

# **\$28 Million FTC settlement with Bear Stearns/EMC Mortgage has significant impact on ARM Industry**

*May provide roadmap of FTC enforcement activity toward ARM Industry.*

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The recent settlement between the FTC and Bear Stearns/EMC Mortgage appears to have broad implications for the ARM Industry. EMC Mortgage is the mortgage loan servicing unit of Bear Stearns which is now owned by JP Morgan Chase. So what does a mortgage loan servicing company have to do with debt buyers, issuers and collection agencies? Everything when the FTC defines both Bear Stearns and EMC Mortgage as a debt collector.

FTC Division of Financial Practices Associate Director Peggy Twohig was quoted recently stating “record-setting enforcement activity is on the horizon” for the industry. The EMC Mortgage case may provide a roadmap to areas where the FTC will focus when investigating industry members. Understanding these issues and taking appropriate preventative measures now can reduce the risk of the FTC showing up on your organization’s doorstep.

The following is information regarding the settlement in a question and answer format. In compiling this information, we have spoken with a number of ACA and DBA members and the Federal Trade Commission. In addition, I have added my own interpretations based on spending the last six years focused on data compliance and security issues as well as the last two years immersed in the ARM Industry working with Clients in the industry. Bottom line: This may be the most important regulatory action to impact the ARM industry since the passage of the FDCPA.

## **Where can I get a copy of the complaint and settlement documentation?**

The complaint, settlement and press release announcing the settlement can be found at the following website: <http://www.ftc.gov/os/caselist/0623031/index.shtm>. We believe it is in the best interest of all members of the industry to read these documents.

## Who is EMC Mortgage and why is this settlement important to the ARM Industry?

The FTC stated in the complaint that EMC Mortgage and Bear Stearns are debt collectors under FDCPA.<sup>1</sup>

The FTC in its complaint made little distinction between Bear Stearns and EMC Mortgage. EMC is a subsidiary of Bear Stearns. The FTC went even further in the complaint.

*Bear Stearns directs, controls, formulates, or participates in the acts or practices alleged in this complaint. Defendant EMC acts in the interests, and is the alter ego, of defendant Bear Stearns.<sup>2</sup>*

What is interesting is that Bear Stearns is a bank. And the perception has been banks are exempt from FDCPA. However, there appears to be exceptions as alleged in this complaint.

*Defendants play a prominent role in the secondary market for residential mortgage loans by acquiring, servicing, and selling large volumes of such loans. In recent years, during the explosive growth of the mortgage industry, defendants acquired and securitized loans at a rapid pace, paying inadequate attention to the integrity of consumers' loan information and to sound servicing practices. As a result, in servicing consumers' loans, defendants neglected to obtain timely and accurate information on consumers' loans, made inaccurate claims to consumers, and engaged in unlawful collection and servicing practice.*

*Defendants operate a vertically integrated mortgage business, which includes the acquisition and servicing of residential mortgage loans, and the packaging of those loans into mortgage backed securities ("MBS") for sale to investors. EMC is the mortgage servicer for many of the loans acquired by defendants. Bear Stearns' employees are primarily responsible for the acquisition of loans, such as the identification, bidding, and negotiation of deals, although frequently EMC is listed as the purchaser and subsequent seller on MBS documents. In many instances, after the defendants have acquired loans and EMC has begun servicing them, Bear Stearns packages the loans into MBS. After the loans have been packaged into MBS and sold on the secondary market, EMC often continues to service the loans pursuant to servicing agreements. In some instances, EMC also retains a residual ownership interest in the loans<sup>3</sup>.*

## What did EMC do wrong?

Two issues are important to note. Most of the issues identified by the FTC were not mortgage specific. Rather, many would apply to any type of consumer debt. Second, the first area covered here is focused on the data integrity. Here are some of the highlights.

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<sup>1</sup> Important Note: JPMC inherited EMC with the purchase of Bear Stearns. The settlement only applies to mortgages purchased by Bear Stearns prior to the merger with JPMC.

<sup>2</sup> <http://www.ftc.gov/os/caselist/0623031/080909emcmortgagecmplt.pdf>

<sup>3</sup> <http://www.ftc.gov/os/caselist/0623031/080909emcmortgagecmplt.pdf>

- 1) Made collection calls without verification of information provided to EMC by the seller of the debt instrument. Specifically, “EMC makes these early collection calls and sends collection notices to consumers before it has obtained complete loan information from the seller and before it has conducted quality control and other data integrity checks to ensure the accuracy of the representations it makes to borrowers.”<sup>4</sup>

Further, “In numerous instances, EMC has lacked a reasonable basis for its representations to borrowers, because it failed to obtain accurate and complete information about the consumer's loan account before making the representation. Despite indications that loan data obtained from prior loan servicers and loaded onto its servicing system was likely inaccurate or unverified, EMC nonetheless used that data to make representations to borrowers about their loans. As a result, defendants have made inaccurate claims to consumers and engaged in unwarranted collection practices.”<sup>5</sup>

- 2) Did not work to resolve client disputes
- 3) Did not forward to credit bureaus updated information regarding the account
- 4) Excessive phone calls, threatening phone calls, and failure to disclose purpose of the call.
- 5) Charged for fees not allowed for under the mortgage contract (i.e., inspections)
- 6) Charged fees in violation of state law.
- 7) Charged loan modification fees which added to balances and did not provide a new truth in lending form.

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<sup>4</sup> <http://www.ftc.gov/os/caselist/0623031/080909emcmortgagecmplt.pdf>

<sup>5</sup> <http://www.ftc.gov/os/caselist/0623031/080909emcmortgagecmplt.pdf>

- 8) Misrepresented fees to consumer in violation of contract and state laws
  
- 9) Collected amounts they were not authorized to collect under the loan agreement (including interest, fees, expenses, etc.).
  
- 10) No providing Truth in Lending statement to consumers when applicable fees were added to the loan balance.

I recently had a conversation with one of the FTC attorneys directly involved in the case. The attorney – and I am paraphrasing - stated *there is an expectation by consumers, when being contacted by any entity collecting a debt, that the information which is being communicated to them or about them through any channel to any party is accurate.*

Actions taken as a result of the failure to keep and communicate accurate information (including validation of the accuracy of the data before any data is exchanged with any third party including the debtor) is considered “false or misleading and constitute deceptive acts or practices”<sup>6</sup> and is therefore an “unfair trade practice” under Section 5 of the FTC Act. The data integrity issue is not only an FDCPA violation and which only applies only to entities which meet the FDCPA definition of a “debt collector.” Rather it’s much broader in scope. It appears it will apply to any entity - including issuers, debt buyers, debt collectors, mortgage servicers - which use the information for the collection of a debt - regardless of whether the debt is charged off, delinquent, etc.

#### **What was the punishment EMC received?**

Beyond the usual FTC settlement requirements about not doing it again, informing the FTC of management changes, and informing new management of the settlement, the key points were:

- 1) Implement a data integrity program

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<sup>6</sup> <http://www.ftc.gov/os/caselist/0623031/080909emcmortgagecmplt.pdf>

- 2) FTC oversight of almost all EMC business operations for a period of 8 years. This includes providing to the FTC the following information (a – f below are taken directly from the settlement agreement).
  - a. Accounting records that reflect the cost of loans acquired and/or sold; revenues generated from servicing fees and/or fees paid by and/or imposed on consumers; and the disbursement of such revenues;
  - b. Personnel records accurately reflecting: the name, address, and telephone number of each person employed in any capacity by such business, including as an independent contractor; that person's job title or position; the date upon which the person commenced work; and the date and reason for the person's termination, if applicable;
  - c. Customer files containing the names, addresses, telephone numbers (if available), dollar amounts paid, and description of fees or other charges imposed;
  - d. Complaints, disputes, and requests from consumers (whether received directly, indirectly or through any third party) and any responses to those complaints, disputes, or requests;
  - e. Copies of all training materials and policy manuals; and
  - f. All records and documents necessary to demonstrate full compliance with each provision of this Order, including but not limited to, copies of acknowledgments of receipt of this Order, required by Section XVI, and all reports submitted to the FTC pursuant to Section XIII.
- 3) EMC must internally audit operations to ensure compliance with the settlement which is signed off on by EMC management. EMC management will be held accountable for meeting the settlement and any false statement in these audits.
- 4) Third party assessment of the data integrity program every two years.
- 5) \$28 million reimbursement pool to be used to compensate consumers who have been harmed by EMC's actions.
- 6) All costs associated with meeting the settlement requirements. The question is – how much will it cost EMC Mortgage to comply with the settlement?

### **What is a data integrity program?**

Good question. We are unaware of any published standard for data integrity by any recognized standards body. Consider it a “we will know it when we see it” type of standard.

However, by reading the complaint and the settlement, it is possible to identify the characteristics of a data integrity program which the FTC is expecting to find and debt buyers and collectors should be implementing. It includes the following:

- 1) Data Security. Instead of looking at accounts which are bought, sold and collected in the industry as accounts or property, think of them as identities. Each entity which touches an

identity must take reasonable and appropriate steps to protect the identity. What is reasonable and appropriate? It would be what is required under federal and state regulations as well as industry standards. For healthcare, the standard is HIPAA. For credit cards, the standard would be PCI DSS, etc. And, all debt collectors must meet GLBA requirements. In addition, there are over 40 states which have passed personal identification information protection legislation.

NOTE: All members of ARM are also required to meet the Red Flag Rule by November 1, 2008. If a member does not meet the rule, and there is a violation, then the fines can be doubled.

- 2) Data Authentication. One of the biggest concerns by the FTC was Bear Stearns would purchase a mortgage and EMC would immediately start collecting on past due accounts without validating the data which they received from the seller was accurate. This includes everything from proof the seller actually owned the debt, to the data which was exchanged was accurate, to the amounts of the debt being accurate, understanding the terms and conditions of the loan agreement, accurately identifying the debtor, etc.
  
- 3) Data Accuracy. Once the data is received and authenticated, it must be maintained and updated reflecting the activity which occurred. This includes keeping records updated with bankruptcies, deaths, identity thefts, and other exceptions as defined under FDCPA.

Further, there must be a defined program for resolving disputes, all activity must be documented, and there must be a timeliness and efficiency in resolving disputes.

Further, if any amount is added to an outstanding balance (or fees the FTC may consider being an increase of the loan balance) as result of collection efforts, a new Truth In Lending Statement must be provided to the debtor.

- 4) Data Exchange. Data which is exchanged between debt collectors and any third party must be accurate.

- a. Credit Bureaus. The data provided to a credit bureau must be accurate and reflect recent activity. And, conversely, the failure to report updated information to the credit bureaus is a violation of FDCPA and FCRA.
  
- b. Selling of Debt. When selling debt to another debt buyer, the seller must be sure to include accurate information in the sales files for all key data points as well as information discovered while working the account regarding bankruptcies, deaths, identity theft, etc. Fail to provide this information and the seller can file a complaint with the FTC and the FTC will likely conduct an investigation.

In addition, the seller needs to ensure the buyer is going to take adequate steps to protect the data. This is a GLBA requirement. Each seller should have a vendor verification program which includes contractual requirements and other ways to verify the seller will take reasonable and appropriate steps to protect the data.

- c. Supporting Media. The exchange of media (documentation associated with an account like copies of contracts, statements, etc.) which contains personal identity information (SSN's, credit card numbers, account numbers, etc.) from an issuer to the current owner of the debt appears to be a GLBA violation as it is currently practiced. Example: the debt has been bought and sold four times. For the current owner to get the media, the request must go through the previous buyers to the issuer. The media then flows back through various debt buyers to the current owner. When the data flows to the debt buyer which does not have an ownership interest in the media there is a problem. Rather, there needs to be a method where the Issuer can release media directly to the current owner without it being a GLBA and/or a FTC Section 5 violation.
  
- d. Secure Data Transfer. Anytime personal identification information is exchanged between parties, it must be secured.
  - i. This means portfolios and media cannot be sent as an email attachment unless the attached data is adequately encrypted.
  - ii. If sent via third party (US Mail, UPS, FedEx, DHL, etc.), it must be sent so it can be fully traced and secure from sender and recipient. Each of these carriers offers such services.

**So is the FTC stating that members of the ARM Industry should have a formal data integrity program? Officially?** The answer is no. However, if you don't implement steps to protect data as described above then you may be found to be in violation of Section 5 of the FTC Act as well as possible FDCPA violations.

**Bottom line, what does this mean to debt buyers and sellers?**

1. Each member needs to implement a data integrity program. This program should include the elements described above.
2. A method of titling debt and securing the exchange of all data needs to be adopted by the industry.
  - a. The current practice of relying upon account information exchanged between debt buyer and seller – especially the farther away the debt gets from the issuer - appears to be in violation of GLBA and/or FTC Section 5.
  - b. Debt collection agencies and attorneys need some form of proof or validation from the entity providing the information to them the data is accurate before initiating phone calls, letters, postcards, litigation, etc.
3. Changes are required in the whole process of buying/selling debt to ensure the data which is being exchanged is accurate including being able to verify the chain of title from issuer to current owner.
4. Not reporting data to the credit bureau is just as much a violation of FCRA as knowingly reporting inaccurate information.
5. Access to the media (electronic copies of loan agreements, statements, etc.) associated with debt needs to be readily accessible to the current owner of debt – whether they are the issuer or the current owner of a portfolio which has been bought and/or sold multiple times.

**How will the changes called for in this settlement impact my business?**

- 1) The data you are relying on in your business should become more accurate. As your data becomes more accurate, expenses resulting from inaccurate data – both hard and soft costs - should be reduced.

- 2) As data becomes more accurate, the risk premium associated with any portfolio resulting from inaccurate data should be reduced. This should result in increased value for portfolios with accurate data and decreased values for portfolios with inaccurate data.
- 3) Members who buy portfolios and discover the quality of data in the portfolio is misleading, fraudulent, was not adequately maintained, double sold, etc. can look at this as more than a property dispute, they can file a complaint with the FTC.
- 4) And, don't be surprised when debtor's attorneys start filing FTC complaints on behalf of their Clients against industry members which do not have data integrity programs.
- 5) Members should expect any settlement agreement resulting from an FTC complaint filed against them will have many of the same elements described in the Bear Stearns/EMC Mortgage settlement. We have seen this pattern over and over again in data security settlements. While the fines may not apply, the data integrity program, reporting requirements, internal audit requirements, etc. will apply.

David Mertz has over 20 years of experience in the IT and has spent the last six years focused on data security and compliance issues. Mertz has been invited to speak across the country on compliance and security issues – including issues impacting the ARM Industry; most recently at DCS 2008. In addition, Mertz has written articles for a number of trade publications and has recently started a blog on data and security issues impacting the ARM Industry at [www.csp-mw.com/b2evolution](http://www.csp-mw.com/b2evolution). Mertz is currently the Managing Partner for Compliance Security Partners, LLC a Kansas City based data compliance and security firm. Contact David Mertz at [dave@csp-mw.com](mailto:dave@csp-mw.com) for additional details.

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