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RE: Response to Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures (PRO 01-18) on behalf of the Commercial Finance Coalition

Dear Mr. Mattson and Mr. Carriere:

The Commercial Finance Coalition ("CFC") is comprised of responsible finance companies that provide needed capital to small businesses through innovative methods. CFC members offer accounts receivable purchase financing to small businesses (also known as "merchant cash advance" or "MCA"), and some also engage in lending, specifically in the state of California through California Finance Lender's licenses. CFC members also include select vendors that provide technology services to the small business finance industry. The CFC appreciates the Department of Financial Protection and Innovation's efforts to draft financial disclosure regulations to implement SB 1235. This letter responds to the Department's proposed regulations pursuant to the Notice of Rulemaking Action issued on September 11, 2020.

I. Proposed APR Disclosure for Sales-Based Financing

After reviewing the proposed regulations, the CFC is concerned that the annual percentage rate (APR) disclosures for sales-based financing would result in confusing and inaccurate APR disclosures to small and medium sized businesses. In addition, the proposed regulations could result in unreasonable

litigation risks for companies attempting to comply with these complex rules, without meaningful benefit to commercial recipients of these disclosures. The CFC respectfully offers the following comments:

A. The Proposed APR Disclosure is Not Based on the Legal Obligation

The Proposed Regulations instruct MCA providers to calculate and disclose an APR in accordance with the APR disclosures required for consumer transactions under the federal Truth in Lending Act (TILA)[1] and its implementing regulation, Regulation Z.[2] Use of those calculations is problematic in the context of "sales based financing," which, as defined by the proposed regulations, includes merchant cash advance ("MCA") transactions. The TILA APR disclosure is based on the consumer's *legal obligations* with the creditor. This "legal obligation" standard means that, in disclosing costs of credit, the creditor is not required to (and in fact, may not) predict the actual timing of a consumer's payments or other factors that would impact the APR that are not legal obligations under the terms of the agreement.

The Proposed Regulations, on the other hand, require an APR calculation for MCA transactions that are based entirely on prediction and, therefore, have no relationship to the recipient's legal obligation. In MCA transactions, it is impossible for the parties to know what the recipient's payments will be, because they are based on yet-unrealized sales, which can be affected by many factors both in and out of the MCA provider's and recipient's control (such as, for example, a pandemic, the introduction of newer products, the loss or addition of a particularly impactful manager or director, seasonal impacts on sales, etc.).

In order to account for the impossibility of knowing what the recipient's payments will be, the proposed regulations require MCA providers to rely on predictions about how the recipient will repay. Sections 2091 and 2092 of the proposed regulations require MCA providers to use an estimated monthly sales, income or receipts projection as the amount the recipient will repay on a monthly basis. This approach will result in an APR disclosure that is inherently inaccurate and does not represent the legal obligation of the parties. An approach that relies on projections and predictions, and not the legal obligation, is precisely counter to what TILA requires and will result in an APR that is not representative of the cost to the MCA recipient.

The weakness of this approach is even more apparent in MCA transactions in which the Purchased Amount (the total amount that the recipient will pay if the transaction is completed) does not change regardless of how quickly the recipient pays. Section 2065 of the proposed regulations states that in disclosing the estimated finance charge, if the finance charge will not increase under any circumstance if repayment takes longer than estimated, the provider may include the following statement: "Your finance charge will not increase if you take longer to pay off what you owe." However, though the proposed regulations recognize that the recipient will not have to pay more in this case, the proposed regulations require the provider to disclose an APR that is calculated by assuming a specific term of repayment. APR is not an effective disclosure for MCA transactions and particularly so when the cost to the recipient will not increase regardless of how long the recipient takes to repay the provider. Moreover, the statement "what you owe" is legally incorrect and, at best, confusing in the context of an MCA transaction where

[1] 15 U.S.C. §§ 1601 *et seq.*
[2] 12 C.F.R. §§ 1026.1 *et seq.*

the amount owed is wholly contingent on the merchant's future sales. MCA transactions differ from loan transactions, which require a merchant to repay amounts borrowed unconditionally and without regard to sales volume or income. MCA transactions do not include unconditional repayment obligations. Including statements such as "what you owe" will likely confuse merchants and discourage merchants from receiving the full benefits of their transactions with MCA providers.

Further, APR is a useful measure of the cost to repay an obligation only when it is calculated uniformly across all products to allow for reliable and informative comparison. For MCA transactions, the proposed regulations require APR to be calculated in a manner that is not based on the legal obligation and is not, therefore, calculated uniformly when viewed against other products (which use the legal obligation as the basis of disclosure calculations). An effort to shoehorn MCA transactions into an APR disclosure regime ultimately will make any APR disclosure, whether provided with an MCA transaction or other consumer or commercial transaction, less informative and less reliable because APR will no longer be a uniform comparison of costs.

B. <u>The Estimated Monthly Sales, Income or Receipts Projection is Misleading and Unreliable</u>

As noted above, the proposed regulations require MCA providers to disclose an estimated APR based on either a historical "estimated monthly sales, income, or receipts projection" or an "internal estimated sales, income, or receipts projection". These approaches produce APRs that are misleading and unreliable.

The "Historical Method" of projecting sales, income or receipts in Section 2091 requires a creditor to "fix the number of months considered to determine the recipient's average monthly historical sales or income" to a period of between 4 and 12 months, at the provider's discretion. Thus, two different MCA providers, offering the same MCA terms with the exact same contractual repayment requirements, might have wholly different disclosures depending on whether the providers use a 4-month term or a 12-month term for purposes of the historical average. For APR to be meaningful, an obligation repayable on the exact same terms should result in the same APR, regardless of which provider ultimately enters into the MCA transaction. Further, while the Department of Financial Protection and Innovation could remedy the inconsistent result by establishing a specific fixed term for determination of the historical average, whatever term the Department of Financial Protection and Innovation might deem to be appropriate may not provide an accurate picture of the historical sales, income or receipts of that recipient. These concerns bring into focus the reasons why APR is inappropriate for MCA transactions.

Moreover, Section 2092 of the proposed regulations allows MCA companies to use an internal "Underwriting Method" to calculate the estimated sales, income, or receipts of a recipient. However, the proposed regulations instruct the MCA company to use "the best information reasonably available..." in calculating disclosures. Therefore, the APR disclosures will be calculated by each MCA company based on different assumptions and information. As a result, the APR disclosures for MCA transactions will have little value in assisting a business in comparing APRs among several potential MCA companies.

Further, the proposed regulations recognize that the Underwriting Method of calculating disclosures for MCA transactions may be particularly vulnerable to inaccurate or misleading APRs. The proposed

regulations include an audit requirement, obligating the MCA provider to perform a "retrospective annualized rate" calculation that would require the MCA company to use the Historical Method to calculate APRs if the weighted average for the "APR spread" is outside prescribed limits in Section 2092. This is problematic for several reasons and demonstrates why an APR regime is inappropriate for MCA transactions.

First, the means by which the proposed regulations determine if a provider's Underwriting Method is reliable require an audit that examines the weighted average of "APR spreads." While the weighted average of "APR spreads" might suggest a provider's method of calculation is reasonably reliable, it does not guarantee that any particular recipient of a merchant cash advance received a reliable APR disclosure. A recipient could be given a disclosed APR that falls well outside of the weighted APR spread even when the provider's audit suggests the provider's Underwriting Method is reliable.

Second, requiring a provider who's audit produces weighted average APR spreads outside of the permitted range (which may not be due to any fault of the MCA company that provides them, but rather on external influences on repayment) to thereafter use the Historical Method does nothing to address the impact of inaccurate disclosures provided to recipients of MCA transactions prior to the audit. By the time the audit would suggest the provider's calculations are inaccurate, the recipient has already relied on the disclosure. Further, the proposed regulations would foster an environment where some disclosures result from an Underwriting Method that has yet to be audited for accuracy (and, therefore, may or may not be reliable), and some by an Underwriting Method that has been audited and appears to be reliable. Because a recipient seeking a merchant cash advance cannot know whether any particular provider's Underwriting Method has been audited or the results of those audits, the recipient cannot know if the APR disclosed to the recipient is likely to be reliable. In addition, MCA providers who have audited their Underwriting Method may be at a competitive disadvantage to those who have not done so.

Third, for the reasons set forth above, the Historical Method of predicting sales, income or receipts is not an accurate means by which to calculate the APR. Thus, requiring a provider to use the Historical Method when an audit shows their Underwriting Method is not reliable or accurate simply substitutes one problematic calculation for another.

C. TILA APRs Do Not Account for Potential Defaults but the Proposed Regulations Require Providers to Anticipate Penalties

The TILA APR is directly related to the amount of the finance charges imposed by a creditor on a credit transaction. Regulation Z excludes from the finance charge "charges for actual unanticipated late payment, for exceeding a credit limit, or for delinquency, default, or a similar occurrence."[3] Section 3003 of the proposed regulations, however, requires the provider to account for penalty payments required when a payment or series of payments falls below a contracted threshold in the calculation of payments (which impacts the APR calculation). The proposed regulations require providers to anticipate that the recipient will trigger penalties as a result of failing to meet contractual thresholds, which is inconsistent with the approach to default fees under TILA and Regulation Z. Further, it is not clear how a provider is

[3] 12 C.F.R. §§ 1026.4(c)(2).

to predict whether any particular penalty will be triggered, when it will be triggered, or the amount of the penalty if the penalty varies based on the amount by which the payment or series of payments falls below a contracted threshold. Moreover, in an MCA transaction, providers typically impose "penalties" only to the extent that the merchant fails to provide the documentation necessary to make a reconciliation calculation. Providers cannot know at or before inception of the transaction whether a merchant will fail to submit necessary documentation over the course of the transaction.

D. An MCA Provider Cannot Reasonably Anticipate True-Ups

Section 303(a) requires a MCA provider to include estimated payments and "reasonably anticipated true-ups" in each estimated APR calculation. The term "true-up" means any payment made to a recipient, any charge assessed to a recipient, and any adjustment to a recipient's periodic payments pursuant to a true-up mechanism.[4] The term "true-up mechanism" means, with respect to MCA, a contractual arrangement with all the following elements:

> (A) The financer receives periodic payments based upon a pre-set amount (or amounts) stated in the contract;
>
> (B) The contract allows the recipient to request, or the financer to initiate, adjustments to the payment amount, credits to the recipient, or charges to the recipient after execution of the contract, so that the total amount paid by the recipient more closely reflects a split rate listed in the contract.[5]

The term "reasonably anticipated true-up" means any "true-up" that the financing provider has a reasonable basis to expect will be made during the term of the contract, taking into account past performance of similar contracts (both those made to the recipient and other similar recipients) and the policies and procedures of the financer.[6]

It is unclear how a provider would "reasonably anticipate" any true-up. A true-up results in the payment obligation of the recipient being adjusted, sometimes dramatically, based on the actual receipts generated by the recipient. Must a provider anticipate that landscaping businesses based in colder climates will obtain a true-up in January resulting in lower payments, but not landscaping business based in warmer climates? Must a provider anticipate that sellers of consumer goods may generate more revenue during the holiday shopping period of November and December, and therefore should make higher payments in those months? And in either case, how would a provider anticipate the exact amount of any true-up? This uncertainty illustrates that in the context of an MCA transaction, the payment obligation is flexible and APR is not reliable or accurate.

Moreover, the COVID-19 crisis has demonstrated how unpredictable true-ups can be. Over the past several months, CFC members have provided true-ups/modifications to approximately 50% of their

[4] Proposed Regulations Section 2057(a))(26).
[5] Proposed Regulations Section 2057(a))(28).
[6] Proposed Regulations Section 2057(a))(27).

nationwide portfolio of customers. This inherent flexibility has resulted in substantial payment relief for small businesses without the need for legislative action to require forbearance. Although this has been a time of extraordinary hardship for small businesses across the U.S., unexpected hardships happen to individual small businesses all the time. As a result, a provider is unable to reasonably anticipate true-ups either on an individual customer basis or across its portfolio.

E. Costs Associated with Providing APR Disclosures Will Outweigh the Supposed Benefits to the Merchant

As discussed above, the APR disclosures for MCA transactions will be inaccurate and misleading to merchants. Therefore, we believe they provide very little value to merchants who choose to use an MCA transaction for their capital needs. Even though there is little benefit to merchants as a result of these APR disclosures, the costs to MCA companies associated with providing these APR disclosures will be significant. The CFC believes that no reasonably accurate cost-benefit analysis would support imposing the disclosures contemplated by the Proposed Regulations.

In order to comply with these APR disclosure requirements, MCA companies will be required to either (1) determine if these APR calculations can be programmed into their computer systems or (2) purchase new systems that may have the capabilities of calculating an APR. These systems must also have the capability of calculating and maintaining the MCA company's "estimated monthly sales, income or receipts projection" or an "internal estimated sales, income, or receipts projection." In addition, the MCA companies will be required to periodically test the accuracy of these calculations. Since MCA transactions are not loans, most MCA companies do not have a loan origination system that could calculate an estimated APR for a transaction. Therefore, these companies will be required to maintain a separate system to calculate these APRs required by the proposed regulations.

MCA companies will also be subject to unnecessary legal and compliance costs associated with calculating the APR disclosures for MCA transactions. These increased compliance costs and associated risks may force many MCA companies to either cease operations in California or increase the costs of their service to their California customers.

These significant and potentially unknown costs to MCA companies associated with providing confusing APR disclosures to merchants clearly outweigh any benefit that an APR disclosure would provide to a merchant before entering into a transaction.

F. Disclosing an APR for an MCA Transaction Will Imply Interest is Being Charged

MCA transactions are purchase and sale agreements. They are not loan transactions. Three important factors in determining whether a transaction is an MCA transaction or a loan are (1) whether or not the contract contains a finite term because an indefinite term is consistent with the contingent nature of a sale of future receipts; (2) whether the funder has any recourse if the business declares bankruptcy; (3) whether the contract contains an interest rate or payment schedule; (4) whether there is an unconditional promise to pay; and (5) whether payments are based on a percentage of receipts and may vary according to differences in income to the merchant.

In the consumer lending space, the difference between interest and APR is a frequent source of confusion. Most consumers, and even lenders, do not understand the differences between these two concepts. This confusion will be even worse in MCA transactions that do not contain an interest component. MCA companies are concerned that by disclosing an APR for MCA transactions many merchants and some courts may think the MCA company is charging interest on the transaction. This confusion could result in the MCA transaction being recharacterized as a loan, and, as a result, being challenged as usurious in California. *See e.g. Milana v. Credit Discount Co.*, 27 Cal.2d 335, 342 (1945) (en banc). Due to this confusion, MCA companies could also be the target of plaintiff's attorneys and government regulators. These MCA companies will be required to defend any such actions, and they will be required to spend significant resources on litigation and compliance examinations.

This problem could be avoided by removing the APR disclosure requirement for commercial finance transactions. Instead, the commercial finance provider could disclose a true of cost of the transaction as an annualized cost of capital. This cost disclosure would be meaningful to the applicant, and it would allow an applicant to compare MCA transactions among lenders and other competitors to shop for the lowest cost services.

Recommendation: The CFC recommends that the proposed regulations be revised to require 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). This is a simpler calculation for all and would eliminate or reduce all the risks problems discussed above caused by an APR disclosure.

II. Testing of Proposed Financial Disclosure Forms

As you are aware, the Department of Financial Protection and Innovation released a Request for Proposal on October 22, 2019 seeking "contractor services to conduct user testing to obtain feedback on the efficacy of multiple versions of proposed financial disclosure forms" related to implementing regulations for SB 1235. The CFC applauds this effort and believes user testing should play a significant role in the development of disclosures that are meaningful for small business owners. Because of the importance of the study, the CFC respectfully requests that the Department of Financial Protection and Innovation release all information—including methods, results, and underlying data—about the study in a timely manner that permits all stakeholders to consider the study in appropriate context. This will permit all stakeholders to have access to the information used in developing the proposed regulations. If the Department of Financial Protection and Innovation has not conducted the study, the CFC respectfully requests that it explain its reasoning and alternative methods for testing the efficacy of the proposed financial disclosure forms.

III. The Definition of Sales-Based Financing Causes Confusion by Including Both Loan and Non-Loan Products

Under the proposed regulations, the term "sales-based financing" means:

> a commercial financing transaction that is repaid by a recipient to the financer as a percentage of sales or income, in which the payment amount increases and decreases according to the volume of sales made or income received by the recipient. Sales-based financing also includes commercial financing transactions with a true-up mechanism.[7]

Accordingly, in a sales-based financing transaction, the recipient's obligation to repay is contingent on the recipient's volume of sales made or income received. In contrast, a loan transaction requires a recipient to repay unconditionally, without regard to the recipient's volume of sales made or income. California courts consider an unconditional obligation to repay "determinative" in distinguishing between a sale and a loan. *See Milana v. Credit Discount Co.*, 27 Cal.2d 335, 342 (1945) (en banc).

The proposed regulations cause confusion by stating that a "closed-end transaction" may include sales-based financing in which there are:

> payments calculated as a percentage of sales or income *but with a minimum requirement payment or payments such that the recipient is eventually required to repay the amount advanced regardless of the sales or income the recipient collects*.[8]

A transaction in which the recipient is unconditionally required to repay the amount advanced and which has a set repayment term is a loan. This is fundamentally distinguishable from a sales-based financing transaction, in which the provider's return is contingent on the recipient's volume of sales made or income received and which has no set repayment term. Stating that a sales-based financing transaction can include an unconditional requirement to repay causes confusion and is legally inaccurate in the context of MCA transactions.

Recommendation: The CFC recommends that the proposed regulations be revised to clarify that a sales-based financing transaction excludes a transaction with an unconditional obligation to repay.

IV. Underwriting Requirements Exceed the Department's Rulemaking Authority and are Unreliable

SB 1235 created the Commercial Financing Disclosures Division, authorizing the Department to adopt regulations as follows:

> (a) The commissioner shall adopt regulations governing the disclosures described in paragraphs (1) to (5), inclusive, of subdivision (b) of Section 22802 and paragraphs (1) to (5), inclusive, of subdivision (a) of Section 22803. Those regulations shall include all of the following:
>
> > (1) Definitions, contents, or methods of calculations for each of the disclosure items set forth in each applicable paragraph of subdivision (b) of Section 22802 and subdivision (a) of Section 22803.

[7] Proposed Regulations Section 2057(a)(22).
[8] Proposed Regulations Section 2057(a)(8)(b) (emphasis added).

> > (2) Requirements concerning the time, manner, and format of the applicable disclosures described in subdivision (b) of Section 22802 and subdivision (a) of Section 22803.
>
> (b) The commissioner shall adopt regulations concerning the annualized rate disclosure described in paragraph (6) of subdivision (b) of Section 22802 and paragraph (6) of subdivision (a) of Section 22803. Those regulations shall include all of the following:
>
> > (1) A determination of the appropriate method to express the annualized rate disclosure and the types of fees and charges to be included in that calculation.
> >
> > (2) When providers shall be permitted to disclose an estimated annualized rate, and how such an estimate shall be calculated. The method of calculation determined by this paragraph shall specify the accuracy requirements and tolerance allowances for the calculation, and the types of fees and charges to be included in the calculation.
> >
> > (3) Requirements concerning the time, manner, and format of the disclosure.
>
> (c) A provider shall not be required to comply with the disclosure requirements of this division until the final regulations are adopted by the commissioner pursuant to this section and become effective on the applicable date described in Section 11343.4 of the Government Code.[9]

This authorization to adopt regulations is focused on disclosure. However, the proposed regulations create substantive underwriting obligations for MCA companies. The proposed regulations require providers of "sales-based financing" to use either an "estimated monthly sales, income, or receipts projection" or an "internal estimated sales, income, or receipts projection" and if provider elects the second option, to conduct an audit every four months. As part of the audit, the provider must calculate a retrospective APR despite the fact that the APR created in TILA is not a retrospective calculation – it is always prospective. If the APR exceeds the limitations in the proposed regulations, the provider may no longer calculate the estimated APR pursuant an internal estimated sales, income, or receipts projection. Nowhere does SB 1235 require providers to perform audits or authorize the Department to require underwriting methods.

In addition to being beyond the authority granted to the Department by SB 1235, the required underwriting methods create confusion and risk. The proposed regulations provide that an MCA company using the "internal estimated sales, income, or receipts projection" when estimating sales projections must calculate these projections using "using the best information reasonably available to the provider." As discussed above, the repayment of an MCA transaction is strictly based on how quickly a merchant receives its receipts from customers. Therefore, these estimates could vary from month-to-month or year-to-year. As a result, the internal estimated sales, income, or receipts projection also could vary

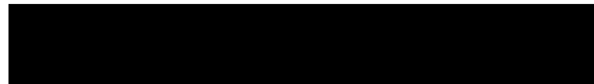
[9] SB 1235 Section 22804.

significantly. As an example, one of the CFC's member companies performed an 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%.

Recommendation: Delete the underwriting requirements in the proposed regulations. In the alternative, create a safe harbor standard based on a demonstration of the reasonableness of the provider's underwriting that relies primarily on supporting documentation used and maintained by the provider. This will help avoid the legal exposure a retroactive review of a provider's underwriting may create given the unpredictability of MCA transactions.

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

Very truly yours,



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