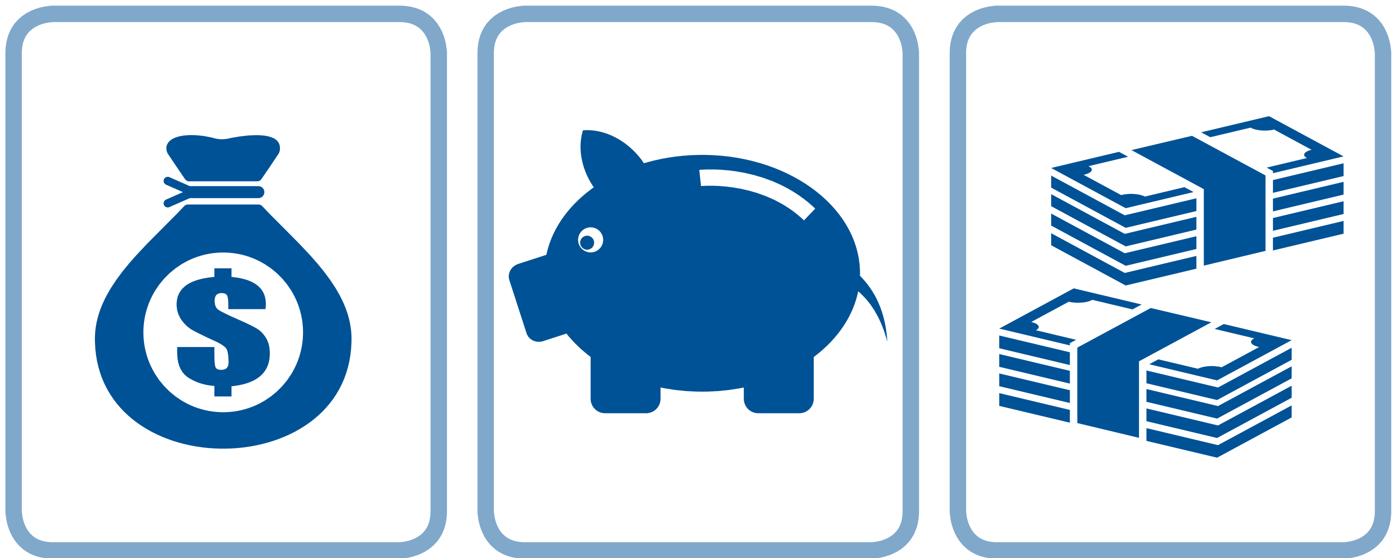

What's a Regulator to Do?

Mandatory Consumer Arbitration, Dodd-Frank, and the Consumer Financial Protection Bureau

By George H. Friedman

The Dodd-Frank Wall Street Reform and Consumer Protection Act addressed fundamental consumer protection issues involving securities, banking, and indeed the US economy. The act, known as Dodd-Frank, also contains language governing the use of predispute arbitration agreements (PDAAs) in consumer financial and investor contracts. Dodd-Frank created the Consumer Financial Protection Bureau (CFPB) and charged the new bureau with studying the use of PDAAs in consumer financial transactions and addressing PDAAs "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…"

This article examines the CFPB's mission under Dodd-Frank as it relates to mandatory use of PDAAs in consumer financial contracts. Often called "mandatory arbitration" and more recently "forced arbitration," the subject is perhaps more nuanced than the reader may realize. The article covers what CFPB must do under Dodd-Frank, what it may do if it so chooses, and what the author thinks the CFPB *should* do. Predicting what CFPB will do and whether it will succeed will not be easy. As that great philosopher Yogi Berra said, "It's tough to make predictions, especially about the future."

What Dodd-Frank Says about CFPB and Arbitration

Let's begin at the beginning by taking a look at precisely what Dodd-Frank says about PDAAs and consumers. The statute carefully defines "consumer" and "consumer financial products and service." Paragraph 15(A) of the statute is a long list covering virtually every conceivable consumer financial product or service except for securities, which is carved out for the SEC and state regulators. And a "covered person" is defined in section 1002(6) as one providing these services or products.

Dodd-Frank *requires* the CFPB to study and report to Congress on the use of PDAAs in consumer financial products and services. Further, the law says the CFPB may promulgate rules that "prohibit or impose conditions or limitations" on the use of PDAAs *if* the aforementioned study supports this action *and* "such a prohibition or imposition of conditions or limitations is in the public

interest and for the protection of consumers." Note that the CFPB's choices are not binary, "yes-or-no" decisions; it can ban PDAAs outright *or* limit their use *or* impose conditions for their use. For example, the CFPB could promulgate a rule that limited PDAA use to a class of transactions (limitation on use) or required that consumers separately initial or click a PDAA (condition for use).[1]

Dodd-Frank takes a different approach to PDAAs used in securities customer-broker contracts. Although the operative language in Dodd-Frank provides guidance similar to that of both the CFPB and SEC about what the agencies are to do about mandatory or forced use of PDAAs, there is a key difference: Dodd-Frank section 921 does not *require* the SEC to do anything about PDAAs in customer-broker contracts. Given the more than 90 mandatory study and rulemaking requirements the SEC has under Dodd-Frank,[2] it is not at all surprising that arbitration is not high on the agency's priorities list.

What has CFPB Done So Far?

The CFPB has been busy in recent months addressing its obligations under Dodd-Frank. The act explicitly bars PDAAs for both mortgage and home equity loans, and early on the CFPB promulgated regulations implementing this change. Similarly, Dodd-Frank section 922 amends the Securities Exchange Act of 1934 to prohibit use of PDAAs in Sarbanes-Oxley (SOX) whistleblower disputes and section 748 amends the Commodity Exchange Act in the same way.

After accepting public comments, the CFPB in December 2013 issued a report titled *Arbitration Study Preliminary Results: Section 1028(a) Study Results to Date*.[3] This 168-page document is not the final report to Congress mandated by Dodd-Frank but is instead the first phase of that endeavor. Essentially, it is a report on what's out there now in terms of PDAAs and consumer financial products and services, principally credit cards, checking and savings accounts, payday loans, and general-purpose prepaid cards, covering 2010 to 2012. The report's key findings (at right) are not exactly earth-shattering. The report stresses that this is not the end of CFPB's study of arbitration.[4]

The CFPB has also conducted "field hearings" on PDAA use, including one in Dallas on December 11, 2013, the same day the preliminary report's major findings were released. The two-and-a-half-hour hearing, which was also webcast, featured a balanced panel that focused on the use of arbitration in the consumer financial area. I came away from the hearing with the distinct impression that the agency's arbitration focus will be consumer financial products and services such as credit cards, payday loans, and car loans, but not securities, as Dodd-Frank provides.

At the field hearing in Dallas, some common themes emerged from those supporting the use of PDAAs in consumer financial products and services and those opposed

Key Findings from the CFPB Arbitration Study

- About 50% of credit card issuers use PDAAs in credit card agreements. The report notes that several large banks settled a major litigation a few years ago and agreed to drop arbitration. Otherwise, this figure would be 94%. Larger banks use them more often than smaller banks or credit unions.
- About 8% of all banks, covering 44% of deposits, include a PDAA in consumer checking account agreements. Larger banks use them more often than smaller and mid-sized banks or credit unions.
- PDAAs are used "across the market" in 81% of prepaid card agreements.
- Almost all PDAAs contain a class action waiver, and some preclude class arbitrations. About 90% of contacts, accounting for almost 100% of loans, have a class action waiver.
- The American Arbitration Association (AAA) is the predominant administrator named in PDAAs for credit cards, checking accounts, and general-purpose prepaid cards.
    - The AAA's yearly average case filings were 415 for the years studied.
    - Consumers were the claim filer in 300 cases a year.
    - About half the credit card cases were cases in which the consumer disputed the debt.
    - Very few of the checking account and payday loan cases were debt collection disputes.
    - About 53% of consumers were represented by counsel. Companies almost always had a lawyer.
    - Almost no cases involved less than $1,000. The average amount in dispute was $13,418, and the median was $8,641. Including filings that did not identify a claim amount and excluding one very large outlier, the average amount in dispute was $38,726, and the median $11,805.
- Most PDAAs studied have carve-outs allowing the parties to go to small claims court. The report notes that only 870 credit card small claims court cases were filed by consumers in 2012 "in jurisdictions with a combined total population of around 85 million..." The report does not theorize as to why.
    - Credit card issuers were "significantly more likely" to sue consumers in small claims court than the reverse.

Dodd-Frank *requires* the CFPB to study and report to Congress on the use of PDAAs in consumer financial products and services. Further, the law says the CFPB may promulgate rules that "prohibit or impose conditions or limitations" on the use of PDAAs *if* the aforementioned study supports this action *and* "such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers."

to it. And there were areas of consensus among all panelists. The chief complaints of those opposed to the use of PDAAs – which they referred to as "forced arbitration" – were the class action waiver problem, PDAAs that were dense and hard to find, a general lack of consumer awareness about the PDAA and the arbitration process, and anecdotal evidence of the arbitration process being used unfairly. They urged the CFPB to get on with the rulemaking process.

The arbitration supporters at the Dallas field hearing stressed that class action *litigation* is not consumer-friendly, with consumers getting cents on the dollar. Recently released data would seem to back them up. The *Wall Street Journal* reported in March that: "Generally, aggrieved investors get only pennies on the dollar. The average settlement amounts to 1% to 5% of shareholder losses, according to the Stanford Securities Litigation Analytics database, which tracks securities litigation since 2000."[5] The arbitration supporters at the hearing argued that arbitration, in contrast to class action litigation, works and that the focus should be ensuring procedural fairness.

The panelists did agree on a few items. Virtually every panelist stated that voluntary, postdispute arbitration is fine, that creating standards of procedural fairness should be a focus, and that improving consumer education is important.

After the hearing, the advocacy group Public Citizen weighed in, issuing a report[6] that urged CFPB to start the process of banning PDAAs. As if to illustrate the problem of hard-to-find consumer PDAAs, a major social media flap erupted in April 2014 over General Mills' imposition of an arbitration clause in its online terms of service. Under the new policy, by engaging in activities such as downloading a recipe or a discount coupon, participating in a contest, or "liking" the company on Facebook, consumers would unwittingly agree to arbitrate. The PDAA was not in the terms of use (TOU); it was contained in a separate "legal terms" area that was linked to the TOU. After several days of withering criticism, General Mills announced that it was rescinding the policy immediately.

What Should CFPB Do?

Having spent a good part of my career interacting with regulators, principally the SEC (while at FINRA, the Financial Industry Regulatory Authority) and state insurance departments (while at the AAA), I have a sense of how they operate – and how they don't. They don't operate in a vacuum. And they do tend to be careful and deliberate. While not partisan or political, regulatory agency leadership is certainly aware of political and social undercurrents. Regulators tend to be careful and deliberate, and therefore act incrementally and avoid radical change. Regulators also stay in close touch with those they regulate, often communicating informally.

Here's what I think CFPB should do:

Complete the Study and Report to Congress: Stating the obvious, first things first. The CFPB should complete the study and issue its final report to Congress before the end of 2014. The final report is the lynchpin for further action; without it, CFPB cannot act. Recent statements from CFPB staff indicate the report will be complete by the end of 2014.

Impose Conditions on PDAA Use: I propose that CFPB write rules that impose conditions on the use of PDAAs in contracts for consumer financial products and services – but not ban PDAAs outright. Specifically, the rules should provide:

- In a consumer financial contract, any predispute arbitration agreement must be clearly identified, optional, and separately signed or clicked by the consumer;
- A consumer cannot be denied goods or services if the consumer declines the arbitration option; *and*
- Clear procedural fairness guidelines must be followed in any consumer arbitration system.

How would this work? Four simple provisions would make for a good CFPB rule:

1. *Consumer choice, but before a dispute arises*
   The consumer should have a choice about whether to submit disputes to arbitration, but this choice should be made when the contract is signed. In my opinion, requiring the parties

to agree to arbitration after a dispute arises is doomed to fail. Why? Because inevitably one party or the other typically has a tactical or strategic reason not to agree to arbitrate after a dispute has arisen. This isn't just my view; there's plenty of research backing me up.[7] Giving the consumer a choice when the contract is signed would give the dominant party an incentive to sell the arbitration process to the consumer. The reverse – requiring all parties to agree to arbitration after a dispute arises – could actually harm consumers, because businesses offering financial products or services would sometimes decline to arbitrate, making the dispute resolution process unpredictable for the consumer.

2. *Clear, knowing, and voluntary agreement to arbitrate*
   To ensure that consumers knowingly and voluntarily agree to arbitrate, CFPB's rule should require that the individual separately initial/click the arbitration agreement. As I've stated in the past, "The Supreme Court having held many times that the arbitration agreement is a separate contract, let's treat it that way. By so doing … [we] would eliminate any uncertainty that the weaker party didn't know what they were getting into."

3. *Promote web-based arbitration systems*
   An arbitration system that steers consumers to travel to a "brick and mortar" arbitration hearing to resolve disputes that typically involve modest amounts is not a good idea.[8] It's a particularly poor one when the consumer's interactions with the business have been entirely online. I suggest giving the consumer the choice of conducting the arbitration via the cloud, using one of the several online dispute resolution providers with varying platforms available to handle the entire arbitration or mediation process online.[9] I am involved with one such platform – Arbitration Resolution Services, a cloud-based dispute resolution system.

4. *Establish procedural fairness criteria*
   The new rules should also require that any consumer or employee arbitration system adhere to basic standards of procedural fairness. These should not be difficult to find.

For example, the CFPB should look to the standards set forth by the Supreme Court in *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 30-31 (1991): "… competent, conscientious, and impartial arbitrators;" limited discovery; written decisions; and the power to fashion equitable relief.

Similarly, the Consumer Due Process Protocol[10] has standards that were developed years ago to ensure procedural fairness and include requirements for independent administration, independent neutrals, reasonable cost, reasonable discovery, right to counsel, a reasonably convenient location for hearings, fair hearings (with the understanding that smaller claims can more efficiently be accomplished through electronic or telephonic means or document review), the availability of the same relief as in court, and explained awards upon request.

There are also models in academia. Professor Tom Stipanowich has developed an "arbitration fairness index," that has as its major elements: (1) meaningful consent, clarity, and transparency; (2) independent and balanced administration; (3) quality and suitable arbitrators; (4) fair hearing; and (5) fair outcomes (awards and remedies).[11] Transparency should include ADR providers posting data on their consumer arbitration programs on their web sites, something already required by some states, such as California.

There are also good exemplars of fairness in existing arbitration rules, such as those of FINRA and the American Arbitration Association. FINRA's rules (detailed on the next page) in particular are extremely investor-friendly.[12] While one may attribute this to the SEC's oversight of FINRA, all the features in these rules were proposed by FINRA, not by the SEC.

In particular, the CFPB should note the last investor-friendly provision, FINRA's Rule 12204, which allows an investor to opt out of arbitration and instead participate in a class action. Given the recent decisions by the Supreme Court allowing PDAAs to contain class action waivers,[13] this provision in a proposed CFPB rule would be crucial, especially if the agency decides not to ban PDAAs but to impose terms for their use.

The chief complaints of those opposed to the use of PDAAs – which they referred to as "forced arbitration" – were the class action waiver problem, PDAAs that were dense and hard to find, a general lack of consumer awareness about the PDAA and the arbitration process, and anecdotal evidence of the arbitration process being used unfairly.

What Should the SEC Do?

As I've noted, the SEC also has a role in regulating PDAAs. In my view, it is politically untenable for the SEC to do absolutely nothing about PDAAs, especially in light of the pressure that's been brought to bear on this issue by Congress, the association of state securities administrators, the bar association for lawyers who represent customers in securities arbitrations, and others. My view is that, at a minimum, the SEC will study the subject (it has since 2011 been accepting comments on the topic), and eventually require some changes (impose limits or conditions). It will not, in my opinion, ban PDAAs outright. Think about it. To ban PDAAs in customer-broker contracts, the SEC would have to find that doing so is "in the public interest and for the protection of investors." Essentially, the SEC would be saying: "We've been supervising customer-broker arbitration for decades. But, you know, we just realized it's a terribly unfair system." On the other hand, a finding that says, "We've studied customer-broker arbitration and we've concluded that it's a fair process. But, you know, these few changes will make it even better" is politically tenable.

Conclusion

My advice to CFPB is to tread carefully and stay focused on its core mission of protecting consumers. Otherwise, to quote composer George Fairman's World War I song, that mission can become "I Don't Know Where I'm Going, But I'm On My Way." ◆

Endnotes

1 On May 22, 2014, the Bureau Arbitration Fairness Act (H.R. 4734) was formally introduced in the US House of Representatives and referred to the Financial Services Committee. The legislation would amend the Dodd-Frank Act "to repeal the authority of the Bureau of Consumer Financial Protection to restrict mandatory pre-dispute arbitration." H.R. Res. 4734, 113th Cong. (2014).

2 *See Implementing Dodd-Frank Wall Street Reform and Consumer Financial Protection Act: Accomplishments,* http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml (last visited Mar. 4, 2014).

3 Consumer Fin. Prot. Bureau, Arbitration Study Preliminary Results: Section 1028(a) Study Results to Date (2013), *available at* http://files.consumerfinance.gov/f/201312_cfpb_arbitration-study-preliminary-results.pdf.

4 On May 29, 2014, CFPB asked for comments on a follow-up phone survey on ADR and credit cards. Comment Request, 79 Fed. Reg. 103 (May 29, 2014).

5 Julie Steinberg, *Do Class Actions Benefit Investors?* Wall St. J. Online (Updated March 2, 2014 8:47 p.m. ET), *available at* http://online.wsj.com/news/articles/SB10001424052702304585004

FINRA's Investor-Friendly Rules

- FINRA serves the claim on the broker with whom the investor has a complaint. This rule saves the investor time and money. Typically, other dispute resolution providers do not serve the claim on the respondent.
- The fee structure favors the investor;
- The hearing is sited where the investor lived when the underlying events occurred;
- There are hearing locations in all 50 states (at least one in each state);
- The process includes a motion-to-dismiss rule that severely limits motions made prior to the claimant resting his/her case and provides sanctions for frivolous motions;
- Parties have access to the FINRA discovery guides and codified discovery provisions in the Code of Arbitration Procedure for Customer Disputes;
- The customer has the option of an all-public panel;
- In close calls, if the investor wants an arbitrator removed for bias, he or she is removed;
- FINRA will enforce arbitration awards in the investor's favor;
- Awards are public, in a searchable database, and available free of charge on the web; statistical data on the program are available on the web; and
- Investors can opt out of arbitration and into a class action.

> In my view, it is politically untenable for the SEC to do absolutely nothing about PDAAs, especially in light of the pressure that's been brought to bear on this issue by Congress, the association of state securities administrators, the bar association for lawyers who represent customers in securities arbitrations, and others.

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6 Christine Hines, Pub. Citizen, Righting a Financial Wrong: Debt Settlement Services, Private Student Lenders, and Auto Lenders Use Forced Arbitration to Escape Accountability When They Harm Consumers (2014), *available at* http://www.citizen.org/documents/righting-a-financial-wrong-forced-arbitration-report.pdf.

7 *See generally* Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act,* 13 U. Pa. J. Bus. L. 59, 104-06 (2010).

8 *See* George Friedman, *"Road Trips" in Consumer Arbitration: There Must Be a Better Way*, Arbitration Resolution Serv., Inc. (Posted on 9/15/2013), https://www.arbresolutions.com/road-trips-consumer-arbitration-must-better-way/#.U8QpkPldX84.

9 The ARS rules governing consumer disputes assume that cases will be decided by electronic review of documents without the need for a hearing. But if a party wants to have a hearing, he or she can require a telephonic one or one conducted by video-conference under section 3.3(c) of the rules. Arb. Resol. Serv. Rules & Regulations § 3.3(c), *available at* https://www.arbresolutions.com/static/b2crules (Member login required).

10 *Arbitration Consumer Due Process Protocol*, http://www.in.gov/dfi/2623.htm (last visited June 12, 2014).

11 *See* Thomas Stipanowich, *The Arbitration Fairness Index: Using a Public Rating System to Skirt the Legal Logjam and Promote Fairer and More Effective Arbitration of Employment and Consumer Disputes*, 60 Kan. L. Rev. 985, 1024-25 (2012).

12 *See 12000. Code of Arbitration Procedure for Customer Disputes,* FINRA, http://finra.complinet.com/en/display/

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