Excellence in Third-Party Vendor Management

Michael L. Mallow, Chair
Consumer Protection Defense Department
Loeb & Loeb LLP

Michael A. Thurman, Founder
Thurman Legal

Overview

An Evolving Regulatory Environment

About the CFPB

Finance Company Liability for Service Providers

CFPB’s New Rules For Managing Service Providers

The Three Critical Stages of Vender Compliance

Stage 1: Entering Into The Relationship

Stage 2: Execution of the Relationship

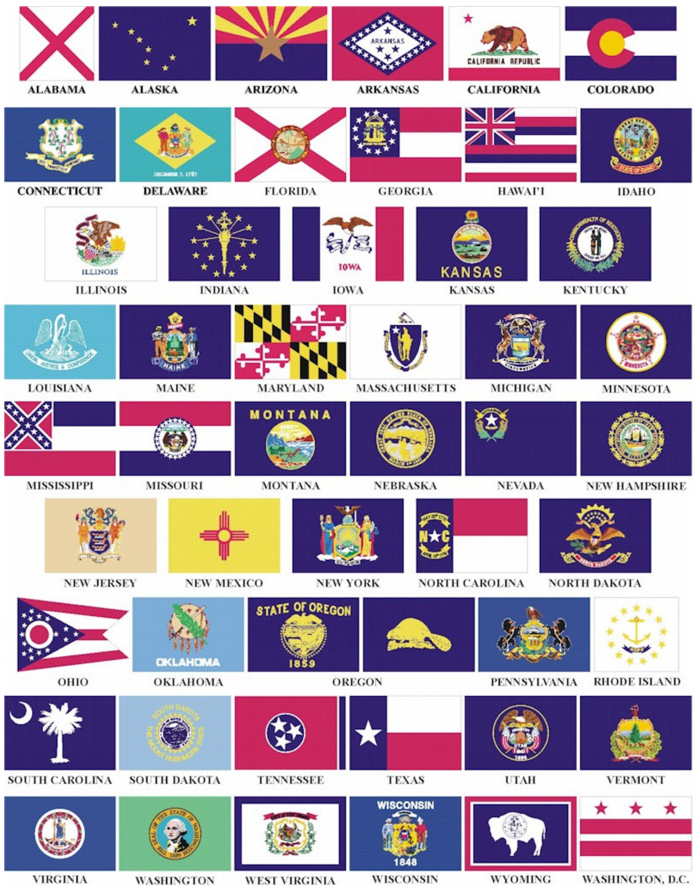
Stage 3: Resolving Problems If Things Go Wrong

Indemnification Clauses??

Questions

An Evolving Regulatory Environment

The Perennial Auto Finance Industry Regulators



FEDERAL TRADE COMMISSION ★ UNITED STATES OF AMERICA ★ MCMXV

THE BIG GORILLA

An Evolving Regulatory Environment

THE BIGGER GORILLA!

cfpb

Consumer Financial
Protection Bureau

About the CFPB

- Washington's newest federal agency
- Created by the Dodd-Frank Act of 2010
- Separately-funded directly by the Federal Reserve
  - Annual budget of **$570 million** for 2014
  - Independent of the Congressional appropriation process
  - Headed by single Director appointed by the President
- More than **$1.56 billion** in consent orders to date
- Expect to have 1,624 employees by the end of 2014
  - **About half are legal, supervision and enforcement**
  - **90% of those are attorneys and paralegals**

CFPB's Purpose

- Primary rulemaking, supervisory and enforcement authority over entities offering consumer financial products and services
  - Including banks and "covered" non-banks
- Responsible for ensuring that markets for consumer financial products and services are fair, transparent and competitive

Consumer Financial
Protection Bureau

Key Definitions

- "Consumer financial products or services"
  - Includes extending credit, servicing or brokering loans, real estate services, deposits, stored value, check cashing, payment processing, credit report and debt collection
    - **Including Auto Loans and Leases**

- "Covered persons"
    - Entities that offer or provide "consumer financial products or services" **as well as their service providers**

"Covered Persons"

Any person or entity that offers or provides a "consumer financial product or service"

Includes:

- banks, thrifts, and credit unions with assets over $10 billion
- consumer finance lenders

“Covered Persons”

- financial and investment advisors that are not registered with the SEC
- payday lenders
- credit counselors
- broker-dealers, non-depository trust companies and deposit intermediation services
- money services businesses, wire and money transmitters
- certain sellers or issuers of stored value cards and instruments
- **Service providers -** ***although auto dealers are expressly excluded, service providers are included in the definition of “covered persons”***

Finance Company Liability for Service Providers

A "Service Provider" is:

> "any person that provides a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service."

12 U.S.C. § 5481(26).

A "material service" includes *but is not limited to* designing, operating or maintaining a consumer financial product or service **or processing transactions** relating to a consumer financial product or service.

Finance Company Liability for Service Providers

Includes all providers of outsourced services:

- Marketers
- Debt collectors
- Repossession agents
- Remarketers
- Dealers?
  - FTC has been attacking dealers lending-related activities
  - Doesn't necessarily spare manufacturers/distributers from CFPB scrutiny on the same issues

CFPB'S New Rules for Managing Service Providers

Supervised banks and nonbanks must the manage risks of service provider relationships, including:

- Must verify that service provider understands and is **capable of complying** with Federal consumer financial laws
- Must request and **review service provider's policies, procedures, internal controls, and training materials**
- Must take steps to ensure service provider conducts **appropriate training** and **oversigh**t of its employees or agents

Source: CFPB Bulletin 2012-03 (April 12, 2012)

CFPB'S New Rules for Managing Service Providers

- **Service provider contracts** should include:
  - Clear expectations about the service provider's compliance requirements
  - Appropriate and enforceable consequences for violation of compliance-related responsibilities
- Must establish internal controls and ongoing monitoring to determine whether the service provider is complying with Federal consumer financial law.
- Must take prompt action to respond to any problems identified through the monitoring process.

Source: CFPB Bulletin 2012-03 (April 12, 2012)

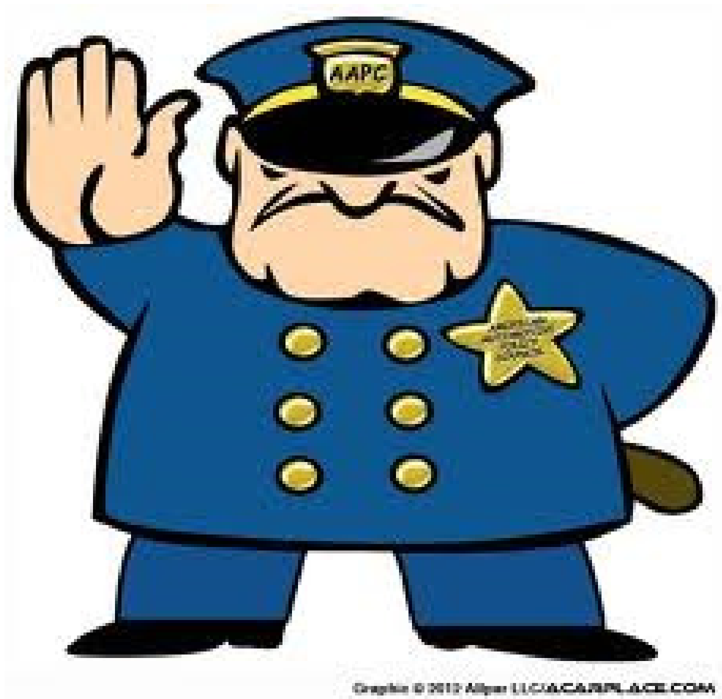
Service Provider Liability

FTC Telemarketing Sales Rule (16 C.F.R. Part 310)

- If telemarketing is involved (*including debt collectors*), service providers can be liable for providing "material assistance" to a person or company that violates provisions of the TSR.
- **Both** the finance company as well as the service provider can be held responsible for violations.

TIME OUT!!

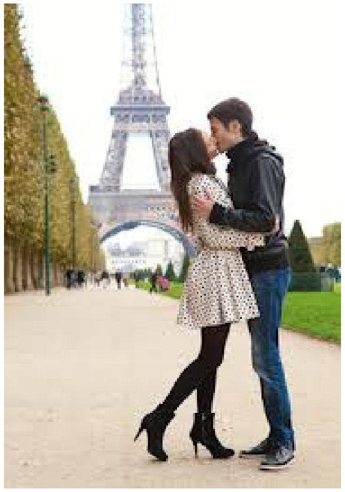
So that's what the law says.



But what the #@%&* does that mean?

The Three Critical Stages of Vendor Compliance

1. Entering Into The Relationship!



2. Execution of the Relationship!

3. Resolving Problems If/When Something Goes Wrong!

Stage 1: Entering into the Relationship

Proposed Outsourcing Partners:

- **Quantum Motors Credit Corporation** – a wholly-owned subsidiary of Quantum Motors, manufacturer of the new “Terabus” multiphibious, photon-drive vehicle.

- **Associated RepoSell** – an operator of a collection, recovery, rehabilitation and resale system, powered by the recently-patented “VersaMaxx” mobile app.

Stage 1: Entering into the Relationship

<u>First: Evaluate the Risks of Outsourcing the Task:</u>

1. Quantum must analyze the risks posed to Quantum of the tasks to be performed by Associated:
   - Should the tasks even be outsourced in the first place?
   - Are these “critical activities”?
   - If so, what resources need to be assigned to manage the outsourced activity?

2. Must be reviewed, approved (and documented) by the Board or senior management if there is no Board.

<u>Source:</u> Bulletin 2013-29, Office of the Comptroller of the Currency (OCC)

Stage 1: Entering into the Relationship

Vetting Associated as a Potential Service Provider:

2. Quantum must evaluate to determine Associated's:
   - Ability to deliver the proposed service on behalf of Quantum, and
   - Awareness of and capability of complying with applicable state and federal consumer financial laws and regulations.

- ***The degree of Quantum's due diligence should be commensurate with the level of risk and complexity of the third party relationship.***
- ***More extensive due diligence is needed if the service provider's role involves critical activities.***

Stage 1: Entering into the Relationship

Associated's Ability to Deliver the Services:

- Review Associated's reputation and past performance in the industry, including current and past contractual relationships, potential bottlenecks or other limitations on its capabilities.
- Evaluate the suitability of its systems for collection, recovery, rehabilitation and remarketing of Quantum's products and ability to deal effectively with Quantum's customers.
- Evaluate risks to Associated's ability to perform based on any operational or legal challenges to its technology, including, for example, wireless coverage issues, susceptibility to coverage or power outtages, availability and sufficiency of back up systems, patent disputes, etc.

Stage 1: Entering into the Relationship

<u>Associated's Ability to Comply With The Law:</u>

- Review Associate's policies and procedures relevant to complying with applicable state and federal laws.
- Evaluate Associated's (and its agents') current and prior litigation history, regulatory archives and internal complaint monitoring and resolution records.
- Evaluate publicly-available sources of complaint information:
  - Better Business Bureau website
  - CFPB Company Portal
  - Other websites such as www.ripoff.com, www.complaints.com, www.scam.com, www.scambusters.com, etc.
- Review Associated's (and its agents') licensing records.

Stage 1: Entering into the Relationship

<u>Review and Approval by the Board/Senior Management:</u>

- Quantum's Board/senior management should review the evaluation of Associated's suitability:
  - If results don't meet expectations, recommend that the proposed vender make appropriate changes, find an alternate vender, conduct the activity in-house, or discontinue the activity.
  - If necessary, before approving the new vender, the Board should direct:
    - Additional investigation be conducted, if warranted, before approving Associated as a new vender.
    - Allocation of additional resources and/or additional procedures to be instituted, if necessary, for monitoring Quantum, especially if the provider will be involved in critical or sensitive activities.

Stage 1: Entering into the Relationship

Contractual Relationship with Associated:

- Spell out all rights and responsibilities of the parties:
- Prior approval of the Board or senior management if the relationship will involve ***critical activities***.
- Vender agreements should be reviewed/approved by the Board annually, particularly those involving **critical activities**, to ensure they continue to address pertinent risk controls and legal protections.
  - If problems or gaps are identified, Quantum should seek to renegotiate the contract at the earliest opportunity.
  - If the vender will not agree to renegotiate the contract, Quantum should commence a search for an alternative provider and terminate the existing agreement at the earliest prudent opportunity under the terms of the operative agreement.

Stage 1: Entering into the Relationship

<u>Contractual Relationship with Associated:</u>

Key Requirements:

- Obligation to comply with state and federal laws, regulations
- Ability to obtain, access and inspect Associated's:
  - Policies and procedures
  - Complaint and response files
- Obligation to provide periodic compliance certifications
- Mandatory notification of:
  - Regulatory investigations or enforcement actions
  - Litigation against Associated

Stage 1: Entering into the Relationship

<u>Contractual Relationship with Associated (cont.):</u>

Additional Key Requirements:

- Ability to impose:
- Sanctions if Associated fails to comply with obligations
- Termination of agreement if Associated fails to comply

Stage 2: Executing the Relationship

Monitoring Associated's Contractual and Legal Compliance

1. **Sufficient resources** must be devoted to adequately monitor Associated's compliance with the terms of the contract and the applicable state and federal laws.
   - More comprehensive monitoring is necessary when the third-party relationship involves **critical activities**.
2. **Sufficient staff** with the necessary expertise, authority, and accountability should be devoted to oversee and monitor the third party commensurate with the level of risk and complexity of the relationship.

Stage 2: Executing the Relationship

3. **Periodic on-site visits** should be conducted to understand fully Associated's operations and ongoing ability to meet contract requirements

- The results and any responses generated by these visits should be documented.

4. The monitoring should focus on Associated's ability to comply with Quantum's agreements, including :

- **Quality and sustainability of Associated's controls**
- Ability to comply with performance metrics and other contractual terms in the agreement
- Ability to comply with legal and regulatory requirements.

Stage 2: Executing the Relationship

5. Significant issues or concerns arising from ongoing monitoring should be escalated to senior management/the Board, including:

- Increases in risk, material weaknesses and repeat audit findings;
- Deterioration in Associated's financial condition;
- Security breaches, data loss, service or system interruptions, or
- Other compliance lapses.

6. Based on the results of the ongoing monitoring and internal control testing, management/the Board should respond to issues when identified.

Stage 2: Executing the Relationship

7. Senior management/the Board should ensure that the controls designed to manage risks from third-party relationships are tested regularly, particularly where critical activities are involved.

8. Senior management/the Board should also assess existing third-party relationships on an annual basis to determine whether the nature of the activity performed constitutes a critical activity.

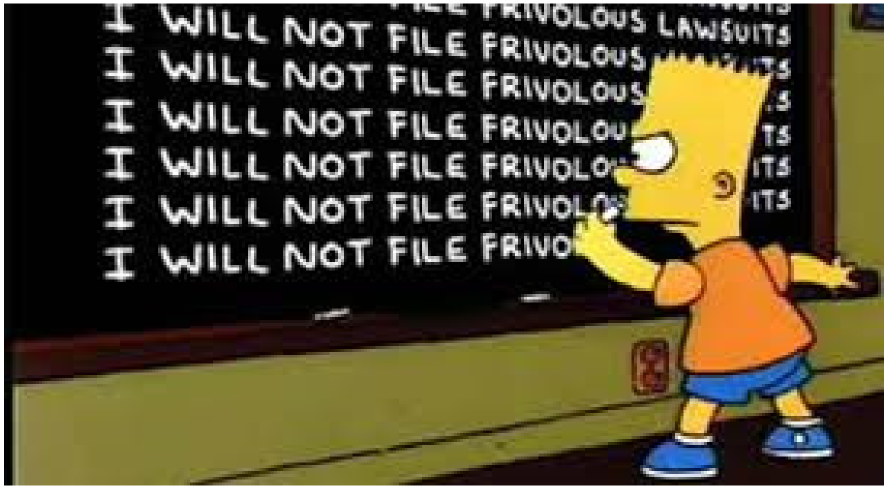
- These annual assessments should be calendared and reflected in the management/Board's minutes.

What Could Possibly Go Wrong?

- Policies and procedures
- Operations
- Complaints
- Compliance
- Enforcement
- Lawsuits
- Regulatory investigations and actions

If we do all that stuff, won't we get sued?

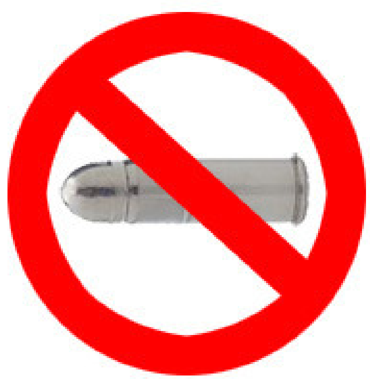
- Control over service provider's activities?
- Independent contractor defenses?
- Vicarious liability?



Indemnification Clause? Not So Fast!!

Many companies believe that they have a "silver bullet" from potential liability costs in the form of indemnification clauses in their marketing and/or other third-party vender agreements.

- Civil penalties are excluded in CFPB consent orders!
- CFPB routinely bans companies from seeking indemnification from other parties.



Questions?

Thank You!

Michael L. Mallow
mmallow@loeb.com
(310) 282-2287

Michael A. Thurman
michael@thurman-legal.com
(626) 399-6205

Follow on Twitter: @CPD_Attorney