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10/28/2020

By Electronic Mail – Charles.Carriere@dbo.ca.gov

California Department of Financial Protection and Innovation
Attn: Charles Carriere, Senior Counsel
One Sansome Street, Ste. 600
San Francisco, CA 94104-4448

Re: Comments on Rulemaking Action
Commercial Financing Disclosures (PRO 01-18)

Dear Mr. Carriere:

On behalf of Strategic Funding Source, Inc., doing business as Kapitus (Kapitus), we would like to thank the Department of Business Oversight, now known as the Department of Financial Protection and Innovation (DFPI) for the opportunity to provide the following comments on the proposed rules related to the implementation of SB 1235.

Kapitus is dedicated to providing capital to small businesses through technology-enabled underwriting. In California, we currently offer two financing products directly to small businesses. First, Kapitus holds a CFL license and originates commercial loans under this license. In the terminology of the proposed regulations, these loans are classified as "closed-end transactions." Second, Kapitus also enters into contracts with small businesses in which it purchases a percentage of a small business's future income. In the terminology of the proposed regulations, these agreements are classified as "accounts receivable purchase transactions" or, alternatively, "sales-based financing".

As an initial matter, Kapitus would like to thank the DFPI for incorporating many of the suggestions we, as well as many others, raised during earlier rounds of the rulemaking process. These changes have improved the proposed regulations substantially. Unfortunately, despite these positive changes, there remain some fundamental issues that will make these regulations both difficult to implement for companies that provide financing to small businesses and difficult for the average small business to understand. To this end, Kapitus offers the following comments and recommendations on the proposed regulations.

General: Annual Percentage Rate (APR)

Kapitus will not repeat the detailed comments in our previous letters, as well as the substantive criticism raised by other stakeholders, related to the many issues with a

TILA-based annual percentage rate (APR) metric for products without a fixed term or payment. However, we will note that many of the issues we raise in this letter would be greatly reduced or even non-existent if a more accurate and transparent metric than APR was used.

An APR metric based on estimates can be problematic, especially when first implemented. Many companies do not now, nor have they ever, disclosed an APR, simply because this metric is not applicable to variable repayment products that by their terms do not have a term or schedule of payments. As further detailed below, if the DFPI retains the APR metric as a disclosure, Kapitus urges the DFPI to include in the regulations the ability for companies to receive advance approval from the DFPI for APR calculations.

General: Disclosures

Kapitus believes that the difference between the purchase price and the sale price is one of the most important disclosures needed for what the DFPI terms "sales based financing." This is the amount our customers look to in order to determine the cost of capital and this metric is how our customers determine the value and desirability of a particular financing agreement. This disclosure also allows customers to compare financing across all products, as the cost of capital to the customer is calculable for any of the products the regulation covers. Kapitus asks that the total cost of the financing be included prominently on the disclosures, in order to allow recipients to succinctly and accurately determine and compare the total cost of the financing, whether that cost is based on an amortized interest rate periodically charged over the life of a product, or a fixed finance charge based on a discount rate.

Moreover, in certain products our customers look to the daily or weekly percentage, referred to as the "remit rate" (not the amount) of accounts receivable due to the provider. This information is critical for comparing different offers, and the proposed regulations prohibit this information from being included on the disclosure page. The intention appears to be to avoid confusion between the APR metric and the remit percentage. However, this illustrates the difficulty in forcing the APR metric on to products that do not naturally fit that disclosure.

Finally, we suggest that providers be required to separately disclose any fees or commissions paid to a broker, rather than including this cost within the APR calculation. We believe this disclosure being listed on its own will allow applicants to better differentiate between the costs imposed by a provider, and the costs imposed by a broker. In addition, this disclosure will allow applicants to immediately identify, and be able to dispute, excessive or additional charges that may be imposed by a broker after the disclosures are sent from the provider. Listing this charge separately will also work to prevent unscrupulous brokers from steering their customers to financing that may not be the best for the customer, but instead has the highest commission for the broker.

Kapitus believes that these three metrics should be added to the disclosures required under these regulations, as they have much more value to the average applicant than many of the proposed disclosures in the draft regulation.

General: Date Calculations

It causes confusion to have designated assumptions regarding months in one section (Section 2060 (a)(4)), and designated assumptions regarding days in two separate different sections (Section 3001 (d)). Kapitus recommends that all assumptions necessary for the calculations required by the disclosures be stated in one place in the regulations.

In addition, we believe these assumptions should be placed on the disclosure statement. Every month does not have 30 days, and every year is not 360 days long. Also, many of our customers do not make payments every day. Giving applicants a disclosure statement that includes a monthly rate and an APR that are based on artificial assumptions is bound to cause confusion when the estimates inevitably fail to line up with real payment amounts.

Also, Kapitus requests that the regulations reconcile the disconnect between daily and monthly calculations. The estimated monthly cost will be calculated on a 30-day-a-month basis, but the APR will be calculated on a 7-day-a-week basis, which means any recipient who tries to recreate the calculations will fail.

Finally, Kapitus requests that the regulations reconcile the disconnect between estimated and actual date calculations. For the audit allowed in Section 2092, the initial disclosures will be given based on date estimates, while the retrospective calculation will be based on actual dates. This disconnect will likely cause a greater APR discrepancy and can lead providers to be temporarily banned from using the method allowed under Section 2092.

General: Pre-Payment Disclosures

Kapitus believes that disclosure of a pre-payment *discount*, not just a pre-payment *penalty*, is important for allowing the recipient to compare products. The applicant should be informed of any positive consequences of pre-payment, not just warned of negative consequences. Hiding this aspect of a transaction biases the disclosures toward certain business methods while penalizing other methods of providing financing and fails to give a clear picture of the entire cost of financing to the recipient.

For example, the Credit Card Accountability Responsibility and Disclosure (CARD) Act, a law that aims to establish fair and transparent practices within the credit card industry, requires a comparison of costs between making minimum payments and paying off the balance within 3 years. Kapitus believes that providing this same type of information would be pertinent to a customer making an informed comparison between offerings.

General: Liability

Kapitus is concerned about the potential for litigation in the event the requirements of SB 1235 are satisfied through estimates, and it is later found that, due to the variables involved, the estimates differed from the actual cost of the financing.

Kapitus urges that the DFPI add regulations to allow companies to consult with the DFPI regarding disclosures, gain approval of the methods being used to comply with DFPI's regulations, and then be protected from both private lawsuits and enforcement actions by the DFPI as long as they comply with these methods.

In addition, Section 3023 requires financing companies to use brokers as intermediaries in transmitting and receiving disclosures from applicants and lays out procedures that financers are required to implement to ensure that the disclosures are received by applicants.

For both these reasons, Kapitus urges that the DFPI add a provision shielding CFL license holders from both private lawsuits and enforcement actions where the licensee has consulted with and gained regulatory approval for the estimated calculations, and shielding financing companies from wrongdoing caused by broker intermediaries.

General: Implementation Date

The regulations require complicated calculations and estimates as currently written and will require significant technology changes prior to implementation. Kapitus requests that the DFPI provide a minimum of 12 months to implement any required changes after the final regulations are released.

Section 2057. Definitions.

4. "At the time of extending a specific offer of commercial financing"

Disclosures are required "at the time of extending a specific commercial financing offer." Kapitus believes that the current definition of this phrase can lead to confusion. Part B of this definition includes any time the terms of a commercial financing contract are amended or supplemented, when that amendment or supplement will increase the finance charge, term, or annual percentage rate. The terms "amended" and "supplemented" are ambiguous and have the potential to cover situations where terms are temporarily or permanently changed or require a disclosure each time a customer requests a change to the financing offer as it is being negotiated prior to funding.

Kapitus would appreciate confirmation that a new disclosure page does not have to be generated and signed any time Kapitus temporarily modifies the payments of the customer at the customer's request, or permanently modifies the payments by entering into a settlement agreement or accepting changed payments from a customer in bankruptcy.

Certain contracts entered into between Kapitus and small business customers include the ability for the customer to request a change in estimated daily/weekly payments ("true ups"). Additionally, Kapitus works with customers in bankruptcy or delinquent with their payments, in order to assist the customer in meeting their obligations. However, any of these changes would almost certainly increase the estimated term and may also change the APR metric. Therefore, Kapitus would like confirmation that

the clause “prior to the recipient agreeing to the changes” in part B of this definition would not apply after the customer has executed a financing agreement in order to remove any temporary or permanent payment modifications either requested by the customer or initiated through litigation, bankruptcy, or settlement from the disclosure statement requirement.

Section 2061. Closed-End Transaction Formatting and Content Requirements.

(a)(1)(B).

This subsection requires the “amount of funds” disclosed to exclude “amounts used to pay off other financings.” However, this requirement ignores the realities of contracts with daily or weekly payments. If an applicant’s existing contract requires daily payments, and it takes more than a day to finalize the closed-end transaction, this amount could change, sometimes by hundreds or thousands of dollars. This change would have implications both to the timing of disclosures and when disclosures need to be re-sent, as well as any calculations under Section 3001.

Section 2065. Sales-Based Financing Disclosure Formatting.

General.

Almost all the numerical disclosures required for the second column on the sales-based financing contracts are estimates, not actual numbers. These estimates are based on inconsistent daily or monthly calculations (among other assumptions), making the estimates unreliable and uninformative for the applicant. Kapitus urges the DFPI to disclose information useful to applicants, such as cost of capital and repayment percentages, while minimizing estimates as much as possible.

(a)(1)(B).

Like closed-end financing disclosures, this subsection requires the “amount of funds” disclosed to exclude “amounts used to pay off other financings.” However, this requirement ignores the realities of contracts with daily or weekly payments. If an applicant’s existing contract requires daily payments, and it takes more than a day to finalize the closed-end transaction, this amount could change, sometimes by hundreds or thousands of dollars. This change would have implications even greater than those experienced with Closed-End Financing, as it would impact both calculations under Section 3003, as well as any auditing that would need to be done under Section 2092.

Section 2091. Estimates – Accounts Receivable Purchase Transactions/Asset-Based Lending Transactions – Historical Method.

The historic method proposed by the DFPI for estimating various amounts fundamentally misunderstands the function of sales-based financing agreements. Speed in the approval and underwriting processes, as well as payment flexibility are

two major reasons that small businesses choose these types of agreements over traditional bank loans. Both of these features are endangered by Section 2091.

Payment flexibility is especially important for seasonal businesses and tourist attractions (for example, a beach restaurant or a ski resort.) Requiring a small number of months' worth of income records would not accurately capture an estimated payment amount for these agreements in particular, since seasonal businesses are almost guaranteed to have ebbs and flows in income. Therefore, a larger number of months of records will be required to average out the calculations and accurately capture the transaction.

However, part (a)3 of this section requires whatever number of monthly income records is required, that number *must* be consistent across all applicants (with a very limited exception for newly created businesses). The necessity of having a larger number of months of records for seasonal businesses will by definition mean that every other applicant has to produce the same number of records. This will slow down the application and underwriting process dramatically, resulting in the loss of a competitive funding option for small businesses.

Section 2092. Estimates – Sales-based financing (Accounts Receivable Purchase Transactions – Underwriting Method)

Subsection 4.

The audit required by Section 2092 covers "all commercial financings paid off during the previous four-month period where the provider made disclosures based upon internal estimated sales projections." This audit appears to require the comparison of a retrospective APR to the estimated APR of the ***initial*** disclosures. By its very nature, this section fails to include any allowances for modifications or "true ups" during the contract period. Any time a customer asked for a modification or "true up" of their contract, the estimated term of the initial disclosures will change. If the intent behind this section is to ensure that the underwriting model accurately predicts the APR of contracts, Kapitus recommends that contracts with changed disclosures, modifications, or "true ups" be removed from any audit.

In addition, part d states that the audit of paid off contracts shall not include financing where legal action was initiated by the provider, or collection of contractual amounts was stopped *by the provider* after the recipient breached the contract. However, the audit does still include contracts where a recipient declared bankruptcy, and contracts where the recipient breached the contract, but eventually paid off the financing. The inclusion of contracts with these situations will also skew the results of the audit and allow for an artificially large APR spread.

Finally, as mentioned above, if the retrospective APR is calculated using actual payment frequency, rather than the daily or monthly estimates used in the initial APR, the numbers will almost certainly be different, even if all the other numbers used in the calculation happen to be the same. Requiring artificial estimates for the initial calculation, due to the inability to use actual frequencies, and a totally different

metric for the retrospective calculation will create a spread, even if all the other numbers match exactly.

Part e.

Kapitus recommends that tolerances for calculations be set higher, in order to account for the inherent fluctuations in sales-based financing. Alternatively, Kapitus recommends that the weighted average not include the average spread for the first year after these regulations are implemented, in order to account for the learning curve on financing transactions where payments may fluctuate significantly.

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In sum, Kapitus supports contract disclosures that provide applicants the ability to compare different products. We believe that these disclosures should be clear, consistent, and not subject to manipulation based on technical differences and ambiguities, and the regulations should not attempt to favor one product or solution over another but provide a consistent and repeatable disclosure that is useful to the small businesses we finance.

Overall, the effect of the regulation is to favor certain business methods or products, specifically, longer term loans with nominal lower interest rates that are overall more expensive but have a lower stated rate. In fact, these proposed regulations allow the true cost of such financing to be hidden from small business customers because the most relevant metric—total cost—is not required to be disclosed. Sales based financing matches the payment obligation to the revenue generated but is not easily translated to an APR metric since almost every metric these draft regulations require is an estimate. We urge DFPI to live up to its new name and not stifle innovative products through disclosures that make them artificially appear more expensive based on estimates that cannot be readily calculated.

Again, we would like to thank the DFPI for taking the time to receive and review our comments. We look forward to working with you on the proposed rulemaking implementation of SB 1235. If you have any questions or need additional information, please contact me.

Sincerely,

MICHAEL JESSE CARLSON
Senior Vice President and General Counsel