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September 17, 2021

Department of Financial Protection and Innovation
Attn: Sandra Sandoval, Legal Division
300 South Spring Street, Suite 15513
Los Angeles, CA 90013

Subject: Comments on PRO 02-21

To Whom It May Concern:

Thank you for the opportunity to comment on the proposed addition of Subchapter X, related to small businesses, nonprofits, and family farms to Title 10 of the California Code of Regulations. I wish to offer two categories of input on the Department's draft language. In the first category, I offer high-level comments, questions, and suggestions regarding the Department's approach to defining unfair, deceptive, and abusive acts and practices (UDAAP) in connection with commercial financing, as well as high-level comments regarding the Department's proposed reporting requirements for commercial transactions. As I discuss in more detail below, I believe that significant changes are warranted to both sections of the draft. However, if you choose to move forward with your current approach, my second category of input includes technical and implementation comments, concerns, and suggestions. Both sets of input are intended to be constructive in nature.

**HIGH-LEVEL COMMENTS REGARDING THE DEPARTMENT'S APPROACH TO
DEFINING UDAAP IN CONNECTION WITH COMMERCIAL FINANCING**

Background:

As you know, subdivision (c) of Financial Code Section 90009 authorizes the Department to prescribe rules applicable to any covered person or service provider, identifying as unlawful, unfair, deceptive, or abusive acts or practices in connection with any transaction *with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.* (emphasis added). That subdivision goes on to require those rules to consider the relative harm to the consumer, the frequency of the act or practice in question, and whether such act or practice is unintentional or stems from a technical, clerical, or nonmaterial error. Finally, that subdivision directs the Department of Financial Protection and Innovation (DFPI; the Department) to interpret the terms "unfair" and "deceptive" consistent with Section 17200 of the

Business and Professions Code and its case law and to interpret the term “abusive” consistent with Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).

Subdivision (e) of Financial Code Section 90009 authorizes the Department, by regulation, to define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing, as defined, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms. Because existing statute provides the Department with no specific guidance regarding the nature of your UDAAP authority over commercial financing and the offer or provision of financial products and services to small business recipients, and family farms, your proposed regulations to clarify your regulatory expectations in this area are welcome. However, as noted below, I believe that your proposal is lacking in several areas.

Key Questions:

Does the Department Intend to Interpret UDAAP Consistently Across Both Consumer and Commercial Financing Transactions? At a threshold level, it is unclear from reading proposed Section X.90009.1 whether the Department is attempting, in issuing draft UDAAP regulations for the commercial context, to mirror the statutory requirements applicable to its interpretation of UDAAP in the consumer context; or, in the alternative, whether the Department is attempting to interpret UDAAP differently in the commercial context than in the consumer context.

I strongly encourage the Department to make clear at the very beginning of its commercial UDAAP regulations whether it intends to use the same criteria for identifying UDAAP in connection with commercial transactions as it is required to do by statute in connection with consumer transactions. If you elect consistency, you would be required to interpret the terms “unfair” and “deceptive” consistent with Section 17200 of the Business and Professions Code and its case law and to interpret the term “abusive” consistent with Title X of Dodd-Frank. Such an approach would also require the Department to consider the relative harm to recipients or prospective recipients of the financing, the frequency of the act or practice in question, and whether such act or practice is intentional or stems from a technical, clerical, or nonmaterial error.

If the Department opts to be consistent in its interpretation of UDAAP across both the consumer and commercial context, I do not believe that any further justification for this approach is warranted. However, if the Department opts to apply different standards when it defines UDAAP in the two different contexts, it owes the regulated community a clear explanation for the rationale behind its different approaches.

Why Is the Language of Proposed Section X.90009.1 So Different from the UDAAP Compliance Manual Issued by the Federal Consumer Financial Protection Bureau (CFPB)?

Recognizing that the regulated community would benefit from an understanding of its regulatory expectations in connection with UDAAP, the CFPB issued a manual for use by members of the regulated community when preparing for examinations

(https://files.consumerfinance.gov/f/documents/102012_cfpb_unfair-deceptive-abusive-acts-practices-udaaps_procedures.pdf). Although the most recent version of this manual offers a template for use by the Department when developing its UDAAP regulations, there is very little evidence that the Department used the manual when developing its proposed Section X.90009.1.

Unfairness: For example, the manual states that “the standard for unfairness in the Dodd-Frank Act is that an act or practice is unfair when: (1) It causes or is likely to cause substantial injury to consumers; (2) The injury is not reasonably avoidable by consumers; and (3) The injury is not outweighed by countervailing benefits to consumers or to competition.” The CFPB observes that the standard for unfairness in the Dodd-Frank Act uses the same three-part test as the Federal Trade Commission Act and goes on to include several paragraphs of explanatory text regarding how the definition is intended to be interpreted.

In its proposal, DFPI has borrowed from the Dodd-Frank Act (albeit incompletely, as the Department fails to clarify to whom the countervailing benefits should accrue), but has chosen to add three additional criteria to its definition of unfairness, at least two of which (see technical comments below) add significant confusion. Why has the Department strayed so far from the standard in use by the CFPB?

Deception: Similarly, in the manual linked above, the CFPB states that “a representation, omission, act or practice is deceptive when (1) the representation, omission, act, or practice misleads or is likely to mislead the consumer; (2) The consumer’s interpretation of the representation, omission, act, or practice is reasonable under the circumstances; and (3) The misleading representation, omission, act, or practice is material.” As was the case in its description of the term unfair, the CFPB includes several paragraphs of explanatory text regarding how the term “deceptive” should be interpreted.

In its proposal, the Department appears to have completely ignored the CFPB’s language in lieu of a circular definition that describes deceptive behavior as behavior likely to deceive. Why has the Department chosen to use a completely different definition of deceptiveness than the one used by the CFPB?

Abusiveness: Abusiveness is the one area in which the Department’s proposal is reasonably close to what the CFPB includes in its manual, but, unlike the definition used by the CFPB, the Department fails to include the concept of materiality, despite the fact that this concept is at the core of the manner in which the CFPB interprets UDAAP.

Does California Case Law Offer Other Useful Templates for Consideration? In its definition of unfairness, the Department includes an act or practice that violates another law, offends an established public policy, or is immoral, unethical, oppressive, or unscrupulous. Are these concepts drawn from case law? If so, it would be helpful if the Department cited that case law and offered the regulated community examples of specific types of inappropriate behavior, in the same way the CFPB offers examples in the manual cited above.

Does the Department Plan to Identify Specific Acts and Practices that Represent UDAAP in the Commercial Context? When the California Consumer Financial Protection Law was being debated, members of the regulated community expressed concern that DFPI would interpret UDAAP in a “we’ll know it when we see it” manner rather than through the issuance of regulations identifying specific behavior that the Department considered to be UDAAP. Although the general concepts in proposed Section X.90009.1 may be somewhat helpful to the regulated community once they are cleaned up and clarified, members of the regulated community will continue to lack examples of specific behaviors that represent UDAAP. At some point in the rulemaking process, it would be enormously helpful if the Department could indicate whether (and if so, approximately when) it plans to follow up these general concepts with more specific examples of behavior it considers to be UDAAP.

TECHNICAL AND IMPLEMENTATION COMMENTS, CONCERNS, AND SUGGESTIONS REGARDING THE DEPARTMENT’S APPROACH TO DEFINING UDAAP

As discussed above, I strongly recommend that you make significant changes to your proposed Section X.90009.1. However, if you opt to retain your proposed language, the following comments and suggestions are intended for your use in clarifying and correcting the proposed language.

- 1) Your definitions should be contained in their own section. As the proposal is currently drafted, you define terms applicable to the entire subchapter in subdivision (b) of Section X.90009.1 and then reference those terms in your proposed Section X.90009.2. It would be clearer if you added a new Section X.90009.1, titled Definitions. Doing so would not only make it clear that those definitions are intended to apply to the entire Subchapter, but would also put the definitions up front, where they are typically found.
- 2) Your draft regulation lacks a definition of “commercial loan,” which adds unnecessary confusion. The draft defines commercial financing by reference to subdivision (d) of Financial Code Section 22800. However, it fails to cross-reference the definition of “commercial loan” in subdivision (e) of Section 22800. This omission adds confusion, because Financial Code Section 22800(e) defines a commercial loan as “a loan of a principal amount of five thousand dollars (\$5,000) or more, or any loan under an open-end credit plan, the proceeds of which are intended by the recipient for use primarily for other than personal, family, or household purposes.” Failure to include that definition in the regulations could lead to confusion over what constitutes a commercial loan. Some could reasonably interpret it as an open- or closed-end loan of any size whose proceeds are intended for other than personal, family, or household purposes.
- 3) Your definition of “nonprofit” would also benefit from further clarity. As drafted, it refers to any type of organization organized under “a state law” authorizing the

establishment of a nonprofit organization. Does the Department wish to cover the extension of financing to nonprofits organized under the laws of any state and operating in any one of the fifty states? Or is the desired scope narrower? If the latter, the language should be revised to clarify your intended scope.

- 4) Clarifying language is missing in three places where its addition could be valuable. I suggest that you add the words “to small business recipients, nonprofits, and family farms” after the phrase “other financial products and services” in paragraphs (1), (2), and (3) of subsection (a) in Section X.90009.1. For example: “An act or practice is unfair and may not be engaged in by a person offering or providing commercial financing or other financial products and services *to small business recipients, nonprofits, and family farms* if the act or practice meets one or more of the following”
- 5) Language used to define unfair behavior is confusing and inconsistent in several places.
 - a) For example, (a)(1)(B) refers to harm, while (a)(1)(D) refers to injury. It is unclear if the two terms mean the same thing or something different.
 - b) The wording of (a)(1)(B) is unclear as drafted. At a minimum, I suggest that you strike the word “conduct” and replace it with the terms “act or practice,” because the whole section is about acts and practices. I also suggest that you strike the term “utility” and replace it with “benefits” to better clarify your meaning. However, even if those changes are made, the paragraph remains unclear. Is one supposed to balance the harm and benefits to the same person or may one also consider the impact on a broader group? For example, if an act or practice results in harm to a single individual but results in benefits to a great many individuals, is the act or practice unfair? Is one supposed to look only at the impact on the borrower/prospective borrower, or may one look more broadly at the entire universe of borrowers/prospective borrowers and their ability to obtain financing?
 - c) It is also unclear why you have both (B) and (D) and whether they are supposed to connote different concepts. As previously noted, (B) refers to harm, while (D) refers to injury. But, beyond that, (B) says that an act or practice is unfair if the harm it causes exceeds the benefits it causes; harm in excess of benefits is sufficient for an act or practice to be abusive. However, (D) requires three conditions to be met before an act or practice is considered abusive: the injury is not outweighed by countervailing benefits (essentially a restatement of (B)), the injury is substantial, and the injury cannot reasonably be avoided. The existence of (B) would appear to render (D) moot.
- 6) Language used to define the term deceptive is circular and not at all clarifying. The proposed language states that an act or practice is deceptive if a small business, nonprofit,

or family farm is likely to be deceived by it. It is unclear how that definition adds anything of value.

HIGH-LEVEL AND SPECIFIC COMMENTS AND QUESTIONS REGARDING THE DEPARTMENT'S PROPOSED COMMERCIAL FINANCING DATA REPORTS

At a threshold level, it is unclear if the reporting requirement is intended to apply to both unregistered covered persons and registered covered persons or only to one of the two groups. The implication is that you intend for both groups to submit the information, but clarification on this point would be helpful to alleviate potential confusion.

However, even once that point is clarified, it will still not be entirely clear what entities are expected to submit reports. Clearly, the Department is seeking information from persons subject to Division 9.5 of the Financial Code, but it appears that you may also be seeking information about commercial financing provided to small businesses, nonprofits, and family farms other than that provided by persons subject to Division 9.5. As just one example of where confusion could arise, the Department defines small business by reference to the Code of Civil Procedure (CCP). Division 9.5 lacks a definition of small business and instead defines the term "recipient." It is highly likely that the CCP definition of small business and the Division 9.5 definition of recipient will fail to overlap exactly. How is a provider of small business financing supposed to know which of his or her book of business to include in the required report? Are there types of commercial financing or recipients of commercial financing you are trying to cover, which are not covered in Division 9.5? If so, it would be helpful if you could clearly identify who they are.

It is also unclear if the information the Department is seeking will be further clarified through the issuance of a form or forms that must be completed by those subject to the requirements. Unfortunately, as Proposed Section X.90009.2 is drafted, it is extremely difficult to discern what specific information is being requested. What does the Department consider a "type of commercial financing"? Will the Department identify the categories and provide guidance regarding how to distinguish between and among them? Identifying your expectations in the regulations would allow interested parties to offer feedback on the specifics.

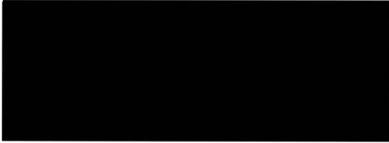
Also unclear is how the Department defines the term "total number [of; sic] transactions in this state for the prior calendar year." Does the Department define a transaction as an origination? How is an open-end line of credit supposed to be counted? How are multiple originations with the same borrower supposed to be counted (individually or as a total)? These questions are relevant, not only to clarify information requested in (b)(1)(3), but also in (b)(1)(4).

Finally, in the interest of clarity, I suggest that you revise Proposed Section X.90009.2(c), as follows: "A person who reports data to the Commissioner under Section 22159 of the California Financing Law shall not report the same loan data to the Commissioner under this rule but shall *instead* report data on any other commercial financing or *the offering or providing of* other financial products and services to small business recipients, nonprofits, and family farms.

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Eileen Newhall Consulting LLC
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Thank you for the opportunity to comment on the proposal. Please don't hesitate to reach out to me at enewhall@newhallconsulting.com or (916) 666-0314 if you have any questions regarding this letter.

Sincerely,



Eileen Newhall, Owner
Eileen Newhall Consulting LLC