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## COMPLIANCE IN A UDAAP RISK ENVIRONMENT

*In this article, the authors report that the CFPB has devoted significant resources to reviewing the compliance management systems (“CMS”) of financial institutions, and has noted that a robust and effective system is a critical component of a well-run financial institution. After discussing the statutory background of CFPB enforcement, the authors set out the characteristics and benefits of a strong CMS program.*

By Anthony Alexis and Levi Swank \*

Why should consumer financial services providers devote scarce resources to developing an effective compliance management system (“CMS”) when the Dodd-Frank Wall Street Reform and Consumer Protection Act (“CFPA”) does not mandate a formal compliance program at all? To be sure, some providers of consumer financial services, particularly banking institutions, may be subject to specific CMS requirements imposed by other federal laws, or state law. For most consumer finance companies, however, the lack of a CMS does not, in and of itself, subject the company to civil or criminal liability.

Yet ignoring proper CMS hygiene comes at a steep price for those companies subject to the jurisdiction of the Consumer Financial Protection Bureau (“CFPB” or “Bureau”), the entity created by the CFPA and tasked with enforcing it. The CFPB’s supervisory oversight is

explicitly “risk-based,” and its enforcement priorities undoubtedly are as well. But the reduced risk of negative regulatory or enforcement outcomes is just one reason to have a CMS. Too often ignored are the multiple positive contributions to the business organization made by a CMS, including a culture of good business operations and morale, a good “seal of approval” by others considering doing business with the company, and concessions from regulators in the event of an investigation or enforcement action.

This article examines compliance through the lens of the CFPB and the prohibition on unfair, deceptive, and abusive acts or practices in the CFPA. It provides a rationale for CMS based on principles that animate the CFPB’s supervisory and enforcement authority, and identifies the key features of a strong CMS for entities subject to the CFPB’s oversight.

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## WHAT IS COMPLIANCE?

In a nutshell, compliance has been articulated as a program developed “to address risks that appear.”<sup>1</sup> Some risk can be avoided only partially; but all risks can be “addressed” to limit the business’s exposure to them. Compliance programs for business organizations are generally designed to address legal risks, ensuring that the business organization *complies* with specific laws or regulations. The particular “risk” addressed in this article – a risk to all major consumer financial services providers – is non-compliance with the CFPB and its prohibition on “unfair, deceptive, or abusive acts or practices.”<sup>2</sup>

## THE CONSUMER FINANCIAL PROTECTION BUREAU

In 2010, in the wake of the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>3</sup> The CFPB created the CFPB. Congress tasked the CFPB with enormous responsibilities for implementing and enforcing federal consumer financial laws, transferring to the Bureau supervisory and enforcement responsibilities for approximately 18 laws governing consumer financial services, including the CFPB (Title X); the Electronic Fund Transfer Act; the Equal Credit Opportunity Act; the Fair Credit Reporting Act; the Fair Debt Collection Practices Act; the Gramm-Leach-Bliley Act; the Home Mortgage Disclosure Act; the Real Estate Settlement Procedures Act; the S.A.F.E Mortgage Licensing Act; the Truth in Lending Act; and the Truth in Savings Act.<sup>4</sup> The CFPB also enforces financial regulations and financial rules. Thus, overnight the CFPB became the primary regulator monitoring the consumer financial marketplace for compliance with laws governing consumer financial services, and, in the event of non-

compliance, enforcing those laws against consumer financial services providers.

## UNFAIR, DECEPTIVE, OR ABUSIVE ACTS OR PRACTICES (“UDAAP”)

In addition to transferring a significant bundle of “known” laws, regulations, and rules to the CFPB to monitor, examine, and enforce, the CFPB created three “new” laws. The CFPB authorizes the CFPB to “take any action . . . to prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service” (hereinafter, “UDAAP”).<sup>5</sup>

Because UDAAP is the CFPB’s primary enforcement mechanism, it is imperative that UDAAP is understood and integrated into each phase of a company’s CMS. Companies often struggle to account for UDAAP compliance risks because UDAAP is a principle: terms like “unfair,” “deceptive,” and “abusive” are context-specific and therefore not reducible to a discrete list of “do’s” and “don’ts.” Exacerbating this difficulty in translating UDAAP to CMS is that while the “unfair” and “deceptive” prongs have substantial history in the law through, in part, equivalences in the Federal Trade Commission Act,<sup>6</sup> which the FTC and Federal Prudential Regulators enforce, the abusive prong does not.

A practice is *unfair* if:

- “It causes or is likely to cause substantial injury to consumers;”
- “The injury cannot be reasonably avoided by consumers;” and

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<sup>1</sup> Susan Lorde, *Martin Compliance Officers: More Jobs, More Responsibility, More Liability*, 29 Notre Dame Journal of Law, Ethics & Public Policy 169, 171 (2015).

<sup>2</sup> Even consumer finance companies outside the purview of the CFPB are likely subject to analogous UDAAP provisions under state law.

<sup>3</sup> Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup> 12 U.S.C. § 5481(12).

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<sup>5</sup> 12 U.S.C. § 5531. In addition to the CFPB’s ability to file matters in District Court for alleged violations of the CFPB, any State may also bring a civil action in its name to enforce provisions of the CFPB. 12 U.S.C. § 5552(a)(1).

<sup>6</sup> 15 U.S.C. § 45(a)(1).

- “The injury is not outweighed by countervailing benefits to consumers or competition.”<sup>7</sup>

The “substantial injury” requirement may be satisfied where small harm is inflicted on a large number of consumers. In addition, actual injury is not required if there is significant risk of concrete harm.<sup>8</sup>

Deceptive is not defined in the CFPA. However, there is significant case law interpreting what constitutes a deceptive act or practice under Section 5 of the Federal Trade Commission Act, which informs the CFPB’s interpretation and application of the deceptiveness prong.<sup>9</sup> Generally the FTC considers an act or practice to be *deceptive* if:

- “The representation, omission, act, or practice misleads or is likely to mislead the consumer;”
- “The consumer’s interpretation of the representation, omission, act, or practice is reasonable under the circumstances;” and
- “The misleading representation, omission, act, or practice is material.”<sup>10</sup>

Case law interpreting “deceptive” considers the totality of the circumstances. In determining if something is “likely to mislead,” the CFPB is likely to consider the prominence of the statement (can it be noticed by the consumer), the placement of the information in a location where consumers typically look or hear (in case of a radio or TV ad), the format of the representation (is it presented in an easy-to-understand format that does not contradict other information), and the proximity of the information to the claim it qualifies. Representations that lack substantiation may be considered deceptive, depending on the circumstances. In assessing the reasonableness of the consumer’s interpretation, the Bureau will consider the circumstances of the target audience (*e.g.*, if the consumer is elderly, if the consumer does not understand English, etc.). Finally, materiality focuses on information that is likely to affect

the consumer’s choice.<sup>11</sup> Certain claims are presumed to be material, such as express misrepresentations or intentionally misleading implied claims.

The abusive prong of UDAAP is new.<sup>12</sup> Under the statute, a practice is *abusive* if it:

- “Materially interferes with a consumer’s ability to understand a term or condition of the product or service” and
- “Takes unreasonable advantage of the consumer’s:”
  - “Lack of understanding of material risks, costs, or conditions of the product or service;”
  - “Inability to protect his or her interest in the product or service selection;” or
  - “Reasonable reliance on the person offering the product or service to act in the interest of the consumer.”<sup>13</sup>

Congress equipped the CFPB with two tools to protect consumers from corporate practices that could cause harm. The first tool was a supervisory mechanism that permitted the CFPB to visit and examine certain financial institutions. The second was an adversarial enforcement mechanism that permitted the CFPB to challenge corporate practices that it thought violated the law in court or through an administrative tribunal. The CFPB is authorized to pursue a wide range of civil remedies including injunctive relief, asset freezes, disgorgement, monetary restitution, rescission of contracts, and monetary damages.<sup>14</sup> The CFPB may also recover civil fines that are defined in three tiers: a penalty of up to \$5,000 per violation of the CFPA; a second tier of up to \$25,000 per violation for recklessly violating the CFPA; and a third tier of up to \$1,000,000 per violation for knowingly violating the CFPA.<sup>15</sup> In approximately seven years the enforcement of the CFPA has resulted in approximately 31 million consumers receiving \$12.4 billion in consumer redress or debt

<sup>7</sup> 12 U.S.C. §§ 5531, 5536.

<sup>8</sup> CFPB, *Supervision and Examination Process Manual v.2*, Unfair, Deceptive, or Abusive Acts or Practices 2 (Oct. 2012), available at [https://files.consumerfinance.gov/f/documents/cfpb\\_supervision-and-examination-manual.pdf](https://files.consumerfinance.gov/f/documents/cfpb_supervision-and-examination-manual.pdf) (hereinafter CFPB Exam Manual).

<sup>9</sup> CFPB Exam Manual at UDAAP 5.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at UDAAP 6.

<sup>12</sup> “Abusive” is not totally unheard of prior to UDAAP. The term “abusive” is found in the Fair Debt Collection Practices Act, 15 U.S.C. § 1692d, and in the Telemarketing Sales Rule, 16 C.F.R. § 310.4.

<sup>13</sup> 12 U.S.C. § 5531(d).

<sup>14</sup> 12 U.S.C. § 5565(a)(2).

<sup>15</sup> *Id.* § 5565(2).

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relief. Further, the CFPB has ordered more than \$1.65 billion in fines and penalties. A brief review of the CFPB's published "enforcement" docket reveals that a vast majority of the matters are for alleged UDAAP violations.<sup>16</sup>

## RISK-BASED COMPLIANCE

To help mold its supervision program, the CFPB not only vested the CFPB with jurisdiction over entities that provided certain consumer financial services and products, it also directed that the supervision program be "risk-based." That means that the CFPB's Office of Supervision must create its strategic prioritization and planning around examination schedules that were driven by an "assessment by the Bureau of the risks posed to consumers in the relevant product markets . . . ."<sup>17</sup> This includes taking into consideration the asset size of the financial institution, market share or volume of transactions by the financial institution, the risks to consumers created by the product, whether there is oversight by state authorities over the financial institution, and other factors to be determined by the CFPB.<sup>18</sup> Likewise, the CFPB's examination and enforcement arms create their strategic priorities and activities based on a risk-based model – that is, the CFPB monitors the activities of the consumer financial services and products market where the greatest risks to consumers are identified.

## RATIONALE FOR CMS

In the face of the potential harmful outcomes for violations of Federal consumer finance law, the benefits

of having a compliance program cannot be overstated. First, and most obviously, a compliance program is a line of defense because it identifies and deters legal violations, thereby reducing the likelihood of expensive and disruptive enforcement proceedings. Second, it protects the reputation of the business organization. Third, it sends a strong signal internally and to competitors that the business organization obeys the law. Fourth, it has the potential to raise morale because it encourages enterprise-wide participation including reporting potentially harmful conduct. Fifth, often overlooked are the additional incentives that enforcement entities and regulators provide to entities that maintain an effective CMS. The regulatory and enforcement benefits of having an effective compliance program can include a range of concessions from the government. From declination of a potential investigation of a criminal<sup>19</sup> or civil matter to reduced regulatory and enforcement penalties and fines. For example, the United States Sentencing Commission created incentives for maintaining an effective compliance program. Specifically, a business organization that violated a criminal statute could receive a potential reduction in sentencing exposure if at the time of the offense the business organization had an "effective compliance program."<sup>20</sup>

On June 25, 2013, the CFPB itself articulated that a robust compliance program could result in potential benefits when the CFPB considers factors in the "exercise of its enforcement discretion." In issuing its bulletin on *Responsible Business Conduct: Self-Policing, Self-Reporting, Remediation, and Cooperation*,<sup>21</sup> the CFPB Office of Enforcement noted that it would consider favorably a party's efforts in "proactively" self-policing for potential violations. In defining "self-policing" it noted that "self-monitoring" and commitment of resources for a robust compliance management system will facilitate the early detection of potential violations.<sup>22</sup> In that case, along with other non-

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<sup>16</sup> CFPB, Enforcement Actions, available at <https://www.consumerfinance.gov/policy-compliance/enforcement/actions/>.

<sup>17</sup> 12 U.S.C. § 5512(b)(2) (emphasis added).

<sup>18</sup> *Id.* § 5512(b)(2)(A)-(E). For example, in remarks made to the Consumer Bankers Association, the then-CFPB Deputy Director, Steven Antonakes, noted that risk for consumers could be based on a product market or based on the institution. If a practice causes a consumer to "lose . . . their voice" and the product is not one the consumer selects, such as debt collection, then the market may pose a higher risk for consumer harm and that could factor into having that particular market remain a prioritized market for examination activity. CFPB, Prepared Remarks of CFPB Deputy Director Steven Antonakes to the Consumer Bankers Association (Mar. 25, 2015), available at <https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-deputy-director-steven-antonakes-to-the-consumer-bankers-association/>.

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<sup>19</sup> The U.S. Department of Justice's Foundational Principles of Corporate Prosecution, JM 9-28.010, acknowledges that having an adequate and effective corporate compliance program" is a factor in determining whether to provide benefits from complete prosecution." 9-28.300 A (7) and 9-28.1000.

<sup>20</sup> United States Sentencing Commission, *Guidelines Manual* § 8C2.5 (2013).

<sup>21</sup> CFPB Bulletin 2013-06 (June 25, 2013), available at <https://www.consumerfinance.gov/about-us/blog/encouraging-responsible-conduct-in-enforcement-investigations/>.

<sup>22</sup> *Id.*

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aggravating factors, the CFPB would consider potentially lenient outcomes.

There are many models for what the minimum components and sub-components of an effective compliance program are. For example, although not in complete alignment with the rationale for having a robust UDAAP CMS program, a study by the Securities & Exchange Commission and the Department of Justice concerning the characteristics of an effective compliance program to combat violations of the Foreign Corrupt Practices Act outlined the minimum precepts of compliance programs. They include: commitment from senior management (to set the tone); the need for written policies and procedures; oversight, autonomy, and resources (to continue to make it a functioning priority); risk assessment; training, and continuing advice to staff; incentives for compliant staff and known discipline for violators; due diligence of third parties and contractors; confidential reporting structure and prompt internal investigations; and continuous improvements and audit.<sup>23</sup>

Despite there being no penalty for lack of a compliance system, the CFPB made rigorous CMS a point of emphasis early in its existence, in an effort to encourage business organizations to maintain appropriate compliance management systems. To that end, the CFPB has devoted significant resources to reviewing the CMS of financial institutions.<sup>24</sup> The CFPB noted that it was a critical component of a well-run financial institution to have a robust and effective CMS designed to ensure that the financial institutions policies and practices are in full compliance with the requirements of the Federal consumer financial law.<sup>25</sup> The CFPB, while relying on the *Supervision and Examinations Manual*, noted that a sound CMS should be fully part of the entities' life-cycle of a consumer product or service, and should address "internal controls, oversight, training, internal monitoring, consumer complaint response, independent testing and audit, third-party service provider oversight, recordkeeping, product development and business acquisition, and marketing practices."<sup>26</sup> The CFPB's manual is clear. Because a

financial institution operates in a "dynamic environment"<sup>27</sup> subject to a lot of internal and external change and challenges, an institution "must develop and maintain" a CMS that is part of the institution's culture and create a tone from the top. At a minimum, a sound CMS protects an institution from financial and reputational harm, and establishes clear "rules of the road." This includes a management direction that CMS is a priority. In addition, the CMS is captured in a set of well-known and well-shared written policies and procedures for how business is conducted that are taught to the managers and staff. The program is monitored and audited. Finally, because of the unique relationship between the financial institution and consumers, monitoring must include evaluating and resolving consumer complaints. Consumer complaint response is critical for successful CMS in a UDAAP world.

## CHARACTERISTICS OF A STRONG CMS

At a minimum, a compliance program should guide the organization's culture of staying within the bounds of the laws that govern its business. First, the compliance function should be managed by a skilled person who occupies a high-level in the organization. This includes appropriate oversight within the organization and involvement of the board of directors. Second, the CMS standards should be clear and written. That is there should be written policies and procedures that identify relevant laws and regulations and how to prevent violations of those laws and regulations. Third, the policies and procedures and code of ethics that govern the relevant laws and regulations should be shared with employees who receive scheduled and appropriate training on the policies and procedures. Fourth, to reduce the risk that the CMS is for show, the business organization should take reasonable steps to ensure adherence to compliance and ethics programs. This includes monitoring behavior to make sure it is aligned with the policies and procedures (and consequences for failure to behave consistent with the policies and procedures), periodic evaluation of the adherence, and auditing. Finally, a compliance system should facilitate, remediate, and evaluate consumer complaints. This should include investigating the root cause of the potential violation in such a manner as to report potential compliance issues to others who have ability to remediate the issue. Finally, the CMS should

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<sup>23</sup> Department of Justice and Securities & Exchange Commission, *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, 57-63 (Nov. 14, 2012).

<sup>24</sup> CFPB, *Supervisory Highlights: Fall 2012*, at 4, available at [https://files.consumerfinance.gov/f/201210\\_cfpb\\_supervisory-highlights-fall-2012.pdf](https://files.consumerfinance.gov/f/201210_cfpb_supervisory-highlights-fall-2012.pdf).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

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<sup>27</sup> CFPB, *CFPB Examination Procedures – Compliance Management Review*, at 9 (Aug. 2017), available at [https://files.consumerfinance.gov/f/documents/201708\\_cfpb\\_compliance-management-review\\_supervision-and-examination-manual.pdf](https://files.consumerfinance.gov/f/documents/201708_cfpb_compliance-management-review_supervision-and-examination-manual.pdf).

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“connect the dots” by using consumer complaint data as a lens through which to assess the risk that a particular business practice may result in UDAAP non-compliance.

At a minimum, a rigorous CMS environment that is designed both to deter UDAAP violations and to obtain the salutary benefits described above should have the following characteristics:

### ***Management Involvement***

The CFPB’s interpretation of what constitutes a robust CMS program necessitates involvement by the highest levels of the company, up to and including the board of directors. Even if the company has no board, the Bureau will examine involvement by whatever entity serves as the functional equivalent of the board of directors. Involvement at the board level ensures oversight of the company’s compliance department and signals to employees that it cares about operating within the boundaries of the law. In addition to a strong commitment to CMS, board involvement ensures that adequate resources are going to be committed to CMS. Finally, board supervision ensures that managers will be held accountable for violating Federal consumer financial laws.

### ***CMS Policies and Procedures***

The CFPB, like other regulators, recommends that an “institution should establish a formal, written Compliance program” that is managed by a person dedicated to the responsibility of implementing and managing the compliance program (chief compliance officer or equivalent).<sup>28</sup> It is important that these policies and procedures are detailed enough that they address the sources of risk – *i.e.*, laws – that the CMS is designed to address. In the context of UDAAP, it is not sufficient for a company’s policies to recite UDAAP. The terms “unfair, deceptive, or abusive acts or practices” are not self-explanatory, particularly to non-lawyers. Thus, CMS policies should include an explanation of what those terms mean in the context of the company’s business operations, and should provide examples of conduct that may increase a company’s UDAAP risks. These policies and procedures should be updated often, both to account for how UDAAP is applied by the CFPB in practice and evolution of the company’s business practices.

### ***Education and Communication***

Policies and procedures should not be a paper lion sitting on a shelf. The existence of such policies is a necessary but not sufficient condition for full realization of the benefits discussed earlier. Instead, the policies and procedures should be taught to the board, the management, and the staff. The education is critical to a successful CMS program. The CMS training should teach the staff what is permitted and what is not permitted at the company and the potentially severe punishment for violations. The CMS training should be formal and provided at specific intervals, such as onboarding new employees and annual refreshers, and impromptu, when events or risks evolve and threaten to undermine legal compliance. Training also should be tailored to the particular staff that is taking the training. For example, a loan officer might be exposed to different UDAAP risks than members of the company’s board. One-size-fits-all CMS training does little to signal that the company takes compliance seriously. The training should be updated in advance of its use to prevent the use of outdated materials, which may not account for evolving compliance threats. In addition to keeping a list of who has had the training, the company should make sure that the staff has constant access to the policies and procedures and training materials.

### ***Monitoring and Auditing***

Monitoring is critical to UDAAP CMS. Monitoring is an ongoing process that requires self-examination of the CMS program – it ensures that business activities comply with industry and legal standards. Unlike auditing, monitoring is the responsibility of the management. This includes creating detailed reports to identify weaknesses in the CMS program, repeat violations of the law, or business units (or individuals) who are engaging in particularly risky behavior and to which management should devote additional attention to ensuring UDAAP compliance. At a minimum, successful monitoring alerts a business to UDAAP risks immediately after they arise. Prompt repair and reporting out is critical.

Auditing, on the other hand, while less frequent, is equally important to UDAAP compliance. It should be performed by a person who is independent of the compliance team. Successful auditing will focus on two

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<sup>28</sup> *Id.* at 6.

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specific questions: (1) whether the company is following its policies and procedures and (2) whether the company complies with UDAAP. The audit process helps reduce risk because it helps a company identify weaknesses in processes, identifies those circumstances where staff is bypassing processes that were established as part of compliance, and ensures that the compliance system is working (addressing the correct laws, for example).

### **Consumer Complaint Management**

The CFPB places particular emphasis on processes that permit consumer complaints and also monitoring consumer response. The CFPB recognizes that “[f]inancial service providers should be responsive to complaints and inquiries from consumers.”<sup>29</sup> The CFPB understood that this feature not only benefits the customer, but analysis of the complaints helps the company “understand and correct weaknesses in their programs” that reflect potential harm to the consumers and could serve as an early warning that Federal consumer law violations are likely occurring or are about to occur.<sup>30</sup>

A critical aspect of UDAAP CMS, therefore, is the consumer experience. Proper CMS ensures that consumer complaints are collected and then directed to the appropriate channel where they can be investigated and resolved. Each complaint should be resolved, and quickly. This does not mean “the consumer is always right,” as such an approach is not sustainable. Rather, this means that a decision should be made and communicated to the consumer after the company

determines the “root cause” of the problem. When the root cause is understood, compliance should report out the consumer complaint to all lines of business.<sup>31</sup>

### **Connecting the Dots**

It is not enough that CMS ensures that consumer complaints are addressed and disseminated throughout the company. In the absence of reporting as to trends in consumer complaints, a business will be unable to calibrate its CMS to focus on those risks that present the greatest threat to the company’s UDAAP compliance. Such reporting should, for example, identify types of consumer complaints by volume and the pecuniary impact to consumers based on the type of complaint in order to determine how substantial the injury may be. In addition to focusing compliance at practices the CFPB is more likely to target, regular reporting may itself identify behavior that is causing consumers to be deceived or misled.

### **CONCLUSION**

Just because no statute administered by the CFPB requires CMS does not mean that a company should de-emphasize CMS in assessing its UDAAP compliance. In fact, because the CFPB’s priorities are “risk-based,” the Bureau is likely to consider a company’s CMS in deciding whether to bring an enforcement action and, if brought, the nature of the remedy sought by the Bureau. But just having CMS is not enough, as a rigorous CMS must include a focus on UDAAP, including targeting business practices that present the greatest exposure to UDAAP risk. ■

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<sup>29</sup> CFPB, *Supervisory Highlights*, at 10 (Summer 2013), available at [https://files.consumerfinance.gov/f/201308\\_cfpb\\_supervisory-highlights\\_august.pdf](https://files.consumerfinance.gov/f/201308_cfpb_supervisory-highlights_august.pdf).

<sup>30</sup> *Id.*

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<sup>31</sup> In addition, consumer finance companies should keep an eye on all third-party service providers. Not only should diligence be performed during the selection and onboarding of such providers, but the financial services company should be monitoring at all levels that the third-party service provider is also complying with applicable federal consumer financial services laws.