Secured Finance Network

April 23, 2021

Via E-Mail: **@dfpi.ca.gov**
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Commissioner of Financial Protection and Innovation
Attn: Sandra Sandoval, Regulations Coordinator
300 South Spring Street, 15th Floor
Los Angeles, CA 90013

Re: Comments on Proposed Regulations for implementation of Commercial Financing Disclosure Regulations

Dear Commissioner:

The Secured Finance Network (formerly known as the Commercial Finance Association) ("SFNet") is the international trade organization founded in 1944 representing the asset-based lending, factoring, trade and supply chain finance industries, with 260 member organizations throughout the State of California, the U.S., Canada and around the world. As we have previously communicated on multiple occasions, SFNet and its membership are supportive of providing as much information as possible to small businesses in order to assist them in making an informed decision on which financing product is right for them. However, SFNet and its members continue to have concerns regarding the disclosure requirements under Commercial Financing Disclosures enacted under SB1235 (Chapter 1011, Statutes of 2018) and signed into law by Governor Brown on September 30, 2018 ("Disclosure Requirements") as well as the regulations proposed by the California Department of Financial Protection and Innovation ("DFPI") regarding compliance with the Disclosure Requirements ("Proposed Regulations").

SFNet and its members strongly urge you to take the below comments and suggestions into account with respect to the Proposed Regulations. Although the Disclosure Requirements and Proposed Regulations have implications with respect to many forms of financial products provided by our members, we specifically direct you to the implications on factoring and asset-based lending.

DISCLOSURES FOR FINANCING CHANGES

Under the latest draft of the Proposed Regulations, Section 2057(a)(4)(C) provides that disclosure will be required subsequent to the consummation of the commercial financing contract if the contract is "changed" and the resulting change would result in an increase in the finance charge. As we have discussed previously with the DFPI, factoring and asset-based credit facilities are designed to provide working capital for the recipient and therefore have to adapt to the working capital needs and fluctuations of the recipient. Because of the need to have the ability to adapt, "changes" to these financing arrangements may occur often during the term of the financing. Requiring the factors and asset based lenders to re-disclose the disclosure information as required by the Disclosure Requirements can be burdensome to the financing provider and create confusion for the recipient. For example, a temporary need for additional capital under the financing may result in the recipient requesting that the provider relax lending standards to provide additional capital. In that situation, the loan documents may need to be amended and the provider may charge an immaterial accommodation or amendment fee. Under this situation, the recipient most likely will not be looking to multiple sources of financing to compare the best product available to them and a re-disclosure does not provide any useful information for the borrower to compare against other financings. The public policy behind the statute imposing the Disclosure Requirements is to provide information to small businesses to make informed decisions on the types of financing available to them. A re-disclosure for a "change" without additional parameters is not in line with the public policy. We propose a few ways in which the re-disclosure requirement may be tailored to provide more useful information to the recipient while staying in line with the public policy.

(1) Changes in Writing. Generally, accommodations made to the recipient during a life of a financing are documented in writing when they are material changes to the financing. Limiting the re-disclosure requirement to written changes to the financing documents would make the re-disclosure requirement more meaningful to the recipient as it would capture material changes to the financing.

(2) Exclusion for Ordinary Course Changes. As discussed above, all small businesses will have ebbs and flows and a financing provided to such businesses will have to adapt to these changes. There will be ordinary course modifications to a factoring facility or asset-based facility which should not trigger a re-disclosure as these changes could happen often and create a burden on the financier and confuse a small business at a time when the small business is not looking for new financing or the ability to compare one financing product against another financing product. Even worse, the potential time delay in providing the disclosure could worsen a small business' situation as circumstances often arise in the life of a financing that require almost immediate action on the part of the financier and small business to address the circumstance or risk worsening the business' situation. We request an exclusion for re-disclosure related to changes in the financing if the changes are in the ordinary course of business.

(3) Material Changes. Similar to the above suggestions, a materiality threshold would help limit confusion as frequent (sometimes daily) changes to the financing

which do not result in a material change to the finance charge would not need to be disclosed. We request that the DPFI strongly consider limiting the requirement to re-disclose to changes which materially increase the APR. Such materiality could be expressed as a fee greater than a dollar amount or a change in APR resulting from such change greater than a certain percentage.

(4) <u>Excluded Avoidable Fees and Expenses</u>. During the life of a financing, there are many instances in which additional fees and expenses may be charged to the recipient due to the actions of a recipient. For example, the recipient may fail to comply with covenants set forth in the financing documents and request that its failure be waived by the provider. In such situation, the provider may charge a waiver or amendment fee to obtain credit approval and document the waiver. Such fees and expenses could have been avoided by the recipient by simply complying with the terms of the contract. In this instance, a re-disclosure is unnecessary and not in line with the public policy behind the Disclosure Requirements. We request that an exception be included in the regulations for re-disclosure due to increases in the financing charge due to the charging of avoidable fees that the recipient failed to avoid.

We remind you that many of the financiers lending to small businesses are themselves small businesses and an open-ended requirement to re-disclose upon ALL changes to a financing creates potential material burden on these small businesses which can result in operational challenges for such small financiers. We hope that the regulations protect all small businesses and not a group of small businesses to the detriment of other small businesses.

<u>TYPES OF ASSETS SUPPORTING A FACTORING OR ASSET-BASED FACILITY</u>

The definition of “Approved Credit Limit” set forth in Section 2057(a)(2) of the Proposed Regulations appears to make a distinction between the different types of collateral supporting a financing. As drafted, this language seems to mainly focus on financings supported by accounts receivable. In practice, financings may also be made based on the value of a recipient’s inventory or other property. To make it clear that each type of supporting asset does not get a separate “Approved Credit Limit,” we suggest the following language changes to the Proposed Regulations:

(1) The definition of “approved advance limit” in § 2057(a)(1) should be modified by adding the following at the end of the definition:

> If the agreement also provides for the financer to pay different maximum advances for different categories of advance (such as advances secured by inventory or others), the approved advance limit shall also include in addition to the above the sum of the different maximum advances for each category of advance.

(2) a corresponding change should be made to § 2071(a)(3)(A)(iii):

> (iii) The parties to the factoring transaction agree in writing prior to execution of their agreement (and prior to the amendment of an existing agreement) that at some point during the agreement, an amount exceeding $500,000 is reasonably expected to be advanced to the recipient ~~for legally enforceable claims that have not yet been paid~~.

(3) Similar to the change above with respect to § 2057(a)(1), the definition of "approved credit limit" in § 2057(a)(2) should be modified as follows:

> . . and advances with respect to one category of advance do not reduce the maximum advance for another category of advance, the approved credit limit means the sum of the different maximum advances for ~~different types of legally enforceable claims~~ [added language follows] <u>each category of advance</u>.

<u>NON-BORROWING FACTORING FACILITIES</u>.

There are factoring transactions that are "non-borrowing." This means that the financing provider does not advance funds against factored accounts receivable. There is no credit extension to the factoring client, and thus there is a $0 "approved advance limit". The provider simply purchases the receivables and assumes the credit risk thereon. If the account receivable is unpaid by the account debtor due to the account debtor's financial inability to pay (i.e. credit risk) the provider absorbs the loss -- the small business does not. However no funds are advanced against the accounts receivable in a non-borrowing factoring arrangement. It should be made clear that no disclosures are required to be made in non-borrowing factoring transactions. Without a change to § 2071(a)(3)(B), the way this section reads today disclosures would be required because the approved advance limit would be less than $500,000 – this is not consistent with the purposes of the Disclosure Requirements. To address, this § 2071(a)(3)(B) should be revised as follows (added language underlined):

> (B) If the factoring transaction does not meet all of the requirements listed in subdivision (a)(3)(A) above, the commercial financing offer shall be considered less than or equal to $500,000<u>, except with respect to a factoring transaction where the approved advance limit is $0, in which case such commercial financing offer for such factoring transaction shall not be subject to these regulations</u>.

<u>AFFILIATED RECIPIENTS</u>

Commercial financings are often provided to related recipients or co-recipients. The test as to whether the disclosure requirement applies should be at the aggregate level for recipients related by common ownership not at the individual recipient level. For example, assume the approved advance limit for one recipient is $550K and for a related recipient the approved advance limit is $200K. Under current rules, the first recipient would not need to be provided the disclosure but the second one would. The proposed change would eliminate the requirement for the second recipient, which is appropriate from a policy standpoint given the two recipients in this example are related by common ownership and the law already does not require the disclosure for the recipient that has the larger approved advance limit. Thus the protections afforded by the disclosure are not needed for the second recipient. Therefore, §2057(a)(20) of the Proposed Regulations should be revised by adding the following at the end of such subparagraph:

"Recipient" shall mean and be interpreted as to any recipient (considered the "first recipient") to include any other recipient that controls, is controlled by, or is under common control with the first recipient."

SAFE HARBOR

Although we appreciate the Proposed Regulations allowing for a tolerance of 1/8 of 1% in Section 3026, because of the numerous assumptions required to allow factors and asset-based lenders to provide an APR calculation, even the best estimation and assumptions could result in a margin of error greater than the tolerance level provided. Therefore we strongly urge the DFPI to provide a safe harbor for providers of commercial loans to small businesses which insulates the providers from liability (through litigation or otherwise) if they comply with the Disclosure Requirements in good faith. This would be very similar to safe harbors contained in the Federal Truth-In-Lending Act for consumer lending disclosures. Specifically see 15 U.S.C. § 1640(b) and 15 U.S.C. § 1640(c). The safe harbor is necessary because many of the providers of commercial loans to small businesses are small businesses themselves and can't absorb the cost of litigating perceived violations of the Disclosure Requirements.

Sincerely,

Richard D. Gumbrecht
Chief Executive Officer
Secured Finance Network