January 22, 2019

**By Electronic Mail - regulations@dbo.ca.gov**

California Department of Business Oversight, Legal Division
Attn: Mark Dyer, Regulations Coordinator
1515 K St., Ste. 200
Sacramento, CA 95814-4052

Re: Comments on Proposed Rulemaking
Commercial Financing Disclosures (PRO 01-18)

To Whom It May Concern:

On behalf of Strategic Funding Source, Inc., now doing business as Kapitus, Inc. (Kapitus) we would like to thank the Department of Business Oversight (DBO) for its effort to work with stakeholders on commercial financing disclosures. Thank you also for this opportunity to provide the following comments on the proposed rulemaking implementation of SB 1235.

**Background**

Kapitus is a financing company dedicated to providing capital to small businesses through technology-enabled underwriting. We provide small businesses across the country with efficient and swift access to financing, often providing funds within 72 hours. We work with small businesses to help them grow and succeed by providing access to capital using automated processes to speed underwriting, while retaining a human element in the process to assess the creditworthiness of the small business, the likelihood that the business will repay its obligations, and the possibility of fraud. Our financing agreements with merchants are commonly repaid in months versus years and are used by businesses for a variety of purposes, including payroll, inventory, materials, and equipment. Our goal is to get every business the financing it needs, when and how it is needed. In California, we currently offer two primary financing products directly, as described below, but have relationships with other sources of capital, including factoring companies, equipment financing companies, and SBA small business lenders to offer a wider range of financing products to our customers.

*Loans*

Kapitus holds a CFL license in California and originates loans under this license. Our loans specify a loan amount, an interest amount, a total repayment amount, and a specified daily or weekly repayment amount based on the revenue generated by the business on a periodic basis. The loan agreement also has a term amount, which can range from months to over a year. This loan requires a personal guarantee of payment as well as performance. Importantly, the loan specifies a fixed finance charge expressed as the interest amount. This charge is set at the beginning of the loan and noted as a set dollar amount on the front page of the loan document, and therefore does not change or compound throughout the life of the loan. There are no penalties for prepayment, and other than a default fee and a returned check fee, no default interest rate.

*Purchase of Future Account Receivables*

In California, Kapitus also enters into contracts in which it purchases future account receivables. These agreements are not loans, but rather are a sale of a portion of the small businesses' future receipts. While these agreements specify a borrowed amount and a total repayment amount, they do not have a set repayment term. The daily or weekly payments on these contracts can fluctuate, either because they are tied to a percentage of the businesses' receipts, or because the merchant has the ability to request a change in the specified periodic payment amount that represents an estimate of the receipts generated. These agreements also do not include personal guarantee of re-payment from the business owner. They only include a guarantee of performance that, in essence, requires the owner not to interfere with the collection of the receipts purchased by, for example, diverting receipts to an alternate bank account. In the event a business closes, and does not breach the agreement, the owner is not responsible for paying the remaining balance on the agreement.

**Specific Comments and Recommendations**

Kapitus offers the following comments and recommendations, based on the questions asked by the DBO.

*Estimated Term Disclosures*

Any agreements where payments are based on a percentage of the daily or weekly receipts of a merchant will never have a set repayment term. So those agreements (whether they are merchant cash advances or factoring agreements) will require an estimated term. And, as noted above, most of these agreements are repaid in months and not years. Therefore, we believe that the DBO should conduct research into how companies like Kapitus should determine the estimated term, rather than simply setting it at an arbitrary period such as one year.

*Method, Frequency, and Amount of Payments*

Both the loans and factoring agreements issued by Kapitus in California specifically note the method and frequency of payments. We work with small businesses to find the financing agreement that is most suitable for their business. Therefore, we have a number of different methods of financing, and offer daily and weekly payments. But this information is always located on the contracts.

As for payment amounts, this is always noted in our contracts as either a specific dollar amount, or as a percentage of daily or weekly income. We advocate that specific payment dollar amounts not be required for all methods of financing, as this is not feasible in factoring agreements and any agreement where the payments are variable. With respect to such agreements, the percentage of income used to calculate the payment should be stated.

Finally, for factoring agreements, Kapitus recommends that the difference between the purchase price and the expected total payment price be disclosed, as well as any charges or fees associated with the transaction that cannot be avoided, such as origination fees or the equivalent. The question of what fees should be disclosed is discussed more fully in the section on fees, below.

*Annualized Rate*

Kapitus generally advocates for an annualized rate that is transparent, consistent, and easy for both lenders and borrowers to calculate and verify. For its California loans that have a fixed payment amount and a fixed term, Kapitus believes that the Annualized Cost of Capital (ACC) - in essence a simple interest calculation - meets these criteria, and Kapitus supported its inclusion in SB 1235. As noted in the DBO's request for comments, the ACC is a very simple calculation that can be performed by both borrowers and lenders based on the information that is required to be disclosed. The Annual Percentage Rate (APR) calculation, on the other hand, has a number of drawbacks for both loans and factoring agreements, especially when using the definitions under Regulation Z of the Truth in Lending Act (TILA).

First, Regulation Z does not contemplate a daily payment schedule. Some merchants are open on weekends and holidays (e.g., restaurants) and others are closed (e.g., dental offices). As a result, a contract with identical terms would have different APRs based on the type of small businesses that is being financed.

Second, Regulation Z does not contemplate the existence of agreements that may never be paid off. As noted above, the factoring agreements offered by Kapitus are based on a percentage of daily or weekly income. These agreements only have a personal guarantee of performance, and not a guarantee of payment. If the small business closes, and does not breach its agreement with Kapitus, neither the business nor the owner will be held responsible for repaying the balance of the agreement. It is entirely possible that the full amount of financing will never be paid, or paid over a long period of time, both of which can drastically change the annualized rate of financing.

Third, APR is biased toward longer-term loans. Commercial lending is fundamentally different than consumer lending. Commercial loans are mainly used for purposes that will result in a return to the business, such as purchasing inventory and equipment, or covering payroll. These are primarily short-term situations where the merchant desires to pay off the funding as quickly as possible as it realizes a return on the capital it is investing. This is diametrically opposed to a consumer loan, where many borrowers prefer to spread payments over as long a period of time as possible (e.g., a 30-year mortgage opposed to a 15-year mortgage). In addition, for contracts based on a percentage of receipts, the receipts may fluctuate over time or seasonally (e.g., a business in a community with a large amount of tourism). As the APR can change substantially depending on the term of the financing, Kapitus is concerned that merchants will be steered into longer term financing, with a higher overall cost spread over a longer period of time, which may in fact be detrimental to their business interests.

Fourth, some APR calculations compound interest. The loan and factoring agreements entered into by Kapitus have a fixed financing amount calculated at the beginning of the contract, which never changes. Because Kapitus only charges a fixed finance fee, and does not charge an interest rate, this fixed financing amount will stay constant whether the merchant takes two months or two years to pay off the financing. The effective interest rate of these transactions can only be accurately calculated after the obligation has been repaid or finally charged off. Kapitus therefore urges the DBO to allow for the use of simple interest calculations instead of mandating a formula with compound interest.

Fifth, as noted below, Kapitus offers a prepayment discount on loans and factoring agreements. The ability for a merchant to pay off a contract early, and receive a discount for doing so, will impact the chances that any stated term or rate (whether estimated or actual) will accurately correlate to the performance of the contract. Kapitus recommends that the DBO study the usefulness of including annualized rates on agreements with prepayment discounts.

Finally, we believe that any contract where the term is unknown and the payments are variable would, by definition, not fit squarely into either APR or ACC. This would likely lead to confusion on behalf of the merchants with which Kapitus enters into contracts. Kapitus recommends the DBO draft or allow for language on contracts where estimated terms are required, to make clear that the annualized rates are theoretical and may not correspond to the actual amount. For this reason as well, the estimated term must be clarified by DBO in order to avoid unscrupulous actors estimating a longer term for repayment in order to drive APR calculations down.

*Fees and Charges*

Kapitus recommends that the DBO draft specific guidance on what fees and charges should be included in the financing calculations. This guidance should include clear definitions of each specific fee, as well as instructions on how to calculate each fee. APR calculation requirements under TILA require the inclusion of a defined set of fees. Without a specific list of what fees are included and how these fees are defined and calculated, it will be impossible for commercial financing companies to calculate an annualized rate of financing using APR.

*Standardized Estimated Terms and Rates*

Kapitus recommends that the DBO promulgate regulations that standardize the methodology for calculating estimated terms and annualized rates, and not allow rates to be set based on each company's internal underwriting criteria. Kapitus supports terms and an annualized rate that are transparent and easily calculated by both parties to the transaction. We believe that terms and an annualized rate that are calculated based on company-specific systems do not advance these objectives. Calculations that are individualized by each company (or by each contract) are likely to cause confusion on the part of the merchant, as they will have no way to independently calculate and verify the assumptions or the estimated terms and rates.

*Explanatory and Qualifying Language*

Kapitus recommends that explanatory and qualifying language be required for any annualized rate calculation. This language should make clear what information is included, and how the annualized rates are calculated. For contracts using estimated information, Kapitus recommends that the DBO draft standard language noting that the numbers provided are for informational purposes only and that the actual numbers may vary significantly based on the performance of the contract.

*Disclosures in Contracts by Using Example Transactions*

Kapitus believes that example transactions will need to be used for factoring agreements, and the formatting and terms should be standardized by the DBO. This will allow information to be easily compared across contracts and across companies and will allow a borrower to easily decide between different financing options and terms.

*Tolerances*

Kapitus recommends that tolerances for calculations be set to account for the various types of financing covered by SB 1235. Factoring agreements have traditionally not been subject to the disclosure of an annualized rate of financing and will certainly need to make assumptions and estimates in calculating this rate. In addition, as noted above, requiring information to be tailored to individual contracts using underwriting assumptions is prone to error, and any tolerances should take this into account.

*Prepayment Policies*

Kapitus does not charge a penalty or fee for prepayment of fixed-payment contracts. In fact, Kapitus gives a discount for prepayment. Kapitus does put restrictions regarding when the prepayment discount applies, so that small businesses do not get a discount for rapidly switching their obligations between different funding companies.

As noted above, Kapitus recommends that the DBO draft specific guidance on whether and how to include any possible prepayment discount into the calculations and disclosures required by SB 1235, and research whether it is useful to include an annualized rate on a contract with a prepayment discount. Any prepayment discount (or, although not applicable to Kapitus, prepayment penalty) will affect the chances that a loan or agreement will remain in effect until the full amount is paid off. This will impact estimated terms and annualized rates.

*Liability*

Kapitus is concerned about the potential for litigation in the event the requirements of SB 1235 are satisfied through example transactions, and it is later found that, due to the variables involved, the examples were significantly different than the actual cost of the financing. Kapitus urges that the DBO add regulations to allow companies to consult with the DBO regarding disclosures, gain approval of the methods being used to comply with DBO's regulations, and then be protected from private lawsuits as long as they comply with these methods.

****

Kapitus supports contract disclosures that provide merchants the ability to compare different products. We believe that these disclosures should be clear, consistent, and not subject to manipulation based on technical differences and ambiguities.

We have enclosed the current templates for our loan and factoring agreements for the state of California, per your request. Again, we would like to thank the Department of Business Oversight for taking the time to receive and review our comments. We look forward to working with you on the proposed rulemaking implementation of SB 1235. If you have any questions or need additional information, please contact me or M. Jesse Carlson, our General Counsel.

Sincerely,

Kyra Grundeman
Deputy General Counsel

Cc: Charles.carriere@dbo.ca.gov

Enclosures