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October 27, 2020

Via E-Mail: **regulations@dbo.ca.gov**
charles.carriere@dbo.ca.gov

Department of Business Oversight, Enforcement Division
Attn: Charles Carriere, Counsel
1515 K Street, Suite 200
Sacramento, California 95814-4052

Re: Comments on Second Modification to Proposed Text of Regulations for Implementation of Commercial Financing Disclosures

Dear Mr. Carriere:

The Secured Finance Network (formerly known as the Commercial Finance Association) ("SFNet") is the international trade organization founded in 1944 representing the asset-based lending, factoring, trade and supply chain finance industries, with 270 member organizations throughout the State of California, the U.S., Canada and around the world. As we have previously discussed on multiple occasions, SFNet and its membership are supportive of providing as much information as possible to small businesses in order to assist them in making an informed decision on which financing product is right for them. However, SFNet and its members continue to have concerns regarding the disclosure requirements under Commercial Finance Disclosures enacted under SB1235 (Chapter 1011, Statutes of 2018) and signed into law by Governor Brown on September 30, 2018 ("Disclosure Requirements") as well as the regulations proposed (including the second modification to the proposed text) by the California Department of Business Oversight regarding compliance with the Disclosure Requirements ("Proposed Regulations").

SFNet and its members strongly urge you to take the below comments and suggestions into account with respect to the Proposed Regulations. Although the Disclosure Requirements and Proposed Regulations have implications with respect to many forms of financial products provided by our members, we specifically direct you to the implications on factoring and asset-based lending as those implications are potentially detrimental to these members and may result in less commercial financing products being available in California.

FACTORING:

Although the Proposed Regulations seek to provide information with respect to a factoring facility in a manner that creates uniformity with other types of financing, Factoring is not a financing product that can be easily compared to a normal commercial loan and the number and type of assumptions necessary to put it into similar terms as other financing products, make the disclosures meaningless, provide information that in no way helps small business in evaluating the cost of factoring against other financing options and creates optics that incorrectly suggest Factoring is extremely expensive. As such, the disclosures provided by factors under the Proposed Regulations will put factors at a disadvantage, which would discourage borrowers from accessing this important source of capital (today used by over 1,000 CA businesses) and result in factors not providing factoring facilities in California. Below is a summary of the issues:

1) Second Row Disclosures - APR. Simply put, factoring facilities are the transfer of an account receivable to the financing provider for consideration. Regardless of when the customer pays the account receivable, the consideration paid will be a certain amount determined based on a discount applied to the face amount of the receivable. Although in many instances interest is not charged in this transaction, the Disclosure Requirements and the Proposed Regulations impose on the factor the requirement to artificially come up with an interest rate in order to calculate the APR. In such cases, the assumptions necessary to artificially create an APR disclosure will result in a percentage which will not accurately reflect the cost of the factoring facility provided to the small business while potentially creating a meaningless percentage which could be a multiple of the actual cost of the facility. This will result in an undue burden on the factor by inaccurately suggesting that the factoring facility is an expensive source of financing and therefore not a viable choice for the small business when, in fact, the factoring facility may be a better option than other financing alternatives. We suggest that the regulations for this row be modified to allow the factor to explain that no interest rate will be charged and therefore an APR is not applicable.

2) Third Row Disclosure – Finance Charge. This disclosure requires that all "finance charges" be disclosed with finance charges being defined under the regulations promulgated for the Federal Truth in Lending Act. Those regulations define finance charges as any fees and charges imposed by the provider as "an incident to or a condition of the extension of credit." This would include any documentation fees, initial due diligence fees and expenses and any other fees and expenses that come up on the closing of a factoring facility. To apply 100% of these fees to one hypothetical invoice and measure the APR based on that one invoice would skew the APR in a way that would be significantly disadvantageous to a provider and make the disclosure meaningless. We suggest that the provider be allowed to pro rate these fees based on a 12-month term and only include the portion that falls within the period of the hypothetical invoice.

3) Fourth Row Disclosure – Payments. As the source of funds to repay an account receivable that is subject to a factoring arrangement come from the customer to the small business, the provider of a factoring facility may not be looking to the small business to make any payments. As such, we strongly urge that this row simply be deleted for transactions where the provider is not looking to the small business to make any payments. Its inclusion creates confusion for small businesses as it introduces a concept that does not apply to factoring.

4) Sixth and Seventh Row Disclosure – Early Prepayment. This disclosure creates confusion for small business as factoring arrangements are generally not subject to early prepayment. Early payment by the small business does not generally occur as the funds used to pay the factor may come from payments made by the customer of the small business on the accounts receivable which is transferred to the factor pursuant to the factoring arrangement. In order

to avoid this confusion, we suggest that language be added to this row similar to the following: "A legally enforceable claim which has been transferred pursuant to this transaction may be transferred to the recipient upon the payment of an amount mutually agreeable (including any fees applicable thereto) between the recipient and provider."

ASSET-BASED LENDING

As with factoring, asset-based lending is a form of finance that has unique differences that cannot be uniformly compared to other sources of capital. Therefore, to avoid similarly discouraging this important source of funding we urge you to adopt the following changes.

1) First Row Assumptions. The Proposed Regulations suggest that the provider make the assumptions based on a hypothetical single lump sum draw on the credit facility and that no other advances will be made during the life of the facility. This is simply not in-line with reality and any calculations based on this assumption will result in presenting unhelpful information to the recipient, which will confuse the recipient rather than help them decide what facility is better suited to their needs. Since asset-based lending transactions are revolving, the small business and provider expect that the small business' continuing working capital needs will result in a loan to always be outstanding. Therefore, providers of asset-based transactions will underwrite the facility taking into account an average monthly outstanding principal balance. This amount will be based on the monthly liquidity needs of the small business and other information obtained from the small business by the provider. Calculating the disclosures using this "average monthly outstanding" calculation will result in more realistic and useful information to be disclosed to the recipient. Additionally, as drafted, the language requires that the provider assume a set amount of daily collections. This is also not in-line with reality as collections are generally "lumpy," meaning that there could be substantial collections on one day and no collections for many days to follow. Many businesses have a seasonal aspect and will have a substantial amount of payments from customers while they receive very little to no payments in other months. Using the average monthly outstanding balance simplifies the assumption and removes the need to make two arbitrary assumptions for the outstanding balance and daily collections.

2) Third and Fourth Row Disclosures. Similar to the comments above to the factoring disclosures, there are a number of fees and financing charges that may be charged on the initial closing date of the facility for due diligence, collateral examinations, appraisals and other matters which, if applied to one lump sum advance, would significantly skew the APR calculation. We strongly suggest that these fees and expenses be allowed to be annualized.

ASSET-BASED LENDING AND FACTORING

1. Please note that factoring facilities often provide for advances against other types of collateral of the borrower in addition to purchases of factored receivables. These additional elements are advances or loans against items of collateral and are not purchases of legally enforceable claims. Thus, the definition of "approved advance limit" in § 2057(a)(1) needs to be modified to account for this by adding the following at the end of the definition:

   "If the agreement also provides for the financer to pay different maximum advances for different categories of advance (such as advances secured by inventory or intellectual property), the approved advance limit shall also include in addition to the above the sum of the different maximum advances for each category of advance."

2. Related to the change proposed immediately above, a corresponding change needs to be made to § 2071(a)(3)(A)(iii). This subparagraph should be revised as follows (deleted language highlighted):

   "(iii) The parties to the factoring transaction agree in writing prior to execution of their agreement that at some point during the agreement, an amount exceeding $500,000 is reasonably expected to be advanced to the recipient ~~for legally enforceable claims that have not yet been paid~~."

3. The definition of "approved credit limit" in § 2057(a)(2) needs to be modified as follows (change occurring at the end of the definition):

   ". . . and advances with respect to one category of advance do not reduce the maximum advance for another category of advance, the approved credit limit means the sum of the different maximum advances for ~~different types of legally enforceable claims~~ [*added language follows*] each category of advance."

4. With respect to both factoring and asset-based lending transactions, the agreements are often structured so that the financer has the discretion to extend advances. The transactions are often not committed facilities. Thus it is incorrect to state that the financer is "required to pay" the advances. To account for discretionary advances, the definitions of "approved advance limit" in § 2057(a)(1) and "approved credit limit" in § 2057(a)(2) need to be modified by: (i) adding the parenthetical "(or has the discretion to pay)" after the phrase "required to pay", which phrase appears in each definition, and (ii) adding the parenthetical "(or the financer has the discretion to pay)" after the phrase "requires the financer to pay", which phrase appears in each definition.

5. As written, it is still unclear when §2057(a)(4)(A) applies. It could be read to apply to cover subsequent financings to the same recipient although it appears that it is not the intent. Subsequent financings are covered under §2057(a)(4)(B). To clarify this, §2057(a)(4)(A) should be revised as follows:

   "Except for the time described in subparagraph (a)(4)(B) below, the time when a specific amount, rate or price, in connection with a commercial financing, is quoted to a recipient, based on information from, or about, the recipient; and"

6. §2057(a)(20) should be revised by adding the following at the end of such subparagraph:

   ""Recipient" shall mean and be interpreted as to any recipient (considered the "first recipient") to include any other recipient that controls, is controlled by, or is under common control with the first recipient."

   Commercial financings are often provided to related recipients or co-recipients. The test as to whether the disclosure requirement applies should be at the aggregate level for recipients related by common ownership not at the individual recipient level. For example, assume the approved advance limit for one recipient is $550K and for a related recipient the approved advance limit is $200K. Under current rules, the first recipient would not need to be provided the disclosure but the second one would. The proposed change would eliminate the requirement for the second recipient, which is appropriate from a policy standpoint given the two recipients in this example are related by common ownership and the law already does

not require the disclosure for the recipient that has the larger approved advance limit. Thus the protections afforded by the disclosure are not needed for the second recipient.

7. There are factoring transactions that are "non-borrowing", meaning that the factor does not advance funds against factored receivables. There is no credit extension to the factoring client. For a small commission (a factoring fee), the factor simply purchases the receivables and assumes the credit risk thereon. If the receivable is unpaid by the account debtor due to the account debtor's financial inability to pay (i.e. credit risk) the factor absorbs the loss -- the factoring client does not. However no funds are advanced against the receivables in a non-borrowing factoring arrangement. It should be made clear that no disclosures are required to be made in non-borrowing factoring transactions. To address, this § 2071(a)(3)(B) should be revised as follows (added language underlined):

   "(B) If the factoring transaction does not meet all of the requirements listed in subparagraph (a)(3)(A) above, the commercial financing offer shall be considered less than or equal to $500,000<u>, except with respect to a factoring transaction where the approved advance limit is $0, in which case such commercial financing offer for such factoring transaction shall not be subject to these regulations</u>."

8. § 3010(a)(3) should be revised by adding the following phrase immediately after the term "face value" in the first line of such subparagraph: "(net of any available prompt payment discount, volume discount, cash discount, trade discount or other discount or rebate offered by the recipient to the account debtor)".

9. § 3021(a)(2) should be revised by adding the following term immediately after the phrase "up to and including" in the second line of such subparagraph: "a specified" and deleting "an".

10. § 3022(b) should be revised by adding the following term immediately after the phrase "up to and including a" in the second line of such subparagraph: "specified".

<u>BENCHMARK RATE</u>

LIBOR is expected to be sunset on December 31, 2021. While there is still ongoing discussion among industry participants as to LIBOR's replacement rate, it appears that the replacement rate will be some variation of the Secured Overnight Funding Rate (SOFR). Thus, the definition of "benchmark rate" in §2057(a)(5) should be revised by adding the following phrase within the parenthetical: "Secured Overnight Funding Rate (SOFR)".

<u>SAFE HARBOR</u>

Although this letter attempts to clarify many of the issues and challenges posed by the Proposed Regulations, both SFNet and its members continue to urge both the DBO and the California Legislature to provide, either through additional legislative action or by the enactment of regulations, a safe harbor for providers of commercial loans to small business which insulates the providers from liability (through litigation or otherwise) if they comply with the Disclosure Requirements in good faith. This would be very similar to safe harbors contained in the Federal Truth-In-Lending Act for consumer lending disclosures. Specifically see 15 U.S.C. § 1640(b) and 15 U.S.C. § 1640(c). The safe harbor is necessary because many of the providers of commercial loans to small businesses are small businesses themselves and can't absorb the cost of litigating against a plaintiff bar in California, which will see the Disclosure Requirements as creating a potential cause of action for

them and their clients. Once the plaintiff's bar becomes active in seeking damages from the providers of loans to small businesses, it will be a matter of time before many of the providers, which are small businesses themselves, go out of business, impacting the availability of credit to small businesses in California.

TREATMENT OF DEPOSITORY INSTITUTION AFFILIATES:

The Disclosure Requirements and Proposed Regulations continue to include any non-depository subsidiaries or affiliates and subject them to the Disclosure Requirements. Subsidiaries of depository institutions are generally not depository institutions themselves, but are regulated nevertheless. SFNet and its members strongly believe that depository institutions should be defined to include those affiliates and subsidiaries which are regulated and subject to regulatory oversight whether or not they are depository institutions.

The definition of "provider" in §2057(a)(19) should be revised by adding the following new clause (C):

"(C) A provider excludes: (i) any financial or bank holding company doing business under the authority of, or in accordance with, an approval issued by the United States, or (ii) any wholly-owned subsidiary of the foregoing or of a depository institution, that in each case is authorized to transact business in this state."

Please note this exclusion only applies to 100% owned subsidiaries and affiliates of bank holding companies or depository institutions. These entities are highly regulated by a number of different federal banking supervisors and agencies, including the FRB, the OCC, the FDIC and the CFPB. The "wholly-owned" requirement ensures that only highly regulated affiliates are excluded. Lesser-owned affiliates, who are not highly regulated and thus from a policy standpoint should not be excluded, are not excluded.

ECONOMIC IMPACT

To quantify the impacts that we suggest may occur above, SFNet polled its members as to how they would adjust their lending practices in California, if at all, in response to the enactment of the Proposed Regulations. Many of the members found the Proposed Regulations very confusing and difficult to comply with. 56% indicated they would only engage in deals over $500,000 in California. 12.5% of those that responded stated that they would cease lending in California and 12.5% said that they would curtail their lending in California. This suggests that there will be a material limitation on the availability of factoring and asset-based credit facilities to small businesses in the state if a simplified compliance process isn't set forth for these providers to comply with the Disclosure Requirements.

Additionally, as stated above, if the Proposed Regulations result in artificially inflating the cost of factoring and asset-based lending facilities in the state of California, many small businesses may choose financing sources which are, in fact, more costly and avoid factoring and asset-based facilities to their detriment. This will have the opposite result of the stated policy behind the enactment of the Disclosure Requirements.

We hope that our comments above are helpful in crafting the final regulations with respect to the Disclosure Requirements and are happy to discuss the above issues with you at any time.

Sincerely,

Richard Gumbrecht
Chief Executive Officer
Secured Finance Network