

November 22, 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;  
Jesse Mattson, [REDACTED]@dfpi.ca.gov

Re: **Comments on the Fourth 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. There are, however, five issues Kapitus would like to raise in this letter: (1) calculation of APR for daily payment products, (2) disclosure of estimated monthly cost, (3) definition of "specific commercial financing offer," (4) disclosure of all amounts paid to brokers, and (5) guidance from the DFPI about compliance with the regulations. To this end, Kapitus offers the following comments and recommendations.

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

As we noted in our last comment letter, we understand why the DFPI deleted section 940(c) in the third set of modifications to the regulations. This section, if enacted, would have assumed more payments than were actually made (because payments cannot be made seven days a week), thereby artificially inflating the APR and leading to a misleading APR disclosure for daily payment products. In response, we noted the need for guidance, because Appendix J to Regulation Z does not provide the necessary information to calculate APR for a daily payment product. Because each month has a different number of days in which payments are collected, providers need to know how many *payment* days to assume exist in every month – not how many calendar days.<sup>1</sup>

In the fourth set of modifications to the regulations, the DFPI amended section 900(a)(33) and (34) to state that “[t]o calculate the number of months in the estimated term, a provider may divide the number of days in the estimated term by 30.4.” We are unsure if in revising the definition of “estimated monthly cost” (as well as “average monthly cost”), the DFPI meant to define the number of calendar days in a month as 30.4, or the number of payment days. If the intent was to use an average of 30.4 payment days in a month, this is problematic for the same reason as former section 940(c). Daily payments cannot be made on weekends or on bank holidays, and thus, an assumption of 30.4 days in a month for purposes of calculating APR for daily payment products is inaccurate and misleading.

There also is a reference in the regulations (in Section 914) to the possibility of payments “every calendar day.”<sup>2</sup> Kapitus wants to make sure that the DFPI understands that payments for daily payment products are not made every calendar day, but rather are made only on weekdays and non-holidays.

Because of the uncertainty around calculating APR for daily payment products, providers need guidance from the DFPI. In our last letter, we suggested a few ways to address the issue. Providers could: (1) assume a certain number of *payment* days each month on average for which payments could be made (e.g., 19, 20.5, or 20 days rather than 30.4 days as 30.4 includes days on which payments cannot be made); (2) base the APR calculation for daily payment products off the estimated average monthly income as described in the regulations, i.e., calculate a monthly payment based on monthly revenue since bank transactions generally only post on

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<sup>1</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.

<sup>2</sup> Section 914(a)(7)(B)(i) states “[i]f the contract provides for daily periodic payments, a short explanation of when daily payments will be required. For example, on weekdays or every calendar day.”



business days when the banks are open and operating; or (3) assume that there are five days in each week and use a weekly payment calculation for the purposes of APR. Kapitus and other providers can implement any of the above approaches but need guidance to ensure that all providers are using a consistent methodology, which is necessary for recipients to be able to compare offers between providers. As things currently stand, providers will have to make their own estimates of payment days, and those estimates may vary.

The daily payment product is a product that many small businesses benefitted from and that was critical during the pandemic, as the variable repayment products Kapitus offers are also daily payment products. If there is uncertainty in the regulations around this product, providers may be reluctant to offer it. We are requesting that the DFPI provide clear guidance on how to calculate APR for daily payment products to avoid the unintended consequence of eliminating products and/or financing options.

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

As Kapitus has noted in prior comment letters, we are concerned that the disclosure of an estimated monthly cost for periodic payments that are not monthly will be confusing to recipients. Recipients who are making payments on a less frequent basis may not understand why there are two different payment amounts in the disclosure document.<sup>3</sup> To prevent confusion, we propose that the actual payment metric (whether it be daily, weekly, or bi-weekly) be disclosed rather than a hypothetical one.

If the regulations do require the inclusion of a hypothetical disclosure, there are challenges in calculating an estimated monthly cost. As with the issues calculating APR for daily payments, 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. In the latest draft of the regulations, the DFPI stated that a provider may divide the number of days in the estimated contract term by 30.4. As noted previously, however, this is not an accurate measure because payments cannot be made on weekends and bank holidays and thus, cannot be made 30.4 days in any month.

Kapitus endorses complete and accurate disclosures that recipients can easily understand. As such, Kapitus believes that a disclosure of the actual metric and not a hypothetical metric makes the most sense. If a hypothetical metric is required, Kapitus recommends that the estimated monthly cost (if it is to be disclosed for all contracts regardless of payment frequency) be based on the actual terms of the contract. To provide an estimated monthly cost for contractual terms different from

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<sup>3</sup> Such disclosure also indicates a preference for products that have a monthly payment and which potentially have a higher overall total cost, which is not in the best interest of the recipients.



a monthly term, it would be essential for the DFPI to define the number of days in a month and for the number of days in a month to reflect the number of days on which payments can be made and not simply an average of days in a month. As noted above, this guidance also is critical for providers to calculate an APR disclosure for daily payment products.

### **Section 900(a)(23). Definition of “specific commercial financing offer.”**

As noted in our last letter, Kapitus would like to thank the DFPI for understanding the challenges associated with defining “at the time of extending a specific commercial financing offer.” As the DFPI has recognized, providers often present multiple offers to a recipient. Rather than defining each step in this iterative process as “the time of extending a specific commercial financing offer,” and requiring a new disclosure document several times through this iterative process, DFPI has defined it as when the recipient selects an offer.

Kapitus believes that additional clarification regarding the timing of disclosures will assist providers in understanding their obligations. Kapitus assumes that the disclosure obligation is triggered not based on a self-report of financial or credit information, but rather after such information has been verified such that a complete and binding offer can be made by the provider. This would help to eliminate any bait and switch tactics by unscrupulous providers. The concern is that a provider will provide an unrealistic initial quote complete with full disclosure documents to make the unrealistic quote appear more legitimate, and then (after the recipient has stopped pursuing other offers), offer a higher rate or higher cost product. To avoid this situation, the offer made with the disclosure documents should be binding.

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. This would mean that the underwriting for the contract has been completed. Kapitus requests 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 956. Funding Recipient Will Receive**

As Kapitus has stated in its prior letters, we are concerned that section 956, as currently drafted, will give recipients a false sense of security in believing that all fees paid to brokers are disclosed when, in fact, only those fees deducted from the amount financed will be disclosed to the recipient. The disclosure in Section 956 provides complete disclosures if recipients are dealing directly with providers without the assistance of a broker. It does not, however, provide complete disclosures if a broker is involved in the transaction.

Section 956 requires an itemization of the amount financed. This itemization purports to disclose all fees paid to brokers. The issue is that it doesn’t reflect the reality of the commercial financing market in which brokers are not compensated in the same manner for every transaction. Brokers or third-party intermediaries are compensated not only from deductions from the amount financed, but also through an increased finance charge the broker negotiates for. For example, the finance charge for a transaction may include \$1,000 charged by the provider and \$950 paid to the broker. This appears to the recipient as a total finance charge of \$1950, but a recipient will not know that this total finance charge includes \$950 paid to the broker. As Kapitus noted in its prior letters, this is important for the following reasons:

- (1) The recipient should know that the price of a 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 as to whether they are receiving value from this additional cost of using a broker.
- (2) The recipient might pay inappropriate fees without realizing it. Recipients often do not question a broker fee included as a deduction from the amount financed because the recipient believes that is the only fee a broker is receiving. Clearly disclosing all amounts a broker is receiving 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 address these concerns, 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 remains unsure about the impact of this change and is unclear what should be disclosed.

There may be other ways to accomplish the goal of complete disclosure, but Kapitus believes that the simplest would be to add back the definition of “funds paid to brokers,” redefine it as stated below, and include this as a separate line item in the disclosures set forth in Sections 910-917.<sup>4</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 955. Tolerances**

Kapitus continues to be concerned about the inherent difficulty in calculating APR and the use of estimates, specifically for daily payment products. 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 (1) Kapitus is using the correct methodology and (2) recipients have the necessary information to compare products across providers. As a licensee under the CFL, Kapitus wants to ensure that it is complying with the regulations 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 and will require significant technology changes prior to implementation,

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<sup>4</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%209.10.18-508.pdf>.



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 clear, consistent, and complete disclosures that provide recipients the ability to compare different products across different providers. In support of this, Kapitus requests that the DFPI (1) provide guidance about calculating APR for daily payment products, (2) eliminate the requirement for a hypothetical disclosure of estimated monthly cost for products that do not have monthly payments, (3) clarify the definition of "specific commercial financing offer," (4) require disclosure of all amounts paid to brokers in connection with an offer of commercial financing regardless of how these amounts are defined or classified, and (5) provide 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

