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D.C. Circuit Court Decision Calls Into Question the Constitutionality of the Appointment of the Director of the CFPB

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This Alert analyzes the possible implications of the January 25,2013 decision of the United States Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit") that limits the ability of the President of the United States to utilize the recess authority to circumvent the authority of the U.S. Senate to "advice and consent" to proposed nominations. Specifically, this analysis discusses whether the appointment of the Director of the Consumer Financial Protection Bureau (the "CFPB") was flawed, and thereby nullifies or otherwise limits actions taken by the CFPB since the Director was appointed by the President, purportedly using the recess appointment authority.

On January 25, 2013, the D.C. Circuit issued its decision in the case of *Canning v. National Labor Relations Board*, No. 12-1115, which challenged the authority of the President of the United States to exercise his "recess appointment" authority to appoint members of the NLRB during a time period in which Congress was not "in session." The significance of the *Canning* decision is that, simultaneously with the putative recess appointments of three members of the NLRB, the President also utilized the same recess appointment authority to appoint Richard Cordray as the first Director of the CFPB. Hence, because Director Cordray's appointment occurred simultaneously with the NLRB appointments, the validity of Director Cordray's appointment is directly linked to the NLRB appointments because the identical constitutional argument (*e.g.,* the use of the recess appointment power) was the basis for Director Cordray's appointment. A case is currently being litigated in the Federal District Court for the District of Columbia directly challenging the appointment of Mr. Cordray; as a result of the *Canning* decision now being controlling authority on the issue, it is possible that Mr. Cordray's appointment as Director of the CFPB may be found to be defective.

In the *Canning* case the D.C. Circuit determined that the recess appointment authority was more limited in scope than was being advocated by the Administration, and could only be used in the "intersession" context in which Congress was adjourned "*sine die*." As a practical matter, the Court easily concluded that

short*, intrasession* adjournments (*e.g.,* namely gaveling open and adjourning for a few days by the U.S. Senate without formally recessing over the 2011 Holiday season), did not constitute a "recess," and the use of the recess authority during intrasession adjournments denied Congress its constitutionally mandated duty to approve or disapprove the nominations of senior officials requiring Senate approval. As summarized wryly by a commentator in the area, the D.C. Circuit determined that the recess appointment power is not available during Congressional lunch breaks. (Although not necessary for its decision, but extremely important for future use of the recess appointment power by the President, the D.C. Circuit also held that a vacancy had to occur during the period of a recess rather than merely to exist within the period that Congress was in recess.)

The implications of the *Canning* decision are potentially significant as applied to the operational authority of the CFPB. This is because the authorization provisions for the CFPB that are set forth in Title X of the Dodd-Frank Act distinguish between certain powers and authorities exercisable by the CFPB *prior* to the appointment of a Director and the exercise of all authorities statutorily given to the CFPB *following* the appointment of a Director.

By means of example, in a report provided to the Inspectors General of several agencies in July of 2011, the designated Treasury official charged with the "standing up" of the CFPB identified categories of authority that did not require an appointed Director and those that first required that a Director be validly appointed.

CFPB Authorities Not Requiring an Appointed Director:

- Prescribing rules, issuing orders, and producing guidance related to the federal consumer financial laws that were transferred to the CFPB and formerly within the authority of the Federal Reserve Board, the OCC, the OTS, the FDIC, and the NCUA;
- Conducting compliance examinations for federal consumer financial laws of banks, savings associations, credit unions and their affiliates with total assets in excess of $10 billion;
- Prescribing rules, issuing guidelines and conducting studies and issuing reports (with certain limitations) under the enumerated consumer laws that were previously within the authority of the Federal Trade Commission;
- Conducting all consumer protection functions previously within the authority of HUD relating to the Real Estate Settlement Procedures Act of 1974, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008, and the Interstate Land Sales Full Disclosure Act;
- Enforcing all orders, resolutions, determinations, agreements, and rulings issued prior to the transfer date by other agencies or courts relating to the performance of consumer financial protection functions transferred to CFPB with respect to a bank, savings association, or credit union with total assets in excess of $10 billion (including affiliates); and
- Replacing the Federal Reserve Board, the OCC, the OTS, the FDIC, the NCUA or HUD in any lawsuit or proceeding that was commenced by or against one of the transferor agencies prior to the designated transfer date with respect to a consumer financial protection function transferred to CFPB.

CFPB Authorities Requiring a Validly Appointed Director:

- Supervising non-depository institutions pursuant to the provisions of Section 1024 of the Dodd-Frank Act , including the authority to: (i) prescribe rules defining the scope of non-depository institutions subject to CFPB's supervision; (ii) prescribe rules establishing recordkeeping requirements that CFPB determines are needed to facilitate non-depository supervision; and (iii) conduct examinations of non-depository institutions;

- Prohibiting unfair, deceptive, or abusive acts or practices in connection with consumer financial products and services;

- Prescribing rules and requiring model disclosures to ensure that the features of a consumer financial product or service are fairly, accurately, and effectively disclosed both initially and over the term of the product or service; and

- Prescribing rules to, among other things, require the filing of limited reports to CFPB for the purpose of determining whether a non-depository institution should be supervised by CFPB.

There are stakeholders in the consumer financial services arena that must consider the implications of the *Canning* decision on the CFPB's jurisdiction; we offer several initial observations in regard to their concerns.

The Administration

Although the Administration has already publically announced its intention to appeal the *Canning* decision (which could be either an *en banc* review by the D.C. Circuit or an appeal to the U.S. Supreme Court), the ambiguity created during the time period while awaiting another appellate decision (which could extend over the next 12 months) raises practical legal difficulties regarding the operational authority of the CFPB during that interim period. For example, while it appears that the CFPB continues to possess jurisdiction in regard to large depository institutions (*i.e.,* banks and similar institutions and affiliates with assets exceeding $10 billion), the jurisdiction of the CFPB regarding non-depository entities is very problematic. Even in the instance in which the CFPB's examination, supervision and enforcement authorities appear legally sound, portions of formal and informal enforcement actions, investigations, and similar matters previously delegated from the Director to subordinate officials at the CFPB are potentially subject to challenge.

The Administration also faces a potential slowdown in its current examination schedule—except for the continued examination and supervision of large depository institutions. For examination of non-depositories such as mortgage banks and similar entities that requires the valid appointment of a Director, at best ongoing examination and supervisory functions become far more negotiable in regard to scope and content.

Assuming that the appointment of Mr. Cordray is defective, the authority to administer the CFPB in its reduced role would once again fall to the Secretary of the Treasury or his designee—which could be Mr. Cordray acting in that capacity until his nomination is resolved.

It is our view that any prolonged delay in regard to the appointment of a Director would be viewed as unacceptable to the Administration—which might result in the Administration negotiating with the Congress not only to approve the appointment of Mr. Cordray by acceding to some of the demands of the House, but also to retroactively validate actions taken under his tenure as Director from the date of his recess appointment in January of 2012. (The primary demands of the Republican majority in the House have

been to establish a five-member CFPB Commission, like the SEC or the FTC, and to place the budget review process for the CFPB under the control of Congress.)

Industry Participants

For financial service industry stakeholders, distinctions might be drawn between: (1) directly regulated large depository institutions; (2) smaller depositary institutions (less than $10 billion in assets) exempted from direct regulation by the CFPB; (3) non-depository consumer financial companies that are specifically subject to CFPB regulation; and (4) non-depositary companies that are identified as “larger” companies and hence subject to CFPB examination and supervision.

In the case of depository institutions with assets exceeding $10 billion, it appears that there may be little in the way of interruption in regard to the CFPB’s examination and supervision functions. Unfortunately, because the CFPB might be prohibited from examining other categories of entities, supervisory activity such as on-site examinations might increase for entities in this category.

In regard to depository institutions with assets less than $10 billion, the dispute regarding the validity of the appointment of a Director should have little effect on the federal oversight of consumer compliance. This is because direct examination and enforcement functions were not transferred for this category of depository institutions from the federal banking agencies to the CFPB, and hence the banking regulators should be expected to continue their regular supervision and examination schedules.

In the case of non-depository entities such as mortgage industry participants specifically identified as being subject to direct CFPB examination following the valid appointment of a Director, prudence dictates a go-slow approach in regard to challenging the CFPB’s examination authority. This is because very little value except delay could be expected by objecting to ongoing CFPB examinations and related functions—and any aggressive objections to CFPB oversight might be detrimental to long-term relations with the CFPB.

In the case of persons and entities which the CFPB must designate as being a larger non-depository entity, this category of covered company is likely to remain unsupervised by the CFPB until the appointment issue is resolved. Among other things, even though the CFPB has designated several categories of large companies such as credit reporting agencies and debt collection agencies for direct supervision, those designations were issued by Director Cordray and are now possibly defective.

This is not to say, however, that raising objections to the exercise of CFPB enforcement authority might not be useful while the appointment of the Director is being resolved. For example, during this time period certain formal enforcement orders, civil money penalties and civil investigative demands may now be of dubious validity, and in the minimum provide a greater opportunity for negotiation with CFPB personnel. For example, several high-profile settlements recently entered into by the CFPB were in part based upon the exercise by the CFPB of its authority to prohibit unfair, deceptive and abusive practices, which arguably require the valid appointment of a Director. While beyond the scope of this analysis, in this and other contexts the CFPB’s regulatory actions may likely overlap between authorizations requiring the valid appointment of a Director and those not requiring that a valid appointment be demonstrated.

Mortgage Lenders and Servicers

A serious conundrum is created in regard to regulations issued following the recess appointment of the Director that were not transferred to the CFPB from other financial service agencies. In the instance of the several mortgage regulations issued by the CFPB in the past two weeks (*e.g.*, the Qualified Mortgage and Ability to Repay Rules, the Loan Officer Compensation Rules, etc.), the validity of those regulations is now

in question. However, and regrettably, if those implementing regulations were defectively issued, Section 1400(c)(3) of the Dodd-Frank Act arguably requires that the modifications to mortgage origination and servicing contained in Title XIV of the Dodd-Frank Act become immediately effective.

This legal result, if correct, would potentially have serious consequences for the mortgage industry. We are aware that there are legal theories under administrative law that might support the validity of some portion of the regulatory actions taken under Director Cordray's leadership; however, any such regulations or actions arguably would be required to be issued under the authority of the Secretary of the Treasury until a Director is validly appointed. In any event, it is highly possible that the mortgage industry may elect to either lobby for an Administration/Congressional compromise along the lines noted above (*i.e.,* a commission form of agency structure and Congressional budget oversight), or defend the recess appointment of Director Cordray as valid, and in any event insist that Congress and the Administration agree to postpone the effective date of the above-referenced statutory mortgage modifications.

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Please note that this Alert is intended to be a starting point for evaluating the authority of the CFPB until the validity of the appointment of Mr. Cordray as Director is resolved. As noted above, in instances in which objecting to the exercise by the CFPB of authority may be necessary, overlapping legal concerns will require careful consideration on a case-by-case basis.

Members of our financial services regulatory and litigation teams are available to discuss any questions or inquiries that might arise following review of this Alert.

If you have any questions, please contact the Pillsbury attorney with whom you regularly work, or the authors:

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