Submitted by Electronic mail to: regulations@dfpi.ca.gov, with a copy to: [redacted]@dfpi.ca.gov and [redacted]@dfpi.ca.gov

August 24, 2021

Commissioner of Financial Protection and Innovation
Attn: Sandra Sandoval, Regulations Coordinator
300 South Spring Street, 15th Floor
Los Angeles, CA 90013

Re: File No.: PRO 01-18 – Sixth Invitation for Comments on Proposed Rulemaking for Commercial Financing Disclosures ("Invitation")

Dear Acting Commissioner Shultz,

Small Business Financial Solutions, LLC dba RapidAdvance ("RapidAdvance") would once again like to thank the California Department of Financial Protection and Innovation ("DFPI") for reaching out for input on the above proposed regulations ("Regulations"). RapidAdvance previously provided five in-depth comments to the informal requests for comments detailing a broad range of issues. In our previous comment letters, we provided a great deal of information regarding annual percentage rates ("APR") and the issues created by new Division 9.5 of the Financial Code (the "Code"). We request that our initial letters be reviewed again as they contain extensive information that the proposed Regulations still do not address.

The proposed Regulations addressed many issues we raised regarding when to provide the disclosures and other practical issues. We greatly appreciate the DFPI incorporating and addressing many of our suggestions and concerns. However, the proposed Regulations still fail to remedy a number of substantive issues that are necessary in order for the required disclosures to be clear, effective and not provide misleading information.

I. OUR COMPANY

RapidAdvance provides working capital to small businesses throughout the United States and operates as a licensed Finance Lender and Broker in California. RapidAdvance and its

affiliates have been providing funding to small businesses for more than a decade and the majority of our customers have grown to become thriving businesses. Our financing products include merchant cash advances ("MCAs") and business loans. MCAs allow small retail businesses to sell their future card sales in exchange for immediate working capital (the transaction is a purchase and sale rather than a loan). The receivables we purchase are delivered to us whenever the merchant batches out its credit card terminal and forwards to us the percentage of funds that we purchased. We do not offer an MCA product in California that includes a true-up mechanism or a fixed payment amount (each payment truly varies based on the split rate). Our small business loan is similar to a traditional commercial loan with two primary differences. First, the borrower makes daily or weekly payments rather than monthly payments. Second, our loans charge a fixed fee rather than an interest rate. A fixed fee allows our customers to easily determine the actual dollar amount the loan will cost and the more frequent payment schedule ensures the business is not overwhelmed by large monthly payments for years. Our underwriting model allows us to fund businesses that traditional lenders turn away and permits us to offer financing solutions to businesses whose growth is constrained by their ability to access capital. Our customers that qualify for both the loan product and the MCA can choose the product that best fits their needs.

The customers that use our financing products include almost every type of small and medium sized business in California. A customer's annual revenue generally ranges from $250,000 to $4,000,000 and the average funding we provide is about $50,000. Approximately 90% of our customers are limited liability companies or corporations. The online small business finance industry now originates more than $15 billion annually and the overwhelming majority of small businesses that have obtained financing from industry participants prefer our products and process over traditional financing sources. The industry has proven to be a great option for small businesses during COVID. Given our products don't have an accruing rate and most businesses have been shut down or negatively impacted since March, many of our customers are not in default despite not making payments (MCAs don't require a payment if there is no revenue being generated due to COVID) or have extended their terms under our loan program for free as we don't charge an accruing rate. The current environment is a great example of why our products work better than traditional loan products and why our customers love us.

II. COMMENTS

A. General Formatting and Contents[1]

While the general formatting and content of the proposed Regulations has greatly improved, there are some remaining items that should be addressed so the final Regulations are easier to read and follow. One of the overarching issues with the formatting is that different sections discuss the various products covered by the Regulations in inconsistent orders. For instance, in Section 2057(a)(30) the definition of "Amount Financed," the first definition is for "sales-based financing" yet, in the disclosure sections, sales-based financing comes after factoring. In order for the Regulations to flow better and be easier to read and understand, we would suggest that anytime the Regulations discuss each type of financing that they remain in the same order throughout so there is no confusion between products.

The definitions in Section 2057 are not listed alphabetically. This makes it extremely difficult to locate a specific definition. Moreover, it is uncommon to have definitional sections in regulations that are not listed alphabetically. We would suggest that the definitions in Section 2057 be listed alphabetically.

In Section 3010(a)(1) there is a typo in the fifth line down. The phrase currently reads "regardless of whether the transaction **is** question…" (emphasis added). The phrase should read "regardless of whether the transaction **in** question…" (emphasis added). We suggest making the change for the sentence to read properly.

There are numerous instances where the proposed Regulations forget periods or semicolons. For example, Section 2057(a)(4)(A) between the word "recipient" (prior to the recently deleted section) and "However" that was just added, there either needs to be a period or semicolon in order to make this Section read properly. Lastly, the proposed Regulations do not include page numbers. For clarity and ease of reviewing, we would request page numbers be added to the bottom of each page.

[1] Note that each header for the different types of financing is labeled differently, which makes it seem as though each type of financing has different requirements or disclosures (e.g., Closed-End Transaction Formatting and Content Requirements; Commercial Open-End Credit Plan Disclosure Formatting; Factoring Disclosure Format; Sales-Based Financing Disclosure Formatting; Formatting and Content Requirements for Lease Financing; General Asset-Based Lending Transaction Disclosure Formatting; and Disclosure Formatting for All Other Transactions). We suggest making the headings uniform (*e.g.,* Commercial Open-End Credit Plan Disclosure Formatting, Factoring Disclosure Formatting, Lease Financing Disclosure Formatting, etc.).

B. Definitions

The following definitions should be revised to avoid confusion.

(i) "At the time of extending a specific commercial financing offer" (Section 2057(a)(4)) – The edits made to this Section are greatly appreciated. However, there are two additional edits that are needed. First, in Section 2057(a)(4)(A), the specific offer should only be required to be provided based on verified information provided by the client or on behalf of the client. Verified information would be actual documentation/information such as a credit report, bank statements, etc. It is important for the information to be verified so that disclosures are not required for simple general inquiries. Additionally, this would stop providers from having to make a second disclosure once verified information is obtained after a general inquiry (which would happen for every inquiry as non-verified amounts are almost always incorrect). This would make the disclosures more meaningful as they would be accurate each time they are provided as opposed to mere guesses based on unverified information. Therefore, we suggest this Section be amended to state: "Any time a … in connection with a commercial financing is quoted in writing to a recipient, based upon verified information from, or about the recipient." Second, additional clarity is necessary as providers often offer discounts for early payment. In some circumstances, a provider might state that if a recipient repays the closed-end financing within a certain amount of time, the fixed fee is reduced. These types of discounts are given typically after the recipient agrees to a financing amount. Because these types of full-term fee discounts may increase the APR (but only if the recipient decides to execute on the option) it is unclear how or if this should be addressed in the disclosures. An example would be a customer gets a 10 month term loan with a fixed cost of $3,500 for an APR of 60%. However, the customer is given the option of paying off the balance within the first 60 days and gets a discount of $1,500 (so the total cost would be $2,000 instead of $3,500 but the APR would be 75% given the reduced term). The proposed Regulations provide no guidance for this type of feature. These early payoff addendums are common in the industry so this issue should be addressed. Because of this, it is important to determine (i) whether or not a disclosure is required for early payoff addendums; and (ii) if a disclosure is required, how is it given and when (as it will conflict with the main disclosures and cause confusion). Our suggestion would be to expressly address this issue and not require a disclosure for discounts given as a result of early payment the recipient may choose to exercise but is not required to exercise.

(ii) Broker (Section 2057(a)(6)) – While the updated definition does provide additional clarity, it is too broad. The way it is currently written, the definition would include a spouse of the owner of the business or the business's accountant either of whom are solely just assisting the business owner with trying to prepare documents for the financing. It does not appear that this is the DFPI's intention. In order to solve this issue, we suggest that brokers be limited to anyone that receives compensation in exchange for the acts listed in the definition.

(iii) Irregular Payment (Section 2057(a)(14)) – An "Irregular Payment" is defined as anything that is not a "periodic payment." Our concern with this definition is that due to bank holidays or a potential bank account switch by the recipient, two or more payments might be collected on the same day. For example, a recipient makes regular contractual payments of $100 each business day but cannot make one on a bank holiday due to the bank being closed and the provider takes two payments ($200 total) the day after the bank holiday (that day's payment and the payment for the bank holiday). The $200 is contractually owed and represents two days' worth of payments, but that specific payment might be considered "irregular" under the definition. It would not make sense for this type of payment to be considered irregular as it is in the ordinary course of the contract and occurs due to a bank holiday. Moreover, if a recipient has to close a business bank account due to fraud, contractual payments may stop for a couple of days until a new account is open. If the contractual payments are $100 each business day and the provider was unable to collect payments Monday through Wednesday, on Thursday of that week the provider will collect $400, which represents the contractual payments for Monday through Thursday. This $400 payment could be considered "irregular" under the definition. The definition should specify that these types of situations are not considered irregular payments.

(iv) Specific Offer – There is no definition of what constitutes a specific offer. A definition for specific offer should be added and state that a specific offer is created in connection with a commercial financing when both of the following occur: (i) a periodic payment amount, irregular payment amount, or financing amount, and (ii) any rate, price, or cost of financing (including without limitation, any total repayment amount) are provided to a recipient. This will then permit you to use the simple phrase "specific offer" throughout the Regulations rather than the long and complicated compound descriptive sentence currently used. For example, in the "Provider" definition (Section 2057(a)(19)(A)), it states that a provider "includes a financer when the financer communicates a specific amount, rate or price, in connection with a commercial financing . . . ."

It would be cleaner if there was a definition for "specific offer" so that the sentence would instead read a provider "includes a financer when a financer communicates a specific offer in connection with a commercial financing . . . ."

(v) Sales-based financing (Section 2057(a)(22)) – This section continues to have the same problems we identified previously. The proposed Regulations attempt to differentiate between closed-end transactions and sales-based financing, but there is still overlap that will create uncertainty as to what disclosures a provider should deliver. This differentiation is important to get right and make sure there is no confusion as the disclosures for sales-based financing include estimated APR and estimated term but closed-end transactions do not. Confusion will arise in connection with products that have hybrid repayment features where payments are based on sales revenue but there is also a minimum payment component that creates a "term." Many participants in the industry treat these products as closed-end loans with unique payment features. Because there is an actual term for these transactions, they generally fit within California's definition of a loan. This should not be confused with sales-based financing products with true-up features. These are different as the true-up feature may shorten or lengthen the estimated term of repayment. For these transactions, there is no fixed term. Therefore, the sales-based financing disclosures are appropriate. However, for loan products with unique payment features that include variable payments but require periodic minimum amounts and therefore have a fixed term, the proposed Regulations should make it clear that these products are closed-end transactions and not sales-based financing products. The definition of "closed-end transaction" appears to address this but in subpart (B) it refers to these transactions as a type of sales-based financing although they are not sales-based financing transactions as they are just unique loan products.

We suggest this issue be resolved by amending the definition of "closed-end transaction" and "sales-based financing" as follows:

1. Closed-end transaction means a transaction in which credit is extended only once over a specific term (including contracts that include an option in which the recipient may extend the term) or that the provider identifies as a loan, and is repaid:
    A. In regular predetermined payments of specified amount over a fixed period of time; or

B. In a combination of variable payments and fixed minimum amounts so that the full amount is repaid during a fixed contractual term or where the contract requires all amounts be repaid by a specific date.

2. Sales-based financing means a commercial financing transaction that is not a closed-end transaction, that is paid by a recipient to the financer as a percentage of sales or revenue, in which the payment amount increases and decreases according to the volume of sales made or revenue received by the recipient and is not identified as a loan by the provider. Sales-based financing also includes commercial financing transactions that have a set payment amount that is based on a percentage of the recipient's sales or income but has a "true-up mechanism."

(vi) Recipient Funds (Section 2057(31)) – The current definition creates confusion as to whether or not the recipient funds is the total amount actually deposited into the recipient's bank account or some other amount. In order to address the confusion, we suggest editing the definition to state in the third sentence "Recipient funds also excludes any part deducted from the amount financed to pay third parties or payoff other financings on the recipient's behalf." This would make it clear that the recipient funds is the amount actually delivered to the recipient. It would not make sense to exclude payoffs of other financings but not to other third party payments. This would lead to odd results where the recipient funds disclosed do not match the amount actually delivered to the recipient because a third party debt was paid but it was not considered a financing.

(vii) Funds Paid to Brokers (Section 2057(32)) – The sentence should clarify that the funds paid to brokers includes those paid by the financer out of the proceeds or from the financer's fee. As currently drafted, the funds paid to broker only includes those funds paid out of the proceeds. However, the vast majority of broker fees paid in the industry are paid by the financer out of the financer's fee – not the proceeds. Please see the additional discussion of broker compensation in Section M below.

C. General Requirements

(i) Section 2060(a)(2) – The following language should be permitted on the bottom of all disclosures (not just the final signed version): "California law requires this information to be provided to you to help you make an informed decision." By keeping this on all disclosures, but

not requiring the signature on all disclosures, a recipient will know why the disclosures are being presented.

(ii) Section 2060(a)(4) requires a provider to assume that there are 30 days in every month and 360 days in every year. This presents significant challenges when trying to calculate daily payments because this mandate will lead to incorrect payment amounts and frequencies. The Truth in Lending Act ("TILA") permits assumptions that are similar to this phrase but such assumptions are expressly limited to the APR calculation. The mandate in the proposed Regulations is problematic when calculating payment amounts because not all months have 30 days and a provider cannot actually collect payments on all 30 days. This results in the payment amount disclosed being incorrect. In order to solve for this, we suggest the language read "a provider shall assume that there are 30 days in every month and that for every 30 day period there are 8 weekend days or holidays . . . ." By adding this language it will solve for the problem of potentially misstating the payment amount because holidays and weekends are not being taken into account.

(iii) Section 2060(a)(5) requires a provider to disclose the annual percentage rate to the nearest ten basis points but does not provide an example. We suggest an example be provided for clarity. As explained in our previous letter, "basis points" has different definitions so providing an example will make your intentions clear.

(iv) Section 2060(a)(8) takes our suggestion to make the columns more uniform so providers do not place disclosures on multiple pages in an attempt to hide costs. However, the "3:3:7" ratio is too prescriptive. While we agree that there should be limits on the ratio, something that is more flexible should be used. We suggest this be amended to state "the approximate ratio of 3:3:7."

(v) Section 2060(a)(11) allows a provider to obtain a recipient's signature electronically. While this Section allows for a provider to use an electronic signature only if it adheres to California's electronic signature statute, it does not allow for a provider to use the federal ESIGN Act. This should be altered to state that a provider is able to use and comply with either given the federal ESIGN Act preempts the California law in most respects.

(vi) Section 2060(a)(15) makes it so that a provider would not have to re-disclose prior to consummation if the amount of financing changes as it is being used to pay-off or pay down another financing agreement and that balance has changed since the date of disclosure. This should be expanded to include any type of pay-off or pay down. Examples of other third party pay-offs with balances that may change over time are lease payments to landlords, tax lien payments, past

due bills with accruing late charges, etc. As currently, drafted, a provider would have to re-disclose for these types of changes. If this Section is not amended from "other financing agreements" to "other amounts owed" (or something similar), it is going to require unnecessary re-disclosure which will cause significant confusion.

(vii) We suggest that somewhere in the disclosure language you add a statement that all disclosures assume and are based on on-time payments and no default. This will stop any confusion in situations where a recipient defaults.

D. Specific Disclosure Forms

1. Closed-end Transactions (Section 2061)

(i) Funding Provided (Section 2061(a)(2)(A)(B)(C)) - This Section is extremely confusing and took three attorneys over one hour to try to figure out what the Regulations were requiring and if each of the phrases "funding provided," "amount financed" and "total amount of funds provided" are actually the same amount. It is imperative that this Section be amended and made more clear or it will lead to misleading disclosures. The phrase "funding provided" is not defined anywhere in the Regulations. However, that phrase is being used interchangeably with "amount financed." We would suggest that "amount financed" be defined to be the "funding provided." This would solve for part of the confusion. Moreover, in SB 1235, this disclosure is labeled as "total amount of funds provided." Therefore, the Regulations do not match the statutory requirement and create three (3) different phrases being used for presumably the same amount. There needs to be clarity on this topic. We suggest the label for the column be "Total Amount of Funds Provided" to match the statutory phase and that this phase be defined so that it is the amount financed. You can then delete all references to the amount financed and funding provided. This would provide much needed clarity.

(ii) Funding Provided (Section 2061(a)(2)(C)(i)) – There is no need for the "[name of financer]" to be included in the disclosure. This is just additional unnecessary wording. Moreover, it does not specify if a provider would be allowed to use a dba name or if it is the legal entity name that must be used. As this is not necessary for the disclosure to be meaningful, it should be deleted.

(iii) Funding Provided (Section 2061(a)(2)(C)(iv)(v)) – Please see our comments above under General Requirements Section 2060(a)(15).

(iv) Funding Provided (Section 2061(a)(2)(C)) – In order to truly have the recipient understand the cost of the financing, it is important to include the amount of commission or fee that a broker is paid. Although the Regulations require certain broker commissions to be disclosed, they fail to address the manner in which the vast majority of broker commissions are paid. The majority of the time the financer pays the broker out of the financer's fees – not from the proceeds. The proposed Regulations only address the scenario where the broker is paid from the proceeds (which is not how it is done most of the time). Therefore, the disclosures as currently drafted are ineffective in identifying to recipients what a broker is getting paid in the majority of transactions. Because broker commissions are usually included in the cost of the financing, recipients do not know what a broker is being paid. The broker fee is typically the most expensive third-party fee associated with a transaction and would be valuable information for a recipients to know. Accordingly, it should be separately itemized and disclosed. For a recipient to truly understand the full cost of the financing, it is imperative that the provider be required to disclose the broker commission to the client. We suggest that this be included in the final Regulations. Please see the additional discussion of broker compensation in Section M below

(v) Annualized Percentage Rate (Section 2061(a)(3)(C)(iii)) – This Section currently reads "Your APR is not an interest rate, and you loan does not have an interest rate." This statement is technically incorrect as an interest fee may still be deemed an interest rate under state law. It would be more accurate to draw a distinction between non-accruing fees and an accruing rate. Accordingly, this disclosure should be amended so that for financing where no part of the finance charge is based upon an accruing rate, the disclosure states: "Your APR is not an interest rate. The cost of this financing is based upon fees charged by the financer rather than interest that accrues over time."

(vi) Payment (Section 2061(a)(6)) – Our comments above regarding irregular payments are relevant to this section as well (please see comments above). It is important to provide clarification as to how make-up payments should be handled so that providers know how to accurately give the disclosures. Once again if a provider is to assume that it can collect on all bank holidays, when in actuality it cannot, it knows that the payment after the holiday will be for two days. That should not be a variable payment under the Regulations.

(vii) Prepayment (Section 2061(a)(8)(9)(10)) – Our concerns from our prior comments surrounding the description of prepayment have once again not been addressed. SB 1235 only requires a "description of prepayment policies." As each provider may have a different policy based on the product, the proposed disclosure does not work and requires more than SB 1235 permits. TILA chose to require a simple statement about prepayment penalties as opposed to requiring disclosure of amounts because doing so creates confusion. For example, the proposed Regulations refer to prepayment fees being fees other than accrued interest. What is accrued interest? In an environment such as commercial lending where there is no applicable maximum rate, no rate calculation restrictions or state prepayment requirements, the parties are free to contract when "interest" accrues. In a fixed fee transaction, the contract can clearly state that all fees are earned on day one and therefore accrue immediately upon closing of the transaction. In this scenario, all "interest" has accrued as of the end of day one and there is no prepayment penalty. As such, under the proposed Regulations, a provider could legally disclose that there are no prepayment fees if the contract provides all fees are earned on day one. The recipient is then further misled by the disclosures when the next row provides that there are no additional fees for prepayment. In this scenario the disclosures make it appear as if there is a discount for repaying early when there is in fact no such discount. Given this, we believe the better approach with respect to prepayment penalties is to have a more definitive statement about them rather than a calculation and a disclosure amount that can be easily manipulated. We suggest you follow TILA's lead here and simply require the following disclosure: "There is no discount or rebate for paying early," "Paying off early will save you fees" or "Please review your contract carefully to better understand the benefits, if any, of paying off early."

(viii) Average Monthly Cost (Section 2061(a)(11)) – The disclosure of the monthly cost for a non-monthly pay product does not implement, interpret, or make specific any provision of SB 1235. Requiring this disclosure will not only be inconsistent with SB 1235 but it will do more harm than good. In fact, this disclosure was not mentioned at any of the hearings for SB 1235, was never proposed by Senator Glazer and was never included in any of the model forms Senator Glazer prepared for the hearings and debates on SB 1235. In fact, this disclosure was considered and rejected when the legislation was being drafted. In addition to this disclosure simply not being permitted under SB 1235, adding it would

frustrate the purpose of SB 1235 as it detracts from other disclosures that the California Legislature deemed to be more meaningful. SB 1235 requires only the "method, frequency and amount of payments," and a disclosure of a monthly cost for a non-monthly pay product is not the actual amount of the payment or the frequency of the payment per the financing contract. The addition of this disclosure frustrates the purpose of SB 1235. It is unclear how disclosing an inapplicable and hypothetical payment amount would be useful information to a recipient. More importantly, the disclosure seems likely to cause confusion given that the information would conflict with the written terms of the commercial financing agreement. Moreover, the disclosure of the average monthly cost is disclosed before the actual payment frequency in the proposed disclosures. This is extremely problematic because the first payment amount disclosed is not the actual payment amount. We would highly recommend this disclosure be removed as it is not necessary or permitted. Because this regulation is inconsistent with the statute enacted by SB 1235, it violates the APA Consistency standard.[2] The regulation also violates the APA Necessity standard.[3] The regulation is not within the scope of authority granted by SB 1235, in violation of section 11342.1 of the APA. It is not reasonably necessary to effectuate the purpose of the statute, in violation of section 11342.2 of the APA.[4]

2. Commercial Open-End Credit Plan Disclosure Formatting (Section 2062)

(i) Funding Provided (Section 2062(a)(3)(a)) - Please see our comments above under Closed-End Transactions referencing Section 2061(a)(2)(A).

(ii) Funding Provided (Section 2062(a)(3)(C)(i)) – Please see our comments above under Closed-End Transactions referencing Section 2061(a)(2)(C)(i)).

(iii) Funding Provided (Section 2062(a)(3)(C)(iv)(v)) – Please see our comments above under General Requirements Section 2060(a)(15).

(iv) Funding Provided (Section 2062(a)(3)(C)) – Please see our comments above under Closed-End Transactions referencing Section 2061(a)(2)(c).

(v) Estimated Payment (Section 2062(a)(7)) – Please see our comments above under Closed-End Transaction referencing Section 2061(a)(6).

[2] CA Government Code § 11349(d)
[3] CA Government Code § 11349(a)
[4] CA Government Code § 11349(a)

(vi) Prepayment (Section 2062(a)(10)(11)(12)) - Please see our comments above under Closed-End Transactions referencing Section 2061(a)(8)(9)(10).

(vii) Average Monthly Cost (Section 2062(a)(13)) - Please see our comments above under Closed-End Transactions referencing Section 2061(a)(11).

3. Sales-Based Financing Disclosure Formatting (Section 2065)

(i) Funding Provided (Section 2065(a)(2)(a)) - Please see our comments above under Closed-End Transactions referencing Section 2061(a)(2)(A).

(ii) Funding Provided (Section 2065(a)(2)(C)(i)) – Please see our comments above under Closed-End Transactions referencing Section 2061(a)(2)(C)(i)).

(iii) Funding Provided (Section 2065(a)(2)(C)(iv)(v)) – Please see our comments above under General Requirements Section 2060(a)(15).

(iv) Funding Provided (Section 2065(a)(2)(C)) – Please see our comments above under Closed-End Transactions referencing Section 2061(a)(2)(c).

(v) Estimated Payment (Section 2065(a)(6)) - Please see our comments above under Closed-End Transaction referencing Section 2061(a)(6). In addition to our concerns over what constitutes a periodic payment or a variable payment, we are also concerned about how true-ups are handled in this Section. Most providers do not have scheduled true-ups listed in the contracts. The majority of providers allow for the flexibility of the recipient to reach out to the provider to request a true-up or for the provider to initiate a true up if they have documented proof of a change in revenue. Because of the flexibility that is built into most true-up provisions, it would be impossible for a provider to disclose this at consummation as it is unknown.

(vi) Prepayment (Section 2065(a)(9)(10)(11)) - Please see our comments above under Closed-End Transactions referencing Section 2061(a)(8)(9)(10).

(vii) Average Monthly Cost (Section 2065(a)(12)) - Please see our comments above under Closed-End Transactions referencing Section 2061(a)(11).

E. Estimates – Sales Based Financing – Historical Method (Section 2091)

Section 2091(b)(2) states that the provider "shall fix the number of months used to calculate the recipient's average monthly historical sales, income, or receipts for all transactions or by recipient industry or financing amount (or both), provided that the period of historical data used by the provider shall not be less than four (4) months or more than twelve (12) months." As stated in previous comment letters, even if a provider requests a certain amount of statements, it does not mean the recipient will provide all months requested. The use of the word "fix" in this Section seems like a requirement for a minimum amount of months. This scenario was taken into account in Section 2091(b)(4)(B), which allows a provider to be able to calculate the historical monthly sales based on what was provided by the recipient if the recipient fails to provide revenue data for all the requested months. But this wording seems to contradict the use of the word "fix." We believe this is just a drafting error and Section 2091(b)(2) should simply be amended to state that the provider "shall request the number of months used to calculate . . . ." Additionally, there should be no limitations on how many months a provider requests as long as they are consistent and following written underwriting policies. This change would also address the issue for renewal transactions. The proposed Regulations would apply the same four (4) or twelve (12) month limit to renewals but in many cases only one (1) month is needed for that (and in some cases no months are needed). For a renewal, the provider already has data from the recipient and should not be required to ask for more when they will not be used. The provider should be allowed to request whatever amount of statements it deems necessary to underwrite the transaction. Moreover, to insure that a provider is not just picking a random number of statements, this Section should require a provider to request a certain number of statements based on its internal policies and require a provider to have written policies to address this. For example, a provider could state in its policies that it only requires four (4) months bank statements for restaurants but six (6) months for trucking and maybe only one (1) month for all renewals.

Furthermore, Section 2091(b)(4)(A) allows a provider to exclude from the average calculation certain months where there were "less than the average monthly sales . . . ." While we understand the intent is to exclude outlier months, it does not make sense to exclude only months that are less than the historical norm. Including only outlier months that are greater than the historical average will cause the provider to take more revenue every day and be more of a burden on the recipient. We suggest that the language be changed to allow a provider to exclude any month that is materially greater or less than the average monthly sales.

F. Estimated Annual Percentage Rate – Sales-based financing (Section 3003)

There is a requirement in Section 3003(a)(4) and (b)(4) to require a provider to use "penalty payments" to calculate the finance charge and estimated APR. This does not make sense as penalty payments are only incurred in the event of a default. Penalty payments are not include in the APR under TILA. Additionally, it is impossible for the provider to know what "penalty fees" will be charged or how often they will be charged as they have no idea if there will be a default or "penalty" or if there is a default or penalty, how many times it will happen. We suggest that (a)(4) and (b)(4) be deleted as they do not make sense to be used in this calculation and conflict with other provisions of the proposed Regulations.[5]

G. Duties of Financers and Brokers (Section 3023)

Section 3023(a)(3) requires that a financer maintain a copy of the "evidence of transmission of the disclosure." There is no description as to what would constitute "evidence of transmission." Would a copy of the sent email or facsimile be sufficient or is there something else specifically that the DFPI is looking for the provider to maintain? Moreover, in the event the broker fraudulently creates an "evidence of transmission," is the provider liable for storing that transmission or not being able to determine if it is fraudulent? Just as a waiver of liability is given to brokers for potentially providing recipients with misleading or incorrect disclosures created by a provider, a provider should be provided with a waiver of liability if the broker fraudulently creates the transmission or alters it in anyway.

Additionally, section 3023(a)(4) requires the financer to develop procedures reasonably designed to ensure recipients receive the disclosures from the broker by making financers change contracts, have investigations and terminate relationships with broker in the event of a breach. This requirement oversteps the authority given to the DFPI by SB 1235. The DFPI cannot require financers to change business practices or tell them how to draft contracts and enter business relationships with third parties. Furthermore, the DFPI cannot interfere with a financer's right to contract or impose what must be included in a contract between a broker and a financer. SB 1235 mandates disclosures and does not regulate substantive practices or contractual relationships. Moreover, the proposed Regulations state that a financer must discontinue a relationship with a broker "who the financer has found not complied" with this Section. What if there was a mistake

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[5] Section 2057(a)(4)(B) makes it clear that the disclosure rules do not "apply to changes made to resolve a recipient's default on a financing contract."

by the broker and the item was timely corrected? Or what if something happens to a broker's server and it loses a transmission before it can send it to a financer? There is no language to state what constitutes a broker not complying or if there is a time frame to cure. This Section completely interferes with a financer's right to contract and should be deleted or amended. In order to avoid this entire issue, the Regulations should simply require a financer to provide the disclosure directly to the recipient and maintain a copy of that transmission.

Section 3023(c) provides brokers with certain protections such as not requiring a broker to evaluate the accuracy of any disclosure, nor transfers liability to a broker if the disclosure is not complaint and limits broker liability if a broker makes a statement based on the disclosure that was provided. However, there are absolutely no protections for financers for any wrongdoings of brokers. What happens if a broker creates a false transmission and the financer relies on the transmission? Or what if a broker alters the disclosure that a financer provides to the broker to give to the recipient? If a financer is not aware of any of these wrongdoings, it should not be held liable. This just invites brokers to not adhere to the requirements because they can potentially shift any blame to the financer. Moreover, it will pull financers into unnecessary litigation when a financer had nothing to do with a broker's wrongdoing. It does not make sense for a broker to obtain protections under the Regulation and a financers to receive no protections. A financer should be given the following protections: (i) a financer should not have to evaluate the accuracy or validity of an evidence of a transmission by a broker; (ii) a financer should not be liable in the event a broker alters a disclosure or gives a recipient a false or altered disclosure; and (iii) limit any liability for a broker falsely and misleadingly describing a disclosure or the commercial financing to a recipient.

H. Other Laws (Section 3024)

While we appreciate that the DFPI taking our comments into consideration for Section 3024(b) relating to how the wording used could be used in a negative way, we do not think the entire section should be deleted as you have done in the proposed Regulations. We suggest you keep the first sentence starting with "A" and ending with "pay off" so that 3024(b) reads as follows: "A provider's mere use of any of the following words as required by this Chapter shall not constitute evidence that a financer's contract with a recipient is or is not a loan under California law: term or estimated term, interest, interest rate, payment or estimated payment, Annual Percentage Rate (APR) or Estimated Annual Percentage Rate, prepayment or pay off."

I. Tolerances (Section 3026)

Section 3026(a)(2) discusses "irregular payments." Please see our prior comments regarding irregular payments when the payment is a make up for a bank holiday, etc. Those comments should be taken into consideration so that providers are able to determine if the APR that is being disclosed is going to have irregular payment tolerances or other non-irregular payment tolerances.

Section 3026(a)(3) references Section 3000 and bases calculations on Section 3000; however, Section 3000 was deleted in the proposed Regulation. Because of this, we believe all of 3026(a)(3) should be deleted.

Lastly, Section 3026(b) only limits provider or financer liability when an inadvertent error is made and the provider or financer catches that error. This liability limitation should also be extended if a recipient discovers the inadvertent error, notifies the provider or financer and the provider or financer makes the appropriate adjustments and refunds any overpayments based on that disclosure within 60 days of being notified by the recipient.

J. Funding Recipient Will Receive (Section 3027)

As stated above, it is imperative that phrasing be consistent throughout disclosures so that not only can providers understand what number should be disclosed but also for recipients to be able to understand and follow the flow of the disclosures. For example, 3027(a)(1) requires "recipient funds" amount to now be labeled as "Amount Given Directly To You." It does not make sense to once again have another phrase being used interchangeably. Another disclosure that should be renamed is "Amount Provided to You or on Your Behalf" as this is actually "Total Amount of Funds Provided." We would suggest keeping all of the phrasing consistent throughout in order for the disclosures to make sense.

In Section 3027(a)(3) it states that a provider can state in generic or general terms what type of party is being paid through part of the recipient funds. We would suggest that this be more generic and just be stated as "total amount of third-party payments." This way it would cover all payments and make it so the disclosure will be easier to calculate and view.

K. Calculation of Annual Percentage Rate (Section 3001)

As we have argued in the other comment submissions we have provided on this topic, we do not believe APR is the best metric and will actually cause more confusion. We incorporate our

prior comments provided to you into this letter. However, given the continued inclusion of APR in proposals, we once again have the following comments on this section.

Section 3001(c) states that a provider "may assume it can collect contractually required payments on every calendar day regardless of bank holidays, weekends, or other days that would otherwise delay or accelerate the provider's collections of payments." This is problematic because by allowing a provider to assume the aforementioned, it will cause the APR to be calculated based on assumptions that are not used when calculating the payment amounts or frequencies. This means that every payment amount and frequency disclosure for every daily or weekly payment transaction will conflict with the disclosed APR for that transaction. While they are various facets to this issue, the simplest way to understand it is to recognize that calculating an APR based on 30 payments per month when there are actually only 22 payments per month does not work mathematically. This means that every disclosure form for such a transaction presented to a court will be wrong (as the APR will always be inconsistent with the payment amounts and schedule). This will render the disclosure misleading and potentially make them unenforceable. In TILA litigation involving APR calculations, the court (or a recognized expert) will take the loan amount, payment amount and frequency and calculate an APR. That APR is then compared to the disclosed APR to see if it is within the applicable tolerance limit. That same process would need to be followed in connection to these disclosures and as currently written it would lead to an incorrect APR disclosure for every daily or weekly payment product disclosure provided despite the fact the provider is calculating APR, payment amount and frequency in compliance with the Regulation.

There must be a concerted effort on your part to make the payment amounts and frequencies work with the APR calculation so that the math will work when trying to confirm if the disclosures are accurate. The only suggestion we have to address this is that the Regulations provide immunity from liability to financers if they calculate APR in accordance with the Regulations even though the math in the disclosures leads to a different result.

Section 3001(d) should be amended so that the "minimum on-time" payments exclude any payments that have been made due to default.

Section 3001 covers the calculation of the APR and states that the APR will be calculated in accordance with Appendix J, 12 C. F. R. Part 1026 (effective December 30, 2011). This reference raises two material points:

1. It does not address amendments. If Appendix J is amended, are providers to ignore any such amendments and follow the language that exists as of December 30, 2011? It seems this section should incorporate amendments after December 30, 2011.

2. Part 1026 specifically covers only closed-end transactions. It does not apply to open-end transactions. This is a material problem as the proposed Regulations will require open-end products to use TILA closed-end calculations. Considering TILA has specific calculations for open-end credit, we suggest the APR for open-end products be calculated in accordance with the open-end sections of TILA (See 12 C.F.R. § 1026.14).

The manner in which APR is addressed under the proposed Regulations creates inherent conflicts with TILA's APR. You can now have a consumer and a business get the exact same financing offer (one under TILA and one under the proposed Regulations) and the APR will be different. You can also have a business get the exact same product offering but one from a bank and one from a non-bank and the APR will be different (the bank will likely follow TILA's calculations). We believe this will create material confusion.

L. Preemption

The Supremacy Clause of the United States Constitution (U.S. Const. art. VI., § 2) establishes that when state law and federal law conflict, federal law preempts state law.[6] Preemption "may either be expressed or implied, and 'is compelled whether Congress' command is explicitly stated in the statute's language or implicitly contained in its structure and purpose."[7] If a state law is not explicitly preempted it can be preempted when the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[8] Therefore, in the event a state law is not expressly preempted by a federal law, preemption may be implied.[9]

TILA includes an express preemption provision, which provides that TILA does not preempt state law unless the state law is "inconsistent with the provisions of this subchapter and

[6] *Hines* v. *Davidowitz,* 312 U.S. 52, 66-67 (1941); *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372 (2000).
[7] *Gade v. Nat'l Solid Wastes Mgmt. Assn.*, 505 U.S. 88, 98 (1992).
[8] *Hines, supra*, at 67.
[9] *Geier v. American Honda Motor Co., Inc.*, 529 U.S. 861, 875 (2000).

then only to the extent of the inconsistency."[10] Regulation Z expands on TILA's statutory preemption provision as follows:

> . . . State law requirements that are inconsistent with the requirements contained in chapter 1 (General Provisions), chapter 2 (Credit Transactions), or chapter 3 (Credit Advertising) of the Act and the implementing provisions of this part are preempted to the extent of the inconsistency. A State law is inconsistent if it requires a creditor to make disclosures or take actions that contradict the requirements of the Federal law. A State law is contradictory if it requires the use of the same term to represent a different amount or a different meaning than the Federal law, or if it requires the use of a term different from that required in the Federal law to describe the same item. [11]

The Official Interpretations to Regulation Z ("Commentary") also explain that a state law is inconsistent with TILA if it contradicts TILA. State laws that contradict TILA include:

i. A state law that requires use of the term finance charge but defines the term to include fees that the Federal law excludes.

ii. A state law that requires a label such as nominal annual interest rate to be used for what the Federal law calls the annual percentage rate.[12]

It is important to note that the Commentary expressly addresses the preemption of state laws that misuse the terms "APR" and "finance charge" in a manner inconsistent with their use in TILA. "APR" and "finance charge" are the two key cost comparison terms defined by TILA and must be more conspicuous than all other required disclosures (in most cases). They are more important than all other TILA disclosures. A finance charge or APR computation cannot differ from TILA's as that would "contradict the amount computed and disclosed under the federal law. [If] the same term is used for different amounts, the state disclosure would be preempted."[13]

Note also that the Commentary refers to "a state law" broadly, without limitation to certain types of state laws. The language is intentionally broad, to protect the value of the key terms of art

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[10] 15 U.S.C. § 1610(a)(1).
[11] 12 C.F.R. § 1026.28(a)(1).
[12] Supplement I Part 3 to 1026 (Comment 2 to 12 C.F.R. § 1026.28(a)).
[13] 47 Fed. Reg. 16203 (April 15, 1982).

that TILA created: APR and finance charge. In fact, state laws that impose finance charge or APR disclosures will face more scrutiny in a preemption analysis as these two terms have such significance under TILA. As the Federal Reserve Board stated when concluding a state law requiring APR and finance charge disclosures was preempted:

> finance charge or annual percentage rate disclosures . . . will be reviewed more strictly; since these disclosures are particularly significant, any contradiction of the corresponding federal disclosure would interfere with the intent of the federal scheme.[14]

A state law may also be preempted even if it does not contradict TILA in the specific manner described in Regulation Z. In those instances, it must be determined whether "the state law significantly impedes the operation of the federal law or interferes with the intent of the federal scheme."[15] The Board has made eight (8) separate TILA preemption determinations pursuant to this guidance.[16]

The plain wording of TILA and Regulation Z, and the above-referenced determinations, make clear that any state law mandating disclosures for consumer financing covered by TILA is preempted by TILA to the extent:

1. The term "Annual Percentage Rate" or "APR" is used but references a different amount than what TILA requires, or the law mandates a calculation different than what TILA requires.

2. The term "finance charge" is used but includes fees not included under TILA's definition of "finance charge," or excludes fees included under TILA's definition of "finance charge."

3. The law requires a TILA closed-end credit APR calculation for an open-end credit product, instead of using the TILA open-end credit APR calculation.

To highlight why TILA preemption is so critical, consider whether a state law could mandate a unique APR disclosure for a consumer credit product that is not subject to TILA. More specifically,

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[14] 47 Fed. Reg. 16202 (April 15, 1982).
[15] 48 Fed. Reg. 4454 (February 1, 1983).
[16] *Id.*; 55 Fed. Reg. 49396 (November 28, 1990).

would TILA preempt a state law that requires all unsecured consumer loans over the TILA monetary threshold to disclose the "APR," but defines "APR" using the simple interest rate and not the APR calculation required under TILA? If such a law is not preempted, consumers would be provided two different "APRs" for essentially the same financing product, where the only difference in the loans is their amounts (which may vary by as little as a penny). This would obviously cause significant confusion and impede the goal of TILA to ensure uniformity in consumer finance disclosures. This hypothetical demonstrates that the value in defining "APR" and "finance charge" as consistent terms of art lie in enforcing their definitions beyond the specific credit products that are subject to TILA. The alternative – allowing the terms to be used inconsistently in different products – degrades the purpose of consistent, uniform terms: ensuring that consumers always know what the terms mean and can thus fairly compare financing options across product lines.

The proposed Regulations mandate disclosure of terms called "APR" and "finance charge" but define and calculate those terms differently than is done in TILA. A state law mandating disclosure of two essential TILA-defined terms for non-TILA products, but defining or calculating those terms differently from TILA, creates significant confusion and is preempted. The proposed Regulations do exactly this. For example, the proposed Regulations mandate use of APR but then change how APR is calculated compared to TILA. The proposed Regulations also create new disclosures and APR calculations called estimated annual percentage rate (if a phrase such as nominal annual interest rate is preempted by Regulation Z, clearly the phrase estimated annual percentage rate is preempted). Additionally, the proposed Regulations require Open-End Credit Transactions to be calculated in accordance with 12 C.F.R. Part 1026, which is for closed-end transactions. 12 C.F.R. § 1026.22 is part of Subpart C of Regulation Z and applies only to closed-end credit. Open–end credit disclosures and open-end APR calculations under TILA are governed by Subpart B of Regulation Z. Accordingly, the Regulations require a closed-end credit APR calculation for an open-end credit product and prohibits an open-end APR disclosure that would be consistent with TILA's open-end APR rules. The proposed Regulations also require that providers who offer products with no fixed terms and no fixed payment amounts make broad assumptions about terms and payment amounts in order to calculate and disclose an "Estimated APR" in contraction with TILA's view on product application and terms. TILA's goal of providing consumers with a precise APR will be frustrated as small business owners subject to Estimated

APR disclosures will come to view such disclosures as merely a guess on costs based on broad assumptions. This, in turn, will make them wary of relying on APR disclosures when they use consumer credit products to finance their business operations.

APR and finance charge are terms of art created by TILA and Congress wanted the terms to be protected so that the disclosures would not lose meaning by States redefining them and then using the same terms in other contexts. While TILA applies mostly to consumer credit transactions, the preemption provisions are not limited to just consumer credit transactions. Rather, the provisions of TILA addressing preemption with respect to APR and finance charge are not limited to consumer credit transactions. *See* 15 U.S.C. § 1610(a)(1). It should be noted that when TILA or Regulation Z intend for the preemption rules to be limited only to consumer credit transactions, they expressly state so. For example, Comment 2 to 12 C.F.R. § 1026.28(d) provides that preemption for credit card and charge card rules applies only to consumer transactions and not to business transactions. There is no such limiting language for preemption of inconsistent APR and finance charge disclosures required by State law. This inconsistency will result in misleading disclosures of credit choices, thwarting Congress' primary objective in enacting TILA. The regulation violates the APA Consistency standard.

M. BROKER COMPENSATION

Based on how the Regulations are drafted, it appears the DFPI either (i) has decided to ignore broker compensation that is paid by a financer directly to a broker rather than from recipient funds, or (ii) misunderstands how the majority of financers compensate brokers for referrals. In either case, the Regulations should be revised so that the amount and manner of compensation a broker receives for a commercial financing transaction is clearly disclosed to a recipient.

For the majority of commercial financing transactions that occur today, the broker is compensated by receiving a commission that is paid from the provider's funds. Unlike the manner envisioned by the Regulations, the commission payment is not deducted from the recipient's funds and paid to the broker. Rather, the financer pays the commission payment to the broker with its own funds. To recoup the amount paid to the broker, the commission amount is included as part of the finance charge and collected by the financer during the term of the transaction. As a result, as currently drafted, the Regulations do not require a disclosure for this type of broker compensation. Accordingly, the proposed Regulations will not require (or even permit) a provider

to disclose a broker fee paid by the provider despite the fact this is an essential disclosure for recipients and something they want to see. By requiring the broker fee payment to be hidden in the finance charge, you are precluding recipients from having the necessary information to negotiate betters terms. Because the broker fee is included in the finance charge, the APR increases and recipients will wrongly believe that the financer is getting all the finance charge, when in actuality the broker is getting a significant portion of the cost of the financing. In order to solve this problem, the Regulations should require the financer to disclose the amount of commission that the financer is paying the broker so that the recipient has a full understanding of the costs of the financing.

III. CONCLUSION

Thank you once again for considering our comments. As always, we remain committed to working with you to implement regulations that provide value to small businesses. We hope you appreciate our comments. We are motivated to make sure the final regulations work, provide value and assist small businesses. We would be happy to discuss these matters with you. You may reach me at 240-482-4684.

Very truly yours,

Joseph D. Looney
General Counsel