Comments on Proposed Rulemaking Commercial Financing Disclosures (PRO 01-18)

The Commercial Finance Coalition ("CFC") is comprised of responsible finance companies that provide needed capital to small businesses through innovative methods. CFC members offer merchant cash advances to small businesses, and some also engage in lending, specifically in the state of California through a California Finance Lender's license. Our members also include select vendors that provide technology services to the small business finance industry. This letter responds to the Department of Business Oversight's invitation for comments on proposed rulemaking for commercial financing disclosures on behalf of the members of the CFC.

1. Types of Commercial Financing

a. *Merchant Cash Advance*

Merchant Cash Advance ("MCA") is a specific form of factoring. In a traditional factoring agreement, a merchant (the client) sells an identifiable account receivable to a purchaser (the factor) at a discount.[1] This upfront money permits the client to access funds before the account receivable is due. In an MCA agreement, a merchant sells revenue that will arise from future sales to a purchaser (the "MCA company").

More specifically, the merchant sells a fixed portion of its future receipts to the MCA company at a discount.[2] This upfront money permits the merchant to access funds before the sales occur. Under MCA agreements, the business does not promise—and is not required—to repay the MCA company.[3] Instead the merchant delivers the receipts that it sold to the MCA company as the merchant generates those receipts.[4] The risks taken by the MCA company are significant. If the merchant fails to generate revenue, the MCA company is not owed anything under the agreement, so long as the merchant has not breached the agreement.[5] The benefit for a merchant to enter into an MCA agreement versus a loan agreement is the flexibility an MCA offers.

For example, an MCA company may purchase $10,000 of a merchant's future revenue and agree to receive 10% of the merchant's future revenue until the MCA company receives $10,000. This transaction would be completed whenever the merchant succeeds in generating $100,000 of future revenue. This milestone could be achieved in a month, a year, or never. MCA has many advantages for merchants. MCA

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[1] *See generally*, Tatge *et al.*, American Factoring Law (2009).
[2] *See, e.g.*, *K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 57 N.Y.S.3d 625 (Sup. Ct. N.Y., Westchester Cnty., 2017).
[3] *See IBIS Capital Group, LLC v. Four Paws Orlando LLC*, 2017 NY Slip Op. 30477(U) (Sup. Ct. N.Y., Nassau County, March 10, 2017) (discussing factors used to distinguish between loans and merchant cash advance agreements).
[4] *See K9 Bytes*, 57 N.Y.S.3d at 632-34.
[5] *See id*.

injects funds into a business without the business incurring debt, as the agreement does not contain an obligation of repayment.[6] MCA has transparent costs for the merchant: the MCA company will receive the amount of revenue that it purchased from the business. The incentives of the MCA company and the business are aligned, because the MCA company's compensation is contingent on the continued success of the business.[7]

Furthermore, MCA addresses a key concern with traditional financing: MCA companies quickly fund businesses by offering efficient and timely underwriting.[8] Moreover, in MCA the business owner does not enter into a partnership or give up control of the business.

b. *Types of Merchant Cash Advance*

There are primarily two types of MCA agreements. The simplest form of an MCA transaction is a "split processing" MCA agreement. Split processing agreements involve a merchant selling a specified amount of only the merchant's credit card receipts (the "Purchased Amount"), which will be delivered to the MCA company as a percentage of the merchant's credit card receipts each day.

To service this transaction, the parties notify the merchant's credit card processor of the agreement. Each day following that notice, the credit card processor delivers the MCA company's purchased percentage of receipts to the MCA company, and delivers the remaining unpurchased receipts to the merchant. This continues only until the MCA company has received the Purchased Amount.

Split processing agreements have many advantages, including that the merchant's deliveries of receipts to the MCA company automatically vary based on the merchant's receipts. However, this can result in volatile and unpredictable delivery schedules, because the amount delivered varies based on the merchant's daily receipts, which may be erratic. Additionally, a merchant can only sell future credit card receipts, which prevents merchants from obtaining financing based on future cash sales.

To help address merchant concerns with volatile delivery schedules and the limits of credit card receipts, MCA companies introduced a second type of MCA transaction: Fixed ACH transactions. In a Fixed ACH agreement, the MCA company purchases a specified amount of all the merchant's future receipts—not merely the merchant's credit card receipts. The merchant agrees to deliver a fixed percentage of all of its receipts until the MCA company receives the Purchased Amount.

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[6] *See id.*
[7] *See id*.
[8] *Opportunities and Challenges in Online Marketplace Lending*, p. 13, United States Department of the Treasury (May 10, 2016), *available at* https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf.

During the underwriting process, the merchant provides the MCA company with bank records showing its revenue over the prior months or even years. Based on these records, the parties estimate a specific daily amount that closely approximates the percentage of receipts the merchant has agreed to deliver.

To ensure that the fixed daily amount does not exceed the specified percentage of future receipts the merchant has sold, the contracts contain a "true up" or "reconciliation" provision. This provision either allows the merchant to 1) request that the MCA company refund any amount that exceeded the specified percentage during the prior month (based on bank records of sales for the prior month); or 2) request that the MCA company adjust the daily amount going forward based on updated bank records (i.e., updating the initial estimate based on new information).

To service this agreement, the merchant provides the MCA company with an ACH authorization. This authorizes the MCA company to debit the specified daily amount effective each business day. The specified daily amount is based on the initial underwriting and may be updated multiple times throughout the transaction, with the option to adjust generally available monthly, as described above.

This "Fixed ACH" structure addresses the downsides of the split processing agreements. First, the merchant can sell any receipts, instead of merely credit card receipts. Second, each month the merchant has a predictable delivery schedule, that is still adjustable based on the merchant's actual receipts.

2. Merchant Cash Advance Transactions Require Estimated Term Disclosures

MCA transactions require estimated term disclosures. As described above, whether the transaction is a split processing or Fixed ACH transaction, the delivery amount and delivery schedule are not fixed. If the merchant delivers receipts slower than initially expected, then the term of the transaction will be longer than initially expected.

For example, if a restaurant received $25,000 in financing from an MCA company in exchange for an agreement to deliver $36,400 worth of receipts at a rate of 10% of the restaurant's daily receipts, the term will depend on how quickly the restaurant generates $364,000 in receipts. If the restaurant has daily receipts of exactly $1,000 then it would deliver $100 to the MCA company daily and the term would be one year.

If, however, the business's receipts declined by 50% after six months, the business could deliver $100 daily for the first six months, and then deliver $50 daily for another 12 months, for the same total of $36,400. The resulting term is 18 months – 50% longer than initially expected. This variability in terms, as outlined below, increases the likelihood of discrepancies in estimated versus actual annualized rate disclosures with these more flexible products.

The ability to adjust the delivery schedule based on the business's receipts provides important flexibility to a merchant. Instead of being locked into a fixed payment schedule, an MCA can vary based on the merchant's ongoing business. Because the duration of transaction varies based on the business's receipts, neither the MCA company nor the merchant can know the transaction term at origination. As a result, MCA transactions must be able to disclose an estimated term to accurately reflect the nature of the transaction to the merchant. Forcing an MCA company to disclose a fixed term would hide a material advantage the merchant receives under the transaction—a flexible delivery schedule—and could deceive a merchant into believing that the flexible delivery schedule was fixed.

3. Annualized Rate Disclosure: Annual Percentage Rate or Annualized Cost of Capital

An Annual Percentage Rate ("APR") disclosure works well for loans with a fixed payment term and a regular weekly, bi-weekly or monthly payment. However, the DBO is charged with adopting an Annualized Rate Disclosure that works for products with a fixed payment term (such as loans), and products without a fixed payment term (such as factoring and MCA), and with payments required on weekdays, but not weekends. As a result, a disclosure that is similar to the Annualized Cost of Capital ("ACC") concept is preferable.

Products with a term or estimated term of one year or less have a tremendous amount of variability in the potential payment terms. With the current use of data and technology to customize products, APR becomes a much more challenging calculation. An APR calculation for weekly and daily payments, if done accurately to account for weekends and holidays, can vary if the funding is done on a Monday or a Friday of the same week—even though it is the exact same product offer.

The biggest challenge our members face with any Annualized Rate Disclosure, although more acutely with APR, is tolerance. As discussed further in our response to question No. 9, below, a tolerance significantly higher than those permitted for consumer transactions would be appropriate. Alternatively, the DBO could require a provider to disclose where the product fits in a range of annualized rates.

As an example, one of our member companies performed analysis utilizing six different APR calculators for the exact same MCA funding offer. While most answers were within a reasonable range of difference, no two calculations yielded the same APR. And some calculations reflected differences of greater than 20%. Our research also indicates the consumer standard for APR, APRWIN, does not calculate accurately for those products that require a payment on weekdays but not on weekends.

Given that payment schedules can vary so much, a simplified rate calculation like the ACC that was outlined in a later version of SB 1235 ((Total Dollar Cost of Financing ÷ Total Amount of Funds Provided) × 365 ÷ (Term or Estimated Term) × 100) requires a simpler calculation for all and would be much easier for

the DBO to check or validate. Whether the funding for a daily or weekly payment occurred on a Monday versus a Friday will not need to be taken into account as it would in an APR calculation.

4. Types of Financing Requiring Estimated Annualized Rates

MCA transactions require estimated annualized rate disclosures. As described above, whether the transaction is a split processing or Fixed ACH transaction, the delivery amount and delivery schedule are not fixed. If the merchant delivers receipts more slowly than initially expected, then the term of the transaction will be longer than initially expected, and the annualized rate would be lower.

For example, if a restaurant received $25,000 in financing from an MCA company in exchange for an agreement to deliver $36,400 worth of receipts at a rate of 10% of the restaurant's receipts, the rate will depend on how long it takes the restaurant to earn $364,000 in receipts. If the business achieves $364,000 in credit cards receipts in 1 year, the annualized rate would be $11,400/$25,000/1 year, or 45.6%. However, if the business takes 3 years to achieve $350,000 in credit card receipts, then the annualized rate would be $10,000/$25,000/3 years, or 13%.

The ability to adjust the delivery schedule based on the business's receipts provides important flexibility to a merchant. Instead of being locked into a fixed payment schedule, an MCA can vary based on the merchant's ongoing business. Because the duration of transaction varies based on the business's receipts, neither the MCA company nor the merchant can know the transaction term or the effective annualized rate at origination. As a result, MCA companies must be able to disclose an estimated annualized rate to accurately reflect the nature of the MCA transaction to the merchant. Forcing an MCA company to disclose a fixed rate would hide a material advantage the merchant receives under the transaction—a flexible delivery schedule—and could deceive a merchant into believing that the flexible delivery schedule as well as the annualized rate was fixed.

5. Fees and Charges Included in an Annualized Rate Calculation

The DBO should require MCA companies to include in the annualized rate calculation all fees to be paid by the merchant to the funder at or before consummation—and fees deducted from the proceeds—as required by the contract between the MCA company and the merchant. This disclosure would encompass all fees and charges imposed by the MCA company under its financing contract and those fees and charges should be included in the annualized rate calculation.

Importantly, the MCA company should not be required to disclose fees that it does not charge under the financing contract as part of the annualized rate calculation—such as broker fees charged by the broker directly to the merchant under a separate agreement. In many cases, the MCA company will not be aware

of what, if anything, the broker charges the merchant—and currently no legal requirement exists forcing the broker to disclose that amount to the MCA company. As a result, the MCA company lacks sufficient information to include those amounts in the annualized rate calculation, or even to disclose that amount to the merchant.

Additionally, the annualized rate calculation should not include avoidable fees that might be incurred throughout the duration of the transaction, such as default fees. Whether or not these fees will be incurred by the merchant is unknown at origination, can be avoided by the merchant, and should not be disclosed as part of the annualized rate disclosure. These fees, instead, should be disclosed separately.

6. Calculating Estimated Terms and Estimated Annualized Rates, and Reliance Upon Internal Underwriting Criteria for Calculations

The estimated terms and estimated annualized rates should be based on the calculations the MCA company used to establish the terms of the transaction—such as underwriting criteria. This disclosure would put the merchant and the MCA company on equal footing regarding this information. The merchant would be able to base its decision to enter into the transaction on the same information used by the MCA company.

Putting the parties on an equal footing promotes fairness and an efficient market. It further ensures that the estimates used by the MCA company are good faith estimates, because the MCA company will also be using these estimates for its own business planning. This further aligns the interests of the merchant and the MCA company. Finally, requiring the MCA company to rely on its internal estimates will reduce regulatory burden, because the MCA company already has access to these calculations.

Regarding the specific example of a business with a recent history of rising gross receipts, requiring disclosures based on the underwriting process would capture any assumptions made by the MCA company. In underwriting, an MCA company might calculate a small business's average monthly receipts or might use various assumptions about the merchant's future expected receipts based on a recent history of rising receipts (e.g., using a weighted average putting more weight on recent months or projecting a continued rise in receipts). If two MCA companies purchased the same percentage of receipts and the same total amount of receipts, the MCA company that only took into account the average monthly receipts would disclose a longer estimated term than the MCA company that accounted for rising receipts.

7. Disclosure of Method, Frequency, and Amount of Payments for Commercial Financing with Flexible or Contingent Repayment Obligations

A merchant's obligation to deliver receipts under an MCA contract are contingent on the merchant generating the receipts. As described above, in a split processing transaction, a credit card processor provides the deliveries, which automatically adjust based on the merchant's credit card receipts. In a Fixed ACH MCA, the contingency is the same, and the merchant or the MCA company may request a reconciliation. This reconciliation process ensures that the deliveries closely match the purchased percentage of receipts. If the merchant's receipts decrease, then it either will receive a refund of the excess amount delivered in that month or will have its payments adjusted on a going forward basis to better reflect its actual revenue.

8. Explanatory and Qualifying Language in Connection with Estimated Terms and Estimated Annualized Rates

For transactions that have estimated terms and estimated annualized rates, the DBO should permit or require the MCA company to give a disclosure explaining why the amounts are estimates and on what the MCA company based its estimates. For example, an MCA company could give a disclosure similar to the following:

> This [Annualized Rate/Term] is only an estimate. Your [Annualized Rate/Term] could be [Higher/Longer] or [Lower/Shorter] than this estimate, because your requirement to deliver future receipts to us can vary in amount from the estimate we used. We based this estimate on the information you provided about your business and the terms of this agreement.

In MCA transactions, the content of this disclosure may vary somewhat based on the type of MCA transaction. In a split processing agreement, the deliveries vary automatically based on the merchant's credit card receipts, while in a Fixed ACH agreement the deliveries are subject to change based on the merchant's actual revenue and whether the reconciliation provision is exercised.

9. Tolerances for Annualized Rate Disclosures

The DBO should establish tolerance levels for the annualized rate and estimated annualized rate disclosures. Additionally, the DBO should expressly clarify that these tolerances are based on an analysis conducted prospectively at origination based on information reasonably available at origination. Whether a transaction falls within tolerance levels should not be determined retroactively based on any future adjustments or changes to the transaction. More specifically, whether the transaction was properly disclosed within tolerance levels should be based on the information available at the time of origination, not based on the adjusted delivery schedule after a reconciliation was conducted. That information could not have been available to the MCA company at origination and could not have been disclosed.

The Truth in Lending Act and Regulation Z recognize that tolerance should depend on the characteristics of the transaction. For example, a higher tolerance is allowed for an irregular transaction than for a transaction covered by the general rule.[9] An irregular transaction under TILA is a transaction that either does not call for a single advance or a regular series of equal payments at equal intervals.[10]

Applying similar principles to an MCA, an MCA would require a higher tolerance. In addition, a higher tolerance should be applied to all daily pay products because the added complexity introduces significant potential for error into an annualized rate calculation. As discussed above, generally a daily pay product requires remittances only on business days, skipping weekends and some holidays. Factors such as what day of the week payments started and including or excluding weekends or some holidays can cause variance in the annualized rate well above the tolerance permitted for an irregular consumer transaction. And allowing higher tolerances will not cause a material change to the disclosure from the business owner's perspective. Most daily pay products have rates that are higher than the rates charged in traditional weekly or monthly pay products. As a result, a disclosure within a significantly higher tolerance will nonetheless provide the business owner with the necessary information to determine whether the business should enter into the transaction.

10. Disclosure Formatting

The regulations should require that an MCA company give the disclosures in a clear and conspicuous manner in a single location. This requirement will give the merchant the information that it needs to make an informed decision about whether to enter into the transaction and give the MCA company flexibility in how to provide the disclosures.

11. Prepayment Policies

MCA agreements are purchase agreements, not loans, and do not require payments. The merchants are simply required to deliver to the MCA company the future receipts that have been purchased. Under the MCA agreement, the MCA company purchases a specified percentage of future receipts that the merchant delivers until an exact amount of future receipts is received. That amount does not change based on when the merchant delivers those receipts. The "delivery schedule" is based on how quickly the merchant earns receipts.

To ensure that the transactions are properly characterized as purchase agreements, and not loans, the merchant agrees to retain no interest in the future receipts that are sold to the MCA company. This

[9] 12 C.F.R. § 1026.22(a)(2)-(3).
[10] 12 C.F.R. § 1026.22(a)(3) cmnt 1.

includes not retaining any right to repurchase the future receipts. The retention of a right to repurchase has been used as a factor in recharacterizing purchase-and-sale agreements as loans.[11] Permitting "prepayment" could arguably be construed as permitting the merchant to repurchase the future receipts, rather than deliver the future receipts when they are earned. As a result, many MCA agreements do not provide a contractual right to deliver the purchased receipts before they are generated by the merchant.

Many MCA companies permit a merchant to make an early delivery of the Purchased Amount. This benefits the MCA company by giving it access to its purchased receipts before they would otherwise be received under the MCA agreement. As a result, some MCA companies even incentivize merchants to make an early delivery by agreeing to give a discount for early delivery. These discounts typically are agreed to in separate agreements after the MCA has been originated. We are not aware of any MCA company that requires a merchant to pay any fee to make an early delivery. If not for the recharacterization risk, it is possible that more MCA companies would offer discounts for early delivery in the MCA contract itself. As a result, if the DBO clarified that under no circumstances could a right to early delivery be used to recharacterize the MCA transaction as a loan—at least under California law—then more MCA companies would likely offer early delivery discounts, which would benefit many merchants.

12. Definitions

There are a number of terms that could use clarification.

a. Total Amount of Funds Provided

The DBO should define the term "Total Amount of Funds Provided." Most importantly, the DBO should clarify whether or not this term includes or excludes fees deducted from the financing proceeds. For example, some MCA companies charge an origination fee, or deduct costs of origination (such as the cost of UCC filings) from the financing proceeds. As a result, the term "Total Amount of Funds Provided" could mean either 1) the total amount of funds received by the merchant after accounting for fees; or 2) the total price paid by the MCA company for the future receipts. The first reading appears to be most consistent with the language of SB 1235, but the DBO may want to clarify.

b. Total Dollar Cost of Financing

The DBO should define the term "Total Dollar Cost of Financing." The term "Total Dollar Cost of Financing" should include all fees to be paid by the merchant to the MCA company at or before consummation—including fees deducted from the proceeds—as required by the contract between the MCA company and

[11] *See e.g., H.J. Heinz Co., Inc. v. Department of Treasury*, 197 Mich. App. 210 (Mich. Ct. App. 1992) (recharacterizing a sale with repurchase option as a secured loan for tax purposes).

the merchant. This disclosure would encompass all fees and charges under the financing contract collected by the MCA company from the merchant at origination. It would also be the same number used to calculate the annualized rate disclosure, discussed above.

Importantly, the MCA company should not be required to include fees that it does not charge under the financing contract as part of the Total Dollar Cost of Financing—such as broker fees charged by the broker directly to the merchant under a separate agreement. In many cases, the MCA company will not be aware of what, if anything, the broker charges the merchant—and currently no legal requirement exists forcing the broker to disclose that amount to the MCA company. As a result, the MCA company lacks sufficient information to include those amounts in the Total Dollar Cost of Financing, or even to otherwise disclose that amount.

Additionally, the Total Dollar Cost of Financing should not include avoidable fees that could be incurred throughout the duration of the transaction, such as default fees. Whether or not these fees will be incurred by the merchant is unknown at origination, can be avoided by the merchant, and should not be disclosed as part of the Total Dollar Cost of Financing. These fees, instead, should be disclosed separately.

Thank you for the opportunity to provide comments .on the DBO's proposed rulemaking for commercial financing disclosures.