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Compliance Insights

Your monthly compliance news round-up

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DOD Issues Additional Guidance Regarding MLA Amendments

In December 2017, the Department of Defense (DoD) issued an interpretative rule amendment to its regulation implementing the Military Lending Act (MLA). The DoD amended its MLA regulation in July 2015, primarily to expand the scope of the credit products and services subject to the regulation's protections. The amendment provides additional guidance to creditors, in the form of questions and answers, building on previous guidance provided in August 2016 to address questions received from the industry and the broader public regarding the MLA regulatory requirements. The amendment does not change the DoD's MLA regulation or impose new requirements on creditors.

The MLA was enacted in 2006 to afford active-duty service members and their dependents (including spouses, children, and other specified dependents) certain protections related to specific types of consumer credit transactions. Such protections include limiting the annual percentage rate (APR) that may be charged to a covered borrower in a given credit transaction, as well as the provision of certain disclosures.

The DoD's published amendments to the MLA in July 2015 extended the protections afforded to such borrowers to a broader range of closed-ended and open-ended credit products and services, including credit cards, installment loans, payday loans, and vehicle title loans. The DoD further restricts the APR charged to service member borrowers on these products and services to 36 percent and prohibits various practices, such as mandatory arbitration or onerous legal notice requirements or requiring waiver of the service member's rights under the Servicemembers Civil Relief Act (SCRA).

To clarify further its amendments, the DoD issued a revised set of questions and answers, specifically updating the responses previously provided to the industry on three questions and answers, and providing an additional question and answer, as follows:

1. The DoD clarified that, in an extension of credit used for the purchase of a motor vehicle or other personal property where the credit amount exceeds the purchase price of the motor vehicle or personal property, the transaction is still considered to be exempt from the MLA so long as the additional cost is expressly related to the vehicle or personal property and not the credit transaction that finances the purchase transaction. For example, financing of gap insurance would disqualify a loan for a motor vehicle purchase from the exemption.

2. The DoD clarified that the ability of a borrower to grant a creditor a security interest in his or her deposit account may be permissible under the MLA. Creditors continue to be prohibited, however, from using the borrower's account information to create a remotely created check or a remotely-created payment order or use a post-dated check to collect payments.

3. Similarly, creditors may be permitted to exercise a statutory right, or a right arising out of a security interest granted by a borrower, to take a security interest in a deposit account.

4. Lastly, the MLA provides a safe harbor to creditors whereby a creditor that confirms an applicant's military status in the DoD's MLA database, and creates and maintains a record of the information obtained, will not be liable and will be subject to providing the required terms of credit to military members or their dependents.

   In its additional guidance, the DoD clarified that creditors can qualify for the safe harbor when they make a timely determination regarding the military service status of a borrower at the time the borrower either initiates the transaction or applies to establish an account, or anytime during a 30-day period prior to such action. Creditors do not have to make this determination simultaneously with the consumer's submission of an application or exactly 30 days prior to taking an action. The DoD clarified that a creditor can determine a consumer's status any time prior to their application, but no more than 30 days prior to their application.

Financial institutions and other non-bank lenders that offer consumer credit products and services covered by the MLA should review the DoD's updated interpretations, thoroughly review their current practices, and take steps to enhance or implement controls, as necessary, to mitigate and manage associated risks.

FINRA Guidance Issued on Customer Due Diligence Rule for Broker-Dealers

In November 2017, the Financial Institution Regulatory Authority (FINRA) issued a regulatory notice providing guidance to broker-dealers regarding implementation of the Financial Crime Enforcement Network's (FinCEN) final rule on Customer Due Diligence (CDD), which was issued in May 2016 and becomes effective in May 2018. FinCEN's rule requires covered entities, including broker-dealers, to, among other things, identify and verify the identity of the beneficial owners of all legal entity customers at the time a new account is opened. The rule establishes a fifth pillar for financial institutions to address in their Bank Secrecy Act/ anti-money laundering (BSA/AML) compliance programs (in addition to policies, procedures and systems of internal controls; independent testing; designation of individual(s) responsible for BSA/AML compliance; and ongoing training).

The key provisions of the CDD rule, and the guidance provided by FINRA to broker-dealers regarding their implementation, include:

- Identifying and verifying the identity of beneficial owners of legal entity customers. For broker-dealers, this means taking steps to ensure that the firm identifies:
    - All underlying beneficial owners of legal entity brokerage accounts who maintain at least a 25 percent ownership in the legal entity; or
    - Any single individual with significant responsibility to control, manage, or direct a legal entity customer, including an executive officer or senior manager (*e.g.*, a chief executive officer, chief financial officer, chief operating officer, managing member, general partner, president, vice president, or treasurer), or any other individual who regularly performs similar functions (*i.e.*, the control prong).
- Understanding the nature and purpose of customer relationships. For broker-dealers, this means taking steps to know their brokerage customers, minimally including and understanding of the purpose of the brokerage account and the anticipated and expected transactions types (for example, trading equities, mutual funds, options, etc.; buying on margin; funds transfer transactions; ACH transactions; and direct at-fund purchases and sales, etc.)

- Conducting ongoing monitoring of transaction activity in customer accounts. For broker-dealers, this includes review of alerted activity in brokerage accounts as well as system generated manual exception reports that detail certain types of brokerage transactions that cannot be monitored electronically to ensure the types of transactions and activity appear to align with expected activity for the brokerage customer (*i.e.*, types of securities traded, money movement, and margin/Regulation T, etc.).

Of note, while the CDD rule does not change the requirements specifically outlined in FINRA Rule 3310 for broker-dealers (which tasks member firms to develop and implement a written BSA/AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and implementing regulations), the CDD rule does amend the minimum statutory requirements to which broker-dealers must adhere by requiring member firms to maintain risk-based procedures for conducting CDD. In its guidance, FINRA encourages member firms to update their existing BSA/AML programs to demonstrate adherence to the requirements of the rule. FINRA further indicated that it continues to evaluate whether further updates and guidance will be necessary to better align FINRA Rule 3310 and the CDD rule.

Broker-dealers should take steps to ensure that a single, consistent view of its customers is maintained throughout their organizations. Broker-dealers should focus on assessing how existing systems and technology can help integrate customer risk profiles with ongoing transaction monitoring to better inform and report suspicious activity identification practices. To aid integration of these BSA/AML compliance program elements, broker-dealers should ensure that risk-based policies and procedures relating to ongoing and event driven reviews, account opening practices, and aggregation for reporting are established, documented and communicated.

Arbitration Agreements After Congress's Invalidation of the CFPB Arbitration Rule

In October 2017, the U.S. Congress passed a joint resolution to invalidate a July 2017 rule implemented by the Consumer Financial Protection Bureau (CFPB) to regulate the use of mandatory arbitration clauses in consumer financial products and services. The rule was set to go into effect in 2018; however, using its authority under the Congressional Review Act (which provides to it the ability to review new federal regulations issued by government agencies and overrule, or invalidate, a regulation by passage of a joint resolution), Congress invalidated the rule. The action further restricts the CFPB from reissuing the rule in substantially the same form in the future.

While the CFPB rule did not prohibit financial institutions from including arbitration clauses in the contracts for such products and services, it did prohibit such clauses from preventing consumers from participating in a group, or class action, legal action against a financial institution. Proponents of the CFPB rule had argued that access to class action lawsuits is essential to protecting the rights of consumers, deterring harmful behavior by financial institutions, and enabling consumers to recover monies they would otherwise forfeit. Critics of the rule, including the U.S. Department of the Treasury, argued that arbitration offers a simpler and more efficient process for resolving disputes and that the rule would impose significant, incremental costs to financial institutions, which in turn would be passed on to consumers broadly. Congress concurred with the rule's detractors, in a move widely considered to be a potential pre-cursor to future actions by Congress and the administration to slow the progress of new, or repeal existing, financial regulations.

Though financial institutions are no longer required to implement the CFPB's rule and they retain the option of including mandatory arbitration clauses in their contracts, they should nonetheless consider evaluating what approaches to arbitration are the most appropriate for their institution, customers, and products and services, consistent with the concept of fair and responsible banking. Financial institutions should take steps to ensure that their contracts that include arbitration agreements are fair and equitable in order to avoid the arbitration clauses from being found as unenforceable by the courts.

Last, arbitration agreements should continue to avoid language that could be construed as overly broad or unduly restrictive, and should be clearly and conspicuously disclosed to consumers in the contracts for consumer financial products and services. On this last point, practices such as providing the arbitration agreement as a stand-alone document and using electronic contracts that provide a clear method by which consumers can demonstrate their review and acceptance of the contract's terms may help consumers readily understand the terms of the arbitration to which they are agreeing.

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