STATE CAPITOL
ROOM 5108
SACRAMENTO, CA 95814
TEL (916) 651-4007

DISTRICT OFFICE
51 MORAGA WAY, SUITE 2
ORINDA, CA 94563
TEL (925) 258-1176

SENATOR.GLAZER@SENATE.CA.GOV

California State Senate

SENATOR
STEVEN M. GLAZER
SEVENTH SENATE DISTRICT

CHAIR
BUSINESS, PROFESSIONS & ECONOMIC DEVELOPMENT
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Manuel Alvarez
Commissioner
Department of Business Oversight

Oct. 28, 2020

Dear Mr. Alvarez

I am writing in regard to the proposed regulations (PRO 01/18) implementing Senate Bill 1235, which I authored.

I want to compliment the Department of Business Oversight for its thorough and conscientious reading of the statute. After months of consultations with experts and stakeholders, the department has developed a set of regulations that, for the most part, faithfully implement the law as written.

I am especially pleased that the Department amended its earlier draft to clarify that the disclosures required by SB 1235 must be provided at the time a specific offer of financing is delivered, not only at the time a transaction is completed. This properly reflects the text of the legislation and fixes an error in the draft regulations that would have severely undermined the ability of small business owners to compare different offers before deciding on their financing, which was the entire purpose of the bill.

I am also pleased that the proposed regulations require a clear and consistent format for the disclosures, which will also make comparison shopping easier; require all fees to be included in the Annual Percentage Rate calculation; and require the clear disclosure of pre-payment penalties, even if providers seek to embed them as part of the transaction.

However, there is one part of the proposal that needs your attention because it could undermine the intent of the Legislature in passing SB 1235. Sections 2091 and 2092, which describe two methods for estimating the Annual Percentage Rate (APR) that will be disclosed to potential customers for sales-based financing, would create a situation where two firms offering the same terms on their financing could describe it to customers in different ways, advertising different APRs. This is exactly what our legislation was seeking to prevent.

One method the proposed regulation allows for calculating the APR relies on the recipient's historical cash flow, while the other allows the provider to use its own estimate of what the recipient's future cash flow is likely to be. The first of these methods is the one that should be required for every disclosure.

The second method invites abuse because the provider's projection of the recipient's cash flow will have a direct impact on the estimated APR that will be disclosed. Yet that projection need not be based on anything in the historical record of the recipient's cash flow. This creates an incentive for the provider to manipulate the projection in order to offer an estimated APR that is low enough to entice the customer to opt for the financing being offered.

I urge you to remove the "underwriting" option proposed in Section 2092, and require providers to base their estimated terms, and thus their estimated APR, on the number of days of immediate past daily cash flow it would take to "repay" the cash advance offered by the provider.

I realize that the Department has attempted to address the risk this section poses by requiring providers to self-audit their transactions and cease using the "underwriting" method for 24 months if the average gap between the estimated and actual APR exceeds 10 percent over a one-year period or 5 percent over a 20-month period.

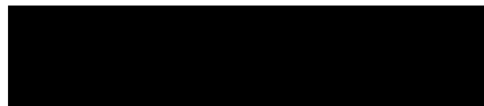
But given the stakes for the financing firms and their customers, this self-policing by the industry is not sufficient. If this type of underwriting, which was not contemplated by the Legislature at the time SB 1235 was debated and passed, is going to be allowed, the firms employing the method should still be required to also disclose the APR based on past cash flow. The difference between the two numbers – one based on actual past cash flow and one based on a projection of future cash flow by the provider of financing – should also be made clear to the recipient.

This would provide one APR that should be consistent among providers offering identical terms, and one APR that might vary depending on the provider's cash flow projections. This side-by-side comparison might then generate questions from a recipient curious about the opaque assumptions that went into the estimate. If the only option offered is one based on a projection, the recipient will never know that the estimate had no connection to their previous cash flow.

Beyond that, providers must be required to report to the department the actual gap between their estimated and actual APR for each transaction. Only by requiring this kind of disclosure will the Department have the tools it needs to ensure that providers are not misleading their customers about the full cost of the financing they are being offered.

Thank you for your consideration. I look forward to the approval of an amended regulation as soon as possible so that the small business owners of California can begin enjoying the protections that they need and deserve.

Should you have any questions about this letter, please contact my chief of staff, Daniel Weintraub, at Daniel.weintraub@sen.ca.gov



Steve Glazer
Senator, 7th District