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## COMMENT ON PROPOSED RULE ON ARBITRATION AGREEMENTS, 12 CFR PART 1040

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*The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.*

We appreciate the opportunity to comment on the rules regarding arbitration agreements proposed by the Bureau of Consumer Financial Protection (the Bureau).<sup>1</sup> The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment does not represent the views of any particular affected party or special-interest group but is designed to assist the Bureau as it considers regulating arbitration agreements in consumer financial products and services on a national scale.

## INTRODUCTION

Section 1028(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the Bureau to provide Congress with a report on the use of arbitration agreements in disputes between consumers and providers of consumer financial products.<sup>2</sup> After issuing its report, the Bureau is empowered to promulgate regulations designed to protect consumers from agreements the Bureau deems to be contrary to the public interest.<sup>3</sup> The Bureau's proposed rules must be consistent with the findings in its study.<sup>4</sup> Any proposal also must comply with the general requirement of Section 1022(b)(2)(A)(i) that, in any rulemaking under Dodd-Frank Title X, the Bureau must consider "the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule."<sup>5</sup>

In its 2013 preliminary results, the Bureau presented data on three main aspects of consumer arbitration: (1) the claimed amount, (2) the frequency with which consumer claimants have legal representation, and (3) the substantive legal basis of consumer claims.<sup>6</sup> In March 2015, the Bureau released its final report to Congress.<sup>7</sup> This report added two main types of data on arbitrations: (1) outcomes in cases that reached final resolution by an arbitrator, as well as basic statistics on how outcomes varied depending on the substantive basis of the consumer's claim and whether the consumer had representation, and (2) some data on the arbitration process, such as how long it took to get a final arbitrator decision, and data on consumers who changed the amount claimed during the arbitral process. At the heart of the Bureau's combined 2013 preliminary results and 2015 study is a quite detailed comparison of the results in consumer class actions with the results in consumer arbitrations performed by the American Arbitration Association (AAA).

On May 5, 2016, the Bureau announced a 377-page proposal that would "prohibit covered providers of certain consumer financial products and services from using an agreement with

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1. Arbitration Agreements, 81 Fed. Reg. 32829 (proposed May 24, 2016) (to be codified at 12 C.F.R. pt. 1040).

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3. *Ibid.*, § 1028(b).

4. *Ibid.*

5. 12 U.S.C. § 5512 (2014).

6. Bureau of Consumer Financial Protection, *Arbitration Study Preliminary Results: Section 1028(a) Study Results to Date*, December 12, 2013.

7. Bureau of Consumer Financial Protection, *Arbitration Study: Report to Congress, Pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a)*, March 2015.

a consumer that provides for arbitration of any future dispute between the parties to bar the consumer from filing or participating in a class action with respect to the covered consumer financial product or service.”<sup>8</sup> The proposal would also “require a covered provider that is involved in an arbitration pursuant to a pre-dispute arbitration agreement to submit specified arbitral records to the Bureau.” This comment letter addresses the first portion of the rule: the proposed prohibition on mandatory arbitration agreements in consumer financial product or service contracts.

The Bureau seeks “comments on its preliminary findings . . . that the class proposal would be in the public interest and for the protection of consumers.”<sup>9</sup> This comment letter responds directly to the Bureau’s request. Specifically, this public interest comment references the proposal using data and evidence from the Bureau’s 2015 study, on which the current proposal is based. A recent study published by the Mercatus Center (attached to this letter) demonstrates that the Bureau’s findings and conclusions are methodologically and factually flawed.

The Bureau claims that “this proposal is based on the Bureau’s preliminary findings—which are consistent with the Study—that pre-dispute arbitration agreements are being widely used to prevent consumers from seeking relief from legal violations on a class basis, and that consumers rarely file individual lawsuits or arbitration cases to obtain such relief.”<sup>10</sup> Contrary to the Bureau’s conclusions, its own evidence shows that arbitration is relatively fair and successful at resolving a range of disputes between consumers and providers of consumer financial products. Thus, regulatory efforts to limit the use of arbitration will likely leave consumers worse off. Moreover, owing to flaws in the report’s design and methodology, as well as a lack of sufficient information, the report should not be used as the basis for any regulatory proposal to limit the use of consumer arbitration.

The Bureau’s proposed ban on arbitration clauses prohibiting class actions is not supported by the evidence in the 2015 study or by the theory and evidence set forth in the proposal. The proposal claims that the evidence in the 2015 study shows that arbitration is not an effective means of compensating consumers and deterring wrongful conduct by consumer financial providers, whereas class actions are effective. In particular, the proposal stresses that for consumer claims involving small amounts of harm (\$1,000 or less), arbitration is completely ineffective, whereas class actions deliver compensation to millions of consumers. This comment argues that neither the 2015 study nor any new evidence in the proposal supports these findings.

The 2015 study’s evidence on consumer compensation and deterrence in class actions is swamped by the settlements in the overdraft fee class actions. However, the Bureau has not even investigated whether the majority of consumers would actually be made better off by the change in check-ordering practices effectuated by those settlements. Even a brief look at the evidence suggests the contrary: The overdraft fee settlement did not make most consumers

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8. Arbitration Agreements, 32830. See [http://files.consumerfinance.gov/f/documents/CFPB\\_Arbitration\\_Agreements\\_Notice\\_of\\_Proposed\\_Rulemaking.pdf](http://files.consumerfinance.gov/f/documents/CFPB_Arbitration_Agreements_Notice_of_Proposed_Rulemaking.pdf) for the Bureau’s original 377-page document.

9. Arbitration Agreements, 32868.

10. *Ibid.*, 32830.

better off and may well have marginally deterred banks from offering checking accounts to lower-income consumers who keep smaller balances. The Bureau's study found that, aside from the overdraft fee class settlements, only a small fraction of consumers are compensated in class settlements, with the average consumer receiving only about \$14 from such settlements.

The Bureau's 2015 study also found that arbitration is an inexpensive, informal, and effective means of compensating consumers: Over 60 percent of consumer claimants before the AAA were likely to receive compensation via a settlement or an actual arbitral damage award. Arbitral awards averaged about \$5,400.

Against this evidence of the effectiveness of arbitration, the Bureau points to evidence from the 2015 study that there are very few consumer arbitrations where the consumer claims less than \$1,000. However, the relative paucity of such small-dollar arbitrations does not compel the conclusion that such claims go uncompensated or that arbitration cannot be an effective means of compensation for small-dollar claims. The Bureau dismisses evidence that financial firms have a very strong, market-driven incentive to internally resolve consumer claims quickly and fairly. But there is no empirical or theoretical basis in the 2013 preliminary report or the 2015 study for the Bureau's substantive claim that financial firms do not compensate consumers based on the validity of the consumer's claim. In fact, existing evidence suggests the opposite.

The Bureau also does not consider how arbitration clauses can be (and have been) drafted to incentivize consumers to pursue small-dollar claims that firms have not resolved with compensation. Indeed, perhaps the only regulatory action that would be justified by the Bureau's evidence thus far would be to incentivize financial firms to adopt arbitration clauses that make small consumer claims in arbitration costless and potentially lucrative for consumers and that consequently incentivize firms to resolve claims without going to arbitration.

Dodd-Frank requires a proposed rule to be consistent with its study—not just with its conclusions, but with its data as well. In this case, the Bureau's proposal is not in the public interest and will not protect consumers as intended and required under the law. The Bureau should go back to the drawing board, conduct a rigorous study with accepted econometric methodology, and reconsider its decision to impose new regulations that will inevitably benefit class-action attorneys and deprive the consumers the Bureau wants to protect of a more efficient means of dispute resolution. The Bureau does not yet have the evidence to prohibit, limit, or even condition the use of arbitration clauses banning class actions. If the Bureau wants to go forward with rules regarding arbitration clauses, it should gather more evidence, and this comment specifies precisely the kinds of evidence that the Bureau should seek to gather.

## **THE BUREAU SHOULD RECOGNIZE THE BENEFITS OF ARBITRATION**

### Benefits of Arbitration

Most consumers handle a dispute—such as an erroneous credit card charge—with the provider of a financial service by complaining to the provider; then, if the provider does not respond to

their satisfaction, they switch to a new provider. For the few who want to take further action when their financial services provider refuses to provide relief, AAA consumer arbitration can offer a low-cost, speedy avenue of dispute resolution.

Arbitration has become cheaper and easier over the years, and more and more companies—such as cellphone providers—offer to pay amounts as large as \$10,000 to consumers who win in arbitration, regardless of the size of the charge or fee that the consumer contests.<sup>11</sup> Arbitration’s procedural setup is also informal, quick, and easy for consumers to use, and hiring counsel to represent a claim in arbitration is usually unnecessary. Litigation, on the other hand, can be expensive, time-consuming, and complex.

In contrast to arbitration, most people who get a notice in the mail explaining that they are part of a class-action lawsuit and might receive compensation never take the time and trouble to fill out the claim form.<sup>12</sup> If consumers feel aggrieved, they recognize that they are unlikely to get more than a couple hundred dollars (often much less)—and if they do get anything, it will be many years later.

Given the poor record of most class-action cases to deliver timely and effective relief to consumers—as opposed to providing significant fees for attorneys—this consumer preference to avoid litigation hardly seems irrational. Consumers turn to complaints and other informal dispute-resolution processes because these procedures are usually effective at obtaining relief quickly and with minimum hassle. Even should these methods fail, a consumer who still feels aggrieved can initiate an arbitration proceeding, which is a quicker and less expensive path to recover greater amounts of relief than in a typical class action. As discussed in greater detail below, however, class-action cases often generate minimal, if any, tangible financial relief to the consumer, and then only after extensive delay.

As the proposal notes, the Bureau’s 2015 study found that only 2.1 percent of consumers would seek legal advice or sue using an attorney if a company incorrectly assessed a fee and failed to remove it in response to a consumer complaint.<sup>13</sup> Additionally, the proposal notes that, according to the Bureau’s survey, 57 percent of customers would simply cancel their credit card in the event of a dispute.<sup>14</sup> The Bureau’s data thus show that consumers prefer the market to the legal response for perceived service failures by a credit card company.<sup>15</sup> When a company does not internally resolve disputes to the customers’ satisfaction, they take their credit card business elsewhere, and they are unlikely to see a need to sue.

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11. See, e.g., “Resolve a Dispute with AT&T via Arbitration,” AT&T website, accessed July 19, 2016, <https://www.att.com/esupport/article.html#!/wireless/KM1045585>.

12. Jason Scott Johnston and Todd Zywicki, “The Consumer Financial Protection Bureau’s Arbitration Study: A Summary and Critique” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, August 2015), 14.

13. Arbitration Agreements, 32843.

14. *Ibid.*

15. Johnston and Zywicki, “Arbitration Study: A Summary and Critique,” 30.

For those who wish to pursue action, arbitration is often a superior and more efficient type of dispute resolution, with quicker resolution times, less procedural complexity, and often a better outcome for consumers.

These are clear benefits to arbitration over class-action litigation, and the Bureau should not impose policy preferences on the market that are unsupported by data, evidence, and consumer preferences.

### Public Policy Favors Arbitration Agreements

Congress and the courts have long supported the use of arbitration instead of litigation to resolve disputes. The Supreme Court has applied a broad interpretation of the Federal Arbitration Act,<sup>16</sup> reflecting a belief that Congress wants arbitration to be given every chance to succeed. The Supreme Court’s jurisprudence on arbitration has made it clear that the strong federal presumption in support of arbitration rests in large part on the idea that consumers benefit from the speed, simplicity, and low costs of arbitration, in contrast to the complex and difficult process of litigation.

The Supreme Court forcefully upheld the use of arbitration provisions in its 2011 decision, *AT&T Mobility v. Concepcion*, which involved a binding arbitration provision in a cellphone contract.<sup>17</sup> In that case, the Supreme Court addressed holdings by a number of state courts that contractual arbitration clauses waiving class-action litigation were unenforceable on grounds of unconscionability or for public policy reasons.

Some courts had reasoned that class-action litigation was necessary to secure an important goal underlying state consumer protection statutes—detering firms from misbehavior that inflicts harm on consumers that is so small that individual claims are not viable but that is large in the aggregate. These courts had found that, with class-action relief waived, small consumer claims would not be effectively pursued, leaving consumers uncompensated and firms undeterred from misbehavior that generates small, nonviable consumer claims.

The Supreme Court disagreed with these court rulings and found that by requiring consumers to be given the choice between individual and class-wide relief after a dispute, the courts would create an inevitable incentive for class-action litigation. This incentive, the Court held, strikes at the heart of the federal policy favoring arbitration because “the switch from bilateral to class arbitration sacrifices the principal advantage of arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment.”<sup>18</sup>

Since *Concepcion*, the Supreme Court has continued to reject challenges to the enforceability of arbitration clauses that are based on their supposed inability to deter firms from malfeasance. In 2013, in *American Express Co. v. Italian Colors Restaurant*, the Court ruled enforceable a clause

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16. 9 U.S.C. § 2 (2014).

17. *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011), <http://www.supremecourt.gov/opinions/10pdf/09-893.pdf>.

18. *Ibid.*, 14.

mandating arbitration and waiving class-wide relief even for claims alleging violations of federal antitrust law.<sup>19</sup> The Court stated, “We specifically rejected the argument that class arbitration was necessary to prosecute claims ‘that might otherwise slip through the legal system.’”<sup>20</sup>

The Bureau points to several instances in which Congress has restricted the use of arbitration agreements in certain types of contracts.<sup>21</sup> Moreover, the Bureau correctly notes that Dodd-Frank contains an explicit prohibition on the use of arbitration agreements in mortgage lending contracts.<sup>22</sup> The Bureau also mentions that the SEC is empowered to restrict or prohibit arbitration agreements in investment adviser contracts but that the SEC is not required to conduct a study.<sup>23</sup> While Dodd-Frank does not require a study similar to that required for the Bureau, the statute does require the SEC to match its rule with a finding that the rule is in the public interest and for the protection of investors.<sup>24</sup> Moreover, in connection with proposing any such prohibition, the SEC would conduct an economic analysis.<sup>25</sup>

These latter two points are telling regarding the intent of Congress, and it is an error to suggest that Congress’s inclusion of §§ 1028(a) and (b) signifies an intent to override decades of legal precedent and specific congressional actions. If Congress had possessed a strong intent to completely prohibit arbitration agreements in consumer financial products and services, then it could have done so in the statute, as it did with mortgage lending contracts. If Congress did not believe that a comprehensive study was necessary, then it could have empowered the Bureau to make rules without relying on the findings in a study. However, Congress made it clear that the Bureau should conduct a study and, if necessary, issue rules that are consistent with the findings in the proposal. The Bureau bases its proposal on the findings of the 2013 and 2015 reports, but those findings are not consistent with banning arbitration agreements.

## KEY PROBLEMS WITH THE BUREAU’S 2015 STUDY AND ITS USE IN SUPPORT OF THE PROPOSAL

### No Identification of a Problem that Needs to Be Solved

*Mandatory arbitration clauses are not widespread.* It is not at all clear from the Bureau’s proposal that mandatory arbitration clauses are so widespread in the market as to constitute a significant problem for consumers. For example, the Bureau’s proposal notes that its 2015 study found that the vast majority (84 percent) of credit card issuers do not use mandatory arbitration clauses. Larger card issuers use arbitration clauses more often, perhaps because larger issuers may be especially prone to large nuisance class actions simply because of their

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19. *American Express Co. v. Italian Colors Restaurant*, 570 U.S. \_\_\_\_ (2013), [http://www.supremecourt.gov/opinions/12pdf/12-133\\_19m1.pdf](http://www.supremecourt.gov/opinions/12pdf/12-133_19m1.pdf).

20. *Ibid.*, 9.

21. *Arbitration Agreements*, 32838.

22. *Ibid.*

23. *Ibid.*

24. Dodd-Frank Wall Street Reform and Consumer Protection Act § 921.

25. Securities and Exchange Commission, Division of Risk, Strategy, and Financial Innovation and the Office of General Counsel, *Memorandum: Current Guidance on Economic Analysis in SEC Rulemakings*, March 16, 2012.

size, and they seek to avoid increased litigation. With respect to checking accounts, mandatory arbitration clauses are even less common; the Bureau's 2015 study found that only 7.7 percent of banks include arbitration clauses in their checking account contracts, although the proposal curiously omits this finding. For checking and credit card accounts, consumers can quite easily avoid contracts with mandatory arbitration clauses if they choose to do so.

*There is no evidence that compliance with federal consumer laws is currently under-incentivized.* With no supporting evidence about the actual level of compliance with various consumer protection laws, the Bureau says it “believes” that “current incentives to comply with consumer protection laws governing financial products and services” are “weaker than economically efficient levels” and that “increasing compliance incentives would be for the benefit of consumers.” Without any kind of support, the proposed rule asserts that if a bank fails to stop a payment as requested by a consumer the consumer would not bring an arbitration. Similarly, the proposed rule claims that consumers would not know they could sue if the bank sent a notice inadequately explaining its reasons for denying the consumer credit.<sup>26</sup> The proposal asserts that because consumers are unaware that they have suffered harm, or because of the cost of bringing an individual action, “class litigation is currently the most effective private enforcement mechanism” in most consumer financial product or service markets.<sup>27</sup>

How can it be that consumers are “unaware” of potentially harmful practices when over 300,000 consumers successfully petitioned Bank of America to reverse its proposed monthly debit card fee? How can the Bureau conclude that compliance incentives are “weaker than economically efficient” when its sole evidence consists of a handful of class-action settlements challenging practices such as high-to-low check ordering in overdraft protection programs that—as discussed in more detail below—may actually have generated benefits, not costs, for the vast majority of consumers?

According to the proposal, “Economic theory suggests that these other incentives (including reputation and public enforcement) are insufficient to achieve optimal compliance (again, assuming that current levels of compliance are less than those that would be economically efficient . . .).”<sup>28</sup> However, there is no mention of any economic study showing that the combination of market reputation and public enforcement is an inadequate deterrent. Indeed, economic theory suggests that market reputation is effective when consumers know about and can respond to a fee or practice, and public enforcement can target practices about which consumers do not have sufficient information.

The proposal argues that even if market reputation does provide an incentive for firms to avoid harming consumers, reputation creates a “strong incentive only to correct issues for the consumers who complain.”<sup>29</sup> As the adoption of overdraft protection programs (discussed below) shows, this argument is incorrect. It is time-consuming and expensive for financial

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26. Arbitration Agreements, 32905.

27. *Ibid.*, 32899.

28. *Ibid.*, 32900.

29. *Ibid.*, 32900.



institutions to respond one by one to complaining customers, and it is often better to invest considerable amounts in systems that address the underlying source of those complaints. There are no published or unpublished papers cited for the Bureau’s argument that firms resolve informal complaints by weighing the profitability of a complaining customer against the “probability that the consumer will take her business elsewhere.” Moreover, and more importantly, there is nothing in the proposal to support the Bureau’s argument that, if this is indeed the calculus followed by firms, consumers would be made better off by threatening firms with potential class liability.<sup>30</sup>

*Customers have effective redress other than class actions for small-dollar harms.* The Bureau seems to believe that truly small-dollar consumer claims are not feasible in arbitration and that such claims can be and often are effectively redressed by class action lawsuits. In terms that more closely track the statutory language, the proposed ban is “necessary” because without the right to file class actions, consumers have no effective redress for small-dollar harms.

The proposal’s discussion of the benefits of banning arbitration clauses that preclude class-action relief adduces no empirical evidence in favor of the ban other than the relative rarity of small-dollar arbitrations revealed by the 2015 study. It is true that the Bureau’s 2015 study found that only 23 consumer arbitration claims (or about 2 percent of all claims) sought less than \$1,000 (the threshold used by the Bureau to define a small-dollar claim).<sup>31</sup>

The relative scarcity of small-dollar consumer arbitrations against financial institutions may reflect something other than the economic feasibility of arbitrations. For instance, the cause of this scarcity may be some factor unique to financial services, such as robust internal dispute-resolution practices. While the Bureau disputes this contention, it provides no data to support its conclusion that the lack of small-dollar consumer claims is owing to consumer ignorance rather than effective internal dispute-resolution practices.<sup>32</sup> Additionally, the Bureau fails to note that class actions against providers of financial services also seldom involve claims of less than \$1,000 per claimant.

Further work is needed to investigate precisely why there is a relatively low number of small-dollar claims in both consumer class actions and consumer arbitrations. The fraction of such small-dollar claims in the Bureau’s arbitration dataset is (statistically) significantly smaller than the 3.5 percent rate at which such claims appear in publicly available AAA data for the entire 2009–2014 period.<sup>33</sup> Thus, small-dollar arbitrations appear to be quite common in other industries relative to consumer financial services. This suggests that the cost of pursuing arbitration is not an intrinsic barrier but that some other factor unique to the financial services industry explains the comparatively small number of small-dollar arbitration proceedings against financial services providers. In addition to the possibility that financial services providers may have

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30. Jason S. Johnston, “Class Actions and the Economics of Internal Dispute Resolution and Financial Fee Forgiveness” (white paper, Manhattan Institute, New York, NY, forthcoming).

31. *Preliminary Results*, 81; *Report to Congress*, App. A.

32. Arbitration Agreements, 32857.

33. See Johnston and Zywicki, “Arbitration Study: A Summary and Critique,” 51.

more responsive and well-developed internal dispute-resolution policies and more generous practices regarding provision of relief to complaining customers, other possible explanations present themselves. Most notably, the particular legal and regulatory regime that governs financial services providers—and particularly the unusually large number of laws that provide for minimum statutory damages—suggests alternative explanations. Ironically, according to the Bureau’s upside-down logic, arbitration would be said to work only if banks began denying refunds to complaining customers en masse, forcing them to bring an arbitration proceeding instead. That the Bureau’s reasoning suggests such harmful, anticonsumer results should lead the Bureau to reconsider its analytical framework on this point.

One possible difference for the Bureau to consider stems from the statutes at issue. Approximately 33 percent of the class actions the Bureau studied were brought under federal consumer protection statutes that award statutory damages without proof of harm. Under such statutes, including the Fair Credit Reporting Act, consumers get between \$500 and \$1,500 per violation alleged (or per consumer). The Bureau’s report shows that almost half of all class actions are brought under statutes that permit consumers to claim up to \$1,500 in statutory damages per violation without proof of harm.<sup>34</sup> As consumers typically seek maximum statutory damages (there is no reason not to do so), claims under these statutes almost always allege at least \$1,000 in damage and so would not be classified as “small dollar” by the Bureau.

The Bureau’s 2015 study counts the number of arbitrations arising under different types of claims such as common law or federal consumer-protection statutes. According to the study, about 335 of the 1060 arbitrations studied by the Bureau (roughly 33 percent) arose under federal consumer-protection statutes that award the kind of statutory damages just discussed.<sup>35</sup> Another 372 arbitrations arose under state consumer-protection statutes. Many state consumer-protection acts entitle the consumer plaintiff to statutory and even treble or punitive damages, with some states allowing treble damages regardless of the egregiousness of the wrongful conduct.<sup>36</sup> There is potential overlap between federal and state claims because arbitration claims could have arisen under multiple statutory or common-law theories of recovery. Still, somewhere between 37 percent and 70 percent<sup>37</sup> of the arbitrations studied by the Bureau arose under federal or state consumer-protection statutes that authorize statutory damages. Claims under these statutes would not be classified as “small dollar” simply because the statute authorizes statutory and treble damages equaling or exceeding the small-dollar \$1,000 threshold. Thus, between 37 percent and 70 percent of all arbitrations studied by the Bureau would not be small-dollar claims simply because of the statutory damages conferred by the federal and state statutes under which they are brought.

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34. Arbitration Agreements, 32847, citing *Report to Congress*, sec. 6, 21–25.

35. *Report to Congress*, sec. 5, 47.

36. Victor E. Schwartz and Cary Silverman, “Common-Sense Construction of Consumer Protection Acts,” *Kansas Law Review* 54 (2005): 1.

37. If all plaintiffs raising claims under federal consumer-protection statutes also raised claims under state consumer-protection statutes (i.e., 100 percent overlap), then only 37 percent of the total arbitrations studied by the Bureau raised claims under consumer-protection statutes. However, if all plaintiffs raised either a federal or state statutory claim, but not both (i.e., no overlap), then the fraction would be 70 percent.

In other words, to compute the fraction of small-dollar claims in arbitration, the Bureau should have excluded from its denominator all arbitration claims brought under state or federal consumer-protection statutes. Changing the calculation in this way would lower the denominator from 1060 to either 360 or 690, and the fraction of small-dollar arbitrations would correspondingly increase to either 6 percent or 3 percent. But even so, the proposal's reasoning would clearly imply that it is cost prohibitive for consumers to pursue small-dollar claims in AAA arbitration. It must be granted that even though AAA consumer arbitration is cheap, speedy and informal, with a \$200 filing fee it is still too costly for a single rational consumer to pursue a really small claim—one less than \$200.

By contract, however, firms can commit (and have committed) themselves to make fair offers to resolve such small claims internally or else risk much greater liability if a consumer claim is rejected and the consumer pursues arbitration. AT&T Mobility, for example, guarantees claimants a minimum of \$10,000 and twice their attorney fees if they obtain an arbitration award that is greater than AT&T's last settlement offer. This provision effectively commits AT&T to make fair offers to preclude consumers from going to arbitration at all; that is, by making arbitration a potentially lucrative option for even a small-claim consumer, the clause primarily incentivizes fair offers by AT&T when the consumer first complains. Judges also may review arbitration agreements in certain circumstances, increasing the incentive for firms to make arbitration clauses fair to consumer in order to survive judicial scrutiny.<sup>38</sup>

Arbitration clauses with large liquidated damages and fee shifting against firms when consumers succeed in arbitration are still relatively new, and many firms may still not have such clauses. However, at the very least, the Bureau should have reported on the historical evolution and frequency of such strongly proconsumer arbitration clauses. Without such evidence, it is impossible to say whether market forces are pushing financial firms to offer arbitration clauses that effectively bind such firms to resolve small-dollar consumer disputes internally and without arbitration.

Even without such evidence on the evolution of arbitration clauses, the relative paucity of small-dollar consumer arbitrations reported by the 2015 study does not necessarily mean that small-dollar consumer disputes are not effectively addressed via internal dispute resolution by financial firms. If such firms are effectively responding to small-dollar consumer complaints through their own internal dispute-resolution systems, then one would not expect to observe very many small-dollar claims in arbitration. To infer from the paucity of small-dollar arbitrations that valid small-dollar claims are not being redressed assumes that the market does not incentivize firms to resolve valid small-dollar claims internally.

Constituting an entire section of the 2015 study, the Bureau's own consumer survey shows that financial firms have a very strong market incentive to respond favorably to valid consumer complaints about small-dollar fees and charges. The Bureau asked consumers what they would do if they complained to a credit card company about an incorrect charge but the company

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38. 9 U.S.C. § 1 et seq. (2014).

failed to refund the charge. Less than 2 percent of respondents said that they would seek legal advice or consider filing a lawsuit. However, almost 60 percent of those surveyed said that they would cancel their account with the credit card company and take their business elsewhere. Financial institutions that have to compete for customers will respond to such pressure from dissatisfied consumers.

For example, according to data provided to Professors Zywicki and Johnston by a midsize regional bank in Texas, almost two-thirds of customer fee complaints were voluntarily resolved in favor of the customer with a full refund. The average refund was \$55.09 per customer (compared to just \$32 per person for class actions, according to the Bureau).<sup>39</sup> The data show that in the San Antonio office, 94 percent of wire transfer fee complaints were refunded, while 75 percent were refunded in the Brownsville office. Further, 74 percent of inactive account fee complaints were refunded in San Antonio, and 56 percent were refunded in Houston.<sup>40</sup> This is exactly what should be expected, given data in the Bureau's study showing that banks usually respond to consumer complaints by canceling or reversing charges. For consumers as well as providers, the market response is often superior to a dispute via either arbitration or litigation.

The Bureau responds to the Texas bank evidence in the proposal by saying that "based on its experience and expertise," refunds and informal dispute resolution are "uncommon"; when they do occur, they are based solely on whether or not a particular consumer is profitable for the bank.<sup>41</sup> In the Bureau's view,

Where consumers do make complaints informally, the outcome of these disputes may be unrelated to the underlying merits of the claim. Nothing requires a company to resolve a dispute in a particular consumer's favor, to award complete relief to that consumer, to decide the same dispute in the same way for all consumers, or to reimburse consumers who had not raised their dispute to a company. Regardless of the merits or of similarities between the complaints, the company retains discretion to decide how to resolve them. For example, if two consumers bring the same dispute to a company, the company might resolve the dispute in favor of a consumer who is a source of significant profit while it might reach a different resolution for a less profitable customer. Indeed, in the Bureau's experience it is quite common for financial institutions (especially the larger ones that interact with the greatest number of consumers) to maintain profitability scores on each customer and to cabin the discretion of customer service representatives to make adjustments on behalf of complaining customers based on such scores.<sup>42</sup>

As support for this conclusion, the Bureau cites our study mentioned above, a *Wall Street Journal* editorial, and evidence from the bank overdraft fee class-action settlements. As the Bureau

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39. Johnston and Zywicki, "Arbitration Study: A Summary and Critique," 7; Todd Zywicki and Jason Johnston, "A Ban That Will Only Help Class Action Lawyers," *RealClearMarkets*, December 9, 2015.

40. Johnston and Zywicki, "Arbitration Study: A Summary and Critique," 31.

41. Arbitration Agreements, 32857.

42. *Ibid.*, 32857 (footnotes omitted).

acknowledges, our study “does not provide information on how many of the bank’s customers complained or why some customers were successful in receiving refunds while others were not.”<sup>43</sup> A *Wall Street Journal* editorial is an opinion, and as the proposal notes, the “evidence” from the overdraft fee litigation was an expert report for the plaintiffs which calculated that at least \$15 million was refunded to consumers who complained about overdraft fees through banks’ own internal dispute resolution systems.<sup>44</sup> That overdraft fees were often refunded demonstrates the incentive for informal, internal dispute resolution.

Even a brief survey of the online personal-finance literature indicates that, had the Bureau done more research into market incentives for financial institutions to grant refunds or fee reversals when consumers complain, it would have found that such reversals are common. While small, a recent survey found that 86 percent of customers who asked had a credit card late payment fee reversed.<sup>45</sup> Although that same survey found that only 28 percent of respondents asked for the fee waiver, it also found that unemployed customers had about the same probability of getting a fee reversal as did employed customers.<sup>46</sup> Issuers have an incentive to help good customers—those who have a history of timely paying off their credit card balances in full—get through temporary financial hardship, not to make it worse by assessing fees. While a cardholder’s credit score does seem to affect an issuer’s decision to reverse a fee,<sup>47</sup> this is likely because card issuers want to avoid waiving fees for cardholders who are unilaterally extending the term of their credit lines by repeatedly paying late. Indeed, some credit card issuers always waive the fee on the first late payment.

The Bureau’s peremptory conclusion that market incentives for such waivers do not coincide with the “merits” of a waiver is likely wrong in two respects. First, the proposal’s discussion misses the very basic point that such waivers are discretionary, not a legal right. All credit card contracts grant the issuer the right to impose late fees. Unless, as with the Discover card,<sup>48</sup> the contract grants the cardholder one free late payment, a consumer only “deserves” a fee waiver if the issuer exercises its discretion to decide that a waiver is appropriate.

Second, the proposal rejects customer “profitability” as the appropriate standard under which an issuer decides whether to grant a waiver. In practice, however, profitability seems to amount to a determination of whether the consumer is a responsible borrower who has made an inadvertent late payment or an inveterate late payer with a low average balance who is likely to leave the issuer with a large unpaid and uncollectible balance. Consumers with poor credit histories who repeatedly make late payments on a card are more likely to eventually walk away from the account, leaving the issuer with a large and uncollectible debt.

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43. *Ibid.*, 32857n369.

44. *Ibid.*, 32850.

45. Keri Anne Renzulli, “The Crazy Easy Trick to Getting a Credit Card Fee Waived or Your Rate Lowered,” *Time*, September 25, 2014.

46. *Ibid.*

47. Matt Schulz, “How to Get a Credit Card Late Payment Fee Waived in Four Easy Steps,” *U.S. News and World Report*, August 25, 2014.

48. “5 Things You Don’t Know about Your Discover Credit Card Grace Period,” Discover Products & Benefits, March 14, 2016, <https://www.discover.com/credit-cards/resources/discover-products/credit-card-grace-period>.

One could say that such consumers are denied fee waivers because they are unprofitable, but it would be just as accurate to say that such consumers have been denied refunds because they were opportunistically taking advantage of the issuer's forgiving refund policy. Consumer opportunism increases issuer costs, some fraction of which is passed on to consumers in the form of higher interest rates or fees. When a bank denies fee waivers to such opportunistic consumers, it is in fact protecting the large majority of consumers who rarely incur fees and obtain waivers when they do incur fees. The Bureau does not cite published or unpublished papers for the argument that firms resolve informal complaints by weighing the profitability of a customer who raised a complaint against the "probability that the consumer will indeed stop patronizing the provider."<sup>49</sup>

Even if financial institutions do grant fee waivers based on customer profitability, the Bureau does not even attempt to make the case that the imposition of class-action liability will make customers better off. If class-action liability essentially requires fee forgiveness that a bank did contract for, then this liability lowers the benefit to a bank from investing in internal dispute-resolution systems that allow fee forgiveness. Because it is the low-balance, frequent-fee-incurring customers whose fees are effectively refunded by class-action settlements, the value of such customers to a bank likely decreases. If such customers become unprofitable, the bank will screen them from its customer base. In recent years, banks have done precisely this by increasing minimum-balance requirements for the waiver of monthly checking-account fees, although these actions have not yet been tied empirically to class-action liability.

The Bureau has failed entirely to consider such a possibility. Indeed, the Bureau made no attempt in either the 2015 study or the current proposed rule to investigate how financial firms respond to potential class-action liability for taking actions that they have the contractual discretion to take. It may be that the Bureau is correct in thinking that customer profitability is divorced from whether the customer's late payment was an innocent mistake or part of a pattern of irresponsible or even opportunistic borrowing behavior. However, no one—including the Bureau—really knows. The great defect of the proposal is the absence of data about how often consumers are granted fee and charge reversals, why and when such reversals are granted, and why and when they are not.

The Bureau's consumer survey that is featured in the 2015 study asked consumers what they would do, hypothetically, if a bank failed to reverse a fee it had incorrectly assessed. However, the Bureau did not ask the right questions about what consumer respondents actually experienced: Had the consumer ever asked for a fee reversal? How had the issuer or bank responded? What were the respondent's credit and demographic characteristics? Had the Bureau asked these questions in the survey, it might have some empirical basis for asserting that market forces are inadequate to protect consumers against "wrongful" fees and charges. Having never asked such questions, the Bureau's proposal does not offer evidence that market forces fail to incentivize firms to resolve small-dollar disputes or that a paucity of small-dollar arbitrations is a sign of unredressed consumer complaints.

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49. Arbitration Agreements, 32901.

The Bureau simply has not shown that there is a problem in need of any solution, let alone a regulatory ban on mandatory arbitration clauses.

#### Incorrect Assessment of the Proposal's Costs and Benefits

The proposal does not adequately consider the costs and benefits of its proposal. It consistently ignores the benefits of arbitration, overestimates the benefits of class-action litigation, and underestimates the costs of its proposal. Moreover, in conducting its analysis, the Bureau makes a number of errors that skew the results.

*Consumers perform better in arbitration than in litigation.* The Bureau has failed to consider that consumers often perform better in arbitration than they do in litigation. According to the Bureau's proposal and its 2015 study, the majority of AAA consumer claimants maintain legal representation (63 percent).<sup>50</sup> However, the Bureau also found that self-represented plaintiffs were seven times more likely than represented plaintiffs to obtain a favorable AAA arbitrator's decision.<sup>51</sup> This finding is consistent with arbitration's simple process. Hiring an attorney likely offers little value to most consumers and is often unnecessary.

The Bureau's proposal also finds that the majority of AAA consumer claimants realize higher rates of overall success (likely defined as settlements or awards on the merits) compared to individual consumer litigants in federal court, with 57 percent of all arbitrations resulting in settlement and 6 percent in an award for a consumer claimant,<sup>52</sup> while 48 percent of individual consumers' lawsuits result in settlements and 7 percent in consumer judgments.<sup>53</sup> Arbitration seems to generate comparable or even slightly better results for individual claimants than do individual consumer lawsuits.

Moreover, the complex procedural motions found in federal court are not permitted in arbitration, and for claims under \$10,000, the arbitrator's decision is by default based only on the documents submitted or, in some cases, on a telephone hearing. Only for claims above \$10,000 is an actual hearing before an arbitrator the default way of resolving the dispute. If a hearing is held, it must be in a location convenient for the consumer. The proposal acknowledges the Bureau's finding that the average consumer traveled 30 miles and the median consumer 15 miles.<sup>54</sup>

The Bureau also found that most arbitrations were resolved in less than five months, and even with an in-person hearing, most were resolved in less than seven months.<sup>55</sup> Yet the Bureau's proposal focuses very little attention on the procedural differences between arbitration and litigation, with only 2 pages (out of 104) in the Federal Register devoted to these differences.<sup>56</sup>

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50. *Ibid.*, 32845.

51. *Ibid.*

52. *Ibid.*

53. *Ibid.*, 32847.

54. *Ibid.*, 32846.

55. *Ibid.*

56. *Ibid.*, 32843-44.

The proposal makes no attempt to estimate the actual transaction costs that a consumer would face in pursuing an individual claim in federal court, which involves complex procedures, pleading standards, motions, and discovery.<sup>57</sup>

*Comparing class-action settlements with arbitration awards is methodologically flawed.* The Bureau erroneously compares class-action *settlements* with arbitration judgment *awards*. Most consumer arbitrations settle, just as most consumer class actions do. Of the consumer arbitrations studied by the Bureau, 57.4 percent were coded by the Bureau as known or likely to have settled.<sup>58</sup> Terms of the settlements were not disclosed to the Bureau, however, and so the Bureau could not compare arbitral settlements to class action settlements. As a result, the Bureau's study does not allow a meaningful comparison of how consumers fare in arbitration versus how they fare as members of class actions. The Bureau's proposal acknowledges that its data from AAA only provide judgment awards, not settlement terms, and that the data on which the Bureau's proposal relies comprise less than one-third of the cases provided by AAA for 2010–2011 (341 out of 1060).<sup>59</sup>

Additionally, the Bureau's 2013 preliminary results compared all consumer arbitrations before the AAA over the period 2010–2012 to a very small sample of settlements in consumer class actions.<sup>60</sup> The Bureau discussed only eight such settlements because, for unexplained reasons, it studied only settlements reached after the latter half of 2009 in cases involving a contract between consumers and providers that dealt with one of the Bureau's three product areas and contained an arbitration clause. Of the eight settlements described by the Bureau in its preliminary results, three cases alleged violations of state payday loan laws, three involved allegedly fraudulent checking-account overdraft fees, one was a credit card case, and one involved currency. In all the settlements described by the Bureau, a large number of class members actually received small payouts, ranging from \$18 to \$85.<sup>61</sup>

In its proposal, the Bureau also reported aggregated data from its 2015 study showing that, for the class-action settlements reviewed over the 2008–2012 period, more than 11 million consumer class members received \$1.1 billion in compensation.<sup>62</sup> In contrast, for arbitrations that the Bureau studied over the much shorter 2011–2012 period, it could verify arbitral awards to only 32 consumers (or 20 percent of consumers making affirmative claims for relief) for a total of \$172,433.<sup>63</sup> Comparing aggregate payouts from class-action settlements and arbitration awards could mistakenly be interpreted to show that arbitration is the weaker instrument of compensation. However, such a comparison is a misleading conflation of two different types of data. Had the Bureau made a proper apples-to-apples data comparison, it would have compared consumer recovery in successful arbitrations not to

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57. Johnston and Zywicki, "Arbitration Study: A Summary and Critique," 23.

58. Arbitration Agreements, 32845.

59. *Ibid.*, 32845.

60. *Preliminary Results*, 103.

61. *Preliminary Results*, 105–109.

62. Arbitration Agreements, 32849.

63. *Ibid.*, 32845.



class-action settlements but to the 2 percent of consumer class actions in which consumers got an individual or classwide judgment.<sup>64</sup> Moreover, the aggregate relief amounts cannot be compared because the arbitration aggregate covers a two-year period, whereas the class-action aggregate covers a five-year period.

The Bureau could have compared arbitration consumer awards to class-action consumer awards. Had it done so, it would have noted that, of the 562 class-action cases it studied, consumers obtained judgments in only 10 (1.8 percent), with 7 of these being individual judgments (1.2 percent of all class-action filings). This left only 3 cases (0.5 percent of all class-action filings) that actually resulted in judgments for the class. By contrast, consumers got individual judgments slightly over 20 percent of the time in arbitration.<sup>65</sup> In other words, consumers were 1000 percent more likely to succeed in arbitration than in class actions. With data on six of the seven individual judgments, the Bureau computed that the average individual judgment was \$2,008 (and \$1,525 median).<sup>66</sup> The average individual consumer recovered \$5,389 (with a median of \$2,682) in arbitration. In other words, consumers got 250 percent more money in individual awards in arbitration than they did in class actions. Thus, had the Bureau reported the correct apples-to-apples comparative data, it would have reported that in arbitration, consumers were 10 times more likely to get individual judgments than in class actions, with average arbitral judgments over twice the size of average individual class-action judgments.

*The Bureau paints a misleading picture of class-action outcomes.* Even if the Bureau had data on arbitration settlements, its data on class-action settlements—which show attorney fees that are an unexpectedly low percentage of total class recovery and class compensation rates that are unexpectedly high—cannot be used to compare arbitration and class actions. These data are inconsistent with other data on class-action settlements.

Bureau director Richard Cordray has observed that class-action litigation returns approximately \$220 million to 6.8 million consumers each year.<sup>67</sup> The first thing to consider regarding these numbers is that noncash relief is far more common in consumer class-action settlements than is cash relief, with almost 10 times more consumers in the Bureau’s study getting noncash relief (316 million) than cash relief (34 million).<sup>68</sup> The second thing to note about the class-action settlements reported by the Bureau is that on average, the cash relief equals only \$32.35 per consumer. The Bureau considers this point in a footnote to its proposal.<sup>69</sup> While claiming that the data on payee information are not “completely congruent” with the data on payment information, the Bureau admits that the estimate of \$32 per class member is “reasonable.”<sup>70</sup>

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64. Johnston and Zywicki, “Arbitration Study: A Summary and Critique,” 50.

65. *Report to Congress*, sec. 5, 41.

66. *Ibid.*, sec. 6, 37–38n67.

67. Richard Cordray, “Prepared Remarks of CFPB Director Richard Cordray at the Arbitration Field Hearing,” October 7, 2015, transcript, <http://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-arbitration-field-hearing-20151007/>.

68. The Bureau found about 350 million class members in consumer class-action settlements, but only 34 million consumers shared in the \$1.1 billion in cash relief. *Report to Congress*, sec. 8, 27.

69. Arbitration Agreements, 32849n305.

70. *Ibid.*

Thus, even with the apples-to-oranges comparison of class settlement payouts to arbitral awards, consumers recover an average of \$32 in class-action settlements, but they recover on average about \$5,400 when they obtain a favorable judgment in arbitration. It is difficult to see how awarding \$32 each to millions of consumers makes class actions a better system of compensation than one that awards \$5,400 on average to consumers who have presumably suffered much greater harm.

An even more serious question arises over the Bureau's 2015 study on the value of the cash relief actually transferred to consumers in class-action settlements. Overall, the Bureau says, 34 million consumers received \$1.1 billion in cash relief under such settlements.<sup>71</sup> However, the proposal reports that 29 million consumers received \$1.015 billion in compensation under settlements of the multidistrict overdraft fee class litigation.<sup>72</sup> Thus, using the Bureau's own figures, and excluding the overdraft fee class settlements, 6 million consumers shared \$85 million in cash compensation in the remaining class-action settlements. This works out to about \$14 per compensated consumer. Had the proposal fully and clearly set out the data on class settlements, it would have had to explain that, at \$32 each, the overdraft fee class members got more than twice as much as class members in all other class-action settlements.

As for the general performance of class actions as a device to compensate consumers, the Bureau reported that, on (unweighted) average, 21 percent of the class received compensation and that attorney fees also averaged 21 percent of the total relief granted to the class.<sup>73</sup> The Bureau's finding on the fraction of class members actually receiving compensation is somewhat higher than previous research has found, but it is fairly consistent with Professor Johnston's ongoing research. Johnston investigated class settlements under federal consumer-protection statutes (in cases filed in the Northern District of Illinois over the period 2011–2012) and found that claims rates vary a great deal across case types.<sup>74</sup> For example, even under a single statute, such as the Fair Credit Reporting Act, claims rates vary from an average of only 12 percent in cases alleging that a credit card expiration date was printed on a receipt to 37 percent in cases alleging that an employment background check (a "consumer report" under that statute) did not comply with the required formalities.<sup>75</sup>

Attorneys are often the big winners in class-action settlements. The Bureau's proposal states that "across all settlements that reported both fees and gross cash and in-kind relief, fee rates were 21 percent of cash relief and 16 percent of cash and in-kind relief."<sup>76</sup> Further, when comparing fees to cash payments in 251 cases, the Bureau reported that 24 percent of the total amount paid out in cash by defendants was paid in fees.<sup>77</sup> These percentages have real dollar

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71. *Ibid.*, 32858.

72. *Ibid.*, 32857n372.

73. *Ibid.*, 32850.

74. Jason Scott Johnston, "High Cost, Little Compensation, No Harm to Deter: New Evidence on Class Actions under Federal Consumer Protection Statutes" (Virginia Law and Economics Research Paper No. 2016-9, Virginia Public Law and Legal Theory Research Paper No. 2016-33, University of Virginia School of Law, Charlottesville, VA, May 2016).

75. *Ibid.*, 26.

76. *Arbitration Agreements*, 32850.

77. *Ibid.*

values behind them: During the 2010–2012 period examined in the Bureau’s 2015 study, class-action attorneys took in \$424,495,451, which the Bureau does not mention in its proposal.<sup>78</sup> As part of assessing the value of class actions in providing relief to consumers, the Bureau should consider whether the amount that plaintiffs’ attorneys receive for pursuing class-action litigation is an acceptable cost. Additionally, the Bureau should consider that some of the costs of litigation and the associated millions of dollars in attorney fees will eventually be passed on to consumers.

To make matters worse, the Bureau’s finding that attorney fees are only 21 percent of the aggregate payment to the class is anomalous in light of other research.<sup>79</sup> In Johnston’s research on class settlements under federal consumer-protection statutes, attorney fees are rarely less than 75 percent of the total amount paid to the class, and they are often three or four times the amount paid to the class.<sup>80</sup> This finding indicates that class-action settlements are an extremely costly and inefficient way of getting money to class members. To see how inefficient, one needs only to ask the question: “Who would pay her lawyer three times the amount that she herself actually recovered?”

The Bureau found to the contrary that attorney fees (on average) are only a small fraction of the amount paid to class members because it computed an aggregate average, adding up fees in the numerator and payouts in the denominator across all types of class-action settlements in its dataset. Using this approach, the statistics from the biggest class settlements swamp the numbers and conceal what are generally much higher fees and much lower payouts to the class. As the Bureau itself reported, attorney fees in the monster class settlements—those exceeding \$100 million—averaged only 10 percent of the total payout to consumers, but these fees averaged a full 56 percent of the payout in settlements of less than \$100,000.<sup>81</sup>

Only six class-action settlements in the overdraft fee class actions, which had a total class payout of \$812 million and millions of class members, comprise 83 percent of total cash payouts in the 241 settlements studied by the Bureau.<sup>82</sup> When the Bureau reported that attorney fees are a relatively low fraction of class payout and the class claims (or payout) rate relatively high, it was really saying that for six very large settlements, costs were low and payouts were high.

The distorting effect of the biggest class-action settlements is even more serious than this because many of the largest settlements did not generate a cash payout to class members but instead brought other “nonmonetary” relief. In securing judicial approval of a settlement with primarily nonmonetary relief, class-action attorneys rely on the testimony of expert economists that attaches a high dollar value to such nonmonetary relief. The “relief” is often illusory or its value greatly overinflated. Indeed, of the total \$644 million that the Bureau estimated consumers received in “in kind” or nonmonetary relief, a full \$575 million or 89 percent was

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78. *Report to Congress*, sec. 8, 33, table 10.

79. Johnston, “High Cost, Little Compensation.”

80. *Ibid.*

81. *Report to Congress*, sec. 8, 34, table 11.

82. *Ibid.*, sec. 8, 28–29, table 5.

from one settlement, where this relief was the value attached to credit-monitoring services offered to class members on a claims-made basis.<sup>83</sup> Thus, as an instrument of actually compensating the class, class-action settlements are likely to be much more costly and much less effective than is suggested by the data in the Bureau's 2015 study.

*The Bureau should have excluded class actions that did not involve financial products or services subject to mandatory arbitration.* The Bureau's class-action sample did not comport with its stated principle of focusing on class actions involving financial products or services that might be subject to a mandatory arbitration clause. The 2015 study analyzed 562 class actions filed in federal and state court over the period 2010–2012.<sup>84</sup> As the proposal reports, in the 2015 study sample, the most common class-action claims (55 percent) arose under the Fair Debt Collection Practice Act (FDCPA) and state consumer-protection statutes.<sup>85</sup>

If the Bureau had followed its stated principles for sample construction, it would have excluded the vast majority of FDCPA class settlements from its sample. Evidence from a recent study by Johnston—the largest study of consumer class actions other than the CFPB's—shows that most of those cases involve actions against debt collectors, not creditors or creditor assignees.<sup>86</sup> A majority of courts considering the issue have held that third-party debt collectors are independent contractors, and as such, they may not avail themselves of an arbitration clause in the contract between the creditor and the debtor.<sup>87</sup>

Given that the Bureau included these debt-collector FDCPA cases in its class-action sample, it should also have included other cases involving obvious financial products that might not have been covered by arbitration clauses. The most notable omission is cases alleging that an ATM owner failed to post a notice of fees for using the machine “on or at” the location of the machine, in violation of a provision of the Electronic Funds Transfer Act (EFTA) that was then effective.<sup>88</sup> In a recent study of all consumer class-action filings in the Northern District of Illinois over the 2010–2012 period—precisely the period studied by the Bureau—Professor Johnston found that ATM “on or at” notice failure cases were relatively frequent among class actions brought under federal consumer protection statutes.<sup>89</sup> Such ATM notice failure class actions were frequent even relative to class actions involving any product or service, and hence they were a very large fraction of all class actions involving financial products or services.

The inclusion of debt collector and exclusion of ATM notice failure class settlements from the Bureau's 2015 study likely biases the study, and therefore the proposal, to report higher class compensation rates and lower attorney fees relative to class compensation. Johnston found that compensation rates in ATM notice failure class-action settlements were very low, while attorney fees were often astronomical multiples (800–900 percent) of the aggregate

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83. *Ibid.*, sec. 8, 24.

84. *Ibid.*, sec. 6, 36.

85. Arbitration Agreements, 32846.

86. Johnston, “High Cost, Little Compensation,” 2.

87. As discussed by Johnston and Zywicki, “Arbitration Study: A Summary and Critique.”

88. Johnston, “High Cost, Little Compensation,” 15.

89. *Ibid.*

cash payment to the class.<sup>90</sup> Conversely, Johnston found that in FDCPA debt-collector cases, compensation rates are often very high, while attorney fees are high relative to the aggregate payout<sup>91</sup> but only because, as the Bureau notes, the FDCPA limits class settlement payouts to 1 percent of the defendant's net worth.<sup>92</sup>

In sum, the Bureau's decision in the 2015 study to exclude ATM notice failure class settlements under EFTA but to include FDCPA debt collector class settlements predictably led to rosier findings about the performance of class-action settlements than the Bureau would have reported had it consistently followed its stated methodology for constructing its class-action settlement sample.

*The Bureau has not shown that class actions produce beneficial industrywide changes.* The Bureau has overstated the benefits of its proposal. The Bureau simply “does not believe that it is possible to quantify the benefits to consumers from the increased compliance incentives attributable to the class proposal due in part to obstacles to measuring the value of deterrence in a systematic way.”<sup>93</sup> The Bureau's assertion that class actions benefit consumers because companies “frequently” change their practices as a result of class settlements<sup>94</sup> is supported by three anecdotal pieces of evidence but no systematic evidence.

The first piece of anecdotal evidence is that law firms and other firms that monitor litigation trends often alert companies to new developments in class-action law, including recent class settlements. This practice says nothing about whether or not such knowledge causes or should cause changes in practices. The Bureau reports, for example, that a variety of newsletters notified banks about class settlements involving purportedly inadequate notices of fees on ATM machines.<sup>95</sup> Since the Bureau thought that such cases were irrelevant to its study (because they involve a claim that would not be covered by an arbitration clause), it is strange for the Bureau to refer to them at all in the proposed rule. Moreover, these cases represent a cause of action that Congress eliminated as completely frivolous, given that fee notices appear on ATM screens before transactions are finalized. Rather than incentivizing banks to make sure they had the required “on or at” notices, class settlements of such cases dramatically illustrated the social waste of the “on or at” notice requirement, leading to its eventual repeal by Congress.

The second piece of anecdotal evidence is that, as a result of the settlement in the consolidated currency-fee antitrust class action, the practice of disclosing foreign transaction fees to debit and credit card holders in initial disclosures spread from the two firms subject to the settlement to the entire market.<sup>96</sup> This new disclosure hardly constitutes evidence of the value of class-action settlements in generating positive change in the industry. There is abundant evidence that transaction-fee disclosures may well be ineffective wherever they are placed and however often they are repeated in written materials.

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90. *Ibid.*, 15–19.

91. *Ibid.*, 29.

92. Arbitration Agreements, 32832n34.

93. *Ibid.*, 32864.

94. *Ibid.*, 32858–59.

95. *Ibid.*, 32862.

96. *Ibid.*, 32863.

The Bureau's final piece of anecdotal evidence comes from the most highly publicized consumer class settlement of the last decade, namely those arising from the bank overdraft fee consolidated class actions. After the settlement, the percentage of banks that commingle debit transactions with checks and process the largest transactions first dropped from 37 percent to 9 percent.<sup>97</sup> It is striking that, even after such a high-profile settlement, almost 10 percent of banks continue to utilize the practice supposedly discontinued by virtue of the overdraft settlement. If anything, this would seem to imply that such settlements have a relatively minor and varying impact on firm behavior.

The Bureau, however, assigns a large benefit to the change wrought by the overdraft class-action settlement. The proposal sets out \$2.6 billion as the harm suffered over a 10-year period by consumers subject to the overdraft settlement—harm that the Bureau says will be averted in the future because so many banks have stopped the challenged practice. The lead class counsel and a law professor generated this figure after the settlement was completed by calculating that the overdraft class settlements provided compensation equal to between 7 and 70 percent of the harm suffered by class members.<sup>98</sup> The Bureau simply accepts the assertion by class counsel that the overdraft fee practices modified as a result of the settlements in the overdraft fee class actions did indeed “harm” consumers and that the new practices make consumers better off.

A brief look at the economics of checking accounts and overdraft fees reveals that it is far from obvious that consumers were actually harmed by the overdraft fee practices at issue or that the settlements have benefited them. Over time, checking accounts have become clear money losers for banks, with one company estimating that pretax income per checking account has gone from \$12.59 in 1992 to a loss of \$47.23 in 2002 and an even bigger loss of \$196.46 in 2012.<sup>99</sup> A study by another financial industry consultant put the 2012 loss per checking account at a somewhat smaller \$81.<sup>100</sup>

Frequent customer overdrafts can add to a bank's expenses in maintaining checking accounts. As one consultant explained, when banks do not provide overdraft coverage—that is, paying overdrafts up to some threshold but charging a service fee—overdrafts are expensive for everybody. “You know how it works: A customer bounces a check, the bank imposes a fee and returns the check to the merchant, who imposes a fee and redeposits it to the bank; the check bounces again and goes back to the merchant, who then imposes another fee and makes angry phone calls to the customer, who then has to come pick up the check and pay with cash. The total time, fees, hassles and embarrassment amount to a lot more than the typical \$25 bank fee.”<sup>101</sup>

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97. *Ibid.*

98. *Ibid.*, 32864, citing Brian T. Fitzpatrick and Robert C. Gilbert, “An Empirical Look at Compensation in Consumer Class Actions,” *New York University Journal of Law and Business* 11, no. 4 (2015): 785.

99. “Stop the Bleeding with a Value Checking Program from Strunk,” Strunk, accessed August 12, 2016, [https://www.strunklp.com/site/page?view=value\\_checking](https://www.strunklp.com/site/page?view=value_checking).

100. Marina Shifrin, “Banks Are Actually Losing Money to Service Your Checking Account,” *MyBankTracker*, January 25, 2012.

101. Alex Sheshunoff, “A New Approach to Covering Overdrafts,” *BankDirector.com*, June 3, 2011, <http://www.bankdirector.com/magazine/archives/2nd-quarter-2002/a-new-approach-to-covering-overdrafts>.

As an alternative to having branch managers decide when a bank will waive the overdraft fee—a costly process leaving the manager exposed to customer complaints about inequitable treatment—many banks followed the recommendations of consultants and adopted automatic overdraft-protection programs. Under these programs, banks charge a fee but pay overdrafts up to a threshold. Some objected that such programs would encourage reckless consumer financial behavior, but:

A certain percentage of our customers choose convenience over financial prudence. For these customers, it may be worth it to pay a fee to their bank if it gives them other benefits, such as avoiding late fees or other consequences resulting from late payments on their mortgage or credit card accounts. . . . Consumers who use overdrafts as a financial management tool are in the minority. Fully 70 percent of checking account customers never overdraw their accounts, and about half of those who bounce checks do so only once or twice a year. For them, automatic coverage provides piece [*sic*] of mind for the occasional lapse or mistake.<sup>102</sup>

Automatic overdraft coverage up to a given threshold is not only a valuable service that customers are willing to pay for in the form of fees, but it is also a source of revenue for banks that lowers their cost of offering checking. By this rationale, overdraft fees would have their biggest relative impact in lowering the cost of offering checking accounts to customers who would otherwise be very unprofitable precisely because they frequently incur overdrafts.

Any regulatory intervention that lowers overdraft fee revenue should decrease banks' willingness to offer free checking accounts to such high-cost customers. Especially in the post-Dodd-Frank world—where, due to the Durbin Amendment, banks' revenues from debit card interchange fees fell by \$6.6 billion to \$8 billion per year<sup>103</sup>—basic economics would predict that any intervention that lowers overdraft fees would increase banks' incentive to restrict and ration the supply of checking accounts, limiting such accounts to low-cost, high-value customers.

If this proposition is true, then even if we grant the Bureau's assumption that consumers were harmed by the practices targeted by the overdraft fee class-action settlements, cessation of those practices also could have harmed many consumers. After all, the theory of harm in the overdraft fee practice class actions was that by ordering checks presented for payment in a given day from high to low, banks increased their overdraft fee revenue.

The Bureau simply assumes that all class members were harmed by the practice of paying checks (and debits) from high to low. In fact, the banks plausibly argued that the typical customer preferred having the biggest checks—checks for things like mortgages and credit card

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102. *Ibid.*

103. Todd Zywicki, Geoffrey Manne, and Julian Morris, "Price Controls on Payment Card Interchange Fees: The U.S. Experience" (George Mason University Law and Economics Research Paper Series 14-18, International Center for Law & Economics, Portland, OR, June 2014).

payments—paid using overdraft protection, leaving smaller checks to potentially bounce.<sup>104</sup> One suspects that the high-to-low check processing method most hurt those customers with a high volume of small transactions and relatively frequent overdrafts. It may have actually reduced overdraft fees for customers who rarely use overdraft protection and do so only to cover a mistake affecting a large check, such as one for a mortgage or credit card payment.

The proposal does not even address the possibility that changing banks' overdraft practices harmed some customers. Instead, the Bureau relies on the assertions about the value of the overdraft fee class settlements set out by class counsel in those actions. Before banning arbitration clauses, the Bureau should go back and conduct a rigorous study into the purported consumer benefits of the overdraft and other class-action settlements.

In undertaking such a study, the Bureau should take into account the dynamics that lead to class-action settlements. Under current legal standards for judicial approval of a class action settlement, the fact that a class-action claim is weak on its substantive legal merits and therefore likely to lose at trial is an argument supporting judicial approval of the settlement. Indeed, the typical motion for judicial approval of a large, nonstatutory class-action settlement in Professor Johnston's Northern District of Illinois dataset argues that it would be very costly to fully adjudicate the class claims on the merits and that the claim would face a high probability of rejection on the merits after such an adjudication.<sup>105</sup> Under this standard, the greater the cost of proceeding with further discovery and litigation, and the more dubious and far-fetched the plaintiffs' claims, the more likely are class-action settlements to be approved. Changes in industry practice made in response to such settlements are unlikely to benefit consumers.

*The Bureau has not adequately considered the costs of its proposal.* The proposal contains vague "theory" on the deterrent value of class settlements, but the Bureau<sup>106</sup> more or less concedes that it has no data at all regarding the proposed rule's compliance costs to financial services providers, and it relies solely on theoretical speculation. Then, without any kind of support, the proposal asserts that if a bank fails to stop a payment as requested by a consumer, the consumer would neither bring an arbitration nor be aware that she could sue when the bank sent a notice inadequately explaining its reasons for denying her credit.<sup>107</sup>

As to the crucial statutory question of how much cost will be passed on to consumers, the Bureau says only that "economic theory does not provide useful guidance," but the Bureau "believes . . . providers might treat administrative costs of additional compliance as fixed."<sup>108</sup> The Bureau was also unable to quantify the investments firms would likely make to "reduce exposure to class litigation" or to quantify and monetize the "extent of the consumer benefit that would result from this investment, or particular subcategories such as improving

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104. Robert L. Clarke and Todd J. Zywicki, "Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, November 2013), 20.

105. Johnston, "High Cost, Little Compensation," 13.

106. Arbitration Agreements, 32904.

107. *Ibid.*, 32905.

108. *Ibid.*, 32911.



disclosures.”<sup>109</sup> Despite this absence of quantitative data, the Bureau concludes that the “costs to consumers are likely to be low, as after all, there are only a few hundred consumer arbitrations per year.”<sup>110</sup>

The Bureau’s proposal notes that the 2015 study examined the settlement in an antitrust case, *Ross v. Bank of America*, as a natural experiment shedding light on whether arbitration clauses lead to lower prices for consumers.<sup>111</sup> Under the settlement in *Ross*, a subset of four defendants agreed to stop using arbitration clauses for at least three-and-a-half years. The Bureau looked at whether the change in the total cost of credit charged to consumers after the imposition of the settlement terms differed between the credit card issuers that stopped using arbitration clauses under the settlement and a large (although not precisely identified) set of issuers not subject to the settlement. The Bureau found no statistically significant difference in the change in the cost of credit across the two groups after one group stopped using arbitration clauses.<sup>112</sup>

Basic economic theory predicts that competition forces firms to pass on to consumers at least a portion of any cost decrease or increase. Empirical evidence shows that financial-products firms do pass on changes in their costs.<sup>113</sup> However, banks are unlikely to adjust their deposit and loan rates quickly or fully to reflect only temporary changes in market interest rates. It is also questionable whether firms would choose to raise prices on consumers—potentially losing them to a competitor—in order to reflect a temporary cost change. Firms in the consumer-services sector adjust prices much more slowly in response to cost changes than do firms in the manufacturing sector, and large firms adjust prices more slowly than do small firms. In light of this, it is not surprising that the Bureau found that the four credit card issuers that agreed to remove arbitration clauses for three-and-a-half years did not change their credit card prices in a way that significantly differed from the practices of other issuers. The Bureau’s study does not scientifically disprove the idea that financial-services providers eventually pass on litigation costs to consumers; on the other hand, economic theory does suggest that providers will eventually pass on those costs.

#### Failure to Consider a Less Restrictive Alternative

The Bureau requests comment on alternative policy options and should consider the option of using incentives to encourage firms to draft fee-shifting clauses.<sup>114</sup>

At most, the evidence now available to the Bureau shows that there are relatively few arbitrations and may suggest that even the \$200 filing fee charged by the AAA deters consumers from filing very small-stakes arbitrations. That same evidence, however, shows that—as discussed

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109. *Ibid.*, 32912.

110. *Ibid.*, 32912.

111. *Ibid.*, 32851.

112. *Ibid.*

113. David S. Evans, Howard Chang, and Steven Joyce, “The Impact of the U.S. Debit Card Fee Regulation on Consumer Welfare: An Event Study Analysis” (University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 658, Chicago, IL, October 2013); Zywicki, Manne, and Morris, “Price Controls on Payment Card Interchange Fees.”

114. Arbitration Agreements, 32922.

above—companies such as AT&T have designed arbitration clauses under which consumers incur no costs in filing arbitration claims, and if successful in obtaining an arbitral judgment that exceeds the company’s last settlement offer, consumers get thousands of dollars in liquidated damages.

Arbitration clauses like this—which may be called consumer-bonus clauses—make small-claims arbitrations a costless and potentially very lucrative proposition for consumers. They therefore provide a strong incentive for companies to make fair and reasonable settlement offers. Rather than banning arbitration clauses, the Bureau should consider whether to use its various powers to provide incentives for financial firms to draft fee-shifting, consumer-bonus arbitration clauses or whether such clauses would spread absent Bureau intervention through competitive pressure.

## **ALTERNATIVES TO BANNING ARBITRATION CLAUSES: CONCRETE PROPOSALS FOR FURTHER RESEARCH**

As argued above, the one thing that is clear from the proposal is that the Bureau does not know nearly enough about arbitration, class actions, or market incentives for consumer-complaint resolution to ban arbitration. The limitations on the the Bureau’s current knowledge, however, point to very concrete areas for further research before the Bureau either bans or restricts arbitration clauses.

First, to really compare arbitration and class actions, the Bureau must identify the underlying allegedly wrongful behavior from arbitral and class-action complaints, then compare outcomes in arbitrations and class actions that are actually challenging that behavior. For example, we know from the Bureau’s 2015 study that a large number of Telephone Consumer Protection Act (TCPA) claims are brought both in AAA arbitration and as class actions. As described by Johnston,<sup>115</sup> among others, there are different sorts of TCPA claims, with one of the most common being an allegation that an unconsented, autodialed call was made to a cellphone in an attempt to collect a debt. The Bureau should identify such debt-call TCPA claims in both arbitration and class actions. Having done so, it could compare outcomes in arbitration versus litigation. Such a research program would allow the Bureau to say something meaningful about the kinds of claims brought in arbitration versus as class actions. In particular, the Bureau could then really speak to the key question of what kind of small-dollar claims are brought in arbitration versus as class actions.

Second, the Bureau should put together a much more precise and fine-grained dataset on class actions and their outcomes. Having identified the allegedly wrongful conduct in both arbitration and class-action claims, the Bureau could then provide data on class-action outcomes by type of challenged conduct. The problem with the Bureau’s existing class-action data is that it is too coarse grained. Aggregate statistics on class settlements reported by the Bureau are swamped by a few gigantic and (based on Johnston’s findings) highly unrepresentative class

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115. Johnston, “High Cost, Little Compensation,” 32.

settlements. The Bureau should report data in a way that allows the public to see how class settlements vary with the type of claim. In addition, the Bureau should consistently follow whatever methodology it says it is using for constructing the class-action dataset. If the Bureau is interested only in class actions that might have been covered by an arbitration clause of which the class defendant could avail itself, then the Bureau should remove all debt-collector defendant class actions from its dataset.

Additionally, the Bureau should perform a more fine-grained analysis of how judges supervise arbitration today, and it should examine whether any further marginal adjustments might be made to arbitration processes within the current system. For example, knowing exactly how many businesses have followed AT&T in providing a minimum recovery in the event the consumer wins would better inform the Bureau's analysis of the effectiveness of arbitration clauses for consumers.

Finally, the Bureau should redo its consumer survey. The first survey done by the Bureau revealed that consumers do not know much about arbitration or class actions; instead of pursuing either avenue of redress, most consumers would simply cancel their account and take their business elsewhere if a credit card company failed to reverse an incorrect charge. The Bureau needs to ask several important questions. Did consumers cancel accounts when their requests to reverse fees and charges were denied? How often did consumers complain and persuade a credit card or other financial-services company to reverse a fee or charge? Under what circumstances (including not only the reason for the charge but the socio-demographics of the consumer) did companies reverse charges, and under what circumstances did they not do so? These questions are crucial to estimating the strength of market incentives for financial-services providers to resolve consumer complaints without any form of ex post dispute resolution, arbitration, or class actions. Only with some sense of the magnitude of these market incentives can the Bureau interpret the economic significance of the number of small-claims disputes observed in arbitration.

## CONCLUSION

The Bureau's proposal ignores the benefits of arbitration to consumers and the public policy that favors the use of arbitration. Using flawed methods to assess the relative costs and benefits of class actions and arbitrations, the Bureau deemed class-action litigation to be superior to arbitration. It now wants to ban arbitration clauses by financial services providers that preclude consumers from joining class actions. Without showing that there is a problem that needs to be solved, the Bureau has proposed a perceived remedy that will likely be very costly for consumers. The Bureau also failed to consider less restrictive, more effective alternatives, including whether it should provide incentives for financial firms to adopt fee-shifting, consumer-bonus arbitration clauses.

Before enacting its proposal, the Bureau should gather and analyze data regarding arbitrations and class actions, small-dollar claims, and the handling of customer complaints. Only with complete data can the Bureau identify whether there is a problem related to arbitration and, if so, how to solve it.