer Financial Services Practice Group.

Best wishes!

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About the Firm

K&L Gates LLP comprises nearly 2,000 lawyers who practice in 41 offices located on four continents. We represent leading global corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. Our practice is a robust full market practice — cutting edge, complex and dynamic, at once regional, national and international in scope. K&L Gates practices law on an integrated basis and indeed has the largest integrated network of offices of any global law firm.

Consumer Financial Services

K&L Gates' Financial Services practice area includes one of the largest and most experienced consumer financial services practices in the United States. The Consumer Financial Services group comprises a core group of more than 35 attorneys and 12 regulatory compliance analysts throughout the country. Nearly 100 lawyers work in closely related practice groups.

The group divides its work among transactional, regulatory compliance, government enforcement, licensing and approvals, public policy and governmental affairs, and litigation (including class action defense). With an exceptional depth of knowledge and experience, the group leads the way in assisting clients with navigating the complex array of federal and state laws that regulate their businesses, structuring transactions, and defending private and government actions.

Our strong presence in Washington, D.C. enhances our ability to work with the various federal agencies that supervise financial service providers. Our close proximity to those agencies is particularly useful in our efforts to obtain agency approvals and defend against administrative enforcement actions. A number of our lawyers have worked at various federal and state agencies including the Securities and Exchange Commission, Federal Trade Commission, Department of Justice, the Department of Housing and Urban Development, and state Offices of the Attorney General, and maintain good working relationships with senior regulatory officials and key industry leaders.

Our clients represent a cross-section of the financial services industry, including traditional financial services companies (such as depository institutions, mortgage banks, consumer finance companies, loan servicers, broker dealers, investment banks, money services businesses, prepaid card issuers and sellers, and payment systems providers), as well as non-financial companies that might incidentally provide financial services to their customers (such as homebuilders, retailers, title insurers and agencies, real estate brokers, relocation service companies, and technology companies).

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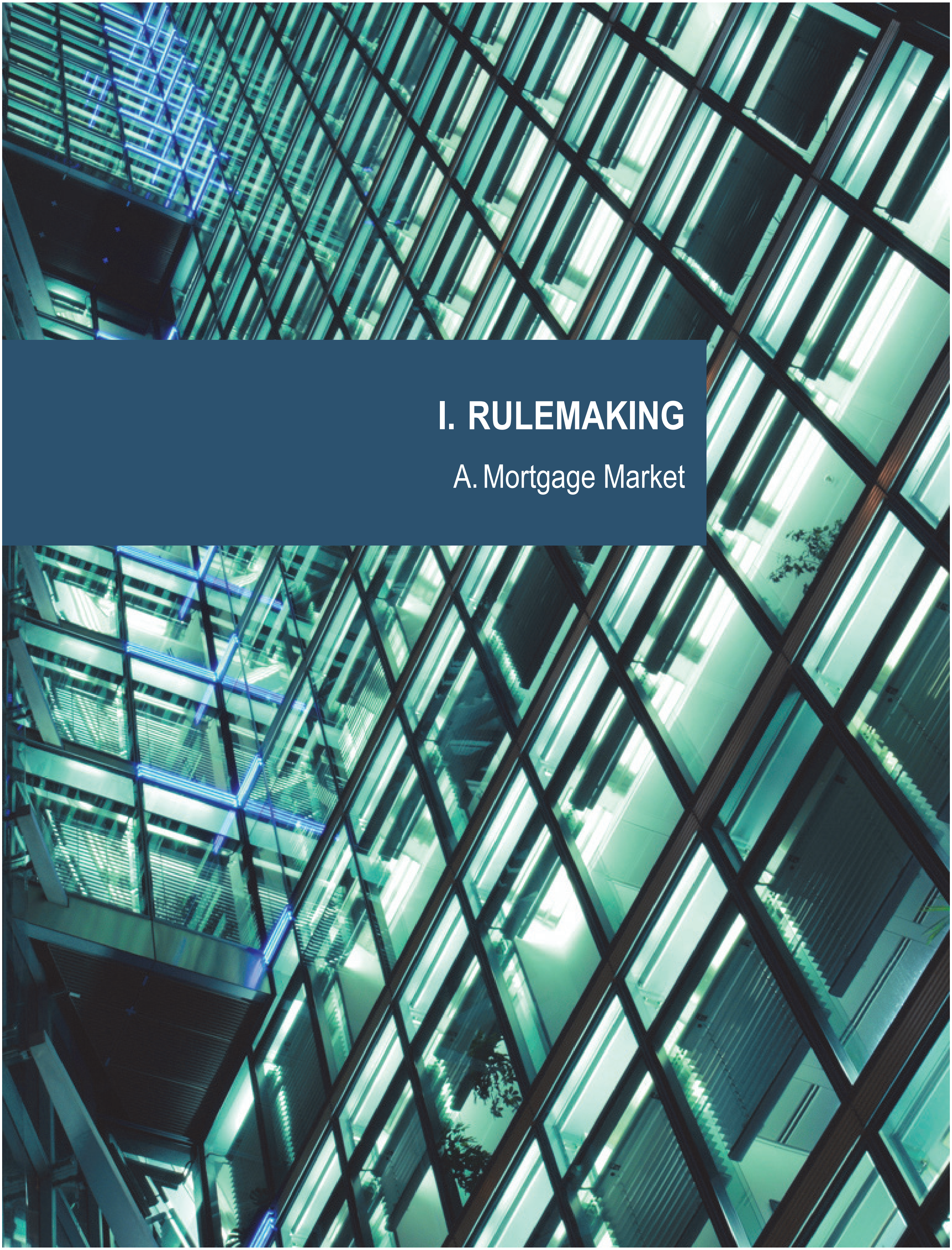

I. RULEMAKING

A. Mortgage Market

CFPB Wades Through QM

By Kris D. Kully

On the day after the Consumer Financial Protection Bureau received its transferred authority from (among other agencies) the Federal Reserve Board, it also received nearly two thousand comments on the Board's proposed rule to define "qualified mortgages" (or "QMs").[1]

Rather than waiting for the designated transfer date, the Board used its lame duck authority to issue proposed rules on several requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[2] including the Act's prohibition against making mortgage loans without regard to the consumer's repayment ability.[3] That proposed rule also must define QMs, which will be presumed to meet that ability-to-repay requirement. Comments on that proposed rule were due on July 22, 2011, the day after the Bureau officially opened for business.

The Board left the Bureau with a hefty task. The proposed rule was approximately 475 typed pages, with options, alternatives, factors, lists, and questions. No one said it would be easy to define a set of closed-end residential mortgage loans that a creditor and its assignees may presume will meet the Dodd-Frank Act's amorphous ability-to-repay requirement. That is particularly true when the definition of a "QM" will also provide the basis for defining "qualified residential mortgages" ("QRMs"), which will be exempted from the Dodd-Frank Act's credit risk retention requirements.

Accordingly, many would agree that, among other tasks, the Bureau has spent its first year essentially determining the future of residential mortgage finance – what mortgage loans will be available to American borrowers, and what mortgage loans are unlikely to be offered at all (at least at affordable rates).

The Bureau has absorbed the information submitted by the commenters. It has considered whether the QM should be broad or narrow. It has analyzed whether the QM should be protected by a safe harbor of compliance with the ability-to-repay requirement, or merely granted a rebuttable presumption of such compliance. It has heard from groups representing consumers, creditors, investors, and lawmakers. Rumors began circulating that the Bureau would be ready to issue its final rule on QM and ability-to-repay this summer, well ahead of the Bureau's January 2013 deadline.[4]

However, rather than a final rule, the Bureau issued a notice on May 31, 2012, informing the public about additional information and data it received, and reopening the comment period until July 9, 2012, primarily to solicit comment on additional loan data and on litigation costs and liability risks.[5] Reopening the comment period was arguably necessary for the Bureau to comply with federal rulemaking requirements (not to mention the Bureau's own policy regarding ex parte communications[6]).

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[1] *See* http://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R%2D1417&doc_ver=1, where the Board provides access to its public comments on the rule.

[2] Public Law 111–203 § 1411, 124 Stat. 1376, 2142 (to be codified at 15 U.S.C. § 1639c). The Consumer Financial Services Group of K&L Gates described many of the Dodd-Frank Act's mortgage reform components in a prior client alert. *See* "Hope You Like Plain Vanilla! Mortgage Reform and Anti-Predatory Lending Act (Title XIV)" (July 8, 2010), available at http://www.klgates.com/hope-you-like-plain-vanilla-07-08-2010/.

[3] 76 Fed. Reg. 27,390 (May 11, 2011).

[4] *See* Section 1400(c) of the Dodd-Frank Act.

[5] *See* Bureau of Consumer Financial Protection, "Notice of Reopening of Comment Period and Request for Comment," Docket No. CFPB-2012-0022 (May 31, 2012), available at www.consumerfinance.gov/f/201205_cfpb_Ability_to_Repay.pdf; 77 Fed. Reg. 33,120 (June 5, 2012).

[6] CFPB Bulletin 11-3, "Policy on Ex Parte Presentations in Rulemaking Proceedings" (Aug. 16, 2011).

Specifically, the Bureau reportedly obtained new loan-level data from the Federal Housing Finance Agency (which oversees Fannie Mae and Freddie Mac), allowing the Bureau to analyze historical loan performance in connection with several variables and to assess the benefits and costs of varying definitions of QM to consumers, including access to credit. The Bureau is now requesting more data and comment, particularly regarding debt-to-income ratios ("DTIs") and measures of residual income, and their relationship to loan performance. The Bureau is clearly continuing to weigh competing demands for a broad QM versus a narrow one, and a QM defined by clear and objective standards (like mandated DTI ratios) versus one defined by more flexible criteria.[7]

The Bureau also asked for more information on the liability risks and estimated litigation costs in connection with future claims of failure to comply with the ability-to-repay requirement. The risks and costs of an alleged failure are significant. Even if a creditor duly underwrites a mortgage loan and determines that the borrower can repay the loan, the borrower has three years to challenge that determination. Further, if the borrower defaults on the loan at any time (even after 29 years of making payments), he or she can still challenge the creditor's determination as a defense in any foreclosure or collection action. However, some have told the Bureau that the risks of litigation have been overstated, and that borrowers are unlikely to have the knowledge, capacity, or desire to bring those challenges.

Accordingly, the Bureau wants additional information about the risks and costs of such challenges, or of other costs (such as the costs of repurchase claims by mortgage loan investors, and the costs of prolonged foreclosure actions). Apparently, the Bureau feels it does not yet understand the likely outcome of choosing a safe harbor versus a mere rebuttable presumption (which as proposed would actually require a more onerous set of underwriting standards). However, the Bureau understands that its choice will have a significant impact on the availability of mortgage credit for American homeowners.

As mentioned above, the Dodd-Frank Act requires the Bureau to finalize the rule by January 2013. The Bureau's second year is thus likely to be even more eventful than its first.

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[7] Regulators across the globe are struggling with the same questions. We describe the efforts of the international Financial Stability Board to issue underwriting principles for its participating jurisdictions in a prior client alert. *See* "Defining Prudent Underwriting: An International Struggle" (June 4, 2012), available at http://www.klgates.com/defining-prudent-underwriting-an-international-struggle-06-04-2012/.

Bureau Gives Mortgage Industry a Pleasant Surprise with Interim Parity Act Rules

By: David L. Beam

The Alternative Mortgage Transaction Parity Act ("AMTPA") preempts for state-chartered institutions various kinds of state laws that regulate "alternative mortgage transactions" ("AMTs"). Before Dodd-Frank, AMTs included pretty much any residential mortgage loan more exotic than a 30-year, fixed-rate, regularly amortizing loan, including an adjustable rate mortgage (ARM) loan, a balloon loan, and a shared-appreciation or shared-equity mortgage loan. Dodd-Frank redefined AMT as, basically, a residential mortgage loan "in which the interest rate or finance charge may be adjusted or renegotiated." Dodd-Frank also provided that AMTPA preempted a state law only if that law "prohibits an alternative mortgage transaction." A lender is required to comply with regulations on AMTs issued by the Consumer Financial Protection Bureau to take advantage of AMTPA.

(AMTPA gave states the option to opt out. Maine, Massachusetts, New York, and South Carolina did for all or most types of loans. Arizona and Wisconsin did for certain kinds of small loans. Nothing discussed here applies to a loan covered by one of these opt-outs.)

On July 22, 2011, the CFPB issued an interim "Regulation D" to implement AMTPA in connection with mortgage transactions for which the application was received on or after July 22, 2011. This Regulation D was pleasant news for the mortgage industry, to put it mildly. In the Official Commentary on Regulation D issued with the rule, the Bureau interpreted the statutory definition of AMT broadly to encompass not only traditional adjustable-rate loans, but balloon loans with a commitment by the lender to extend the loan term and shared appreciation loans. The rule also provided that a state law was preempted if it "restricts the ability of the housing creditor to adjust or renegotiate an interest rate or finance charge with respect to the transaction or to change the amount of interest or finance charges included in a regular periodic payment as a result of such an adjustment or renegotiation." It expressly did not preempt most disclosure laws, or restrictions on prepayment or late fees. The regulation also established some consumer protection requirements that creditors had to satisfy in order to rely on AMTPA, including rules regarding the indexes to which a creditor could tie an interest rate.

Many in the industry had not known what to expect from the Bureau's AMTPA rule. The Dodd-Frank AMTPA amendments were ambiguous in several respects, which gave the Bureau broad discretion to decide the scope of preemption. Many had feared that the Bureau's pro-consumer focus would lead it to interpret AMTPA as sparingly preempting state consumer protection laws. In fact, the interim rule represented one of the broadest preemptive interpretations of AMTPA that the Bureau could have justified. This is a reminder that even though the Bureau is a consumer protection agency, it is still a *federal* consumer protection agency—and thus might still have the preference for uniform federal requirements historically exhibited by federal prudential regulators.

That being said, the CFPB was clear in the preamble that it had favored broad preemption in the interim rule because it feared disrupting the mortgage markets by changing the standards without careful consideration. The Bureau sought comment on what the final version of Regulation D should say, and its questions evidence a willingness to consider a rule that would provide for narrower preemption under AMTPA.

But that was a year ago, and the Bureau has not given a recent indication that a final Regulation D is imminent. It seems that the mortgage industry will be able to enjoy broad preemption by AMTPA for the foreseeable future.

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The CFPB and Fair Lending: Expectations for the Coming Year

By: Melanie H. Brody

The Consumer Financial Protection Bureau's Office of Fair Lending & Equal Opportunity is up and running, and currently conducting fair lending examinations of very large banks, independent mortgage companies and other non-bank creditors. Although the Bureau is still figuring a lot of things out, and its position on many fair lending topics remains to be seen, we do know of at least three fair lending issues that are likely to be focal points for the Bureau in the coming year.

First, like the Department of Justice and the Department of Housing and Urban Development, the CFPB has announced that it will use the disparate impact theory to enforce compliance with the Equal Credit Opportunity Act ("ECOA"). On April 18, 2012, the Bureau issued CFPB Bulletin 2012-04 (Fair Lending), stating that "the legal doctrine of disparate impact remains applicable as the Bureau exercises its supervision and enforcement authority" under ECOA and Regulation B. Unlike the disparate treatment theory of discrimination, which requires evidence of discriminatory intent, under the disparate impact doctrine, a creditor can be liable under ECOA if its use of a *neutral* practice has a disproportionate, adverse effect on a minority group, and the practice is not justified by a legitimate business consideration. Although the application of disparate impact can be tricky, making it difficult for lenders to assess potential risk, the Bulletin is largely confined to explaining the Bureau's rationale for adopting the approach as opposed to providing detail on *how* the doctrine will be applied. Thus, for example, we do not yet know what types of practices the CFPB is likely to challenge under the disparate impact doctrine, or what type of business considerations the CFPB may accept as a sufficient justification. Although there is a great deal of uncertainty, at a minimum, creditors need to be aware that the Bureau will analyze their fair lending compliance using the disparate impact standard, and should evaluate their lending policies to identify areas of potential risk.

Second, the Bureau is likely to focus a significant amount of fair lending examination and enforcement effort on small business lending. Section 1071 of the Dodd-Frank Act amended ECOA to require financial institutions to collect and report information about credit applications from women-owned businesses, minority-owned businesses and small businesses. Last year, the Bureau confirmed that the new ECOA information collection and reporting provisions will not go into effect until the Bureau finalizes implementing regulations. The Bureau has not yet proposed regulations implementing Section 1071, so the new reporting requirements are not yet imminent. However, consistent with Section 1071's intent to emphasize antidiscrimination in small business lending, the CFPB has begun to include small business lending in its ECOA exams. Thus, small business lenders should not delay in developing their fair lending compliance and monitoring programs.

Third, in the coming year, the Bureau can be expected to propose regulations to implement Dodd-Frank's amendments to the Home Mortgage Disclosure Act. Under the Dodd-Frank amendments, the Bureau must issue regulations requiring residential mortgage lenders to report additional information fields, including the loan applicant's age, total points and fees, prepayment penalty term, collateral value, teaser period, non-fully amortizing payment feature, loan term, origination channel, SAFE Act originator ID, universal loan identifier, property parcel number and applicant credit scores. Once the implementing regulations are finalized, the CFPB can be expected to leverage the new fields to target its fair lending enforcement activities. For instance, the Bureau will be able to use the new data to identify potential cases of age discrimination, and potential discrimination in transaction terms such as points and fees and prepayment penalties. On the bright side, the Bureau also should be able to use the new data to rule out potential fair lending enforcement targets *before* initiating an investigation. For instance, borrower credit scores can be a powerful explanatory factor in analyzing differences in underwriting outcomes and loan pricing across borrower groups. Once the CFPB has access to credit score information, it will have the ability to explain certain disparities with HMDA data only, thus sparing some lenders the expense and disruption of a fair lending investigation.

If you have any questions about these or any other fair lending issues, please give us a call.

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Loan Originator Compensation on the CFPB's Birthday – It's Seven Years in Dog Years

By: Jonathan D. Jaffe

Even though the Consumer Financial Protection Bureau is in its infancy, it has in its first year of existence issued two Bulletins and one Outline of Proposals dealing with loan originators and loan originator compensation. In fact, it did this in a five-week period in April and May of this year. In the past, it might have taken federal regulators seven years to issue what the CFPB has issued in its first year.

Background

As most readers know, the Federal Reserve Board (the "FRB") promulgated mortgage loan originator ("MLO") compensation rules (the "LO Comp Rule") under the Truth-in-Lending Act ("TILA") and its implementing regulation, Regulation Z. Pursuant to the Dodd-Frank Act (the "DFA"), rulemaking authority under TILA transferred from the FRB to the CFPB.

Subject to certain narrow exceptions, the LO Comp Rule provides that no MLO may receive (and no person may pay to an MLO), directly or indirectly, compensation that is based on any terms or conditions of a mortgage transaction.

Contributions to Qualified Plans Based on Profit Pools

The CFPB issued its first pronouncement—which it refers to as a Bulletin—regarding the LO Comp Rule on April 2, 2012.[1] The CFPB took the position in that Bulletin that the LO Comp Rule does not prohibit employers from contributing to qualified profit sharing, 401(k), and employee stock ownership plans ("Qualified Plans") out of a profit pool derived from loans originated by employees.

Qualified Plans are tax creatures subject to nondiscrimination rules issued by the IRS that prevent employer contributions from disproportionately favoring highly compensated employees. Consequently, employers almost universally satisfy this requirement using "safe harbor" allocation formulas that require uniform allocations to employees on the basis of their W-2 compensation—*e.g.*, the employer makes a contribution to all employees equal to 4% of their W-2 compensation for the year. Thus, it is difficult to imagine an employer contributing to a Qualified Plan where the contributions would vary from one MLO to another based on the profitability of each MLO's loans.

Transitional Licensing

The CFPB, again in response to state licensing agency inquiries, issued its second Bulletin addressing MLO compensation, albeit indirectly, one week later, on April 9, 2012.[2]

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[1] *Bulletin 2012-02: Payments to Loan Originators Based on Mortgage Transaction Terms or Conditions under Regulation Z* at http://files.consumerfinance.gov/f/201204_cfpb_LoanOriginatorCompensationBulletin.pdf. For a more detailed discussion, see also Jonathan Jaffe, *CFPB Issues First "Bulletin" Regarding TILA's Loan Originator Compensation Rule* at http://www.consumerfinancialserviceswatch.com/2012/04/10/cfpb-issues-first-bulletin-regarding-tilas-loan-originator-compensation-rule.

By K&L Gates on April 10th, 2012.

[2] *Bulletin 2012-05: SAFE Act – Transitional Loan Originator Licensing (and SAFE Act exam procedures?)* at http://files.consumerfinance.gov/f/201204_cfpb_bulletin_safe-act-transitional-loan-originator-licensing.pdf.

An MLO cannot be compensated for loan origination activities unless he or she is properly registered under federal law (if working for a federal banking agency-regulated institution, *e.g.*, a bank) or licensed under state law (if working for a non-bank). Of course issues arise when an MLO wants to move from one entity to another, particularly if the MLO is only registered rather than licensed, since federal registration requirements are somewhat less stringent than most state licensing requirements.

According to the Bulletin, the SAFE Act permits one state to provide a transitional license to an individual MLO licensed in another state. (A transitional loan originator license allows an individual licensed in one state to act as an MLO in another state while pursuing a license in that state.) However, the Bulletin also stated that states are prohibited from providing a transitional license for a registered MLO who is pursuing a state license in order to move from a bank to a non-bank employer.

Small Business Review Panel for Residential Mortgage Loan Origination Standards Rulemaking

As we previously discussed in another Client Alert,[3] the CFPB indicated its intent to issue significant new regulations (possibly in July of 2012) relating to MLOs and their compensation. It did this by issuing a *Small Business Review Panel for Residential Mortgage Loan Origination Standards Rulemaking - OUTLINE OF PROPOSALS UNDER CONSIDERATION AND ALTERNATIVES CONSIDERED* (the "Proposal").[4] While the Proposal covers a number of topics, its focus primarily addresses changes to MLO compensation and discount points and fees. We too will focus on these issues.

1. Dual Compensation

While the LO Comp Rule allows a consumer to pay upfront points and fees to a creditor, the DFA generally prohibits consumers from paying discount points, origination points, or fees where an individual MLO is being compensated by the creditor or brokerage firm. The CFPB is considering using its authority to create exemptions from this prohibition to allow consumers to pay upfront points and fees in connection with both retail and wholesale loans, subject to the following conditions:

- Consumers may pay discount points, provided: (1) the discount points are bona fide, *i.e* ,they result in a minimum reduction of interest rate for each point paid; and (2) the creditor also offers the option of a no discount point loan. The Bureau will define "bona fide discount points" in a separate rulemaking.
- Consumers may pay "flat" upfront origination fees in creditor-paid transactions (but not if it is compensation to the individual MLO) that do not vary with the size of the loan.
- Upfront "flat" fees may also be paid to affiliates of the MLO or affiliates of the creditor.

Of course there is a practical issue with the "bona fide" requirement. First, secondary market pricing of loans is not linear, *i.e.*, there is not a drop of X percent in the coupon rate for every 25 basis points in discount points. Second, discount points can vary based on loan terms, such as points charged to address

[3] Kris Kully, *CFPB Proposes Strict Controls on Discount Points, Origination Fees, and Broker Compensation*, May 16th, 2012 at http://www.consumerfinancialserviceswatch.com/2012/05/16/cfpb-proposes-strict-controls-on-discount-points-origination-fees-and-broker-compensation/.

[4] *Small Business Review Panel for Residential Mortgage Loan Origination Standards Rulemaking - OUTLINE OF PROPOSALS UNDER CONSIDERATION AND ALTERNATIVES .CONSIDERED* at http://files.consumerfinance.gov/f/201205_cfpb_MLO_SBREFA_Outline_of_Proposals.pdf.

loan level price adjustments that some investors charge and that do not serve to reduce the loan's note rate. Those are just a few examples of the many where discount points might not result in a direct reduction in interest rate, or might result in a reduction of X basis points on one loan, but a larger or smaller number of basis points in another.

There are similar practical issues with the "flat fee" requirement. For a flat fee to net to the lender what the lender would typically receive under a percentage based origination fee, the lender would need to effectively charge what it determines to be the average of all loans. This is probably best explained by example. If a lender charges a standard origination fee of 100 basis points on three loans of $50,000, $200,000 and $500,000, the lender would gross $7,500. To gross that same amount with a flat fee on those same three loans, the lender would need to charge a loan origination fee of $2,500 per loan. This would, of course, benefit the borrowers on the larger loans, while working to the detriment of the borrower with the $50,000 loan. And of course the $2,500 loan origination fee would almost certainly result in a loan that exceeds both federal and state high cost loan limits. Perhaps more to the point, these rules collectively would limit the ability of consumers to choose how they wish to pay for their mortgage loan.

The CFPB has also considered requiring creditors to offer a no-fee loan. The CFPB would require the difference between the higher interest rate on the no-fee loan, and the interest rate on the loan with upfront fees, to be reasonably related to the amount of upfront fees. Finally, the CFPB is considering requiring creditors to offer consumers the option of a no-point, no-fee loan.

2. Pricing Concessions

The LO Comp Rule does not allow creditors or mortgage brokers to set an MLO's compensation at a certain level and then lower it in selective cases, which they might want to do to avoid high-cost loan restrictions, cure a tolerance error in connection with the Good Faith Estimate, or even to meet competition. The CFPB indicated that it is considering permitting MLOs to help consumers cover costs, but only when there are unanticipated increases in third-party settlement charges and those settlement charges are not controlled by the MLO, the creditor or their affiliates. The CFPB does not appear inclined to permit MLOs to make other pricing concessions—such as concessions to prevent the creditor from making a high-cost mortgage or to undercut a competing offer.

3. Proxies

The existing Commentary to the LO Comp Rule prohibits compensation "based on a factor that is a proxy for a transaction's terms or conditions." The Commentary identifies credit scores and debt-to-income ratios as two examples of factors that are proxies for loan terms.

The CFPB proposes the following tests to determine whether a factor is a proxy: (i) does it substantially correlate with a loan term; and (ii) does the MLO have discretion to use the factor to present a loan to the consumer with more costly or less advantageous terms than terms of another loan available through the MLO for which the consumer likely qualifies.

4. Point Banks

Some creditors have established "point banks" for MLOs. The MLO may use points from the bank to obtain pricing concessions from the creditor. For example, the MLO may use points to pay discount points to obtain a lower rate for the consumer, thereby providing the MLO with the ability to close some transactions that may not have closed if the MLO did not have the benefit of a point bank.

As a general rule, the CFPB would prohibit point banks. But the CFPB might permit point banks funded by a creditor provided: "(1) the creditor does not base the amount of the contribution to an MLO's point bank for a given transaction on the terms and conditions of the transaction; (2) the creditor does not change its contributions to the point bank over time based on terms or conditions of the MLO's transactions, or on whether the MLO overdraws the MLO's point bank; and (3) if a creditor permits an MLO to overdraw the MLO's point bank, the creditor does not reduce the MLO's commission on a transaction when the [MLO] does so."

This would be a welcome change from the FRB's prior interpretation, and one that could ultimately benefit many consumers.

The CFPB is celebrating its one-year birthday with a splash, offering proposals that are likely to have a significant impact for many years to come.

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Industry Anticipates Additional Appraisal Reform

By: Nanci L. Weissgold

By most accounts, the Bureau of Consumer Financial Protection has been a whirlwind of activity since it opened its doors in July 2011. The same cannot be said, however, about its treatment of appraisals. Despite statutory authorization to finalize the Federal Reserve Board's (FRB) Interim Final Rule[1] on appraisal independence and to prescribe regulations to impose appraisal management company (AMC) minimum requirements, set standards for AVMs, implement ECOA amendments, and add appraisal restrictions for higher-priced mortgage loans, little has been done.

At a recent Congressional hearing on appraisal practices[2], legislators voiced concern that real estate appraisals are holding back the housing recovery. There may be more than a little truth to that sentiment. The appraisal industry is in a state of flux; old practices are out and new laws are in. In an era where appraisals are the foundation for many repurchase demands from secondary market participants, lenders are placing additional emphasis on the quality of their underwriting and valuations and struggling to implement the Dodd-Frank Act's appraisal independence provisions.

The appraisal independence provisions arose as a result of the Home Valuation Code of Conduct (HVCC), a 2008 settlement agreement between FHFA, the New York State Attorney General, and the GSEs[3]. The Dodd-Frank Act amended TILA (thereby replacing the HVCC) to prohibit mortgage lenders and their agents from unduly influencing the independent judgment of appraisers. These provisions were implemented by a 2011 FRB Interim Final Rule; the CFPB has the authority to issue a final rule but is under no specific statutory deadline to do so.

The appraisal independence requirements (of TILA and HVCC) fundamentally changed the ordering and management of the appraisal process. In order to ensure a layer of insulation between those responsible for loan production and the independent appraisers, many lenders hire AMCs to act as the sole point of contact between the lender and the appraiser. AMCs have grown in prominence, as has the awareness that AMCs lack substantial and uniform oversight. As a fix, Congress requires the CFPB, federal banking regulators[4] and the FHFA (Agencies) to establish, by regulation, minimum standards by January 2013 requiring that the AMC:

- register with and be subject to supervision by a state appraisal board in each state where the company operates (except a subsidiary which is owned and controlled by a federal financial institution);
- verify that only licensed or certified appraisers are used for federally related transactions;
- require that appraisals coordinated by the AMC comply with the USPAP; and,
- require that appraisals are conducted independently and free from inappropriate influence and coercion pursuant to the appraisal independence standards under Section 129E of TILA.

The states must then implement a regulatory scheme for AMCs within three years of the Agencies finalizing their rules establishing minimum standards, subject to a possible extension. Although the

[1] *See* Truth in Lending Interim Final Rule, 75 Fed Reg. 66554 (Oct. 28, 2010) (codified at 12 C.F.R. § 226).

[2] On June 28, 2012, the House Financial Services Committee, Subcommittee on Insurance, Housing and Community Opportunity held a hearing entitled "Appraisal Oversight: The Regulatory Impact on Consumers and Businesses." This hearing was held in order to examine the current state of the appraisal system and how it is affecting consumers.

[3] *See, e.g.,* Freddie Mac, "Home Valuation Code of Conduct," *available at* http://www.freddiemac.com/singlefamily/pdf/hvcc_746.pdf

[4] The federal banking regulators include the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and National Credit Union Administration.

majority of states have enacted AMC registration laws in anticipation of the rules, their enforcement may be inconsistent. According to a recent GAO report commissioned by the Dodd-Frank Act, "[s]etting minimum standards that address key functions AMCs perform on behalf of lenders could provide greater assurance of the quality of the appraisals that AMCs provide."[5]

Three additional sets of regulations are required under the Dodd-Frank Act:

- The CFPB must promulgate regulations that implement changes to ECOA to require that each creditor furnish to an applicant a copy of any and all written appraisals and valuations *developed* in connection with the applicant's application for a first-lien loan not later than three days before loan closing (regardless of whether credit is granted, denied, withdrawn or the application is incomplete). Currently, ECOA requires a creditor to provide a copy of the appraisal report *used* in connection with an application for credit and "appraisal report" means the document(s) *relied upon* by a creditor in evaluating the value of the dwelling.
- The Agencies must prescribe regulations to implement the appraisal requirements for "higher-risk mortgages" (i.e., mortgages secured by a consumer's principal dwelling and defined similarly to "higher priced mortgage loans" in Regulation Z, 12 CFR 226.35(a)) (and may jointly exempt, by rule, a class of loans if the Agencies determine that the exemption is in the public interest and promotes the safety and soundness of creditors). These regulations must implement the requirements in Section 129H in TILA that, among other requirements, (i) prohibit BPOs or AVMs for the origination of a higher-risk mortgage by requiring a licensed or certified appraiser to conduct an appraisal by visiting the interior of the mortgage property; (ii) require the creditor to obtain a "second appraisal" if a higher-risk mortgage is financing the purchase or acquisition of a property at a price higher than its prior sales price, within a 180-day window; and, (iii) require the creditor to provide the consumer with a free copy of the appraisal no later than three days before closing.
- The Agencies, in consultation with the Appraisal Subcommittee and the Appraisal Standards Board of the Appraisal Foundation, must promulgate regulations regarding quality control standards of AVMs, a computerized model used by mortgage originators and secondary market issuers to determine the collateral worth of a mortgage secured by a borrower's principal dwelling. Such standards must, at a minimum: (i) achieve a high level of confidence in the estimates produced by AVMs; (ii) protect against the manipulation of data; (iii) seek to avoid conflicts of interest; and, (iv) require random sample testing and reviews of AVMs (but the sampling does not expressly have to be carried out by a certified or licensed appraiser).

Additionally, although not required, the Agencies may issue regulations that ensure the portability of appraisals between lenders for loans secured by the borrower's primary residence.

[5] GAO 12-840T, "Residential Appraisals: Regulators Should Take Actions to Strengthen Appraisal Oversight," June 28, 2012, *available at* http://www.gao.gov/assets/600/592000.pdf

We are still waiting for the Bureau's whirlwind of activity with respect to appraisals. No one promised simplicity with these anticipated requirements, but compliance obviously remains a requirement.

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CFPB Proposes Regulations to Combine RESPA and TILA Mortgage Disclosures: Buckle Up for the Long-Anticipated Ride

By: Holly Spencer Bunting

In one of the most anticipated actions of the Consumer Financial Protection Bureau's "Know Before You Owe" campaign, on July 9, 2012, the CFPB published 1,099 pages of a proposed regulation to combine mortgage disclosure forms required under the Real Estate Settlement Procedures Act ("RESPA") and the Truth in Lending Act ("TILA").[1] As the Dodd-Frank Wall Street Reform and Consumer Protection Act charged the CFPB with creating combined disclosure forms and proposing regulations implementing such forms by July 21, 2012, the Bureau met that deadline with a few weeks to spare. Now mortgage companies, title insurance and settlement agents, real estate brokers, and all other interested parties are digging in to the proposed regulations in an attempt to understand how the Bureau's proposed changes could impact their businesses. Industry participants should have plenty of time to digest the proposed regulations; public comments on the proposed changes to the calculation of the finance charge are due on September 7, 2012, while all other comments on the proposed combined disclosures are due on November 6, 2012.

I. Loan Estimate

The Bureau is proposing to add the new combined mortgage disclosure requirements to Section 1026.19 of TILA regulations, as well as add two sections to TILA regulations that would dictate detailed line-by-line instructions for completion of the disclosure forms. Notably, for all closed-end consumer credit transactions secured by real estate, other than reverse mortgages, creditors would be required to provide a Loan Estimate disclosure within three business days of receiving an application. While the timing of providing this disclosure is generally the same as is required for providing a Good Faith Estimate ("GFE") and initial TILA disclosure, the proposed regulation would change the definition of "application" to remove the catch-all provision that currently permits lenders to collect any other information the lender deems necessary to make a credit decision before issuing the GFE. As the Bureau has expressed concern that lenders are using the current definition of "application" to delay the issuance of early disclosures, the proposed definition would require creditors to issue the combined Loan Estimate disclosure within three "business days" (which would be defined as all calendar days except Sunday and legal public holidays) of receiving six pieces of information: the borrower's name, income, social security number, the property address, an estimate of the value of the property, and the mortgage loan amount sought. In addition, in a change from current GFE requirements, a creditor would be required to provide a Loan Estimate disclosure no later than the seventh business day before closing, although a consumer could waive such a waiting period after receiving the disclosure in the case of a bona fide personal financial emergency.

With regard to the Loan Estimate form, the proposed disclosure is a three page document that combines a summary of loan terms and projected payments with a detailed disclosure of estimated closing costs and other cash needed to close a loan, as well as a streamlined summary of certain disclosures regarding the transaction. While the structure of the form and the detailed *itemization* of loan terms and closing costs

[1] *See* Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), Docket No. CFPB-2012-0028 (July 9, 2012), *available at* http://www.regulations.gov/#!documentDetail;D=CFPB-2012-0028-0001. This proposed regulation has yet to be officially published in the Federal Register.

are significantly different from the GFE, certain of the proposed regulations mirror current RESPA requirements. For instance, the proposed regulations maintain the requirement to provide a written list of settlement service providers to assist consumers in shopping for settlement services required by a creditor in a closed-end, real estate-secured consumer credit transaction.

The provision of a written list also would be tied to restrictions on the change in closing costs disclosed as part of the proposed Loan Estimate. Mortgage lenders know such restrictions as tolerances under the current RESPA regulations. Although the proposed regulations would characterize such restrictions as estimating closing costs in "good faith," rather than tolerances, the end result is the same; mortgage lenders would continue to be held accountable for changes in certain closing costs based on the amounts disclosed on the proposed Loan Estimate. Those standards, however, would be stricter under the proposed regulations; any third party services obtained from lender-affiliated companies or non-affiliated companies selected by the lender, absent changed circumstances permitting the revision of the Loan Estimate, could not exceed at closing the amount disclosed on the Loan Estimate. Any such excess would need to be credited back to the borrower by the creditor. With these stricter standards and the proposal by the CFPB to essentially define a "good faith estimate" as *the disclosure of the actual amount charged to a consumer at closing* (with limited exceptions), the legal issue of whether the CFPB has the statutory authority to impose these restrictions on lenders, as well as the subsequent requirement to refund the excess fees, is, once again, ripe for discussion.

II. Closing Disclosure

Following the Loan Estimate, the proposed regulations offer two alternatives for providing the Closing Disclosure to a borrower no later than three business days before closing. Given the combination of loan terms and closing costs on the proposed disclosure, the CFPB is asking the public for comments on whether the creditor should be solely responsible for completing and providing this form to the borrower, or whether the settlement agent should have the option to provide the Closing Disclosure when the creditor would maintain ultimate responsibility for providing the disclosure. The proposed regulations are written to present two alternative regulatory provisions reflecting these options. (Note that the settlement agent would have sole responsibility for providing a seller with a Closing Disclosure reflecting the seller's side of the transaction no later than the date of closing.) Although the proposed regulations would permit consumers to waive the three business day waiting period after receiving the disclosure in the case of a bona fide personal financial emergency, in all other cases, if the Closing Disclosure is revised and reissued to the borrower, a new three business day waiting period would apply before closing, except in certain circumstances, including changes resulting from buyer and seller negotiations and fee changes of less than $100.

With regard to the Closing Disclosure form, the proposed disclosure is a five page document that would: (1) repeat the first page of the Loan Estimate as the first page of the Closing Disclosure; (2) include a detailed itemization of closing costs similar to the current HUD-1 Settlement Statement ("HUD-1"), but with categories of fees grouped to match the structure of the proposed Loan Estimate; (3) summarize the borrower's cash needed to close, which would factor in impermissible changes to closing costs; (4) provide a summary of both the borrower's side and the seller's side (if applicable) of the transaction similar to the current HUD-1; and (5) include two pages of loan disclosures and transaction-specific calculations, such as escrow account disclosures and the calculation of the annual percentage rate ("APR") and finance charge.

III. Other Proposed Changes

In addition to proposing combined disclosure forms and regulations implementing those forms, the CFPB's proposed regulation includes other changes to RESPA and TILA, including the removal of the RESPA exemption for loans secured by properties of 25 acres or more and an overhaul to the calculation of the finance charge. With regard to the later proposal, the CFPB is proposing to remove most of the exclusions that allow lenders to exclude certain fees from the calculation of the finance charge and revise the calculation to match the statutory language under TILA.

Notably, under the TILA regulations, a fee or charge is included in the finance charge if it is "payable directly or indirectly by the consumer" to whom credit is extended and "imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." With the proposed amendments, exclusions for certain real estate-related fees would be removed from the calculation, which means fees for services like title searches, document preparation, appraisals, credit reports, and notaries would be included as part of the finance charge. That said, the proposed regulation would continue to exclude fees or charges paid in comparable cash transactions, late fees and similar default or delinquency charges, seller's points, amounts required to be paid into escrow accounts if the amounts would not otherwise be included in the finance charge, and premiums for property and liability insurance if certain conditions are met. As this revised calculation could result in higher APRs and more "high-cost" loans or cause loans to fail the three-point test under the definitions of "qualified mortgage" and "qualified residential mortgage," the Bureau is imposing a September 7, 2012 public comment deadline on the finance charge proposal. This will allow the agency to consider these comments together with other comments submitted in response to the CFPB's separately-proposed changes to the Home Ownership and Equity Protection Act.

The proposed regulations also would add a partial exemption to the RESPA regulations to exempt federally-related mortgage loans that are closed-end, real estate-secured consumer credit transactions from certain provisions of the RESPA regulations, including Section 1024.7 governing the GFE and Section 1024.8 governing the HUD-1. Reverse mortgages, however, would remain subject to the GFE and HUD-1 requirements. In fact, the CFPB proposes to incorporate reverse mortgage-specific Frequently Asked Questions issued by the U.S. Department of Housing and Urban Development into the regulatory instructions for preparation of the GFE and HUD-1.

IV. What's Next

We will continue to review and analyze the CFPB's proposed regulation and provide a more-detailed discussion of the Bureau's proposals in the near future. In the meantime, while the proposed disclosure forms are substantially different from the current GFE and HUD-1, many of the regulatory requirements behind the disclosures, like timing, collection of up-front fees, restrictions on revisions to the disclosures, and fee tolerances, appear to be similar to the processes that mortgage lenders have in place. Thus, industry participants should keep these differences and similarities in mind as they review the proposed regulations and weigh the important impact the changes could have on the origination and closing of mortgage loans, as well as the technology and other systems lenders use in their businesses.

Significant time and attention have gone into the proposals announced by the CFPB, and if modifications are to be made to the proposed regulations, it will be important for mortgage lenders and all other settlement service providers to submit detailed public comments outlining the consequences of the Bureau's proposals. Please contact us if you have questions about the CFPB's proposed mortgage disclosure regulations or if we can assist you in working through the implications of the proposed regulations for your business.

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CFPB Will Use Rulemaking Authority to Establish Mortgage Servicing Standards

By: Kerri M. Smith

While the Bureau of Consumer Financial Protection is required under the Dodd-Frank Act to promulgate rules under RESPA and TILA addressing certain general servicing-related issues (such as payoff requests and monthly disclosures), the CFPB has announced that it will go beyond the Dodd-Frank Act's provisions to address "the perceived lack of transparency and accountability within the servicing industry."[1] But was that really Congress' intent in enacting the Dodd-Frank Act's servicing provisions?

The CFPB will formally propose its servicing rules this summer with the intention that these rules will be finalized in January 2013. In the meantime, the CFPB has issued an overview of the rules under consideration to solicit feedback on the effect of its servicing proposal on small businesses.[2]

Since the Dodd-Frank Act's enactment, the servicing industry has faced elevated scrutiny, and such scrutiny gave rise to the national mortgage settlement between the five largest servicers and state and federal regulators. Precipitating the settlement were allegations of defective default servicing, and the resulting settlement standards are quite detailed on this topic. By contrast, the Dodd-Frank Act's TILA and RESPA amendments are silent on this issue. Instead, the Act addresses aspects of non-default mortgage servicing activity, such as disclosing interest rate adjustments, providing payoff statements timely, requiring timely application of payments, providing informative monthly statements, and imposing standards about when a servicer may "force-place" insurance. The Dodd-Frank Act also requires a servicer to investigate errors and respond to borrowers' inquiries that are not a qualified written request ("QWR").

Clearly, the CFPB's proposed rule will implement the Dodd-Frank Act provisions noted above. The more interesting question is the extent to which the CFPB plans to use rulemaking to adopt default servicing standards. In its proposal, the CFPB has signaled it will use its discretionary authority to tackle default servicing reform by: (1) imposing a more robust operational process for tracking and storing borrower documents and information to facilitate loss mitigation efforts; (2) proposing early intervention procedures for troubled and delinquent borrowers; and (3) requiring the establishment of direct, ongoing access to staff who are dedicated to servicing troubled borrowers.

For example, the CFPB may consider requiring that a servicer maintain a servicing system that properly records account information, makes relevant records relating to a borrower's account promptly available to appropriate loss mitigation personnel, receives documents, tracks information for inquiries and complaints, and provides accurate and timely disclosures and other information to borrowers. The CFPB has also signaled that it will impose borrower outreach campaigns targeting distressed borrowers. For example, the CFPB may require that servicers provide delinquent borrowers with information within 45 days of delinquency about options to avoid foreclosure and the foreclosure process, including loss mitigation programs available, requirements for qualifying for such programs (including documentation), a brief explanation of the foreclosure process, and contact information for housing counselors who may be able to

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[1] *See* CFPB, "Consumer Financial Protection Bureau Outlines Borrower-Friendly Approach to Mortgage Servicing," Apr. 9, 2012, *available at* http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-outlines-borrower-friendly-approach-to-mortgage-servicing/.

[2] *See* CFPB, "Small Business Review Panel for Mortgage Servicing Rulemaking: Outline of Proposals Under Consideration and Alternatives Considered," Apr. 9, 2012, *available at* http://files.consumerfinance.gov/f/201204_cfpb_small-business-review-outline_mortgage-servicing-rulemaking.pdf.

assist the borrower. The CFPB would not be breaking new ground with this requirement, as loss mitigation solicitation efforts are mandated by HAMP and GSE requirements, and by numerous state laws.

Further, the CFPB may require servicers to provide borrowers with direct, ongoing access to "a staff of the servicer's customer service employees" who are dedicated to servicing all troubled borrowers. It is unclear from the CFPB's overview whether a servicer could satisfy this requirement with a team of personnel rather than an individual "single point of contact." The CFPB proposal also does not describe when a dedicated employee fulfills his or her duties (e.g., if the borrower becomes current), although this may be addressed in the forthcoming proposed rule.

So how does the CFPB's servicing proposal measure up to the comprehensive standards found in the national mortgage settlement?[3] Unlike the national mortgage settlement, the CFPB proposal does not plunge into tenants rights, dual tracking, SCRA protections, foreclosure document deficiencies, or servicing fees (except to prohibit fees for a QWR). The CFPB proposal suggests that the servicing rule will cover topics discussed in the mortgage settlement standards, such as force-placed insurance, payment application processes, monthly billing statements, consumer complaints, operational advancements, borrower outreach, and single point of contact (and separately, by Bulletin 2012-03, vendor management standards).[4]

A more thorough comparison will be warranted once the CFPB promulgates its proposed rule, but it is unlikely that the CFPB's rules will be as exhaustive in scope or as detailed in nature as the national mortgage settlement standards.

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[3] K&L Gates LLP, "Global Foreclosure Settlement: What You Need To Know," *available at* http://www.klgates.com/files/Publication/63cbedf0-3d81-42cc-92cc-e7d160b73c25/Presentation/PublicationAttachment/40b115ab-dd18-4600-bd4f-8289577f6fa3/Global_Foreclosure_Settlement_5.7.pdf.

[4] Jonathan D. Jaffe and David A. Tallman, "Unlucky Day for Consumer Financial Servicer Providers? The CFPB Issues Its Vendor Management Bulletin on Friday the 13th," May 11, 2012, *available at* http://www.klgates.com/unlucky-day-for-consumer-financial-servicer-providers--the-cfpb-issues-its-vendor-management-bulletin-on-friday-the-13th-05-11-2012/.

Forget Plain Vanilla – How About Pickle?

Proposed HOEPA Rule Threatens to Curtail Consumer Credit

By Jonathan D. Jaffe, David A. Tallman

It is no secret that the high cost home loan provisions of the Home Ownership and Equity Protection Act of 1994 ("HOEPA") operate as a *de facto* federal usury limit. In large part, this is because HOEPA provides that purchasers of high cost home loans are subject to all claims and defenses that the consumer could assert against the original creditor under both federal and state law.[1] Without a secondary market willing to assume assignee liability risk, high cost home loans have acquired such a toxic reputation that very few lenders choose to originate them and even fewer will finance or buy them. The Dodd-Frank Wall Street Reform and Consumer Protection Act[2] ("Dodd-Frank") greatly expanded HOEPA's reach by extending its coverage to purchase money mortgages and home equity lines of credit ("HELOCs"); lowering the existing cost thresholds; adding a new prepayment penalty threshold; and revising the APR, finance charge, and points and fees calculations. At the same time, Dodd-Frank targets makers and holders of non-plain vanilla mortgages (*i.e.*, those that do not qualify as a qualified mortgage ("QM") or qualified residential mortgage ("QRM")) with enhanced monetary damages, defenses to foreclosure, and risk retention requirements.[3] Those few lenders who might be able and willing to offer credit outside the plain vanilla confines of the QM/QRM will not have much pricing flexibility to meet their customers' legitimate credit needs before running into pickle-flavored HOEPA.

The Bureau of Consumer Financial Protection (the "CFPB" or the "Bureau") issued a proposed rule last week to implement Dodd-Frank's HOEPA amendments[4] (the "HOEPA Rule"). To its credit, the Bureau appears to recognize that HOEPA's expanded scope is likely to have a substantially negative impact on consumer access to credit. The Bureau's proposal accordingly attempts to soften some of the harsher – and likely unintended – impacts of the Dodd-Frank amendments. Most notably, to prevent too many loans from triggering the HOEPA rate threshold, the Bureau suggests using a new "transaction coverage rate" (or "TCR") in the rate threshold instead of the APR, in light of the expanded scope of the finance charge and APR in its proposed rule to combine the TILA and RESPA origination disclosures (the "TILA/RESPA Rule")[5]. Unfortunately, the HOEPA thresholds would remain overinclusive, even if the Bureau were to replace the APR with the TCR – particularly in light of the credit-constraining effects of the proposed QM and QRM rules.

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[1] The consumer's right to assert claims and defenses is subject to certain limitations, and it remains an open issue whether consumers may assert affirmative claims against purchasers.

[2] Pub. L. 111-203, H.R. 4173.

[3] For more information about the credit-constraining effects of Dodd-Frank, see our previous alert, *Hope You Like Plain Vanilla! Mortgage Reform and Anti-Predatory Lending Act (Title XIV)* (July 8, 2010), available at http://www.klgates.com/hope-you-like-plain-vanilla-07-08-2010/.

[4] CFPB, Docket No. CFPB-2012-0029, *Proposed Rule - High-Cost Mortgage and Homeownership Counseling Amendments to the Truth in Lending Act (Regulation Z) and Homeownership Counseling Amendments to the Real Estate Settlement Procedures Act (Regulation X)*, available at http://files.consumerfinance.gov/f/201207_cfpb_proposed-rule_high-cost-mortgage-protections.pdf (last accessed July 17, 2012). The HOEPA Rule covers a number of topics we do not address in this Client Alert, including counseling requirements, balloon loan provisions, late charges, and payoff statement fees in connection with HOEPA loans.

[5] CFPB, Docket No. CFPB-2012-0028, *Proposed Rule - Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z)*, available at http://files.consumerfinance.gov/f/201207_cfpb_proposed-rule_integrated-mortgage-disclosures.pdf (last accessed July 17, 2012).

If the Bureau is serious about preserving consumer access to credit, it should exercise its authority to make more significant adjustments to the HOEPA thresholds.

A Primer on High Cost Thresholds

A. General

HOEPA currently applies to any consumer credit transaction that is secured by the consumer's principal dwelling (other than certain "residential mortgage transactions" (e.g.., purchase-money loans), reverse mortgages, or open-end credit) in which either:

> 1. The annual percentage rate at consummation will exceed by more than 8 percentage points for first-lien loans, or by more than 10 percentage points for subordinate-lien loans, the yield on Treasury securities having comparable periods of maturity to the loan maturity as of the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor (the "Treasury Yield"); or
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> 2. The total points and fees payable by the consumer at or before loan closing will exceed the greater of 8 percent of the total loan amount, or $400 (adjusted annually for inflation).[6]

Among other things, the Bureau's proposed HOEPA Rule would: (i) extend HOEPA's coverage to purchase-money mortgage loans and HELOCs, as required under Dodd-Frank; (ii) revise the APR and points and fees thresholds; and (iii) add a new prepayment penalty threshold. Specifically, a high cost home loan would include any consumer credit transaction secured by the consumer's principal dwelling, other than a reverse mortgage, in which:

> 1. The APR (or, alternatively, the "transaction coverage rate") at consummation of the transaction exceeds the average prime offer rate for a comparable transaction ("APOR") by more than: (i) 6.5 percentage points for transactions secured by a first mortgage on the consumer's principal dwelling (except that the threshold would be 8.5 percentage points, if the dwelling is personal property and the total transaction amount is less than $50,000); or (ii) 8.5 percentage points for transactions secured by a subordinate mortgage on the consumer's principal dwelling;
>
> 2. The total points and fees payable in connection with the transaction, other than bona fide third-party charges not retained by the mortgage originator, creditor, or an affiliate of either, exceed: (i) in the case of a loan of $20,000 or more, 5 percent of the total loan amount; or (ii) in the case of a loan of less than $20,000, the lesser of 8 percent of the total loan amount or $1,000 (adjusted for inflation); or
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> 3. The transaction provides for prepayment fees and penalties that: (i) may be imposed more than 36 months after consummation or account opening or (ii) exceed, in the aggregate, more than 2 percent of the amount prepaid.

Because HOEPA loans are subject to expanded TILA liability, and because purchasers of HOEPA loans are subject to all claims and defenses that the consumer could assert against the original creditor, HOEPA loans are essentially unsaleable in the secondary market. Which of course means that few, if any, lenders are willing to make HOEPA loans. Consequently, the HOEPA Rule's lower APR and points and fees

[6] 12 C.F.R. § 1026.32(a). The dollar trigger for 2012 is $611.

thresholds (and to a lesser extent, the new prepayment fee threshold) effectively would significantly tighten the availability of credit.[7] We discuss each of these thresholds in more detail below.

B. Rate Threshold

The Bureau's proposal would lower the current APR thresholds from 8 percentage points over the Treasury Yield for first-lien mortgages and 10 percentage points over the Treasury Yield for subordinate-lien mortgages, to 6.5 percentage points over the APOR for most first liens and 8.5 percentage points over the APOR for subordinate liens. As noted above, these changes will almost certainly have a negative impact on the ability of consumers to access residential mortgage credit. However, the impact of the Dodd-Frank amendments on the scope of HOEPA will be even greater than is readily apparent from these numerical changes.

First, TILA and Regulation Z currently permit creditors to exclude from the finance charge – and by extension from the APR – several fees and charges, including most third-party fees.[8] The CFPB, in its proposed TILA/RESPA Rule, considers expanding the definition of finance charge for closed-end credit to include virtually all fees or charges payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. The only exclusions from this definition would be: (i) fees or charges payable in comparable cash transactions; and (ii) late fees and similar default or delinquency charges, seller's points, amounts required to be paid into escrow accounts if the amounts would not otherwise be included in the finance charge, and property and liability insurance premiums if certain conditions are met. Thus, a large number of fees currently excluded from the finance charge would now be included in the expanded finance charge and APR calculations, such as: (i) closing agent charges; (ii) application fees charged to all applicants for credit whether or not credit is extended; (iii) taxes or fees required by law and paid to public officials relating to security interests; (iv) premiums for insurance obtained in lieu of perfecting a security interest; (v) taxes imposed as a condition of recording the instruments securing the evidence of indebtedness; and (vi) various real-estate related fees, including title insurance premiums.

The CFPB recognizes that without further action, the more inclusive finance charge definition would cause even more closed-end loans to trigger HOEPA protections for high cost loans (as well as protections under state laws similar to HOEPA), a result that Congress may not have considered or intended. The Bureau thus has proposed two alternative HOEPA rate thresholds. The first alternative is to continue to use the APR, letting the chips fall where they may, while the second is to replace the APR with a new "transaction coverage rate" (or "TCR") identical to the APR, except that the TCR only would include charges retained by the creditor, a mortgage broker, or any affiliate of either. Because the proposed expansion of the finance charge definition applies solely to closed-end credit, the Bureau proposes to use the TCR only for closed-end credit (and even then, only if the Bureau decides to implement the finance charge expansion).

While using a TCR instead of the APR would mitigate the impact of the expanded finance charge definition on the HOEPA rate threshold, the finance charge is not the only factor pushing HOEPA ever farther towards "plain vanilla" territory. Not only does Dodd-Frank lower the percentage thresholds and replace the Treasury Yield with the APOR, it also mandates for purposes of the HOEPA threshold that the APR on an adjustable-rate mortgage ("ARM") must be based on the *maximum* interest rate. When the

[7] The Bureau has announced its intent to focus on fair lending violations, and to apply a disparate impact test in doing so. The lower APR and points and fees thresholds under the proposed HOEPA Rule, as well as the tests suggested under the QM and QRM Rules, will almost certainly result in an increased percentage of loan applications being denied. This will be evident through HMDA reports. It remains to be seen whether this will result in general in an increase in the percentage of denials of members of protected classes.

[8] *Id*. § 1026.4.

APR may adjust solely in accordance with an index, the maximum rate should be determined by adding the maximum margin to the index value in effect at consummation or account opening. When the APR may adjust for other reasons, the maximum rate must be based on the maximum interest rate that may be imposed during the term of the loan. The current HOEPA APR calculation is not based on the maximum rate, but rather is based on the fully indexed rate (using an index value in effect during the look-back period before consummation and blended with any introductory rate(s)). The Bureau's proposal to use the maximum rate as the basis for both the APR and TCR represents a significant expansion of HOEPA. It could have particularly dire ramifications for HELOCs, which often provide for an interest rate that may increase to the maximum extent permitted by state law. Requiring the APR or TCR to be based on the maximum rate would hinder lenders' ability to control for interest-rate risk, increase the cost of credit, and curtail the availability of both HELOCs and closed-end ARMs.

C. Points and Fees Threshold

1. General

The proposal also lowers the HOEPA points and fees threshold, and amends the calculation of points and fees to comply with Dodd-Frank's amendments to TILA. It is noteworthy that to be considered a QM/QRM, the points and fees payable in connection with a mortgage loan may not exceed 3 percent of the total loan amount, while, for most residential mortgage loans, the HOEPA Rule establishes a points and fees threshold of only 5 percent of the total loan amount.[9] In other words, because the same definition of "points and fees" is used for both the HOEPA calculation and the QM/QRM definitions, there will be only a very narrow window between "plain vanilla" and "pickle" no matter what fees are included in the calculation.

It is difficult to assess how much the numerical reduction in the points and fees threshold would expand HOEPA's coverage, because the HOEPA Rule would incorporate new statutory exclusions into the underlying definition of "points and fees." Further, the Bureau once again attempts to mitigate the effect of its proposed expansion of the finance charge by excluding from points and fees on closed-end loans those charges that would be brought into the points and fees calculation solely by operation of the more inclusive finance charge definition. But for a number of reasons, it still seems likely that the proposed points and fees definition will cast a wider net than the existing calculation. For example, under the proposed definition, "points and fees" would include for the first time the maximum prepayment penalties that could be charged under the transaction documents, any prepayment penalties incurred in a same-lender refinance, fees payable after closing, and all loan originator compensation related to a particular transaction.

2. Definition of Points and Fees

HOEPA and Regulation Z currently define "points and fees" to include:

> 1. All items required to be disclosed under 12 C.F.R § 1026.4(a) and 1026.4(b) (*i.e.*, the finance charge), except interest or the time-price differential;

[9] The Bureau also proposes amending the definition of "total loan amount" such that the amount financed is no longer the starting point for the calculation. Instead, the proposal suggests that the "total loan amount" for closed-end credit should be the amount of credit extended at consummation that the consumer is legally obligated to repay, as reflected in the loan contract, less any cost that is both included in points and fees and financed by the creditor (for open-end credit, the "total loan amount" would be the credit limit for the plan when the account is opened).

2. All compensation paid to mortgage brokers;

3. All items listed in 12 C.F.R. §1026.4(c)(7) (other than amounts held for future payment of taxes) unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor (these are the fees commonly referred to as 4(c)(7) fees); and

4. Premiums or other charges for credit life, accident, health, or loss-of-income insurance, or debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law) that provides for cancellation of all or part of the consumer's liability in the event of the loss of life, health, or income or in the case of accident, written in connection with the credit transaction.

As discussed below, the Bureau's proposed rule would substantially revise this definition to implement Dodd-Frank's statutory amendments, with some accommodations for open-end credit. While certain aspects of the new definition will be narrower than the current definition (*e.g*., the new exclusions for bona fide discount points and third-party fees), others will be much broader. The proposed definition would apply both for purposes of the HOEPA high cost home loan threshold and the QM/QRM rules.

a. Closed-End Credit

For closed-end credit, the proposal would define points and fees to include:

1. All items included in the finance charge under 12 C.F.R. § 1026.4(a) and (b), but excluding items described in 12 C.F.R. § 1026.4(c) through (e) (except to the extent otherwise included by the revised points and fees definition) and also excluding:

a. Interest or the time-price differential; and

b. Any premium or other charge for any guaranty or insurance protecting the creditor against the consumer's default or other credit loss to the extent that the premium or charge is:

i. assessed in connection with any Federal or State agency program;

ii. not in excess of the amount payable under policies in effect at the time of origination under section 203(c)(2)(A) of the National Housing Act,[10] provided that the premium or charge is required to be refundable on a pro rata basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan; or

iii. payable after consummation;

2. Subject to certain exclusions, all compensation paid directly or indirectly by a consumer or creditor to a loan originator, including a loan originator that is also the creditor in a table-funded transaction;

3. All items listed in 12 C.F.R. § 1026.4(c)(7) (other than amounts held for future payment of taxes), payable at or before consummation, unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor (note that 4(c)(7) charges include many of the charges typically assessed in a residential mortgage transaction);

[10] 12 U.S.C. § 1709(c)(2)(A).

4. Premiums or other charges payable at or before consummation for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract;

5. The maximum prepayment penalty that may be charged or collected under the terms of the mortgage loan; and

6. The total prepayment penalty incurred by the consumer if the consumer refinances the existing mortgage loan with the current holder of the existing loan, a servicer acting on behalf of the current holder, or an affiliate of either.

Note that even beyond the new treatment of prepayment penalties, the broader loan originator compensation provision (described in item 2 above) represents a significant expansion of "points and fees." Under the current definition, only compensation paid to mortgage brokers by borrowers is required to be included in the calculation. However, subject to limited exceptions, the proposed definition of "loan originator" includes *any* person with respect to a particular transaction who for compensation arranges, negotiates, or otherwise obtains an extension of consumer credit for another person (other than the creditor in most circumstances). Thus, the revised points and fees calculation will capture not only borrower-paid broker compensation, but also lender-paid broker compensation, compensation paid from any source to any other loan originator in connection with the transaction, and even compensation paid to the creditor's own employees, even though the borrower's costs for much of this compensation would already be reflected in the interest rate and captured in the APR (or TCR). To demonstrate the reach of this provision, consider loan originator compensation paid to an employee. The proposed definition would include any compensation an employer pays to an employee when the compensation is attributable to the employee's origination of the particular closed-end mortgage, whether paid before or after closing (as long as that compensation can be determined at the time of closing), including bonuses, commissions, awards of merchandise, services, trips, prizes, and even the hourly pay for the actual number of hours worked on the transaction. Once again, the same definition of points and fees is proposed to be used for purposes of the QM / QRM definitions, which means that those calculations also would include all such loan originator compensation.

b. Open-End Credit

For open-end credit, the proposal would define points and fees to include:

1. All items included in the finance charge under 12 C.F.R. § 1026.4(a) and (b) and payable at or before account opening, except interest or the time-price differential;

2. All items listed in 12 C.F.R. § 1026.4(c)(7) (other than amounts held for future payment of taxes) payable at or before account opening, unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor;

3. Premiums or other charges payable at or before account opening for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract;

4. The maximum prepayment penalty that may be charged or collected under the terms of the open-end credit plan;

5. Any fees charged for participation in an open-end credit plan, whether assessed on an annual or other periodic basis; and

6. Any transaction fee, including any minimum fee or per-transaction fee, that will be charged for a draw on the credit line.

The term "points and fees" would not, however, include any fees or charges that the creditor waives at or before account opening unless the fees or charges may be imposed on the consumer after account opening. Nor does the proposed definition for open-end credit include loan originator compensation. This is because the Bureau determined that loan originator compensation is rarely paid with respect to open-end credit. Further, the calculation does not exclude amounts that would be added to the finance charge by the TILA/RESPA Rule, because the expanded definition would apply only to closed-end credit. Similarly, the proposed definition of points and fees for open-end credit does not exclude mortgage insurance premiums, because mortgage insurance premiums generally are not payable on HELOCs.

c. Exclusions

For both closed-end and open-end credit, points and fees would *not* include:

1. Any bona fide third-party charge not retained by the creditor, loan originator, or an affiliate of either, except mortgage insurance premiums otherwise required to be included in points and fees;

2. Up to 2 bona fide discount points[11] paid by the consumer in connection with the transaction, if the interest rate for the loan or plan without such points does not exceed by more than 1 percentage point:

a. The APOR; or

b. In the case of a transaction secured by personal property, the average rate for a loan insured under Title I of the National Housing Act;[12] and

3. As an alternative to (2), a single bona fide discount point if the interest rate for the loan or plan without that point does not exceed the APOR (or the National Housing Act average rate, as applicable) by more than 2 percentage points.

D. Prepayment Penalty Threshold

Finally, the Bureau proposes to implement the new Dodd-Frank prepayment penalty threshold, under which a consumer credit transaction will be considered high cost under HOEPA if the transaction provides for prepayment fees and penalties that: (i) may be imposed more than 36 months after consummation or account opening; or (ii) exceed, in the aggregate, more than 2 percent of the amount prepaid. (The proposed definition of prepayment penalty is much broader than the common meaning of the term.[13]) The

[11] For this purpose, "bona fide discount point" would have the same meaning as in 12 C.F.R. § 1026.43(e)(3)(iv), which the QM proposed rule would define as any percent of the loan amount of a covered transaction paid by the consumer that reduces the interest rate or time-price differential applicable to the covered transaction based on a calculation that: (i) is consistent with established industry practices for determining the amount of reduction in the interest rate or time-price differential appropriate for the amount of discount points paid by the consumer; and (ii) accounts for the amount of compensation that the creditor can reasonably expect to receive from secondary market investors.

[12] 12 U.S.C. §§ 1702 *et seq.*

[13] The proposed Commentary gives the following examples of prepayment penalties: (i) a charge determined by treating the loan balance as outstanding for a period of time after prepayment in full and applying the interest rate to such "balance," even if the charge results from interest accrual amortization used for other payments in the transaction under the terms of the loan contract; (ii) a fee, such as an origination or other loan closing cost, that is waived by the creditor on the condition that the consumer does not prepay the loan; (iii) a minimum finance charge in a simple interest transaction; and (iv) computing a refund

Board correctly notes that this threshold is not likely to have a significant impact on residential mortgage lenders or assignees, because other provisions of the Truth-in-Lending Act will operate to prohibit most prepayment penalties that could exceed this threshold in any event. In particular, HOEPA provides that if a loan is a high cost mortgage, it may not include a prepayment penalty. The Bureau's proposed commentary thus clarifies that the prepayment penalty "threshold" effectively establishes a maximum limit on the term and amount of a prepayment penalty on any transaction that *could* be subject to HOEPA coverage (*i.e.*, a closed- or open-end transaction secured by a consumer's principal dwelling, other than a reverse mortgage transaction). Further, under the QM rule as proposed, 12 C.F.R. § 1026.43(g) would: (i) prohibit prepayment penalties for most closed-end mortgages, unless the transaction is a fixed-rate QM with an APR that falls below certain statutorily prescribed thresholds; and (ii) restrict prepayment penalties even for these QMs to 3 percent of the amount prepaid in the first year, 2 percent in the second year, and 1 percent in the third year.[14] The practical effect of the prepayment penalty threshold accordingly appears extremely limited.

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The combination of Dodd-Frank's expansion of HOEPA and the QM/QRM thresholds will almost certainly result in further tightening of credit, even for creditworthy borrowers. The CFPB has proposed to modify both the APR and points and fees thresholds to mitigate this impact, but the Bureau's proposal does not go far enough. Unless the Bureau exercises its discretion to implement more substantial adjustments to the HOEPA thresholds, including with respect to the statutory percentage points for the APR threshold and the definition of "points and fees,"[15] the residential mortgage market soon will resemble the Neapolitan ice cream from hell – a whole lot of plain vanilla, a very thin band of chocolate, and all the rest pickle.

Comments to the Bureau's proposal must be received on or before September 7, 2012.

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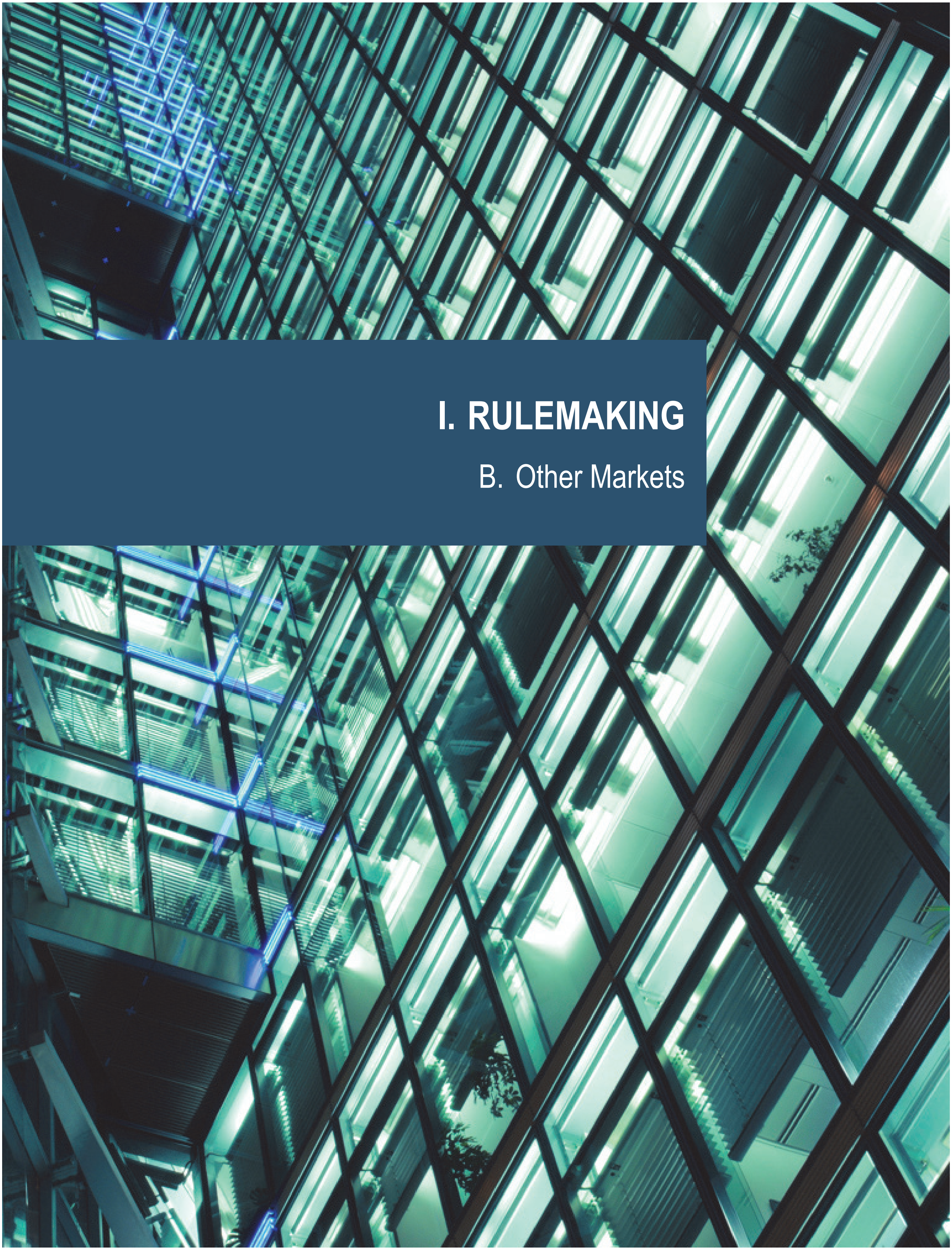
of unearned interest by a method that is less favorable to the consumer than the actuarial method, as defined in 15 U.S.C. 1615(d).

[14] *See* 76 FR 27390, 27472-78 (May 11, 2011).

[15] *See* 15 U.S.C. § 1602(bb).



I. RULEMAKING

B. Other Markets

CFPB Supervision of Nonbank Covered Persons Posing Risks to Consumers

By: Stephanie C. Robinson, Eric Mitzenmacher

The ability for a federal agency to supervise state-licensed non-depository providers of consumer financial services was a key element to the creation of the Consumer Financial Protection Bureau. Prior to the Bureau's enactment, the federal government could supervise depository institutions and their affiliates, in certain cases, as well as lenders making federally insured or guaranteed loans. Only the states, however, had day-to-day supervisory authority over licensed lenders. In fact, some companies conducting consumer financial services business under state law may have been regulated, but not subject to supervision by any government agency. That has now changed.

The Dodd-Frank Act provides the CFPB supervisory authority over three classes of nonbank covered persons: (1) participants in certain enumerated consumer financial markets including consumer mortgages;[1] (2) larger participants in other consumer financial markets;[2] and (3) other nonbanks engaging in "conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services."[3]

The third class provides the CFPB with supervisory authority on a case-by-case basis. Dodd-Frank expressly requires the Bureau to designate a nonbank covered person as posing risks to consumers only by order after notice and a reasonable opportunity to respond.[4] The CFPB is required to use information available to it—including consumer complaints, but not expressly limited to any particular sources—as the basis for any such order.

The CFPB issued procedural rules May 25, 2012 regarding the manner by which it intends to designate nonbank covered persons as subject to supervision because they pose risks to consumers.[5]

Notice and an Opportunity to Respond

The CFPB's proposed process would typically begin with the Bureau issuing a "Notice of Reasonable Cause" to a particular nonbank covered person. The notice would state the basis on which the CFPB "may have reasonable cause to determine that the nonbank covered person is engaging, or has engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services."[6]

Upon receiving a Notice of Reasonable Cause, a nonbank covered person wanting to challenge the determination would first provide a written response and documentary evidence within 20 days.[7] The nonbank covered person could then request a supplemental oral response.[8] At the oral response stage, nonbank covered persons would be limited to further explaining their written response. The proposal

[1] *See* 12 U.S.C. § 5514(a)(1)(A),(D),(E).
[2] *See id*. § 5514(a)(1)(B).
[3] *Id*. § 5514(a)(1)(C).
[4] *See id*.
[5] *See* Procedural Rules to Establish Supervisory Authority over Certain Nonbank Covered Persons Based on Risk Determination, Proposed Rule, 77 Fed. Reg. 31,226-37 (May 25, 2012).
[6] *Id*. at 31,233-34.
[7] *See id*. at 31,234-35.
[8] *See id*. at 31,235.

institutes a relatively strict waiver rule, under which respondents would be barred from introducing new arguments or evidence at the oral response phase that had not been raised in a written response.[9] Additionally, the CFPB proposes that the notice and response process would not constitute an adjudicatory proceeding under the Administrative Procedure Act.[10] Accordingly, there would be no discovery, a supplemental oral response would not constitute a hearing on the record, and no witnesses would be allowed to be called.

The Determination to Supervise

Under the proposed process, a nonbank covered person could fall under CFPB supervisory authority in two ways.

First, it could voluntarily consent to supervision. The Notice of Reasonable Cause itself would contain a consent agreement by which the nonbank covered person could consent to supervision under an expedited method without negotiation.[11] Alternatively, at any time prior to a final determination by the Bureau, a respondent may consent to supervision under negotiated terms.[12]

Second, it could be determined to fall within the Bureau's supervisory authority at the conclusion of the proposed process. Following the notice, written response, and supplemental oral response described above, the Assistant Director of the CFPB would recommend a determination to the Director no later than 45 days after the receipt of a timely-filed written response, if no supplemental oral response was requested, or no later than 90 days after the service of a Notice of Reasonable Cause, if a supplemental oral response was requested.[13] The Director would make the final determination, without being bound by the recommendation, within 45 days of receiving the Assistant Director's recommendation.[14]

A nonbank covered person that becomes subject to CFPB supervision as a result of the proposed process may petition the Director for termination of the supervision after two years, except that a party voluntarily consenting to the CFPB's supervisory authority may not petition for termination of supervision earlier than the time specified in its executed consent agreement.[15]

An Alternative Process

The CFPB intends for the proposed process to be the primary method through which it obtains supervisory authority over nonbank covered persons posing risks to consumers. The proposal, however, identifies a second pathway to supervision. If the Bureau otherwise issues a Notice of Charges against a person, the Bureau may also provide a notice and opportunity to respond, as required under Dodd-Frank.[16] In such circumstances, the procedures of the proposal would not apply, but the "notice and opportunity to respond" might then be an adjudicative proceeding under the APA.

[9] *See id*. at 31,230.
[10] *See id*. at 31,228.
[11] *See id*. at 31,235.
[12] *See id*. at 31,228, 31,237.
[13] *See id*. at 31,235-36.
[14] *See id*. at 31,236.
[15] *See* id.
[16] *See id*. at 31,237.

Potential Pitfalls for Nonbank Covered Persons

Supervision by the CFPB is likely to be disruptive and costly. There are reasons, therefore, that a nonbank covered person should not wait until receiving a Notice of Reasonable Cause to consider how it would respond. These reasons are magnified by two particular aspects of the Bureau's proposal: (1) the proposal's ambiguous approach to the concept of "risk"; and (2) the strict waiver regime imposed during the process.

While the CFPB intends to provide targeted nonbank covered persons with a description of the basis for the assertion that the Bureau has reasonable cause to believe that the person's conduct poses risks to consumers, the proposal does not attempt to define "risk." Dodd-Frank establishes a set of criteria the CFPB must consider when exercising its supervisory authority to ensure that it does so in a manner based on risks posed to consumers. The factors the Bureau is instructed to consider include: (1) the size of the supervised entity; (2) whether the entity is otherwise overseen by state or federal regulators; and (3) the risks attributable to the products or services provided by the entity.[17] However, these criteria will not necessarily apply to determinations as to which nonbanks to supervise and, even if they do, they offer little concrete guidance.

Additionally, while the CFPB has put forward a multi-step process in which recipients of a Notice of Reasonable Cause will be able to respond and then explain their response, the waiver regime imposed on respondents will limit their ability to react to CFPB assertions. Since new evidence and arguments will not be allowed in supplemental oral responses, respondents will need to ensure that their initial written responses cover the ground necessary to completely respond to the concerns of the Bureau.

The intersection of the two issues is of particular concern. Waiver puts a premium on understanding the Bureau's concerns, but an ambiguous definition of "risk" may prevent full understanding. Given the short timeframe for initial responses, nonbank covered persons may find it beneficial to have a well-crafted narrative prepared in advance of receipt of a Notice of Reasonable Cause to avoid a scramble that may leave the entity without a proper defense.

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[17] *See* 12 U.S.C. § 5514(b)(2).

CFPB Issues Proposed Rule Detailing Supervisory Powers Over Larger Debt Collectors and Finalizes Rule on Supervision of Larger Consumer Reporting Agencies

By: David G. McDonough, Jr.

The Consumer Financial Protection Bureau also exercised its discretionary authority under the Dodd-Frank Act to supervise nonbank "larger participants" in certain consumer financial product and service markets. Specifically, on February 12, 2012, the CFPB issued a proposed rule establishing its supervisory (*i.e.*, examination) authority over the nation's largest debt collectors and consumer reporting agencies.[1] The comment period for the proposed rule closed on April 12, 2012, and the Bureau finalized the consumer reporting portion of the proposed rule on July 17, 2012 (with an effective date of September 30, 2012); the Bureau says it will finalize the debt collector portion of the proposed rule later this fall.[2]

For a more in-depth discussion of the proposed rule, please see our March 15, 2012.[3]

Debt Collectors

Under the proposed rule, any debt collector whose "annual receipts" from debt collection exceed $10,000,000 would be subject to the Bureau's supervision (including periodic examination). The Bureau estimates that about 175 debt collectors would meet this threshold, or less than 4% of all debt collectors; notably, these 175 companies account for about 63% of all collection receipts.

What Constitutes "Debt Collection"?

Under the proposed rule, consumer debt collection generally means "collecting or attempting to collect, directly or indirectly, any debt owed or due or asserted to be owed or due to another and related to any consumer financial product or service." Critically, it includes collecting a debt on behalf of another person without any qualification that the debt must have been in default when the entity acquired collection rights.

Who Is a Larger Participant?

As noted, the proposed rule would subject to supervision any debt collector whose "annual receipts" from debt collection exceed $10,000,000. The Bureau borrowed the concept of "annual receipts" from the Small Business Administration. Receipts is defined as "total income" plus "cost of goods sold," as both terms are defined in IRS tax return forms. The definition also backs out the following items: (a) net capital gains or losses; (b) taxes collected for and remitted to a taxing authority if included in gross or total income, such as sales or other taxes collected from customers and excluding taxes levied on the entity or its employees; and (c) amounts collected for another (but fees earned in connection with such collections are receipts).

[1] A copy of the CFPB's proposed rule can be found at http://www.regulations.gov/#!documentDetail;D=CFPB-2012-0005-0003.

[2] A copy of the CFPB's final rule on larger participants in the consumer reporting market can be found at http://files.consumerfinance.gov/f/201207_cfpb_final-rule_defining-larger-participants-consumer-reporting.pdf

[3] A copy of our full client alert on the CFPB's proposed rule can be found at http://www.klgates.com/its-a-whole-new-world-cfpb-proposed-plans-to-supervise-the-activities-of-debt-collectors-responsible-for-almost-two-thirds-of-all-collection-receipts-03-15-2012/.

The proposed rule would lay out a procedure that a debt collector could follow if it disagreed with the Bureau's determination that the debt collector is a larger participant. When the Bureau sends a letter initiating a "supervisory activity," the recipient has 30 days to dispute that it is a larger participant. The dispute must be sent to the CFPB's Assistant Director, and "must include an affidavit setting forth an explanation of the basis for the person's assertion that it does not meet the definition of larger participant of a market." There are no provisions in the proposed rule for any further appeals within the agency.

Potential Issues With the Proposed Rule

As with many of the CFPB's activities, the devil is in the details. For instance, some companies (most notably servicers of performing accounts) that are not deemed debt collectors under the principal federal law governing debt collection (*i.e.*, the Fair Debt Collection Practices Act) may be supervised as debt collectors by the CFPB. The FDCPA generally excludes servicing a loan that was not in default at the time that the loan was acquired for servicing, or collecting one's own debt if the debt was not in default at the time it was acquired. The proposed rule's definition of debt collection does provide that a debt buyer is engaged in debt collection only with respect to debts that were in default at the time they were acquired, but there is no such qualifier for an entity that is "collecting the debt on behalf of another person."

Also, because of the way the CFPB calculates "annual receipts" (*i.e.*, it is roughly equivalent to gross revenue), a debt collector that employs a debt buyer model would have higher receipts than a debt collector that collects on commission and has exactly the same size collection portfolio. This conclusion results from the proposed rule's exclusion from "annual receipts" amounts collected on behalf of another. So a debt collector operating under a commission model includes only its commission (and other compensation) in its receipts; the debt collector would exclude payments on the debt that it receives and remits to the creditor. However, a debt collector operating under a debt buyer model does not, by definition, collect amounts *for another*. Because the debt buyer owns the debt, all debt payments it receives are to its own account. The result is that all amounts collected are counted as receipts for the debt buyer, but not for the debt collector operating under a commission model.

Additionally, the proposed rule would cover practicing attorneys who enforce security instruments on behalf of creditors, despite the Dodd-Frank Act's general exclusion for attorneys and without sufficient explanation why the Act's limited exceptions to the general exclusion should apply.

Consumer Reporting Agencies

As noted, on July 17, 2012, the CFPB finalized the proposed rule defining "larger participants" for the consumer reporting market. The final rule largely tracks the proposed rule, including maintaining the concept of "annual receipts" and setting the threshold at $7,000,000. Notably, however, the final rule states that "[t]he Bureau has not determined that annual receipts ... would be appropriate for any other market that may be the subject of a future larger participant rulemaking." Left unsaid was whether this means the Bureau is backing away from using "annual receipts" for the debt collection market.

"Consumer reporting" generally means "collecting, analyzing, maintaining, or providing consumer report information or other account information used or expected to be used in any decision by another person regarding the offering or provision of any consumer financial product or service." The term excludes, however, certain activities related to furnishing information to an affiliated person, as well as information to be used solely in a decision regarding employment, government licensing, or residential leasing or tenancy.

The provisions discussed above concerning how "annual receipts" are calculated and how a company may dispute such calculation largely apply with equal force to the final rule defining larger participants in the consumer reporting market. One change, however, is that the final rule extends to 45 days (from 30 days) the time a company has to dispute classification as a larger participant.

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Bureau Begins Rulemaking Process for GPR Cards

By: David L. Beam

The Consumer Financial Protection Bureau is in the early stages of a significant rulemaking for the prepaid card industry. Gift cards already are regulated by rules that the Federal Reserve Board issued pursuant to the Credit Card Accountability Responsibility and Disclosure Act of 2009. But those rules exclude prepaid cards that are reloadable and not marketed as gift cards or gift certificates. These cards—commonly called general purpose reloadable ("GPR") cards—also arguably fall outside the provisions of Regulation E that govern bank accounts and similar consumer asset accounts. Because GPR cards are becoming integral financial tools for many "unbanked" consumers, consumer advocates have been calling for several years now to close the perceived federal regulatory gap.

The CFPB published an Advance Notice of Proposed Rulemaking (ANPR)[1] on the subject of GPR cards in the Federal Register on May 24, 2012. In the ANPR, the Bureau announced that it plans to issue a proposal to extend Regulation E to cover GPR cards, and explained that it was considering some additional requirements for GPR cards beyond those that Regulation E imposes on bank accounts. This decision appears to be more or less final—the Bureau never asks for input on whether this is a good idea—but the Bureau does say that it will consider waiving or modifying certain Regulation E requirements that are inappropriate for GPR cards. GPR card issuers are sure to ask the Bureau to require issuers to comply with no more than the so-called "Reg E Lite" provisions, a slightly modified set of requirements applicable to payroll cards. Industry commenters might also ask the Bureau to waive or modify various other provisions of Regulation E.

But the ANPR also suggests that the Bureau is contemplating a unique set of disclosure rules for GPR cards. (The Bureau does not say whether it would issue these requirements pursuant to its rulemaking authority under the Electronic Funds Transfer Act, or would rely on its general rulemaking authority to declare certain practices to be deceptive, unfair or abusive; how the Bureau justifies its authority will no doubt depend on exactly what it decides to do.) Most of the Bureau's questions revolved around how the varying fee structures on GPR cards can be synthesized into a uniform disclosure that allows consumers to make "apples-to-apples" comparisons. The Bureau also says that it may require issuers to disclose whether the funds on the card are insured by the FDIC or NCUA on a pass-through basis (meaning that each cardholder is insured up to $250,000).

The Bureau also seeks comments on certain features that some GPR card issuers are offering, such as associated savings accounts, overdraft lines of credit, and the ability to build a credit history with the card. The Bureau does not say much about whether or how it intends to regulate these features.

[1] CFPB, Advanced Notice of Proposed Rulemaking, 77 Fed. Reg. 30,923 (May 24, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-05-24/pdf/2012-12565.pdf.

Because the Bureau has not yet even issued a proposed rule, it is premature to speculate too much about the impact that this rulemaking will have on industry participants. Issuers who are not yet in compliance with Reg E Lite will face operational costs from bringing their activities in compliance. The greater impact on the industry as a whole might come from the possible other rules that the Bureau is considering. Particularly interesting to watch will be how the Bureau tries to standardize the disclosures around fees, given the diversity of fee schedules for GPR cards. The Bureau appears for now not to be considering any direct restrictions on GPR card fees. But fee disclosure requirements can still affect fees, as issuers try to structure their fee schedules to minimize the impact on the disclosures. In any event, the existence of a federal regulatory scheme for GPR cards will certainly be a change for the industry.

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"Know Before You Owe" and the CFPB's Attempts at Improving Student Loan and Credit Card Disclosures

By: Stephanie C. Robinson, Rebecca Lobenherz

One of the Consumer Financial Protection Bureau's main goals since its inception has been promoting transparency in the consumer credit industry. The CFPB's "Know Before You Owe" campaign seeks to provide consumers with lending transparency primarily by "making disclosures simpler and more effective, and doing it with the input of the people who will actually use them."[1] While this initiative originated out of the Bureau's efforts to update and combine mortgage disclosures,[2] the CFPB has also used this platform to launch projects in the student and credit card lending arenas as well. All of the Bureau's "Know Before You Owe" initiatives have placed the emphasis on obtaining consumer input, through extensive consumer testing and public comment, and then working to draft disclosure language which takes into account consumer opinion. Due to the extensive consumer outreach component of the Bureau's "Know Before You Owe" projects, the creation of model disclosure forms in the student and credit card lending sectors has been a time-consuming endeavor for the CFPB.

Know Before You Owe: Student Loans

The CFPB launched the "Know Before You Owe: Student Loans" project in October 2011[3] and the first initiative focused on how to improve financial aid offer forms issued by the Department of Education. Following public hearings hosted by the Department of Education on September 13, 2011, the CFPB published its first model financial aid shopping sheet, labeling it a "thought starter," and solicited public comment for the form through the Bureau's website.[4] In addition to general comments, the Bureau asked consumers to rank the features that were most important to prospective students when reviewing an initial financial aid offer.

[1] The CFPB Mortgage Disclosure Team, "Preparing For New Mortgage Disclosures: A Look Back at Know Before You Owe," July 5, 2012, *available at* http://www.consumerfinance.gov/blog/preparing-for-new-mortgage-disclosures-a-look-back-at-know-before-you-owe/.

[2] CFPB, "Timeline," *available at* http://www.consumerfinance.gov/knowbeforeyouowe/timeline/. For more information on the CFPB's work on mortgage disclosures, *see* Holly Bunting, "CFPB Proposes Regulations to Combine RESPA and TILA Mortgage Disclosures: Buckle Up for the Long-Anticipated Ride."

[3] Rhohit Chopra, "Know Before You Owe: Let's Tackle Student Loans," Oct. 26, 2011, *available at* http://www.consumerfinance.gov/blog/know-before-you-owe-lets-tackle-student-loans/; *see also* Kathryn Baugher, "CFPB Announces 'Know Before You Owe' for Student Loans," Nov. 7, 2011, *available at* http://www.consumerfinancialserviceswatch.com/2011/11/07/cfpb-announces-know-before-you-owe-for-student-loans/.

[4] CFPB, "Know Before You Owe: Student Loans," *available at* http://www.consumerfinance.gov/students/knowbeforeyouowe/about/; U.S. Department of Education, "Higher Education: Model Financial Aid Offer Form," *available at* http://www2.ed.gov/policy/highered/guid/aid-offer/index.html.

Due to the large amount of consumer feedback - the Bureau noted that over twenty thousand persons viewed the model form in the first days of it being published - it took the Bureau until January 2012 to review consumer comments and release a summary of the public's overall feedback.[5] Based on the comments, the Bureau noted that consumers wanted the following information reflected in a financial aid shopping sheet:

1. Estimated debt at graduation;
2. Estimated monthly payment after graduation;
3. Likely ability to repay my loans;
4. A complete breakdown of cost at school by category; and
5. Whether students at the school have been able to repay loans.[6]

Per the Bureau's report, other areas that public commenters focused on included the separation of federal work-study offers and traditional financial aid offers, the inclusion of repayment information and definitions for key terms, and the creation of a web-based interactive version of the model form.[7] The period for submitting consumer feedback on the initial "thought starter" form ended June 20, 2012 and the Department of Education hopes to release an official model form incorporating this feedback sometime in the coming months.[8]

The Bureau has also expanded the "Know Before You Owe: Student Loans" initiative beyond disclosures by creating a college cost comparison tool, currently in its beta format.[9] The purpose of this tool is to "make it easier to compare different options when making decisions on student debt" and the Bureau hopes to update the tool prior to next year's financial aid season.[10]

While much of the emphasis of the Bureau's "Know Before You Owe: Student Loans" project is on promoting general knowledge on student loan terms and college costs, the Bureau has also made consideration of for-profit college practices a priority for the initiative.[11] The Bureau has described the increase in the number of nontraditional, high-priced private loans offered by, or in partnership with, for-profit colleges as a "worrisome trend" and has expressed concern over the failure of these institutions to ensure that borrowers will have the ability to repay the debt after college.[12] As part of this effort, the Bureau has been accepting and reviewing complaints on private student loans.[13]

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[5] *See* Rhohit Chopra, "Your Feedback on Know Before You Owe: Student Loans," Jan. 27, 2012, *available at* http://www.consumerfinance.gov/blog/your-feedback-on-know-before-you-owe-student-loans/.

[6] Rhohit Chopra, Student Loan Ombudsman, CFPB, "Memorandum Re: Summary of Your Feedback," Jan. 2012, *available at* http://files.consumerfinance.gov/f/2012/01/Memorandum_KBYOStudentLoans_FeedbackSummary_Jan2012.pdf.

[7] *Id*.

[8] U.S. Department of Education, "Higher Education: Model Financial Aid Offer Form," *available at* http://www2.ed.gov/policy/highered/guid/aid-offer/index.html.

[9] CFPB, "Paying for College*," available at* http://www.consumerfinance.gov/payingforcollege/.

[10] *Id*.

[11] Rebecca Lobenherz, "Office of Servicemember Affairs Looks at the Lending Practices of For-Profit Colleges and Their Impact on Military Members," Dec. 7, 2011*, available at* http://www.consumerfinancialserviceswatch.com/2011/12/07/the-cfpb%E2%80%99s-office-of-servicemember-affairs-looks-at-the-lending-practices-of-for-profit-colleges-and-their-impact-on-military-members/.

[12] Raj Date, "Know Before You Owe: Student Loans," Oct. 26, 2011, *available at* http://www.consumerfinance.gov/speeches//know-before-you-owe-student-loans/.

[13] *See* Department of Education, "Consumer Financial Protection Bureau Now Taking Private Student Loan Complaints," Mar. 5, 2012, http://www.ed.gov/news/press-releases/consumer-financial-protection-bureau-now-taking-private-student-loan-complaints.

Know Before You Owe: Credit Cards

The "Know Before You Owe: Credit Cards" project is currently focused on developing "a shorter, simpler credit card agreement that spells out the terms for the consumer."[14] Again, the Bureau is not labeling the sample credit card agreement posted on its website a "model form"; rather, the Bureau is using the agreement as a starting off point for public input on credit card disclosures.[15] Like the student loan "thought starter," the Bureau is soliciting comments on the agreement primarily through its online commenting portal. However, the Bureau is also launching a test program with one credit card issuer to "learn how this approach can work with a real credit card product."[16] The purpose of the test program is to determine how consumers use their existing agreements and how they use the prototype form.[17]

The "Know Before You Owe: Credit Cards" project is still in its beginning stages and only one sample form has been released so far. However, we can expect a similar trajectory of consumer testing, public comment, and revisions for the credit card agreement, which we have witnessed with the mortgage and student loan disclosure projects to date.

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[14] CFPB, "Know Before You Owe: Credit Cards," *available at* http://www.consumerfinance.gov/credit-cards/knowbeforeyouowe/.

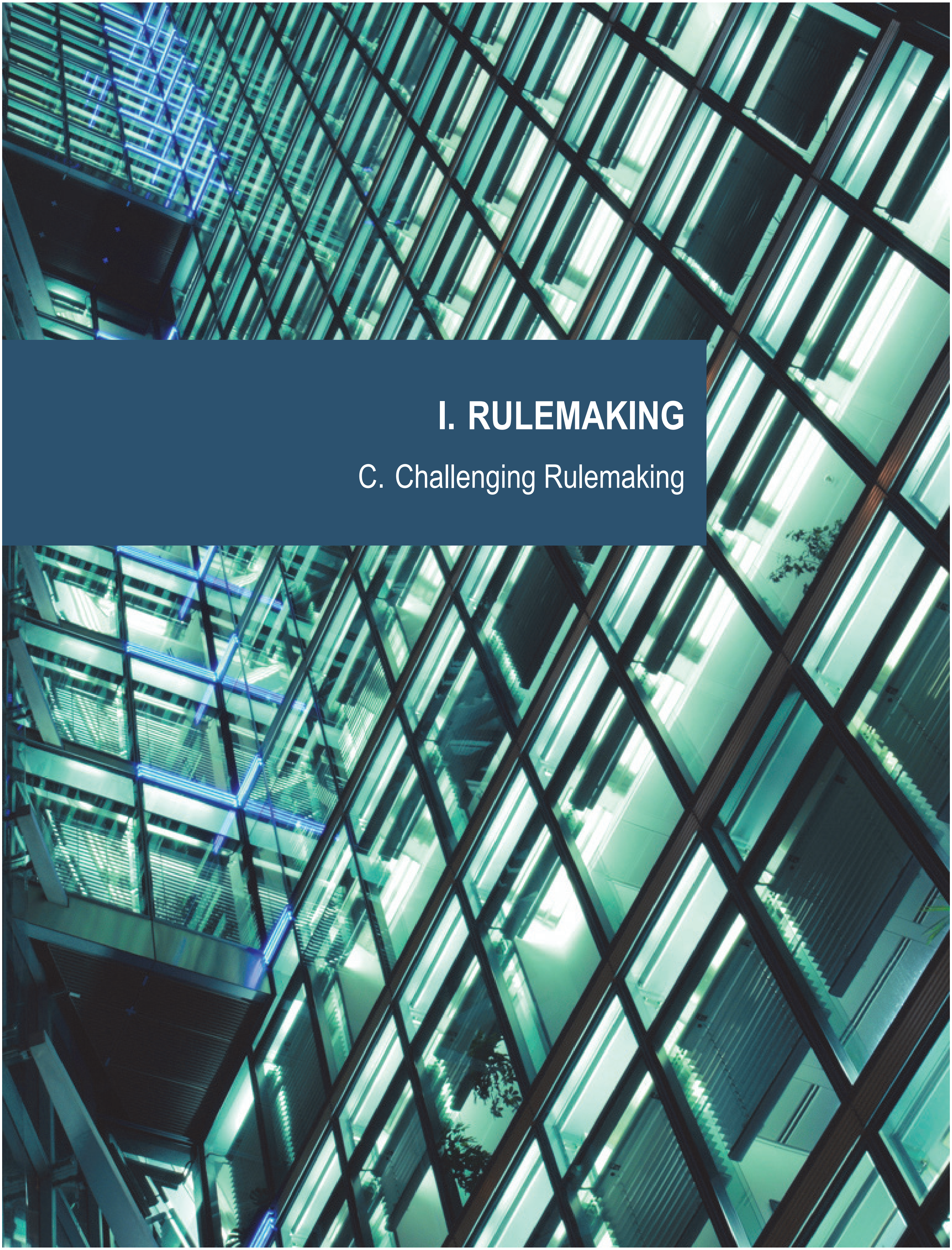
[15] *Id*.

[16] Marla Blow, "Know Before You Owe: Making Credit Card Agreements Readable," Dec. 7, 2011, *available at* http://www.consumerfinance.gov/blog/know-before-you-owe-making-credit-card-agreements-readable/.

[17] *Id*.

I. RULEMAKING

C. Challenging Rulemaking



Holding the Bureau's Rulemaking Process to Account

By: John L. Longstreth

An agency's decisions interpreting and implementing a statute are often as important as the language of the statute itself, and this is particularly so with respect to the Consumer Financial Protection Bureau's implementation of the Dodd-Frank Act. The breadth of the Act's standards, for example in prohibiting unfair, deceptive or abusive acts or practices, gives the agency great latitude in defining the specific rules under which regulated parties will operate. Congress has made clear, however, that the agency must undertake a careful analysis in issuing its rules, and the courts have made clear that judicial review of those rules will not be toothless. Moreover, the agency cannot avoid applicable rulemaking requirements simply by terming a rule imposing binding requirements on regulated entities as something else, such as a policy statement, an enforcement guideline, or a matter of purely internal agency procedure.[1]

In addition to the requirements imposed on all agency rulemaking by the Administrative Procedure Act, Dodd-Frank imposes several specific requirements on the Bureau. Foremost among these is the requirement that the Bureau assess the potential benefits and costs of the rule to consumers and regulated entities, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule.[2] In a series of recent decisions, the federal appeals court for the District of Columbia Circuit, whose decisions on administrative law are widely respected and influential, has made clear that such a requirement imposes significant responsibilities on agency decisionmakers.

Interpreting similar language applicable to regulations issued by the Securities and Exchange Commission, the court has held that an agency required to assess costs and benefits in its rulemakings cannot "inconsistently and opportunistically frame[] the costs and benefits of the rule"; fail to adequately "quantify the certain costs or to explain why those costs could not be quantified"; or neglect to "support its predictive judgments" or "respond to substantial problems raised by commenters."[3] An agency must also assess costs to individual firms where data on aggregate costs is unavailable,[4] and must determine whether existing state or federal regulations offer sufficient protections to provide the benefits asserted for the regulation.[5] As the Bureau has yet to complete many significant new rulemakings,[6] courts have not yet

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[1] *See* David Tallman, "Regulation through Examination: An Overview of CFPB Examination Guidance." *See also Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1019 (D.C. Cir. 2000) (setting aside agency's "guidance document" for failure to follow notice and comment procedures applicable to legislative rules); *Pickus v. United States Board of Parole*, 507 F.2d 1107, 1113 (D.C. Cir. 1974) (exemption for rules relating to agency procedure and practice "should not be deemed to include any action which goes beyond formality and substantially affects the rights of those over whom the agency exercises authority.").

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §1022(b)(2)(A) (2010) ("Dodd-Frank Act").

[3] *Business Roundtable v. SEC,* 647 F.3d 1144, 1148-49 (D.C. Cir. 2011).

[4] *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).

[5] *American Equity Investment Life Insurance Company v. SEC*, 613 F.3d 166, 167–68 (D.C. Cir. 2010).

[6] The agency proposed rules on July 9, 2012 to integrate mortgage disclosures and to implement amendments to the Home Ownership and Equity Protection Act of 1994 ("HOEPA") expanding the types of "high cost" loans potentially subject to HOEPA coverage, the restrictions that HOEPA imposes on those mortgages, and homeowner counseling requirements. *See* Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z), Docket No. CFPB-2012-0028 (July 9, 2012) (to be published in the Federal Register) (seeking comment on the proposed "2012 TILA-RESPA rule"), *available at* http://files.consumerfinance.gov/f/201207_cfpb_proposed-rule_integrated-mortgage-disclosures.pdf; High-Cost Mortgage and Homeownership Counseling Amendments to the Truth in Lending Act (Regulation Z) and Homeownership Counseling Amendments to the Real Estate Settlement Procedures Act (Regulation X), Docket No. CFPB-2012-0029 (July 9, 2012) (to be published in the Federal Register) (seeking comment on proposed rule to implement HOEPA amendments), *available at*

been called upon to assess its compliance with these requirements, but they will require careful justification of any requirements not compelled by statute.

Dodd-Frank also requires the Bureau to give particular attention to the effects of its rules on insured depository institutions and credit unions with assets under $10 billion, on consumers in rural areas, and on the cost of credit for small entities. If a rule will have a significant economic impact on a substantial number of small businesses, a panel with representatives from the Bureau, the Small Business Administration and the Office of Management and Budget will be formed and meet with representatives from small business, generally 15 or 20 in number, to discuss the impact of the rule and potential alternatives. The Bureau has issued guidance on how it will select the participants in this process.[7] The Bureau must consider alternatives that reduce these costs on small entities, and its compliance with these procedures is reviewable under the provisions of the Regulatory Flexibility Act.[8] The Bureau must also consult with the appropriate prudential regulators or other federal agencies prior to proposing a rule, and during the comment process, regarding consistency with prudential, market, or systemic objectives administered by such agencies, and address significant objections by those regulators.[9]

The Bureau has also issued guidance on how it will deal with *ex parte* contacts in its rulemakings, that is, contacts made outside the normal process of commenting on a proposed rule pursuant to a public notice of proposed rulemaking.[10] The Bureau notes that it seeks to encourage public participation so that it can understand the impacts of its rules and that such *ex parte* contacts will generally be summarized and put on the public record. This process is intended to assure that interested parties are aware of information on which the agency might be relying and will also assure that the material is part of the record for purposes of judicial review.[11] Contacts from elected officials will not be considered *ex parte*, however, unless they add significant new information intended to influence the agency's decision.

Finally, while many of the agency's significant rulemakings have not progressed to the point where they can be challenged judicially, a broader challenge to the Bureau's exercise of authority has recently been brought in the federal district court in Washington, D.C.[12] Filed by a small bank in Texas and several nationwide advocacy groups, the complaint alleges that the Bureau and the Financial Stability Oversight Council ("FSOC") violate the constitutional "separation of powers" because Congress has delegated authority to the agencies too broadly. Although an improper delegation argument of this type has not prevailed in over 75 years,[13] the challengers contend that the delegation problems are compounded by various restrictions on executive branch and judicial oversight of the agency, including insulation of its budget from the regular appropriations process. Plaintiffs also challenge the recess appointment of the Bureau's Director on the basis that the Senate was not in recess at the time of the appointment. The suit

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http://files.consumerfinance.gov/f/201207_cfpb_proposed-rule_high-cost-mortgage-protections.pdf. These rules are not expected to take effect until January 2013. Many other potentially significant rules are in development or in the information gathering stage.

[7] CFPB, "Fact Sheet: Small Business Review Panel Process," *available at* http://files.consumerfinance.gov/f/201205_CFPB_public_factsheet-small-business-review-panel-process.pdf.

[8] *See* 5 U.S.C. §§ 604, 611.

[9] Dodd-Frank Act, §1022(b)(2)(B)-(C).

[10] CFPB Bulletin 11-3, "Policy on Ex Parte Presentation in Rulemaking Proceedings," Aug. 16, 2011, *available at* http://files.consumerfinance.gov/f/2011/08/Bulletin_20110819_ExPartePresentationsRulemakingProceedings.pdf.

[11] The Bureau's procedures are thus similar to the process in place at most agencies pursuant to the direction given in *Home Box Office, Inc. v. FCC*, 567 F.2d 9 (D.C. Cir. 1977).

[12] *See State National Bank of Big Spring v. Geithner*, No. 12-1032 (filed June 21, 2012) (Huvelle, J.).

[13] *See Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 474 (2001) (requiring merely an "intelligible principle"). See *also Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) (agency must assure a "fair and reasonable" result); *National Broadcasting Co. v. United States*, 319 U.S. 190, 225-26 (1943) (result must be in the "public interest").

alleges that the FSOC's designation of nonbank financial companies as systemically important, or "too big to fail," gives these entities an unfair capital subsidy to the detriment of smaller banks.

The challenge will, in the normal course, be decided within the next 6-12 months. A ruling for the Plaintiffs could significantly hamstring the Bureau's ability to continue its various regulatory missions. It is also possible that the court will determine that such challenges are not timely until a rule or other regulatory action is taken that more directly affects a complaining party.

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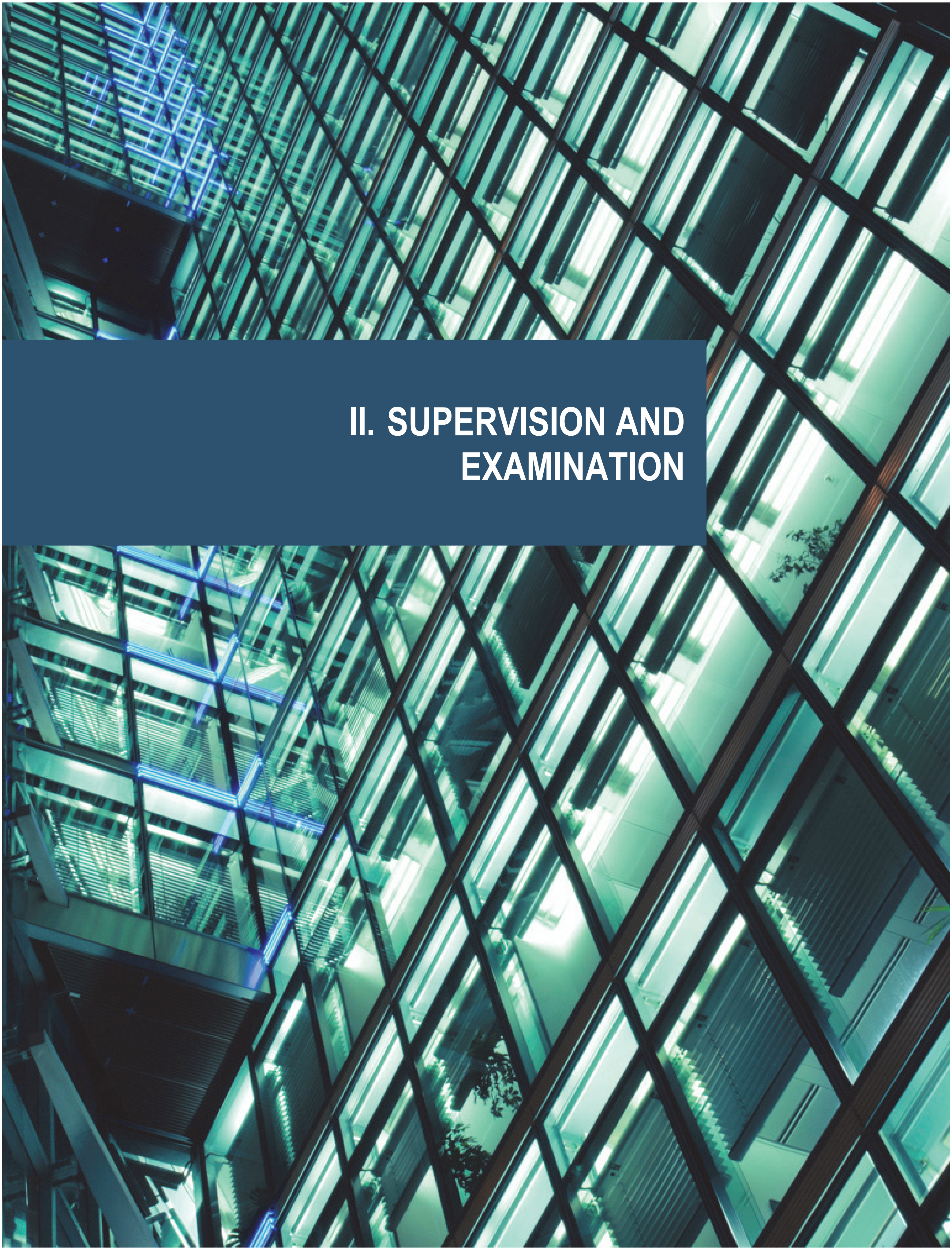
II. SUPERVISION AND EXAMINATION



CFPB and Federal Supervisory Agencies Issue Memorandum of Understanding on Supervisory Coordination

By: Krista Cooley

In June of 2012, the Consumer Financial Protection Bureau, along with four federal supervisory agencies, announced that they had entered into a Memorandum of Understanding ("MOU") to clarify how the five agencies will coordinate certain of their supervisory activities.[1] The MOU between the CFPB and the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency (the "Prudential Regulators") became effective on May 16, 2012.[2]

The MOU applies to certain aspects of the agencies' supervision of insured depository institutions, including insured credit unions, with total assets of more than $10 billion and their affiliates. With regard to these institutions, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") requires that the CFPB coordinate its supervisory activities with the supervisory activities conducted by the Prudential Regulators, including consulting regarding their respective schedules for examining these institutions and requirements regarding reports to be submitted by the institutions. The MOU constitutes the mutual agreement between the agencies to implement these statutory requirements. The agencies are not required to coordinate their enforcement activities, as their respective enforcement authorities are clearly delineated in the Dodd-Frank Act. Therefore, the MOU does not address enforcement.

According to the definitions section of the MOU, the supervisory activities covered by the MOU generally include material supervisory activities that have the purpose of evaluating: (1) compliance with the requirements of federal consumer financial laws and certain other federal laws and their implementing regulations, such as the Fair Housing Act, that are not consumer financial laws but that specifically and directly regulate the manner of offering or providing, or content or terms and conditions of, any consumer financial product or service; (2) consumer compliance risk management programs and systems, including vendor management; (3) underwriting, sales, marketing, servicing, collections or other activities related to consumer financial products or services; and (4) such other matters on which the agencies may agree. Examinations covered by the MOU include: (1) point-in-time examinations that are scheduled in advance to occur at regular periodic intervals and yield a report of examination that concludes a supervisory cycle and corresponding rating; and (2) targeted reviews scheduled in advance as part of an agency's continuous supervision program, the results of which will be included in a report of examination.

The MOU contains two sections setting forth the agencies' guidelines for simultaneous and coordinated examinations and information sharing. With regard to examinations, the MOU states that the agencies will consult regarding the scheduling of examinations and agree to a reasonable timetable for sharing scheduling information for the coming year and will share information about the scope of each covered examination. While the MOU does not require a Prudential Regulator and the CFPB to conduct examinations jointly, the MOU states that the CFPB generally will carry out examinations of covered

[1] Read the agencies' joint press release announcing the MOU here: http://www.consumerfinance.gov/pressreleases/agencies-sign-memorandum-of-understanding-on-supervisory-coordination/.

[2] *See* Memorandum of Understanding on Supervisory Coordination, May 2012, *available at* http://files.consumerfinance.gov/f/201206_CFPB_MOU_Supervisory_Coordination.pdf.

institutions in a simultaneous manner, meaning that material portions of examinations by the Prudential Regulator and the CFPB will be conducted during a concurrent time period pursuant to each agency's procedures. The MOU also permits covered institutions to request that the Prudential Regulator and the CFPB conduct separate examinations. Pursuant to the MOU, the agencies will share draft reports of examination and will consider any comments provided by the reviewing agency before issuing a final report of examination or taking a supervisory action in connection with an examination.

With regard to information sharing, pursuant to MOUs regarding information sharing and confidentiality previously executed by the CFPB and the Prudential Regulators, the agencies will share material supervisory information that relates to the supervisory activities or examinations covered by the MOU, including: (1) final versions of supervisory letters, actions, and appeals of material supervisory determinations; (2) final reports of examination; and (3) any other material supervisory information the CFPB and the Prudential Regulators agree to share. Moreover, the MOU expressly states that the CFPB will, to the fullest extent possible, use reports pertaining to covered institutions that have been provided or are required to have been provided to a federal or state agency, and information that has been reported publicly. Pursuant to the MOU, the Prudential Regulators will routinely share Community Reinvestment Act performance evaluation schedules as part of the annual scheduling of examinations of covered institutions.

The agencies' stated objectives of the MOU are to address requirements of the Dodd-Frank Act regarding examination coordination, to establish voluntary arrangements for coordination and cooperation between the CFPB and the Prudential Regulators, to minimize unnecessary regulatory burden on the impacted institutions, and to decrease the risk of conflicting supervisory directives by the CFPB and the Prudential Regulators. The MOU also contains an agreement by the agencies to review the operation of the MOU on the first anniversary of its execution, which will be May 16, 2013, to consider revisions to better accomplish these objectives.

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This MOU provides some insight into the coordination of supervisory activities by the CFPB and the Prudential Regulators regarding their supervision of large depository institutions and their affiliates and demonstrates a good-faith effort by the agencies to coordinate their supervisory activities. That said, like the MOU between the CFPB and FTC regarding non-bank enforcement efforts issued in January, this MOU on supervisory coordination is short on specific details that would give certainty or comfort to impacted institutions that the CFPB and the Prudential Regulators will meet their stated objectives. Thus, it remains to be seen how the agencies will navigate these new relationships in the coming months and whether the broad terms of the MOU are sufficient to minimize the potential regulatory burdens associated with multiple supervisory agencies examining the covered institutions and their affiliates.

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Regulation through Examination: An Overview of CFPB Examination Guidance

By: David A. Tallman

The CFPB's examination guidance blurs the lines between the Bureau's supervisory, regulatory, and enforcement functions. In particular, the Bureau's Supervision and Examination Manual[1] (the "Manual") and the accompanying examination procedures[2] suggest that the CFPB may intend to use the supervision process to limit (or at least discourage) practices that the Bureau considers to be suspect or indicative of unfair, deceptive, or abusive acts and practices ("UDAAP"). Unfortunately, the examination materials were issued without the benefit of public notice and comment and do not provide either financial institutions or the Bureau's own examiners with sufficiently clear guidance regarding the conduct that the Bureau will consider to violate UDAAP standards. Other CFPB supervisory policy statements, including recent statements regarding asset size[3] and vendor management "expectations," similarly seem to sidestep the formal rulemaking process.

The Manual establishes a Consumer Risk Assessment process under which CFPB examiners will analyze two sets of factors to determine: (i) the inherent risk in a particular entity or line of business, and (ii) the quality of controls that manage the inherent risk. The CFPB began using the Consumer Risk Assessment for large depository institutions and credit unions (with assets more than $10 billion) and their affiliates in the fourth quarter of 2011. CFPB examiners subsequently will complete a Consumer Risk Assessment for each large depository institution and its affiliates at least once every year. For non-depository consumer financial services companies, the Nonbank Supervision Risk Analytics and Monitoring unit of the CFPB will collect data and assess risk in order to determine "examination prioritization," *i.e.*, to decide which companies the Bureau will examine first. Depository institutions should already be familiar with risk assessments, but many non-depository companies will be experiencing the process for the first time. Even depository institutions used to prudential regulation may be surprised by the CFPB's more rigorous focus on consumer risk.

The Consumer Risk Assessment purports to be a pre-examination tool that the CFPB will use to decide how to focus its examination and supervision activities, which should not be used to determine whether an entity has violated the law. However, the assessment requires the examiner to note potential legal issues, including UDAAP issues or other matters that the examiner will review more closely during an examination. In this context, it is troubling that an institution's risk rating may be at least partly determined by an examiner's subjective determinations of perceived risk – after all, there is no commonly accepted definition of what constitutes a "risk" to a consumer (much less an "inherent risk"), and the methodology set forth in the Manual was not vetted pursuant to notice and comment.

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[1] Consumer Fin. Prot. Bureau, Supervision and Examination Manual (2011), *available at* http://www.consumerfinance.gov/guidance/supervision/manual/.

[2] The four sets of issue-specific examination procedures cover mortgage servicing; mortgage origination; short-term, small-dollar lending; and SAFE Act compliance. *See* Consumer Fin. Prot. Bureau, Mortgage Servicing Examination Procedures (2011), *available at* http://www.consumerfinance.gov/guidance/supervision/manual/mortgage-servicing-examination-procedures/; Consumer Fin. Prot. Bureau, Mortgage Origination Examination Procedures (2012), *available at* http://files.consumerfinance.gov/f/2012/01/Mortgage-Origination-Examination-Procedures.pdf.; Consumer Fin. Prot. Bureau, Short-term, Small-Dollar Lending Examination Procedures (2012), *available at* http://files.consumerfinance.gov/f/2012/01/Short-Term-Small-Dollar-Lending-Examination-Manual.pdf; Consumer Fin. Prot. Bureau, SAFE Act Examination Procedures (2012), *available at* http://files.consumerfinance.gov/f/201203_cfpb_update_SAFE_Act_Exam_Procedures.pdf.

[3] Interagency Statement for Determining Asset Size of Institutions for Federal Consumer Financial Law Supervisory and Enforcement Purposes (Nov. 17, 2011), *available at* http://files.consumerfinance.gov/f/2012/01/CFPB_Institutions_Size_Letter_11-17-2011.pdf.

The four sets of examination procedures do not offer much hope that the examination phase will be any more objective than the risk assessment, because they similarly leave it up to the individual examiners to decide whether a company's practices raise UDAAP concerns. The procedures are divided into "modules" that represent different aspects of the regulated consumer finance activities. Within each module, the procedures not only identify which substantive consumer financial laws apply to the particular activities, but also set out what the CFPB euphemistically refers to as "Other Risks to Consumers." Although the Bureau is careful to hedge its language, this category seems to imply that the Bureau might consider dozens of consumer financial practices to be unfair, deceptive, or abusive, or at least to be suggestive of UDAAP violations. While some of the targeted practices have an established legal basis in the "deception" standard under the FTC Act, most appear to be predicated on the more amorphous "unfair" or "abusive" standards.

Regardless of whether these practices should be prohibited as a matter of public policy, it is not clear that the CFPB has the expertise to devise this kind of guidance without soliciting formal comment or input. It also is unclear whether the Bureau has the legal authority to limit certain of these practices through the supervision process. But the Bureau has seemed inclined to avoid the formal rulemaking process. For example, the Bureau articulated substantive standards for determining when a financial institution will be considered a "large institution" for examination and supervision purposes in an informal interagency statement (and apparently out of whole cloth).[4] Similarly, in Bulletin 2012-03, the CFPB announced its vendor management "expectations" in five short bullet points, which provide little of the detail that financial institutions need for guidance, while at the same time arguably requiring a financial institution to perform an unprecedented level of consumer compliance due diligence on vendors.

By choosing not to follow the Administrative Procedure Act ("APA") with respect to its supervision and examination materials, the Bureau effectively is imposing substantive requirements on financial institutions without receiving the benefit of public input through formal publication, notice, and comment. Sidestepping the APA also enables the Bureau to avoid assessing the impact that its requirements might have on small businesses, as it otherwise would be required to do under the Small Business Regulatory Enforcement Fairness Act. Ultimately, however, the Manual and the related materials show that financial institutions will need to implement formal internal controls and compliance programs to a degree that is unprecedented, particularly for non-depository institutions unused to such active supervision.

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[4] Under that standard, an institution generally will not become a "large institution" unless it has reported total assets of greater than $10 billion in its quarterly call report for four consecutive quarters. Similarly, an institution will not cease to be a large institution unless it has reported total assets of $10 billion or less in its quarterly call report for four consecutive quarters. *Id*.

Unlucky Day? The CFPB Issues Its Vendor Management Bulletin on Friday the 13th

By: Jonathan D. Jaffe, David A. Tallman

The Bureau of Consumer Financial Protection (the "Bureau" or the "CFPB") may have increased the incidence of triskaidekaphobia among banks and consumer financial service companies when it released Bulletin 2012-03[1] (the "Bulletin") on Friday, April 13, 2012. The Bulletin describes how the Bureau intends to exercise its supervisory and enforcement authority over how banks and non-bank consumer financial service companies control their third-party vendors (e.g., service providers such as subservicers, foreclosure trustees and law firms, and force place insurers, to name a few).

In the Bulletin, the CFPB announces its "expectations" of the financial institutions over which the Bureau has jurisdiction (which include the nation's largest banks and most non-bank providers of consumer financial products and services). The CFPB is effectively mandating those institutions to:

- Conduct thorough due diligence to verify that the service provider understands and is capable of complying with federal consumer financial law.
- Request and review the service provider's policies, procedures, internal controls, and training materials to ensure that the service provider conducts appropriate training and oversight of employees or agents that have consumer contact or compliance responsibilities.
- Include in contracts with service providers clear expectations about compliance, as well as appropriate and enforceable consequences for violating any compliance-related responsibilities, including unfair, deceptive, and abusive acts and practices.
- Establish internal controls and ongoing monitoring to determine whether the service provider is complying with federal consumer financial law.
- Take prompt action to address fully any problems identified through the monitoring process, including terminating the relationship where appropriate.

Note that the Bulletin applies by its terms only to "federal consumer financial laws," which include (subject to certain limitations) the Consumer Leasing Act, the Electronic Fund Transfer Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, subsections (b) through (f) of section 43 of the Federal Deposit Insurance Act, sections 502 through 509 of the Gramm-Leach-Bliley Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the S.A.F.E. Mortgage Licensing Act, the Truth in Lending Act, the Truth in Savings Act, section 626 of the Omnibus Appropriations Act, 2009, and the Interstate Land Sales Full Disclosure Act.

It is also important to note that while the Bulletin focuses on the responsibilities of a financial institution vis-à-vis its service providers, the Dodd-Frank Act gives the CFPB the authority not only to supervise service providers to the same extent as a federal banking regulator may exercise its supervisory authority over a service provider to a bank,[2] but also to bring a direct enforcement action against a service provider.[3] Thus, if a service provider violates a federal consumer financial law because the financial institution failed to exercise adequate oversight over its vendors, the CFPB could exercise its supervisory authority to

[1] CFPB Bulletin 2012-03, "Service Providers," Apr. 13, 2012, *available at* http://files.consumerfinance.gov/f/201204_cfpb_bulletin_service-providers.pdf.

[2] 12 U.S.C. § 5515(d).

[3] *Id*. § 5536.

require the financial institution to improve its vendor management program, bring an enforcement action directly against the service provider, or both. In certain circumstances, it also could bring an enforcement action for the substantive violation against the financial institution itself (e.g., if the Bureau finds that the institution knowingly or recklessly provided substantial assistance to the service provider in connection with a UDAAP violation).[4]

Most of the obligations described in the Bulletin are consistent with existing regulatory guidance and industry practices to which banks have been subject for years,[5] and more recent requirements.[6]

The Bulletin is nevertheless noteworthy for at least a few reasons.

First, consumer financial servicer providers that are not affiliated with banks have not been subject to this type of substantive regulation until now. While banks have contractually imposed on their service providers requirements similar to those found in the Bulletin, the Bulletin is the first issuance that directly applies these requirements to non-depository institutions. More importantly, for the first time, those institutions are now potentially subject to regulatory agency action for failing to adhere to those requirements.

Second, the CFPB chose not to follow the Administrative Procedure Act by failing to treat its "expectations" as regulations that are subject to publication, notice and comment. Nor did the CFPB choose to attempt to determine what impact the Bulletin's requirements might have on small businesses, which the CFPB is required to do under the Small Business Regulatory Enforcement Fairness Act ("SBREFA") when implementing regulations. The SBREFA provides that if a proposed rule will have a significant economic impact on a substantial number of small entities, the CFPB must seek input directly from small entities about potential costs of a proposed rule and potentially less-burdensome alternatives before issuing the proposal for public comment. The CFPB has apparently attempted to avoid characterizing the third-party vendor requirements as a regulation by instead calling the document a "Bulletin" and calling the requirements mere "expectations." However, the Bulletin has all the hallmarks of a regulation.

Third, the "expectations" are contained in five short bullet points, providing little of the detail that consumer financial services institutions need for guidance, while at the same time arguably requiring an unprecedented level of due diligence on vendors. For example, as noted above, a covered institution must review its third-party service providers' policies, procedures, internal controls, and training materials to ensure that the service providers conduct appropriate training and oversight of employees or agents that have consumer contact or compliance responsibilities. That is a very broad, open-ended requirement. Contrast that with the OCC's more detailed guidance in OCC Bulletin 2001-47 (Third-Party Relationships)[7], which provides that banks should thoroughly evaluate the third party's:

- Experience in implementing and supporting the proposed activity, possibly to include requiring a written proposal;

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[4] *Id*. § 5536(a)(3).

[5] *See, e.g.,* OCC Bulletin 2001-47, "Third-Party Relationships, Risk Management Principles" Nov. 1, 2001, *available at* http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-47.html; FFIEC Information Technology Examination Handbook, *available at* http://ithandbook.ffiec.gov/it-booklets.aspx.

[6] See, for example, the vendor management requirements articulated in the 2011 residential mortgage servicing consent order entered into between various banking agencies and residential mortgage loan servicers. *See* OCC, "OCC Takes Enforcement Action Against Eight Servicers for Unsafe and Unsound Foreclosure Practices," Apr. 13, 2011 *available a*t http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html.

[7] OCC Bulletin 2001-47, "Third-Party Relationships, Risk Management Principles" Nov. 1, 2001, *available at* http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-47.html.

- Audited financial statements of the third party and its significant principals (the analysis should normally be as comprehensive as the bank would undertake if extending credit to the party);
- Business reputation, complaints, and litigation (by checking references, the Better Business Bureau, state attorneys general offices, state consumer affairs offices, and, when appropriate, audit reports and regulatory reports);
- Qualifications, backgrounds, and reputations of company principals, to include criminal background checks, when appropriate;
- Internal controls environment and audit coverage;
- Adequacy of management information systems;
- Business resumption, continuity, recovery, and contingency plans;
- Technology recovery testing efforts;
- Cost of development, implementation, and support;
- Reliance on and success in dealing with subcontractors (the bank may need to consider whether to conduct similar due-diligence activities for material subcontractors); and
- Insurance coverage.

As you can see, most of the OCC's requirements involve safety and soundness concerns, rather than regulatory compliance. Consequently, they will not be particularly helpful to either banks or non-bank consumer financial service companies in interpreting the CFPB's Bulletin.

To demonstrate the significance of this provision, consider a small financial institution that purchases consumer loans and engages a third-party debt collector to collect payments on delinquent obligations. Among other risk controls, the financial institution ordinarily would require the collector to: (a) represent and warrant that it will comply with applicable law and certain performance standards; (b) indemnify the financial institution against losses incurred in connection with a compliance failure; and (c) agree to periodic auditing and reporting requirements. But the financial institution could rely at least to some extent on the service provider's collection expertise – a smaller institution that does not service loans or engage in collection activity should not necessarily be expected to know all of the ins-and-outs of the Fair Debt Collection Practices Act. However, the CFPB now appears to expect such an institution to investigate the debt collector's substantive understanding of the FDCPA and other federal consumer financial protection laws and also to assess the sufficiency of all of the collector's compliance controls.

Unlike the OCC's guidance in OCC Bulletin 2001-47, the CFPB's Bulletin fails to include any limitations based on the level of risk a third-party vendor poses to the financial institution. The OCC recognized that the risk management principles it identified were to be adapted as necessary to reflect specific circumstances and individual risk profiles. As the OCC noted,

> In practice, a bank's risk management system should reflect the complexity of its third-party activities and the overall level of risk involved. Each bank's risk profile is unique and requires a tailored risk mitigation approach appropriate for the scale of its particular third-party relationships, the materiality of the risks present, and the ability of the bank to manage those risks.

While the consent orders entered into by federal banking agencies and the largest residential mortgage loan servicers noted above do not contain a similar limitation, the consent orders were relatively specific in identifying the vendors in question, such as firms providing representation of the servicers in foreclosure and bankruptcy proceedings, which clearly rise to the level of relationships that entail material risk.

Finally, the CFPB recognizes at the outset of the Bulletin that financial institutions often retain service providers precisely because they need to rely on expertise that would not otherwise be available without significant investment. But this acknowledgement seems little more than lip service, because the Bulletin essentially requires financial institutions to develop substantive expertise with respect to all of the compliance obligations that might apply to any outsourced function.

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The Bureau's Treatment of Confidential Supervisory Information

By: Paul F. Hancock, David I. Monteiro

Before the Consumer Financial Protection Bureau came into being, depository institutions could and routinely did share privileged information with their federal regulators without risk that sharing those documents would be deemed a waiver of the privilege. Two federal statutes expressly provide that such information-sharing with the several banking agencies would not constitute a waiver of privilege.[1] The beginning of operations of the Bureau's supervision program over the course of the past year has brought to light a number of shortcomings and omissions in the statutes governing those programs, but perhaps none has been so uniformly acknowledged as Congress's unfortunate failure to expressly add the Bureau to the list of agencies covered by the privilege-waiver exclusion.

The absence of express provision of these protections gave both the Bureau and institutions subject to its examination authority cause for concern: covered institutions were understandably wary that providing privileged information to the Bureau might effect an irrevocable waiver of that privilege for all other purposes,[2] and the Bureau was concerned that supervised institutions' hesitancy to share privileged documents would significantly complicate its efforts to build an effective supervision program.[3]

Over the past year, the reaction from the Bureau has consequently been to take an escalating series of steps to reassure supervised institutions that sharing their privileged information with the Bureau's examiners does not waive the privilege. While none has yet been tested, the patchwork of defenses the Bureau has set up should provide the protections that the Bureau believes it will.

The three primary steps the Bureau has taken have been (1) to issue guidance explaining preexisting judicial authority that could protect the privilege against waiver, (2) to promulgate regulations through the administrative process that purport to provide the protections that the statute omitted, and (3) to encourage legislative efforts that would extend the existing privilege protection statute to cover the Bureau.

First, apparently immediately upon recognizing the issue, the Bureau's General Counsel issued Bulletin 2012-01, which acknowledged the institutions' concerns and articulated two legal arguments for the position that providing privileged information to the Bureau would not constitute a waiver. The Bureau pointed to a 1996 United States District Court decision holding that the mandatory provision of documents to a federal agency could not constitute a waiver because it was not voluntary conduct[4] and a 1991 interpretative letter from the Office of the Comptroller of the Currency making the same point.[5] The Bureau also argued that the transfer of "all powers and duties" related to examinations for compliance with the statutes under the Bureau's authority from the prudential regulators—who are covered by the existing statute—to the Bureau implicitly extended the protection from waiver to the Bureau's supervisory process. While the latter argument may be helpful to depository institutions, it is, of course, substantially less useful to non-depository institutions subject to examination because the authority to conduct such examinations originated in the Dodd-Frank Act itself and was not "transferred" to the Bureau.

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[1] 12 U.S.C. § 1828(x); *see also* 12 U.S.C. § 1785(j).

[2] *See, e.g., Hearing on Legislative Proposals to Promote Accountability and Transparency at the Consumer Financial Protection Bureau Before Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 112th Cong. (2012) (statement of the U.S. Chamber of Commerce), *available at* http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-APincus-20120208.pdf.

[3] *See, e.g.,* Consumer Financial Protection Bureau, Bulletin 2012-01 (Jan. 4, 2012).

[4] *Boston Auction Co., Ltd. v. W. Farm Credit Bank*, 925 F. Supp. 1478, 1482 (D. Haw. 1996).

[5] OCC Interpretative Letter, 1991 WL 338409 (Dec. 3, 1991).

Second, on March 15, 2012, the Bureau proposed a new rule that would expressly provide that the provision of confidential information to the Bureau would not constitute a waiver of privilege.[6] The rule, which the Bureau formally adopted earlier this month with an effective date of August 6, 2012, tracks the language of the non-waiver provision in the statute applicable to prudential regulators:

> The submission by any person of any information to the CFPB for any purpose in the course of any supervisory or regulatory process of the CFPB shall not be construed as waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information under Federal or State law as to any person or entity other than the CFPB.[7]

The Bureau went out of its way in issuing the final rule to emphasize that the rule was intended to have the force of law and to invoke various doctrines of regulatory deference that the agency believes will make the rule binding on the courts.[8]

Third, the Bureau has supported legislation to expand the statutory non-waiver rule to cover the Bureau explicitly.[9] Although the agency has formally taken the position that such legislation is not necessary—apparently to avoid the risk of undermining its regulatory efforts[10]—an act of Congress would finally resolve the issue most cleanly. Multiple bills have been introduced that would close the gap, but none has yet been enacted. One, H.R. 4014, passed the House of Representatives on March 26, 2012, and was placed on the Senate calendar where it is awaiting action; the parallel Senate Bills, S.1099 and S.2055, however, have been pending in the Senate Banking Committee since February. Of the bills that have been introduced, most have—likely inadvertently—focused on banks rather than all institutions under the Bureau's jurisdiction, such as credit unions and non-depository institutions.[11] For example, H.R. 4014 would simply add the Bureau to the list of agencies covered by 12 U.S.C. § 1828(x); the section by its terms applies to "[t]he submission by any person of any information"[12] and so should apply broadly, but the placement of the provision within the Federal Deposit Insurance Act creates at least the risk that the law could be interpreted as applying to depository institutions only.

The Bureau's policies concerning the sharing of supervisory information with other supervisory and enforcement agencies add an additional layer of complexity to this issue. The formal policy of the agency is to treat all information obtained in the course of an examination as confidential, privileged, and exempt from disclosure under the Freedom of Information Act.[13] But the Bureau will share the information under two principal sets of circumstances. First, the Bureau is required by law to share its supervisory information with other federal and state bank supervisory agencies with overlapping jurisdiction provided

[6] *See* 77 Fed. Reg. 15,286 (Mar. 15, 2012).

[7] 77 Fed. Reg. 39,617, 39,623 (July 5, 2012) (to be codified at 12 C.F.R. § 1070.48(a)).

[8] *See id.* at 39,618 & n.19 (citing *United States v. Mead Corp.*, 533 U.S. 218, 229 (2001), and *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council*, 467 U.S. 837, 845 (1984)).

[9] *See, e.g., How Will the CFPB Function Under Richard Cordray?: Hearing Before Subcomm. on TARP, Fin. Serv. & Bailouts of Pub. & Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. (2012) (statement of Richard Cordray, Director, Consumer Financial Protection Bureau); *see also* 77 Fed. Reg. at 39,618.

[10] *Cf.* 77 Fed. Reg. at 39,618 ("Although the Bureau has expressed its support for legislation codifying the Bureau's view that the submission of privileged information to the Bureau does not result in a waiver, the Bureau does not believe such legislation is necessary.").

[11] *See* Stephanie C. Robinson, "Recently Introduced Bills to Protect Privileged Documents: Are They Sufficient to Protect Credit Unions and Nonbanks?" Feb. 20, 2012, *available at* http://www.consumerfinancialserviceswatch.com/2012/02/20/recently-introduced-bills-to-protect-privileged-documents-are-they-sufficient-to-protect-credit-unions-and-nonbanks/.

[12] 12 U.S.C. § 1828(x).

[13] *See* 12 C.F.R. § 1070.41.

that those entities agree to maintain its confidentiality.[14] Second, the Bureau will provide confidential supervisory information to enforcement agencies—including, for example, state attorneys general—on a discretionary basis, but only when the agency's General Counsel determines that the law enforcement interest at stake outweighs the risk to the integrity of the supervisory process.[15] The agency's General Counsel has emphasized that it will authorize such sharing "only in very limited circumstances."[16]

In light of these policies, the Bureau announced in the same rulemaking that articulated the non-waiver rule an additional layer of protection for shared confidential supervisory information. The final rule, which also takes effect August 6, 2012, provides that:

> The CFPB shall not be deemed to have waived any privilege applicable to any information by transferring that information to, or permitting that information to be used by, any Federal or State agency.[17]

The language of this provision now tracks that of 12 U.S.C. § 1821(t), which applies to the banking agencies, and supersedes a previous interim final rule that provided essentially the same protections using different language.[18] Section 1070.47 already affirms that transferred information remains at all times the property of the Bureau and provides that the state and federal agencies who receive such information must maintain its confidentiality;[19] this additional provision should serve to negate any argument that the Bureau's sharing of information under strict confidentiality constraints in any respect itself constitutes a waiver of privilege.[20]

This series of aggressive steps should be adequate to protect privileged information the Bureau obtains in the course of its supervisory functions from waiver. If the courts ultimately hold that they are not, the negative effect both on the operation of the Bureau's supervision program and on every supervised entity under the Bureau's jurisdiction would be very serious. The issue nevertheless will remain open until either the courts have definitively weighed in on the effect of the Bureau's rule or Congress acts.

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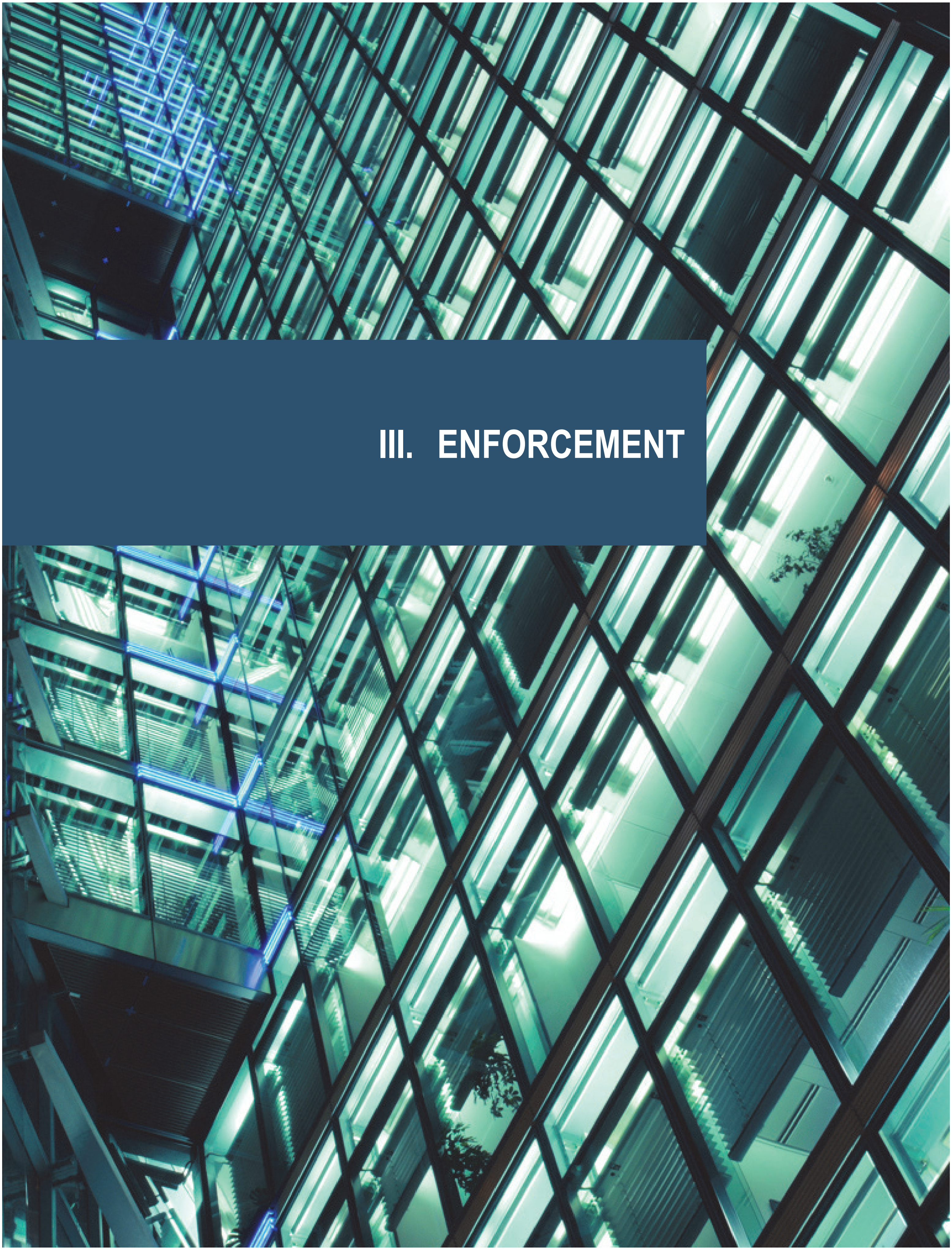
[14] 12 U.S.C. § 5512(c)(6)(C)(i).
[15] *See* Bulletin 2012-01, at 5 (citing 12 C.F.R. § 1070.43).
[16] *Id*.
[17] 77 Fed. Reg. at 39,623 (to be codified at 12 C.F.R. § 1070.47(c)).
[18] *See* 12 C.F.R. § 1070.47(c) ("The provision by the CFPB of any confidential information pursuant to [12 C.F.R. part 1070, subpart D] does not constitute a waiver, or otherwise affect, any privilege any agency or person may claim with respect to such information under federal law.").
[19] *See* 12 C.F.R. § 1070.47(a).
[20] *See* 77 Fed. Reg. at 39,621.

III. ENFORCEMENT



Maneuvering the Unchartered Seas of CFPB Investigations

By: Michael J. Missal, Shanda N. Hastings, Noam A. Kutler, Stephanie C. Robinson

One year after the Consumer Financial Protection Bureau came into existence, it is already aggressively commencing investigations of covered persons and entities. Investigations by federal agencies are often complicated and resource intensive matters, and the Bureau's entry into this arena adds yet another cause for concern for covered entities facing possible oversight and enforcement. The Bureau issued its final rules regarding investigations on June 29, 2012.[1] It fashioned its rules after those of the Federal Trade Commission, the Securities and Exchange Commission and other government regulators. Among other matters, the new rules address: (1) the initiation and notification of an investigation; (2) rules governing civil investigative demands ("CIDs"); (3) investigational hearings; and (4) the confidentiality and protection of materials produced during an investigation.

While much of the rules remain as initially proposed, the final rules clarify that only the Assistant Director of the Office of Enforcement and the Deputy Assistant Directors of the Office of Enforcement may initiate an investigation and issue CIDs. Additionally, the rules clarify how the CFPB will notify a person of an investigation and the procedures for filing a petition to modify or set aside a CID. The final rules also address the restrictions imposed upon a witness's attorney during an investigational hearing, allowing him or her to object only on grounds of privilege. As discussed in greater detail below, this nascent agency's tough investigation rules, broad jurisdiction and ability to assess large fines and penalties make a CFPB investigation something that every company should take seriously and address in a strategic manner.

The Civil Investigative Demand

A covered individual or company will likely first learn of a CFPB investigation through the receipt of a CID. Issued pursuant to 12 C.F.R. § 1080.6, a CID can include a request to produce documents and tangible things, provide written reports, answer interrogatories, and even provide oral testimony. As part of the CID, the CFPB must provide the recipient with a description of the purpose and scope of the investigation.[2]

Following receipt of the CID, the recipient is given 10 calendar days to meet and confer with the Bureau's investigating attorney.[3] The meeting is intended to help better define the scope of the demand and resolve any other outstanding issues. Ten calendar days does not give much time to assess a large or complex matter and understand the limitations on what can be reasonably produced. However, it is important to schedule this meeting in a timely fashion because it is required in order to later petition the Director for an order modifying or setting aside the demand. Such a petition must be filed with caution. As discussed in more detail below, a CFPB investigation is treated as confidential, while a petition to modify or set aside the CID is treated as a public record and can be discovered later by third parties.[4] The Director's response to the petition is also considered public record. If the target of a CID decides to petition the Director, it must be done within 20 calendar days of receiving the CID and "set forth all factual and legal objections to the civil investigative demand."[5]

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[1] Rules Relating to Investigations, 77 Fed. Reg. 39,101 (June 29, 2012) (to be codified at 12 C.F.R. pt. 1080).

[2] 12 C.F.R. § 1080.5.

[3] *Id.* § 1080.6(c).

[4] *Id.* § 1080.6(g).

[5] *Id.* § 1080.6(e).

The CID will include a deadline when all responses are due. These can be modified through the meet and confer process or through petition, but the Bureau has stated that it will only grant extensions of the time prescribed for compliance for good cause shown. As such, it is very important to make the response to the CID a high priority for your company and be able to communicate clearly to the investigator your reasons for requesting extensions of time to respond to the specific items the Bureau has requested.

When responding to a CID, keep in mind that each answer or report is produced as though under oath.[6] While it is important to respond in a timely manner to the CID, it may be even more important to ensure that all answers are accurate and complete.

Investigational Hearings

In addition to requesting documents and responses to specific questions, the Bureau can also request that a company designate individuals to testify under oath in an on-the-record hearing.[7] In such a situation, the CID will describe "with reasonable particularity" the matters to be discussed.[8] This is done in order to assist the CID recipient in best identifying the appropriate individuals to testify on those subjects. Since a "meet and confer" is generally required in connection with all CIDs, there will be an opportunity for a CID recipient to discuss with the investigator any issues about which persons the entity designates to testify on its behalf.

A hearing will be conducted by a CFPB investigator. Only the investigator, the person being examined, his or her counsel, the officer before whom testimony is to be taken, any individual transcribing or recording the testimony, and representatives from any other agency conducting a joint investigation with the CFPB are allowed to attend the hearing. Additionally, the investigator can invite other third parties to join the hearing, with the consent of the person being examined.[9]

While counsel is permitted to attend the hearing, counsel's ability to consult with and advise his or her client during the hearing is severely restricted by CFPB regulations. Counsel may only raise an objection if the objection is grounded in a constitutional or other legal right or privilege. Otherwise, the witness's counsel is barred from voicing any objections during the course of the testimony.[10] Furthermore, counsel may only seek permission for his client to clarify the record at the end of the hearing and even then, it is allowed at the sole discretion of the investigator.[11] Such restrictions make it all the more critical that witnesses go through extensive preparation and review in advance of their testimony.

Early Warning Notice (NORAs)

The CFPB issued a bulletin on November 7, 2011, expressing its intent to provide advance notice of potential enforcement actions to individuals and companies under investigation.[12] While not required by law, the Bureau will provide the recipient of this notice with an opportunity to respond before it pursues an enforcement action. This process is fashioned after the SEC's Wells Notice and is referred to as the Notice and Opportunity to Respond and Advise, or a "NORA Notice."

[6] *Id.* § 1080.6(a).
[7] *Id.* § 1080.7.
[8] *Id.* § 1080.6(a)(4)(i).
[9] *Id.* § 1080.7(c).
[10] *Id.* § 1080.9.
[11] *Id.* § 1080.9(b)(4).
[12] *Early Warning Notice*, CFPB Bulletin 2011-04 (Nov. 7, 2011).

The decision to provide a potential target of an enforcement action with a NORA Notice is discretionary. When received, however, it is important to make the most of the opportunity and respond effectively to the Bureau's policy and legal concerns. The Bureau intends to provide a recipient with 14 days to respond by means of a written statement no longer than 40 pages. Given the short period of time to respond, it may make sense in some circumstances to prepare a draft of a response in anticipation of receiving a NORA Notice.

While in most cases recipients should avail themselves of the opportunity to respond, they should also be aware of the potential risks that come with responding to a NORA Notice. The Bureau notes that any factual assertions relied upon in the statement must be made under oath and can be used by the CFPB in future enforcement actions. Additionally, such assertions and the actual response to the NORA Notice may be discoverable by third parties. Thus, attention to detail and strong strategic thought is essential when preparing a response.

The Confidentiality of an Investigation

As with other government investigations, maintaining the confidentiality of the investigation and preserving privilege in the event of other litigation is of paramount importance. If not dealt with properly, applicable privileges can be waived during document production. Thus, when responding to a CID, it is important to always consider what effect the production of certain documents will have on any future claims of privilege.

As part of its supervisory powers, the CFPB has stated that it intends to request privileged materials from supervised entities through the examination process and "will not consider waiver [of privilege] concerns to be a valid basis for the withholding of privileged information."[13] While the CFPB states that it does not consider this production of information during an exam to be a voluntary submission and thus would not waive privilege, the lack of statutory protection makes this a risk worth considering in any future examination or investigation.[14]

In an investigation, unlike an examination, a person may withhold responsive material if asserting a claim of privilege.[15] When claiming privilege, the CFPB requests a rather extensive privilege log that includes the type of information being withheld; the names, addresses, and positions of the authors and recipients of this information; and the specific grounds for claiming that the item is privileged.[16]

There are instances when a party may inadvertently disclose privileged information as part of a production. The CFPB recognizes this possibility and states that it will not consider such inadvertent disclosures to constitute a waiver of privilege.[17] In order to take advantage of this exception, however, the person must demonstrate that: (1) the disclosure was inadvertent; (2) the person making the production took reasonable steps to prevent the disclosure of privileged material; and (3) once aware of the disclosure, the person took prompt and reasonable steps to correct the mistake.[18]

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[13] *The Bureau's Supervision Authority and Treatment of Confidential Supervisory Information*, CFPB Bulletin 2012-01 (Jan. 4, 2012).

[14] The CFPB has examination powers similar to those of the banking agencies, but Congress did not include the Bureau in the statutory privilege waiver protections granted to those other agencies. *See* 12 U.S.C. §§ 1821(t), 1828(x).

[15] 12 C.F.R. § 1080.8(a).

[16] *Id*.

[17] *Id*. § 1080.8(c)(1).

[18] *Id*.

In addition to protecting privileged material, those providing information in a CFPB investigation should also be concerned with confidentiality. The CFPB treats all information received as part of its investigation as confidential and exempt from disclosure under the Freedom of Information Act ("FOIA").[19] While the initial CFPB investigation is confidential, it is important to note that several related parts of the investigation are in fact treated as part of the public record. First, should a person decide to petition the Bureau for the modification or cancellation of a CID, the Bureau treats the petition and its response as public record. Additionally, any response to a NORA Notice can become part of the public record that both the CFPB and other third parties can use in future litigation.

While the Bureau treats information it receives from both investigations and examinations as confidential, it may nevertheless share such information with other agencies. For example, in its May 16, 2012 Memorandum of Understanding with Prudential Regulators, the CFPB laid out its plans to share information it gathers through the supervisory process with other regulators that share supervisory jurisdiction.[20] And, although CFPB "will not routinely share" confidential supervisory information with law enforcement agencies not engaged in supervision, it has discretion to disclose confidential information to a federal or state agency (including a State Attorney General) to the extent that disclosure is relevant to the exercise of the agency's statutory or regulatory authority.[21] In a recent speech to the National Association of Attorneys General, CFPB Director Richard Cordray discussed his intention "to establish a general framework to share information on consumer financial protection issues" with the State Attorneys General.[22] While this increased cooperation will help the CFPB and others more effectively marshal their resources and possibly better coordinate investigations amongst themselves, those responding to CFPB investigations should be aware of this potential for sharing amongst both federal and state agencies. Of particular concern, the CFPB has jurisdiction over banks with more than $10 billion in assets and this information sharing could serve as a backdoor for State Attorneys General to gain access to otherwise unavailable information.[23]

A person concerned about confidentiality or waiver of privilege has few immediate options. If the Bureau rejects a party's argument to withhold documents on grounds of privilege or confidentiality, there are no means of appealing the decision for immediate relief. Instead, a party must either comply with the Bureau's request or choose to withhold the documents and see if the CFPB brings an enforcement action in a court to compel production and possibly seek civil contempt charges.[24] Only then can a party raise objections to the scope of the CID or specific document requests.

How CFPB Investigations Compare to Those of Other Regulators

Those familiar with investigations by the SEC and the FTC will see many similarities in the way that the CFPB handles its investigations. Some differences do exist and it is important to be aware of those differences when facing a CFPB investigation. First, unlike SEC subpoenas, which only require the production of documents, a CID issued by the CFPB can include requests for extensive interrogatories, analysis and reports. Since CIDs will also make extensive requests for documents, responding to a CID can be an especially time consuming, expensive and resource intensive process. This

[19] *See* 5 U.S.C. § 552(b)(8); *see also* 12 C.F.R. pt. 1070.

[20] *Memorandum of Understanding on Supervisory Coordination*, CFPB, 5, 8-9 (May 16, 2012).

[21] *See id.* at 5; *see also* 12 C.F.R. § 1070.43(b).

[22] Richard Cordray, Director, Consumer Fin. Prot. Bureau, Remarks Before The Nat'l Ass'n. of Attorneys Gen. (Mar. 6, 2012).

[23] Legislation is currently pending before Congress that would add the CFPB to the list of covered agencies that may share information with other covered or Federal agencies without waiving any privilege associated with that information. *See* H.R. 4014, 112th Cong. (as passed by House of Representatives, Mar. 26, 2012).

[24] *Id*. § 1080.10.

makes it all the more important to assess immediately the scope of the requests and to negotiate with the CFPB staff at the meet and confer to limit the requests, to the extent possible.

Next, unlike the SEC, Department of Justice, Commodity Futures Trading Commission and other agencies charged with investigating possible misdeeds, the CFPB is particularly insulated from traditional Congressional or Executive oversight. The CFPB is funded by the Federal Reserve, which eliminates Congressional oversight over its budget and thus limits its ability to influence the direction over the CFPB mission.[25] Moreover, there are fewer layers of review involved in the decision to initiate an investigation and then later bring charges against a person. The only appeal from the head of Enforcement is to the Director of the CFPB. The combination of these factors, plus the restrictions imposed upon the President's ability to remove the CFPB Director,[26] reduce the usual level of checks and balances in place for other agencies.

Finally, the CFPB retains supervisory authority as well as investigatory powers over covered entities. This means that the CFPB will be routinely examining companies under its purview and can request extensive document productions that even include privileged material. As discussed previously, while the Bureau has expressed its general intent to maintain the confidentiality and privileged nature of these documents, it is yet to be seen what, if any, protections will be established to guard against the blurring of lines within the Bureau. If examiners and investigators share information amongst themselves, it could effectively eliminate some of the protections otherwise provided to entities that are the subject of a CFPB investigation.

What to Do If You Receive a CID From the CFPB

It is important from the very first day to consider the resources that will be required to respond to the CID, the legal issues behind the request, and what other external concerns may apply. With this in mind, you and your counsel can more effectively negotiate with CFPB staff to refine and address the many requests that often appear in an initial CID. Additionally, thought should always be given to how this investigation and your response will affect the long-term relations of the company with the Bureau. Specific investigations could also impact other state and federal investigations. Given the often overlapping jurisdiction of the CFPB and other agencies, along with its somewhat controversial creation, the CFPB is likely to pursue matters aggressively in order to stake out its jurisdiction. All of these are factors to consider throughout the CFPB investigatory process.

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[25] 12 U.S.C. § 5497 (2011).
[26] *Id*. § 5491(c)(3).

CFPB Takes Steps to Encourage Whistleblowers

By: Matt T. Morley

The Consumer Financial Protection Bureau has mounted an effort to encourage whistleblowers to contact them directly about potential violations of federal consumer financial laws. Since December 2011, the Bureau has maintained and publicized a toll-free hotline and an e-mail address that whistleblowers can use for this purpose.[1] In announcing the program, Richard Cordray, then Director of Enforcement for the agency, said that it provides whistleblowers with "a direct line of communication to the CFPB." He also noted that the tips received will help inform the agency's "strategy, investigations, and enforcement." The CFPB has also indicated that it is in the process of creating a website through which such reports can be made.

In seeking to encourage whistleblowers, the CFPB has also noted that federal law protects certain whistleblowers against retaliation for making reports about potential misconduct. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, employees of companies offering or providing a consumer financial product or service may not be terminated or in any way discriminated against for informing the CFPB about a potential violation of a federal consumer financial law or CFPB regulation, so long as the employee had a reasonable belief that there had been a violation.[2] These protections also extend to personnel of companies providing services to consumer financial product companies. Persons claiming to have been the subject of retaliation have the right to file a complaint with the U.S. Department of Labor within 180 days of the alleged retaliation, and the Department can order that the employee be reinstated and receive back pay and other compensatory damages.

The CFPB's whistleblower program is substantially more limited than the one established by Dodd-Frank for reports of violations of laws enforced by the Securities and Exchange Commission and the Commodity Futures Trading Commission. Persons providing information leading to a successful enforcement action by either of those agencies will receive a bounty of between 10 and 30 percent of the total fines, penalties and other amounts recovered from wrongdoers. In addition, stronger anti-retaliation protections apply in those cases. Persons alleging that they have been retaliated against in connection with such reports can file complaints directly in federal court seeking reinstatement and two-times back pay. The SEC reports receiving hundreds of reports in just the first few weeks of its program.

Even though the CFPB is not offering the prospect of cash bounties to whistleblowers, some employees may decide to skip any kind of internal reporting and take their concerns directly to the CFPB. From a company's standpoint, there are significant advantages in learning about and responding to potential wrongdoing before law enforcement authorities become involved. Although some employees may be reluctant to raise questions about the actions of their fellow employees – particularly higher-ranking ones – that reluctance may be overcome if employees are confident that the company wants to receive such information, and that employees who report concerns will be protected from retaliation. Companies can best position themselves to cope with the prospect of whistleblower reports by evaluating whether their internal reporting systems are well-known, well-understood, and easy to use.

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[1] *See Bureau Invites Whistleblower Information and Law Enforcement Tips, and Highlights Anti-Retaliation Protections*, CFPB Bulletin 2011-05 (Dec. 15, 2011).

[2] *See* 12 U.S.C. § 5567.

Expeditious, Fair and Impartial? Only Time Will Tell Whether the CFPB Adjudication Process Meets the Bureau's Stated Goals

By: Stephen J. Crimmins, Michael J. Missal, Amanda B. Kostner, Karen Kazmerzak

Crafting an adjudication process from parts of Securities and Exchange Commission rules here, pieces of Federal Trade Commission rules there, and bits of various other agencies' rules to fill in the gaps, the Consumer Financial Protection Bureau stated that its goal was to create an expeditious, fair, and impartial adjudication process. Only time will tell how the Bureau interprets its adjudication rules and whether it meets its stated goals for the process. On June 6, 2012, the Bureau issued its final rules relating to the practices and procedures applicable to adjudication proceedings authorized by Section 1053 of the Dodd-Frank Act ("Adjudication Rules"). Effective as of June 29, 2012,[1] the Adjudication Rules govern the Bureau's use of administrative adjudications to enforce compliance with the Consumer Financial Protection Act and any other federal law or regulation the Bureau is authorized to enforce. The Adjudication Rules apply to proceedings that arise after the Bureau issues a notice of charges.[2]

Similar to other agencies' proceedings, the Bureau initiates adjudication proceedings by filing and serving upon a defendant a notice of charges setting forth the Bureau's legal authority and basis for the proceedings.[3] Unless the respondent moves for a protective order within 10 days of service, the Bureau will make public any notice of charges.[4] Respondents must file an answer within 14 days of service of the notice of charges. The Adjudication Rules require that the respondent answer the notice of charges, unlike those of the SEC.[5] The parties shall meet and confer prior to the initial scheduling conference, which is held within 20 days of service of the notice of charges.[6] As with the SEC and FTC processes, respondents should be prepared to substantively discuss a number of matters at the initial scheduling conference, including hearing dates, production of documents, subpoenas, and the use of experts.[7] Also, like the FTC, the CFPB rules provide for expert discovery with the goals of increasing efficiency and clarity in the proceedings. The SEC rules do not provide for the use of expert discovery.

Hearing officers have considerable discretion in conducting the proceedings[8]—the Adjudication Rules grant hearing officers the authority to issue subpoenas, take depositions, rule upon motions, including dispositive motions, issue sanctions, reject submissions for failure to materially comply with the Adjudication Rules, and deny confidential status to documents.[9] The Bureau requires that all persons responding to a subpoena for documentary material file a sworn certificate of compliance with the subpoena response confirming that all of the documentary material required by the subpoena and in the possession, custody, or control of the person was produced and made available.[10]

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[1] *See* Rules of Practice for Adjudication Proceedings, 12 C.F.R. § 1081 (2012).

[2] *Id*. § 1081.100.

[3] *Id*. § 1081.200(a)-(b).

[4] *Id*. § 1081.200(c).

[5] *Id*. § 1081.201. The SEC rules state that the Commission's order instituting proceedings "may" require an answer; in practice, however, the order frequently requires an answer.

[6] *Id*. § 1081.203.

[7] *Id*.

[8] *See* Rules of Practice for Adjudication Proceedings, 77 Fed. Reg. 39,059 (June 29, 2012); *see also* 12 C.F.R. § 1081.104.

[9] 12 C.F.R. § 1081.104.

[10] *Id*. § 1081.208(g).

While generally following the SEC's procedures regarding confidentiality, the Bureau adopted the FTC's substantive confidentiality standard. Under this standard, a motion for protective order will be granted only where public disclosure will likely result in a clearly defined, serious injury to the party or third party requesting confidential treatment.[11] The Bureau declined to follow the SEC's substantive standard—where motions for protective orders are granted if the harm resulting from disclosure outweighs the benefits—in order to provide more transparency to the proceedings.[12]

No later than 10 days before the adjudication hearing, each party must serve and file a pre-hearing statement outlining the party's theory of the case or defense, including the legal theories upon which the party will rely.[13] The burden of proof at the hearing lies with the Bureau.[14] The Adjudication Rules regarding admissibility largely follow the Administrative Procedure Act and the Federal Rules of Evidence, and relevant, material, and reliable evidence that is not unduly repetitive is admissible.[15] In a departure from judicial trials, but in line with the FTC's rules, hearsay evidence is admissible provided it meets satisfactory indicia of reliability.[16]

The CFPB adopted an affirmative disclosure approach to fact discovery modeling that of the SEC[17] with the intention of streamlining the proceedings and ensuring that respondents have prompt access to the documents underlying the enforcement counsel's decision to commence the action. For example, similar to the SEC's procedures, the CFPB's Office of Enforcement will permit parties to inspect and copy certain categories of non-privileged documents in connection with the investigation conducted prior to initiation of the proceedings; this rule applies only to documents obtained by the Office of Enforcement and not other divisions of the CFPB.[18] The Bureau indicated that in most cases, it will affirmatively provide either paper or electronic copies of the material at issue to the respondents,[19] which is also the general practice in SEC adjudication proceedings. In addition, the CFPB has a general obligation to turn over material exculpatory evidence to respondents, with the exception of information provided by another government agency upon the condition that it not be disclosed.[20] Unlike the FTC's administrative adjudication rules, the Bureau does not provide for other typical forms of civil pre-trial discovery, such as interrogatories and discovery depositions. Failure to comply with the Bureau's affirmative disclosure requirement is presumed harmless error unless the respondent establishes otherwise.[21]

While the Bureau indicated that it will affirmatively provide certain non-privileged documents to respondents, the Bureau did not address how it will handle document production and questions of privilege where the Bureau is investigating multiple, related cases with potentially overlapping documentation. This issue arises in SEC adjudications and has not yet been addressed on an agency-wide basis by the SEC. This document production issue is likely to be case specific, requiring institutions to raise this issue on some, but not all, matters before the hearing officers.

Following the adjudication hearing, the hearing officer will issue a recommended decision within 90 days after the deadline for filing post-hearing briefs and in no event later than 300 days from service of the

[11] *Id.* § 1081.119.
[12] *Id.*; *see also* 77 Fed. Reg. 39,066 (June 29, 2012).
[13] 12 C.F.R. § 1081.215.
[14] *Id.* § 1081.303.
[15] *Id.*
[16] *Id.*
[17] 77 Fed. Reg. 39,059 (June 29, 2012).
[18] 12 C.F.R. § 1081.206.
[19] *Id.*; *see also* 77 Fed. Reg. 39,070 (June 29, 2012).
[20] 12 C.F.R. § 1081.206(b).
[21] *Id.* § 1081.206(f).

notice of charges.[22] While hearing officers are permitted to request an extension of the deadline, the Bureau's stated intent, which is similar to that of the SEC, is that extensions will be granted only in "rare circumstances" and are "strongly disfavor[ed]."[23] Any party may contest the hearing officer's recommended decision by filing a notice of appeal within 10 days of service of the recommended decision and later perfecting the appeal.[24] Should a party fail to timely file a notice of appeal or perfect the appeal, the Director may either adopt the hearing officer's recommended decision or order further briefing limited to findings of fact or conclusions of law contained in the recommended decision.[25]

If the recommended decision is not appealed, the Director shall issue a final decision within 40 days of the recommended decision.[26] Where a recommended decision is appealed or the Director orders additional briefing, the Director has 90 days from the submission of the case to the Bureau to issue his or her final decision and order, which will also be published on the Bureau's website.[27] Unlike the processes at either the SEC or FTC, where a hearing officer's initial decision or appeal of such decision is reviewed by the full Commissions, the CFPB initial decisions and appeals will be subject to review by only one individual, the CFPB Director.

Conclusion

While the Bureau's Adjudication Rules are largely based on those of the SEC and FTC, only time will tell how the Bureau actually implements and interprets its rules. Since the CFPB has not yet initiated its first adjudication proceeding, it may be some time before its adjudication practices are fully developed.

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[22] *Id*. § 1081.400.
[23] *Id*. § 1081.115; *see also* 77 Fed. Reg. 39,059 (June 29, 2012).
[24] 12 C.F.R. § 1081.400.
[25] *Id*. § 1081.402(b).
[26] *Id*.
[27] *Id*. § 1081.405(d)-(e).

IV. POLITICS

Can the CFPB Make It Out of the Crib? Continuing Questions About Its Legitimacy and Likely Longevity

By: Bruce J. Heiman, Daniel F. C. Crowley, Akilah Green

As the Consumer Financial Protection Bureau celebrates its one-year anniversary, its legitimacy remains the subject of considerable controversy, and the CFPB is under assault by congressional Republicans. Debate rages over Congress' atypical decisions to delegate rulemaking authority to an autonomous director. Critics contend that the Dodd-Frank Wall Street Reform and Consumer Protection Act inappropriately insulated CFPB from congressional, judicial, or executive oversight in contravention of the constitutional "separation of powers" doctrine. Serious questions also have been raised over the validity and longevity of President Obama's "recess" appointment of Richard Cordray as CFPB Director.

The Director Makes the Rules – For Now – as Calls for Changing the Bureau's Structure Continue

Dodd-Frank vests exclusive rulemaking authority in the Director of the CFPB.[1] Vesting exclusive rulemaking power in an individual is unusual for financial services regulatory bodies. Entities such as the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System, for example, are all governed by a multi-member board. Republican legislators have sharply criticized the CFPB's structure because decision making authority is vested in one individual. Senator Richard Shelby, the most senior Republican senator on the Senate Banking, Housing, and Urban Affairs Committee, recently opined that it is "only a matter of time before this concentration of power is abused or misused to the detriment of American businesses and consumers."[2]

Several bills have been introduced to change the structure of the CFPB – most notably, the Consumer Financial Protection Safety and Soundness Improvement Act of 2011 (H.R. 1315), which was introduced by House Financial Services Chairman Spencer Bachus (R-AL), Rep. Shelley Moore Capito (R-WV), and Rep. Sean Duffy (R-WI). The bill, which was approved by the House of Representatives in July 2011 by a vote of 241-173, would establish a five-member bipartisan commission to manage the CFPB, create a specific review process for rules promulgated by the CFPB, and would require a Senate confirmed chair of the commission. However, companion legislation has not been introduced in the Senate, and such legislation is unlikely to be enacted this year. Depending on the election results, such legislation could have a much better chance of passage next year.

Legislators Continue to Seek More Accountability in the Bureau's Budget

The CFPB also has faced criticism regarding the legitimacy of its insulation from the usual annual appropriations process – the process by which Congress funds the activities of the federal government.

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[1] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1022(b)(1) (2010) ("Dodd-Frank") (outlining rulemaking powers of Director).

[2] *See* Richard Shelby, *The Danger of an Unaccountable "Consumer Protection" Czar*, The Wall Street Journal, July 21, 2011, *available at* http://online.wsj.com/article/SB10001424053111903554904576457931310814462.html.

The CFPB's budget is funded, not through a congressional appropriation, but instead through a mandatory transfer of funds from the Federal Reserve's budget, which also is independent of the congressional appropriations process and primarily obtains funding from the interest earnings on its portfolio of securities. Indeed, Dodd-Frank prohibits the House and Senate Appropriations Committees from reviewing the CFPB's budget.[3]

House Republicans strongly objected to this funding scheme during debate over Dodd-Frank because Congress's inability to control the CFPB's purse strings would make it difficult for Congress to influence the Bureau's operations. House Republicans also continue to express concern about the lack of transparency in the Bureau's budgeting process. In April 2011, Congressmen Bill Posey (R-FL) and Randy Neugebauer (R-TX) renewed their calls for more accountability, introducing bills that would bring the CFPB within the Department of the Treasury and thus subject it to the appropriations process.[4] More recently, the House Appropriations Committee approved legislation (H.R. 6020) in June 2012 that would allow the committee to carefully review the Federal Reserve's transfers to the CFPB and would permanently bring the Bureau within the appropriations process beginning in 2014. This provision may well be considered in the context of an end-of-year omnibus appropriations bill.

Detractors Argue That the CFPB Is Insulated from Judicial and Executive Review

Some critics have even argued that Dodd-Frank limits judicial review of the CFPB's actions. Dodd-Frank does mandate considerable judicial deference to the validity of rules promulgated by the CFPB, instructing judges to defer to the Bureau's rulings as if it "were the only agency authorized to apply, enforce, interpret, or administer the provisions of such Federal consumer financial law."[5] However, this provision appears to have been included to clarify to which agency the courts must defer rather than to substantively limit a court's review of a particular CFPB decision or action. Dodd-Frank was explicit in its grant of exclusive authority to the CFPB, requiring several different financial regulators to transfer their rulemaking and examination authority regarding federal consumer financial laws to the Bureau on July 21, 2011.[6] Accordingly, the same section of Dodd-Frank that includes the judicial deference provision also states that notwithstanding any other provision of law "to the extent that a provision of Federal consumer financial law authorizes the Bureau and another Federal agency to issue regulations under that provision of law for purposes of assuring compliance with Federal consumer financial law and any regulations thereunder, the Bureau shall have the exclusive authority to prescribe rules subject to those provisions of law."[7]

Additionally, some argue that Dodd-Frank inappropriately insulates the CFPB Director from Presidential oversight by constraining the president's ability to remove the director. Under Dodd-Frank, once the CFPB Director is appointed by the president with the advice and consent of the Senate, he serves in that position for a five-year term and may only be removed by the president for "inefficiency, neglect of duty,

[3] Dodd-Frank, § 1017(a)(3).

[4] *See, e.g.,* Bureau of Consumer Financial Protection Accountability Act, H.R. 1640, 112th Cong. (2011) (sponsored by Rep. Posey); Bureau of Consumer Financial Protection Accountability and Transparency Act of 2011, H.R. 1355, 112th Cong. (2011) (sponsored by Rep. Neugebauer).

[5] Dodd-Frank, § 1022(b)(4)(B); *see also* Dodd-Frank, § 1061(b)(5)(E).

[6] Dodd-Frank, § 1061.

[7] Dodd-Frank, § 1022(b)(4)(A).

or malfeasance in office."[8] However, the Supreme Court decades ago upheld precisely such limitations on the president's ability to remove the heads of independent agencies.[9]

Taken together, some have argued that the existing structure of the CFPB has granted unlimited discretion to the Bureau and its director by unduly insulating the Bureau and its operations from meaningful congressional, judicial, and executive oversight, thereby removing the Constitution's fundamental scheme of checks and balances in violation of the constitutional "separation of powers" doctrine.[10]

Serious Questions Have Been Raised About the Validity of Cordray's Recess Appointment

Perhaps the most advanced challenge to the CFPB concerns the constitutionality of President Obama's recess appointment of Cordray. Senate Republicans had promised to filibuster, or refused to vote on the confirmation of, any nominee to the Director position. In December 2011 and January 2012, the Senate also held so-called "pro forma" sessions to prevent President Obama from installing Cordray under the Recess Appointments Clause, which grants the president the authority to fill vacant positions during "the Recess of the Senate."[11] These sessions, in which a lone senator from a jurisdiction convenient to Washington, D.C. called the Senate into session for a few minutes at a time, were specifically intended to prevent President Obama from installing Cordray as Director of the Bureau over this holiday recess.

Ignoring these pro forma sessions, President Obama installed Cordray as Director on January 4, 2012 – the day after a one-minute pro forma session was held to begin the second session of the 112th Congress.

Senate Republicans immediately denounced President Obama's actions as constitutionally infirm, arguing that because the Senate was conducting pro forma sessions the Senate was not in recess. Indeed, the Constitution also states that neither chamber of Congress may recess for more than three days without the consent of the other.[12] In this case, the Senate did not receive the consent of the House to recess.

Previous legal opinions from courts and various attorneys general have suggested that the president retains "large, although not unlimited, discretion" to determine when there is a "real and genuine" recess of the Senate.[13] In defending Cordray's installation, the Department of Justice's Office of Legal Counsel wrote that the Senate's "lengthy intra-session recess broken only by pro forma sessions closely resembles an unbroken recess of the same length" and that President Obama could properly conclude that the Senate was thus practically unavailable to fulfill its advice-and-consent duties.[14]

A further question arises as to the length of the Cordray appointment. The timing of his appointment appears to have been quite deliberate. The Constitution provides that the terms of recess appointments shall expire at the end of the next congressional session. Therefore, some argue that the appointment is

[8] Dodd-Frank, § 1011(c)(3).

[9] *Humphrey's Executor v. United States*, 295 U.S. 602 (1935); *see also Free Enterprise Fund v. Public Co. Accounting Oversight Bd.,* 130 S.Ct. 3138 (2010) (holding that congressional restrictions on the power of the executive branch to remove inferior officers are constitutional in certain circumstances).

[10] *See* Complaint*, State Nat'l Bank of Big Spring v. Geithner*, No. 12-cv-01032-ESH (D.D.C. June 21, 2012).

[11] U.S. Const. Art. II, § 2.

[12] U.S. Const. Art. I, § 5, cl. 4.

[13] *Executive Power-Recess Appointments*, 33 Op. Att'y Gen. 20, 25 (1921) ("To give the word 'recess' a technical and not a practical construction…is to disregard substance for form"); *see also* Opinions of the Office of Legal Counsel, *The Constitutional Separation of Powers Within the President and Congress*, May 7, 1996, *available at* http://www.justice.gov/olc/delly.htm#N_1_.

[14] *See* Opinions of the Office of Legal Counsel, *Lawfulness of Recess Appointment During a Recess of the Senate Notwithstanding Periodic Pro Forma Sessions*, January 6, 2012 at *14.

good through the first session of the next Congress – the end of 2013 – because the appointment was made during a recess of the second session of the current Congress. But questions remain about a president's ability to make a recess appointment that extends beyond a current Congress.

Importantly, the validity of the appointment may be more than a passing constitutional curiosity. Dodd-Frank prevents the CFPB from fully assuming its statutory duties until its Director is confirmed by the Senate.[15] If a court finds Cordray's appointment invalid, the legitimacy of the CFPB's actions taken under his direction will be clouded with uncertainty.

Lawsuits Begin to Challenge the CFPB's Structure and Leadership

Following months of controversy regarding the CFPB's structure and leadership, three plaintiffs filed suit in June 2012, charging that the Bureau's structure contravenes the constitutional principle of separated powers.[16] The complaint alleges that Dodd-Frank impermissibly insulates the Bureau's budget from congressional appropriations, the Director's rulemaking authority from presidential oversight, and the Bureau's rules from meaningful judicial review. The suit also asserts that Dodd-Frank's simultaneous insulation from the appropriations process, presidential oversight, and judicial review is unprecedented. The complaint also challenges the validity of Cordray's appointment as Director.

Senate Republicans and the U.S. Chamber of Commerce also are reportedly contemplating legal action, particularly focused on the invalidity of the recess appointment.

Conclusion

The CFPB has survived its first year and has, to date, withstood continuing criticism regarding its structure, funding mechanism, and the installation of its Director. Nonetheless, these issues remain very much unsettled, and their eventual resolutions – after the 2012 elections and in the courts – will have important implications for the future of the CFPB and possibly for the validity of the actions that the CFPB will have already taken.

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[15] *See* Dodd-Frank § 1066(a) (Treasury Secretary "authorized to perform the functions of the Bureau…until the Director of the Bureau is confirmed by the Senate").
[16] *See State Nat'l Bank, supra*.

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