

FINAL STATEMENT OF REASONS  
FOR RULE CHANGES UNDER THE  
ESCROW LAW AND  
CALIFORNIA RESIDENTIAL MORTGAGE LENDING ACT

As required by Section 11346.9 of the Government Code, the California Corporations Commissioner ("Commissioner") sets forth below the reasons for the amendments to existing Rule 1741.5 and adoption of Rules 1729 and 1741.5 (operative March 31, 2002) under the Escrow Law (Title 10, Chapter 3, Sections 1729 and 1741.5 of the California Code of Regulations) and adoption of Section 1950.302 under the California Residential Mortgage Lending Act (Title 10, Chapter 3, Section 1950.302 of the California Code of Regulations). It is noted that this regular rulemaking project seeks to permanently adopt these same changes in the regulations that were adopted pursuant to emergency regulation and which are effective January 1, 2002 and readopted on April 30, 2002 to August 29, 2002.

I. Escrow Law

The Department of Corporations ("Department"), California's Investment and Financing Authority, licenses and regulates independent escrow agents under the Escrow Law (Financial Code Sections 17000 to 17702). Up until December 31, 2001, the Escrow Law, under Financial Code Section 17405, required the Commissioner to conduct a routine regulatory examination of every escrow agent licensee at least once every other calendar year, starting from the first day of the previous examination. The purpose of the examination is to determine if escrow agent licensees are in compliance with the Escrow Law and the rules promulgated thereunder.

A legislative bill enacted last year and which became effective on January 1, 2002, i.e., Assembly Bill 459 (Chapter 499, Statutes of 2001) ("AB 459"), amended the Escrow Law to, among other things, amend Financial Code Section 17405 to change the frequency of the routine regulatory examination of every licensed escrow agent conducted by the Commissioner to as often as the Commissioner deems necessary and appropriate, but not less than once every 48 months. In determining how often a licensee shall be examined, AB 459 specifies that the Commissioner may consider each escrow agent licensee's compliance with the Escrow Law and other factors the Commissioner may by rule or order designate. Although AB 459 became effective on January 1, 2002, the bill, however, provides that the change in the frequency of the routine regulatory examination (from every other year to at least once every 4 years) does not apply or become operative until the Commissioner establishes, by rule or order, the factors that may be considered in determining how often an escrow agent licensee will be examined.

In order to implement AB 459 with respect to the new routine regulatory examination cycle for escrow agent licensees, the Commissioner proposes to adopt Rule 1729 to set forth, by rule as this would be a standard of general application, the

factors the Commissioner may consider in determining how often a routine regulatory examination of an escrow agent licensee will be conducted. These factors are (1) past and current violations of the Escrow Law and the regulations promulgated thereunder, taking into consideration the nature and severity of the violations and the number of violations and (2) the number of years the escrow agent has been licensed under the Escrow Law. Accordingly, this rule is needed to establish, and provide notice of, the factors to be considered by the Commissioner in connection with routine examinations and in order to make the new routine regulatory examination cycle operative.

The Commissioner also proposes to amend Rule 1741.5 that sets forth the instructions for preparing the Independent Annual Audit Report required by Financial Code Section 17406. Under Financial Code Section 17406 each escrow agent licensee must submit to the Commissioner, at its own expense, an audit report containing audited financial statements for the licensee's established fiscal year. This audit report must include additional relevant information as the Commissioner may require. The audit report is due in the Commissioner's office within 105 days after the escrow agent licensee's fiscal year end. Rule 1741.5 provides instructions that are to be considered in the preparation of the independent annual audit report. The Commissioner proposes to require additional information to be included in the audit report in order to better assist the Commissioner in determining if an escrow agent licensee is in compliance with the Escrow Law. The Commissioner will use the additional information in the audit reports to determine the frequency of the routine regulatory examinations as this information may reveal violations of the Escrow Law and/or regulations.

AB 459 also requires that the routine regulatory examination shall be conducted for the 12 month period immediately preceding the date the examination is commenced unless the Commissioner finds, based on information uncovered in the examination or in the most recent audit report, that the examination should be extended beyond the 12 month period. The proposed changes to Rule 1741.5 will provide additional information that will assist the Commissioner in making a determination if it is necessary to extend the examination beyond the 12-month period.

However, the Commissioner proposes to not require the additional information in the audit reports until March 31, 2002. This will allow the escrow agent licensees and their independent accountants sufficient time to be aware of and to begin preparing for the upcoming changes and to implement the changes for those audit reports with fiscal year-ends of March 31, 2002 and thereafter. In order to make it easier and clear in accomplishing the goal of requiring the additional information on audit reports on or after March 31, 2002, the Commissioner proposes to amend existing Rule 1741.5 to add subsection (b) to state that this rule shall remain in effect only until March 31, 2002, and as of that date is repealed, and proposes to adopt a new Rule 1741.5 that specifically states it shall become operative March 31, 2002, and which contains the same language as existing Rule 1741.5 plus incorporates the additional information. In addition, the Commissioner proposes to make technical and conforming changes to

existing Rule 1741.5.

The additional information the Commissioner proposes to be included in the audit reports is as follows:

- Require that the audit report include a schedule showing the computation of the licensee's liquidity and tangible net worth for measuring compliance with Financial Code Section 17210 and an itemized schedule listing each item included in the computation. And require certain information be included that is necessary to include marketable securities and fee receivables as liquid assets. (This additional information will allow the Commissioner to easily confirm that the licensee is in compliance with the liquid and tangible net worth requirements of Financial Code Section 17210 since some liquid assets and some long-term liabilities require additional documentation to be either included or excluded from the calculations.)
- Require that the audit report include copies of the trust bank reconciliations for each location as of the balance sheet date, including all interest bearing and dormant accounts and all outstanding checklists. The report shall include an explanation for all adjustments appearing on the reconciliation, including an affirmative statement if any reconciling items were not adjusted as of the date of the balance sheet and whether or not any of the adjustments cause debit balances or shortages. The Department shall be required to maintain the outstanding checklists in the confidential section of the licensee's file. (Requiring a copy of the escrow trust bank reconciliations for all locations, interest-bearing accounts and dormant accounts will allow the Commissioner to determine if the licensee's escrow books and records are current, reconciled properly and in compliance with Rules 1732 and 1732.2. Requiring the audit report to include an explanation for all adjustments and a statement as to whether or not the adjustments have been corrected as of the balance sheet date will allow the Commissioner to determine if adjusting items are being researched and corrected properly in a timely manner. The escrow trust bank account is not considered reconciled and current if old adjusting items on the reconciliation have not been researched and properly corrected. Requiring that the report include an affirmative statement whether or not any of the adjustments created a shortage will allow the Commissioner to determine if a shortage existed as of the balance sheet date, the reason for the shortage and whether or not the shortage was corrected. The outstanding checklist is to be maintained in the confidential section of the Department's records because the list contains names of escrow customers, which is considered personal and confidential information.)
- Require that the audit report include separate trial balances for transactions covered by Escrow Agents' Fidelity Corporation ("EAFC") and those requiring separate fidelity bonding. The Department shall be required to maintain the trial balances in the confidential section of the licensee's file. (This information will allow the Commissioner to determine if the licensee has the proper fidelity coverage, either by EAFC and/or a separate fidelity bond, as required by Financial Code Sections

17312 and 17203.1 and Rule 1723. The trial balances are to be maintained in the confidential section of the Department's records because the trial balances contain the names of escrow customers and other personal and confidential information.)

- Require a statement in the audit report whether or not the escrow agent licensee maintains trust bank accounts and escrow trust records for those transactions covered by EAFC separate from the trust bank accounts and escrow trust records for those transactions not covered by EAFC. (This will require that the auditor report whether or not the licensee is in compliance with Financial Code Section 17409(b) which requires a licensee to maintain escrow trust bank accounts and escrow trust records for those transactions covered by EAFC separate from those transactions not covered by EAFC.)
- Require a statement in the audit report that the escrow agent licensee is in compliance with the fidelity bonding requirements. (This will require that the auditor confirm that the licensee has the proper amount of fidelity coverage, either from EAFC or a separate fidelity bond for those transactions not covered by EAFC. This information is necessary to ensure that the public's funds are properly insured given that the frequency of the Department's routine regulatory examination of a licensee may be extended to four years.)
- Require that the audit report include a full explanation of the resolution of all debit balances or a statement that the debit balances have not been resolved as of the auditor's report date. (Under the current rules, the auditor is required to include a full explanation of the nature and cause of any debit balances that exist as of the balance sheet date. This proposed change will require that the auditor include an explanation as to how the debit balance was corrected or a statement that the debit balance has not been corrected as of the balance sheet date. This will allow the Commissioner to determine if the debit balances constitute serious violations of the Escrow Law or its rules or that shortages exist in the escrow trust account.)
- Require that the auditor perform procedures to determine the disposition of old dormant trust funds and old outstanding checks and include the results of the procedures in the audit report. (In order to monitor the disposition of old dormant trust funds and old outstanding trust checks, the Commissioner proposes to require that the auditor perform certain procedures to verify the proper handling of these funds and to report the results in the audit report. This will allow the Commissioner to review the disposition of the old dormant funds and old outstanding checks as the routine regulatory examination cycle is extended.)

## II. California Residential Mortgage Lending Act

The Department licenses and regulates residential mortgage lenders and mortgage servicers under the California Residential Mortgage Lending Act ("CRMLA") (Financial Code Sections 50000 to 50707). Pursuant to Assembly Bill 2403 (Chapter

968, Statutes of 2000), Financial Code Section 50302 was changed, effective January 1, 2001, to require the Commissioner to conduct a routine regulatory examination of every CRMLA licensee as often as the Commissioner deems necessary and appropriate, but at least once every 48 months. Prior to the change, the law required a routine regulatory examination at least once every 24 months.

Since the Commissioner has considered and will be considering the same factors as discussed above relating to escrow agents in determining how often a routine regulatory examination of a CRMLA licensee shall be conducted, the Commissioner proposes to adopt a similar rule for the CRMLA in order to be consistent under both laws and to immediately clarify for licensees this standard or factors the Commissioner may consider in determining a licensee's routine examination cycle.

Specifically, the Commissioner proposes to adopt Rule 1950.302 to set forth the factors the Commissioner may consider in determining how often a routine regulatory examination of a CRMLA licensee will be conducted. These factors are (1) past and current violations of the CRMLA and the regulations promulgated thereunder, taking into consideration the nature and severity of the violations and the number of violations and (2) the number of years the licensee has been licensed under the CRMLA. Accordingly, this rule is needed to establish, and provide notice of, the factors to be considered by the Commissioner in connection with routine examinations.

#### ALTERNATIVES CONSIDERED

No reasonable alternative considered by the Department or that has otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the regulation is proposed, or would be as effective and less burdensome to affected private persons, than the adopted actions.

#### DETERMINATIONS

The Commissioner has made a determination that the proposed regulatory action does not impose a mandate on local agencies or school districts.

The Certified Public Accountants that the Department contacted, all of which are involved in preparing audit reports for escrow agents, estimate that the additional reporting requirements for the annual audits will increase the cost of each annual audit by \$250 to \$500. However, it is anticipated that the additional reporting costs to be incurred by the escrow industry will be offset by the cost savings that the industry will realize from less frequent routine regulatory examinations. Therefore, it is the Department's determination that this action will not have a significant adverse economic impact on business.

## ADDENDUM REGARDING PUBLIC COMMENTS

No request for hearing was received during the 45-day public comment period which ended on May 13, 2002. No public hearing was scheduled or heard.

### COMMENT RECEIVED DURING THE 45-DAY COMMENT PERIOD

Only one comment was received. Mr. Ted J. Hicks, President, Gramercy Escrow Corporation, suggested having an examination every other year to help eliminate misappropriations.

In response, the Department notes that the industry sponsored legislation to amend existing law and provide for an examination at least once every 4 years, based on specified criteria. Using the criteria set forth in this proposed rulemaking, more frequent audits may be conducted for those independent escrow companies that pose more risk of misappropriation.

No other comments were received during the 45-day public comment period.