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Latest Developments in Financial Services Law

A Recap Of Key Issues Impacting Financial Institutions In 2016,
And What Is Next In 2017

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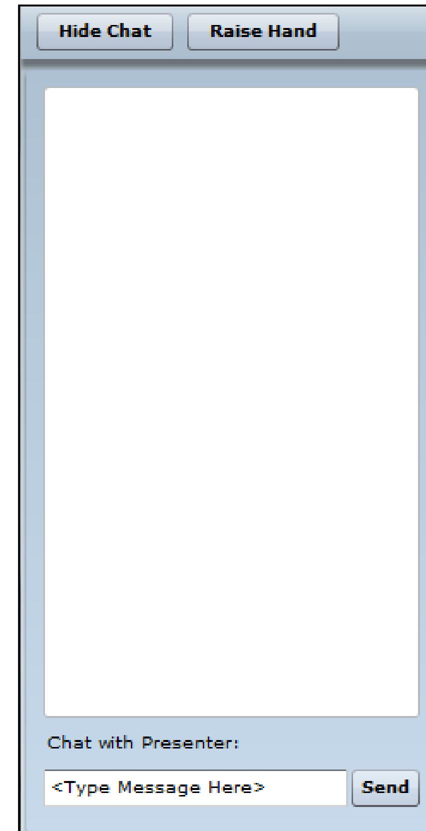

Overview

This seminar will provide information on recent developments in financial services law over the past year, including a high level recap of:

- **Agency Rulemaking** – what new proposals were unveiled in 2016 that you need to be aware of to advise your clients
- **Regulatory Enforcement Actions** – what areas did regulators focus on in 2016 from an enforcement perspective, and how to help your clients avoid becoming an enforcement statistic in 2017

Overview (cont.)

- **Regulatory Risks and Opportunities** – what were the common regulatory issues financial institutions struggled with in 2016, and how to address them in 2017.
  - Cybersecurity
  - High Volatility Commercial Real Estate (“HVCRE”)

- **Civil Litigation Trends** – what are the latest litigation trends impacting financial institutions.
  - Challenges involving website accessibility under the ADA
  - Potential prohibition/limitation against mandatory arbitration clauses in certain consumer contracts

Overview (cont.)

- **What to expect in 2017** – how a Trump Presidency may change the outlook for financial institutions in the new year.
  - Financial CHOICE Act
  - PHH v. CFPB – Will President Trump tell Richard Cordray, “You’re Fired!”
  - OCC Fintech charter – the beginning of the end for state licensing?

Agency Rulemaking

- Interagency Rulemaking
  - Incentive Based Compensation Arrangements. https://www.fdic.gov/news/board/2016/2016-04-26_notice_dis_a_fr.pdf
  - The NPR uses a tiered approach that applies provisions to covered financial institutions according to three categories of average total consolidated assets: Level 1 ($250 billion or more), Level 2 ($50 billion to $250 billion), and Level 3 ($1 billion to $50 billion).
  - For all covered institutions, the proposed rule would:
    - Prohibit types and features of incentive-based compensation arrangements that encourage inappropriate risks because they are "excessive" or "could lead to material financial loss" at a covered institution.
    - Require incentive-based compensation arrangements to adhere to three basic principles: (1) a balance between risk and reward; (2) effective risk management and controls; and (3) effective governance.
    - Require appropriate board of directors (or committee) oversight and recordkeeping and disclosures to the appropriate agency.

- Incentive-Based Compensation includes any variable compensation, fees or benefits that serve as an incentive or reward for performance.
- Requirements for Level 3 Covered Financial Institutions
  - Level 3 covered financial institutions will be required to annually create, and maintain for a period of seven (7) years, records that document the structure of all incentive based compensation arrangements and demonstrate compliance with the requirements of the Proposed Rule. These records must include at a minimum copies of all incentive-based compensation plans, a record of who is subject to each plan, and a description of how the incentive-based compensation plan is compatible with effective risk management and controls;
  - Level 3 covered financial institution's Board of Directors, or a committee they establish, must:
    - Conduct oversight of the incentive-based compensation plan; Approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.
- Level 3 covered financial institutions are prohibited from establishing or maintaining any type of incentive-based compensation arrangement that encourages inappropriate risks by providing a covered person with excessive compensation, fees or benefits, or that could lead to a material financial loss.

- What is considered excessive compensation?
  - Compensation, fees and benefits are considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into consideration all relevant factors, including, but not limited to:
    - The combined value of all compensation, fees, or benefits to the covered person;
    - The compensation history of the covered person;
    - The financial condition of the covered financial institution;
    - Compensation practices at comparable covered institutions based on factors such as asset size, geographic location and the complexity of the covered institutions operations and assets;
    - For post-employment benefits the projected total cost and benefit to the covered institution; and
    - Any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with respect to the covered institution.
- As mandated by the Dodd-Frank Act, the factors for determining excessive compensation are comparable to the standards contained in the Federal Agency Safety and Soundness Guidelines implementing Section 39 of the Federal Deposit Insurance Act.

- For Level 1 and Level 2 institutions, the proposed rule would:
  - Require the following: the deferral of awards for senior executive officers and significant risk takers; the subjecting of unpaid and unvested incentive compensation to the risk of downward adjustments or forfeiture; the subjecting of paid incentive compensation to the risk of "clawback;" establishing a board compensation committee; expanded risk-management and control standards; additional recordkeeping requirements for senior executive officers and significant risk takers; and detailed policies and procedures to ensure rule compliance.
  - Prohibit certain inappropriate practices, including: the purchase of hedging instruments that offset decreases in the value of incentive compensation; allowing a range of payouts that might encourage risk taking; and basing compensation solely on comparison to peer and volume-driven incentives without regard to transaction quality or compliance with sound risk management.

- Standard for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies. (Dodd-Frank Section 342(b)(2)(C). FAQs issued in August, 2016: https://fdic.gov/about/diversity/re_faq.html

  - Section 342(b)(2)(C) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) required the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (together, the "Agencies"), and certain other federal financial agencies to develop standards to assess the diversity policies and practices of the entities they regulate.
  - The Policy Statement states that regulated entities' self-assessments of their diversity policies and practices are voluntary, and submissions of information regarding those self-assessments to their primary federal financial regulator are also voluntary.
  - The Policy Statement contemplates that a regulated entity should voluntarily provide information pertaining to its self-assessment to the Director of the Office of Women and Minority Inclusion of its primary federal financial regulator and publish information pertaining to its efforts on its website or in other appropriate forms of communication.
  - An entity's diversity policies and practices will not be assessed by its primary federal financial regulator. The Agencies believe the entities are in the best position to assess their own diversity policies and practices, and the self-assessments can provide entities with an opportunity to focus on areas of strength and weakness in their policies and programs.

- CFPB Rulemaking
  - Notice of Proposed Rulemaking on Payday, Vehicle Title, and Certain High-Cost Installment Loans. (Proposed) https://www.federalregister.gov/documents/2016/07/22/2016-13490/payday-vehicle-title-and-certain-high-cost-installment-loans
    - Proposed Rule impacts more than just payday lenders
    - Creates a new "total cost of credit" calculation to be applied to added consumer protections that significantly broadens the scope of what is considered a higher cost loan
    - Over 1 million comments received

Agency Rulemaking

- Arbitration Agreements. (Proposed) https://www.federalregister.gov/documents/2016/05/24/2016-10961/arbitration-agreements
  - Likely to be finalized prior to the end of the Obama Presidency

- Prepaid Accounts under the Electronic Fund Transfer Act (Regulation E) and the Truth In Lending Act (Regulation Z). (Effective October 2018) https://www.federalregister.gov/documents/2016/11/22/2016-24503/prepaid-accounts-under-the-electronic-fund-transfer-act-regulation-e-and-the-truth-in-lending-act

- FinCen
  - Customer Due Diligence/Beneficial Ownership Rule (Effective May, 2018) https://www.federalregister.gov/documents/2016/05/11/2016-10567/customer-due-diligence-requirements-for-financial-institutions
    - Requires institutions to adopt due diligence procedures to identify and verify a legal entity customer's beneficial owner(s) at the time a new account is opened
    - Beneficial owner is each individual who owns, directly or indirectly equal to or greater than 25% of the legal entity equity interests

    - Adds a 5th "pillar" to a financial institutions AML Program:
    - Policy, procedure and internal controls
    - Independent testing;
    - Designated compliance official;
    - Employee training; and
    - **Creation of customer risk profiles and ongoing monitoring to identify and report suspicious activity and update customer information**.

- OCC
  - Exploring Special Purpose National Bank Charters for Fintech Companies. (Proposed) https://www.occ.gov/topics/bank-operations/innovation/special-purpose-national-bank-charters-for-fintech.pdf

- Department of Defense
  - Military Lending Act Interpretative Rule (July 2015) became effective on October 3, 2016) http://www.defense.gov/News/News-Releases/News-Release-View/Article/612795/department-of-defense-issues-final-military-lending-act-rule

  - Subsequent DOD Interpretative Rule (Effective August 2016) https://www.federalregister.gov/documents/2016/08/26/2016-20486/military-lending-act-limitations-on-terms-of-consumer-credit-extended-to-service-members-and

Regulatory Enforcement Actions

- CFPB

  The Bureau initiated or finalized 36 enforcement actions in 2016. See http://www.consumerfinance.gov/policy-compliance/enforcement/

  - Most actions focused on the non-depository industry including actions against payment processors, pawn brokers, title lenders, student loan servicers, check cashers and auto finance companies
    - The Bureau continued to use enforcement actions as a policy making tool in 2016

Two significant actions against Depository Institutions:

- In the Matter of Wells Fargo Bank, N.A. http://files.consumerfinance.gov/f/documents/092016_cfpb_WFBconsentorder.pdf

Wells Fargo entered into a consent decree with the Bureau based on claims they were engaged in:

- Opening deposit accounts and transferring funds without authorization, sometimes resulting in insufficient funds fees.
- Applying for credit-card accounts without consumers' knowledge or consent, leading to annual fees, as well as associated finance or interest charges and other late fees for some consumers.

- Issuing and activating debit cards, going so far as to create PINs, without consent.
- Creating phony email addresses to enroll consumers in online-banking services. http://www.consumerfinance.gov/about-us/blog/hundreds-thousands-accounts-secretly-created-wells-fargo-bank-employees-leads-historic-100-million-fine-cfpb/
- Customer refunds to be determined and $100 million civil money penalty

- In the Matter of Navy Federal Credit Union http://files.consumerfinance.gov/f/documents/102016_cfpb_NavyFederalConsentOrder.pdf

Navy Federal entered into a consent decree with the Bureau based on claims they:

- Falsely threatened legal action and wage garnishment:
- Falsely threatened to contact commanding officers to pressure servicemembers to repay
- Misrepresented credit consequences of falling behind on a loan
- Illegally froze members' access to their accounts
- $23 Million in customer restitution and $5.5 million civil money penalty to the CFPB

- DOJ
  - Discriminatory mortgage loan practices – United States of America and Consumer Financial Protection Bureau v. Bancorp South. http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-and-department-justice-action-requires-bancorpsouth-pay-106-million-address-discriminatory-mortgage-lending-practices/

Lessons Learned

- Development, implementation and adherence to a Compliance Management System ("CMS") is important!
- Stay abreast on the latest enforcement trends – especially from the CFPB
- Engage in an ongoing and critical audit process to find issues before the regulators do – and if you find significant issues consider proactively reporting

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Cybersecurity

Preparedness

- Know the legal and regulatory landscape
- Conduct a risk assessment
- Adopt policies and programs
- Evaluate third-party vendor risk
- Adopt incident/breach response plan
- Consider cyber insurance

Legal and Regulatory Landscape

- Federal--Cybersecurity Information Sharing Act
- State—27 states introduced legislation in 2016
  - Adopting notification requirements—26 states
  - Requiring government or public agencies to implement security practices
  - Offering incentives to cybersecurity industry
  - Providing exemptions from public records laws for security information
  - Promoting cybersecurity training and education

Risk Assessment

- **FFIEC Cybersecurity Assessment Tool**
  - Identify risks
  - Assess “cybersecurity maturity”

- **Third-party Vendor Risk**
  - Due diligence
  - Contractual protections

Policies and Programs--WISP

- Prevention
  - Risk assessment
  - Data map—what, where stored, movement
  - Safeguards—physical, technical, administrative
  - Identifies employee responsible for the policies
  - Data destruction
  - Employee training
  - Investigation and corrective action
- Incident/Breach Response

Incident/Breach Response Plan

- How the organization addresses a security "Event" v. "Incident" v. "Breach"
- Escalation of events
- Responsibility for investigation and reporting
- Internal and external contacts
- Recordkeeping
- PR, law enforcement & reporting obligations
- Updating

Cyber Insurance

- **Cyber Policy**
  - Endorsement to Property & Casualty is not sufficient
  - Primary policy
- **Key Points**
  - **Scope of coverage**
- **Cost & Coverage Limits**

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High Volatility
Commercial Real Estate
"HVCRE"

What is HVCRE?

- **High Volatility Commercial Real Estate**
- **Classification Exposure for Risk Weighting**
- **Basel III**
  - Final Rule on Risk-based and Leverage Capital Requirements for FDIC-insured Financial Institutions

Why Does HVCRE Classification Matter?

- **Risk Weighting of Loans**
  - 100% for Real Estate secured loans
  - 50% for Multi-family loans
  - 150% for HVCRE loans
- **Higher Risk Weighting**
  - higher capital required
  - higher cost to lender
  - (maybe) higher cost to borrower

Goal—Avoid HVCRE Classification!

- **HVCRE Classification**
  - Applies to any commercial real estate loan that is for acquisition, development or construction (ADC)
  - Persists for the life of the project
- **UNLESS one of four exceptions applies**
  - One- to four-family residential properties
  - Loan qualifies as investment in community development
  - Agricultural loans
  - Loan satisfies LTV and Equity Requirements

Exception 4– LTV Requirement

- **LTV must be ≤ applicable maximum amount for loan type**
  - Raw land – 65%
  - Land development – 75%
  - Construction (commercial, multi-family and other non-residential) – 80%
  - Construction (1-4 family residential) – 85%
  - Construction (improved property) – 85%
- **At time of loan closing/origination**

Exception 4—Equity Requirement

- Borrower has contributed capital ≤ 15% of appraised "as completed" value; AND
- Contribution of capital must be made prior to any loan advance; AND
- Capital contributed by the borrower or "internally generated by the Project" is contractually required to remain in the project for the life of the project

Loan Documents

- **Structure**
- **Closing Conditions**
  - Expressly state max LTV based on as completed value
  - Expressly state amount of required equity contribution
- **Covenants**
  - Expressly require contributed and generated capital remain in the project for the life of the project
  - Specify consequence (other than event of default for violation, eg, increase in interest rate, increased cost indemnification provision
  - Acknowledge the regulations may change prior to loan maturity

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Civil Litigation Trends Impacting Financial Institutions

Two Key Developments

- Challenges involving website accessibility under the Americans with Disabilities Act (ADA).
- Potential prohibition – or at least significant limitation – against mandatory arbitration clauses in certain consumer contracts.
- Both of these developments have implications for financial institutions from a litigation and a business perspective.

Accessibility Under The ADA

- Title III of the ADA prohibits discrimination against individuals “on the basis of disability in the full and equal enjoyment of the goods, services, facilities, privileges, advantages or accommodations of any place of public accommodation.” 42 U.S.C. § 12182(a).
- Requires banks and other financial institutions to be accessible to individuals with disabilities.
  - “Brick and mortar” office space.
  - ATMs.

What Is Website Accessibility?

- Making websites accessible to individuals with disabilities.
  - E.g., vision-impaired or hearing-impaired individuals.
  - Making websites compatible with assistive devices that allow individuals with disabilities to access webpage content.
- A World Wide Web Consortium has recommended what is known as the Web Content Accessibility Guidelines (WCAG 2.0 AA), a set of highly technical standards for web content accessibility.

Absence of DOJ Regulatory Guidance On Website Accessibility Under The ADA

- The Web Content Accessibility Guidelines are not the law.
- The Department of Justice (DOJ) is in the process of developing regulations for website accessibility, but any rulemaking is unlikely to be completed before 2018.

Case Law On Website Accessibility

- The question of whether a website can be a "place of public accommodation" has been the subject of litigation in the courts.
- *National Federation of the Blind v. Target Corporation*, 452 F. Supp. 2d 946 (N.D. Cal. 2006).
  - Court noted that the ADA "applies to the services ***of*** a place of public accommodation, not services ***in*** a place of public accommodation." *Id.* at 953 (emphasis in original).
  - Accordingly, the court ruled that the plaintiff could indeed premise a Title III claim on the accessibility of Target's website, even if the violation occurred "away from a 'place' of public accommodation." *Id.*

Case Law On Website Accessibility (cont.)

- *National Ass'n of the Deaf v. Netflix, Inc.*, 869 F. Supp. 2d 196 (D. Mass. 2012), and *National Federation of the Blind v. Scribd Inc.*, 2015 WL 1263336 (D. Vt. 2015).
  - In both of those cases, the courts ultimately concluded Title III of the ADA did include websites within the scope of a public accommodation.
  - Notably, the DOJ filed a Statement of Interest brief in *Netflix* supportive of the position that websites are within the scope of Title III protection.

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Case Law On Website Accessibility (cont.)

- *National Association of the Deaf, et al. v. Harvard University, Civil Action No. 15-cv-30023-MGM (D. Mass. Nov. 3, 2016)* [Document 77)].
  - Denied motions to dismiss.
  - Declined to stay the case pending the DOJ's promulgation of technical standards for website accessibility, concluding it did not need to wait for DOJ's guidance on the subject.

Financial Institutions: The Next Big Target

- The absence of any federal regulations governing website accessibility has not stopped plaintiffs' lawyers from filing lawsuits or, more often, sending demand letters to companies challenging inaccessible websites and trying to extract settlements.
- These efforts initially targeted online consumer retailers/e-commerce, but there seems to be a recent focus on banks and other financial institutions.

Response Strategies To Demand Letters

- Assessing potential exposure from a demand letter is challenging at best.
- Alternatives:
  - Pay nominal settlement to minimize exposure.
  - Devote resources instead towards ensuring websites are accessible (or at least more accessible) to individuals with disabilities, thereby increasing likelihood of ADA compliance before any formal rulemaking by the DOJ.

Potential Ban On Mandatory Arbitration Clauses In Consumer Contracts That Preclude Class Actions

- Many contracts for consumer financial products and services include mandatory arbitration clauses.
  - Typically require all disputes between the financial institution and the consumer to be arbitrated.
  - Generally block class action lawsuits in court and prevent group claims in the arbitration process.
- The Dodd-Frank Wall Street Reform and Consumer Protection Act.
  - Authorized CFPB to study the use of mandatory arbitration clauses in such consumer contracts.
  - Authorized CFPB to promulgate regulations protecting consumers consistent with the study.

CFPB's Dim View Of Arbitration Provisions

- On May 5, 2016, the CFPB announced that it was seeking comments on proposed rules that would prohibit mandatory arbitration clauses in contracts for consumer financial services and products.
- Proposed rules add "Part 1040 – Arbitration Agreements" to Title 12, Chapter X of Code of Federal Regulations.
- CFPB's view of mandatory arbitration provisions in contracts for consumer financial services and products: a "contract gotcha." *See* CFPB's press release at http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-prohibiting-mandatory-arbitration-clauses-deny-groups-consumers-their-day-court/

Who Will Be Impacted By The Proposed Rules?

- All "Providers" of consumer financial products or services, with limited exceptions. E.g., any company:
  - Extending "consumer credit" under the Equal Credit Opportunity Act.
  - Acquiring, purchasing, selling or servicing an extension of credit.
  - Extending or brokering an automobile lease.
  - Providing services to assist with debt management, debt settlement, modifying the terms of any extension of credit or avoiding foreclosure.
  - Providing savings accounts subject to the Truth in Savings Act;
  - Providing accounts or remittance transfers subject to the Electronic Fund Transfer Act.
  - Providing check cashing, check collection and check guarantee service.
  - Collecting debt arising from any of the consumer financial products or services described in the proposed rules.
- Most financial services companies will be considered a "Provider."

Exceptions To The Proposed Rules

- Some limited exceptions in which the proposed rules will not apply. For example:
  - Broker dealers to the extent that they are providing products or services subject to rules promulgated or authorized by the U.S. Securities and Exchange Commission with respect to pre-dispute arbitration agreements.
  - Any federal, state, local or tribal government, or their affiliates providing any product or service directly to a consumer.
  - Any person who provides a covered financial product or service to no more than twenty-five (25) consumers in the current or preceding calendar year.
  - Merchants, retailers, or other sellers of nonfinancial goods or services, including anyone who purchases or acquires an extension of consumer credit from these entities, provided their activities fall within the exemption from CFPB rulemaking established by the Dodd-Frank Act.

Will Mandatory Arbitration Clauses Be Banned Entirely?

- No. The proposed rules do not limit the use of mandatory arbitration clauses in cases that are not class actions (i.e., individual lawsuits).
- However, the proposed rules mandate several new requirements for the use of mandatory arbitration provisions:
  - Added disclosures.
  - Submission of information to the CFPB for increased transparency and reporting.

Disclosure Obligations Under Proposed Rules – New Consumer Contracts

- New agreements subject to the proposed rules will have to contain specific disclosure language:
  - "We agree that neither we nor anyone else will use this agreement to stop you from being part of a class action case in court. You may file a class action in court or you may be a member of a class action even if you do not file it."

    OR

  - "We are providing you with more than one product or service, only some of which are covered by the Arbitration Agreements Rule issued by the Consumer Financial Protection Bureau. We agree that neither we nor anyone else will use this agreement to stop you from being part of a class action in court. You may file a class action in court or you may be a member of a class action even if you do not file it. This provision applies only to class action claims concerning the products or services covered by that Rule."

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Disclosure Obligations Under Proposed Rules – Existing Consumer Contracts

- If existing agreements previously entered into between the parties include a mandatory arbitration clause, then the Provider will either have to:
  - Amend the agreement to state "We agree that neither we nor anyone else who later becomes a party to this pre-dispute arbitration agreement will use it to stop you from being part of a class action case in court. You may file a class action in court or you may be a member of a class action even if you do not file it."

    OR

  - Provide a new disclosure stating "We agree not to use any pre-dispute arbitration agreement to stop you from being part of a class action case in court. You may file a class action in court or you may be a member of a class even if you do not file it."

CFPB Reporting Under Proposed Rules

- Under the proposed rules, Providers that use mandatory arbitration clauses in their contracts will be required to submit any claims filed and awards issued in arbitration to the CFPB.
- The CFPB will also collect correspondence from arbitration administrators regarding a company's non-payment of arbitration fees and its failure to adhere to the arbitration forum's standards of conduct.

What to expect in 2017

- Financial CHOICE Act of 2016 – H.R. 5983. http://financialservices.house.gov/uploadedfiles/bills-114hr5983ih.pdf

- PHH Corp. v. CFPB, 2016 WL 5898801 (D.C. Cir. 10/11/16) – Can the CFPB Director be removed without cause, and what will President Trump do when he takes office?

- OCC Fintech Proposal. https://www.occ.gov/topics/bank-operations/innovation/special-purpose-national-bank-charters-for-fintech.pdf

Thank you!

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