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February 5, 2024

Department of Financial Protection and Innovation
Attn: DeEtte Phelps
2101 Arena Boulevard
Sacramento, CA 95834

Subject: Comments on Second Modified Text of PRO 01-21, Released January 17, 2024

To Whom It May Concern:

Thank you for the opportunity to comment on the proposed regulations. Although the Department made a few beneficial changes to the First Modified Text of PRO 01-21, I am disappointed to see that the bulk of the First Modified Text remains unchanged. For that reason, I believe that the Second Modified Text of PRO 01-21 continues to suffer from three main flaws:

1) It creates tremendous regulatory uncertainty for income-based advance providers.
2) It thwarts, rather than fosters innovation.
3) It misses an opportunity to embed extensive consumer protections into the registration scheme for income-based advance providers.

Although the initial years of the Department's proposed approach will be fairly benign to the income-based advance industry, the longer-term effect of the Department's proposal threatens the viability of the income-based advance industry in the state and risks depriving California consumers of a product they actively use to reduce their reliance on high-cost credit.

PRO 01-21 CREATES REGULATORY UNCERTAINTY

As redrafted, Section 1461 of Article 4 of Subchapter 6 (California Financing Law; CFL) states that the provider of any advance of funds to be repaid in whole or in part by the receipt of a consumer's wages, salary, commissions, or other compensation for services does not require a CFL license if two conditions are met: 1) the advance of funds is an income-based advance, as defined in California Consumer Financial Protection Law (CCFPL) regulations *and* 2) the provider is registered with the Department to offer income-based advances under the CCFPL. Section 1461 goes on to say that the second condition expires when registration requirements for income-based advance providers expire.

The presence of the "and" between paragraphs (1) and (2) in subdivision (e) is what creates the uncertainty. As Section 1461 is drafted, one of the two required conditions will be unattainable

if registration requirements for income-based advance providers sunset. Thus, income-based advance providers that do not hold CFL licenses as of the date the registration requirements sunset will be considered unlicensed lenders in violation of the CFL as of that date.

A regulatory "gotcha" like this is troublesome for multiple reasons: 1) it imposes significant uncertainty on a still-nascent industry; 2) it imposes significant costs on that same industry, because most, if not all, providers will feel obliged to apply for CFL licenses to ensure that they will not be violating California law once the registration requirement sunsets; 3) it forces an industry whose products bear virtually no relation to California's installment loan law under the requirements of that law; 4) it hampers, rather than fosters innovation, with no resulting consumer benefit.

THE REGULATORY UNCERTAINTY EMBEDDED IN PRO 01-21 THREATENS INNOVATION

The income-based advance industry currently relies on two primary sources of funding to support its advances: venture capital provided by venture capital firms and lines of credit made available by large depository institutions or their bank holding companies. Both types of funders are reluctant to place strong support behind industries whose continued existence is questionable. Yet, in drafting Section 1461 as it is proposing in its Second Modified Text, the Department is knowingly and intentionally creating a regulatory environment wrought with uncertainty.

There are several possible outcomes that could result upon the sunset of the registration requirements for income-based advance providers. First, venture capital firms and large depositories will likely pull back their funding from any companies that are violating California law by making "loans" subject to the CFL without having a license to do so.

Second, if the Department brings regulatory action against income-based advance providers for acting in an unlicensed manner, these companies will be forced to notify the regulators in all of the states in which they are currently operating to inform them that they are the subject of regulatory action related to their income-based advance activities in California. Under the laws increasingly being enacted in other states, California regulatory sanctions will threaten the ability of income-based advance providers to continue operating in other states.

Third, even if an income-based advance company does obtain a license under the CFL, it is entirely unclear what that means in a practical sense for the way in which that company must change its operations, and the confusion that is likely to result will impose even greater regulatory uncertainty. The CFL is an installment loan law that was drafted based on the model of a single sum of money being lent to a borrower and that single sum of money being repaid over time in multiple installments. The income-based advance industry advances multiple installments of money to its customers and is typically repaid in a single lump-sum that coincides with the customer's payday. The CFL contemplates interest rates, origination fees, late fees, prepayment penalties, and refinancings, among many other concepts that are not a part of

income-based advances. How is a company whose product bears no relation to the CFL supposed to operate under the CFL? Any company that guesses wrong will be subject to disciplinary action, which creates the same problems I noted immediately above. Venture capital firms and large depositories will likely withdraw or significantly reduce their funding, and the sanctioned companies will be forced to notify the regulators in all of the states in which they are currently operating to inform them that they are the subject of regulatory action related to their income-based advance activities in California, an action that threatens their ability to continue operating in the other states.

As I stated in a previous comment letter on PRO 01-21, forcing income-based advance providers under the CFL makes a mockery of the Department's responsibility to support and appropriately regulate responsible financial innovation. When the California Consumer Financial Protection Law (CCFPL) was proposed by the Newsom Administration in 2020, it was characterized as a law that sought to protect consumers and to foster innovation. One of the four guiding purposes of the CCFPL (Section 90000(b)(4)) is "promoting nondiscriminatory consumer-protective innovation in consumer financial products and services." Because promoting consumer-protective innovation was viewed as a key role of the Department, the Newsom Administration chose the Department's name carefully; it is not the Department of Financial Protection, but rather the Department of Financial Protection *and Innovation* (emphasis added). Furthermore, when the CCFPL was being debated by the Legislature during 2020, both the Department and the Newsom Administration repeatedly argued that the Department needed the authority to regulate providers of consumer financial products and services in a more flexible way than California's existing financial services laws allowed. Their argument was "there are a lot of new, innovative consumer financial products and services being offered in California, which don't fit neatly within the licensing laws drafted multiple decades ago. Rather than trying to squeeze these innovative offerings into our existing licensing regimes, the Department should have the authority to promulgate new, unique regulatory regimes specific to these innovative products."

As the Department and Administration described it and the Legislature understood it during 2020, the Department planned to use its new authority to identify innovative industries it believed were worthy of additional oversight; collect data from the industry participants to inform the Department's regulatory approach; and then propose registration requirements for these industries in a manner that promoted consumer protection, while reflecting the unique and innovative nature of the industries it sought to regulate. And yet, over three years after the CCFPL was signed, the most innovative approach the Department can come up with is "we'll require you to be registered initially, but once those registration requirements sunset, we're going to force you to squeeze your business model into provisions of an installment loan law whose provisions are over fifty years old."

Far from promoting innovation, the Department's proposal sends a message to financial innovators that, regardless of the Department's name and regardless of the Department's authority to craft industry-specific rules, the Department intends to look no farther than its

existing licensing laws for its menu of regulatory options when regulating innovative providers of financial products and services. That approach is not only short-sighted, but it renounces California's opportunity to be the nation's most responsive and innovative consumer protection regulator in favor of the outdated status quo.

THE PROBLEMS ABOVE ARE EASILY FIXED

The easiest way to mitigate the significant problems above is to replace the "and" between paragraphs (1) and (2) of proposed subdivision (e) of Section 1461 with an "or" (Article 4 of Subchapter 6, California Financing Law).

An alternative, slightly more complicated approach, would replace the proposed subdivision (e) with the following:

(e) A provider of an advance of funds as described in subdivision (a) does not require a license under the California Financing law if:

(1) The provider is registered with the Department to offer income-based advances under California Code of Regulations, title 10, Section 1010; or

(2) No registration requirement for income-based advance providers is in place under the California Consumer Financial Protection Law, and the provider does all of the following:

(A) Submits an annual statement of information to the Department containing such information as the Department shall require;

(B) Submits an annual report containing such information as the Department shall require; and

(C) Refrains from representing that its income-based advance activities have been approved by the Commissioner of DFPI.

This alternative approach would keep the Department apprised of the ongoing activities of income-based advance providers in California and continue all of the consumer protections that are embedded in the proposed registration scheme, *without* forcing income-based advance providers under the requirements of the CFL upon the sunset of registration requirements.

THE PROPOSED REGULATIONS CONTAIN RELATIVELY FEW CONSUMER PROTECTIONS

When it enacted AB 1864 (Chapter 157, Statutes of 2000), the Legislature granted DFPI extensive authority to prescribe required and prohibited acts applicable to persons subject to the CCFPL[1]. Despite this extensive authority, the Department has chosen to apply very few rules to income-based advance companies via PRO 01-21 and is missing an opportunity to embed more extensive consumer protections in its regulation.

[1] See Financial Code Sections 90009 and 90012, in particular.

As drafted, the regulation proposes to require income-based advance companies to register; submit specified supplemental information as part of their registration applications; and file annual reports; and prohibits registrants from representing that registration represents approval by the Commissioner of DFPI. These requirements are bureaucratic, but fall far short of representing a comprehensive regulatory scheme with extensive consumer protections.

The only elements of the proposed regulation that appear to focus on consumer protection are embedded in the definition of the term income-based advance. Paragraph (3) of subdivision (g) of proposed Section 1004 (Article 1, Subchapter 4) defines an income-based advance as one in which the provider of that advance warrants to the consumer that it has no legal or contractual claim or remedy against the consumer based on the consumer's failure to pay the full amount due, the provider will not undertake debt collection activities to collect unpaid amounts due, and the provider will not report the consumer's failure to repay amounts due to a consumer reporting agency.

Ironically, the relatively few consumer protections embedded in the proposed regulations make it quite easy to retain these protections once the registration requirements sunset, as I have proposed in the suggested language immediately above. However, as I indicated in my comment letter dated November 27, 2023, I believe that the Department is missing a critical opportunity to embed an extensive series of industry best practices into its regulation.

In the interest of space, and because the Department has already rejected my prior proposal, I will not repeat it here. However, I continue to believe that the Department would better protect consumers and better sustain an industry that has become important to several hundred thousand Californians if it were to adopt a version of the language proposed in my November comment letter.

THE REGULATIONS FAIL TO CLARIFY THE EFFECT OF A SUNSET ON ARTICLE 1 OF SUBCHAPTER 4

Although the Department failed to act on this concern in its Second Modified Text, I believe this issue is important enough to raise a second time. Subdivision (b) of Financial Code Section 90009.5 states that "the regulation requiring a covered person to register with the department shall become inoperative on January 1 of the calendar year that is four years following the initial year of required registration," unless the Legislature takes specified actions. This language begs the question, "how much of what the Department is proposing in PRO 01-21 will cease to be operative on the January 1 that is four years following adoption of the proposal?"

I believe a strong case can be made that the entirety of Subchapter 4 (California Consumer Financial Protection Law) will survive the sunset of a *specific* registration requirement, and that the only effect of a sunset would be to render Section 1010 inapplicable to specific groups of persons whose registration requirements are no longer in force. However, it may be valuable for

the Department to include in its regulation some statement to that effect. Doing so should help ensure that cross references, both within regulations implementing the CCFPL and regulations implementing other laws administered by DFPI, are not rendered meaningless following a possible sunset. One possible way of addressing this issue would be the addition of a new Section 1054 to Article 3 of Subchapter 4.

1054. Effect of a Sunset
Unless the language of this subchapter expressly provides otherwise, its provisions shall survive the sunset of a registration requirement pursuant to subdivision (b) of Financial Code Section 90009.5.

Thank you for the opportunity to comment on the proposal. Please don't hesitate to reach out to me at or if you have any questions regarding this letter.

Sincerely,

Eileen Newhall, Owner
Eileen Newhall Consulting LLC