

NOTICE OF PROPOSED REGULATORY ACTION

Notice is Hereby Given (Gov. Code, § 11346.5(a)(1))

The Commissioner of the Department of Financial Protection and Innovation, formerly the Commissioner of the Department of Business Oversight, (“Commissioner”) is proposing adding sections 1711.1 and 1741.7 regarding “personal property” and “prohibited compensation” and amendments to sections 1732.2, 1737.3 and 1741.5 of title 10 of the California Code of Regulations (hereafter referred to as “Rule”),¹ regarding the escrow books and records and the annual audit report of the financial statement of escrow agents under section 17406 of the Escrow Law (Cal. Fin. Code, § 17000, et seq.). The amendments clarify (1) the meanings of “personal property” and “prohibited compensation”; (2) how to maintain books and preserve records and (3) that the annual report must consist of audited financial statements and the results of an agreed upon procedures engagement, an agreement between an escrow company and a certified public accountant on audit procedures.

Public Hearing (Gov. Code, § 11346.5(a)(17))

A public hearing has not been scheduled. Any interested person or his or her duly authorized representative may request a public hearing no later than 15 days prior to the close of the written comment period. If the Department of Financial Protection and Innovation, formerly the Department of Business Oversight, (“Department”) receives a request for a public hearing, the Department will provide notice of the time, date, and place of the hearing by mailing the notice to every person who has filed a request for notice with the Department.

Comment Deadline (Gov. Code, § 11346.5(a)(15))

Written comments related to the proposed action must be received by February 15, 2021 to be considered by the Department before it proceeds with this regulatory action.

Comments may be submitted by e-mail to the following address:

regulations@dfpi.ca.gov

Comments may be submitted by U.S. mail to the following address:

Department of Financial Protection and Innovation

¹ Use of “Rule” in this notice of proposed action refers to the California Code of Regulations.

Attention: Regulations Coordinator
300 S. Spring Street, Suite 15513
Los Angeles, California 90013
(213) 897-3432

Comments may be submitted by fax to the following number:
(213) 897-8860

Authority (Gov. Code, § 11346.5(a)(2))

The authority for this regulatory action is California Financial Code sections 17315, 17400 and 17406.

Reference (Gov. Code, § 11346.5(a)(2))

The reference for this regulatory action is California Financial Code sections 17003, 17403.5, 17404, 17406, 17409 and 17420.

Informative Digest (Gov. Code, § 11346.5(a)(3))

Section 17404 of the Escrow Law requires every person subject to the Escrow Law to keep and use in its business, books, accounts, and records which will properly enable the Commissioner to determine whether the escrow functions performed by such person comply with the provisions of the Escrow Law and rules. Section 17409 further requires that all moneys deposited in escrow, which are to be delivered upon the close of escrow or upon any other contingency, be deposited in a noninterest-bearing demand or checking account in a bank insured by the Federal Deposit Insurance Corporation and approved by the Commissioner. Such funds, when deposited, must be designated as "trust funds," "escrow accounts," or with a name that indicates the funds do not belong to the escrow agent. Rule 1732.2 sets forth what books an escrow agent is required to establish and maintain regarding its escrow accounts and specifies how often they must be reconciled. In particular, the existing rule specifies the escrow ledger and liability controlling account must be reconciled at least once a month with bank statements of the "trust" or "escrow" account, and the escrow ledger must be reconciled at least once a week with the escrow liability controlling account. The existing rule contemplates non-electronic reconciliation, such as using adding machines, which is time consuming and does not involve software. Reconciling accounts using adding machines is more time consuming than reconciling them electronically and it does not involve the use of computer programs.

Many escrow agents currently establish and use electronic books, accounts and records. As a result, these escrow agents perform their required reconciliations electronically as well. The existing Rule 1732.2 does not provide clarification regarding the use of computer programs. To address this shortcoming, the proposed amendment

to the rule provides clarification for the use of accounting software in regard to escrow liability controlling accounts by requiring that the accounts be maintained separately from any accounting software used by an escrow agent. The existing rule also provides clarification regarding the use of adding machines, which is no longer necessary because such machines are no longer widely used. To address this outdated provision, the proposed amendment to the rule would delete this outdated provision. Lastly, the existing rule requires reconciliation of the escrow ledger and the escrow liability controlling account once a week. Due to modern technology, this process has been made much more expedient. Since misappropriations, accidental or intentional, may occur on a daily basis, to help alleviate these potential issues, the proposed amendment to the rule would require such reconciliations to occur on a daily basis. Since all licensees currently do the daily liability reconciliations on a daily basis, this will not be a change for them.

Section 17404 of the Escrow Law requires every person subject to the Escrow Law to keep and use in its business, books, accounts, and records which will properly enable the Commissioner to determine whether the escrow functions performed by such person comply with the provisions of the Escrow Law and rules. Specifically, section 17403.5 of the Escrow Law provides that: (1) all required records may be maintained by Internet escrow agents and submitted to the Commissioner electronically; (2) all transfers by Internet escrow agents between accounts may be made electronically; and (3) customer account statements may be sent by Internet escrow agents via email or the Internet. Rule 1737.3 requires escrow agents to preserve records for at least five years from the close of escrow. The existing rule implies that records can be destroyed after five years from the close of escrow. It does not consider that there could be undisbursed funds in escrow or outstanding checks that need to be escheated. The State Controller's Office requires files for escheated funds be kept for 7 years. To address that issue, the proposed amendment to the rule would take these events into account by requiring the company to keep and use the files for five years, or longer, if necessary to properly disburse the funds or escheat them to the state. Additionally, the existing rule does not provide clarification regarding the use of computers and electronic records. The proposed amendments to the rule would clarify what licensees should do when using technology, including providing "images" of checks, using encryption or other secure methods when sending records by email, and maintaining printed copies of all requisite records when they are no longer available electronically due to a change in an escrow agent's software.

Section 17406 of the Escrow Law requires each licensee to submit to the Commissioner an audit report containing audited financial statements within 105 days after the close of each calendar or fiscal year. The licensee must also file additional relevant information required by the Commissioner. Rule 1741.5 sets forth the

requirements for preparing the annual audit report. The existing rule contemplates an audit engagement that culminates in an unqualified opinion by a certified public accountant stating that the financial statements of the licensee are fairly stated.

Interested parties have notified the Commissioner that the existing rule sets forth procedures for a certified public accountant (“CPA”) to follow in the annual audit of the licensee, which if accompanied by an unqualified opinion would result in the CPA violating the professional accounting principles. In particular, the provisions of Rule 1741.5 that dictate the procedures for a CPA to follow may only be performed under an agreed-upon procedures engagement, and may result in findings regarding the procedures performed. However, the CPA may not provide an unqualified opinion on audit procedures not established under the CPA’s own professional judgment.

To avoid violating the professional accounting principles, CPAs have been refusing to draft the annual audit reports as required by the Escrow Law. As a result, many escrow agents are out of compliance with the requirement for submitting an annual audit report. The proposed rulemaking would provide the guidance needed to enable CPAs to prepare the required audit reports without simultaneously violating their professional standards of conduct.

To address these concerns, the Commissioner is proposing revisions to Rule 1741.5 to provide that a licensee must engage a CPA to submit an unqualified opinion regarding the financial statements and supplementary information of the licensee, and a report of findings regarding the agreed-upon procedures set forth in the rule. Cumulatively the reports will constitute the annual audit report and additional information authorized under section 17406 of the Escrow Law.

The Escrow Law defines an “escrow” as any transaction in which one person, in order to sell, transfer, encumber, or lease real or personal property to another person, delivers a written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held until the happening of a specified event or the performance of a prescribed condition, at which time it is delivered to a grantee, grantor or its representative, pursuant to Financial Code section 17003. The definition of “escrow” does not specify if “personal property” includes “gametic material.” To address this issue, the rulemaking would clarify that “personal property” within the definition of “escrow” includes “gametic material.” This would enable the Department to regulate surrogacy transactions and protect the public.

The Escrow Law prohibits escrow licensees from paying over to any other person any commission, fee, or other consideration as compensation for referring, soliciting, handling, or servicing escrow customers or accounts, pursuant to Financial Code

section 17420. The compensation language is vague because “consideration as compensation” may be interpreted in many ways, including discounting and waiving escrow fees. The lack of clarity limits the Department’s administrative ability to take actions against companies paying referral fees and kickbacks. To address this vague language, the rulemaking would clarify “consideration as compensation” by plainly describing what constitutes an act of referral for business similar to the provisions in the Insurance Code. This would enable the Department to more easily enforce the prohibition.

The objective of this rulemaking is to update rules regarding establishing, maintaining and preserving escrow books and records, to ensure that CPAs may participate in engagements to meet the annual audit report requirement for Escrow Law licensees without violating any rule of professional conduct, to clarify that “personal property” as used in the definition of an escrow includes “gametic material,” and to clarify what are considered to be prohibited escrow referral compensation acts. A specific benefit of this action is to ensure that adequate procedures are set forth regarding establishing, maintaining and preserving escrow books and records and the annual audit to provide the Commissioner with the assurance that the trust accounts of the licensee are accurately reflected in the licensee’s books and records, and no consumer funds have been misappropriated. Additionally, the rulemaking would benefit escrow agents because it would enable them to comply with their audit report requirements and thus avoid license suspension or revocation. Finally, the rulemaking would provide clarification regarding the definition of “escrow” and what acts are prohibited as escrow referral compensation. After conducting an evaluation, the Department has found that these are the only regulations concerning state escrow books and records, annual audit report, personal property and prohibited compensation. Therefore, the proposed regulations are neither inconsistent nor incompatible with existing state regulations.

Documents Incorporated by Reference

No documents are incorporated by reference.

Any other matters prescribed by statute (Gov. Code, § 11346.5 (a)(4))

No other matters are prescribed by statute.

Determination Regarding Mandate on Local Agencies or School Districts (Gov. Code, § 11346.5(a)(5))

This regulatory action does not impose a mandate on local agencies or school districts.

Estimate of Cost or Savings (Gov. Code, § 11346.5(a)(6))

State Agency

This regulatory action may increase the time for the Department of Financial Protection and Innovation, formerly the Department of Business Oversight, (“Department”) to review annual audit reports. However, the Department anticipates that this increase will not be significant and is absorbable within existing resources. The action may also create additional costs to the Department by clarifying that “gametic material” is “personal property” under the definition of “escrow.” This will result in the Department being authorized to regulate “assisted reproduction agreements.” Regulation of the financial portion of the assisted reproduction industry will increase the Department’s cost of doing business in licensing and examination based on the number of new licensees that do these types of escrow transactions. At this point, it is unknown if this change will result in any new licensees. However, part of the cost of any new licensees would be offset by the licensees’ fees.

Other

This regulatory action will not result in any cost to any local agency or school district required to be reimbursed, will not result in other nondiscretionary cost or savings imposed on local agencies, and will not result in cost or savings in federal funding to the state.

Determination Regarding Adverse Economic Impact (Gov. Code, § 11346.5(a)(7) and (8))

The Department has made an initial determination that this regulatory action will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

Cost Impacts on Representative Private Person or Business (Gov. Code § 11346.5(a)(9))

The Department anticipates that a licensee will incur an additional cost related to the need for two separate audit engagements for the annual report. However, the substantive audit requirements that are being moved from an audit of financial statements to an agreed-upon procedures engagement have been in Rule 1741.5 since 2002, and therefore no additional field work is required for the agreed-upon procedures engagement. Consequently, while the amendments to the rule will require the former single audit report to be separated into two parts and two separate engagements, the workload will remain substantially the same. As a result, the Department anticipates that the typical cost for a licensee to amend its past audit procedure to comply with the

new audit procedure required by this proposed rulemaking will be \$1,000 or less. The current rule does not specify the procedures a CPA must perform to make the statements required in the report. The procedures proposed in the proposed regulation may be different than those previously used by CPAs. Therefore, the time to perform them may vary slightly for different CPAs. Also, some proposed requirements will require smaller samples, which will reduce the time necessary to perform those procedures.

The addition of “gametic material” to the definition of “personal property” under the “escrow” definition will clarify that escrow agents may conduct transactions that hold and disburse funds under assisted reproduction agreements. This clarification of personal property will create more business opportunities for escrow agents, which will provide more benefit than cost to them.

Results of Economic Impact Assessment (Gov. Code, § 11346.5(a)(10))

The Department has assessed the potential for adverse economic impact on California business enterprises and individuals, with consideration of the ability of California businesses to compete with businesses in other states.

The Department finds that this regulatory action will not result in the creation or elimination of jobs within the state; will not result in the creation of new businesses or the elimination of existing businesses within the state; and will not result in the expansion of businesses currently doing business within the state. The Department finds that this regulatory action will benefit the welfare of California residents by setting forth procedures that will help ensure trust funds placed on deposit with escrow agents are not misappropriated. The regulatory action will not benefit worker safety or the state’s environment.

Determination of Effect of Small Business (Cal. Code of Regs., tit. 1, § 4.)

The Commissioner has made a determination that the proposed regulation will not affect small business. Under Government Code section 11342.610, “small business” does not include the professional or business activity of escrow agents.

Finding Regarding Report (Gov. Code, § 11346.5(a)(11))

This regulatory action requires a report. The Department finds that it is necessary for the health, safety, or welfare of the people of the state that this regulation apply to businesses.

Effect on Housing Costs (Gov. Code, § 11346.5(a)(12))

The Department finds that this regulatory action will not have a significant effect on housing costs.

Statement Regarding Reasonable Alternatives (Gov. Code, § 11346.5(a)(13))

The Department must determine that no reasonable alternative considered by the Department or that has otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

Agency Representative and Backup Contact (Gov. Code, § 11346.5(a)(14))

Agency representative for substantive inquiries:

Department of Financial Protection and Innovation
Attn: Sherri Kaufman, Senior Counsel
2101 Arena Boulevard
Sacramento, California 95834
(916) 217-6643; sherri.kaufman@dfpi.ca.gov

Agency representative for non-substantive requests:

Department of Financial Protection and Innovation
Attn: Sandra Sandoval
300 S. Spring Street, Suite 15513
Los Angeles, California 90013
Telephone: (213) 897-3432; regulations@dfpi.ca.gov

Reference to Statement of Reasons (Gov. Code, § 11346.5(a)(16))

The Department has prepared a statement of the reasons for the proposed action, has available all the information upon which the proposal is based, and has available the express terms of the proposed action. This notice of rulemaking, the text of the proposed regulatory action, and the initial statement of reasons for the proposed regulatory action are on the Department's website at www.dfpi.ca.gov. Additional public records relating to this regulatory action will be made available upon request.

Availability of Full Text (Gov. Code, § 11346.5(a)(18))

The full text of any sufficiently related modifications to the original proposed regulation will be available for at least 15 days prior to the date the Department adopts, amends, or repeals the resulting regulation of this regulatory action.

Final Statement of Reasons (Gov. Code, § 11346.5(a)(19))

Any person may obtain a copy of the final statement of reasons after its preparation through the Department's website at www.dfpi.ca.gov, by e-mailing a request to the Regulations Coordinator at regulations@dfpi.ca.gov, by calling the Legal Division at (213) 897-3432 , or by sending a request by mail to the Regulations Coordinator at 300 S. Spring Street, Suite 15513, Los Angeles, California 90013.

Internet Availability (Gov. Code, § 11346.5(a)(20))

Documents related to regulatory actions are available on the Department's website at www.dfpi.ca.gov, under the "Laws & Regs" tab and "Rulemaking" links. For assistance, contact the Regulations Coordinator at (213) 897-3432 or regulations@dbo.ca.gov.