The Consumer Finance Observer

A periodic update on legal developments in consumer finance

Fall 2022

JENNER & BLOCK

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Potential Bias in AI Consumer Decision Tools Eyed by FTC, CFPB

Ali M. Arain, *Michael W. Ross*, *and Jonathan Steinberg* | February 9, 2022

Potential discrimination and bias resulting from consumer tools based on artificial intelligence and automated data will be an enforcement focus of regulators this year, Jenner & Block attorneys predict. Accuracy and transparency are also on the table, they say.

Given the growing use of artificial intelligence (AI) and automated decision-making tools in consumer-facing decisions, we expect federal regulators in 2022 to continue their recent track record of interest in potential discrimination and unfairness, as well as data accuracy and transparency.

Significant technological developments in these areas and the increasing use of data analytics to make automated decisions will likely result in further regulatory action this year in three key areas: (1) assessing whether AI and algorithms are excluding particular consumer groups in an unfair and discriminatory manner, whether intentionally or not; (2) evaluating whether collected data accurately reflects real-world facts and whether companies are giving consumers an opportunity to correct mistakes; and (3) assessing whether automated decisionmaking tools are being used in a transparent manner.

Over the last year, federal regulators with enforcement authority in the consumer space—the Federal Trade Commission (FTC) and the Consumer Financial Protection Bureau (CFPB)—have expressed their intention to continue enforcement efforts.

The FTC has identified "technology companies and digital platforms," "bias in algorithms and biometrics," and "deceptive and manipulative conduct on the Internet" as among its top enforcement priorities for the coming years, and directed staff to use compulsory processes to demand documents and testimony to investigate potential abuses in these areas.

The FTC and the CFPB have each initiated or continued investigations into practices involving the collection of consumer data and the use of data analytics in consumer decisions, including the use of AI and algorithms by financial institutions, digital payment platforms, and social media, and video streaming firms.

Both agencies have also made public statements that provide insight into the types of regulatory action that may be coming this year.

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FTC ENFORCEMENT AREAS

For example, the FTC published blog posts on its website outlining its thinking on AI-enforcement focus areas.

Discrimination and Unfairness

The FTC emphasized that Section 5 of the FTC Act, which prohibits "unfair or deceptive" practices, gives it jurisdiction over racially-biased algorithms. The FTC cautioned companies that regardless of how well-intentioned their algorithm is, they must still guard against discriminatory outcomes and disparate impact on protected classes of consumers.

Accuracy

The FTC stated that it planned to rely on its decades of experience enforcing the Fair Credit Reporting Act (FCRA) when analyzing whether other types of consumer-related AI meet the requirements of this law.

The FTC also advised companies not to rely on "data set[s] missing information from particular populations" and advised companies to give "consumers access and an opportunity to correct information used to make decisions about them."

Transparency

The FTC said that companies should "embrace transparency … by conducting and publishing the results of independent audits" and by disclosing to consumers the key factors used in algorithms to assign risk scores.

Companies should examine their data inputs, ask questions before they "use the algorithm," and "validate" and "revalidate" their AI models so that they fully understand the implications of their use of these data tools.

CFPB ENFORCEMENT FOCUS

The CFPB has likewise highlighted its interest in the following areas.

Discrimination and Unfairness

In recent testimony before Congress, CFPB Director Rohit Chopra expressed a desire to reinvigorate "relationship banking," explaining that it would counteract the "automation and algorithms [that] increasingly define the consumer financial services market" and may "unwittingly reinforce biases and discrimination, undermining racial equity."

Accuracy

A November 2021 advisory opinion by the agency emphasizes the need for accuracy in relying on data tools to make consumer decisions.

The CFPB specifically advised that "matching consumer records solely through the matching of names" is not a "reasonable procedure to assure maximum possible accuracy" under the FCRA. The CFPB further encouraged the use of more sophisticated and reliable data analytics.

Transparency

In a March 2021 RFI to financial institutions seeking their views on governance, risk management, and compliance management in the "Use of Artificial Intelligence, including Machine Learning," the CFPB stressed the importance of AI "explainability"—in other words, the need for companies to be able to ascertain and explain how their AI applications use data "inputs to produce outputs" in a conceptually sound manner.

The RFI also discussed the need for companies to monitor and validate algorithms that evolve on their own or dynamically update.

EEOC, DOJ ALSO LOOKING AT AI

Other regulators have also indicated an interest in AI-related enforcement. For example, the Equal Employment Opportunity Commission has announced an initiative assessing the propriety of AI tools for hiring and other employment decisions.

In addition, the Department of Justice, along with the CFPB and the Office of the Comptroller of Currency, launched the an effort to combat discriminatory redlining by lenders; in his statement announcing this effort, Chopra said that they plan to focus on "new digital and algorithmic redlining" in addition to "old forms of redlining."

In all, we expect these and other efforts by regulators will continue to focus on issues of discrimination and unfairness, and accuracy and transparency in the use of AI and consumer data. As the rules of the road continue to be written through regulatory activity in 2022, it is critical for companies to keep up to date with the latest developments.

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California Attorney General Sends "Strong Message" in Fining Sephora $1.2 Million for CCPA Violations and Announces "New Investigative Sweep"

Madeleine V. Findley and Effiong K. Dampha | August 26, 2022

On August 24, 2022, California Attorney General Rob Bonta announced a $1.2 million settlement with cosmetics retailer Sephora Inc. (Sephora), the first public enforcement action under the California Consumer Privacy Act (CCPA).[1] The settlement resolved allegations that Sephora failed to disclose it was selling consumers' personal information, failed to honor opt-out requests from user-enabled global privacy controls, and failed to cure these violations within 30 days, as required by CCPA. The settlement is part of "an enforcement sweep" of online retailers and their use of third-party tracking software on websites and mobile apps. The Attorney General simultaneously announced a new "investigative sweep" focused on whether businesses are complying with opt-out requests from user-enabled global privacy controls. Attorney General Bonta underscored his commitment to "robust enforcement" of California's privacy law, stating "My office is watching, and we will hold you accountable."[2]

Sephora Settlement for Failure to Disclose Third-Party Tracking and Honor Opt-Out Requests

According to the Attorney General, Sephora allowed third-party companies to install cookies and other tracking software on its website and in its app that collected data about consumers, including the type of device a consumer used, the brand of cosmetic product the consumer placed in the shopping cart, and the consumer's precise location. The Attorney General found this data sharing to be a sale of consumer information, and that Sephora had failed to notify consumers of the sale and offer an opt-out or to honor opt-out requests via global privacy controls.

The settlement required Sephora to pay $1.2 million in penalties and to:

1. clarify its online disclosures and privacy policy to state that it sells data,
2. provide opt out mechanisms, including via the Global Privacy Control, and
3. conform its service provider agreements to the CCPA's requirements.

The agreement also required Sephora to provide status reports to the Attorney General on its progress on each of these obligations.[3]

Notices of Non-Compliance with Global Privacy Controls

The Attorney General also announced a "new investigative sweep" focused on compliance with global privacy controls. As part of this "sweep," the Attorney General sent notices of non-compliance on August 24 to over a dozen businesses relating to their alleged failure to process consumer opt-out requests made through user-enabled global privacy controls, such as the GPC. After quietly adding an FAQ about the GPC to the AG's CCPA webpage in 2021 that the GPC "must be honored" as a request to opt out of the sale of personal information, the AG's actions signal an increasingly aggressive enforcement approach. Businesses that receive a notice will have 30 days to cure their noncompliance—but this right to cure will expire when the California Privacy Rights Act becomes effective on January 1, 2023. The new round of notices makes clear that the Attorney General's expectation that businesses will honor user-enabled global privacy controls.

Additional Case Examples

The Attorney General also updated the CCPA Enforcement Case Examples webpage for the first time since July 2021 with 13 new case summaries. These include failure to honor consumer opt out requests, failure to appropriately disclose financial incentives in loyalty programs, flaws in responding to consumer requests to access or delete personal information, and non-compliant privacy policies. The businesses involved ranged from telehealth providers to fintech to fitness chains.

In a press statement, Attorney General Bonta emphasized his view that the Sephora settlement would "send a strong message to businesses," and noted "there are no more excuses" for not complying with CCPA. The settlement, case examples, and new round of notices reflect an increasingly robust focus on enforcing California privacy law, and pose additional compliance challenges as businesses prepare for the California Privacy Rights Act to take effect in 2023.

[1] Press Release, Cal. Dept. of Justice, *Attorney General Bonta Announces Settlement with Sephora as Part of Ongoing Enforcement of California Consumer Privacy Act* (Aug. 24, 2022), https://oag.ca.gov/news/press-releases/attorney-general-bonta-announces-settlement-sephora-part-ongoing-enforcement (AG Bonta Press Release)

[2] AG Bonta Press Release

[3] AG Bonta Press Release; *California v. Sephora, Inc.*, Case No. CGC-22-601380 (Cal. Sup. Ct. Aug. 24, 2022), available at https://oag.ca.gov/system/files/attachments/press-docs/Filed Judgment.pdf

CFPB Adds "Discrimination" to its "Unfair, Deceptive, or Abusive Acts and Practices" (UDAAP) Examination Guidance

Michael W. Ross, Ali M. Arain, and Jonathan S. Steinberg | April 5, 2022

On March 16, 2022, the Consumer Financial Protection Bureau (CFPB) announced its intent to address discrimination as an "unfair practice" under the Consumer Financial Protection Act (commonly known as Dodd-Frank). Specifically, by indicating that discrimination falls within "unfair practices" in its Exam Manual, the CFPB has authorized its examiners to look "beyond discrimination directly connected to fair lending laws" and ask companies to "review any policies or practices that exclude individuals from products and services, or offer products or services with different terms, in an unfairly discriminatory manner."[1]

Utilizing the Bureau's manual, CFPB Examiners play a critical role in evaluating companies' compliance with Dodd-Frank and other federal consumer protection laws in addition to aiding in the determination of whether "supervisory or enforcement actions are appropriate."[2]

In its efforts to combat discrimination, the CFPB is particularly concerned with the growing use of artificial intelligence and machine learning, and how consumers from protected classes may be uniquely harmed by biased algorithms. For example, "data harvesting and consumer surveillance fuel complex algorithms that can target highly specific demographics of consumers to exploit perceived vulnerabilities and strengthen structural inequities."[3]

Dodd-Frank prohibits "any provider of consumer financial products or services" from engaging in unfair, deceptive and abusive acts and practices (UDAAP).[4] It further provides the CFPB with "enforcement authority to prevent unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service."[5] In addition, Dodd-Frank provides the CFPB with "supervisory authority for detecting and assessing risks to consumers and to markets for consumer financial products and services."[6] In this capacity, the CFPB maintains "supervisory authority over banks, thrifts, and credit unions with assets over $10 billion, as well as their affiliates [and] . . . nonbank mortgage originators and servicers, payday lenders, and private student lenders of all sizes."[7]

Under Dodd-Frank, "an act or practice is unfair when:

- It causes or is likely to cause substantial injury to consumers;
- The injury is not reasonably avoidable by consumers; and
- The injury is not outweighed by countervailing benefits to consumers or to competition."[8]

The CFPB, in its updated manual, details how it contends discrimination satisfies this definition. First, regarding the likelihood of "substantial injury," the manual points to "[f]oregone monetary benefits or denial of access to products or services" that can result from discrimination.[9] Critically, the CFPB notes that "[c]onsumers can be harmed by discrimination regardless of whether it is intentional."[10] Next, concerning reasonable avoidability, the CFPB states that the question is not "whether a consumer could have made a better choice[,]" but rather "whether an act or practice hinders a consumer's decision-making."[11] To that end, the CFPB contends that "[c]onsumers cannot reasonably avoid

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discrimination."[12] Finally, the CFPB's press release notes that "discrimination may meet the criteria for 'unfairness' … where that harm is not outweighed by countervailing benefits to consumers or competition."[13]

While the manual's updated language does not create legal duties, such as those imposed by fair lending laws, it establishes the CFPB's expectations for covered entities. For this reason, these changes to the manual will likely have a substantial real-world impact on companies that engage in consumer-related financial transactions.

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[1] Eric Halperin & Lorelei Salas, *Cracking Down on Discrimination in the Financial Sector,* Consumer Fin. Prot. Bureau (Mar. 16, 2022), https://www.consumerfinance.gov/about-us/blog/cracking-down-on-discrimination-in-the-financial-sector/.

[2] Consumer Fin. Prot. Bureau, CFPB Supervision and Examination Manual, 11 (March 2022) https://www.cfpaguide.com/portalresource/Exam%20Manual%20v%202%20-%20UDAAP.pdf (Examination Manual).

[3] Halperin & Salas, *supra* note 1.

[4] Press Release, Consumer Fin. Prot. Bureau, CFPB Targets Unfair Discrimination in Consumer Finance (Mar. 16, 2022), https://www.consumerfinance.gov/about-us/newsroom/cfpb-targets-unfair-discrimination-in-consumer-finance/.

[5] Examination Manual, *supra* note 2, at 1.

[6] *Id.* at 1.

[7] Consumer Fin. Prot. Bureau, *Institutions Subject to CFPB Supervisory Authority*, https://www.consumerfinance.gov/compliance/supervision-examinations/institutions/ (last visited Mar. 28, 2022).

[8] Examination Manual, *supra* note 2, at 1–2. This is the same test applied by the FTC under the FTC Act.

[9] Examination Manual, *supra* note 2, at 2.

[10] Press Release, Consumer Fin. Prot. Bureau, *supra* note 4.

[11] Examination Manual, *supra* note 2, at 2.

[12] *Id.* at 2.

[13] Press Release, Consumer Fin. Prot. Bureau, *supra* note 4.

CFPB Publishes Market Snapshot Report on Consumer Use of State Payday Loan Extended Payment Plans

Jenna L. Conwisar | April 19, 2022

Payday loans are small-dollar cash loans typically due in a single payment on the borrower's next payday—they are extremely short-term and generally high-interest forms of consumer credit.[1] If the borrower cannot pay off the loan when it's due, some states allow the borrower to pay a fee to defer full payment on, or "rollover," their loan. A 2014 Consumer Financial Protection Bureau (CFPB) report found that over 80% of payday loans are rolled over within two weeks.[2]

The CFPB notes that upwards of 12 million borrowers utilize payday loans each year.[3] 16 states now require that payday lenders allow borrowers to repay their payday loans at regular intervals through Extended Payment Plans, or EPPs, typically at no additional cost to the borrower.[4]

On April 6, 2022, the CFPB published a report examining state EPPs.[5] Below are some of the CFPB report's key findings.

Variation and Commonality Among State EPP Laws

The CFPB report found "substantial variation" among state EPPs, particularly in consumer eligibility requirements.[6] Depending on the state they are borrowing in, consumers may become EPP-eligible after surpassing a set number of rollovers, after they pay a certain percentage of the outstanding balance, or after they enroll in credit counseling.

Most states require EPPs to include at least four equal or substantially equal installments, and consumers are typically limited to one EPP election in a 12-month period. Many states mandate that lenders disclose the availability of an EPP option to consumers at the time they enter into the payday loan agreement or at the time of default.

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EPP Usage, Default, and Rollover Rates

According to the CFPB report, extended payment plan usage rates vary drastically across states, with Washington reporting that 13.4% of payday loans converted to EPPs in 2020 compared to Florida's 0.4%. In California, EPP usage rates doubled from 1.2% in 2019 to 3.0% in 2020. While the COVID-19 pandemic saw payday loan volume decrease by 65%, EPP usage rates tended to rise slightly. The report attributes the decline in overall payday loan volume to the federal Economic Impact Payments.

Meanwhile, rollover and default rates still remain higher than EPP usage rates. For example, 27% of Washington payday borrowers defaulted on their loan in 2020 and 47.1% of Idaho borrowers rolled over their loan in 2016. The CFPB attributes these high rates to lenders implementing practices that discourage EPP use. In the report's press release, CFPB Director Rohit Chopra acknowledged that "[p]ayday lenders have a powerful incentive to protect their revenue by steering borrowers into costly re-borrowing" causing "state laws that require payday lenders to offer no-cost extended repayment plans [to] not work[] as intended."[7]

* * *

Imbedded throughout the report is the CFPB's clear preference for expanded EPP opportunities in order to prevent consumers from amassing repeat rollover fees. In 2014, the CFPB reported that most borrowers rollover their payday loans enough times that the accumulated rollover fees exceed the original loan amount.[8] Lenders should take note that the CFPB "will continue to monitor lender practices that discourage consumers from taking extended payment plans and take action as necessary."[9]

[1] Payday loans are legal in only 26 states: Alabama, Alaska, California, Delaware, Florida, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Nevada, North Dakota, Rhode Island, South Carolina, Tennessee, Texas, Utah, Washington, Wisconsin, and Wyoming.

[2] *CFPB Finds Four Out Of Five Payday Loans Are Rolled Over Or Renewed, CFPB (Mar 25, 2014).*

[3] *CFPB Finds Payday Borrowers Continue to Pay Significant Rollover Fees Despite State-Level Protections and Payment Plans, CFPB (Apr 6, 2022).*

[4] Alabama, Alaska, California, Delaware, Florida, Idaho, Indiana, Louisiana, Michigan, Nevada, South Carolina, Utah, Washington, Wisconsin, and Wyoming.

[5] *Market Snapshot: Consumer Use of State Payday Loan Extended Payment Plans, Consumer* Financial Protection Bureau (April 2022).

[6] *Id.* at 5, 7.

[7] *CFPB Finds Payday Borrowers Continue to Pay Significant Rollover Fees Despite State-Level Protections and Payment Plans*, *supra* note 3.

[8] *CFPB Data Point: Payday Lending*, CFPB (March 2014).

[9] *Market Snapshot*, *supra* note 5, at 14.

CFPB and other Federal Regulators Eye Regulation Aimed at Curbing Algorithmic Bias in Automated Home Valuations

Michael W. Ross, *Ali M. Arain*, *and Jonathan Steinberg* | March 10, 2022

Late last month, the Consumer Financial Protection Bureau (CFPB) took another step toward adopting rules governing the use of artificial intelligence (AI) and algorithms in appraising home values. Specifically, the CFPB issued a detailed outline and questionnaire soliciting feedback from small business entities on a proposed rulemaking proceeding for using Automated Valuation Models (AVMs).

The CFPB and other federal regulators[1] intend to adopt rules designed to: (1) ensure a high level of confidence in the estimates produced by AVMs; (2) protect against the manipulation of data; (3) avoid conflicts of interest; and (4) require random sample testing and reviews.[2] In addition, federal regulators are now considering whether to include express nondiscrimination quality control requirements for AVMs as a "fifth factor." Once adopted, the new rules will apply to banks, mortgage lenders who use AVMs to make underwriting decisions, and mortgage-backed securities issuers, and are intended to protect homebuyers and homeowners who may be negatively impacted by inaccurate appraisals.

Automated Valuation Models

AVMs are defined by statute as "computerized model[s] used by mortgage originators and secondary market issuers to determine the collateral worth of a mortgage secured by a consumer's principal dwelling."[3]

According to the CFPB, AVMs are increasingly being used to appraise homes, a trend driven "in part by advances in database and modeling technology and the availability of larger property datasets."[4] The benefits of better AVM technology and increased availability of data are their potential to reduce costs and decrease turnaround times in performing home valuations. However, like algorithmic systems generally, the use of AVMs also introduces risks, including issues of data integrity and accuracy.

Moreover, there are concerns that AVMs "may reflect bias in design and function or through the use of biased data[,] [] may introduce potential fair lending risk."[5] Due to the "black box"[6] nature of algorithms, regulators fear that "without proper safeguards, flawed versions of these models could digitally redline certain neighborhoods and further embed and perpetuate historical lending, wealth, and home value disparities."[7] "Overvaluing a home can potentially lead the consumer

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to take on an increased amount of debt that raises risk to the consumer's financial well-being. On the other hand, undervaluing a home can result in a consumer being denied access to credit for which the consumer otherwise qualified, potentially resulting in a canceled sale, or offered credit at less favorable terms."[8]

The Proposed Rule

On February 23, 2022, the CFPB released a 42-page outline, detailing several possible rulemaking options, which provides a glimpse into the agencies' thinking as to the scope of future regulation.

The proposed rule will be a joint interagency rule as the CFPB maintains enforcement authority over non-depository institutions, whereas the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Housing Finance Agency maintain enforcement authority over "insured banks, savings associations, [] credit unions[,] . . . [and] federally regulated subsidiaries that financial institutions own and control."[9]

To address concerns about data integrity, accuracy, and reliability, the CFPB is considering two options—one that is "principles-based" and one that is "prescriptive." A principles-based approach would require entities to maintain their own "AVM policies, practices, procedures, and control systems" to meet the first four quality control standards noted above.[10] The CFPB acknowledges that this may be preferable as a rule with stringent requirements may not be able to keep up with evolving technology and could present a significant burden for smaller entities. On the other hand, if the agencies decide to promulgate a prescriptive rule, they contemplate requiring controls related to "fundamental errors" that could produce inaccurate outputs, "management oversight of the availability, usability, integrity, and security of the data used," a clear separation between persons "who develop, select, validate, or monitor an AVM" and employees involved in the "loan origination and securitization process," and ongoing validation of the entities' AVM through "random sample testing and reviews."[11]

As part of the same proposed rule, the CFPB and the aforementioned federal regulators are also eyeing adding a nondiscrimination quality control under their authority to "account for any other such factor . . . determine[d] to be appropriate."[12] The CFPB recognizes that a standalone nondiscrimination factor may be unnecessary as nondiscrimination may already be encompassed in three of the first four statutorily stipulated quality controls. Additionally, AVMs are subject to federal nondiscrimination laws such as the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA). However, the CFPB contends that "an independent requirement for institutions to establish policies and procedures to mitigate against fair lending risk in their use of AVMs. . . . may help ensure the accuracy, reliability, and independence of AVMs for all consumers and users."[13]

To address lending discrimination, federal regulators are considering both a flexible, principles-based approach, similar to the approach described above, and a prescriptive nondiscrimination rule. A principles-based approach would provide companies with "the flexibility to design fair lending policies, practices, procedures, and control systems tailored to their business model"[14] and "commensurate with an institution's risk exposures, size, business activities, and the extent and complexity of its use of AVMs."[15] In contrast, a prescriptive rule would "specify[] methods of AVM development (e.g., data sources, modeling choices) and AVM use cases" in order to mitigate the "risks that lending decisions based on AVM outputs generate unlawful disparities."[16]

Last month's announcement was triggered by the CFPB's duty to convene a Small Business Review Panel prior to issuing a proposed rule that "could have a significant economic impact on a substantial number of small entities."[17] The outline released by the CFPB was meant to elicit feedback from small business entities, such as mortgage loan brokers with annual receipts at or below $8 million, real estate credit companies with annual receipts at or below $41.5 million, and secondary market financing companies and other non-depository credit intermediation companies with annual receipts also at or below $41.5 million. For these small entities, the outline presents over forty questions and an early opportunity to influence the rulemaking process.[18]

Next Steps

As evident by the CFPB's outline, a great deal remains in flux as regulators continue to contemplate their options. Because the

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CFPB is subject to heightened rulemaking processes for regulations affecting smaller entities, we have this early glimpse into the agencies' thinking on AVM algorithmic bias. In the coming months, the CFPB will convene the Small Business Review Panel, release the Panel's report, and work with its federal partners in drafting a proposed rule subject to the standard notice and comment process.

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[1] The CFPB shares enforcement authority over AVMs with the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Housing Finance Agency.

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act requires federal regulators to adopt rules ensuring that AVMs satisfy certain quality control standards designed to: "(1) ensure a high level of confidence in the estimates produced by automated valuation models; (2) protect against the manipulation of data; (3) seek to avoid conflicts of interest; (4) require random sample testing and reviews; and (5) account for any other such factor that the agencies determine to be appropriate." 12 U.S.C. § 3354(a) (2010).

[3] § 3354(d).

[4] Consumer Fin. Prot. Bureau, Outline of Proposals and Alternatives Under Consideration, Small Business Advisory Review Panel For Automated Valuation Model (AVM) Rulemaking, 2 (Feb. 23, 2022) https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf.

[5] Id. at 24.

[6] Id.

[7] Press Release, Consumer Fin. Prot. Bureau, Consumer Financial Protection Bureau Outlines Options To Prevent Algorithmic Bias In Home Valuations (Feb. 23, 2022), https://www.consumerfinance.gov/about-us/newsroom/cfpb-outlines-options-to-prevent-algorithmic-bias-in-home-valuations/

[8] Consumer Fin. Prot. Bureau, Outline of Proposals and Alternatives Under Consideration, Small Business Advisory Review Panel For Automated Valuation Model (AVM) Rulemaking, at 24.

[9] Id. at 2.

[10] Id. at 21.

[11] Id. at 22.

[12] 12 U.S.C. § 3354(a) (2010).

[13] Consumer Fin. Prot. Bureau, Outline of Proposals and Alternatives Under Consideration, Small Business Advisory Review Panel For Automated Valuation Model (AVM) Rulemaking, at 25.

[14] Id.

[15] Id.

[16] Id.

[17] Id. at 3.

[18] Id. at 29.

California's Consumer Finance Regulator and Fintech: A Look at the DFPI's First Year

Jeremy M. Creelan, *Megan B. Poetzel*, *Jenna E. Ross*, *and Karolina L. Bartosik* | April 27, 2022

The regulation and enforcement of financial technology (Fintech) remains in sharp focus for California's consumer finance regulator, the Department of Financial Protection and Innovation (DFPI), as it moves into its second year of operation. This Alert provides a short overview of the DFPI's origins, a comparison of the DFPI's stated priorities with its regulatory activities in its inaugural year, and an analysis of recent enforcement actions relevant to Fintech.

BACKGROUND

In August 2020, the California legislature passed Assembly Bill 1864, which included the California Consumer Financial Protection Law (CCFPL), one of the most expansive consumer protection laws in the country, and replaced the Department of Business Oversight (DBO) with the DFPI. As discussed in a contemporaneous blog post in Jenner & Block's Consumer Law Round-Up, the CCFPL charges the DFPI with regulating "the provision of various consumer financial products and services" and exercising "nonexclusive oversight and enforcement authority under California and federal (to the extent permissible) consumer financial laws."

To meet its "dual mission to protect consumers and foster responsible innovation," the CCFPL expanded the scope of the DFPI's oversight authority powers to cover entities and products not previously regulated by DBO, although it exempted major financial institutions from its reach. The DFPI now oversees nonbank small business lenders and Fintech companies, along with debt relief companies, consumer credit reporting agencies, among others, and can investigate and sanction unlawful, unfair, deceptive, or abusive acts or practices by any person offering or providing consumer financial products or services in the state. The CCFPL also grants the DFPI "the power to bring administrative and civil actions, issue subpoenas, promulgate regulations, hold hearings, issue publications, conduct investigations, and implement outreach and education programs."

A COMPARISON OF THE DFPI'S STATED PRIORITIES WITH ITS 2021 ACTIVITIES

In its first monthly bulletin after the implementation of the CCFPL, the DFPI announced three notable areas of interest. Over a year later, in March 2022, the DFPI published a report summarizing its 2021 activities. A comparison of the two reveals areas of progress and sustained focus.

First, the DFPI promised to "review and investigate consumer complaints against previously unregulated financial products and services, including debt collectors, credit repair and consumer credit reporting agencies, debt relief companies, rent to own contractors, private school financing, and more." In its annual report, the DFPI reported that it has collected "close to $1 million in restitution for consumers from enforcement actions" and reviewed 30% more complaints in 2021 than in 2020. Notably, "[t]he top categories of [consumer] complaints included debt collection, cryptocurrency, and 'neo banks'

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(fintech companies partnering with banks to offer deposit account services)."

Second, the DFPI prepared to open the Office of Financial Technology Innovation, made "to work proactively with entrepreneurs and create a regulatory framework for responsible, emerging financial products." Almost immediately, the DFPI signaled its interest in regulating earned wage access (EWA), or the ability for employees to access their wages before their scheduled payday. Not long after publication of its monthly bulletin, the DFPI entered into memoranda of understanding (MOU) with five EWA companies. The companies agreed to deliver quarterly reports beginning in April 2021 "on several metrics intended to provide the [DFPI] with a better understanding of the products and services offered and the risk and benefits to California consumers." Later, the DFPI signed six additional MOU with EWA companies and stated in its annual report that the quarterly reports required in the MOU will "inform future oversight efforts." The DFPI also indicated potential rulemaking may be forthcoming related to wage-based advances, including the registration of covered persons, record retention, and reporting.

Third, the DFPI stated that it would create the Division of Consumer Financial Protection, which would "feature a market monitoring and research arm to keep up with emerging financial products." Per its report, the DFPI created a research team in September 2021, which is "in the process of evaluating DFPI's consumer complaint data to identify broader market trends that may pose risks to consumers."

KEY AREAS OF DFPI ENFORCEMENT RELATED TO FINTECH

The Fintech industry has been a focus of DFPI enforcement activity since its inception. In one early action, for instance, the DFPI entered a desist and refrain order against a Fintech platform for allegedly selling securities, including cryptocurrency, without a broker-dealer certificate; misleading consumers in the sale of the securities; and engaging in unlicensed securities transactions.

In the last few months, the DFPI has continued to provide guidance to the industry in a variety of areas, via interpretive opinions and enforcement actions. Companies providing similar financial products and services in California should take note.

"True lender" and interest rate caps

In December 2021, the DFPI entered a consent order with a California company that had marketed consumer loans to California borrowers with interest rates in excess of the maximum set by California law. In the consent order, the company agreed not to market or service loans of less than $10,000 with interest rates greater than those set by the California Fair Access to Credit Act. The entrance of the consent order reveals that the DFPI viewed the California company as the true finance lender under the California Financing Law and the CCFPL, even though the company did not fund the loans and had provided servicing and marketing services to its banking partner, a Utah bank that is exempt from California's usury laws.

In reaction to the above order, a Fintech platform and nondepository that operates a similar bank partnership program filed suit against the DFPI in March 2022, seeking a declaration that California's interest rate caps do not apply to its loan program because its Utah bank partner originates and funds the loans. In April 2022, the DFPI filed a cross-complaint, accusing the Fintech platform of deceptive and unlawful business practices, by engaging in a "rent-a-bank" partnership scheme that allows it to evade California interest rate caps and promote predatory lending practices. The cross-complaint alleges that the Fintech platform is the "true lender" of the loans because it has the predominant economic interest in the transaction, as it collects nearly all of the loan profits after purchasing the loans' receivables within days of their funding, shielding its bank partner from any credit risk. The DFPI also alleges that the Fintech platform performs traditional lender roles in marketing, underwriting, and servicing the loans. The DFPI seeks at least $100 million in penalties, in addition to restitution to the affected borrowers.

Wage-based advances and lender licensing

In a February 2022 interpretive opinion, the DFPI concluded that certain employer-facilitated advances, for which an EWA provider contracts with an employer to offer its employees early access to wages, were not loans under either the California Financing Law, which regulates consumer credit, or the California Deferred Deposit Transaction Law, which regulates payday loans. In reaching this conclusion, the DFPI found that the source of the funding (the employer), the limit on the funding amount (to the amount an employee earned),

Continued from previous page

and the nominal fees associated with the advance counseled against the application of California's lending laws. Therefore, the inquiring EWA provider and its employer-partner were not required to obtain lending licenses.

By contrast, the DFPI alleged in two recent enforcement actions that a merchant cash agreement (providing funding in exchange for a percentage of a company's future revenue) and an income share agreement (providing college tuition funding in exchange for a percentage of the student's income after graduation) qualify as loans, and such providers must be licensed in accordance with applicable California law.

Cryptocurrency and digital asset trading

In a March 2022 interpretive opinion, the DFPI addressed whether the California Money Transmission Act (MTA), which prohibits unlicensed engagement in the business of money transmission in the state, applies to software that provides retail and institutional investors with the ability to buy, sell, and store cryptocurrency. Of note, the MTA defines "money transmission" to include the selling or issuing of "stored value"; the selling or issuing of payment instruments; and the receipt of money for transmission. The DFPI concluded that closed-loop transactions, where the company does not facilitate the exchange of cryptocurrency transactions with a third party and the customer can only redeem monetary value stored in the account for cryptocurrency sold by the company, do not meet the definition of "money transmission." However, the DFPI explained that it has not determined whether a "wallet storing cryptocurrency" is a form of "stored value" under the MTA. Accordingly, the DFPI did not require the inquiring platform to be licensed in order to provide customers with fiat and digital wallets to store and exchange cryptocurrency directly with the platform. The DFPI noted, however, that the licensing requirements remain subject to change.

A month earlier, the DFPI concluded in a February 2022 consent order that sales of a cryptocurrency retail lending product qualify as a security under California law. Specifically, the company at issue offered and sold interest-bearing digital asset accounts, "through which investors could lend digital assets to [the company] and in exchange, receive interest" paid in cryptocurrency. The DFPI concluded that these accounts are securities, and that the company had wrongfully engaged in unregistered securities transactions. The DFPI's decision came shortly after the federal Securities and Exchange Commission charged the company with a similar violation of federal securities laws, finding that the accounts were both "notes" and "investment contracts" because the investors' digital assets were pooled and packaged as loan products that generated returns for the company and yielded variable monthly interest payments contingent on the company's deployment and management of the assets.

As this overview makes clear, Fintech remains a top priority for the DFPI's regulatory and enforcement activity in 2022. Jenner & Block will continue to monitor the DFPI and report on the dynamic regulatory landscape affecting Fintechs.

CFPB Warns Digital Marketers, Loops In State AGs

Jacob D. Alderdice and Michael W. Ross | September 22, 2022

In a recent interpretive rule announced on August 10, 2022,—and unveiled at a summit of the National Association of Attorneys General—the CFPB stated that digital marketers are subject to the CFPB's jurisdiction, and expressly warned that it may take enforcement action against these entities. Such enforcement is likely to concern anti-discrimination provisions, and the new rule notes that State Attorneys General have jurisdiction to enforce these rules as well.

Prior to the CFPB's August 10 rule, digital marketers—companies that market to consumers through social media, websites, and other online and digital channels—may have considered themselves outside the reach of the Consumer Financial Protection Act of 2010 (CFPA), which provides that an entity is not a covered "service provider" if it provides "time or space" for an advertisement for a consumer financial product or service through print, television, or electronic media.

In its new interpretive rule, however, the CFPB announced that it believes digital marketers are not exempt if they are "materially involved" in the development of a "content strategy" for the marketing of financial products, and thus are covered service providers under the CFPA. The CFPB noted the evolution of modern digital ad targeting, describing how instead of just providing a forum for an ad, digital marketers are increasingly involved in the selection of prospective customers or the placement of content to affect consumer behavior, often based on the gathering of consumer data. Whereas the former practices would not be covered, the CFPB contends that the latter are more similar to conduct that would typically be performed by persons covered by the CFPA. The rule singled out practices such as lead generation, customer acquisition, and other marketing analysis or strategy using data and technology, as amounting to "material" involvement and thus covered behavior.

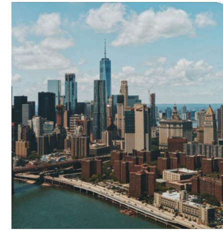
The new rule is a signal that the CFPB will be increasing enforcement in this area. In its accompanying press release, it described the new rule as a "warning" to digital marketing providers, and CFPB Director Rohit Chopra stated, "When Big Tech firms use sophisticated behavioral targeting techniques to market financial products, they must adhere to federal consumer protection laws. . . . Federal and state law enforcers can and should hold these firms accountable if they break the law." In his remarks at the rule's unveiling, Chopra also encouraged state attorneys general to pursue claims under the Consumer Financial Protection Act for any misconduct involving consumer financial products or services, including as to digital marketers.

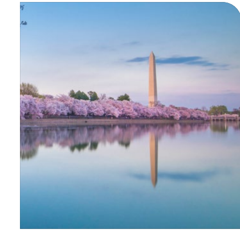
The rule's reference to "state law enforcers" is notable. The rule was first unveiled by Director Chopra during a summit of the National Association of Attorneys General, on consumer protection in the digital world. In his prepared remarks, Chopra emphasized the "role of state enforcers in policing unlawful conduct at the intersection of consumer finance and digital marketing." The interpretive rule notes state AG jurisdiction, and the CFPB has stated previously that state enforcement authorities also have jurisdiction to enforce the CFPA.

Substantively, a stated purpose of this effort by the CFPB is to address discrimination, which the CFPB has raised as a concern with regard to AI and machine learning. The new rule warns that the UDAAP provision (unfair, deceptive and abusive acts/practices) will be used to combat the use of protected characteristics to make marketing decisions (i.e. digital redlining).

The CFPB has taken other actions directed towards discrimination more broadly. It recently updated its Examination Manual to include discrimination as a part of UDAAP, and the agency is currently litigating the reach of ECOA (Equal Credit Opportunity Act) to digital marketing. In July 2019, we publicly highlighted the use of UDAAP and similar authority as a basis for enforcement actions alleging discrimination in the use of digital tools.

Companies involved in digital marketing should review the new interpretive guidance carefully, re-review their practices to consider whether they may be potentially subject to enforcement action at the state or federal level, and be on the lookout for any potential challenges to the new rule.





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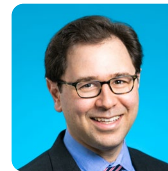

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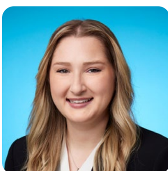

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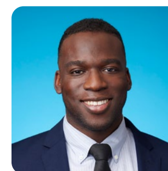

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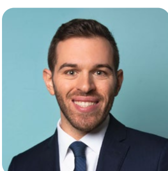

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