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CFPB Releases Long-Awaited Proposal on Pre-Dispute Arbitration Agreements

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On May 5, 2016, the Consumer Financial Protection Bureau (CFPB or the Bureau) released a proposed rule[1] to prohibit the use of pre-dispute arbitration agreements to block consumer class actions. The Bureau's proposal reflects concerns about the effects of mandatory consumer arbitration provisions, and a final rule is likely to substantially reduce the efficacy of arbitration clauses for consumer lenders, significantly increase compliance costs and class action exposure, and reduce or eliminate the substantial benefits arbitration provides to consumers. While consumer groups and the class action bar are likely to welcome the proposal—as evidenced by remarks from representatives at a field hearing coinciding with the issuance of the proposed rule—legal challenges are expected to any final rule.

The proposed rule would prohibit covered providers of consumer financial products and services from including pre-dispute arbitration clauses in new contracts that bar a consumer from filing or participating in a class action with respect to the covered consumer financial product or service, and would require any covered pre-dispute arbitration agreement to include specific language to that effect. The proposal also would require a covered provider that uses pre-dispute arbitration agreements to submit certain arbitral records to the Bureau.

The proposed rule would apply to most consumer financial products and services within the CFPB's jurisdiction, including the core consumer financial markets that involve lending money, storing money, and moving or exchanging money.[2]

Background

For the last few years the CFPB has been examining the role of arbitration agreements in consumer disputes over financial products and services. The Bureau's analysis of arbitration agreements came on the heels of the U.S. Supreme Court's 2011 decision in *AT&T Mobility LLC v. Concepcion*,[3] which held that the Federal Arbitration Act preempts state law purporting to prohibit class action waivers in arbitration agreements. In March 2015, the CFPB completed a study[4] of arbitration agreements and other methods for dispute resolution in markets for consumer financial products

and services, as directed by the Dodd-Frank Act.[5] In October 2015, the Bureau released an outline of its proposals, convened a Small Business Review Panel, and sought input from the public, consumer groups, industry, and other stakeholders. That process concluded in December 2015 with a written report to Director Richard Cordray.

At the May 5 field hearing, Cordray stated that the "study found that class actions provide a more effective means for consumers to challenge problematic practices by these companies. According to the study, class actions succeed in bringing hundreds of millions of dollars in relief to millions of consumers each year…."[6]

Highlights

The proposal is based on the Bureau's preliminary findings—which follow the March 2015 study—that pre-dispute arbitration agreements are used to prevent consumers from seeking relief from legal violations on a class basis, and that consumers rarely file individual lawsuits or arbitration cases to obtain such relief.

Under the proposed rule, providers would be prohibited from relying on a pre-dispute arbitration agreement entered into after the compliance date with respect to any aspect of a class action that is related to any of the covered consumer financial products or services, unless the court has ruled that the class action may not proceed and any interlocutory appellate review of that ruling has been resolved. Providers would be required to ensure that any pre-dispute arbitration agreements entered into after the compliance date contain a specified provision disclaiming the applicability of those agreements to class action cases concerning a consumer financial product or service covered by the proposed rule.[7] The proposed rule would permit an arbitration agreement that allows for class arbitration, provided that a consumer could not be required to participate in class arbitration instead of class litigation.[8]

In addition, providers that use pre-dispute arbitration agreements would be required to submit certain records relating to arbitral proceedings to the Bureau. This requirement would apply to both individual arbitration proceedings and class arbitration proceedings. The Bureau intends to use the information it collects to "continue monitoring arbitral proceedings to determine whether there are developments that raise consumer protection concerns that may warrant further Bureau action."[9] For example, depending on what the collected data shows, the Bureau could propose a rule that bans individual and/or class arbitration. The proposal would require submission only of records arising from arbitrations pursuant to pre-dispute arbitration agreements entered into after the compliance date, where one or more of the parties is a provider and the dispute concerns a product covered by the rule. The Bureau expects to publish these materials on its website in some form to provide greater transparency into the arbitration of consumer disputes. The CFPB also believes the records requirement is in the public interest because, inter alia, it will: provide insight on the types of claims being brought to arbitration and the way in which arbitrators resolve them; allow the Bureau to take action against providers engaged in potentially illegal actions; allow the Bureau to better evaluate that laws are being enforced consistently; and help the Bureau learn of providers that have violated the law and determine whether arbitrations proceed fairly and efficiently.

The proposal would apply to providers of certain consumer financial products and services carrying out the core functions of lending money, storing money, and moving or exchanging money. The coverage of the proposed rule would include most providers engaged in:

- most types of consumer lending (such as making secured loans or unsecured loans or issuing credit cards) and activities related to that consumer lending (such as providing referrals, servicing, credit monitoring, debt relief, and debt collection services, among others, as well as the purchasing or acquiring of such consumer loans);

- extending and brokering those automobile leases that are consumer financial products or services;

- storing funds or other monetary value for consumers (such as providing deposit accounts); and

- providing consumer services related to the movement or conversion of money (such as certain types of payment processing activities, transmitting and exchanging funds, and cashing checks).[10]

The proposed rule would apply to products and services to the extent they are offered or provided for use by consumers primarily for personal, family, or household purposes or provided in connection with such products and services. To the extent the proposed rule covers extensions of credit, it is limited to "consumer credit" and therefore should not apply to business loans.[11] The CFPB seeks comment, however, on whether to expand the definition of covered products and services.

Limitations and Exclusions

The Bureau's proposal does not cover products outside the core areas of lending money, storing money, and moving or exchanging money, and thus does not cover every type of consumer financial product or service defined in Dodd-Frank section 1002(5). The Bureau will continue to monitor other markets.[12] The proposal also excludes several categories of contracts: those for (1) products or services already subject to arbitration rules issued by the Securities and Exchange Commission (SEC); (2) products or services provided by federal, state, local, and tribal governments, and any affiliate of such governments; (3) products or services provided by persons when not regularly engaged in business activity (e.g., an individual who may loan money to a friend); (4) certain nonfinancial goods or services provided by merchants, retailers, or other sellers; and (5) products or services provided by persons excluded from the Bureau's jurisdiction. The proposal would also permit providers of general-purpose reloadable prepaid cards to continue selling packages that contain non-compliant arbitration agreements on a temporary basis if certain requirements are met.

As the CFPB acknowledges in the proposal, important questions remain about the scope of these exclusions as to SEC-regulated entities. The rule as proposed expressly excludes broker-dealers to the extent they are providing any products and services otherwise covered by the rule, provided the product or service is also subject to specified rules promulgated or authorized by the SEC prohibiting the use of pre-dispute arbitration agreements in class litigation and providing for making

arbitral awards public. The rule as proposed does not exclude any other person acting in an SEC-regulated capacity, such as an investment adviser. (Section 921 of the Dodd-Frank Act authorized the SEC to issue rules to prohibit or impose conditions or limitations on the use of arbitration agreements by investment advisers, though the SEC has not issued any such regulations to date.)

The Bureau also considered an exclusion for products or services that are already subject to arbitration rules issued by the Commodity Futures Trading Commission (CFTC).[13] The CFTC's regulation requires that pre-dispute arbitration agreements in customer agreements for products or services regulated by the CFTC be voluntary.[14] According to the Bureau, however, the CFTC regulation does not ensure consumers have access to private remedies in class actions and does not provide for transparency of arbitral awards. The Bureau also believes that complying with both rules would not be unduly burdensome for any affected providers. Under the proposed rule, any product or service that is subject to both the Bureau's proposed rule and the CFTC rule would therefore need to meet the requirements of both rules.[15]

At this time, the Bureau is not proposing an exemption for small entities because it believes that the availability of class actions protects consumers who do business with small entities. But the Bureau seeks comment on whether it should exempt small entities from some or all requirements of the proposed rule. In the event the Bureau were to adopt a small entity exemption, the Bureau seeks comment on how to formulate such an exemption for all small providers or for small providers in particular industries.

Public Comments and Compliance Considerations

The proposed rule and disclosures will be open for public comment for 90 days after their upcoming publication in the Federal Register. We expect numerous comments from various industry participants and other observers.

Because the proposed rule would prevent consumers from waiving their right to bring a class action, it would impose a number of costs on affected entities. Covered providers can anticipate increased class action litigation and a corresponding increase in administrative, litigation, court, settlement, and insurance costs.

Affected entities are also likely to incur costs as a result of revising the language of their arbitration agreements to provide that the agreements do not apply to cases on a class basis. This would likely entail a one-time cost of changing language in consumer contracts; those contracts entered into 180 days after the rule's effective date must contain the class action carve-out. Providers also could be affected on an ongoing or sporadic basis in the future as they acquire existing contracts as the result of regular or occasional activity, such as a merger. This is because providers who become a party to an existing contract with a pre-dispute arbitration agreement that does not already contain the proposed language would be required to amend the agreement to include that provision, or send the consumer a notice indicating that the acquirer would not invoke that pre-dispute arbitration agreement in a class action.[16]

The CFPB recognizes that some portion of the increased costs could be passed through to consumers but believes that on balance the proposed rule would be “in the public interest and for

the protection of consumers." The Dodd-Frank Act authorizes the CFPB to impose limitations on pre-dispute arbitration agreements if it finds that such action is "in the public interest and for the protection of consumers." Dodd-Frank also requires that the findings in any such rule be consistent with the arbitration study. According to public reports, litigation under the Administrative Procedure Act is likely. Many in the affected industries are critical of the conclusions in the CFPB arbitration report and could challenge the rule on each of the three Dodd-Frank prongs—in the public interest, for the protection of consumers, and supported by the study's findings.

Additionally, the House Financial Services Committee is investigating the CFPB's examination and rulemaking of pre-dispute arbitration agreements. In an April 20, 2016 letter, Congressman Sean Duffy requested internal CFPB communications as well as communications with certain consumer advocacy groups relating to pre-dispute arbitration agreements, draft reports concerning arbitration agreements, and records relating to the Small Business Regulatory Enforcement Fairness Act process.

Effective Date

The Bureau is proposing an effective date of 30 days after a final rule is published in the Federal Register. Consistent with the Dodd-Frank Act, the proposed rule would apply only to agreements entered into after the end of the 180-day period beginning on the regulation's effective date. As such, compliance would be required for any pre-dispute arbitration agreement entered into after the date that is 211 days after publication of the final rule in the Federal Register.

Comments on the notice of proposed rulemaking (NPRM) will likely be due sometime in August (90 days after the NPRM is published in the Federal Register). Once the comment period closes, the CFPB will review and analyze the comments received and decide whether any adjustments are needed before issuing a final rule. We anticipate that it will likely take the CFPB several months to finalize the rule. Even then, arbitration clauses in existing contracts will remain enforceable because of the statutorily required grandfathering rule, meaning some provisions would continue to be in effect for many years.

Conclusion

The Bureau's proposed arbitration rule would, if issued as a final rule in its current form, substantially reduce the frequency with which consumer finance disputes are resolved in arbitration. This development would impose significant costs on industry, and the substantial benefits to consumers that arbitration provides will also be reduced. The Bureau's proposal also says that it "will continue to evaluate the impacts on consumers of arbitration and arbitration agreements. To the extent necessary and appropriate, the Bureau intends to draw upon all of its statutorily authorized tools to address conduct that harms consumers[,]" including its UDAAP authority.[17] This suggests that the proposed rule may represent a starting point and not an end point for regulatory action, a possibility industry must continue to contemplate.

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[1] Consumer Financial Protection Bureau, Arbitration Agreements: Proposed rule with request for

public comment (May 5, 2015).

[2] Congress previously prohibited arbitration agreements in the largest market that the Bureau oversees—the residential mortgage market—and in July the U.S. Department of Defense (DOD) announced a final rule amending the Military Lending Act's implementing regulations to prohibit consumer lenders from enforcing arbitration clauses against qualifying military borrowers.

[3] 563 U.S. 333 (2011).

[4] Consumer Financial Protection Bureau, Arbitration Study: Report to Congress, pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a) (Mar. 2015).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, § 1028(a), Pub. L. No. 111-203, 124 Stat. 1376, 2004 (2010).

[6] Consumer Financial Protection Bureau, Field Hearing in Albuquerque, New Mexico (May 5, 2016).

[7] "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." 1040.4(a)(2)(i). See also 1040.4(a)(2)(ii) (similar language for agreements with respect to both covered and uncovered products).

[8] In other words, a pre-dispute arbitration agreement that allows a consumer to choose whether to file a class claim in court or in arbitration would be permissible, although an arbitration agreement that permits the claim to only be filed in class arbitration would not be permissible.

[9] *Proposed rule* at 6.

[10] For an illustrative set of examples of persons providing the covered products and services, see the introduction to the Section-by-Section Analysis to proposed § 1040.3(b).

[11] *See* Section-by-Section Analysis to 1040.3(a)(1)(i) and (ii).

[12] Even where the person offering or providing a consumer financial product or service may be excluded from coverage under the proposed regulation, for instance because that party is an automobile dealer extending a loan in circumstances that exempt the automobile dealer from the rulemaking authority of the Bureau under Dodd-Frank section 1029, the proposed rule would still apply to providers of other consumer financial products or services (such as servicers or debt collectors) in connection with the same loan.

[13] 17 C.F.R. § 166.5.

[14] This means that the customer receives a specified disclosure before being asked to sign the pre-dispute arbitration agreement, is not required to sign the pre-dispute arbitration agreement as a condition of receiving the product or service, and is only subject to the pre-dispute arbitration agreement if he or she separately signs it, among other requirements.

[15] For example, any pre-dispute arbitration agreement would need to both satisfy the CFTC requirements to ensure the contract is voluntary and contain the provision mandated by proposed § 1040.4(a)(2).

[16] *See* § 1040.4(a)(2)(iii).

[17] *Proposed rule* at 228-29.

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