November 22, 2021

VIA EMAIL regulations@dfpi.ca.gov

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 – Invitation to Comment on Fourth Modifications to Proposed Regulations Under Division 9.5 of the California Finance Code

Dear Commissioner Shultz,

The Revenue Based Finance Coalition ("RFBC")[1] is comprised of responsible finance companies that provide needed capital to small businesses through innovative methods. RFBC members offer revenue based financing to small businesses and some members also engage in lending in the state of California through a California Financing Law license. Our members include select vendors that provide technology services to the small business finance industry. This letter responds to the Department of Financial Protection and Innovation's "Notice of Fourth Modification to Proposed Regulations Under Division 9.5 of the California Financial Code" dated November 5, 2021.

The RFBC has previously submitted five comment letters to the DFPI during the regulation drafting process. Respectfully, the proposed commercial finance regulations continue to lack clarity because of ambiguous terms and are inconsistent with the purpose of Senate Bill 1235. We ask the DFPI to again review the five comment letters that the RFBC has submitted since January 2019. Specifically, we would like to draw the DFPI's attention to the following:

I. Lack of Clarity Due to Ambiguous Terms

APR Calculations Need to be Clarified for Open-End Credit

The proposed regulations reference Appendix J of Regulation Z for calculating the estimated APR for transactions. It is unclear if the DFPI intended for Appendix J to also be used for calculating the APR for open-end credit. Generally, Appendix J is not used for calculating an APR for open-end credit.

In addition, some open-end credit products do not contain any periodic rates associated with the credit, and instead assess only flat fees (e.g., cash advance fees and periodic balance fees). Generally, if an open-

[1] The RBCF is formerly known as the Commercial Finance Coalition.

end credit product does not contain a periodic rate, then the creditor is not required to disclose an estimated APR as a part of the account-opening disclosures or the periodic statements.

Under the proposed regulations, there is no guidance whether a creditor would be required to disclose an APR for an open-end credit product if it is not utilizing any periodic rates associated with the credit. Under Section 1026.14(c) of Regulation Z, creditors are provided optional rules for calculating APRs when no periodic rates are used. Even though these rules were intended in Regulation Z for credit secured by a dwelling, the concepts and rules sometimes are used for calculating an estimated APR when the creditor does not use any periodic rates. Appendix F of Regulation Z provides additional guidance on this issue.

Section 911 of the proposed regulations describe the disclosures required for commercial open-end credit. The types of credit described in this section include descriptions of credit that is not open-end credit, including Section 911(a)(2)(A) which describes "If the contract allows only for a single payment option." This credit option does not appear to relate to open-end credit. Accordingly, the DFPI would need to draft additional guidance for whether a creditor would be required to disclose an APR for an open-end credit product.

A. Clarifications for Multiple Draw Loans

The proposed regulations do not address how to calculate estimated APRs for multiple draw commercial loans. The DFPI should add guidance to the regulations that address these types of loans.

II. The Proposed Regulations are Inconsistent with Senate Bill 1235

Senate Bill 1235 (Chapter 1011, Statutes of 2018) authorizes the DFPI to draft regulations implementing the specific requirements of the disclosures to be provided to recipients, including: definitions, methods of calculation for certain disclosure items, the method of expressing the annualized rate, disclosure, the time, and the manner and format of the disclosures. The purpose of these disclosures is to provide meaningful information to small business owners seeking financing.[2] As currently drafted, the proposed regulations will result in disclosures that will be misleading to businesses and frustrate the purpose of Senate Bill 1235. The following are a few areas where the proposed regulations are inaccurate and misleading in the context of sales-based financing transactions:

The Proposed APR Disclosure is Not Based on the Legal Obligation of the Parties

The proposed regulations instruct sales-based financing providers to calculate and disclose an APR in accordance with the APR disclosures required for consumer transactions under the federal Truth in

[2] *See Browsing to Borrow: "Mom & Pop" Small Business Perspectives on Online Lenders*, Board of Governors of the Federal Reserve, available at https://www.federalreserve.gov/publications/files/2018-small-business-lending.pdf.

Lending Act (TILA)[3] and its implementing regulation, Regulation Z.[4] Use of those calculations is problematic in the context of sales-based financing transactions. The TILA APR disclosure is based on the consumer's *legal obligations* with the creditor. This "legal obligation" standard means that, in disclosing costs of credit, the creditor is not required to (and in fact, may not) predict the actual timing of a consumer's payments or other factors that would impact the APR that are not legal obligations under the terms of the agreement.

The proposed regulations, on the other hand, require an APR calculation for sales-based financing transactions that are based entirely on prediction and, therefore, have no relationship to the recipient's legal obligation. In sales-based financing transactions, it is impossible for the parties to know what the recipient's payments will be because they are based on yet-unrealized sales, which can be affected by many factors both in and out of the sales-based financing provider's and recipient's control (such as, for example, a pandemic, the introduction of newer products, the loss or addition of a particularly impactful manager or director, seasonal impacts on sales, etc.).

In order to account for the impossibility of knowing what the recipient's payments will be, the proposed regulations require sales-based financing providers to rely on predictions about how the recipient will pay. Sections 942 of the proposed regulations requires sales-based financing providers to use an estimated monthly sales, income, or receipts projection as the amount the recipient will pay on a monthly basis. This approach will result in an APR disclosure that is inherently inaccurate and does not represent the legal obligation of the parties. An approach that relies on projections and predictions, and not the legal obligation, is precisely counter to what TILA requires and will result in an APR that is not representative of the cost to the sales-based financing recipient.

The weakness of this approach is even more apparent in sales-based financing transactions in which the Purchased Amount (the total amount that the recipient will pay if the transaction is completed) does not change regardless of how quickly the recipient pays. Section 914 of the proposed regulations states that in disclosing the estimated finance charge, if the finance charge will not increase under any circumstance if repayment takes longer than estimated, the provider may include the following statement: "Your finance charge will not increase if you take longer to pay off what you owe." However, though the proposed regulations recognize that the recipient will not have to pay more in this case, the proposed regulations require the provider to disclose an APR that is calculated by assuming a specific term of repayment. APR is not an effective disclosure for sales-based financing transactions and particularly so when the cost to the recipient will not increase regardless of how long the recipient takes to pay the provider. Moreover, the statement "what you owe" is legally incorrect and, at best, confusing in the context of a sales-based financing transaction where the amount "owed" is wholly contingent on the merchant's future sales. Sales-based financing transactions differ from loan transactions that require a merchant to repay amounts borrowed and repaid without regard to sales volume or income. Sales-based financing transactions do not include unconditional repayment obligations. Including statements such as "what you owe" will likely confuse merchants and discourage merchants from receiving the full benefits of their transactions from sales-based financing providers.

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[3] 15 U.S.C. §§ 1601 *et seq.*
[4] 12 C.F.R. §§ 1026.1 *et seq.*

Further, APR is a useful measure of the cost to repay an obligation only when it is calculated uniformly across all products to allow for reliable and informative comparison. For sales-based financing transactions, the proposed regulations require APR to be calculated in a manner that is not based on the legal obligation and is not, therefore, calculated uniformly when viewed against other products that use the legal obligation as the basis of disclosure calculations. An effort to shoehorn sales-based financing transactions into an APR disclosure regime ultimately will make any APR disclosure, whether provided with a sales-based financing transaction or other consumer or commercial transaction, less informative and less reliable because APR will no longer be a uniform comparison of costs.

Disclosing an APR for a Sales-Based Financing Transaction Will Imply Interest is Being Charged

Sales-based financing transactions are purchase and sale agreements, not loans. Three important factors in determining whether a transaction is a sales-based financing transaction or a loan are:

(1) whether or not the contract contains a finite term, because an indefinite term is consistent with the contingent nature of a sale of future receipts;

(2) whether the provider has any recourse if the business declares bankruptcy; and

(3) whether the contract contains an interest rate or payment schedule.

In consumer lending, the difference between interest and APR is a frequent source of confusion. Most consumers, and even lenders, do not understand the difference between these two concepts. This confusion will be even worse in sales-based financing transactions that do not contain an interest component. Sales-based financing companies are concerned that by disclosing an APR many merchants and some courts may think the sales-based financing company is charging interest on the transaction. This confusion could result in the sales-based financing transaction being recharacterized as a loan, and, as a result, being challenged as usurious in California. Due to this confusion, sales-based financing companies could also be the target of plaintiff's attorneys. These sales-based financing companies will be required to defend any such actions, and they will be required to spend significant resources on litigation.

This problem could be avoided by removing the APR disclosure requirement for commercial finance transactions. Instead, the commercial finance provider could disclose the true cost of the transaction as an annualized cost of capital. This cost disclosure would be meaningful to the applicant, and it would allow an applicant to compare sales-based financing transactions among lenders and other competitors to shop for the lowest cost services.

Even though sales-based financing transactions do not provide for any interest relating to the transaction, sales-based financing companies will be required to calculate an estimated APR, which will be calculated using the actuarial method. Section 940(a) of the proposed regulations states that "the annual percentage rate shall be determined in accordance with either the United States Rule method or the actuarial method set forth in Appendix J [of Regulation Z]." These APR disclosures will be calculated using formulas that were not meant for sales-based financing transactions that do not include any interest component. Instead, the APR disclosures will assume that the transaction contains interest. This assumption is not

accurate in a sales-based financing transaction, and it will only add to the confusion related to the APR disclosures.

The Estimated Monthly Sales, Income, or Receipts Projection is Misleading and Unreliable

The proposed regulations require sales-based financing providers to disclose an estimated APR based on either a historical "estimated monthly sales, income, or receipts projection" or an "internal estimated sales, income, or receipts projection". These approaches produce APRs that are misleading and unreliable.

The "Historical Method" of projecting sales, income, or receipts in Section 930 requires a creditor to fix the number of months used to calculate the recipient's average monthly historical sales, income, or receipts to a period of between 4 and 12 months, at the provider's discretion. Thus, two different sales-based financing providers, offering the same sales-based financing terms with the exact same contractual payment requirements, might have wholly different disclosures depending on whether the providers use a 4-month term or a 12-month term for purposes of the historical average. For APR to be meaningful, an obligation repayable on the exact same terms should result in the same APR, regardless of which provider ultimately enters into the sales-based financing transaction. Further, while the DFPI could remedy the inconsistent result by establishing a specific fixed term for determination of the historical average, whatever term the DFPI might deem to be appropriate may not provide an accurate picture of the historical sales, income, or receipts of that recipient. These concerns bring into focus the reasons why APR is inappropriate for sales-based financing transactions.

Moreover, Section 931 of the proposed regulations allows sales-based financing companies to use an internal "Underwriting Method" to calculate the estimated sales, income, or receipts of a recipient. However, the proposed regulations instruct the sales-based financing transaction company to use "the best information reasonably available..." in calculating disclosures. Therefore, the APR disclosures will be calculated by each sales-based financing company based on different assumptions and information. As a result, the APR disclosures for sales-based financing transactions will have little value in assisting a business in comparing APRs among several offers from sales-based financing companies.

Further, the proposed regulations recognize that the Underwriting Method of calculating disclosures for sales-based financing transactions may be particularly vulnerable to inaccurate or misleading APRs. The proposed regulations include an audit requirement, obligating the sales-based financing provider to perform a "retrospective annual percentage rate" calculation that would require the sales-based financing company to use the Historical Method to calculate APRs if the weighted average for the "APR spread" is outside prescribed limits in Section 931. This is problematic for several reasons and demonstrates why an APR regime is inappropriate for sales-based financing transactions.

First, the means by which the proposed regulations determine if a provider's Underwriting Method is reliable require an audit that examines the weighted average of "APR spreads." While the weighted average of "APR spreads" might suggest a provider's method of calculation is reasonably reliable, it does not guarantee that any particular recipient received a reliable APR disclosure. A recipient could be given

a disclosed APR that falls well outside of the weighted APR spread even when the provider's audit suggests the provider's Underwriting Method is reliable.

Second, requiring a provider whose audit produces weighted average APR spreads outside of the permitted range (which may not be due to any fault of the sales-based financing company that provides them, but rather on external influences) to thereafter use the Historical Method does nothing to address the impact of inaccurate disclosures provided to recipients of sales-based financing transactions prior to the audit. By the time the audit would suggest the provider's calculations are inaccurate, the recipient has already relied on the disclosure. Further, the proposed regulations would foster an environment where some disclosures result from an Underwriting Method that has yet to be audited for accuracy (and, therefore, may or may not be reliable), and some by an Underwriting Method that has been audited and appears to be reliable. Because a recipient seeking a sales-based financing transaction cannot know whether any particular provider's Underwriting Method has been audited or the results of those audits, the recipient cannot know if the APR disclosed to the recipient is likely to be reliable. In addition, sales-based financing providers who have audited their Underwriting Method may be at a competitive disadvantage to those who have not done so.

Third, for the reasons set forth above, the Historical Method of predicting sales, income or receipts is not an accurate means by which to calculate the APR. Thus, requiring a provider to use the Historical Method when an audit shows their Underwriting Method is not reliable or accurate simply substitutes one problematic calculation for another.

Annual Audit Requirements and Penalties for Using Internal Estimated Sales Projections

Sales-based financing companies may use "internal estimated sales, income, or receipts projections" when estimating sales projections in order to calculate an estimated APR. Sales-based financing transaction companies also may calculate these projections using "the best information reasonably available to the provider at the time of the disclosure." The merchant's payment of a sales-based financing transaction is strictly based on how quickly a merchant receives revenue from customers. Therefore, these estimates could vary from month-to-month or year-to-year. As a result, the internal estimated sales projections also could vary significantly.

Under the proposed regulations, a sales-based financing company is required to conduct an annual audit of its sales projections, and if the weighted average for the last three audits is greater than 15%, then the sales-based financing company will be prohibited from using the internal estimated sales projections for 24 months. The sales-based financing company then will be required to use the estimated monthly sales or receipts projection for its estimated APR calculations, which may not provide a projection that is any more reliable due to the contingencies involved in the payment of sales-based financing transactions. As an example, one of our member companies performed analysis utilizing six different APR calculators for the exact same sales-based financing offer. While most answers were within a reasonable range of difference, no two calculations yielded the same APR, and some calculations reflected differences of greater than 20%.

A Sales-Based Financing Provider Cannot Reasonably Anticipate True-Ups

Section 914(a) requires a sales-based financing provider to include estimated payments and "reasonably anticipated true-ups" in each estimated APR calculation. The term "true-up" means any payment made to a recipient, any charge assessed to a recipient, and any adjustment to a recipient's periodic payments pursuant to a true-up mechanism. The term "true-up mechanism" means, with respect to sales-based financing transaction, a contractual arrangement with all the following elements:

(A) The financer receives periodic payments based upon a pre-set amount (or amounts) stated in the contract;

(B) The contract allows the recipient to request, or the financer to initiate, adjustments to the payment amount, credits to the recipient, or charges to the recipient after execution of the contract, so that the total amount paid by the recipient more closely reflects a split rate listed in the contract.

The term "reasonably anticipated true-up" means any "true-up" that the financing provider has a reasonable basis to expect will be made during the term of the contract, accounting for past performance of similar contracts (both those made to the recipient and other similar recipients), and the policies and procedures of the financer.

It is unclear how a provider would "reasonably anticipate" any true-up. A true-up results in the payment obligation of the recipient being adjusted, sometimes dramatically, based on the actual receipts generated by the recipient. Must a provider anticipate that landscaping businesses based in colder climates will obtain a true-up in January resulting in lower payments, but not landscaping business based in warmer climates? Must a provider anticipate that sellers of consumer goods may generate more revenue during the holiday shopping period of November and December, and therefore should make higher payments in those months? And in either case, how would a provider anticipate the exact amount of any true-up? This uncertainty illustrates that in the context of a sales-based financing transaction, the payment obligation is flexible, and APR is not reliable or accurate.

Moreover, the COVID-19 crisis has demonstrated how unpredictable true-ups can be. During the height of the crisis, RFBC members provided true-ups/modifications to approximately 50% of their nationwide portfolio of customers. This inherent flexibility has resulted in substantial payment relief for small businesses without the need for legislative action to require forbearance. Although this has been a time of extraordinary hardship for small businesses across the U.S., unexpected hardships happen to individual small businesses all the time. As a result, a provider is unable to reasonably anticipate true-ups either on an individual customer basis or across its portfolio.

For example, a provider may know based on past experience that 30% of its recipients will request a true-up. When preparing the disclosures, does this mean that the provider should reasonably anticipate a true-up for 100% of its customers? Or, can the provider assume that the particular recipient will not request a true-up because, based on historical percentages, it is more likely that the recipient is part of the 70% who do not request true-ups? The proposals lack guidance as to how a provider is expected to reasonably anticipate a true-up for any particular recipient, and without such guidance the industry is left

left to guess as to whether it should anticipate a true-up in any particular case. This creates a lot of exposure to providers. Further, if in the example above, the provider must reasonably anticipate true-ups for the entire population of recipients, if history shows that only 30% will actually request such a true up, the disclosures will be inaccurate for 70% of the provider's customers. The proposals provide no guidance as to how to approach these issues when preparing disclosures.

We respectfully request that the DFPI address the lack of clarity in the proposed regulations and revise the proposed regulations to make them consistent with the purpose of Senate Bill 1235.

Sincerely,

Deveron Gibbons, Executive Director
Revenue Based Financing Coalition

cc: Jesse Mattson @dfpi.ca.gov
Charles Carriere @dfpi.ca.gov