

COMMISSIONER'S BULLETIN



DEPARTMENT OF CORPORATIONS

Supporting a Fair and Secure Financial Services Marketplace for all Californians

www.corp.ca.gov

Edmund G. Brown Jr.
Governor

Jan Lynn Owen
California Corporations Commissioner

DATE: December 5, 2012

Commissioner's Bulletin No: 001-12

Emergence of Third-Party Risk Management Companies

The Department of Corporations ("Department") has become aware of certain business arrangements that may involve unlawful referral fees to third-party risk management companies. The business model of some third-party risk management companies may lead to violations of licensing laws by entities subject to the Department's jurisdiction, including lenders and escrow agents. Consequently, the Department is issuing this Commissioner's Bulletin to prevent licensees from inadvertent violations of law.

BACKGROUND

On April 13, 2012, the Consumer Financial Protection Bureau ("CFPB") released guidance to supervised banks and nonbanks about overseeing their business relationships with service providers in a manner that ensures compliance with federal consumer financial laws. Among other things, the CFPB guidance advised supervised banks and nonbanks to take steps to ensure that their business arrangements with service providers, such as escrow companies, do not present unwarranted risks to consumers, such as: (1) conducting due diligence on service providers to ensure the service provider can comply with financial laws; and (2) reviewing the service providers' policies and procedures to ensure appropriate training and oversight of employees.

In response, third-party risk management companies have emerged to provide supervised banks and nonbanks with a screening service to pre-screen potential service providers. The Department has learned that some third-party risk management companies are requiring that potential service providers pay a fee in order to be pre-

screened by the companies, and to appear on a list of "approved" service providers. In addition, some supervised banks and nonbanks have been advising potential service providers that the service providers must be on the third-party risk management company's "approved list" in order to receive business.

Lenders subject to the Department's jurisdiction should be cautious of delegating their responsibility to vet service providers to third parties, and are reminded that they are responsible for such companies' compliance with the law. Escrow agents should be cautious of subscribing to the vetting services of third party companies for a fee, in order to get on a list provided to lenders, as these actions may lead to violations of law. All parties should take necessary precautions prior to sharing personal and confidential information with third parties.

ESCROW LAW RESTRICTIONS ON PAYING FOR REFERRALS

Among other things, one purpose of this bulletin is to remind escrow agents of the prohibition in Financial Code section 17420 against the payment of referral fees for soliciting escrow accounts. Section 17420 of the Financial Code states as follows:

"Except for the normal compensation of his own employees, it shall be a violation of this division for any person subject to this division to pay over to any other person any commission, fee, or other consideration as compensation for referring, soliciting, handling, or servicing escrow customers or accounts."

The payment of fees to be on a referral list appears to fall within this prohibition, and consequently may be a violation of the Escrow Law.

BUYER'S CHOICE ACT (AB 957 (Chap. 264, Stats. 2009))

In addition to potential violations of the Escrow Law, the practice of mandating the use of a service provider from a preapproved list may result in a violation of the Buyer's Choice Act (Civil Code Section 1103.22 et seq.). The Buyer's Choice Act provides that certain "sellers" of real estate may not require, directly or indirectly, as a condition of selling property, that title insurance covering the property or escrow service provided in connection with the sale of the property be purchased by the buyer from a particular title insurer or escrow agent. For purposes of the Buyer's Choice Act, "seller" is defined to include a mortgagee who obtains title to residential real property at a foreclosure sale.

A lender mandating the use of a particular service provider on a third-party risk management company's list, or prohibiting the use of a service provider not appearing on such list, may be violating California's Buyer's Choice Act.

RESPA PROHIBITION ON KICKBACKS

Federal provisions of law should also be considered in the context of paying for referrals. Section 8(a) of the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §2607(a) prohibits the giving or receiving of any fee, kickback or thing of value for the referral of settlement service business. The Department defers to the CFPB on

whether the referral fee arrangement of the third-party risk management companies violates this provision.

UNFAIR BUSINESS PRACTICES

Section 17200 of the California Business and Professions Code prohibits unfair business practices. The practice of requiring a service provider, such as an escrow agent, to pay for the referral of business from a lender is prohibited under the Escrow Law and raises an issue as to whether the conduct is an unfair business practice under the Business and Professions Code.

CONSUMER PROTECTION

The Department recognizes industry efforts to ensure that service provider relationships result in compliance with the law. The purpose of this bulletin is not to discourage these efforts, but to alert licensees to potential regulatory pitfalls of business models that require settlement agents to pay for inclusion on referral lists, or that limit a consumer's ability to select service providers.

CONCLUSION

The Department of Corporations is closely evaluating the business arrangements of its licensees under its lending and escrow laws that involve third-party risk management companies, which purport to pre-screen service providers for a fee paid by the service provider. The Department cautions licensees that it may bring an action against licensees that contract with third-party risk management companies or place restrictions on service providers, in a manner that violates the law.

Questions regarding this bulletin may be addressed to the attention of Kathleen Partin at (213) 576-7595 or kpartin@corp.ca.gov.