Submitted by Electronic mail to: regulations@dbo.ca.gov and charles.carriere@dbo.ca.gov

Department of Business Oversight, Legal Division
Attn: Mark Dyer, Regulations Coordinator
1515 K Street, Suite 200
Sacramento, CA 95814-4052

Re: File No.: PRO 01-18 – Invitation for Comments on Proposed Rulemaking for Commercial Financing Disclosures ("Invitation")

Dear Commissioner Owen,

Small Business Financial Services, LLC dba RapidAdvance ("RapidAdvance") would like to thank the Department of Business Oversight ("DBO") for reaching out to stakeholders and inviting them to provide input on the above referenced rulemaking. RapidAdvance appreciates that the DBO invited industry participants ("Providers") to submit their thoughts and comments.

In this letter, we address each of the topics and questions you list in your Invitation. However, before doing so, we thought it would be helpful to address some broad topics about RapidAdvance and the industry and to also comment on the evolution of the use of the Annual Percentage Rate ("APR") in financing disclosures.

I. OVERVIEW

RapidAdvance provides working capital to small businesses throughout the United States and operates as a licensed Finance Lender in California. RapidAdvance and its affiliates have been providing funding to small businesses for more than a decade and many of our customers have grown to become thriving businesses. Our financing products include merchant cash advances ("MCAs") and business loans. MCAs allow small retail businesses to sell their future card sales in exchange for immediate working capital (the transaction is a purchase and sale rather than a loan).[1] Our small business loan is similar to a traditional commercial loan with two primary

[1] Note that this is the only MCA product offered by RapidAdvance (*e.g.* a purchase of a percent of a business' daily credit card receivables) and we refer to this as a traditional MCA. Others in the industry offer another MCA product in which a percent of the business' daily gross revenue is purchased and we refer to this as a gross revenue MCA. In both cases, the Provider is purchasing a revenue stream similar to traditional factoring transactions (traditional factors purchase payment obligations owed by customers to the business and traditional MCAs purchase payment obligations owed by card acquiring banks to the business).

differences. First, the borrower makes payments on a daily or weekly basis rather than monthly. Second, our loans charge a fixed fee rather than an interest rate. A fixed fee allows our customers to easily determine the actual dollar amount the loan will cost and the more frequent payment schedule ensures the business is not overwhelmed by large monthly payments. Our underwriting model allows us to fund businesses that traditional lenders turn away and permits us to offer financing solutions to businesses whose growth is constrained by their ability to access capital.

The customers that use our financing products include almost every type of small and medium sized business in America. Our customers' annual revenue generally ranges from $250,000 to $4,000,000. The average funding we provide is about $50,000. Approximately 90% of our customers are limited liability companies or corporations. The online small business finance industry now originates more than $15 billion annually and the overwhelming majority of small businesses that have obtained financing from industry participants prefer our products and process over traditional financing sources.

In connection with SB 1235, there has been much discussion about the need for mandatory cost disclosures with the core of the debate centering on an annualized rate disclosure. Basic requirements of contract law require that financing companies disclose the funds the business will receive (total amount of funds provided); what they will pay back (not required in SB 1235 but clearly should be added); method, frequency and amount of payments; the prepayment policy; and for products with a term, the duration. All of these terms are required in order for the financing contract to be enforceable. Without these terms being agreed to in writing between the Provider and small business, the Provider would not be able to enforce the terms under basic contract law. Moreover, if Providers fail to provide these disclosures, it would be difficult for them to obtain customers as these are the core terms small business owners use to negotiate financing arrangements. So while there may be some debate about the details of these disclosures and the format in which they are provided, every industry participant is in agreement that these are the core terms that businesses expect to see when applying for financing. In fact, this was exactly what occurred when SB 1235 was being drafted – most industry participants agreed these terms were valuable, helpful and necessary. Creating uniformity around how these terms are communicated will help businesses compare products and enable them to make faster and informed decisions.

The disclosure item that caused the most debate during the enactment of SB 1235 was the annualized rate metric. The original version of the bill included APR, but then a revised version replaced APR with Annualized Cost of Capital ("ACC") and the final bill simply requests the DBO to determine the appropriate annualized rate disclosure. During the legislative process and at the DBO's introductory meeting on November 29, 2018, some erroneous statements were made by industry participants indicating a high degree of confusion and misinformation regarding the value of APR disclosures. In order to make a reasonable determination as to whether APR should be the annualized rate metric used, we believe the evolution of APR disclosures should be understood. SB 1235 is the first law in the country that requires cost disclosures for small business financing products and may serve as a model for other states to adopt similar laws. Accordingly, we do not think disclosure metrics should be adopted simply based on anecdotal evidence of what may or

may not be helpful to small businesses. Rather, we believe DBO should thoroughly investigate which annualized disclosure provides the most value to small businesses, is easily understood and assists in comparison shopping. Importantly, that investigation should include input from randomly selected small business owners who have actually used these products to grow and manage their business finances. Thus far very little of the discussion has been driven by small business owners who have obtained our products. Rather, it has been driven by various groups of capital providers, with the lower cost providers arguing for more disclosure and the higher cost providers arguing for less disclosure.

II. ANNUAL PERCENTAGE RATE

The APR is a measure of the cost of credit created by Congress as part of the adoption of the Truth in Lending Act ("TILA") in 1968. It was created for the specific purpose of helping consumers compare the cost of credit for lending products with different terms. It was not intended to apply to commercial loans and the APR calculation by definition is limited only to consumer transactions. When the APR was first adopted in 1968, there was a debate about whether it should apply to commercial transactions. Congress concluded it should not and this view has not changed since 1968. Since the original creation of APR, Congress and the applicable federal regulators have often considered whether TILA and/or the APR disclosures should be expanded to apply to commercial transactions but they have refused to do so. Most recently, in 2010 the Federal Reserve Board studied this issue and concluded that TILA's disclosure provisions should not be expanded to apply to small business credit cards as it was not clear if the benefits would outweigh the costs.

Not only have the applicable federal regulators refused to expand the use of APR to small business financing, they have reduced the importance of APR in consumer transactions and in some cases stopped requiring certain APR disclosures for consumer transactions. For example, in 2009, the Federal Reserve Board ("Board") underwent a review of the credit card disclosure rules (or the open-end, non-mortgage disclosure rules) required under TILA (74 Fed. Reg. 5244 (Jan. 29, 2009)). After extensive consumer testing related to credit cost disclosures, the Board adopted new disclosure requirements that eliminated the effective APR as a measure of cost of credit for unsecured open-end credit due to the confusion consumers exhibited when asked to explain what it meant. Before those rules became effective, Congress enacted additional substantive protections for credit card accounts (referred to as the CARD Act) and in adopting rules to implement those new statutory protections, the Board *readopted* the rules that eliminated the effective APR. They replaced the effective APR disclosure with an annualized simple rate and a separate dollar disclosure of fees. In adopting this rule, the Board rejected numerous comments from consumer advocates arguing that the effective APR was a critical disclosure for consumers to understand the cost of credit. In rejecting the consumer advocates' arguments to maintain the effective APR, the Board stated, "Most consumers do not understand the effective APR, and that for some consumers the effective APR is confusing and detracts from the effectiveness of other disclosures." It should be noted that when the Board started this review, it specifically contemplated two possible approaches. First, was to spend resources to educate consumers so they better understand the effective APR and to help creditors to better understand how to calculate the APR. Second, was to remove the effective APR disclosure all together. (*See:* 72 Fed. Reg. 32955 (June 14, 2007). In

choosing to proceed with the second option, the Board determined that an annualized rate disclosure that included all fees was not valuable to consumers. Prior to this, in an open-end credit product (such as a credit card), TILA required two types of APR disclosures – the corresponding APR and the effective APR. The corresponding APR simply discloses the rate that *will be* assessed and does not include fees and other charges (functionally equivalent to a simple interest rate disclosure). The effective APR was a disclosure required each month that reflected the actual rate *that was* assessed on the outstanding balance for that month and included all finance charge fees imposed that month (it was the total cost of the plan for that month as it included all fixed finance charge fees assessed that month as well as all fees imposed as a result of the application of a periodic rate or interest rate). The corresponding APR was always lower than the effective APR anytime the open-end plan was used and any finance charge fees were imposed. Consumer advocates argued that the effective APR was the true representation of the cost of the credit and must remain as a required disclosure so that consumers can better compare credit and understand the true costs of credit. The view of consumer advocates was that the corresponding APR was insufficient as it did not include fees, was merely a projection of what the simple interest rate would be and did not reflect the true cost of credit charged for any applicable month (they wanted the higher rate (effective APR) to be disclosed and not the lower rate (corresponding APR)). The Board rejected these arguments and made disclosure of the effective APR optional. This decision permitted credit card issuers to disclose only a corresponding APR (a lower APR that according to consumer advocates did not reflect the actual cost of credit). So in effect, the Board concluded that with respect to credit cards the interest rate disclosure has some value to consumers but the APR as traditionally thought of (inclusive of fees) does not.

Despite the focus group studies and overwhelming research concluding that the APR is confusing and detracts from other disclosures, consumer advocates continued to argue that APR is the most important cost disclosure for consumers when comparing credit. However, the federal regulators continue to reject this premise based on the results of additional studies. In 2013, the Consumer Financial Protection Bureau ("CFPB") conducted what is believed to be the largest study ever done on the topic in connection with the issuance of its Integrated Mortgage Disclosure rules (78 Fed. Reg. 79730 (Dec. 31, 2013)). The results of the study led the CFPB to conclude that the APR is not used by most consumers and is confusing. As a result, when the new disclosures were adopted for mortgage lending (commonly referred to as TRID), the CFPB decided to move the APR disclosure to the back of the disclosure forms and make it less conspicuous. This move was significant as TILA has always required the APR to be more clear and conspicuous than other disclosures and the CFPB used its authority to simply change this with no Congressional action. In doing so, the CFPB stated, ". . . consumer testing and historical research indicate that consumers do not understand the APR and do not use it when shopping for a loan. Highlighting the APR on the disclosure form contributes to overall consumer confusion and information overload, complicates the mortgage lending process, and hinders consumers' ability to understand important loan terms."

The conclusion by the CFPB makes it clear that APR has much less value than advocates claim. Various quotes by the CFPB throughout the TRID rulemaking process make it clear beyond dispute that the APR is confusing, is not used by consumers to compare products (at least in the

mortgage industry) and has limited usefulness. Below is a list of various quotes by the CFPB taken directly from the rulemaking for the TRID disclosures:

> "[T]he APR is limited in its usefulness as a measure of the cost of credit."
>
> "Prior studies conducted by other Federal agencies as well as consumer testing conducted by the [CFPB], however, indicate that consumers do not really understand . . . APR . . . ."
>
> "[C]oncerns have been raised repeatedly over the last two decades that consumers are confused by what the APR represents and do not use it for its intended purpose: to compare loans."
>
> "[The CFPB's] consumer testing similarly indicates consumer confusion regarding the APR disclosure and that consumers do not use the APR when comparing loans."
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> "[I]n light of consumer confusion over the APR and the fact that consumers do not appear to use the APR in comparing loan offers, the [CFPB removed the requirement] that the annual percentage rate disclosure be more conspicuous than other disclosures . . . ."
>
> "[C]onsumer testing conducted by the [Federal Reserve Board and CFPB], and comments received by the [CFPB] consistently indicate consumer confusion over the APR."

Given that the express purpose of creating the APR was to assist consumers in comparing the costs of credit, the fact that the CFPB has concluded that the APR is not used for that purpose is a material finding. In fact, even Congress recognizes the APR is insufficient and does not serve its intended purpose. The Dodd-Frank Act amended TILA to require a new rate disclosure - the Total Interest Percentage ("TIP"), which is simply the total amount of interest that the consumer will pay over the life of the loan expressed as a percentage (*e.g.,* a $100,000 mortgage loan with $50,000 of interest over the life of the loan would have a TIP of 50%). *See* Dodd-Frank Wall Street Reform and Consumer Protection Act sec. 1419(19). The CFPB issued implementing regulations for this new rate disclosure as part of the TRID rules. The TIP disclosure is an attempt to provide information to consumers that is more useful than APR, easier to understand and easier for creditors to calculate.

Potentially causing further confusion as to the use and/or reliability of the APR, the CFPB is also considering amending the manner in which the APR is calculated for mortgage loans by changing what types of fees are included in the definition of finance charge. The goal is to make APR easier to understand and easier to calculate. The CFPB considered doing this as part of the TRID rules but did not proceed given the magnitude of such a change. However, the CFPB did state it plans to study the issue and address changes to the APR calculation and finance charge definition when it reviews the TRID rules in the next 2-3 years.

With the above factual record explaining the shortcomings of APR and the fact APR is not used to compare the cost of credit, it is possible to better respond to the various inaccurate statements made by those arguing APR is the only annualized disclosure that should be considered for small business financing products. Below are the two key arguments that were made by advocates of APR in connection with SB 1235 followed by a brief response for each:

1. Small businesses use credit cards and mortgages to finance their businesses and will use the APR to compare those products with other small business financing options.

   As explained above, credit cards no longer require a true APR disclosure (only an APR disclosure that is equivalent to a simple interest rate is required). Accordingly, the comparison of a credit card APR to a closed-end commercial loan APR (assuming it is adopted from the TILA closed-end APR rules) will simply cause even more confusion as the two APRs will not be calculated the same (it will not be an apples to apples comparison as the required open-end APR disclosure does not include non-rate fees but the required closed-end APR does). Also as explained above, the APR for mortgage loans has been moved to the back page of disclosures, made less conspicuous and has been complimented with a new rate disclosure – the TIP. However, even more important is the fact the CFPB has concluded that consumers simply do not use the APR for comparison shopping. Therefore, there is simply no evidence that small business owners want or will use APR to compare credit cards, mortgages and small business loans when considering how to finance their businesses. This fact and the confusion surrounding the usefulness of the APR makes it clear that there is limited value in requiring APR disclosures for commercial financing products. In fact, based on the studies commissioned by of the Federal Reserve Board and the CFPB, requiring an APR disclosure is certain to create confusion in the small business financing marketplace.

2. Creating a new disclosure like Annualized Cost of Capital ("ACC") will be confusing.

   The counterpoint to this argument is that the APR itself is confusing. Adopting a new rate disclosure would be a good thing given that APR is not used for comparison purposes and is confusing. This is the exact reason Congress required TIP – a new rate disclosure for mortgages that was easier to understand and calculate than APR. The ACC is in fact simply a version of TIP (uses the same basic math (total fees/interest divided by principal) but then annualizes the rate, which TIP does not do).

When researching the annualized rate issue and deciding what rate disclosure should be required, we would also suggest DBO consider these additional broad issues:

1. Requiring any accruing rate disclosure (like simple interest rate or APR) for fixed fee loan products or non-loan products (MCAs, factoring, etc.) will be misleading as the fixed fee loan products have no accruing rate. A fixed cost product that is not paid back during the originally agreed upon or estimated term, does not continue to accrue fees or charges. So the longer it takes to pay back, the cheaper the transaction becomes (unlike a traditional loan where an accruing rate is charged for as long as a balance is outstanding). Disclosing a rate for fixed cost products will simply cause the customer to incorrectly believe a rate is applied to a balance and will be applied for as long as any balance is outstanding.

2. APR is a complicated mathematical calculation. APR is a mathematical calculation under TILA that has various elements and is calculated differently for open end loans, mortgage loans and closed end loans. The rules for its calculation are very specific and take up numerous pages in the Code of Federal Regulations. Given the mathematical precision required for the formula, it is very difficult to calculate for most products. While many people will refer to an APR as being easy to calculate and can be done using a spreadsheet, that is simply not true. Typically, those who do this are calculating a rate of return or simple interest yield and not the much more complicated APR. In fact, various APR calculators produce conflicting results for anything other than the standard fixed rate, closed end, monthly payment products. These calculators fail to account for the nuances in the APR calculation and the complications created by variable payment, variable rate or variable term products. These problems are material in the consumer loan industry as a disclosed rate that varies by more than .5% can create significant liability for lenders based on the limited tolerance levels permitted under TILA for misstated APRs.

3. APR or an annualized rate similar to APR will be even more confusing in the business financing industry as payment terms are so unique. APR can be misleading for many of the more innovative products that provide more frequent payments or unique repayment features. For example, two products with identical pricing and terms will have different APRs if one is a monthly pay product and one is a daily pay product. In fact, a monthly product can be materially more expensive on a dollar basis than a daily pay product but still have a lower APR. This can lead a small business to believe a product is cheaper when in fact the product is more expensive. (See Appendix A for examples of comparison of daily and monthly pay product APRs).

4. While there are numerous differences between consumer financing transactions and commercial financing transactions, the main difference is the underlying purpose. Consumers obtain financing to purchase items for lifestyle needs or desires. Small businesses obtain financing to grow their business and make more money. So for small business financing transactions the total dollar cost is the most important disclosure as

that can be compared to the expected business benefit to calculate the monetary return to the business. If a small business can obtain financing and the cost is $3,000 but they can use the money to make $9,000 in additional profit that is what is most important. Creating any disclosure regime that may make it harder to understand the actual dollar cost of a financing transaction should be avoided. Requiring an annualized rate disclosure that is more conspicuous than the total dollar cost will simply hurt small businesses and frustrate the purpose of SB 1235. Also, requiring a rate disclosure that makes a product appear less expensive compared to another product when in fact the dollar cost of that product is more expensive will cause confusion (see Appendix A for an example of how this could occur).

5. If the DBO adopts an annualized metric that accounts for the declining balance (like APR does), the rate calculations must address how to handle daily payment transactions and variable payment transactions. However, TILA and its implementing regulations never envisioned daily pay products and do not provide guidance on how to address the issues created by these types of products. Daily payment transactions create issues for such calculations as payments may or may not be required on weekends or holidays. Current APR guidance under TILA does not expressly address how to handle the unique issues raised by variable amount and daily payment transactions. For example, a transaction with the exact same terms originated on different dates may have different APRs as the number of weekends and/or holidays may be different based on the origination date of each transaction. This issue is further complicated as different Providers make different payment assumptions (some assume there are 20 payment days each month and some assume there are 22 payment days each month). A further complication is presented by the fact that a Provider may assume payments do not even occur every business day (might assume every other day or only 15 varying days per month). All of these issues must be addressed by specific guidance if APR is the required disclosure given the mathematical certainty required by the APR.

6. Requiring an annualized rate disclosure typically used for loans (like simple interest rate or APR) to be used for non-loan products (MCAs, factoring, etc.) will create massive confusion. For variable payment products such as MCAs, Providers must disclose the percentage rate of the daily receivables the small business must deliver to the Provider each day. In order for the agreement to be enforceable under basic contract law, that rate must be included in the contract. If an APR or similar rate is also required to be disclosed, small business owners will be confused. For the percentage rate of daily receivables, the disclosure might be 9% but the APR might be 40%. The small business will be confused as to which rate reflects the cost of the financing and in the end will simply ignore both of them (which the CFPB acknowledges has happened in the mortgage industry – APRs are simply ignored by most consumers).

7. The above issues are made more complicated given annualize rate disclosures have never been imposed on consumer purchase and sale transactions. It is impossible to calculate even an implied rate for purchase and sale transactions because there is no fixed term or accruing rate. Because purchase transactions do not require specific amounts to be paid at a designated frequency, the term for these products cannot be calculated until after the transaction has concluded. Without a known term, only an estimated term and rate can be provided, which means the annualized rate and term disclosed will be, by definition, incorrect and misleading. For this reason, no state or federal law has ever required an annualized rate disclosure for these products – consumer or commercial. For example, TILA does not apply to purchase and sale transactions with consumers. Rather, it applies only to loans, lines of credit and retail installment financing. Accordingly, TILA does not apply to transactions with consumers when they sell something for a lump sum such as lottery winnings, inheritance proceeds, litigation proceeds, etc. APR or other rate disclosures are not required in any of these transactions because implying a rate disclosure on a purchase transaction is confusing and unwarranted. For these types of consumer transactions, many states have taken action and provided their own disclosure regimes that do not artificially treat purchase transactions as loans but recognize them for what they are under the law and require appropriate disclosures. *See e.g.*, Cal. Prob. Code sec. 11604.5 (law regulating the sale of inheritance proceeds where no rate is required but other disclosures are required). Even the federal Equal Credit Opportunity Act respects the distinction between financing transactions and purchase and sale transactions. *See* 12 CFR 1002.9(a)(3) – Comment 3 ("Factoring refers to purchase of accounts receivable, and thus is not subject to [ECOA or regulation B]."

8. Given the fact that APR is confusing and not used for comparison shopping and that purchase and sale transactions do not have rates or terms, we believe the DBO should adopt a new rate and not use APR. If a rate is required for commercial financing products, the required rate must be easier to calculate than APR and be less confusing than APR. We believe the ACC is a good starting point. A rate more easily understood and calculated is preferable to APR as it will make comparison shopping easier and will be more likely to be used for its intended purpose – to compare product costs.

We are happy to meet with the DBO to discuss the above issues in an effort to formulate a resolution. Our current thought is the best thing to do is to design some disclosure forms and then work with a research firm, preferably one that is familiar with the issues discussed above, to conduct testing and statistically determine what form and disclosures make the most sense to small businesses. Whenever federal regulators impose new disclosure requirements, they complete a study to make sure the required disclosures make sense and serve the intended purpose. More

often than not, the federal regulators use Kleimann Communications Group, Inc. When the CFPB undertook the redesign of mortgage disclosures as part of the TRID rules, they noted that Kleimann has been hired by numerous other Federal agencies to perform similar design and qualitative testing work in connection with other financial disclosure forms (*e.g.* the FTC and bank agencies for model privacy disclosures and HUD for RESPA disclosures).

Thank you for permitting us to summarize some of the history of APR and to explain the broad issues raised by APR as well as outline much of the misinformation that has been used to argue APR should be used as part of SB 1235. Below we move on to address the specific questions raised in your Invitation.

III. INVITATION REQUESTS

A. Definitions

We believe a disclosure should be added for the total payback amount, which then would require the phrase to be defined. Of all the numerical values SB 1235 requires to be disclosed, it fails to require disclosure of arguably the most important amount – the total payback amount. This amount tells the customer what their total legal obligation is and also permits them to verify the other calculations. Without this disclosure, it is impossible to confirm the other items are properly calculated. In fact, for consumer transactions, the payback amount (called the "Total of Payments" under TILA and described as the amount the customer will have paid when they have made all scheduled payments.") is one of the key disclosures.

We also believe the following definitions provided in SB1235 are incomplete and should be clarified:

1. 22800(a) and (k) "Account" and "Payment Intangible" – These terms are terms of art under the Uniform Commercial Code ("UCC"). The UCC has extensive commentary and a long history of case law addressing these definitions. We suggest these definitions be amended to simply incorporate the relevant provisions from the UCC in order to gain the clarity from the UCC commentary and the long history of case law addressing these terms.

2. 22800(c) "Asset Based Lending Transaction" – This definition is contrary to the common usage of this phase. Asset based lending is almost universally used to describe a transaction where a lender loans money to a borrower based on the value of an asset or assets of the borrower. In the consumer world, mortgages and auto loans are common asset based lending transactions. In the small business world, asset based loans are often based on inventory or other assets. The key element for an asset based loan is simply that there is some asset that the lender loans against and expects to repossess if the borrower defaults. However, the definition in SB 1235 applies only to "transaction[s] in which

advances are made from time to time contingent on a recipient forwarding payments received from one or more third parties . . . ." In fact, many asset based lending transactions have nothing to with payments being received from third parties. It appears this definition is confusing asset based lending transactions and traditional factoring transactions. In traditional factoring transactions, payments are received by third parties but there is often no asset securing the transactions. Virtually every factoring transaction is a purchase and sale and is not a lending transaction so even the title to the definition (asset based lending transaction) will create confusion. We suggest any regulations clarify these mistakes and make it clear as to what transactions are covered. Because SB 1235 is intended to cover all type of transactions that provide financing to small businesses, it would be clearer just to provide a generic definition for all such transactions and not define each sub-type of transaction (the specific sub type definitions serve no material purpose in the disclosure requirements so the distinctions are largely irrelevant).

3. 22800(m) "Provider" – Our suggestion is to make the definition of a bank partnership model not as rigid so that various types of bank partnership models are covered. Banks are very flexible in structuring partnerships so the regulatory definition should be broad enough to capture current and future models.

4. 22800(n) "Recipient" – The definition's use of the word "presented" creates ambiguity. It is not clear what is meant by "presented" and there is no guidance on whether the disclosure requirements are triggered whenever they are "presented" or only when they are "presented to the small business customer" (it is not uncommon for offers to be "presented" to brokers first). It would be helpful to clarify that the recipient is the person who requested the commercial financing for itself and clearly explain when terms are presented so as to trigger the disclosure requirement.

B. <u>Commercial Financing Requiring Estimated Term Disclosures</u>

Any commercial financing agreement that is not a loan, line of credit or lease does not generally have a term. All purchase and sale transactions have no term as the purchaser is simply purchasing the right to a revenue stream whenever that stream may occur. So transactions such as factoring transactions have no fixed term as they do not create an absolute obligation to repay a sum certain according to a specific schedule. Transactions that typically fit into this category are purchasing of invoices or accounts payables (traditional factoring); traditional merchant cash advances (these are simply a newer form of traditional factoring where the purchaser is purchasing a portion of the revenue stream owed to the small business by the acquiring bank (the amount owed to the business by the acquiring bank is generally viewed as a payment intangible)); or the purchase of a portion of gross revenue (which is simply the purchase of a portion of the business' total payment stream). Since these transactions are purchase and sale transactions, the buyer is taking the risk of non-payment as well as the risk that payments will be made over an extended time period. Accordingly, there is no term for these products to

be disclosed. Regulations could compel purchasers to disclose an assumed or estimated term when setting the price but that creates material issues as the business customers may view any estimated term as an actual term and not realize certain rights they may have given it is a purchase and sale transaction. Accordingly, if an estimated term disclosure is required it should be accompanied with a disclaimer explaining there is no term for these types of transactions and that the actual term will differ.

C. Disclosure of Method, Frequency, and Amount of Payments for Commercial Financing with Flexible or Contingent Repayment Obligations

The method, frequency, and amount of payments should be displayed as stated in 22803(a). There should also be additional disclosure information explaining how the method, frequency, and amount of payments are determined so that the recipient can understand the items. Providers should be required to include an explanation next to or with the disclosures and we suggest the regulations mandate what that language be so it is uniform for each type of repayment option.

D. Annualized Rate Disclosure

As explained above in section II, the APR is a cost disclosure that was created by the federal government and modified over the last 50 years in an effort to provide a clear cost comparison tool to consumers. However, as described in Section II herein, it is clear that the APR is not accomplishing its intended goal. It is confusing to the vast majority of consumers, is ignored for comparison shopping purposes and creates material risk for creditors given it is so complicated to calculate. For these reasons, federal regulators have stopped requiring a true APR disclosure for credit cards (as the changes made by the CARD Act require that card issuers disclose only a corresponding APR, which more similar to a simple interest rate) and mortgage disclosures have now moved the APR to the back page as consumer testing found it caused too much confusion, was not used for comparison shopping and detracted from other disclosures. Despite the constant drum beat from consumer advocates that the APR is the most important disclosure consumers have when comparing the cost of credit, federal regulators have failed to confirm this assumption after extensive testing and research. In fact, the testing and research show the opposite – the APR is not useful and confuses consumers.

As part of SB 1235's enactment, various parties argued that the APR should apply to commercial financing even though it was never intended to apply to that type of transaction. Moreover, federal regulators have concluded that the costs of requiring APRs for commercial transactions outweigh the benefits (the costs being confusion, reduction of credit made available to small business owners due to risks associated with APR, etc.). APR is simply a mathematical formula and like all mathematical calculations may be changed and improved over time to arrive at simpler calculation methods that achieve better results.

During the process of drafting SB 1235, RapidAdvance worked with the bill's author to devise an alternative to APR that would be easier to understand and easier to calculate. That calculation became known as the Annualized Cost of Capital or ACC. The ACC is simply a

form of the APR calculation that ignores the impact of the declining balance on the rate calculation. We found this proposal helpful for the following reasons:

1. APR requires complicated math and the complications become exponentially harder as more payments are required during the term or when daily payments may fluctuate in amount for certain products. For daily payment products and variable payment products, the math required to properly calculate an accurate APR is extremely difficult. These types of products did not exist when the APR was initially adopted and these types of payments are still not used in the consumer lending industry so there is no guidance on how to handle the unique issues created by these products.

2. The APR has always been synonymous with lending products. Given SB 1235 requires a rate disclosure for lending products and non-lending products (like purchase transactions) it will cause less confusion if a new metric is developed that is not viewed as a lending only disclosure.

3. While we appreciate that the creation of a new rate disclosure may cause some confusion, that risk must be weighed against the fact that we ***know*** APR causes confusion. Trying to offer a better solution is a more reasonable path in our view than simply continuing to use APR - a rate disclosure most people do not use to compare costs and that has repeatedly been proven to be confusing. Additionally, ACC had its genesis in federal legislation that created the Total Interest Percentage disclosure for mortgage transactions (commonly referred to as the TIP). The TIP is basically the same calculation as the ACC but the ACC annualizes the cost while the TIP does not. The fact that the federal government just created this new cost disclosure for mortgages (the most significant financial transaction for most consumers), should encourage the DBO to adopt a new rate disclosure that makes more sense than APR and will do more to assist business owners in comparing costs.

4. The ACC enables small businesses to focus on the true dollar cost of the transaction and not let the rate disclosure be artificially influenced by payment frequency (which is already required to be disclosed elsewhere in SB 1235). By requiring payments to be made less frequently, a lender can make the cost of a transaction appear lower (showing a lower APR) but the dollar cost may actually be higher. The ACC avoids this issue and prevents lower rates with higher dollar costs based solely on payment frequency (see Appendix A for examples of the impact of payment frequency on APR and how ACC is a more consistent and reliable measure of the costs of credit).

Beyond doubt, the adoption of APR will cause confusion and frustrate the purpose of SB 1235 (*e.g.* to enable small businesses to compare the costs of different financing products). Whatever rate the DBO adopts must address the following issues:

1. Be easy to understand and calculate.
2. Be a rate that is unique from APR as APR is a rate used for lending transactions and SB 1235 applies equally to lending and non-lending transactions.
3. Be a rate that is not easily manipulated based on payment frequency.

4. Be a rate that is not capable of being confused with a daily percentage or specific amount for transactions where payments are a percent of a business's daily revenue or certain receivables (showing a 9% Daily Percentage next to a 14% APR will simply cause even more confusion than has been proven to exist in consumer mortgage transaction).
5. Be a rate that does not imply that the rate is accruing on the outstanding balance as many transactions subject to SB 1235 do not have an accruing rate and the longer they take to repay the cheaper the transaction becomes.

We believe the ACC addresses these issues and encourage the DBO to adopt ACC or a similar annualized rate. Whatever rate the DBO adopts, we would suggest the DBO create an online calculator that Providers can use to calculate the rate so it is clear that every Provider is using the same mathematical formula. The regulations should provide that the use of such a calculator would create a safe harbor for Providers so Providers are not liable for miscalculations caused by the calculator. Moreover, an online calculator would be beneficial for the small business as many would prefer to calculate the rate themselves to ensure what is being presented in the disclosures is accurate is consistent with their understanding or assumptions.

E. Types of Commercial Financing

The below are examples of commercial financing transactions that are not fixed-rate, fixed-payment financing:

- Merchant cash advance
- Open-end commercial loans and lines of credit
- Traditional factoring
- Equipment leasing

These transactions all present unique challenges with respect to SB 1235 as they are not fixed rate monthly payment loan products. Accordingly, the repayment features are different, legal structure is different and the consequences of requiring consumer oriented loan cost disclosures are different. SB 1235 is different from any other legislative action in California or the country in that it attempts to lump non-lending transactions in with lending transactions and impose the same disclosure requirements. This is not done in consumer transactions in California or federally. For example, California does not impose consumer lending transaction disclosures on inheritance financing transactions (the purchase of inheritance payments), structured settlement financing (purchase of lawsuit settlements) or lottery financing (purchase of lottery payments). Nor does the federal government treat consumer leasing transactions the same as consumer loans (TILA applies to consumer loans and the Consumer Leasing Act applies to consumer leases). There are reliable and long standing policy and legal reasons why consumer loans are treated differently than consumer lease and purchase transactions. Those same reliable and long-standing policy and legal reasons apply to commercial loans and commercial lease and purchase transactions. Yet, SB 1235 treats all of these transactions the same, which will simply cause a massive amount of confusion that will disserve small businesses and make disclosures more confusing, less reliable and clearly frustrate the purpose of SB 1235.

F. Types of Financing Requiring Estimated Annualized Rates

Any transaction that does not have fixed payment amount, fixed payment dates and a fixed term will require an estimation of an annualized rate.

G. Fees and Charges Included in an Annualized Rate Calculation

We recommend including all fees charged by a Provider in the rate disclosure. One of the lessons learned from TILA and the APR is that creating unique rules for various fees creates numerous issues. First, it makes the APR calculation more challenging as an analysis is required for each and every fee to determine if the fee is a finance charge and included the APR calculation. Second, it creates an incentive for lenders to create questionable fee structures in an effort to artificially lower the APR. In fact, it is these exact issues that are the reason why the CFPB is planning to reassess the APR calculation and what fees should be included (see the discussion on TRID rules above).

We also believe the regulation should make it clear that any fees charged by third parties and paid directly to third parties by the customer should not be included the rate calculation.

H. Calculating Estimated Terms and Estimated Annualized Rates

The Invitation requests comments on how Providers should calculate estimated terms and estimated annualized rates for the various commercial financing transactions subject to SB 1235. It is difficult to suggest how rates should be estimated until a decision has been made on what type of rate is going to be used. There are numerous issues with estimated rates for APR given the precision and specificity of the TILA APR calculations. However, for the ACC or some other newly created rate disclosure, there is much more flexibility in how to handle calculations and estimates as it does not force products into a regulatory regime and mathematical formula that was never intended to handle these types of products. Accordingly, we suggest the DBO propose a rate and then ask for comments on how to address issues raised by the use of that specific rate.

If an estimated annualized rate is required to be disclosed, it will create the potential for litigation against Providers. Such estimated disclosures may be required through projections or examples and when it is later determined that the projections or examples provided were different than the actual cost of the financing, litigation against Providers will skyrocket. An active plaintiff’s bar in California would use the good faith effort of the Provider to comply with SB 1235 and the implementing regulations to file hundreds and possible thousands of lawsuits. If so, there will be a dramatic impact on small business financing in California as many Providers will cease providing financing to small businesses in California. Therefore, we request that the DBO provide rules and regulations to make it clear that a cause of action is not available to recipients based on the disclosures made by examples or projections so long as such disclosures are provided in good faith by the providers.

I. Reliance Upon Internal Underwriting Criteria to Calculate Estimated Terms and Estimated Annualized Rates

Estimated terms should simply be the term the Provider used to underwrite and/or price the product. We also suggest that the regulation create some rule as to how this data should be verifiable to provide documentary proof to the customer of the estimated term. This will help reduce instances of Providers creating artificial terms for the sole purpose of deflating the disclosed rate.

J. Explanatory and Qualifying Language in Connection with Estimated Terms and Estimated Annualized Rates

This disclosure is bound to cause confusion as it highlights a fundamental flaw with SB 1235 - it attempts to treat loan and purchase transactions the same. As explained elsewhere in this letter, this has never been done for long standing policy and legal reasons. In the consumer context, treating leases like loans makes no sense and is why the federal government enacted both a lending disclosure law (TILA) and a leasing disclosure law (Consumer Leasing Act). This is also why California has a consumer loan law and an inheritance financing law (one applies to loans the other to purchases). Trying to force purchase transactions to make loan disclosures and then attempt to resolve the various issues created by doing so by adding more disclaimers and disclosures to explain the amounts and terms will cause information overload and make all disclosures meaningless. This is what happened with consumer mortgage disclosures over the last 30 years and why the CFPB recently made major changes to federal mortgage disclosure rules (the TRID rules).

K. Disclosures for Factoring and Asset-Based Lending Transactions with Master Financing Agreements

The relevant provisions of SB 1235 addressing these master financing agreements are confusing to us. We do not currently use master financing agreements so this is not directly relevant to us. However, it would seem that permitting disclosures based on sample terms will simply open the door for Providers to restructure products to have master financing agreements and provide sample disclosures that are not representative of most of the underlying transactions.

L. Tolerances

It is difficult to suggest how tolerances should addressed until a decision has been made on what type of rate will be used. There are numerous issues with the use of an APR given the precision and specificity of the TILA APR calculations. However, for the ACC or some other newly created rate disclosure, there is much more flexibility for handling calculations and tolerances may not be so complicated. Accordingly, we suggest the DBO propose a rate and then ask for comments on how to address tolerance issues for the specific rate.

M. Disclosure Formatting

We would first like to see all proposed disclosures and related explanations before proposing a specific format and structure. However, generally speaking we think the proper order would be the amount provided first, then the total payback amount (which is not a required disclosure but should absolutely be added for the disclosure regime to be comprehensive), the total dollar cost, the applicable rate, the payment amounts and structure and a statement regarding the prepayment policy. All of the required disclosures should appear on a page separate from all other disclosures and should be segregated from all other contractual terms. It is important that the recipient has quick and easy access to view the required disclosures. None of the required disclosures should be made more conspicuous than other required disclosures as the disclosures as a whole will be useful but any one disclosure by itself may be misleading and cause confusion. This is exactly why the CFPB recently moved the APR disclosure from the front page in mortgage transactions and also removed the requirement that it be more conspicuous than other disclosures.

N. Prepayment Policies

Prepayment policies vary by Provider and product. For some Providers there is no prepayment option, for others prepayment is permitted without penalty and for yet others prepayments are subject to an additional fee. All prepayment policies are currently disclosed in the customer agreements. Basic contract law requires that such penalties or fees be agreed to in the agreement and such contractual language must be sufficiently clear to avoid ambiguity or the Provider runs the risk of a court not enforcing the prepayment terms. Prepayment penalty language can be complicated and involve certain mathematical formulas so we do not believe a detailed description of the prepayment penalty amount should be included as part of the required disclosures. Rather, we think the regulations implementing SB 1235 should simply require that the required disclosures compel the Provider to include a statement as to whether or not a prepayment penalty is assessed and if so a reference to specific section in the underlying agreement where the amount or calculation is described.

Thank you for considering our comments. We remain committed to working with you to implement regulations that provide value to small businesses. We would be happy to discuss these matters in person or by telephone. You may reach me at 240-482-4684.

Very truly yours,

Joseph D. Looney
General Counsel

APPENDIX A

APR and ACC Comparisons

Below are a few examples showing the impact of payment frequency on APR and comparing APR to ACC. Note that we used the Office of the Comptroller of the Currency's ("OCC") APR calculator to calculate the APR for the single payment product and the monthly payment product. For the daily payment products, we used our own calculator as the OCC calculator does not provide the flexibility to properly calculate a TILA APR for a daily payment product (does not account for holiday or weekends which can materially impact the APR for daily pay products). Note that these comparisons involve only loan products and not purchased receivable products (such as MCAs) where payments vary from day to day and payments may not occur on a regular schedule.

This first example is for a one year loan with a single balloon payment at the end of the year. This example shows that ACC and APR are exactly the same when there is no declining balance during the term.

	ACC	APR	Advance Amount	Payback Amount	Fee Amount	Payment Amount
12 month balloon payment	30%	30%	$10,000.00	$13,000.00	$3,000.00	$13,000.00

The second example compares a product that has monthly payments with one that has daily payments. The pricing for the products is identical but the ACC and APR are different because of the impact of the payment frequency and the declining balance. This example shows that the impact of the declining balance has a compounding effect on APR making a product that is priced the same and has the same term look more expensive if payments are made more frequently.

	ACC	APR	Advance Amount	Payback Amount	Fee Amount	Payment Amount
12 month monthly pay loan	30%	51%	$10,000.00	$13,000.00	$3,000.00	$1,083.33
12 month daily pay loan	30%	57%	$10,000.00	$13,000.00	$3,000.00	$54.17

The third example is the same as the two examples above but increases the costs for the monthly pay product. The purpose is to show that a monthly payment product can charge more than a daily pay product but have the same or lower APR. In this example the dollar cost of the

monthly product is actually 10% more expensive than the dollar cost of the daily pay product but has a 1% lower APR. This example shows that the APR will make customers think a product is cheaper but the product is in fact 10% more expensive.

	ACC	**APR**	**Advance Amount**	**Payback Amount**	**Fee Amount**	**Payment Amount**
12 month monthly pay loan	33%	56%	\$10,000.00	\$13,300.00	\$3,300.00	\$1,108.33
12 month daily pay loan	30%	57%	\$10,000.00	\$13,000.00	\$3,000.00	\$ 54.17

We believe these examples show the problems with APR calculations. It is for reasons like these that the Federal Reserve Board and CFPB have removed APRs in some consumer disclosures (like the historical APR in credit cards) and made APRs less important in other disclosures (like mortgages). Many people don't understand how significant an impact the declining balance has on the APR. In fact, most people think APR is just an annualization of the costs of a product and does not include the impact of the declining balance, which is precisely what the ACC does.