

8/24/21

Commissioner of Financial Protection and Innovation
Attn: Sandra Sandoval, Regulations Coordinator
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Re: **Comments on the Second Modifications to Proposed Regulations Under Division 9.5 of the California Financial Code (PRO 01/18)**

Dear Ms. Sandoval:

On behalf of Strategic Funding Source, Inc. doing business as Kapitus (Kapitus), we would like to thank the Department of Financial Protection and Innovation (DFPI) for the opportunity to provide the following comments on the proposed rules relating 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 originates commercial loans under a CFL license. In the terminology of the proposed regulations, these loans are classified as "closed-end transactions." Second, Kapitus enters into contracts with small businesses where it purchases a percentage of a small business's future income. In the terminology of the proposed regulations, these agreements are classified as "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. Despite these positive changes, however, there are four issues we want to bring to your attention. The first relates to Section 3027 and the need to make sure recipients are provided with full and transparent disclosure about all amounts brokers receive. The second relates to "average monthly cost," an added definition to the last iteration of the proposed regulations. The third involves the definition of "at the time of extending a specific commercial financing offer" in Section 2057(a)(4). And the fourth relates to Section 3026, as providers request a resource to ask questions and seek guidance from the DFPI given the technical

complexity of the regulations and their application to different products. To this end, Kapitus offers the following comments and recommendations on the proposed regulations.

Section 3027. Funding Recipient Will Receive

Kapitus applauds the additional disclosures and further modifications set forth in Section 3027. In adding these disclosures and making further modifications to this Section, Kapitus believes that the DFPI intended to provide complete information to recipients about all fees impacting the price of financing so that recipients can make informed decisions. Even with the further modifications, however, the current disclosure has a critical missing piece and does not provide the necessary disclosures.

As an initial matter, there is a fundamental issue that needs to be addressed. In the market for commercial financing (and financial services more generally), brokers get paid from two sources: (1) directly from the recipient and (2) from the provider. The current disclosure in Section 3027 addresses and itemizes the fees paid directly from the recipient (identified as "Brokerage Fee"). It does not, however, provide any disclosure of the fees paid by the provider to the broker in connection with a specific offer or extension of financing. These fees paid from providers to brokers may be included in the cost of financing, and at times are negotiated by brokers, but are not separately identified as "broker" or "brokerage fees." Because the fees are included are part of the cost of financing, the recipient does not have visibility into the amount being paid to the broker. The recipient just receives the total cost of financing and does not know what percentage of this cost is attributable to a broker fee that may have been included by the broker, and does not know that the price of the product is being increased because of a payment to a broker. And because it is not labeled a "broker fee," recipients don't realize that brokers are being paid this additional amount of money. This is misleading. Recipients should be told all fees associated with the cost of financing and who receives the fees. Recipients should know that the price of the product is higher because part of the cost of the financing is being paid to the broker even though it is not labeled a "broker fee." Such disclosure is essential for recipients to have the necessary information to make informed decisions.

Specifically, full disclosure is critical for recipients to differentiate between costs imposed by a provider and costs imposed by a broker. This is important so recipients can identify and dispute any excessive or additional charges imposed by a broker. Recipients often do not question additional, inappropriate fees thinking that they are the only fees a broker is receiving. Clearly disclosing what a broker is getting paid from a provider will help to eliminate the practice of charging additional and unwarranted fees and will make the broker's financial incentives clear. Such a disclosure also will work to prevent unscrupulous brokers from steering their customers to financing options that are most lucrative for the broker, for example, those with the highest commission rather than financing that represents the best option for the recipient.



To ensure that recipients fully understand both the cost of financing and who is receiving the fees, Kapitus proposes two courses of action. First, the additional disclosures of Section 3027 be included in the main disclosure (as part of Sections 2061-2068) rather than as a separate document. This would ensure that recipients have all necessary information upfront and do not miss these critical additional disclosures that are directly relevant to the total cost of the product. Second, an additional disclosure be added as a line item in Sections 2061-2068. Again, the purpose of this additional disclosure is to ensure that recipients are aware of **all** amounts paid to brokers in connection with an offer of commercial financing.

This is consistent with the Small Business Administration ("SBA")'s approach to fees paid to third party intermediaries by applicants. The SBA requires that a disclosure form be completed in connection with any payment to an agent for preparing an SBA loan. SBA requires the disclosure of fees paid by the applicant to the broker and fees paid by the lender to the broker to the SBA. "The purpose of this form is to identify Agents and the fees and/or compensation paid to Agents by or on behalf of a small business applicant." The form specifically requires the disclosure of "Consulting, Broker, or Referral services paid by the Applicant, SBA Lender, or Third Party Lender" and requires that the Agent be identified along with all services being provided, and "the party paying the fee and the amount paid must also be disclosed." It further requires the Agent to certify that the compensation in the form is "the only compensation that has been charged to or received from the Applicant or SBA Lender or that will be charged" for the services set forth in the form. See Fee Disclosure and Compensation Agreement, SBA Form 159 <https://www.sba.gov/sites/default/files/2020-08/Form%20159%20-%20%28FINAL%29%209.10.18-508.pdf>.

Kapitus believes that the intent of the DFPI in the disclosure of broker fees to the applicant is consistent with the intent of the SBA, to make sure recipients have full information about all fees being paid to allow them to make informed decisions about financing. Although Kapitus believes this was the goal of Section 3027, and that Section 3027 is an important step, as currently drafted, the additional disclosures in Section 3027 do not ensure that recipients are aware of **all** amounts paid to brokers. Section 3027 provides for disclosure of the itemization of the amount financed, which is important. It does not, however, provide for an itemization of fees a recipient will pay, directly or indirectly, to the broker based on the offer selected. It does not require disclosure of fees incorporated into the cost of financing and being paid by the provider.

There is a simple fix to address this concern.

Kapitus recommends that the DFPI redefine "funds paid to brokers" as stated below and add this amount as a separate line item in the disclosures set forth in Sections 2061-2068.

(32) Funds paid to brokers means the total amount of compensation that a provider pays to a broker in connection with the specific financing.



Disclosure of Average Monthly Cost (for periodic payments that are not monthly)

See Section 2057(a)(33); Section 2061(a)(11); Section 2062(a)(13); Section 2065(a)(12); Section 2066(a)(11); Section 2068(a)(11).

As currently drafted, the regulations require disclosure of an average monthly cost for periodic payments that are not monthly. Such disclosure has two problems: (1) it will lead to confusion by the recipient and (2) it expresses a preference for products that may ultimately be more expensive.

Requiring disclosure of the actual frequency and amount of payments makes sense and is helpful to the recipient. Requiring disclosure of a hypothetical frequency and amount is potentially harmful because of the confusion it will create. Recipients may not understand why they are receiving a disclosure of a monthly cost and it may cause them to think that they have a monthly payment when, in fact, they have payments of a different frequency. Adding such confusion is contrary to the purpose of the regulations, which is to provide clear and transparent disclosures. Studies have shown that the more points included in a disclosure, the less effective the disclosure; more disclosure is not better. Adding a hypothetical metric that is not consistent with the actual terms of the product provided is contrary to the stated purpose of the regulations.

Further, requiring disclosure of an average monthly cost for payments that are not monthly expresses a preference for products with monthly payments because products with monthly payments will generally have a lower average monthly cost than a product with daily or weekly payments because the products are longer term. A preference for products with monthly payments, however, ignores the reality that such products often have a higher overall total cost for the same reason—such products are longer in term. In Kapitus’s experience, a small business’s biggest concern when seeking financing is the overall total cost of a product and how that cost compares to the return on the investment from the financing. The average monthly cost of a product is not relevant if it does not reflect the actual payments a recipient makes, or even the actual monthly cost, given that daily, weekly, and bi-weekly payment frequencies all will have different monthly costs and different averages.¹ And it does not make sense for the DFPI to indicate a preference for a potentially more expensive product.

To eliminate confusion and provide purely facts to recipients rather than a hypothetical scenario to recipients, Kapitus recommends deleting the requirement of disclosing an average monthly cost for products that do not have monthly payments.

¹ If this metric is included, further guidance on how to calculate average monthly cost is needed. Each month has a different number of business days; months vary in the number of payments that can be made on a weekly or a bi-weekly basis depending on the day of the week a payment is initiated, holidays, and the timing of the weeks in each month.



Section 2057(a)(4). Definition of “at the time of extending a specific commercial financing offer.”

Kapitus would like to thank the DFPI for recognizing the challenges associated with defining “the time of extending a specific commercial financing offer.” As DFPI addressed in its most recent edits, providers often present multiple offers and rather than defining each step in this iterative process as “the time of extending a specific commercial financing offer,” DFPI defined it as when the recipient selects the preferred option.

There is, however, a second issue that needs to be addressed. As currently drafted, it is unclear if “the time of extending a specific commercial financing offer” would be triggered when (1) a recipient self-reports its financial or credit information or (2) after such information has been verified. This distinction is important because of the potential for “bait and switch” tactics from unscrupulous providers, where a low rate is initially quoted and, once the customer has selected an offer and further underwriting is completed, a much higher rate or higher cost product is offered. We want to prevent the situation where a recipient self-reports information and receives a misleading quote based on this incomplete or inaccurate information only to later learn, after verification, that the actual offer has much less favorable terms for the recipient.

Kapitus believes the DFPI appreciated this issue and attempted to address it by providing clarification as to the definition of “about the recipient” in Section 2057(a)(4)(A). The DFPI stated that information “about the recipient” includes a “recipient’s financial or credit information” and “not the recipient’s name, address, or general interest in financing.” This is an important point and makes it clear that getting a quote based on a general interest in financing is not sufficient to trigger “the time of extending a specific commercial financing offer.” Kapitus requests, however, one edit to provide further clarification and proposes the inclusion of “verified” before “financial or credit information” such that it reads as follows:

Information “about the recipient” includes information about the recipient that informs the provider’s quote to the recipient, such as the recipient’s **verified** financial or credit information, but not the recipient’s name, address, or general interest in financing.”

Section 3026. Tolerances

Due to the latest set of modifications (specifically the modifications to Section 2091, Estimates-Sales-Based financing – Historical Method, which require Kapitus, among other things, to determine if it should exclude from the average calculation months in which it does not require and receive monthly sales, income or receipts documentation as well as whether it should include in its average calculation additional months for which the recipient has provided sales, income or receipts documentation), Kapitus continues to be concerned about the inherent difficulty in calculating APR and the use of estimates, and the reality that these estimates could



differ from the actual cost of the financing. For this reason, Kapitus again urges that the DFPI add language to allow providers the ability to ask questions and seek guidance from the DFPI (perhaps through a designated individual or office) regarding the methods being used to comply with the DFPI's regulations. This is essential to ensure that Kapitus is using the correct methods to provide the disclosures that the DFPI is mandating and to ensure that recipients have the necessary information to compare products across providers. As a licensee under the CFL, Kapitus wants to ensure it understands the intent of the regulations and that it complies with the regulations. Further, it wants to ensure that it understands and complies before an examination. Without a resource to ask questions and seek guidance or a safe harbor, Kapitus is concerned that it will misunderstand or misapply the regulations and be left exposed to the risk of possible adverse action during the examination process.

As such, Kapitus recommends the addition of Section 3026(d):

"A provider or financier shall have the ability to consult with the DFPI on the methods of estimates and calculations called for under this Subchapter and rely on the guidance offered in writing by the DFPI regarding interpretive questions as safe harbor."

General: Implementation Date

The regulations require complicated calculations and estimates as currently written and will require significant technology changes prior to implementation. For its sales-based financing products, Kapitus will have to determine if it should use the historical or underwriting method. For the historical method, as stated in the latest round of modifications, Kapitus will have to determine how to calculate the estimated monthly sales, income, or receipts projection as well as how to determine the number of months on which to base the recipient's average monthly historical sales, income, or receipts. In determining whether to exclude a month from the average calculation, Kapitus will have to determine if it should exclude from the calculation the monthly sales, income, or receipts if it does not require and receive monthly sales documentation from those months. Kapitus will have to decide whether to include in its average calculation all or none of the additional months for which the recipient has provided sales, income, or receipts documentation.

For the underwriting method, as stated in the draft regulations, Kapitus must calculate the disclosures using an "internal estimated sales, income, or receipts projection" through the particular payment channel or mechanism using the best information available to it. Kapitus must determine what is the best information available to it. Under this underwriting method, Kapitus also must conduct audits of its commercial financings once every four months.

All of this will require significant analyses and putting in place additional processes and procedures, including many technology changes. Kapitus requests that (1) the DFPI provide at least 6 months to implement any required changes after the final regulations are released; and (2) the DFPI allow licensees the ability to ask for an



extension beyond this 6-month period if it is necessary due to challenges with estimates, calculations, and/or technology, provided that the provider has made good faith efforts to comply as demonstrated to the DFPI.

In sum, Kapitus supports disclosures that provide recipients the ability to compare different products. Kapitus believes that these disclosures should be clear, consistent, complete and product agnostic. Kapitus requests (1) that the DFPI require additional disclosures so that recipients are aware of **all** amounts paid to brokers in connection with a specific offer of commercial financing regardless of how these amounts are defined or classified, (2) that the DFPI eliminate the requirement to disclose an average monthly cost for products that do not have monthly payments, (3) that the DFPI clarify the definition of "at the time of extending a specific commercial financing offer," and (4) that providers have the ability to ask questions and seek guidance from the DFPI regarding the methods and calculations used to comply with these regulations.

Again, Kapitus would like to thank the DFPI for taking the time to receive and review its comments. Kapitus looks forward to working with the DFPI on the proposed rulemaking implementation of SB 1235. If the DFPI has any questions or needs additional information, please feel free to contact me.

Sincerely,

MICHAEL JESSE CARLSON

Senior Vice President and General Counsel

