

October 27, 2021

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

**By Electronic Mail:** [regulations@dfpi.ca.gov](mailto:regulations@dfpi.ca.gov)  
**With Copies To:** [Charles Carriere, \[REDACTED\]@dfpi.ca.gov](mailto:Charles.Carriere@dfpi.ca.gov);  
[Jesse Mattson, \[REDACTED\]@dfpi.ca.gov](mailto:Jesse.Mattson@dfpi.ca.gov)

Re: **[Comments on the Third 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 five issues we want to bring to your attention. The first relates to Section 956 and the need to make sure recipients are provided with full and transparent disclosure about all amounts brokers receive. The second relates to the calculation of APR for daily payment products. The third relates to the disclosure of estimated monthly cost. The fourth involves the definition of “specific commercial financing offer” in Section 900(a)(23). And the fifth relates to Section 955, 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 956. Funding Recipient Will Receive**

As Kapitus discussed in prior letters, we believe it is critical to provide complete information to recipients about all fees impacting the price of financing so that recipients can make informed decisions. Although we think that is the intent of Section 956, we are concerned that as currently drafted, recipients will be misled into believing that all broker fees are disclosed when in fact only a portion of the fees are disclosed.

To address this concern, Kapitus proposed revisions to the definition of “funds paid to brokers” to require that the disclosure include the total amount of compensation that a provider pays to a broker in connection with the specific financing offer. The DFPI did not revise the definition, but instead, deleted both the definition and the phrase from the disclosure while at the same time keeping the sample disclosure in Section 956 as is. Kapitus is unsure about the impact of this change and is unclear what should be disclosed.

As we noted in our previous letter, in the market for commercial financing (and financial services more generally), brokers are compensated: (1) directly from the recipient and (2) from the provider. Kapitus believes that recipients are entitled to disclosure of both types of fees. The current sample disclosure in Section 956, which did not change from the last set of revisions, appears to itemize the fees paid directly from the recipient (identified as “Brokerage Fee”). It does not, however, appear to provide any disclosure of the fees paid by the provider to the broker in connection with a specific offer or extension of financing.

This is problematic because without this disclosure:

- (1) The recipient does not know that the price of the product it is considering buying is being increased because of a payment to a broker. Recipients should have access to all information to make informed decisions.
- (2) The recipient might pay inappropriate fees without realizing it. Recipients often do not question additional fees thinking that the only fees a broker is receiving have been disclosed. Clearly disclosing all amounts a broker is receiving—either from a provider or from the customer—will help to eliminate unauthorized fees.
- (3) The recipient may not receive the best financing options. Requiring the disclosure of all fees received by a broker will work to prevent unscrupulous brokers from steering recipients into financing that is most lucrative for the broker, for example a product with the highest commission, rather than financing that is best for the recipient.



To ensure that recipients fully understand both the cost of financing and who is receiving the fees, Kapitus recommends that the DFPI add back the definition of “funds paid to brokers,” redefine it as stated below, and add this as a separate line item in the disclosures set forth in Sections 910-917.<sup>1</sup>

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

### **Section 940. Calculation of APR for Daily Payment Products**

In the latest version of the regulations, the DFPI deleted section 940(c), which provided direction about calculating APR for daily payment products. We understand why the DFPI deleted this section as it assumed a greater number of payments than were actually made, thereby artificially inflating the APR and leading to an inaccurate APR disclosure. However, guidance is still necessary as to how to calculate APR for daily payment products as Appendix J does not provide the necessary information to do the calculation. Because each month has a different number of days in which payments are collected, providers need to know how many days to assume exist in every month.<sup>2</sup>

There are a few ways to address this issue. Kapitus could: (1) assume a certain number of days each month on average (e.g., 20.5 days); (2) base the APR calculation for daily payment products off the estimated average monthly income as described in the regulations; or (3) assume that there are five days in each week and use a weekly payment calculation for the purposes of APR. Kapitus can implement any of the above approaches but needs guidance to ensure that all providers are calculating APR using a consistent methodology, which is necessary for recipients to have consistent information to compare offers between providers.

Without such guidance, daily repayment products without a fixed amount, which many small businesses benefitted from, and which were critical during the pandemic, will be taken off the market because of uncertainty about how to comply with the regulations. We don't think it is the intent of these regulations to eliminate products and financing options and request that the DFPI provide clear guidance on how to calculate APR for daily payment products.

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<sup>1</sup> As previously noted, this is consistent with the practice required by the Small Business Administration (“SBA”). See Fee Disclosure and Compensation Agreement, SBA Form 159 <https://www.sba.gov/sites/default/files/2020-08/Form%20159%20-%20%28FINAL%29%209.18-508.pdf>.

<sup>2</sup> We are aware that section 901(a)(16)(B) and (C) recognizes that the dates of scheduled payments may be changed because the scheduled date is not a business day and that months have different numbers of days, but this language does not resolve the issue of how many days should be assumed per month or how to calculate APR for a daily payment product.



**Disclosure of Estimated Monthly Cost (for periodic payments that are not monthly) See Section 914(a)(12)**

As Kapitus noted previously, the current requirement for disclosure of an estimated monthly cost for sales-based financing (or average monthly cost for closed-end transactions) for periodic payments that are not monthly is problematic for two reasons. It will lead to confusion by the recipient regarding whether the small business has a monthly payment or a payment of a different frequency. It also expresses a preference for products that potentially have a higher overall total cost. To eliminate confusion and provide purely facts to recipients rather than a hypothetical scenario, Kapitus recommends deleting the requirement of a hypothetical disclosure and instead require just a disclosure of the actual payment amount and frequency.

If this hypothetical metric is included, however, further guidance on how to calculate estimated monthly cost is needed. Each month has a different number of business days and 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.

Further, the disclosure as currently drafted could cause the estimated monthly cost included as part of the required disclosure to be different from the payment amount included in the actual contract. The reason for this inconsistency is, for sales-based financing, the current language of the disclosure requires a disclosure of an estimated monthly cost that is based on a fixed number of months of data across sales-based financing products, even if a provider underwrites a financing offer based on a different number of months of data. As a result, the following inconsistency could arise:

A provider collects seven months of data due to the specific circumstances of the small business seeking financing and calculates the average monthly revenue based on these seven months. This seven-month average monthly revenue is the basis of underwriting decisions and determines the payment amount in the contract. Under the current draft of the regulations, for this same recipient, the estimated monthly cost, for purposes of this disclosure, would be calculated not based on seven months, but on the term the provider has chosen in advance, which according to the regulations, will be between four and twelve months. An average monthly revenue based on seven months of data likely will be different than an estimate based on, for example, four months. Because both the estimated monthly cost as well as the estimated payment amount are derived from the calculation that relies on a set number of months of data, these amounts could be different from the actual payments stated in the contract, which are based on the actual data collected rather than a set amount. The result is that the amounts in the disclosure identified as "Estimated Payment" could be different from the payment amount set forth in and required under the contract.



To have an estimated payment amount that is different from the actual payment amount will lead to tremendous confusion. To avoid this problem, Kapitus recommends that:

- (1) the estimated payment in the disclosures be defined to match the amount in the contract rather than a mathematical calculation based on a hypothetical monthly revenue estimate; and
- (2) the estimated monthly cost (if it is to be disclosed for all contracts regardless of payment frequency) also be based on the actual terms of the contract. To provide an estimated monthly cost for contractual terms different from a monthly term, it would be essential for the DFPI to define the number of days in a month. As noted above, this also is critical for providers to calculate an APR disclosure for daily payment products.

### **Section 900(a)(23). Definition of “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 has addressed, 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 has defined it as when the recipient selects an option.

There is still uncertainty, however, in the latest draft of regulations about when the disclosure obligation is triggered. As currently drafted, it is unclear if the disclosure obligation would be triggered when a recipient elects to pursue an offer based on a self-report of financial or credit information or after such information has been verified such that the offer would be binding on the provider. 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. Kapitus seeks 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.

We believe the New York Department of Financial Services recognized this concern and in its most recent draft (released on October 20, 2021) addressed it by including the following language:

“any time specific terms of commercial financing, including price or amount, is quoted in writing to a recipient, based upon information from, or about, the recipient, which, if accepted by a recipient, shall be binding on the provider.”

The addition of “shall be binding on the provider” makes it clear that the provider cannot employ a bait and switch tactic and must honor the offer if accepted by the recipient. We request that the DFPI add language to its definition of “specific commercial financing offer” such that it reads as follows:



(23) "Specific commercial financing offer" means a written communication to a recipient, based upon information from, or about, the recipient, of a (i) 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), in connection with a commercial financing, **which, if accepted by a recipient, shall be binding on the provider.** Information "about the recipient" includes information about the recipient that informs the provider's quote to the recipient, such as the recipient's financial or credit information, but not the recipient's name, address, or general interest in financing.

### **Section 955. Tolerances**

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 955(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**

As stated previously, because the regulations require complicated calculations and estimates as currently written and will require significant technology changes prior to implementation, 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.

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In sum, Kapitus supports disclosures that provide recipients the ability to compare different products. Kapitus believes that these disclosures should be clear, consistent, and complete. Kapitus requests (1) that the DFPI require disclosures so that recipients are aware of **all** funds paid to brokers in connection with an offer of commercial financing regardless of how these amounts are defined or classified, (2) that the DFPI provide guidance as to how to calculate APR for daily payment products, (3) that the DFPI eliminate the requirement to disclose an average monthly cost for products that do not have monthly payments and redefine the disclosures such that the actual payment amount is disclosed rather than an estimated hypothetical amount, (4) that the DFPI add language to clarify the definition of "specific commercial financing offer," and (5) 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

