ARNOLD & PORTER LLP

UDAP: Past, Present, & Future

The Changing Regulatory Landscape

Michael B. Mierzewski

Arnold & Porter LLP

California Bankers Association Annual Regulatory Compliance Conference

October 5 – October 8, 2010

Legal Framework

- Section 5 of the Federal Trade Commission Act (FTC Act), enacted in 1938, prohibits "unfair or deceptive acts or practices in or affecting commerce."
  - Explicitly exempts depository institutions from the Federal Trade Commission (FTC)'s enforcement authority
- Section 8 of the Federal Deposit Insurance Act (FDI Act), enacted in 1950, empowers federal banking agencies to take appropriate enforcement actions against insured depository institutions and their subsidiaries for violations of *any* "law, rule, or regulation."
- Minimal enforcement of Section 5 against depository institutions by federal banking agencies into the 1970s

FTC Improvement Act of 1975

- The Federal Reserve Board (FRB) "shall prescribe…regulations defining with specificity such unfair or deceptive acts or practices, and containing requirements prescribed for the purpose of preventing such acts or practices."
- Specifically empowers federal banking agencies to enforce these FRB regulations through Section 8 of the FDI Act
- Required each banking agency to establish a division of consumer affairs to receive and respond to complaints alleging unfair or deceptive acts or practices by entities subject to their supervision

Absence of FRB Regulations

- The FRB has exercised its rulemaking authority under Section 5 only once (Regulation AA).
- Question: Can a federal banking agency take action against an institution in the absence of FRB regulations that identify an act or practice as unfair or deceptive?
  - Minimal federal banking agency Section 5 enforcement activity continued through the 1990s

The Legacy of Providian

- In June 2000, the Office of the Comptroller of the Currency (OCC) announced that it had entered into a settlement with Providian National Bank, directing the bank "to cease a number of *unfair and deceptive practices* and to pay at least $300 million to consumers harmed by those practices."
- Despite the absence of FRB regulations, the OCC asserted that federal banking agencies retained their enforcement powers under Section 8 of the FDI Act, allowing them to address violations of *any* law, including the FTC Act, committed by entities under their supervision.

The Legacy of Providian (con't)

- Given the absence of FRB regulations or guidance, what standards would federal banking agencies use to evaluate potential Section 5 UDAP violations?

- The same standards used by the FTC.
  - See FDIC Financial Institution Letter 57-2002, OCC Advisory Letter 2002-3

UDAP STANDARDS

Unfair

An act or practice is unfair if it:

1) Causes or is likely to cause substantial injury to consumers;
2) Cannot be reasonably avoided by consumers; AND
3) Is not outweighed by countervailing benefits to consumers or to competition.

Unfair (con't)

1) "Substantial injury"
   - Not trivial or "merely speculative" harms
   - Generally monetary in nature
   - May involve "causing very severe harm to a small number of people" or "a small harm to a large number of people"
   - Practices that rise to the level of "unfair" generally "present relatively extreme situations" with "an inordinate degree of risk or harm to the consumer."

Unfair (con't)

2) Unavoidable
   - Emphasis on the value of consumer choice: an act or practice that interferes with or creates obstacles to the free exercise of consumer decision-making—specifically consumers' ability to evaluate whether to incur a injury—may be deemed unfair
     - E.g., practices that subject consumers, especially those known to be particularly susceptible, to undue influence or coercion
   - Agencies are directed not to "second-guess the wisdom of particular consumer decisions," but should take action to prevent "behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decision-making."

Unfair (con't)

3) Not outweighed by any countervailing benefits to consumers or competition
   - Recognition that most business practices entail a mixture of economic and other costs and benefits so that agencies should "not find that a practice unfairly injures consumers unless it is injurious in its net effects"
   - Such a determination thus requires the enforcing agency to assign relative weights to various costs and benefits.

Deceptive

An act or practice is deceptive where:

1) A representation, omission, or practice misleads or is likely to mislead the consumer;
2) A consumer's interpretation of the representation, omission, or practice is considered reasonable under the circumstances; AND
3) The misleading representation, omission, or practice is material.

Deceptive (con't)

1) Likely to mislead
   - Agencies should examine "[t]he entire advertisement, transaction, or course of dealing," giving due weight to contextual and relevant extrinsic factors.
   - The issue is whether the act or practice is likely to mislead, rather than whether it causes actual deceptions.

Deceptive (con't)

2) Reasonable interpretation

- Issue: Is the interpretation reasonable in light of the claim?
- Agencies should look at the complete act or practice and formulate opinions on the basis of the net general impression conveyed rather than on isolated excerpts.
- When representations or sales practices are targeted to a specific audience, the agency determines the effect of the practice on a reasonable member of that group.

Deceptive (con't)

3) Materiality

- The enforcing agency considers whether the representation, omission, or practice would be likely to influence a consumer's choice of or conduct concerning a product or service.
- Price/cost is generally considered to be material.

Unfair/Deceptive

- An act or practice may be found to be both unfair and deceptive, but an agency may bring a Section 5 enforcement action if it deems the act or practice to be either unfair or deceptive.
- Historically, the majority of enforcement actions have been brought under the "deceptive" prong because the standard of proof is less stringent and the assessment criteria more subjective.

EARLY APPLICATION OF THE UDAP STANDARDS: THE CREDIT CARD CASES

2000 OCC-Providian Consent Order

OCC Findings

- Providian failed to disclose adequately to consumers the limitations in a credit protection program it marketed.
- The bank represented to consumers that they would save money by transferring their balances to a Providian credit card, despite the fact that the interest rate on the card was higher than what many were paying with other products.
- The bank advertised a "No Annual Membership Fee" credit card but failed to disclose that the card required the purchase of credit protection, for which it charged $156 a year.
- The bank's employees were specifically instructed to provide misleading or false information to complaining customers.

2000 OCC-Providian Consent Order (con't)

- While the consent order did not include a full UDAP analysis, the OCC appeared to reach its conclusions under the "deception" prong.
- Providian agreed to pay <u>at least</u> $300 million to consumers harmed by the identified practices.
- Under the terms of the agreement, Providian did not admit or deny any wrongdoing.

The Credit Card Cases

Direct Merchants Credit Card Bank, N.A. (May 2001)

- After finding that the bank had mislead its customers by "downselling" credit card products on less favorable terms than promised, the OCC ordered the bank to pay approximately $3.2 million in restitution to 62,000 customers harmed by such practices.

First National Bank of Marin (Dec. 2001)

- The OCC ordered the bank to pay $4 million in restitution for using "false and misleading statements, …to induce [consumers with poor or non-existent credit histories] to apply for its credit card and to pay substantial fees."

First National Bank in Brookings (Jan. 2003)

- The OCC ordered the bank to establish a $6 million reserve fund to compensate customers who were deceived by various credit card marketing practices.

The Credit Card Cases (con't)

CompuCredit Corporation, Columbus Bank & Trust Company (CB&T), First Bank of Delaware, and First Bank & Trust (Dec. 2008)

- CompuCredit was ordered to pay $100 million to consumers—as well as a $2.4 million civil money penalty—after the FDIC found that the marketing and solicitation techniques used by CompuCredit and its three partner banks in connection with its credit card products were deceptive.
- CB&T had earlier agreed to establish a $7.5 million reimbursement fund to settle its own charges. The other two partner banks did not establish independent funds.

THE PRESENT:
EXPANSION OF UDAP ENFORCEMENT BY FEDERAL BANKING AGENCIES

Wachovia Bank, N.A. (April 2008)

Failure to protect consumers from fraud

- The OCC alleged that Wachovia failed to take appropriate steps to protect consumers from telemarketers and telemarketer payment processors who maintained deposit accounts with Wachovia.
- The OCC asserted that the volume of returned and disputed items associated with such accounts should have alerted Wachovia that fraud was occurring in the accounts.
- Wachovia was directed to pay at least $125 million into a restitution fund and to pay a $10 million civil money penalty.
- Wachovia also was directed to deposit $8.9 million into a consumer education fund.
- Notably the majority of consumers remediated by the settlement had no direct relation to the bank.

Advanta Bank Corp. (June 2009)

Cash-back rewards programs

- Although Advanta's cash back rewards program advertised a percentage of cash back on certain purchases by business credit card accountholders, the FDIC concluded that it was effectively impossible for accountholders to get the stated percentage of cash back reward payments.
  - For such violations, Advanta was ordered to pay customers restitution not to exceed $14 million.
- The FDIC also alleged annual percentage rate (APR) irregularities due to Advanta's disclosure practices and required restitution for such offences not to exceed $21 million.
- Advanta also paid $150,000 in civil money penalties.

Woodforest Bank (April 2010)

Failure to establish aggregate overdraft fee limits

- The Office of Thrift Supervision (OTS) alleged that the savings association failed to impose a reasonable limit on aggregate overdraft fees assessed under an automatic-enrollment overdraft program and further failed to provide consumers overdrawn on their accounts with a reasonable opportunity to cease the imposition of additional daily fees for remaining overdrawn.
- The thrift was directed to deposit at least $12 million into a restitution account and to agree to pay a $400,000 civil money penalty.

Monterey County Bank (September 2010)

Failure to disclose information necessary to allow consumers to make informed decisions

- Ordering Monterey County Bank to pay more than $3 million in restitution and other charges, including funds to pay civil money penalties and to establish a consumer financial literacy account, the FDIC alleged that the Bank had failed to disclose all fees related to its debit card products as well as the terms and conditions of its balance transfer credit card products.

Lessons Learned: Our Experience

- Federal banking agencies have demonstrated an increasing willingness to exercise their enforcement powers under Section 5.
- Consumer protectionism is clearly a "hot button" issue in the current environment.
- Full and accurate disclosure of product terms and conditions is no longer enough. Institutions must begin substituting their judgments for their customers.
- "Banks as bartenders"—you have to cut customers off

Lessons Learned: Our Experience (con't)

- Dawn of the era of consumer "paternalism"?
  - Enhanced scrutiny of products and services targeted towards lower-income consumers and those who have experienced previous financial problems
  - Willing to hold institutions liable for the informed decisions of their customers if the agency concludes that such decisions were not, in its opinion, in the customers' best interest
  - Despite the clear standards and criteria articulated by the FTC, federal banking agencies have taken an expansive reading of "unfair" and "deceptive," providing loose or even incomplete analysis under the required elements of the tests.

THE FUTURE: BUREAU OF CONSUMER FINANCIAL PROTECTION & BEYOND

Bureau of Consumer Financial Protection (Bureau)

- Title X of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) provides the Bureau with rulemaking and enforcement authority over financial institutions with respect to "unfair, deceptive, or abusive acts or practices."
- It remains unclear as to what the standards for an "abusive" act or practice might be.
- The standards for "unfair" and "deceptive" are likely to remain consistent with past FTC precedents.

Abusive

Under Dodd-Frank, the Bureau may consider an act or practice "abusive" if it—

- Materially interferes with the ability of the consumer to understand a term or condition of a consumer financial product or service; or
- Takes unreasonable advantage of—
  1) A lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  2) The inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
  3) The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

Abusive (con't)

- In two 2003 Advisory Letters, the OCC intimated that it considered practices prohibited by the Home Owners Equity Protection Act (HOEPA) to be abusive.
  - Other practices that have been cited as abusive include prepayment penalties, automatic interest rates changes on a default, balloon payments, negative amoritization, and extension of credit without adequate consideration of payment ability.
  - Lending based on the value of the collateral rather than the borrower's ability to pay has been specifically identified as an abusive practice.
- In its 2006 Compliance Manual, the FDIC implies that it considers unfair and deceptive acts and practices to be abusive acts and practices.

Conclusion

- UDAP enforcement in the financial services industry is an ever-evolving and seemingly expanding phenomenon which is likely to impact significantly the operating environment of banks, savings associations, and other financial companies for years to come.
- Banks should conduct a thorough review of their product offerings to ensure that appropriate limits and other consumer safeguards are in place.