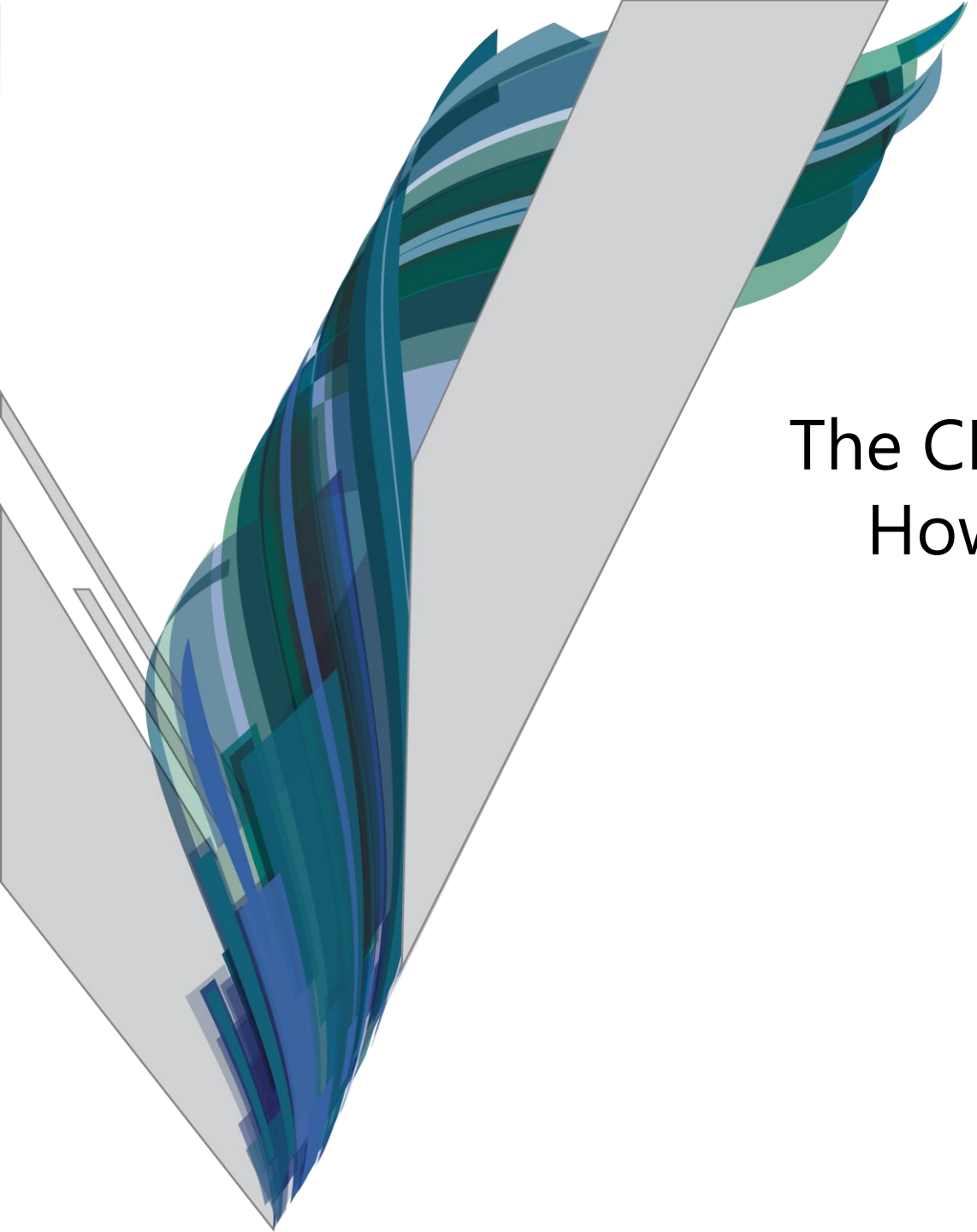

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The CFPB's New Arbitration Clause Ban: How to Prepare Your Organization

June 15, 2016

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Agenda

- Current state of the rulemaking process
- Overview and statutory background of the CFPB's proposed rule
- Arbitration and class action litigation – effect on industry and consumers
- Challenging the proposed rule: how industry can shape the proposal during the comment period
- Next steps: what companies can expect and how they may want to respond
- Regulatory compliance and change management

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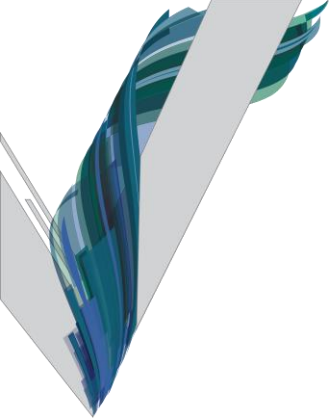

Arbitration Rule: Overview of the CFPB's Proposed Rule

The NPRM, Study, and Statutory Background

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Arbitration Rule Timeline

April 2012	The Bureau issues a Request for Information regarding arbitration clauses.
December 2013	The Bureau releases its preliminary study.
March 2015	The Bureau releases its final study and report to Congress.
October 2015	The Bureau releases a proposed framework for review by a panel of small businesses.
May 2016	The Bureau issues the NPRM and publishes the Proposed Rule in the *Federal Register*.
August 2016	Deadline for comments on the Proposed Rule.

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The Arbitration NPRM

- Creates a new section of 12 C.F.R.: Section 1040.

- Two elements to the CFPB's proposal:

    1) Elimination of agreements that may create barriers to consumer participation in class actions.

    2) Submission to the CFPB of arbitral claims, awards, and other details about the arbitration process for some form of public posting.

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The Arbitration NPRM

- Prohibits covered providers of consumer financial products and services from relying on pre-dispute arbitration agreements to prevent consumers from pursuing class actions in court.

- Requires certain language, the standard form of which reads: "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."

Scope of the Proposed Rule

Applies to pre-dispute arbitration agreements "**entered into**" after the compliance date.

- The term "entered into" is included in Section 1028(d), but not defined.
- The Bureau proposes to add in the official interpretations a series of examples of what would and would not constitute ''entering into'' a pre-dispute arbitration agreement:
  - Providing new products or services (excluding new charges on a credit card);
  - Acquiring or purchasing a covered product; and
  - Adding a pre-dispute arbitration agreement to an existing product or service.

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Scope of the Proposed Rule

- Proposes exclusions from the term "entering into" a pre-dispute arbitration agreement:
  - Modifying, amending, or implementing the terms of a product or service pursuant to a pre-compliance date agreement (except when doing so would constitute providing a new covered product or service); and
  - Acquiring a product that is subject to a pre-dispute arbitration, without becoming a party to the agreement.

- Certain acquisitions of consumer financial contracts may require the acquirer to amend the contract to include the form language or provide notice to the other party to the contract.

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Potentially Affected Products and Services

The Proposed Rule would apply to "certain consumer financial products and services in the core consumer financial markets of lending money, storing money, and moving or exchanging money, including, among others:

- Most types of consumer lending (extending consumer credit under Regulation B, such as making loans, issuing credit cards, certain types of retail installment sales, and providing credit in certain other contexts);
- Providers of credit in the form of deferred third-party billing services;
- Participating in activities related to the extension or decision to extend consumer credit, such as providing referrals, servicing, credit monitoring and repair, debt relief, debt collection services, and purchasing consumer loans;
- Extending or brokering of automobile leases; and
- Other business related to storing, transmitting, or exchanging funds (including savings and deposit accounts, remittance transfer providers, providers of domestic money transfer services or currency exchange, general-purpose reloadable prepaid card issuers, and check cashing providers, among others).

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Exclusions, Limitations, and Carve-outs

The Proposed Rule would exclude certain types of agreements, including

- Agreements that are already subject to arbitration rules issued by the SEC/FINRA (currently, broker-dealers);
- Agreements with federal, state, local, and tribal governments, and any affiliate of such governments;
- Agreements with persons (including individuals) not regularly engaged in business activity (25 or fewer consumers, annually);
- Certain nonfinancial goods or services provided by merchants, retailers, or other sellers; and
- Agreements involving products or services provided by persons excluded from the Bureau's jurisdiction.

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Dodd-Frank Act Section 1028 - 12 U.S.C. § 5518

Section 1028. AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.

(a) STUDY AND REPORT.—The Bureau shall conduct a study of, and shall provide a report to Congress concerning, the use of agreements providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services.

(b) FURTHER AUTHORITY.—The Bureau, by regulation, may prohibit or impose conditions or limitations on the use of an agreement between a covered person and a consumer for a consumer financial product or service providing for arbitration of any future dispute between the parties, if the Bureau finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers. The findings in such rule shall be consistent with the study conducted under subsection (a).

(c) LIMITATION.—The authority described in subsection (b) may not be construed to prohibit or restrict a consumer from entering into a voluntary arbitration agreement with a covered person after a dispute has arisen.

(d) EFFECTIVE DATE.—Notwithstanding any other provision of law, any regulation prescribed by the Bureau under subsection (b) shall apply, consistent with the terms of the regulation, to any agreement between a consumer and a covered person entered into after the end of the 180-day period beginning on the effective date of the regulation, as established by the Bureau.

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Dodd-Frank Act Section 1022 - 12 U.S.C. § 5512(b)(1)-(2)(A)

Section 1022. RULEMAKING AUTHORITY.

(b) RULEMAKING, ORDERS, AND GUIDANCE

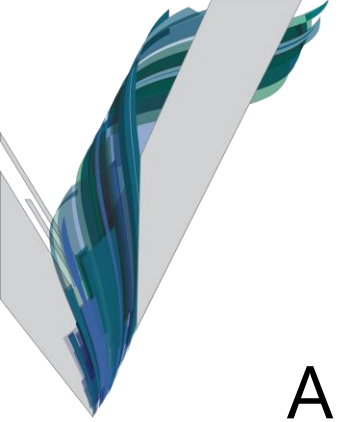
(1) General authority: The Director may prescribe rules and issue orders and guidance, as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof.

(2) Standards for rulemaking: In prescribing a rule under the Federal consumer financial laws—

(A) the Bureau shall consider—

(i) the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule; and

(ii) the impact of proposed rules on covered persons, as described in section 5516 of this title, and the impact on consumers in rural areas . . . .

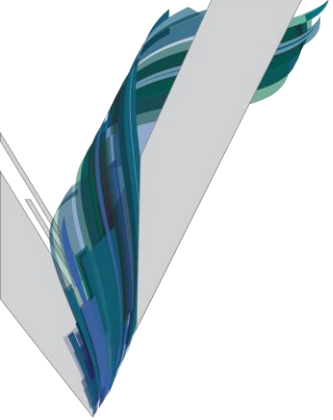


The Federal Arbitration Act (FAA) - 9 U.S.C. § 2

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Steps Forward in the Administrative Rulemaking Process

- Public comment period (90 days) – Deadline for comments is August 22, 2016.
- Comment review period.
- Finalization of the Proposed Rule.
- Implementation of the Final Rule (effective 211 days after issuance).



CFPB Arbitration Study

Brief Overview of the Bureau's Final Arbitration Study

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CFPB's Arbitration Study: Overview

The Study examines the following substantive areas:

- Clause incidence and features
- Consumer understanding and awareness
- Arbitration incidence and outcomes
- Class litigation incidence and outcomes
- Individual litigation incidence and outcomes
- Small claims court
- Class settlements
- Public and private enforcement
- Price and output effects of arbitration provisions

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CFPB's Arbitration Study: Elements

- Analyzed ~**850** consumer finance agreements to examine the prevalence of arbitration clauses and their terms.
- Reviewed ~**1,800** consumer finance arbitration disputes filed over a period of three years and ~**3,400** individual federal court lawsuits.
- Reviewed ~**42,000** credit card cases filed in selected small claims court in 2012.
- Looked at ~**420** consumer financial class action settlements in federal courts over a period of five years and ~**1,100** state and federal public enforcement actions in the consumer finance area.
- Conducted a telephonic survey of ~**1,000** consumers with credit cards concerning their knowledge and understanding of arbitration and other dispute resolution mechanisms.

CFPB's Arbitration Study: Findings on Prevalence

53%: The market share of credit card issuers that include arbitration clauses;

44%: While fewer than 8% of banks and credit unions include arbitration clauses in their checking account agreements, those who do represent 44% of insured deposits;

92%: The percentage of prepaid card agreements the CFPB obtained that are subject to arbitration clauses;

86%: In the private student loan market, 86% of the largest lenders include arbitration clauses in their contracts;

99%: More than 99% of storefront locations in California and Texas include arbitration clauses in their agreements; and

88%: Among mobile wireless providers who authorize third parties to charge consumers for services, 88% of the largest carriers include arbitration clauses. Those providers cover more than 99% of the market.

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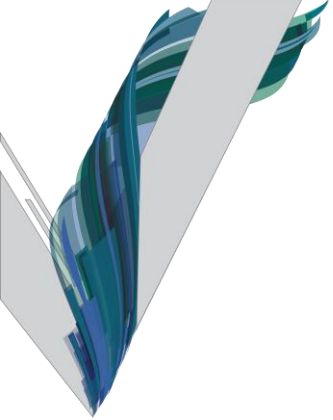

In Perspective: Arbitration and Class Action Litigation

Review of the Interplay between Arbitration, the Federal Arbitration Act, Supreme Court Precedent, and Class Action Litigation

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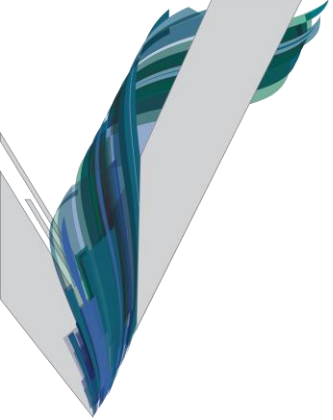
Consumer Class Action Dynamics

- Rule 23(b)(3) "spurious" class actions born in 1966.
- Vests discretion in trial court to certify class where common class issues "predominate" over questions affecting individual members.
  - Especially where individual recoveries are too small to pursue.
- Consumer class actions became cottage industry in 1980s, fueled by broad consumer fraud statutes and statutory damage regimes.
- Industry response: arbitration provisions with class action waivers.
- Decisional law often conflicted about effect of these clauses:
  - Adhesion contracts not entitled to enforcement.
  - Giving effect to unilateral offers in mass marketing.
  - Arbitrability of class claims in absence of class waiver.

Concepcion and its progeny . . .

- *Discover Bank* Rule: California Supreme Court held class action waivers unenforceable in consumer contracts of adhesion, and that FAA did not preempt state court constraint of arbitration.
- *Concepcion*: Supreme Court held Discover Bank Rule is obstacle to FAA's purpose, and therefore is preempted. Also held classwide arbitration inconsistent with consensual arbitration under FAA.
- *CompuCredit Corp*: Federal statute creating right to sue and mandating related disclosures does not override FAA.
- *Italian Colors*: Lack of feasible arbitration process for effective vindication of antitrust claims does not evince an intention to preclude class action waiver or violate public policy.



Forecast: What's Next?

Possible Legal Challenges and What Industry Participants Can Expect

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Possible Legal Challenges to the Final Rule

Overview

- Many different legal challenges may be filed against such an important rule by many different parties who are adversely affected by its provisions.

- Generally, there are two types of challenges that are filed against such rules – sweeping challenges to the broad thrust of the rule (here, limitations on the use of arbitration provisions) and smaller-scale challenges to specific provisions or applications of the rule (for example, how it applies to specific consumer financial products).

- The sweeping challenges tend to consume many pages in the petitioners' briefs and to crowd out the narrower, more specific challenges. The page limit compression phenomenon is especially acute in the appellate courts. Accordingly, it can be difficult for parties with challenges to specific parts of the rule to have their arguments presented fully to the courts.

- It is not possible to tell what narrower/more focused challenges might be filed until the Final Rule is issued.

- The critical feature of the comment period is that challengers must submit to the administrative record all factual information necessary to show that the rule is ill advised and harmful.

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Possible Legal Challenges to the Final Rule

The Bureau's Arbitration Study

- Under Section 1028(a), the CFPB was required to "conduct a study" of arbitration before it may issue a rule prohibiting or imposing conditions on the use of arbitration agreements in connection with "the offering or providing of consumer financial products or services."

- The findings in the Final Rule must be "consistent with the study." This standard gives the Bureau substantial flexibility in drafting a rule that could be deemed to satisfy this requirement.

Possible Legal Challenges to the Final Rule

Congress's Delegation of Authority to the CFPB

- Under Section 1028(b), the CFPB may prohibit or impose limits on the use of arbitration agreements concerning the offering of consumer financial products or services if it finds that such a prohibition or limitation on the use of an arbitration agreement "is in the public interest and for the protection of consumers."
- In the Proposed Rule, the Bureau separates this provision into two inherently interrelated tests:
  - "In the public interest," which focuses on the entire range of impacts on consumers and other members of the public, including the primary effects on consumers, and such secondary effects as impacts on pricing, availability of products, accessibility, and general systematic considerations; and
  - "For the protection of consumers," which focuses on the effects of the rule in promoting compliance with laws applicable to consumer financial products and services and avoiding harm to consumers.

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Possible Legal Challenges to an Arbitration Rule

Challenge to the Bureau's Legal Authority

- The broadest legal challenge would be that the Bureau has exceeded the scope of the legal authority granted by Congress.
  - The "public interest" standard is extremely broad and has been upheld by the Supreme Court in a series of cases since the 1940s as a constitutional delegation of Congress's authority to an agency.
  - This standard grants an agency extraordinary latitude in justifying a rule as long as there is factual support in the administrative record to show that its provisions are reasonable.
- There have been suggestions that Section 1028(b) could be challenged on the ground that Congress made an unconstitutional delegation of its authority to the CFPB by granting it authority, in practice, to partially repeal the Federal Arbitration Act.

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Possible Legal Challenges to an Arbitration Rule

Challenge to CFPB's Cost/Benefit Analysis

- Under the Bureau's general rulemaking provision in Section 1022(b)(2), in promulgating a rule, the agency must consider "the potential benefits and costs to consumers . . ., including the potential reduction of access by consumers to consumer financial products or services resulting from such a rule . . . ."
- Since the Supreme Court's 2015 decision in *Michigan v. EPA*, many challenges are being brought against rules on the ground that the agency did not conduct a proper analysis of the costs and benefits.
- There is no requirement that the benefits of a rule exceed its costs, as long as the agency has a reasonable justification for its actions. But such challenges often are brought against rules where the quantifiable costs exceed the quantifiable benefits.
- The Proposed Rule suggests that many of the costs are quantifiable, whereas the benefits are unquantifiable to a significant extent. Accordingly, a challenger might bring a procedural attack on the rule under Section 1022(b)(2), for failure to properly consider these factors.

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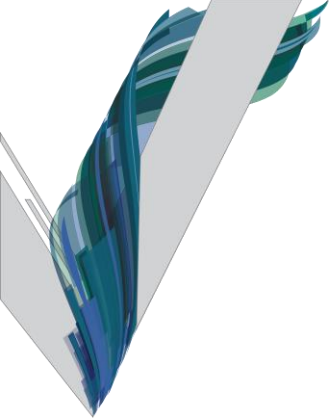

Moving Forward: What Does This Mean for Regulatory Compliance?

Issues in Compliance and the Regulatory Change Management Process

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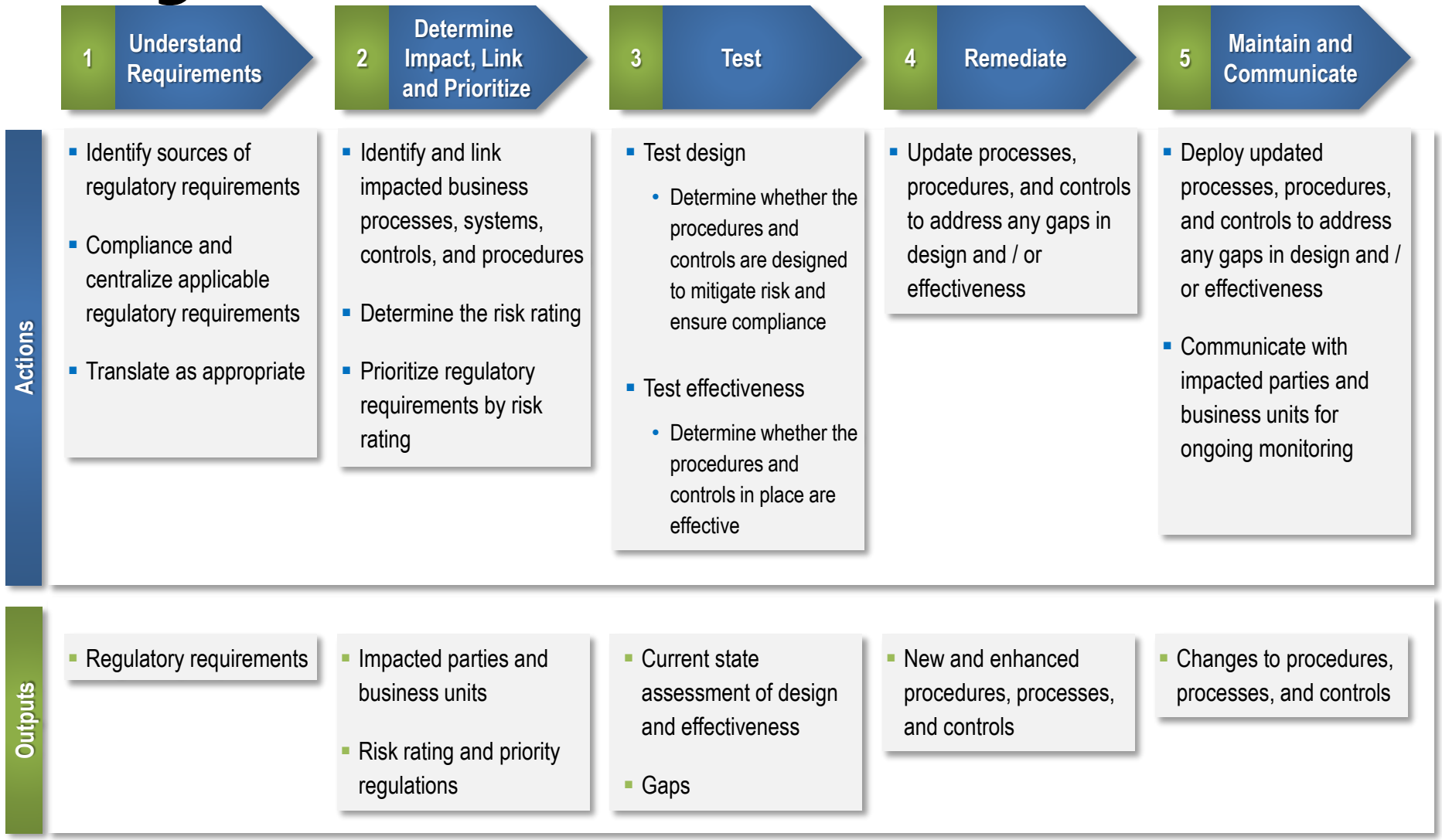
Deploy an End-to-End Regulatory Change Management Process



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Who needs to be involved in the conversation?

- Compliance Management Committee
  - Litigation counsel
  - Regulatory counsel
  - Compliance team
- Business owners (each product and service)
- Customer Support
- Other?

What needs to be considered?

Assess Litigation Exposure

(What's your new last line of defense? How does this impact vendor relationships?)

Assess Recourse Available to Consumers

Know the Terms of Your Contract

Know Plans for Resale/Purchase

Understand Implementation Periods

Consider Product and Service Enhancements

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Next Steps for the Rulemaking Process

- **Comment Period:**
  - Public comment on the Arbitration NPRM is due by August 22, 2016.
- **Final Rule:**
  - The timing of the finalization of any proposed rule lies with the agency, as it digests and considers public comments.
- **Possible Legal Challenge?**
- **Possible Legislative Intervention?**
- **Compliance:**
  - Under Section 1028(d) and the NPRM, providers would be required to comply with the final rule **211** days after it is promulgated by the Bureau.

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Compliance and Class Action Considerations after CFPB's Rule

- Scope of the CFPB's proposal.
- No *Concepcion* touchstone re procedural or substantive unconscionability.
- FINRA/Magnuson-Moss predicates adopted.
- *Spokeo* impact.
- Choice-of-law provisions.
- Enforcing arbitration in absence of class claims.
- Impact of defeating class certification: can an obligation to arbitrate survive pre-certification litigation?
- Regulatory compliance and change management.

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Questions?

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