Consumer Finance Monitor (Season 6, Episode 26): The Legality of "Regulation by Enforcement" and Other Considerations, A Discussion with Special Guest, David Zaring, Professor, Wharton School of the University of Pennsylvania

Speakers: Alan Kaplinsky and David Zaring

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly podcast show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm. And I'm your host, Alan Kaplinsky, former practice group leader for 25 years, and now senior council of the Consumer Financial Services Group at Ballard Spahr. And I'm very pleased to be moderating today's program.

For those of you who want more information, don't forget about our blog, which also goes by the name of Consumer Finance Monitor. We've hosted our blog since 2011, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com.

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So let me introduce our guest today, and then I'm going to tell you a little bit about the topic that we'll be covering today. So I'm very pleased to have as our guest today, David Zaring. David is the Elizabeth F Putzel professor in the Legal Studies and Business Ethics Department at the Wharton School, I should say my alma mater many years ago. He writes at the intersection of financial regulation, international law, and domestic administration. He's written over 50 articles, including publications in the Chicago, Cornell, Michigan, NYU, and Virginia Law Reviews and a number of international law journals. He's the author of the Globalized Governance of Finance. In addition to teaching at the Wharton School, he has previously taught at the Bucerius, Cambridge, Penn, Vanderbilt, and Washington Elite Law Schools. He has testified on financial regulation before Congress on multiple occasions, and he has written an occasional column on the subject for the New York Times. A deal, book, art column I should say.

So today we're going to be talking about a topic that often gets mentioned in connection with the agency that our listeners follow every move of, namely the Consumer Financial Protection Bureau or by shorthand, we'll call it the CFPB. And that's the topic of regulation by enforcement. When that term is used, it's not used in a complimentary fashion, at least by people that are within the consumer financial services industry. It's meant as a criticism of the CFPB.

There is another criticism of the CFPB that we won't be covering today, but I would say the other criticism is even harsher. And that is, they very infrequently issue regulations that is formal regulations that have gone through the required procedure that is within the Administrative Procedures Act. Instead, they issue things that are a lot less formal and they don't solicit comment or input on these edicts that come down. They are issued unilaterally by the director of the CFPB, Rohit Chopra. They're issued in the form of guidance, no action letters. Public speeches, statements on the CFPB blogs, advisory opinions. The label that is put on these documents is endless and their issuance seems endless. Almost every day in the week, there's something new coming down that is unexpected and that gives the industry collective shivers.

Well, anyway, today we're going to focus on regulation by enforcement, and David is a true expert in this area. He has recently co-authored a law review article that I believe will be published soon and David will tell us more about that. But let's start today, David, with I guess a basic question and that is, when you use the term regulation by enforcement, what is it?

David Zaring:

Yeah. And thanks for having me. It's a pleasure to be on the podcast. So you were talking a little bit earlier about one thing that agencies do that I think can often upset regulated industry, which is regulation by guidance. That's where you put out something that doesn't have the force of law, but suggests how an agency is going to approach some regulatory issue in the future. And I think industry finds that sort of regulation by guidance to be frustrating because it's really hard to get judicial review of it. And you get hints about what the agency might be doing next, but you don't get anything you can sort of grab hold of and take to court if you're worried about it.

Regulation by enforcement is a little different. But it's not totally unrelated to regulation by guidance. Regulation by enforcement is where an agency, instead of proceeding by a rule making where it goes through notice, comment, the APA procedures, and then gets judicial review, tries to make regulatory policy through adjudication. They'll bring a case against some industry participant in either administrative proceedings before the agency, maybe before an administrative law judge, or they'll go sue them in federal court. And so that's what we're talking about when we're talking about regulation by enforcement. The agency's making policy not with a rule, not with something comprehensive, but rather with a lawsuit, and that's regulation by enforcement.

Alan Kaplinsky:

All right. How about giving us some examples of what agencies have done? And I know you've looked at a variety of agencies and I know in particular you focus on the FCC as one agency. And I'd like our audience to hear of examples.

David Zaring:

Yeah, so let me give you an SEC example, and let me give you a CFPB example. So an SEC example of regulation by enforcement would be, allegedly, at least, people in that industry have been quite upset about this sort of thing, would be the SEC suit against Coinbase, I guess he was sort of like a administrator there.

Alan Kaplinsky:

They’re a crypto exchange, I believe?

David Zaring:

Yeah. Coinbase is a crypto exchange, and one of the questions that the crypto industry has constantly been wondering is what kind of crypto is legal and consistent with the SEC security laws and what isn't? So Coinbase, it's a crypto exchange and it's tried to be in general regulatorily compliance. And it recently received a wells notice from the SEC, which means that the SEC is about to sue it for securities law and non-compliance.

But before it did that, it brought a case of insider trading against a Coinbase administrator for basically trading on cryptocurrencies that Coinbase was about to list. And so the idea is when Coinbase, which is a really pretty big exchange, would list these cryptocurrencies, the currencies would often go up in value. It was sort of an imprimatur of sort of stability and an endorsement by the larger crypto community that this cryptocurrency is legit. So when the SEC sued this guy for trading before Coinbase announced that it was going to list a particular kind of cryptocurrency on its website and let people buy and sell it there, basically the SEC was saying that the currencies listed on Coinbase are securities because you can't have an insider trading without a trade in securities.

And so by suing this one guy, the SEC was saying, "We think that Coinbase is listing securities. You can only do that if you're a registered exchange. Coinbase hasn't registered with the SEC." And so this is an example of regulation by enforcement. It's using one insider trading action to basically take a bunch of cryptocurrencies and tell the sort of sponsors of those cryptocurrencies that the SEC thinks they're securities and should be registered with the SEC. And to tell Coinbase itself,

which was offering these securities for sale, they did have to register with the SEC. And so lots of implications for the broader cryptocurrency industry and yet encompassed in this one case against this one guy who was alleged to have committed insider trading.

Okay, so that's my SEC example. Should I go on to talk a little bit about the Credit Acceptance Corporation case?

Alan Kaplinsky:

Yeah, sure, sure.

David Zaring:

Okay. So this is something I wouldn't say I know as the heart of what I do, but the idea behind the Credit Acceptance Corporation Enforcement action is basically that the CFPB here was filing suit against a particular company that basically bought car loans from used car sellers. And the idea was kind of the act of purchasing car loans was a violation of the consumer protection laws. And if that's true, it's not just credit acceptance which is in trouble, it would be the entire sort of secondary market in used car loans. And so that would be a big deal.

And once again, the idea is the agency isn't sort of setting up a bunch of rules for the resale of car loans, used car loans, to loan servicers like Credit Acceptance Corporation. It's not passing some regulations that would sort of govern how that industry conducts itself, but rather it's engaging in an enforcement action against one loan servicer that really throws the business models of the entire sector of the car loan servicing industry into doubt.

Alan Kaplinsky:

And I might add in this case, the industry, or credit acceptance corporation, was making appropriate disclosures under the Truth and Lending Act to consumers. But the claim was that a certain amount of the amount of money being paid by the dealer to the sales finance company should have been considered to be part of the cash price of the automobile. And what the CFPB was claiming was just contrary to the way things had ever been done. And it's something that if they thought the industry was doing something wrong, then it seems to me they should have proceeded with a regulation or at least some guidance telling the industry, giving them some advanced notice, that we don't like something you're doing. But that's not the way they proceeded there.

And there are numerous other examples that we could spend the entire time talking about regulation by enforcement at the CFPB. A matter that occurred a few years ago in the privacy area against a company called Dwolla, D-W-O-L-L-A. A position that they took with respect to garnishment of bank accounts that where they proceeded against one major bank in the country. Something totally unexpected and also was quite... It was quite impactful on the entire industry because the CFPB's expectations were different than what the industry had been doing.

So we're not going to get into any more of the examples. What I want to delve into now is the legality of this regulation by enforcement. Is it legal what they're doing or is it subject to being challenged on some theory?

David Zaring:

So the approach that me and my co-authors take in describing regulation by enforcement is... And I think we've got pretty good legal support for this, even though we're often critical of the regulatory approaches that it's completely legal and has been for a number of years. It's not to say there are no clouds on the horizon, and maybe we can get into that. But the basic story about the legality of this approach to regulation comes from a Supreme Court case in the 1940s and a Supreme Court case in the 1970s.

And the 1940s case is a case called SEC versus Chenery Corp. And in that case, which went up to the Supreme Court a couple of times, in the first iteration, the question was kind of like, "How is the SEC going to regulate water utilities?" And the issue here became there was a great industrialist named Sam Insole, and what he did was he'd create these holding company arrangements that meant that a small number of insiders could control the corporate actions and also win any sort of board votes or anything like that through a pattern of holding companies that basically gave a small group of insiders control over water utilities. And so Congress passed a law telling the SEC to do something about that.

And the SEC brought an action, an enforcement action, against one of these holding company arrangements. Basically, the SEC came to the conclusion that the company ought to sort of divest itself at this holding company structure. And the Supreme Court said, "Well, you did it wrong," the first time it came up in SEC versus Chenery Corp. "You did it wrong and we'd really encourage you to go back and make a rule on how you're going to approach water utility holding company oversight." And the SEC decided not to do that, but instead relaunched its enforcement action against one particular water utility holding company structure. And in the second iteration of the Chenery case, the Supreme Court said, "An agency has absolute discretion whether to proceed through rule making or through adjudication. If it wants to go case by case, it can do so. And if it wants to make a rule, it can do so. And even though we thought maybe making would be a good idea, we leave it to the agency to decide how to proceed on."

Alan Kaplinsky:

Now how old is that Chenery case?

David Zaring:

It's pretty old. 1947. And so one question is, is the current Supreme Court going to conclude that this sort of unfettered discretion to proceed by rule making and adjudication is still warranted? That said, there's a 1960s case involving the NLRB where the Supreme Court reaffirmed this total discretion on rule making an adjudication. So we'll see.

Alan Kaplinsky:

Yeah, the only thing I would add is of course the composition of the court is significantly different today than it was when it came down with Chenery where you have a court dominated by six Republican conservatives, all of who look askance at just about anything that administrative agency does. They don't like the administrative state, and they really are critical of agencies who think that they're acting like Congress or who think that they're Congress and can legislate. They don't like that at all. And they don't like agencies that issue sweeping regulations that are not authorized by whatever statutory authority Congress gave them. So at different times today, and I guess maybe that they'd reconsider the Chenery doctrine. I'm not sure though of that, of course.

David Zaring:

Yeah. Well, they said that... We don't want to be too cynical about these kinds of things, but essentially between the switch in time that saved at nine, the new deal, the Supreme Court got pretty liberal. And between then, 1937 and about 1970, the administrative state never lost a case before the Supreme Court. And then that really changed from 1970 going forward. First it was liberals who were skeptical that agencies are being captured, and then it was conservatives who were skeptical that agencies were sort of doing this over weaning undemocratic overregulation. And so we do live in a different world now, that's for sure.

Alan Kaplinsky:

Yeah. Yep. Okay. I didn't mean to interrupt your train of thought, David.

David Zaring:

The other case. Okay, so the black letter rule is rule making adjudication. It's up to the agency and a court won't review it. The second case that is a big deal in this space was Heckler versus Chaney. And this was a case by a bunch of death penalty activists who wanted the Food and Drug Administration to launch an enforcement action against the maker of death penalty drugs. And the idea was, their idea was, well, these drugs are obviously not safe and effective. They kill people if administered in the sort of quantity that states were using for lethal injections. And so the FDA ought to prosecute these drug manufacturers for making this drug that could be used in a lethal cocktail. And the FDA said, "We're not going to do that. We're not going to do an enforcement action against these drug makers." And the question was, do courts have the right to

review that? And the answer was no. If an agency decides not to enforce or to enforce, that is essentially subject to the agency's unreviewable discretion.

Alan Kaplinsky:

Well, and the other thing, I guess you could say, a corollary to that, if the decision of who to proceed against is discretionary; like I'll often hear comments from people within the consumer finance industry, "Well, how come the CFPB proceeded against company A when there are 100 other companies they could have gone against? Does that mean that they now have to go against all these other companies, or can they just for any reason at all that they don't even have to disclose, just pick out a company?"

And often a lot of people complain that they'll select a company that if they want to make new law that is not very large, doesn't have sophisticated outside council, can't spend a lot of money on legal fees because that will tilt the litigation in their favor. I mean, I've heard that kind of thing, but to be honest, I haven't really seen that with the CFPB. There's not much I like about what they do in this area, but they've gone after the major banks in the country, the regional banks, and they of course cannot go after the smaller banks because there's an asset threshold. You have to be above a certain threshold for them to have jurisdiction over enforcement.

David Zaring:

Yeah, certainly this enforcement action against Credit Acceptance Corporation. My understanding is they're a pretty big player in this used car resale space. The Coinbase case is a total example of that. They didn't sue Coinbase, they didn't sue any of the sponsors of the cryptocurrencies listed on Coinbase. Instead, they went after this one mid-level employee for insider trading with real implications for how those Coinbase and the cryptocurrencies are covered by the securities laws. Now he's got some good lawyers, the defendant in that case. I know a couple of them.

Alan Kaplinsky:

I would guess Coinbase may be footing the bill.

David Zaring:

No, they're not going to want... Yeah, they're not going to want this case to be up to just some guy who can afford a little bit of cash or whatever. That's one of the things we think, by the way. So I told you that regulation by enforcement can be problematic and yet legally is pretty much in the clear. But we think that are certainly some best practices that agencies could adopt. And one of the things we think would be a good idea is to make those adjudications where you single out a particular defendant a little bit more like a rule making.

Take amicus briefs from parties who are interested. Maybe let interventions happen, if necessary. Try to do what you can to... If you're doing precedent setting enforcement actions, try to open up the enforcement action to other stakeholders in a way that can allow them to participate in the action so that they don't say, "Well, this guy over here, he settled a case and now I'm really in regulatory peril and I didn't even know about it." So we think that that would be something that agencies could do to make regulation -

Alan Kaplinsky:

Or how about the thought of just issuing some guidance to say, "This is a practice that we as an agency are very concerned about and we're thinking about bringing an action, challenging what one or more of these companies are doing. But before we do that, we'd like to hear..." You didn't even have to call it a regulation but, "We would like to hear from the industry. We'd like to receive some commentary." And go through that process. And then if you still want to proceed, then at that point you proceed. But at least nobody can say they were caught off guard.

And then others in the industry may try to participate as amicus, though generally at the trial court level, you don't see a lot of that. It's more at the appellate level, but it's been done. It just seems to me that they could sort of take some of the good parts about governing by regulation and they could import that into the enforcement area to create a process that's more fair.

David Zaring:

I think without saying that they get it right every time. An example of this kind of thing, you could kind of see with the bank regulators. Mike Hsu came up to Wharton, he's the comptroller of the currency, the acting comptroller of the currency, and gave a speech last year saying, "I'm really worried about the resolve ability of mid-size banks. The regionals." And other financial regulators suggested that they were also worried that these mid-size banks... The largest banks have a pretty rigorous stress testing regime. The smallest banks are largely exempt from those. And it's these mid-size banks that got some sort of regulatory relief in 2019 from Congress though the bank regulators had the discretion to supervise them and subject them to stress tests and that kind of thing. And they exempted them. And the regulators pretty clearly said, we're not sure we're still comfortable with the exemption of these mid-size banks.

So then there was a financial, the signature and Silicon Valley Bank, they were these kinds of mid-size banks and they collapsed. But I've got to say, I don't think that the banks are going to be surprised, the mid-size regional banks, if the banking regulators come out pretty soon with a new regime that subjects these mid-size banks to stress testing and other sort of more aggressive capital supervisory things. Because the regulators have been indicating that this is on the agenda. And that kind of thing, I think, is a good way to proceed to give speeches and do Q&As and basically indicate that you're thinking about something rather than a sort of surprise enforcement action.

Alan Kaplinsky:

Last year, David, I interviewed a colleague of yours at Penn Law, Coglianese, and we were talking more about regulation by guidance and what the problems are with that. And he drew my attention to a few articles that had been written and actually have the articles in here. So basically the thesis of the articles, and I'm not going to get into the detail because we don't have the time, is that if an agency wants to establish something as the law in a certain area, you're going to have a higher degree of compliance with what the agency wants if you involve the industry. If you bring them into the process, you seek comment, you reach out to them, you meet with them, you tell them about things that the industry that are troubling you, you meet with their trade associations if you can't meet with the entire industry, and then they're given an opportunity to comment on what you're thinking of doing.

And sometimes those comments have an impact. I know when the Federal Reserve Board was in charge of regulating in the consumer finance area and not the CFPB... I'm now going back to the time before the enactment of Dodd-Frank. That's exactly what the Federal Reserve Board would do. They would reach out. They'd reach out to consumers too. They reached out to all the relevant stakeholders and they tried to get input. So it seems to me that that's a process that is probably going to lead to a higher degree of compliance than just simply proceeding by an enforcement action against some one player. But do you have a reaction to that, or?

David Zaring:

Yeah, no, I think that's right. And to me, that indicates regulation by guidance is a killer problem. Industry wants and needs that guidance and the slow ramp up of sort of policymaking through Q&As at trade association meetings, speeches. That is really useful. And then again, if that's the only way that the agency is regulating, it becomes infuriating because you never have some sort of rule of law moment where a aggrieved industry member can go get judicial review of a specific policy.

Alan Kaplinsky:

Here is another thing that troubles me about regulation by enforcement. I don't think you cover it in your article, but I might have overlooked it. And that is, as we all know, most litigation gets settled. Very few lawsuits are seen all the way through and go to trial and then are appealed and you get some judicial precedent coming out of it. Settlements are entered into. And with agencies, they're often referred to as consent orders. And consent orders can be quite draconian. And it'll be sometimes restitution has to be paid. Sometimes there's a civil money penalty. But more importantly from an industry standpoint, very often these consent orders will have injunctive relief. They will say, "From now on, you will do the following." Or, "From now on, you, Company A, will not engage in the following practices."

And so I'm an outside lawyer in this area, counseling clients all the time. And we will issue on our blog that Company A entered into a consent order and we'll describe all the features of the consent order. And the client will call me, the client who is in the same industry, and say, "Does that mean that we have to now comply with all that injunctive relief that is imposed upon Company A? What do we do? We don't want to get sued by the CFPB." And I'll say to them, "Well, a consent order is not precedent, okay? But it does give you some idea of what the agency might do to you if they decide to go after you." So that's another... I'd like to get your reaction to that. So regulation by enforcement becomes regulation by consent order.

David Zaring:

Yeah, it's a real issue in financial services. And I mean, without judging the merits of the question, it's amazing that Wells Fargo recently paid the CFPB a $1.7 billion penalty and $2 billion in consumer relief. That's a lot of money. Consent order. So not litigated, no official judgment by a court or anything like that, but Wells Fargo to put this problem with the way it was doing sort of mortgage services and other kinds of consumer facing financial services said, "We're going to pay a big fine. And that's not all we're going to do, we're going to commit to not doing the things that made you mad in the past in the future." And so that kind of injunctive component of consent orders can be pretty demanding. And I'm guessing that other providers of consumer financial services are taking a pretty close look at that consent order and saying, "Well, could we get into trouble for doing the same kinds of things?"

Alan Kaplinsky:

Yeah. Well it's interesting when heads of the CFPB have been asked when they've been interviewed about how they view consent orders, they sort of waffle. They'll say, "Well, they're only binding between the parties, our agency and company A," but they shouldn't be ignored by others that are in the same industry. So yeah, they're not full-blown regulations. They don't require a court to follow anything in there. A court need not defer to them or give them Chevron deference. Not that there is such a thing anymore as Chevron deference, I'm not sure. But it becomes another body of law, not quite as formal, not as official, but nevertheless not to be ignored.

And as I indicated, practically all cases end up being resolved by consent order. And sometimes I'll have clients come to me and say, "Gee, this company should... They were right. They should have continued to litigate with the CFPB. Is there anything that we can do as an industry? Can I get my trade association to appeal?" And I'll say, "Unfortunately not. The only people who can appeal..." In fact, once there's a consent order and for they're very often approved by the court, nobody can appeal. It's not like the settlement of a class action where there is a process to challenge a settlement that's entered into privately. But you can't do that. And that's part another failing I think of regulation by enforcement.

David Zaring:

Yeah. A company may have its own private good reasons to settle a case, even if it thinks it's strong on the merits. And we absolutely think that consent orders are a part of regulation by enforcement.

Alan Kaplinsky:

Yeah, yeah, yeah. So David, we're drawn to the end of our program, but I'm wondering before we wrap things up, if you have anything else that you think we ought to bring to our audience's attention that we might have overlooked?

David Zaring:

Well, I think regulation by enforcement is not going anywhere. And one of the goals of our-

Alan Kaplinsky:

It's not going away, you mean?

David Zaring:

No, it's not going away. And so one of the goals of our article was to maybe identify some best practices. So I told you a little bit about maybe agencies should think about some of these enforcement actions by broadening participation in them by accepting interventions and adjudications. We also think agencies could come up with some other best practices. Regulation by enforcement in an area of regulatory uncertainty might be okay. One or two exploratory adjudications before an agency makes policy. But we worry about a situation where an agency settles on regulation by enforcement is a policy of last resort. Not precedent to some broader, more participatory process, but rather this end sum of how it's going to regulate in a particular area. And so we encourage agencies to not settle on regulation by enforcement as, this is our last word, but rather to think about it maybe as an initial thing on its way to a more comprehensive regulatory approach.

Alan Kaplinsky:

The name of your article, what is it called and where is it going to be published?

David Zaring:

It's called Regulation by Enforcement. My co-authors are Yesha Yadav at Vanderbilt and Chris Brummer at Georgetown. And it's coming out this year, 2023, in the Southern California Law Review. We were invited to participate in a symposium there, and so we came up with this article as our contribution.

Alan Kaplinsky:

Okay. And I guess if people want to preview it, they can do that, right? It is available.

David Zaring:

It's available on the internet. In particular, the Social Science and Research network, SSRN, has our preliminary copy up. And of course, if people are interested and have commentary for me, I'd urge them to take a look at the article on SSRN and get in touch with their thoughts.

Alan Kaplinsky:

Yeah, sure. Okay. Well thank you very much, David, for your time today and sharing with our listeners the research that you've done and the wisdom that you've acquired by really focusing into this extremely important and timely subject.

David Zaring:

Happy to do it.

Alan Kaplinsky:

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