FINAL STATEMENT OF REASONS
FOR RULE CHANGES UNDER THE
ESCROW LAW

As required by Section 11346.9 of the Government Code, the Commissioner of Corporations ("Commissioner") sets forth below the reasons for the proposed amendments to Rules 1722 and 1723 of Title 10, California Code of Regulations (10 C.C.R. Secs. 1722 and 1723).

The Department of Corporations ("Department") licenses and regulates independent escrow agents under the Escrow Law (Financial Code Sections 17000 to 17702). Up until January 1, 2000, the Escrow Law required every escrow agent licensee to participate as a member of Escrow Agents' Fidelity Corporation ("EAFC"). EAFC was created by statute under the Escrow Law for the purpose of providing limited indemnification to member licensees against a loss of trust funds caused by fraudulent or dishonest abstraction, misappropriation, or embezzlement by an officer, director, trustee, stockholder, manager, or employee of the licensee.

Assembly Bill 410 (Chapter 253, Statutes of 1999), which became effective on January 1, 2000, limits the membership requirement for escrow agent licensees with, and indemnity coverage by, EAFC to those licensees engaged in the business of receiving escrows in certain specified types of transactions, such as real property escrows and bulk sale escrows. AB 410 limits EAFC's indemnity coverage to loss of trust obligations with respect to the types of transactions specified in the bill and requires escrow agents to provide indemnity coverage, in accordance with Financial Code Section 17203.1, for all other types of escrow transactions, i.e., those types of transactions not specified in the bill.

Financial Code Section 17203.1 requires an indemnification bond of all officers, directors, trustees, and employees of an escrow agent who have access to trust funds or who draw checks upon the escrow agent or upon the trust funds of the escrow agent for the purpose of indemnifying the escrow agent against loss of money or property and requires the Commissioner to prescribe the aggregate amount of the bond and the terms which the bond runs.

Rule 1722 requires bonds filed pursuant to Section 17203.1 of the Financial Code to have at least the coverage provided in standard forms of fidelity bonds. The Commissioner proposes to amend Rule 1722 to clarify that, except as otherwise provided in Rule 1723, a bond filed pursuant to Section 17203.1 of the Financial Code shall have at least the coverage provided in standard forms of fidelity bonds. This change is necessary to recognize and allow for the coverage changes/additions to be made in Rule 1723 that may not be contained in standard fidelity bond forms.

Rule 1723 implements Financial Code Section 17203.1 by setting forth the form and amount of the fidelity bond. Rule 1723 requires the filing of a fidelity bond of not less than $50,000 at the time of filing an application for license as escrow agent. Rule 1723 also requires the licensee to maintain minimum fidelity coverage in accordance with a certain schedule based on monthly average escrow liability. The schedule ranges from a minimum fidelity coverage of $50,000 for monthly average escrow liability of up to $50,000 to a minimum coverage of $110,000 for monthly average escrow liability of $175,000 to $200,000, with additional coverage at the rate of 25% of any monthly average in excess of $200,000. In addition, Rule 1723 requires that the fidelity bond contain a rider which provides that the coverage of the bond extends to all officers, directors, trustees, and employees of the insured whether or not such officers, directors, trustees, and employees are compensated by the insured.

Existing licensees that are required to obtain separate individual fidelity/indemnity coverage as a result of AB 410 will be unable to comply with Rule 1723 because they are not "applicants" and because it is unclear whether Rule 1723 applies to existing licensees affected by AB 410. The changes in the law as a result of AB 410 need to be tied into Rule 1723. Furthermore, the amounts of bond coverage specified in Rule 1723 reflect the circumstances of the real estate market and escrow business that were in effect over 20 years ago when escrow agents averaged low monthly escrow liability amounts and are now outdated and inadequate to protect the escrow funds of consumers. Today, the annual liability reports filed by escrow agent licensees with the Department indicate that licensees average millions of dollars in monthly escrow liabilities. Prior to AB 410, the Commissioner did not require fidelity coverage pursuant to Rule 1723 and there was no need to revise and update the amounts of fidelity coverage stated in Rule 1723 because all licensees were required by law to obtain fidelity bond coverage through EAFC and had done so for at least the last 15 years.

In order to conform the Commissioner's rules to the changes made by AB 410, the Commissioner proposes to amend Rule 1723 to:

- Clarify that its provisions apply to applicants for an escrow agent's license and licensees that are not required to be members of EAFC or that will engage in or are engaged in the business of receiving escrows for deposit or delivery of the types of transactions not specified in subdivision (c) of Section 17312 of the Financial Code.

- Clarify the purpose of the fidelity bond consistent with the intent of AB 410, which is to provide similar indemnity coverage as provided by EAFC. EAFC is required to indemnify a member escrow agent against a "loss" of trust obligations. Financial Code Section 17304 defines "loss" to mean the loss of trust obligations held by a member as a result of the fraudulent or dishonest abstraction, misappropriation, or embezzlement of trust obligations by an officer, director, trustee, stockholder, manager, or employee of a member. However, for purposes of Rule 1723, "stockholder" cannot be included because such persons are not specifically stated in Financial Code Section 17203.1. Therefore, under Rule 1723, the Commissioner proposes to expressly set forth the purpose of the fidelity bond, which is to indemnify the escrow agent, or the escrow agent's successor in interest, for loss of trust obligations held by the escrow agent as a result of the fraudulent or dishonest abstraction, misappropriation, or embezzlement of trust obligations by an officer, director, trustee, or employee of the escrow agent. Included in this purpose is the indemnification of "the escrow agent's successor in interest" in order to anticipate and cover those situations where the Commissioner has taken possession of the escrow agent and a conservator, receiver, or other fiduciary has been appointed over the escrow agent as a "successor in interest" pursuant to Chapter 6 of the Escrow Law. This is also consistent with what is required of EAFC with respect to their fidelity coverage. This change would make it clear and avoid any confusion over the purposes of the fidelity bond and should assist insurers in preparing appropriate bond policy provisions.

- Increase the amount of the fidelity bond required to be filed with the Department to no less than $125,000 and revise the schedule to require a minimum fidelity coverage of $125,000 for monthly average escrow liability of up to $125,000 and ranging up to $5,000,000 for monthly average escrow liability of $7,500,001 to $10,000,000, with additional coverage at the rate of $1.00 for every $3.00 of average escrow liability in excess of $10,000,000. The

higher levels (i.e., over $1,000,000 minimum coverage) are the same as that provided by EAFC (see Financial Code Section 17314). There are some licensees affected by AB 410 that are required to obtain individual fidelity coverage but only do a small amount of such escrow transactions and, therefore, don't need the higher levels of coverage, which can be very costly to them. Also, bond underwriters may not want to write policies for amounts that are significantly more than a company's average trust balance. Thus, the lower levels will allow escrow agents access to more reasonable and affordable individual fidelity bonds. The revised schedule takes into account the level of escrow business that the licensee is engaging in and will not hinder the licensee's ability to conduct that type of escrow business. This revision of the schedule is necessary in order to provide more appropriate and adequate protection for the escrow funds of consumers.

- Adopt new subsection (b) to recast the rider and to specify additional provisions applicable to the rider. These additional provisions would clarify whom the term "employee" is to include and require a 30-day prior notice to the Commissioner of the bond's cancellation by the insurer. The subsection would provide that the term "employee" shall include: (a) the Commissioner and his or her authorized representative when the Commissioner has taken possession of the property and business of the escrow agent pursuant to Chapter 6 of the Escrow Law, (b) temporary or part-time personnel, except as provided in case the individual is covered by other insurance, and (c) an independent contractor, as defined. This would make the definition of employee consistent with the employee definition set forth in EAFC's fidelity policy. In addition, clarifying this definition would make it clear to bond insurers of their bond coverage obligation with respect to employees of the escrow agent. The 30-day notice of cancellation is necessary to provide time for the escrow agent to obtain new coverage and to alert the Department of the upcoming cancellation.

- Clarify that Rule 1725 does not apply to a bond required under this rule. Rule 1725 provides that a bond shall contain the "California Escrow Rider," as in effect on July 1, 1983. Since Rule 1723, as proposed to be revised, will already contain the specific provisions of the rider that are applicable to Rule 1723 fidelity bonds, this provision is necessary in order to make it clear that the rider referenced in Rule 1725, i.e., the "California Escrow Rider," is not applicable to a bond required under Rule 1723. This would avoid any confusion over which rider applies to Rule 1723 bonds.

- Adopt new subsection (c) to provide that a fidelity bond may contain a deductible and, if the bond does contain a deductible, the escrow agent is required to file with the Commissioner a surety bond in the amount of the deductible and to always maintain the surety bond in the same amount as the deductible. The purpose of the surety bond is to cover any loss of trust obligations that the escrow agent's fidelity bond does not cover due to the fidelity bond's deductible. The Department has found that there are some insurers that are not willing to issue fidelity bonds at all without deductibles and some that will issue fidelity bonds without deductibles but will charge more for such policies. In order not to limit the market for fidelity bonds and to allow for more affordable policies, the Department proposes to allow the use of deductibles, but require the purchase of a surety bond in the amount of the deductible so as to always provide 100% protection of the consumers' trust funds held by the escrow agent.

Finally, the Commissioner proposes to make some minor technical changes.

ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for which the regulation is proposed, would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small businesses.

FISCAL IMPACT

Cost to Local Agencies and School Districts required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code: None.

No other nondiscretionary cost or savings are imposed on local agencies.

DETERMINATIONS

The Commissioner has determined that the proposed regulatory action does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

The proposed regulation changes bring the rules into conformance with the law and would require similar fidelity coverage had AB 410 not been enacted, therefore, there will be no significant adverse economic impact on business.

ADDENDUM REGARDING PUBLIC COMMENTS

A. 45-Day Comment Period

The public comment period ended on July 28, 2000. The Department did not receive any request for hearing, and no public hearing was scheduled or heard. Three comment letters were received during the 45-day public comment period. It is noted that the Department did not receive any comments from the persons that would be directly affected by these changes to Rules 1722 and 1723, i.e., the Department's escrow agent licensees or any potential escrow agent applicant.

(1) COMMENTOR: Michael C. Haas, CPA, Morton Alan Haas & Co., letter dated June 7, 2000. (Note: Mr. Haas' comments relate to the emergency regulations that the Department issued, effective May 1, 2000, and which are the same as the original proposed text of this rulemaking project.)

(a) COMMENT: There is a typographical error under the "Note" for the repeal of Rule 1725. The reference to Section "17240" of the Financial Code should be to Section "17204" of the Financial Code.

RESPONSE: No correction or change is necessary as the Department has dropped the proposal to repeal Rule 1725.

(b) COMMENT: Mr. Haas expresses concern and confusion as to the Department's intent in repealing Rule 1725, which governed the rider, known as the "California Escrow Rider", applicable to the fidelity bonds provided by the Escrow Agents' Fidelity Corporation ("EAFC"), and incorporating the California Escrow Rider into Rule 1723, a section that does not pertain to EAFC bonds.

RESPONSE: The Department's intent is not to address, clarify or change the rider that is applicable to EAFC. The purpose of this rulemaking project is to implement AB 410 (Chapter 253, Statutes of 1999) which requires separate indemnity coverage pursuant to Financial Code Section 17203.1 for those escrow agents no longer required to be members of EAFC or for those types of escrow transactions no longer required to be covered by EAFC. Thus, the intent of this rulemaking project is solely to address the individual fidelity bonds that are now required as a result of AB 410 and to set forth the amounts of required coverage and the terms and other requirements relating to these bonds, including the specific rider provisions that are applicable to these bonds. In order to avoid any confusion, the Department has made some changes. The Department is no longer proposing of repealing Rule 1725, has removed all proposed references to the "California Escrow Rider" in Rule 1723, and has included a statement in Rule 1723 that provides that Rule 1725 shall not apply to a bond required under Rule 1723. Proposed subsection (b) to Rule 1723 would specify the rider provisions that are applicable just to the new bonds required under Rule 1723.

(2) COMMENTOR: Daniel I. Bovill, President, Escrow Agents' Fidelity Corporation, letter dated June 14, 2000. (Note: Mr. Bovill's comments also relate to the emergency regulations that the Department issued, effective May 1, 2000, and which are the same as the original proposed text of this rulemaking project.)

(a) COMMENT: The fidelity bonds of EAFC have included the California Escrow Rider set forth in Rule 1725. The repeal of Rule 1725 would, in effect, remove the requirement that the EAFC fidelity bond must contain the California Escrow Rider.

RESPONSE: Same as response to comment (1)(b), above.

(b) COMMENT: The rider applicable to the new individual fidelity bonds required under Rule 1723 should contain the exact same elements (or provisions) as the "California Escrow Rider" applicable to EAFC.

RESPONSE: AB 410 does not require all requirements applicable to EAFC to also be applicable to the separate individual fidelity bonds that escrow agents will have to obtain for those types of transactions that are no longer subject to indemnity coverage by EAFC. Further, AB 410 does not state or require that any of the Escrow Law provisions that expressly apply to EAFC, i.e., Chapter 2.5 of the Escrow Law (Financial Code Sections 17300 through 17350), shall also apply to the individual fidelity bonds now required to be provided in accordance with Financial Code Section 17203.1, nor does AB 410 state or require such individual fidelity bonds to be consistent with EAFC's coverage. Furthermore, none of the committee and floor analyses on AB 410 state or indicate that it is the intent of the bill to require the same requirements or standards that apply to EAFC and EAFC's fidelity bond to also apply to the separate individual fidelity bonds. As a matter of fact, the Assembly floor analysis of August 13, 1999, states that "[t]he purpose of this bill [AB 410] is to clarify that EAFC coverage and assessment applies to traditional escrow activities, while separate bonding requirements will apply to non-traditional, personal property escrows, such as Internet escrows" and that "[t]his bill attempts to protect these differences by specifying that EAFC coverage shall be limited to traditional escrows and requiring non-traditional escrows receive their own 'insurance' and bonding requirements".

AB 410 merely provides, under subdivision (d) of Financial Code Section 17312, that "[i]ndemnity coverage for those types of transactions not specified in subdivision (c) shall be provided by escrow agents in accordance with **Section 17203.1**." (Emphasis added.) Financial Code Section 17203.1 requires an indemnification bond of all officers, directors, trustees, and employees of an escrow agent who have access to trust funds or who draw checks upon the escrow agent or upon the trust funds of the escrow agent for the purpose of indemnifying the escrow agent against loss of money or property (i.e., trust obligations) and requires the Commissioner to prescribe the aggregate amount of the bond and the terms which the bond runs. Thus, Section 17203.1 gives the Commissioner discretion to set forth the appropriate amounts, terms and other requirements that apply to the Section 17203.1 indemnity/fidelity bonds.

Furthermore, based on discussions with and other information obtained from the escrow industry, insurance brokers, and insurance companies, the Department has determined that it is not possible to impose the exact same requirements on the individual fidelity bonds as are imposed by law or otherwise on EAFC's bond. A major difference is that EAFC's indemnity bond covers an entire industry, i.e., over 400 licensed escrow agents. The Rule 1723 bonds are bonds that individual escrow agents will have to go out and shop for from the marketplace, most of which will be for very small amounts. Thus, one major difference between the Rule 1723 bonds and EAFC's bond will be the required amounts of minimum fidelity coverage, an issue none of the commentors had a problem with and for which it appears that there is the realization that there will be differences. The Department's objective of this rulemaking project is to continue to ensure that the escrow moneys of consumers are adequately protected from a loss resulting from fraudulent or dishonest abstraction, misappropriation or embezzlement, while at

the same time not placing unnecessary or undue hardships on licensees that must obtain the individual fidelity bonds and thereby ensuring that such licensees affected by AB 410 are able to obtain appropriate, reasonable and affordable individual fidelity bonds.

As stated by the commentor, the elements contained in the California Escrow Rider, which are included in EAFC's fidelity bond, provide for: (1) an expanded definition of "employee"; (2) a deletion of the typical coverage exclusions in the standard forms of fidelity bonds for losses caused by an insured (owner) or the partner of the insured: (3) a 90-day notice of cancellation provision; and (4) the deletion of the "manifest intent" requirement to prove dishonesty. The Department's response to each of these provisions follows. It is also noted that the fidelity bonds
that the escrow agents were required to file prior to the existence of EAFC did not have the same rider that EAFC has in its bond.

Expanded Definition of "Employee". The California Escrow Rider includes "shareholder" (or "stockholder") and "manager" in its definition of "employee". The commentor has suggested that both also be included in Rule 1723. The Department believes that this definition of employee was included in the California Escrow Rider in order to be consistent with the fidelity coverage that EAFC is required to provide in case of a loss as defined in Financial Code Section 17304. Section 17304 defines "loss" to mean the loss of trust obligations held by a member as a result of the fraudulent or dishonest abstraction, misappropriation, or embezzlement of trust obligations by an officer, director, trustee, "stockholder, manager," or employee of a member. However, AB 410 requires the separate fidelity coverage to be in accordance with Financial Code Section 17203.1.

Section 17203.1 specifically applies only to "officers, directors, trustees, and employees", requiring such persons to have a bond indemnifying the escrow agent against loss of money or property. Since this section does not include shareholders/stockholders and Rule 1723 implements this section, the Department has determined that it does not have the statutory authority to include the term "shareholder" (or "stockholder") in Rule 1723. The Legislature would first have to amend Section 17203.1 to include the term.

With respect to including the term "manager", the Department believes that it would be redundant to do so since a manager is already an "employee".

Deletion of Clause Excluding Loss By Insured. The commentor has suggested that the rider in Rule 1723 also include a clause requiring the deletion of typical coverage exclusions in standard forms of fidelity bonds for losses caused by any fraudulent or dishonest acts by the insured or a partner of the insured.

The Department believes that adding such clause to Rule 1723 is unnecessary as the amendments to Rule 1723 would clearly require that coverage shall extend to all officers, directors, trustees, and employees of the insured whether or not such persons are compensated by the insured. Furthermore, the proposed changes to Rule 1723 would expressly provide that the purpose of a fidelity bond under this rule is to indemnify the escrow agent for loss of trust obligations held by the escrow agent as a result of the fraudulent or dishonest abstraction, misappropriation, or embezzlement of trust obligations by an officer, director, trustee, or employee of the escrow agent. These provisions are clear as to who and what is required to be covered under a Rule 1723 bond. This would require insurance companies not to include or delete by rider any clauses that would be in conflict with this requirement.

90-Day Cancellation Provision. The commentor suggests to increase from 30 days to 90 days the required time for notice of cancellation of the fidelity bond by the insurer to the Commissioner, consistent with what is required with respect to EAFC's fidelity bond.

The Department believes that 30 days prior notice to the Department of the upcoming cancellation is adequate time and that 30 days should provide sufficient time for an escrow agent to obtain new coverage. Furthermore, the Department has found that insurance companies would increase the premiums on the bond if coverage is extended for 90 days as there is the risk that no premiums could be paid at all during this time and the insurance company would nevertheless still be required to provide coverage for this extended amount of time. Also, all of the surety bonds that are filed by escrow agents pursuant to other provisions of the Escrow Law have a 30-day cancellation notice period and the fidelity bonds that were required prior to the formation of EAFC had a 30-day cancellation notice period.

Deletion of "Manifest Intent" Clause. The commentor has suggested that the rider in Rule 1723 also include a provision requiring the deletion of the "manifest intent" clause that is contained in most fidelity bonds. The manifest intent clause is a definition of dishonesty that requires that the loss has to be caused by the dishonest or fraudulent acts committed by an employee with the intent to cause the insured to sustain such loss and to obtain financial benefit from such loss.

The Department has determined that it is unnecessary to include such a provision in Rule 1723. The Escrow Law provides that escrow trust funds must be kept in a bank account designated as "trust funds" or "escrow accounts" and that the trust funds do not belong to the escrow agent (Financial Code Section 17409). In addition, Financial Code Section 17414 provides that any director, officer, stockholder, trustee, employee or agent who abstracts or willfully misappropriates money, funds, trust obligations or property deposited with an escrow agent is guilty of a felony. The Department believes that a manifest intent clause could not successfully be used as a defense by the insurance company to pay on an escrow loss claim given it is a violation of the Escrow Law and a felony for any officer, director, employee, etc. who abstracts or willfully misappropriates money, fund, trust obligations or property deposited with an escrow agent and given that the Escrow Law already covers the type of consumer protection that is expected with respect to trust funds. Nevertheless, the Department has included language in the proposed amendment to further clarify that the purpose of a Rule 1723 fidelity bond is to indemnify the escrow agent or the escrow agent's successor in interest for loss of trust obligations that result from the fraudulent or dishonest abstraction, misappropriation, or embezzlement of trust obligations by an officer, director, trustee or employee of the escrow agent. This language clarifies that the fidelity bond shall cover these losses, regardless of whether or not there was an intent to cause the insured to sustain a loss and to obtain a financial benefit. This should help eliminate those cases in which the insurance company attempts to deny a claim using a "manifest intent" clause. Thus, no greater burden of proof to show a loss will be required of an escrow agent subject to Rule 1723 merely because Rule 1723 will not require the deletion of the "manifest intent" clause.

Finally, the Department's experience is that the "manifest intent" clause is used by insurance companies as an attempt to limit the liability of the insurance company when poor business practices of the insured as opposed to fraudulent acts of an employee caused the loss.

(c) COMMENT: The commentor suggests that Rule 1725 not be repealed but rather be amended to include each of the four elements of the "California Escrow Rider".

RESPONSE: Same as response to comment (1)(b), above.

(d) COMMENT: The commentor recommends that the individual fidelity policies provide that the definition of "loss" shall be the same as defined in Financial Code Section 17304.

RESPONSE: The Department has included language in the proposed amendments to Rule 1723 that is similar to the definition of "loss" as set forth in Financial Code Section 17304. Section 17304 provides that "loss" means "the loss of trust obligations held by a member as a result of the fraudulent or dishonest abstraction, misappropriation, or embezzlement of trust obligations by an officer, director, trustee, stockholder, manager, or employee of a member". Proposed paragraph (1) of subsection (a) of Rule 1723 would include the purpose of the fidelity bond which is to indemnify the escrow agent for "loss of trust obligations held by the escrow agent as a result of the fraudulent or dishonest abstraction, misappropriation, or embezzlement of trust obligations by an officer, director, trustee, or employee of the escrow agent". However, this provision does not include "stockholder" and "manager" as in Section 17304 for the reasons discussed above under response to comment (2)(b).

(e) COMMENT: The provisions should require that the bond coverage be "coextensive" with the statute.

RESPONSE: It is unclear what this comment means. The commentor has also failed to specify what statute he is referring to. If the commentor means to refer to Financial Code Section 17314.1, which provides that the protection to members provided by EAFC and by the fidelity bond or insurance policy, if any, shall therefore be deemed to be coextensive except as specified, see response below to comment (3)(f).

(3) COMMENTOR: Michael G. Evans of Gascou, Gemmill & Thornton, General Counsel to Escrow Agents' Fidelity Corporation, letter dated July 25, 2000.

(a) COMMENT: The repeal of Rule 1725 is not logical as EAFC members would now not be subject to the California Escrow Rider requirement. Rather, the California Escrow Rider requirement should apply to all licensed escrow agents, whether or not members of EAFC.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above.

(b) COMMENT: The rider proposed under Rule 1723 fails to require deletion of the "manifest intent" element of the dishonesty definition thereby creating two standards of coverage and

placing a greater burden of proof on those handling non-EAFC covered transactions to show a covered loss.

RESPONSE: Same as response to comment (2)(b), above.

(c) COMMENT: The rider proposed under new subsection (b) of Rule 1723 does not contain each of the four minimum requirements or elements of the California Escrow Rider that is in EAFC's bond.

RESPONSE: Same as response to comment (2)(b), above.

(d) COMMENT: The expanded "employee" definition under proposed subsection (b) of Rule 1723 should include "shareholders". This status is included in the definition of "loss" in Financial Code Section 17304 and is included in the EAFC fidelity bond California Escrow Rider.

RESPONSE: Same as response to comment (2)(b), above.

(e) COMMENT: The coverage schedule in Rule 1723(a)(2) does not require notice to the Commissioner nor an increase in the fidelity bond if monthly average trust balances increase whereas, pursuant to Financial Code Section 17314(c), EAFC members must monitor escrow liability every month and immediately report an increase in escrow liability to EAFC and the Commissioner so the requirement of additional fidelity coverage can be satisfied.

RESPONSE: Proposed Rule 1723(a)(2) requires that the escrow agent shall maintain minimum fidelity coverage in accordance with the schedule in the regulation. The schedule is based on the monthly average escrow liability. Thus, it is not necessary to require that the licensee notify the Commissioner if the average escrow liability increases. It would be the escrow agent's responsibility to ensure that the amount of the coverage is sufficient at all times. The escrow agent would be required to increase the amount of the bond and, upon request, provide evidence of the increase to the Commissioner if the average escrow liability increases. Those licensees that fail to maintain sufficient coverage would be subject to enforcement action by the Department.

Furthermore, contrary to EAFC's comment, Financial Code Section 17314(c) does not require notice of an increase in escrow liability to the Commissioner. Also, the reason Section 17314(c) requires notice to EAFC of an increase in escrow liability is because EAFC is the one that issued and holds the bond and the one that needs to make the necessary arrangements to provide for the increase in coverage and to bill and collect from the escrow agent the amount necessary to provide for the increased coverage. On the other hand, the individual fidelity bonds to be obtained under Rule 1723 would have to be obtained and purchased from private insurance companies.

(f) COMMENT: The proposed regulations do not require that the fidelity bonds provide coverage which is "co-extensive" with the Escrow Law whereas coverage by EAFC and its fidelity bond is "co-extensive" as required by Financial Code Section 17314.1.

RESPONSE: A similar provision in Rule 1723 is not necessary. First of all, Financial Code Section 17314.1 specifically applies only to EAFC. AB 410 does not require that all, or for that fact, any, of the Escrow Law provisions that are expressly applicable to EAFC, i.e., Chapter 2.5 of the Escrow Law (Financial Code Sections 17300 through 17350), to also apply to the individual fidelity bonds required to be provided in accordance with Financial Code Section 17203.1. Secondly, the purpose of the co-

extensive provision in Section 17314.1 was to give EAFC the same defenses that were available in the bond that was obtained by EAFC. Since escrow agents subject to Rule 1723 will have to obtain the fidelity bonds directly from the insurance company, the insurers will already have all of the defenses available to them in the bonds they issue.

(g) COMMENT: The Informative Digest is technically deficient as the "Plain English Overview" is too complex to meet the legal requirement that the explanation may be interpreted by people with no more than eighth grade level of proficiency in English.

RESPONSE: The Department has complied with the definition of "plain English" as set forth in Government Code Section 11342(e) and has written the Informative Digest in language that can be interpreted by a person who has no more than an eighth grade level of proficiency in English. The Department has written the digest in a way that can be easily understood and followed and has avoided the use of technical or complex terms.

(h) COMMENT: The statement in the notice of proposed action that the proposed regulatory action does not have a significant adverse economic impact on business (page 4) does not include a description of the facts, evidence, documents or other evidence upon which the agency relies.

RESPONSE: The Administrative Procedure Act ("APA"), under Government Code Section 11346.5(a)(8), requires that if a state agency, in adopting or amending a regulation, determines that the action will not have a significant adverse economic impact on business, it shall make "a declaration to that effect in the notice of proposed action". The Department has complied with this requirement and has declared in the notice of proposed action, page 5, that "the Commissioner has determined that the proposed regulatory action…[d]oes not have a significant adverse economic impact on businesses, including the ability of California businesses to compete with businesses in other states". The APA does not require a state agency to include a description of the facts, evidence, documents or other evidence in support of this declaration in the notice of proposed action.

(i) COMMENT: There is no reference in the notice of proposed action to any facts, evidence, documents or other evidence relied upon to support the conclusion that the proposed regulatory action does not significantly affect the creation or elimination of jobs, new businesses or the elimination of existing businesses within California, or the expansion of current business in California (page 4 of notice).

RESPONSE: Government Code Section 11346.5(10) merely requires the notice of proposed action to include a statement of the results of the assessment required by Government Code Section 11346.3(b), it does not require a description or references to the facts, evidence, documents or other evidence relied upon. The Department has complied with the requirements of Section 11346.5(10) (see last paragraph on page 4 of the notice of proposed action).

(j) COMMENT: The proposed regulations are not consistent with Financial Code Sections 17312, 17203.1, 17302 and 17304 as the description of the fidelity bond form in Rule 1723 and the repeal of Rule 1725 creates confusion concerning the required form of the fidelity bond which EAFC may obtain.

RESPONSE: Same as response to comment (1)(b), comment (2)(b), and comment (2)(d), above.

(k) COMMENT: The notations following each of the proposed regulations do not accurately list

specific statutes as legal authority in support of the proposal. Specifically, Financial Code Sections 17630, 17631, 17635, 17636, 17637, 17638 and 17640 (all which concern conservators or receivers) are not authority which logically supports the proposed regulation, Rule 1723.

RESPONSE: The notations following the proposed text of Rule 1722 and Rule 1723 are in compliance with Section 11346.2(a)(2) of the APA. With respect to Rule 1722, the statute that authorizes the Department to adopt or amend regulations is accurately stated as Financial Code Section 17400 and the notation accurately states the two statutes that are being implemented (i.e., Financial Code Sections 17203.1 and 17312).

With respect to Rule 1723, the statute that authorizes the Department to adopt or amend regulations is also accurately stated as Financial Code Section 17400 and the notation also accurately states the two statutes that are being implemented (i.e., Financial Code Sections 17203.1 and 17312) and the statutes made specific by the regulation (i.e., Financial Code Sections 17621, 17628, 17629, 17630, 17631, 17635, 17636, 17637, 17638 and 17640). The latter statutes were included because Rule 1723 would specifically provide that the purpose of a fidelity bond under Rule 1723 is also to indemnify "the escrow agent's successor in interest", which can be the Commissioner, a receiver or a conservator pursuant to these latter statutes. Furthermore, these latter statutes, which are part of Chapter 6 of the Escrow Law, are referenced in the body of the proposed text under subsections (b) and (c) of Rule 1723.

Finally, since the proposal to repeal Rule 1725 has been dropped by the Department, there is no need to address its notations.

(l) COMMENT: The authority and reference in the notation to the proposed repeal of Rule 1725 is incorrect.

RESPONSE: No correction or change is necessary as the Department has dropped the proposal to repeal Rule 1725.

(m) COMMENT: The proposed regulations create inconsistent fidelity coverage with a greater burden of proof upon non-EAFC members to show the employee had the "manifest intent" to cause the member to sustain a loss, to obtain coverage, and this could have a significant adverse economic impact on business.

RESPONSE: Same as response to comment (2)(b), above.

(n) COMMENT: The commentor recommends that existing Rule 1725 be retained and amended to include the specific elements of the California Escrow Rider.

RESPONSE: Same as response to comment (1)(b), above.

(o) COMMENT: The commentor recommends that the fidelity bond form (Rule 1723) should be required to reference or incorporate the fidelity coverage standards in the Escrow Law so the terms of coverage under the statute, under the fidelity bond and that provided by EAFC will all be "co-extensive" and consistent.

RESPONSE: Same as response to comment (2)(b) and comment (3)(f), above.

(p) COMMENT: The commentor recommends that the form surety bond for the fidelity bond deductible should be rewritten to eliminate coverage issues, forbid third party claims and clarify consistency with EAFC and Escrow Law coverage standards.

RESPONSE: The surety bond form, and its content, for purposes of proposed subsection (c) of Rule 1723 is beyond the scope and not part of this rulemaking project.

(q) COMMENT: The proposed changes do not clarify the purpose of the fidelity bond as allowing manifest intent (by not requiring in Rule 1723 the deletion of the "manifest intent" clause) defeats the purpose and creates inconsistent standards of coverage.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above. In addition, the use of the statement on page 2 of the initial statement of reasons that states that the Commissioner proposes to amend Rule 1723 to "[c]larify the purpose of the fidelity bond consistent with the intent of AB 410, which is to provide the same type of indemnity coverage as provided by EAFC" is meant to refer only with respect to a "loss" of trust obligations as that term is defined in Financial Code Section 17304. The paragraph where this statement is contained goes further to explain this and the corresponding changes proposed in Rule 1723. This statement does not say and was not intended to mean that every statutory requirement applicable to EAFC and its bond shall also be applicable to the separate individual fidelity bonds under Rule 1723.

(r) COMMENT: Contrary to what is stated in the Statement of Reasons, "stockholder" (or "shareholder") can be included in Rule 1723 as this term is included in the statutory definition of "loss" (Financial Code Section 17304), is included in the California Escrow Rider attached to EAFC's fidelity bond, and Financial Code Section 17315 authorizes the Commissioner to do so by rule.

RESPONSE: Same as response to comment (2)(b), above. In addition, the statute cited by the commentor, i.e., Financial Code Section 17315, provides that the "commissioner may establish rules with are reasonable and necessary to carry out the provisions of **this chapter**". "This chapter" means Chapter 2.5 of the Escrow Law. However, AB 410 specifically provides that indemnity coverage for those types of transactions not specified in Financial Code Section 25312(c) shall be provided by escrow agents "in accordance with Section 17203.1". Section 17203.1, which Rule 1723 implements, is not included in Chapter 2.5 of the Escrow Law. Even then, Section 17315, just like Section 17400, would not allow inclusion of "stockholder" by rule for the reasons explained in the response to comment (2)(b).

(s) COMMENT: The purpose of indemnification of the "escrow agent's successor in interest" is misstated in the Statement of Reasons and the status of a licensee's successor in interest is too great to be covered by a mere parenthetical within the proposed regulation.

RESPONSE: The purpose is not misstated. It is the Department's intent to require that the fidelity bond under Rule 1723 cover losses that may result from a successor in interest, such as a conservator appointed by the Commissioner over the escrow agent or a receiver appointed by a court. This would make the regulation clear and specific that coverage for the Rule 1723 fidelity bonds extends to successors in interest. Otherwise, this could pose a risk to the public if losses result from a successor in interest. Finally, in response to the commentor's concern, the Department has made a change by removing the parenthesis around the phrase "or the escrow agent's successor in interest" in proposed

Rule 1723(a)(1).

(t) COMMENT: There is no provision to increase coverage if the volume of the escrow licensee's business increases and its average monthly trust obligations increase, and this omission is inconsistent with the statutory EAFC coverage.

RESPONSE: Same as response to comment (3)(e), above.

(u) COMMENT: The Statement of Reasons inaccurately states that the proposed Rule 1723(b) will "identify and recast the provisions of the California Escrow Rider" as the proposed rule changes do not accurately define the California Escrow Rider.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above. Also, the Statement of Reasons has been revised to reflect the new changes (see Final Statement of Reasons).

(v) COMMENT: An escrow agent may not be able to find a replacement fidelity bond with 30 days and, therefore, a 90-day notice of cancellation period is more justified and is also consistent with what is contained in the California Escrow Rider in the EAFC fidelity bond.

RESPONSE: Same as response to comment (2)(b), above.

(w) COMMENT: The Statement of Reasons is incorrect that "Rule 1725 is no longer necessary since the California Escrow Rider has been incorporated into and set forth in Rule 1723" as the California Escrow Rider is not incorporated into Rule 1723 and Rule 1723 applies only to licensees who are not EAFC members.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above. Furthermore, the Statement of Reasons has been revised to reflect the new changes (see Final Statement of Reasons).

(x) COMMENT: The form surety bond for the fidelity bond deductible is inconsistent with EAFC coverage, is inconsistent with standard fidelity bonds, creates coverage disputes, improperly allows third party claims, has defective notice of cancellation, and may impair fidelity bond coverage.

RESPONSE: The surety bond form, and its content, for purposes of proposed subsection (c) of Rule 1723 is beyond the scope and not part of this rulemaking project.

(y) COMMENT: The comment in the Informative Digest/Plain English Overview that "Rule 1723 implements Financial Code Section 17203.1" is inaccurate because the proposed rule results in a standard of coverage for licensees who are not EAFC members inconsistent with that provided by EAFC.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b).

(z) COMMENT: The observation in the Informative Digest that "It is unclear whether Rule 1723 applies to existing licensees" is incorrect as it does apply to existing licensees.

RESPONSE: As explained in the Informative Digest and in the Statement of Reasons, existing Rule 1723 speaks in terms of only "applicants". This made it unclear as to whether Rule 1723 could apply to existing licensees affected by AB 410. In order to make this clear and specific, the Department included proposed language in Rule 1723 to also make its provisions expressly applicable to licensees that are not required to be members of EAFC or that will engage in or are engaged in the business of receiving escrows for deposit or delivery of the types of transactions not specified in subdivision (c) of Financial Code Section 17312. With these proposed changes, both applicants and existing licensees affected by AB 410 will be able to comply Financial Code Section 17203.1 and Rule 1723.

(aa) COMMENT: There is no plain English explanation of which regulations apply to EAFC members.

RESPONSE: Same as response to comment (1)(b), above. Furthermore, explaining or addressing the regulations that are applicable to EAFC members is beyond the scope of this rulemaking project.

(bb) COMMENT: The statement in the Informative Digest that the new Rule 1723(b) identifies and recasts the California Escrow Rider is incorrect and the shorter notice of cancellation is a significant adverse economic impact on business which could affect jobs in California.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above. In addition, the Department believes that the shorter cancellation notice of 30 days will not have an adverse economic impact on business or jobs, rather it will have a positive impact as the fidelity bonds under Rule 1723 will be less expensive and easier to obtain with a 30-day cancellation notice period than with a 90-day cancellation notice period.

(cc) COMMENT: The comments in the Informative Digest on proposed Rule 1723(c) are too abbreviated to have any meaning.

RESPONSE: Section 11346.5(a)(3) of the APA requires the informative digest to merely contain a concise and clear summary of existing laws and regulations, if any, related directly to the proposed action and the effect of the proposed action, with the informative digest to be drafted in a format similar to the Legislative Counsel's digest on legislative bills. In compliance with this section, the informative digest contains a concise and clear summary of proposed subsection (c) to Rule 1723, which authorizes a surety bond to cover the amount of the fidelity bond deductible, if any. As required, the reason and purpose for proposed subsection (c) is more fully explained in the Statement of Reasons.

(dd) COMMENT: Rule 1725 should not be repealed as two inconsistent standards of fidelity coverage will result.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above.

(ee) COMMENT: The commentor recommends that Rule 1725 not be repealed but instead should be amended to include all the requirements of the "California Escrow Rider" and to be made applicable to all escrow agents, whether EAFC members or not.

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above.

(ff) COMMENT: The commentor recommends that proposed Rule 1723(a)(2) be modified to require the entire amount of a proven loss be indemnified under the fidelity bond, after which the member pay the specified deductible, or, in the alternative, proposed Rule 1723(c) should be modified to require that no person other than the insurer who underwrites the fidelity bond shall have standing to make a claim on the surety bond but no part of the penal sum of that surety bond shall be paid for any conservatorship or receivership estate expenses, fees or costs. The commentor also recommends that the provision (in the surety bond form) which allows third party claims and partial payments to third parties be deleted.

RESPONSE: These recommendations are unnecessary. First of all, the proposed language in Rule 1723 already provides that the purpose of the fidelity bond is to indemnify the escrow agent for a loss of trust obligations resulting from fraudulent or dishonest abstraction, misappropriation or embezzlement and proposed Rule 1723(a)(2) sets forth the amount of fidelity coverage that is required according to the escrow agent's monthly average escrow liability. The amount of coverage is required according to the schedule set forth in subsection (a)(2), regardless of whether there is a deductible.

Secondly, there is no need to modify proposed Rule 1723(c) as this subsection does not allow any person to make a claim on the surety bond. Subsection (c) specifically provides that the surety bond "shall run to the state for the use of the state to cover any loss of trust obligations that the escrow agent's fidelity bond does not cover due to the fidelity bond's deductible". The subsection further provides that the surety under the bond may pay the amount of its liability to the Commissioner, a conservator appointed by the Commissioner, or a receiver or other fiduciary appointed by the court in lieu of payment to the state. This makes it clear what the purpose of the surety bond is and to whom it is to be paid. Thus, the surety bond can only be used cover loss of trust obligations and only the specified person can make a claim on the surety bond.

With respect to the last recommendation, the surety bond form, and its content, is beyond the scope and not part of this rulemaking project.

B. 15-Day Comment Period

Only one letter was received during the additional 15-day public comment period, which ended on September 8, 2000. No other comment letters were received after the close of the 15-day public comment period.

COMMENTOR: Michael G. Evans of Gascou, Gemmill & Thornton, General Counsel to Escrow Agents' Fidelity Corporation, letter dated September 7, 2000.

(a) COMMENT: EAFC objects to the deletion of the "California Escrow Rider" in the emergency regulation to Rule 1723 as a separate rider for non-EAFC covered transactions creates inconsistent fidelity coverage with that provided by EAFC for its members and that creating different fidelity coverage standards for escrow agents based only on the kind of property in escrow was not the intent of AB 410. (Note: The emergency regulations referred to by EAFC in its letter is contained in Document OP 20/99-Emergency Order-3, which was approved by OAL, and which is identical to the proposed final text of rules that was put out for the additional 15-day public comment period.)

RESPONSE: Same as response to comment (1)(b) and comment (2)(b), above under "A. 45-Day Comment Period".

(b) COMMENT: Proposed Rule 1723(a)(2) does not require notice to the Commissioner if the amount of trust obligations increase nor does it require an escrow company to increase its fidelity coverage should trust obligations increase into the next threshold in the schedule. This is inconsistent with fidelity coverage requirements of EAFC and its members.

RESPONSE: Same as response to comment (3)(e), above under "A. 45-Day Comment Period".

(c) COMMENT: The emergency regulations do not include "shareholder" status in the "employee" definition contrary to the definition of loss under Financial Code Section 17304.

RESPONSE: Same as response to comment (2)(b), above under "A. 45-Day Comment Period".

(d) COMMENT: The emergency regulations contain no requirement that the fidelity bond coverage be co-extensive with the fidelity bonding requirements of the Financial Code.

RESPONSE: Same as response to comment (3)(f), above under "A. 45-Day Comment Period".

(e) COMMENT: Although EAFC appreciates the withdrawal of the proposal to repeal Rule 1725, that regulation does not expressly define the California Escrow Rider.

RESPONSE: Same as response to comment (1)(b), above under "A. 45-Day Comment Period". Thus, amending Rule 1725 to expressly define the California Escrow Rider that is applicable to EAFC is beyond the scope of this rulemaking project.

(f) COMMENT: EAFC objects to the Finding of Emergency for the same reasons set forth on pages 6 through 14 of its July 25, 2000 letter regarding the Statement of Reasons.

RESPONSE: The "Finding of Emergency" itself is not relevant to and not part of the changes that

were made and noticed for the additional 15-day public comment period. Nevertheless, the same responses of the Department to the comments of EAFC contained in pages 6 through 14 of its July 25, 2000 letter apply equally here (i.e., responses to comments (3)(q) through (dd)).

(g) COMMENT: There is no discussion in the Finding of Emergency of impact on small business or statement why proposed alternatives have been rejected.

RESPONSE: The "Finding of Emergency" itself is not relevant to and not part of the changes that were made and noticed for the additional 15-day public comment period. Nevertheless, Section 11346.1(b) of the APA does not require any statement or discussion in the finding of emergency on the impact on small business and on alternatives. This section only requires that the finding of emergency include a written statement which contains the information required by paragraphs (2) to (6) of subdivision (a) of Section 11346.5.

(h) COMMENT: Application of the new regulations as set forth in the sample fidelity bond form attached to the letter illustrates that its coverage is not consistent with EAFC's coverage under the Escrow Law and the EAFC fidelity bond. The commentor discusses various parts of the sample bond form that are inconsistent with EAFC's coverage.

RESPONSE: The fidelity bond form attached to the commentor's letter is not part of this rulemaking project and not part of the changes that were made and noticed for the additional 15-day public comment period. Thus, the fidelity bond form is beyond the scope of this rulemaking project. However, the Department further responds that the sample fidelity bond form has not been approved by the Department. The Department does not intend to include the form and content of the fidelity bond in the regulations. Financial Code Section 17203.1 requires that each escrow agent shall furnish a bond to the Commissioner indemnifying the escrow agent against loss of money or property. The proposed changes to Rule 1722 clarifies that, except as otherwise provided in Rule 1723, the bond or bonds filed pursuant to Financial Code Section 17203.1 shall have at least the coverage provided in standards forms of fidelity, commercial blanket or blanket position bonds. The Commissioner would have the authority to reject a bond that does not meet these criteria, including the requirements of Rule 1723.

Finally, the comments that the proposed rule changes will result in coverage that is not consistent with EAFC's coverage has already been made several times in the commentor's July 25, 2000 letter and the Department has already responded accordingly (see responses to comments (3)(a), (3)(b), (3)(c), (3)(d), (3)(e), (3)(f), (3)(j), (3)(m), (3)(o), (3)(q), (3)(t), (3)(v), and (3)(y), above under ""A. 45-Day Comment Period").