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Department of Financial Protection and Innovation
Attention: Sandra Sandoval
300 S. Spring Street, Suite 15513
Los Angeles, California 90013
regulations@Department.ca.gov.
cc: colleen.monahan@Department.ca.gov
VIA ELECTRONIC TRANSMISSION

PRO 02-21: COMMENTS, ANALYSIS, AND RECOMMENDATIONS FROM SMALL BUSINESS, CONSUMER, FINANCIAL SERVICES INDUSTRY, AND LOW-INCOME GROUPS TO PROPOSED REGULATIONS IMPLEMENTING FINANCIAL CODE SECTION 90009(e)

Background

California is facing vast and permanent COVID-caused damage to the small business ecosystem that helps produce our middle class and the fabric of our local communities. When we drive past the closed storefronts in our towns and cities, we need no reminder that small businesses are devastated by the impacts of COVID-19, desperate for help, and more vulnerable than ever to predation.

On August 18, 2021, the Department of Financial Protection and Innovation ("Department") invited comments regarding a proposed regulatory approach to implementing Financial Code section 90009(e).[1] As the Department correctly noted in its August 18th invitation, that statute authorizes the Department to implement regulations that define unfair, deceptive, and abusive acts and practices ("UDAAP") in connection with the offering or providing of commercial financing or other financial products and services to small business recipients, nonprofits, and family farms, and to collect data and reporting from providers of commercial financing.

What follows are the invited comments of a broad, cross-sector coalition of 64 organizations representing tens of thousands of small businesses, for-profit and nonprofit small business financing providers, consumers, and low-income groups, i.e. the legislatively-intended beneficiaries of the statute. Across a diverse breadth of interests, we came together as the base of support and advocacy for AB 1864, the bill that authorizes promulgation of these proposed regulations.

In the following comment, we offer four primary recommendations to the Department:

1. **Adopt the proposed UDAAP language**

   We applaud the Department for its proposed definition of UDAAP, and urge the Department to adopt this language. In this comment, we provide legal analysis finding that the Department has unambiguous authority to promulgate and enforce these regulations, and that the proposed regulatory definition is lawful and wise.

2. **Pricing data must be collected in the form of APR**

   We applaud the Department for proposing a framework of data collection documenting small business financing. However, pricing data *must* be collected in the form of APR, as an alternative to, or in addition to, raw dollar cost. Because raw dollar cost does not take the cost of financing over time into account, the rule as proposed would inject into the policymaking bloodstream fundamentally misleading information that falsely portrays short-term, high-price financing as less expensive than longer-term, more affordable financing. Use of APR solves this problem, and thus is recognized as a critical measure of the cost of financing, including by the Department itself. The Department has led the nation in developing the framework for APR in commercial financing in the regulations enacting SB 1235. It should use that same foundation here for these regulations.

[1] All future "section" references generally are to the California Financial Code unless otherwise specified.

3. **Collect data on the accuracy of disclosure estimations in order to prevent high-cost financing providers from misleading small businesses**

   The Department's proposed small businesses truth-in-lending regulations would functionally allow merchant cash advance ("MCA") providers to mislead small businesses and distort the market, by underestimating the APRs they disclose in some circumstances. The Department can and should solve this problem by pairing the *flexibility* granted to financing providers in estimating the terms they disclose to small businesses with *accountability* for the accuracy of their estimations. That accountability can be created simply by requiring modest data reporting on the accuracy of certain disclosures that were estimated. For easier administration by the Department and easier compliance by providers, we recommend a more narrow data collection proposal than previously suggested by the Responsible Business Lending Coalition in comments made on the rules implementing SB 1235.

4. **Avoid redundant reporting**

   If any data elements required by the Department under this regulation are already collected by the Consumer Financial Protection Bureau ("CFPB") under Dodd-Frank Section 1071, the Department should collect this data from the CFPB rather than requiring redundant reporting from financing providers.

If these recommendations are implemented, these regulations will help 4 million California businesses create up to $18.8 billion in positive economic impact, and 14,000 jobs. They will also encourage the right kind of innovation through healthier competition based on quality and price, not on novel deception, and improve the ability of the Department to wisely regulate California's financing markets by providing much-needed data on financing to small businesses, nonprofits, and family farms.[2]

[2] See "Economic Impacts: Question 3" below.

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Recommendation 1: Adopt the proposed UDAAP definitions

We strongly support the promulgation of the Department's proposed definitions for unfair, deceptive, and abusive acts and practices for financing to small businesses, nonprofits, and family farms. The Department has a unique mandate from the California Legislature to fill gaps in financial protection regulation, especially in new and emerging industries that are unaddressed by the CFPB. Defining these terms through regulation is an important, enforcement-facilitating part of fulfilling that mandate.

I. Enforcement-facilitating definitions applicable to small businesses, nonprofits, and family farms are urgently needed because ambitious enforcement of current law is urgently needed, especially to protect communities of color.

One of the more significant regulatory gaps is in the area of commercial financing to small business financing companies, who are often not covered by financial protection laws that protect consumers. For example, small business financing is generally not subject to the federal Truth in Lending Act. A new and growing industry of small business high-rate financing companies targeting small business and nonprofits is exploiting the relative lack of financial protection and oversight of small business financing, with devastating consequences for family wealth, especially in underserved communities of color hallmarked by small, unsophisticated borrowers. Federal Reserve research recently concluded that Black and Hispanic entrepreneurs are twice as likely to be affected by "potentially higher-cost and less-transparent credit products." This research

specifically identifies MCA and factoring products as "potentially higher-cost and less-transparent credit products.[3]

Indeed, some of these emerging financing products offered by companies operating in this regulatory gap charge over 300%[4] and the industry has developed a troubling record of UDAAP concerns.[5]

The California State Legislature's enactment of section 90009(e) in the California Consumer Financial Protection Law ("CCFPL") reflects a recognition that small business owners are also individuals, doing business through a corporate form. It is, for example, common for small businesspeople to raise start-up capital by borrowing against their greatest personal asset; the equity in their homes. If, in their aspect as a small business, they may as non-corporate, real-people fall prey to predatory lenders, they may lose their livelihoods and possibly their homes. Their employees may also lose their livelihoods. Therefore, consistent enforcement of the proposed financial protections is necessary for the financial health of California's small businesses, and the individuals, families, and communities that those small businesses represent.

These enforcement-facilitating definitions for UDAAP are also a needed response to the economic disaster wrought by COVID-19, which has put California small business in crisis, exacerbated foundational societal inequities, and has made small businesses much more vulnerable to predatory financing schemes. A report by Yelp found that 19,000 businesses in California had already permanently closed as of a year ago -- September 2020.[6] The California Restaurant Association estimates 23,000 restaurants, or up to 30%, will be gone forever, when all is said and done.[7]

Again, the economic pain of these closures has been far from equally distributed. Black-owned and immigrant-owned businesses have closed at more than double the rate of White-owned businesses during COVID, followed closely by Latinx-owned businesses. Asian-owned and woman-owned

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[3] Zeeuw, Mels de, Federal Reserve Bank of Atlanta, "Small Business Credit Survey: Report on Minority-Owned Firms," Dec 2019. https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf

[4] See, e.g. St. Louis, Weaver, Donaker Brown, and McShane, Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," May 2016. https://www.opportunityfund.org/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/; Clark, Patrick. "How Much is Too Much to Pay for a Small Business Loan," May 16, 2014. Bloomberg. https://www.bloomberg.com/news/articles/2014-05-16/how-much-is-too-much-to-pay-for-a-small-business-loan

[5] Responsible Business Lending Coalition, "E: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21)." March 8, 2021. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_to_dfpi_on_ccfpl_rulemaking__pro_01-21__-_march_2021.pdf

[6] "Yelp: Local Economic Impact Report," September 2020. https://www.yelpeconomicaverage.com/business-closures-update-sep-2020.html

[7] California Restaurant Association, "COVID-19 Restaurant letter to Governor Gavin Newsom and the state legislature," March 27, 2020. https://www.calrest.org/news/covid-19-restaurant-letter-governor-gavin-newsom-and-state-legislature

businesses have closed at 1.5 times the rate of white-owned businesses.[8] This economic disaster has rendered small businesses even more vulnerable to predatory lending.

In our comment letter submitted to the Department on March 8, 2021, and attached, the Responsible Business Lending Coalition and ally organizations described, in detail, specific types of UDAAP violations observed in the market.[9] These types of violations include:

A. Mischaracterizing financing as not being credit to evade lending laws

B. Failing to comply with SB 1235 truth-in-lending rules, including by non-licensees

C. Quoting pricing in misleading ways outside of the required SB 1235 disclosure

D. Double-charging of fees in a practice called "double dipping"

E. Using "doing business as" names to conceal a lender's identity and avoid accountability for abuse

F. Advancing less than the financing amount to apply pressure

G. Brokers steering borrowers into products that pay high, hidden fees to brokers

H. Broker-driven "flipping" and fee churning

I. "Stacking" of multiple sales-based financing products

J. Deceptively marketing short-term products for long-term use

K. Charging exorbitant and arbitrary fees

L. Abusing ACH withdrawal authority

M. Abusive collection practices

N. Abusing UCC lien notices

These attached comment to the Department from March also provides detailed stories from California small businesses and nonprofits affected by these unfair, deceptive, and abusive acts and practices, including:

- The Antelope Valley Community Clinic, which provides medical care to low-income Californians, was deceived and abused at a cost of millions of dollars by a financing

[8] Fairlie and NBER, University of California, Santa Cruz, "The Impact of Covid-19 on Small Business Owners: Evidence of Early-Stage Losses from the April 2020 Current Population Survey," May 2020. https://siepr.stanford.edu/sites/default/files/publications/20-022.pdf

[9] Responsible Business Lending Coalition, "E: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21)." March 8, 2021. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_to_dfpi_on_ccfpl_rulemaking__pro_01-21__-_march_2021.pdf

company, charged an estimated APR of 233%, and was forced to shrink its service to needy Californias and lay off 25 medical workers.

- A software company serving emergency response providers was charged $1 million in interest and fees, despite receiving only $600,000 of the $2.35 million advance it had agreed upon.
- Thirty-three African American churches were defrauded in a lease financing scam. The same financing company was pursuing legal action to collect against an African American church in California as recently as last year.[10]
- After thirty years in operation, a woman-owned wine company was nearly destroyed by an MCA that had been sold under deceptive terms.

A suit by the New York Attorney General against several merchant cash advance companies provides several other examples of acts and practices that could be described as unfair, deceptive, or abusive. In an affirmation submitted by the New York Attorney General's office in support of the suit, the headings in the table of contents provide a troubling list of acts and practices that have "demolished the businesses, finances, and credit of merchants and their principles," including the following:

> "Respondents' Merchant Cash Advances Bear the Telltale Signs of Loans and Are Issued at Usurious Interest Rates...
>
> Respondents Misrepresent that Their Cash Advances Require "No Personal Guarantee or Collateral...
>
> Respondents Misrepresent and/or Conceal the Fees They Deduct from Their Cash Advances...
>
> Respondents Use a Percentage-Based Fees Clause to Conceal Their Actual Fee Amounts...
>
> Respondents Charge Fees Exceeding Both Their Express Fees and Their Percentage-Based Fees...
>
> Respondents Reduce Merchant Cash Advances by "Reserve" Amounts They Do Not Disclose...
>
> Respondents Spring Late Changes on Merchants after They Have Already Signed Respondents' Agreements and Confessions of Judgment...

[10] Southern California Record, "Case activity for Balboa Capital Corp. vs Pure Word Missionary Baptist Church on Aug. 19," August 21, 2020. https://socalrecord.com/stories/549240185-case-activity-for-balboa-capital-corp-vs-pure-word-missionary-baptist-church-on-aug-19

Respondents Misrepresent the Basis of their Fees...

Respondents Misrepresent the Amounts of Their Daily Debits...

Respondents Continue to Debit Merchants' Bank Accounts after Their Advances Have Been Paid off...

Respondents Misrepresent that They Will Provide Flexible Payment Plans and Will Reconcile Merchants' Payment Amounts...

Although Respondents' Agreements Authorize Them to Debit Merchants' Accounts Only "Each Business Day," They Do so for Holidays as Well...

Respondents Use Confessions of Judgment and False Affidavits to Defraud Merchants and the Courts...

Respondents Use Confessions of Judgment to Obtain Rapid Judgments Against Merchants with No Documentary Evidence, No Notice to the Merchants, and No Judicial Review...

Respondents File False Affidavits Misrepresenting to Courts the Nature of the Payments They Collect...

Respondents File False Affidavits Misrepresenting the Facts and Amounts of Merchants' Purported Defaults...

Respondents File Confessions of Judgments in Circumstances Their Own Agreements Do Not Provide for...

Respondents Cause Merchants to Enter into Unconscionable Contracts...

Respondents Engage in Procedurally Unconscionable Tactics...

Respondents' Agreements Contain Unconscionable Provision...

Respondents Harass and Threaten Merchants to Pressure Them into Repaying Advances...

Respondents Have Demolished the Businesses, Finances, and Credit of Merchants and Their Principals"[11]

We offer our strong support to the Department in moving forward with the proposed UDAAP language in order to provide guidance to the regulated industry about what is permitted, and to facilitate DFPI enforcement, thus providing a realistic disincentive for businesses that might otherwise, in the absence of a patrolling "cop on the beat", engage in unlawful conduct. This will also serve to encourage responsible innovation by financing providers, and support a healthy economic recovery from COVID. As part of this support, we offer the following legal analysis of the

[11] https://ag.ny.gov/sites/default/files/affirmation_of_john_p._figura.pdf

Department's authority for promulgating and enforcing this regulation, and conclude that that the proposed language is both lawful and wise.

II. The Department is unambiguously vested with the authority to promulgate and enforce regulations that "define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing … or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms" pursuant to Financial Code Section 90009(e).

Not only are the definitions urgently needed, the Department clearly has the authority to promulgate regulations defining unfair, deceptive, and abusive acts and practices in connection with offering or promoting financial products to small businesses, nonprofits, and family farms, because the statute unambiguously provides for such regulations:

> (e) The Department, by regulation, may define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms. The rulemaking may also include data collection and reporting on the provision of commercial financing or other financial products and services.

"When the language of a statute is clear and unambiguous, there is no need for interpretation and we must apply the statute as written."[12] Here, the Department's general authority to promulgate definitional regulations is clear. For these reasons, a regulation defining unfair, deceptive, and abusive acts and practices would easily satisfy the state law requirement that it be "authorized."[13]

These comments are directed to the proposed regulation with respect to small business UDAAPs, so that they do not affect the broad flexibility of the DFPI with respect to consumer UDAAPs. It would be helpful for the regulation to state that it does not constrain the scope of what may be a UDAAP with respect to a consumer.

III. The Department is unambiguously vested with the authority to enforce regulations that "define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing … or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms" pursuant to Financial Code Section 90009(e).

Moreover, promulgating a regulation defining unfair, abusive, and deceptive would not be an idle act but one that, by clarifying which acts and practices fall under these rubrics, would have the twin salutary consequences of offering regulated entities clearer guidance on how to avoid discipline,

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[12] *Lafayette Morehouse, Inc. v. Chronicle Publishing Co.* (1995) 39 Cal.App.4th 1379, 1382,

[13] *See,* Government Code section 11349(b) which defines "authority" as follows: "(b) 'Authority' means the provision of law which permits or obligates the agency to adopt, amend, or repeal a regulation."

and providing the Department a clear benchmark for determining which acts and practices merit its enforcement attention.

Further, the Department through civil actions unambiguously will have authority to enforce regulations promulgated pursuant to section 90009(e). This authority at minimum includes the power to seek injunctions, orders, or writs against businesses that are operating in defiance of the regulation. This is true for five reasons:

First, section 90013 plainly and unambiguously vests the Department with "civil action" enforcement power. That statute in relevant part, with emphases added, provides:

> The Department may bring a ***civil action*** in accordance with the following:
>
> (a) If a person violates any … ***rule … ,*** the Department may ***bring an action*** in the name of the People of the State of California ***in the superior court to enjoin the acts or practices or to enforce compliance with … any rule … herein under***. Upon a proper showing, ***a permanent or preliminary injunction, restraining order, or writ of mandate shall be granted*** …"

Thus, the Department may unambiguously in a "civil action" lawfully sue in superior court "to enjoin acts or practices or to enforce compliance with…any rule[.]" The Department in such an action may obtain injunctions, restraining orders, or writs. The plain language of this statute entirely and completely answers the first question presented. Again, "[w]hen the language of a statute is clear and unambiguous, there is no need for interpretation and we must apply the statute as written."[14]

The clarity of this language makes it extremely unlikely a business could persuade a judge that the Department does not have the power to do that which this statute plainly says it has the power to do.

Second, section 90006 in part also clearly and without limitation permits the Commissioner to bring "civil actions" and provides (emphases added):

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[14] *Ibid.* Courts do not consider legislative history when, as here, the plain language of a statute is unambiguous. "When the words are clear and unambiguous, there is no need for statutory construction or resort to other indicia of legislative intent, such as legislative history." *California Fed. Savings & Loan Assn. v. City of Los Angeles* (1995) 11 Cal.4th 342, 349. Courts do not look to legislative history to create an ambiguity where there is none on the face of the statute. "The proper function of legislative history is to solve, and not create, an ambiguity." *United States v. Rone* (9th Cir. 1975) 598 F.2d 564, 569. Moreover, of all of the kids of legislative history that courts consider, the least relied upon is that based on defeated bills or amendments. *Dyna-Med, Inc. v. Fair Employment & Housing Com* (1987) 43 Cal. 3d 1379, 1396 ("Unpassed bills, as evidences of legislative intent, have little value."); *Gay Law Students Assn. v. Pacific Tel. & Tel. Co.* (1979) 24 Cal. 3d 458, 480, fn. 13 ("California courts have frequently noted, however, the very limited guidance that can generally be drawn from the fact that the Legislature has not enacted a particular proposed amendment[.]") Finally, the legislative history of AB 1864 (Limon) reveals that the Legislature was told the bill would aid small businesses. From page 2 of the Assembly Floor analysis : "(d) Authorizes DFPI to prescribe rules related to the following: iv) Unfair, deceptive, and abusive acts or practices in connection with the offering or provision of commercial financing, as specified, to small business recipients, nonprofits, or family farms." And, from page 4 "Arguments in Support: A coalition of consumer protection groups and legal aid organizations writes: 'SB 819 would … establish California as a national leader in protecting … small businesses… struggling to recover financially from the pandemic…"

> (b) In addition to existing functions, powers, and duties, ***the Department shall have*** all of ***the following*** functions, ***powers***, and duties in carrying out its responsibilities under this law:
>
> (1) ***To bring*** administrative and ***civil actions, and to prosecute those civil actions before state and federal courts.***

Third, section 326(a), with emphases supplied, in part also provides that

> The Commissioner … is responsible for the … exercise of ***all powers*** … and the ***assumption and discharge of all responsibilities vested by law in the Department and the divisions thereunder***. The commissioner has and may exercise ***all the powers necessary or convenient for the administration and enforcement*** of, among other laws, the laws described in Section 300.

These "necessary "powers include "the authority to … enforce rules and regulations."[15] In fact, "an administrative agency is compelled to enforce its own regulations[.]"[16] Indeed, "any time a State is enjoined by a court from effectuating statutes enacted by representatives of its people, it suffers a form of irreparable injury."[17]

Fourth, section 320(b) in pertinent part and with emphasis added, provides:

> (b) The Commissioner of Financial Protection and Innovation shall employ legal counsel to act as the attorney for the commissioner in actions or proceedings brought by or against the commissioner under or ***pursuant to any law under the jurisdiction of the Department of Financial Protection and Innovation***, or in which the commissioner joins or intervenes as to a matter within the jurisdiction of the Department of Financial Protection and Innovation, as a friend of the court or otherwise.

A regulation is a law.[18] A regulation issued by the Department pursuant to section 90009(e) is a "law under the jurisdiction" of the Department – that is why the Department may both promulgate regulations pursuant to the statute and enforce such a regulation. Therefore, because the Department is expressly empowered *to retain counsel* to be used "in actions" "brought by … the commissioner" pursuant to "any law under the jurisdiction of the" Department, the Department must impliedly be permitted *to enforce* "any law under the jurisdiction of the" Department using such counsel "in actions," meaning lawsuits.

Fifth, even if none of these four statutory authorities existed, the Department *still* would have the power through a civil action to enforce regulations promulgated pursuant to section 90009(e) because "[i]t is well settled in this state that [administrative] officials may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by

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[15] *Gleason v. Glasscock (E.D.Cal.2011)* 2011 WL 773249.

[16] *Woods v. Superior Court* (1981) 128 Cal.3d 668, 680.

[17] *New Motor Vehicle Bd. of California v. Orrin W. Fox Co*. (1977) 434 U.S. 1345, 1351 (1977).

[18] A regulation is "every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of any rule, regulation, order, or standard adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it[.]" Gov. Code, section 11342(g).

statute or as may fairly be implied from the statute granting the powers."[19] Thus, the Department "may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute, or as may fairly be implied from the statute granting the powers."[20]

It is easy to infer that the Department must be permitted to sue to enforce the regulations promulgated under the authority granted by section 90009(e) because otherwise that statute would be senseless. What policy aim is achieved by granting the Department the power to promulgate regulations if the regulations cannot be enforced? And at the barest minimum, the Department, like every other person in California, is not prohibited from and therefore may seek relief under Civil Code sections 527 (preliminary injunction) and 3422 (permanent injunction) and Code of Civil Procedure section 1085(a) ("A writ of mandate may be issued by any court to any … person, to compel the performance of an act which the law specially enjoins[.]")

That a different subdivision -- section 90009(c) -- applies to "covered persons" does not mean section 90009(e) is limited to "covered persons." In fact, the clear legislative purpose embodied in section 90009(e) is to extend similar legal protections not *only* to covered persons, but *also* to "small business recipients, nonprofits, and family farms."

Section 90009 invokes the Unfair Competition Law ("UCL") in two different ways. As applied to "covered persons" or "service providers" offering products or services to "consumers," section 90009(c), provides:

> (c) The Department may prescribe rules applicable to any covered person or service provider identifying as unlawful, unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. Such rules shall consider the relative harm to the consumer, the frequency of the act or practice in question, and whether such act or practice is unintentional or stems from a technical, clerical, or nonmaterial error. Rules under this section may include requirements for the purpose of preventing those acts or practices.
>
> (1) The Department shall interpret "unfair" and "deceptive" consistent with Section 17200 of the Business and Professions Code and the case law thereunder.

Section 90009(e), however, applies based upon *who receives* the financial products or services; namely small businesses, nonprofits, and family farms:

> (e) The Department, by regulation, may define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms….

Thus, two different, freestanding subdivisions of equal dignity in the same statute extend the UCL differently to different classes of persons. The UCL is made applicable to "covered persons" and "service providers" "in connection with" financial products extended *to "consumers"* in section

[19] *Dickey v. Raisin Proration Zone No. 1* (1944) 24 Cal.2d 796, 810.
[20] *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 824.

90009(c). In contrast, in section 90009(e) the UCL is invoked "in connection with" "commercial financing" or other "financial products and services" offered *not to consumers* (they are entirely omitted) but instead to "small businesses recipients, nonprofits, and family farms." And, unlike section 90009(c), which the Legislature made applicable to specified businesses based on *two* criteria – who they are ("covered persons or service providers") and who they sell to ("consumers") – section 90009(e) surgically omits the former criterion entirely and applies simply based on who receives financial products and services.

For these reasons, the statutory text compels the conclusion that section 90009(e) applies to any business that sells covered financial products or services to the small businesses, nonprofits, and family farms referenced. There is simply no basis in text to infer that section 90009(e) should apply in a more limited manner than the legislature expressly provided in the statute it enacted.

> [W]e have often noted that when Congress includes particular language in one section of a statute but omits it in another—let alone in the very next provision—this Court "presume[s] that Congress intended a difference in meaning." *Loughrin v. U.S* (2014), 573 U.S. 351, 421. *See also*: *City of Port Hueneme v. City of Oxnard* (1959) 52 Cal.2d 385, 395 ("Where a statute, with reference to one subject contains a given provision, the omission of such provision from a similar statute concerning a related subject is significant to show that a different intention existed.")

For these five reasons, the Department has the power to initiate civil proceedings to enforce Department regulations, including those promulgated pursuant to section 90009(e).[21]

IV. The Proposed Definitions Of "Unfair," "Deceptive," And "Abusive" Are Wise

Beyond the Department's authority to adopt and enforce UDAAP definitions generally the approach adopted by the proposed definitional regulations is both lawful and wise. The terms "unfair, deceptive, and abusive acts and practices" are already defined as a matter of California statutory law and by judicial precedent. The similar terms in the Dodd-Frank Act are likewise already defined as a matter of federal statutory law and by judicial precedent.

The approach of simply adopting regulations that extend such extant legal definitions to financial products offered to "small business recipients, nonprofits, and family farms is wise because, as stated earlier:

(i) Legal certainty permits regulated entities the best opportunity to avoid discipline by conforming their operations to extant law, thus promoting consumer-protecting compliance with legislatively-intended strictures without the necessity of discipline. "As the California Supreme Court observed

[21] Indeed, however, the best reading of the Financial Code is that the Department has broader powers to enforce regulations promulgated under section 90009(e) beyond court orders, injunctions, and writs. That is because section 90013 also provides the Department two additional enforcement options in "civil actions" brought to "enjoin acts or practices or enforce compliance with" "any rule." The first is the option of seeking judicial appointment of "a receiver, monitor, conservator, or other designated fiduciary or officer of the court [who] may be appointed for the defendant or the defendant's assets". And, second, "any other ancillary relief may be granted as appropriate" in a civil action brought to enforce "any rule."

when it came to a poorly defined statutory proscription against "unfair" business conduct, "[a]n undefined standard of what is 'unfair' fails to give businesses adequate guidelines as to what conduct may be challenged and thus enjoined and may sanction arbitrary or unpredictable decisions about what is fair or unfair. In some cases, it may even lead to the enjoining of procompetitive conduct and thereby undermine consumer protection, the primary purpose of the antitrust laws."[22]

(ii) Legal certainty facilitates enforcement by permitting the Department to more easily distinguish between predictable and winning cases and ones that are more risky, thus promoting the filing of the former. Said another way, definitional clarity in the law offered by a regulation that courts are duty-bound to defer to allow the Department to avoid repetitively, expensively, and unpredictably having to litigate the meaning of these terms *de novo*, in every case. Using the tool of regulations to establish such certainty is particularly appealing from a Department enforcement-litigation point of view, because courts adjudicating cases involving the Department's application of its regulations are constrained from adopting competing and exculpatory interpretations offered by defendants. Rather courts would, here, defer to the lawfulness of the Department's regulations adopted under section 90009(e) and would afford them the standard judicial deference to regulations that an agency has adopted pursuant to its lawful authority as conferred by the legislature. Although this is true for various agency actions, it is especially true for any valid exercise of legislative authority that is embraced formally in a regulation. As the leading California administrative law cases teaches:

> It is a "black letter" proposition that there are two categories of administrative rules and that the distinction between them derives from their different sources and ultimately from the constitutional doctrine of the separation of powers. One kind — quasi-legislative rules — represents an authentic form of substantive lawmaking: Within its jurisdiction, the agency has been delegated the Legislature's lawmaking power. … Because agencies granted such substantive rulemaking power are truly "making law," their quasi-legislative rules have the dignity of statutes. When a court assesses the validity of such rules, the scope of its review is narrow. If satisfied that the rule in question lay within the lawmaking authority delegated by the Legislature, and that it is reasonably necessary to implement the purpose of the statute, judicial review is at an end.
>
> We summarized this characteristic of quasi-legislative rules in *Wallace Berrie & Co. v. State Bd. of Equalization* (1985) [citation]: "[I]n reviewing the legality of a regulation adopted pursuant to a delegation of legislative power, the judicial function is limited to determining whether the regulation (1) is 'within the scope of the authority conferred'" [citation] and (2) is "reasonably necessary to effectuate the purpose of the statute" [citation].' [Citation.] 'These issues do not present a matter for the independent judgment of an appellate tribunal; rather, both come to this court freighted with [a] strong presumption of regularity....' [Citation.] Our inquiry necessarily is confined to the question whether the classification is 'arbitrary, capricious or [without] reasonable or rational basis.' [citations].)"[23]

[22] *Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co.* (1999) 20 Cal. 4th 163, 185.
[23] *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 10-11.

Functionally, the broader the terms being construed through regulation, the greater the discretion a regulator has to interpret them free from judicial second-guessing. An instructive example comes from the case of *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 280. In that case, the California Supreme Court upheld as against a vigorously pressed insurance industry challenge a highly complicated, multi-page ratemaking formula statutorily enabled by eye-of-the-beholder," "unfair"-like statutory words commanding that "[n]o rate shall be approved or remain in effect which is excessive, inadequate, or unfairly discriminatory." The administrative law principles and authorities described in 20th Century that afforded the Insurance Commissioner so much judicial deference in interpreting "excessive, inadequate, and unfairly discriminatory" by regulation would with equal weight compel judicial deference to the Department's interpretation of section 90009(e).

(ii) As well, legal certainty promotes a predictable regulatory and thus fairly competitive environment, where the "rules of the game" are known to all, to the benefit of competition based on quality and price rather than advantages obtained by creative lawyering.

The actual language of the proposed regulation is lawful because it simply deploys words and phrases long familiar to the regulated community and to their counsel and compliance officials.

The definitional portion of the proposed regulation is introduced as follows:

> **Section X.90009.1. Unfair, Deceptive, or Abusive Acts and Practices**
>
> (a) In connection with the offering or providing of commercial financing, as defined in subdivision (d) of Financial Code section 22800, or other offering or providing of financial products and services to small business recipients, nonprofits, and family farms, the following constitute unfair, deceptive, or abusive acts and practices, respectively.

It is useful from here to address each portion of the proposed regulation specifically.

A. "Unfair"

The proposed regulation defines "unfair" as:

> (1) An act or practice is unfair and may not be engaged in by a person offering or providing commercial financing or other financial products and services if the act or practice meets one or more of the following.
>
> (A) The act or practice violates another law.

This (A) part of the regulation simply embraces the "unlawful" prong of what under California's UCL is "unfair" competition. This derives from the plain language of Bus. & Prof. Code section 17200 which decrees any "unlawful" conduct *ipso facto* to be "unfair" and illegal:

> As used in this chapter, unfair competition shall mean and include any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising and any act prohibited by Chapter 1 (commencing with Section 17500) of Part 3 of Division 7 of the Business and Professions Code.

The proposed regulation then moves to embrace the "unfair" prong of the UCL:

> (B) On balance, the harm from the conduct outweighs the utility of the conduct.
>
> (C) The act or practice offends an established public policy, or the act or practice is immoral, unethical, oppressive, unscrupulous, or substantially injurious to a person.
>
> (D) (1) The injury is substantial, (2) the injury is not outweighed by countervailing benefits, and (3) the injury could not reasonably have been avoided.

This phrasing is nearly verbatim from current and longstanding California law defining "unfair" under California's UCL, Business & Professions Code section 17200, *et seq*. While courts acknowledge that no tightly prescriptive definition of "unfair" has yet been settled upon by courts or lawmakers[24] courts frequently used one of two tests.

Test 1: The first definition of what is "unfair" "involves an examination of [the practice's] impact on its alleged victim, balanced against the reasons, justifications and motives of the alleged wrongdoer."[25] In brief, "the court must weigh the utility of the defendant's conduct against the gravity of the harm to the alleged victim …"[26]

Test 2: The second definition of "unfair" California courts have adopted derives from language long used by the FTC in its Guidelines. It equates "unfair" in the UCL to section 5 of the FTCA.[27] A business act is "unfair" when it "offends an established public policy or when the practice is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers."[28]

That the California Supreme Court in *Cel-Tech Communications, Inc. v. L.A. Cellular Telephone Co.* (1999) 20 Cal. 4th 163, 180 ("Cel-Tech") seems to have rejected these tests in the context of a lawsuit brought by a business against a competitor is, for three reasons, irrelevant to whether the strategy of adopting through regulation court-embraced definitions of "unfair" is a lawful and smart exercise of the Department's discretion.

First, the *Cel-Tech* test is limited to lawsuits brought by a business against a competitor. The court specifically did not create a test for "unfairness" prong cases brought on behalf of consumers.[29] The tests echoed in the proposed regulatory definition of "unfair" therefore

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[24] See *Mui Ho v. Toyota Motor Corp.* (N.D. Cal. 2013) 931 F. Supp. 2d 987, 1000 n.5 ("California courts and the legislature have not specified which of several possible 'unfairness' standards is the proper one."); *Doe One v. CVS Pharmacy, Inc.* (N.D. Cal. Dec. 12, 2018) No. 18-cv-01031-EMC, 2018 WL 6574191, at *12-13 (acknowledging that the law remains unsettled).

[25] *Motors, Inc. v. Times Mirror Co.* (1980) 102 Cal. App. 3d 735, 740.

[26] *State Farm Fire & Cas. Co.,* (1996) 45 Cal. App. 4th 1093, 1104 (citations omitted).

[27] See *Colgate v. JUUL Labs, Inc.* (N.D. Cal. 2019) 402 F. Supp. 3d 728, 760.

[28] See *Cmty. Assisting Recovery, Inc. v. Aegis Sec. Ins. Co.* (2001) 92 Cal. App. 4th 886, 894; *State Farm Fire & Cas. Co.,* 45 Cal. App. 4th at 1104; see also *Bardin v. DaimlerChrysler Corp.* (2006) 136 Cal. App. 4th 1255, 1270 (2006); *Jolley v. Chase Home Fin., LLC* (2013) 213 Cal.App. 4th 872, 907-08.

[29] The Supreme Court adopted the following test for "unfair" business practices for suits between competitors: "When a plaintiff who claims to have suffered injury from a direct competitor's 'unfair' act or practice invokes section 17200, the word 'unfair' in that section means conduct that threatens an incipient violation of an antitrust law, or violates the policy or spirit of one of those laws because its effects are comparable to or the same as a violation of the law, or otherwise significantly threatens or harms competition." Id. at 187.

indisputably apply to cases brought by the Department which would be only bringing such a case on behalf of small business, nonprofit, and family farm consumers of financial products under section 9009(e) (certainly not on behalf of competing financial institutions). Indeed, application of the *Cel-Tech* test (quoted in the margin) makes no sense as applied to actions under section 90009(e) to protect small businesses, nonprofits, and family farms against financial institution misdeeds. Such an interpretation would have to be grounded in an inference that the Legislature intended through enactment of section 90009(e) strangely and only to protect small businesses, nonprofits, and family farms from theoretical financial institution antitrust violations and that the Legislature intended to exclude from violations that actually and daily imperil these three "little guys." No rational reading of the statute or legislative history supports this contortion and constriction of legislative will. Nor is there any hint in text or history of a legislative intent to empower the Department to transform itself into an antitrust regulator; a task as far from the Department's core mission and expertise as it is mostly useless to the small businesses, family farms, and nonprofits section 90009(e) was intended to protect.

Second, under the principles of deference to administrative rulemaking discussed above, the Department is permitted to adopt an entirely unique definition of "unfair" that nevertheless hews to the small business, nonprofit, and family farm-protecting legislative intent of section 90009(e) and so has the lesser included power to adopt a familiar case law definition of "unfair" from a slightly different context, if the context were different, which it is not.

Three, adoption of tests from longstanding case law afford courts, the Department, consumers, and regulated entities – every stakeholder – the most certain roadmap for complaints, compliance, enforcement, and defense.

The phrasing of the proposed regulation defining "unfair" also is sensibly grounded in Dodd-Frank; specifically, 12 U.S.C. sections 5531. An act or practice is unfair under this statute when:

- It causes or is likely to cause substantial injury to consumers;
- The injury is not reasonably avoidable by consumers; and
- The injury is not outweighed by countervailing benefits to consumers or to competition[30]

Invoking Dodd-Frank's wording regarding injury is an especially important feature of the proposed regulations, memorializing and solidifying maximum flexibility for the Department to bring actions that afford the greatest bang-for-the-buck protection. Under Dodd-Frank, a "substantial injury" most commonly is a kind of monetary harm, such as fees or costs paid by consumers because of the unfair practice. But, under Dodd-Frank, the substantial injury

[30] 12 U.S.C. sections 5531in relevant part provides: "(c)Unfairness (1) In general -- The Bureau shall have no authority under this section to declare an act or practice in connection with a transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service, to be unlawful on the grounds that such act or practice is unfair, unless the Bureau has a reasonable basis to conclude that—(A)the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and (B) such substantial injury is not outweighed by countervailing benefits to consumers or to competition. (2) Consideration of public policies In determining whether an act or practice is unfair, the Bureau may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination."

does not have to be monetary.[31] Indeed, in certain circumstances emotional harm caused by unfair practices may qualify as substantial injury.[32] Finally, under federal guidance, as it would clearly be under state law, too, if the proposed definition invoking Dodd-Frank is adopted, a significant risk of harm is sufficient for an act to be "unfair."[33]

B. "Deceptive."

The proposed regulation defines "deceptive" as follows:

> (2) An act or practice is deceptive and may not be engaged in by a person offering or providing commercial financing or other financial products or services if a small business, nonprofit, or family farm is likely to be deceived by the act or practice.

While the "likely to be deceived" standard is found in longstanding UCL case law, a UCL "deceptive" violation, unlike a common law fraud claim, can be established even if no one was actually deceived, relied upon the fraudulent practice, or sustained any damage. The "deceptive" prong of the UCL requires only a showing that the statement is likely to deceive the public from the standpoint of the reasonable consumer."[34] The proposed definition of "deceptive" is also to some extent mirrored by the CFPB's manual definition of Dodd-Frank's definition[35] which, relying on the FTC's definition[36], defines "deceptive" as:

- The act or practice misleads or is likely to mislead the consumer;
- The consumer's interpretation is reasonable under the circumstances; and
- The misleading act or practice is material.

For the reasons discussed above, the proposed definition of "deceptive" is both supported and sensible.

C. "Abusive."

The proposed regulation defines "abusive" as follows:

> (3) An act or practice is abusive and may not be engaged in by a person offering or providing commercial financing or other financial products or services, if the act or practice does any of the following.
>
> (A) Interferes with the ability of a small business, nonprofit, or family farm to understand a term or condition of a financial product or service.
>
> (B) Takes unreasonable advantage regarding any of the following.

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[31] *See*, CFPB Exam Manual at UDAAP 2; *FTC v. Accusearch, Inc.* (D. Wyo. Sept. 28, 2007) 06-cv-105-D, 2007 WL 4356786, at *7- 8; FTC Policy Statement on Unfairness (Dec. 17, 1980), http://www.ftc.gov/bcp/policystmt/ad-unfair.htm

[32] Ibid.

[33] Ibid.

[34] *Haskell v. Time, Inc.* (E.D.Cal.1994) 857 F. Supp. 1392, 1398.

[35] CFPB Consumer Laws and Regulations, "Unfair, Deceptive, or Abusive Acts or Practices," October 2012. https://files.consumerfinance.gov/f/documents/102012_cfpb_unfair-deceptive-abusive-acts-practices-udaaps_procedures.pdf

[36] See FTC Policy Statement on Deception, available at http://www.ftc.gov/bcp/policystmt/ad-decept.htm. Examiners should be informed by the FTC's standard for deception.

1. A lack of understanding on the part of the small business, nonprofit, or family farm of the material risks, costs, or conditions of the commercial financing or other product or service.

2. The inability of the small business, nonprofit, or family farm to protect its interests in selecting or using the commercial financing or other financial product or service.

3. The reasonable reliance by the small business, nonprofit, or family farm on a person offering or providing commercial financing or other financial product or service to act in the interests of the small business, nonprofit, or family farm.

This proposed definition of "abusive" is wisely and almost exactly modeled after the Dodd-Frank federal definition as interpreted by the CFPB[37] and which reads as follows:

An abusive act or practice:

• Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service or

• Takes unreasonable advantage of:

o A lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;

o The inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or

o The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

For the reasons discussed above, the proposed definition of "abusive" is both supported and sensible.[38]

For all of the reasons above, we support the Department's proposed definitions of unfair, deceptive, and abusive acts and practices, and urge the Department to move forward with these rules.

Recommendation 2: APR pricing data must be collected

The proposed regulations recognize the importance of data reporting to enable the Department to regulate the financing market wisely so that responsible innovation grounded in competition to provide better priced, better quality products is encouraged and predatory practices are curbed, and to ensure that members of the public and stakeholders are able to monitor trends and issues as they partner with the Department. Recommendations 2-4 describe three necessary changes to the data collection section of the proposed rule.

[37] CFPB Consumer Laws and Regulations, "Unfair, Deceptive, or Abusive Acts or Practices," October 2012. https://files.consumerfinance.gov/f/documents/102012_cfpb_unfair-deceptive-abusive-acts-practices-udaaps_procedures.pdf see page 9.

[38] The proposed definitions of small business, nonprofit, and family farm, too, properly invoke current law.

First among these necessary changes, the rule must collect price data in the form of APR. This could be an alternative to, or in addition to, the current proposal to collect price data only in the form of dollar cost.

As the California Legislature recognized when it included "annualized rate" among the required terms disclosed to small businesses under SB 1235, dollar cost is insufficient as a measure of the price of financing because it does not account for time. As proposed, the data on dollar cost collected would not be useful to the Department or others, and could be misleading.

To illustrate, consider the following two portfolios that might be reported to the Department:

	Financing Amount	**Dollar Cost**	Term (not reported)	Monthly Payment (not reported)	APR (not reported)
Portfolio A	**$100,000**	**$10,000**	12 months	$9,167	18%
Portfolio B	**$100,000**	**$10,000**	1 month	$110,000	120%

Under the current proposal, these two portfolios would appear to be of equal price to their customers. Both have a dollar cost of $10,000 for financing of $100,000. But while Portfolio A provided customers with 12 months of use of $100,000, Portfolio B provides only one month's use of that money. The small business paid the same dollar cost, but they received something very different.

APR solves this problem by measuring cost over a common unit of time--the year. Under the Department's proposed SB 1235 regulations, which include disclosure of APR, the small business borrowers would be informed that the APR of Portfolio A is 18%, while the APR of Portfolio B is 120%. To understand the market effectively, the Department should know this information too.

Put another way, to obtain 12-months of use of Portfolio B's capital, bringing it equal in this sense to Portfolio A, the small businesses would need to re-borrow Portfolio B's 1-month financing 12 times. The dollar cost of Portfolio B, to be equivalent in use to Portfolio A, would thus be $120,000 rather than $10,000. (This is the $10,000 monthly cost 12 times over.)[39] The dollar cost metric currently proposed by the Department would not capture this drastic difference in the actual dollar cost.

Financing with different APRs can also have very different impacts on the health of California small businesses. One way the practical differences between Portfolio A and B are evident is in the monthly payment and its impact on cashflow--the lifeblood of a small business. While Portfolio A's 12-month term required monthly payments of $9,167, Portfolio B required monthly payment of $110,000.

[39] Of course, these small businesses re-borrowing Portfolio B each month would also have the inconvenience of needing to repay the full amount each month, preventing the capital from being invested in business uses that would require a longer repayment and potentially stressing the businesses cashflow.

Accion Opportunity Fund's alarming research also found that the average payment charged to small businesses using high-APR financing was about *double* what the small business could afford to pay.[40] The *average* financing contract, in this high-APR category, was pushing its small business customer from profitability into unprofitability. This indicates that higher-APR financing can have distinct implications for the viability of California small businesses, and the jobs and economies they support.

If the Department collects data based on dollar cost, without APR, the data will fail to capture this dynamic, and in fact would conflate affordable and unaffordable financing.

The payday-like re-borrowing described above, in comparing 12-month to 1-month financing, is not an abstract hypothetical. The business model of many small business financing companies intentionally encourages borrowers to renew their short-term financing over and over, year after year, similar to a payday loan. Some celebrate this on their websites! To quote one alternative financing company:

> "Approximately 90% of our Merchant Cash Advance clients participate in the program more than once. In fact, the average customer renews about ten times!"[41]

Thus the company is celebrating selling a short term financing product, which might appear to have a lower dollar cost, when a longer term financing product may be more appropriate for the customer and have a lower dollar cost over the period of time that the financing is actually used.

Another financing company website explains:

> "[Company name] has designed an excellent Renewal Program for our customers. Once your Merchant Cash Advance or Business Loan payback is 50% complete, you'll be eligible to renew with us for additional funding.
>
> Over 70% of our merchants take advantage of this option, many of them renewing for a third or fourth time. Our cash advance and business loan terms are less than a full year, which means just a few months after funding, you'll have a chance to get funded again…
>
> Our goal is to make a lasting connection with every merchant, and be there for them whenever they need a financing boost. That's what our Renewal Process is all about."[42]

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[40] See, e.g. St. Louis, Weaver, Donaker Brown, and McShane, Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," May 2016. https://www.opportunityfund.org/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/; Clark, Patrick. "How Much is Too Much to Pay for a Small Business Loan," May 16, 2014. Bloomberg. https://www.bloomberg.com/news/articles/2014-05-16/how-much-is-too-much-to-pay-for-a-small-business-loan

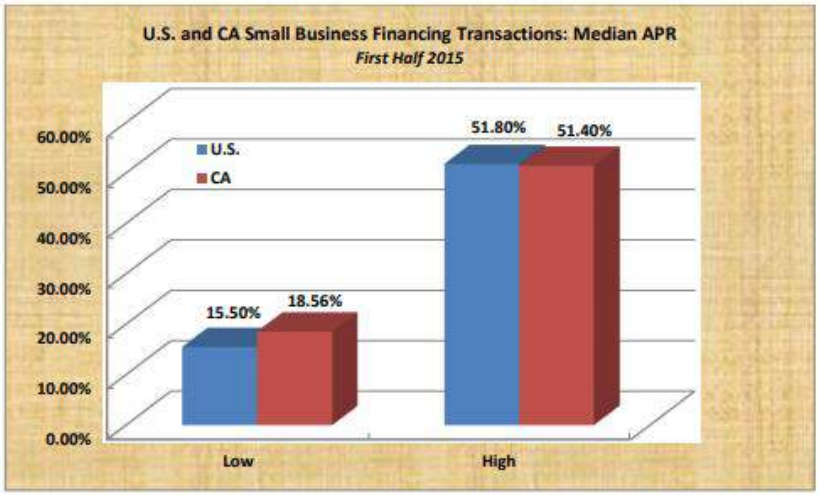
[41] RapidAdvance, "RapidAdvance Merchant Cash Advance Program," http://web.archive.org/web/20161110041235/http://www.rapidadvance.com:80/merchant-cash-advance

[42] Capify. https://www.capify.com/renewal-process-70-merchants-renew/

If a financing company's business model encourages borrowers to renew their short-term financing every time the financing is 50% repaid as part of "a lasting connection," it would be misleading to compare only the dollar costs of single transactions while missing the cost of the "lasting connection."

If the Department maintains price collection based on only dollar cost, without APR, it would perceive market activity in a way that is blind to, and could even encourage, financing designed to push small businesses into these payday-like cycles of borrowing.

For these reasons, the Department used APR as the metric of choice to evaluate the cost of commercial financing. In 2015, when the Department undertook a survey of the online small business financing market, it collected price data solely in the form of APR.[43] The following table was published by the Department in 2015, summarizing some of the conclusions of that survey:[44]



Collecting APR data will be even easier and more consistent with market practice than it was in 2015. Under the Department's proposed SB 1235 regulations, every financing provider in California will have the APR of each financing account they offer, or have clear guidance from the Department on how to calculate such APRs. Thus, collection and reporting of APR will not pose a higher burden on financing companies than collection and reporting of dollar cost.

APR is the only appropriate metric for the Department to use to sufficiently assess the cost of financing products offered to California small businesses, nonprofits, and family farms.

[43] Department of Business Oversight, "SURVEY OF ONLINE CONSUMER AND SMALL BUSINESS FINANCING COMPANIES – 01/01/2010 through 06/30/2015," https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/02/Survey-Response-Summary-Report-04-08-16.pdf
[44] Ibid.

Recommendation 3: Prevent misleading pricing by requiring reporting

These data collection rules can provide a much-needed solution to an unaddressed gap that regrettably remains in the Department's proposed rulemaking under the small business truth in lending law, SB 1235. In 2018, the California Legislature passed SB 1235 as the country's first small business financial protection law of the modern era. It has initiated a wave of similar laws across the country, including one passed in New York and others proposed in at least six other states and at the federal level. In its well-considered rulemaking under SB 1235, the Department is leading the national regulatory framework for small business financing.

However, a gap in the rules proposed under SB 1235 could undermine the effective function of that law, and its benefits to California's small businesses and economy. The proposed rules here must there be slightly modified to ensure that MCA companies' *flexibility* in estimating terms they disclose is paired with sufficient *accountability*. Under the currently proposed rules, MCA providers could mislead small businesses into higher-cost financing by disclosing unreasonably low payment amounts and APRs, without concern for consequence.

Under SB 1235, financing products that do not have a defined repayment term rely on a projection of the borrower's future revenue in order to calculate the estimated payment amount, term, and APR to be disclosed.

The proposed SB 1235 rules wisely establish two methods by which these projections can be determined for disclosure calculation purposes. The default is the highly-proscriptive "historical method," which is structured to avoid being "gamed" by financing companies that would seek to underestimate their APRs.

An additional, flexible "underwriting method" option is offered to enable providers to establish these projections though their own discretion. This underwriting method is a valuable alternative to the historical method for financing providers sophisticated enough to reflect sales trends, seasonality, or expected future sales events in their projections.

However, as currently written, the *flexibility* of the underwriting method is not paired with sufficient *accountability* to prevent its abuse. The underwriting method was originally proposed by the Responsible Business Lending Coalition to include reporting to the Department to establish that accountability. As currently written, providers using the underwriting method would instead conduct their own internal assessment of whether their disclosures have been sufficiently accurate. This creates two problems:

1) **There is little or no accountability** - The Department will have no way of knowing whether the required internal assessment has taken place. If the internal assessment is conducted, and finds that a merchant cash advance company's payment amount and APR disclosures are unacceptably low, the Department will have no way of knowing whether the required changes are made to improve the disclosure. These companies will be well aware that the

Department is in the dark. Relying on self-policing by an industry regularly compared to pre-crisis subprime mortgage lending[45] is insufficient.

2) **The Department will be unable to learn and improve the rules** - The SB 1235 rules establish accuracy tolerances of 10% and 5% for use of the Underwriting Method. It is not yet known whether these tolerance thresholds are too restrictive or too permissive. They may be significantly too restrictive, unduly complicating the financing process, or significantly too permissive, distorting the market by allowing much lower accuracy in disclosure than could be expected. Without reporting, the Department may never know, and will be unable to make informed regulatory decisions to adjust these thresholds.

We urge the Department to solve these problems by adding the following language to the proposed rule, which closely parallels the reporting proposed by the Department under these rules:

> (5) For providers of sales-based financing who elect to use the underwriting method to establish projections used in the calculations of terms disclosed to financing recipients pursuant to California Code of Regulations Title 10, Chapter 3, § 2092, [reporting of] the total number and total dollar amount the sales-based financing transactions in this state paid off during the prior calendar year with small businesses, nonprofits, and family farms. The minimum, maximum, average by unit count, and median annual percentage rate as disclosed to the recipient, and the minimum, maximum, average by unit count, and median retrospective annualized rate, under California Code of Regulations Title 10, Chapter 3, of the financing at each interval set forth in paragraph (3).

We urge the Department to adopt this recommendation in light of the following three considerations:

1) **Narrow scope, lower administrative cost for the Department** - This recommendation is simpler, and narrower in scope, than the reporting urged by the Responsible Business Lending Coalition and allies in previous comment letters regarding rulemaking under SB 1235. We previously recommended reporting data on each individual loan or advance, additional data points, and a new reporting framework. We now recommend including reporting groups of loans or advances bucketed together in loan loan size intervals (i.e. all financing amounts of $50,000 to $100,00) as proposed by the Department in these regulations, and fewer data points (disclosed APR vs. actual retrospective APR only). Rather than requiring a new reporting framework, this recommendation utilizes a reporting framework already proposed by the Department. The Department need only accept another set of data points, from a small subset of financing providers, through the reporting framework the Department has proposed in these regulations.

2) **New explicit legal authority** - AB 1864 granted the Department explicit new authority for rulemaking to require reporting on commercial financing activities. Section 90009(e) of that law reads: “The department, by regulation, may define unfair, deceptive, and abusive acts

[45] See, e.g. Shin, Laura, Forbes, “Why Online Small Business Loans are Being Compared to Subprime Mortgages,” Dec 2015. https://www.forbes.com/sites/laurashin/2015/12/10/why-online-small-business-loans-are-being-compared-to-subprimemortgages/#1afdbb592889

and practices in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms. The rulemaking may also include data collection and reporting on the provision of commercial financing or other financial products and services." If the Department was previously concerned that it lacked the authority under SB 1235 to gather the data it needs to ensure sensible, accurate, and useful monitoring and enforcement of this sector, clear statutory authority has now been granted.

3) **Lower regulatory burden on financing providers** - This recommended reporting on APR accuracy would be required only of sales-based financing providers who voluntarily elect to use the "underwriting method" in their disclosure calculations. This reporting would thus not be required of all businesses, but voluntarily elected only if a business firm sees a business benefit in utilizing the flexibility of the "underwriting method." Those firms will have the data required for this reporting, as the data will be required by the Department for use in internal audits under Section 2092 of the proposed SB 1235 regulations.

   Additionally, reporting of much more detailed data is required under New York's Small Business Truth in Lending Act, S5470/A10118, passed by the New York legislature in June of 2020.[46] Financing companies already preparing to report this data to the New York Department of Financial Services would not be unduly burdened by submitting a smaller set of equivalent data to the California Department of Financial Protection and Innovation as well. By adopting a reporting requirement to create the needed accountability for accuracy, the Department would also aid interstate harmonization of small business financing disclosure regulation, and set an example that New York state could consider following in its rulemaking.

California's small business truth-in-lending law is a model for the nation, and has the potential to be of enormous benefit to our state's small businesses and economy. Despite the Department's laudable work to implement this law, defeat will be snatched from the jaws of victory if merchant cash advance companies are able to low-ball the APRs they disclose to small businesses, without the Department knowing.

The Department has clear legal authority to prevent this deception by requiring narrowly-scoped reporting that would compare the APRs disclosed to the APRs actually charged, in the narrow set of

[46] The New York State Senate, "NY State Senate Bill S5470B," March 2020. https://www.nysenate.gov/legislation/bills/2019/s5470
Specifically, New York's S5470 reads: "§ 803(c)(II) The provider using the opt-in method shall determine the estimated annual percentage rate, the estimated term, and the projected payments, using a projected sales volume that the provider elects for each disclosure, provided, that they participate in a review process prescribed by the superintendent. A provider shall, on an annual basis, report data to the superintendent of estimated annual percentage rates disclosed to the recipient and actual retrospective annual percentage rates of completed transactions. The report shall contain such information as the superintendent, by rule or regulation, may prescribe as necessary or appropriate for the purpose of making a determination of whether the deviation between the estimated annual percentage rate and actual retrospective annual percentage rates of completed transactions was reasonable."

cases where the potential for abuse exists. The Department also has proposed a reporting framework to collect very similar data. We strongly urge the Department to use these capabilities as recommended here to ensure California's small businesses are not misled.

Recommendation 4: Avoid redundant reporting

The Department wisely has sought to avoid regulatory burden that would result from requiring financing providers to report the same data repeatedly. In Section X.90009.2.(C) of the proposed rule, the Department specifies that, "A person who reports data to the Commissioner under section 22159 of the California Financing Law (Fin. Code, § 22159) shall not report the same loan data to the Commissioner under this rule…"

We recommend a similar exclusion be offered with respect to data reported by covered persons to the CFPB, if that data is made available by the CFPB to the Department.

As you know, the CFPB has begun a rulemaking process for data collection on financing to small businesses under Dodd-Frank Act section 1071. The data collection proposed by the CFPB is broader in scope than the Department's proposed rule, but final scope of the CFPB's rulemaking, as well as timing of enactment, is uncertain and may be years away.

The CFPB's proposed rules do not include data of great value to the Department in its market monitoring and financial protection efforts. For example, as discussed in Recommendation 3 above, data on the accuracy of APR disclosures by merchant cash advance companies is crucial to the success of California truth-in-lending law, but that data may not be included in the federal rulemaking under Dodd-Frank Act section 1071.

Therefore, we encourage the Department to move forward with the proposed commercial financing data collection, but also to avoid the prospect of unnecessary regulatory burden that would result from redundant reporting of the same data to both the Department and the CFPB. If the Department is able to obtain data specified in this rule from the CFPB, it should do so and exempt that data from reporting obligation under this rule.

Clarifying Suggestions

In addition to the substantive suggestions above, we suggest several other clarifications to the data collection section of the proposed regulation:

a) Specify whether the average price is to be by unit or by dollar.

b) Split the proposed pricing amount bucket of pricing "over $100,000" with a presumed maximum of $500,000 into two buckets: "over $100,000 but under or equal to $250,000" and "over $250,000 but under or equal to $500,000." In addition, the Department may clarify the financing size buckets to include amounts exactly of $25,000, $50,000, and $100,000.

c) If “dollar cost” continues to be included, alongside APR, clarification is needed as the term “dollar cost” does not provide legal clarity as to which fees or charges are to be included. Again, the Department should look to its rulemaking under SB 1235 and replace the undefined term “dollar cost” problem with the more specifically-defined term “finance charge.”

Summary and redline of related recommendations

Below, in redline, are recommended revisions to the proposed Section X.90009.2. Commercial Financing Data, implementing recommendations 2, 3, and 4 discussed above:

(a) On or before March 31 of every year, each person engaged in the business of offering or providing commercial financing or other financial products or services to a small business, nonprofit, or family farm, including a provider under subdivision (m) of Financial Code section 22800, shall file the report required by this section with the Commissioner.

(b) Each person engaged in the business of offering or providing commercial financing or other financial products or services to a small business, nonprofit, or family farm shall report the following information regarding activity within this state for the calendar year preceding the due date of the report.

(1) The person’s contact and organization identification information.

(2) By type of commercial financing or other financial products or services, the person’s total number and total dollar amount of transactions in this state for the prior calendar year with small businesses, nonprofits, and family farms.

(3) By type of commercial financing or other financial products or services, the person’s total number transactions in this state for the prior calendar year with small businesses, nonprofits, and family farms for financing over $250,000 but under or at $500,000, over $100,000 but under or at $250,000, over $50,000 but under or at $100,000, over $25,000 but under or at $50,000, over $10,000 but under or at $25,000, and at or less than $10,000.

(4) On or after the operative date for the regulations under Financial Code section 22804, for the commercial financing data reported under paragraph (3) of this subdivision, the minimum, maximum, average by unit count, and median annual percentage rate ~~total dollar cost~~ of the financing at each interval set forth in paragraph (3).

(5) For providers of sales-based financing who elect to use the underwriting method to establish projections used in the calculations of terms disclosed to financing recipients under California Code of Regulations Title 10, Chapter 3, § 2092, the total number and total dollar amount the sales-based financing transactions in this state paid off during the prior calendar year with small businesses, nonprofits, and family farms. The minimum, maximum, average by unit count, and median annual

percentage rate as disclosed to the recipient, and the minimum, maximum, average by unit count, and median retrospective annualized rate, under California Code of Regulations Title 10, Chapter 3 of the financing at each interval set forth in paragraph (3).

(c) A person who reports data to the Commissioner under section 22159 of the California Financing Law (Fin. Code, § 22159) or who reports data to the Consumer Financial Protection Bureau under Dodd Frank Consumer Protection Act § 1071 in a form reasonably obtainable by the Commissioner shall not report the same loan data to the Commissioner under this rule but shall report data on any other commercial financing or other financial products or services."

Economic Impacts: Questions and Answers

The Department has invited input on the economic consequences of its proposed regulations. We offer our answers to these welcome questions below.

1. Whether the draft language impacts small businesses, where the small business is the provider of financial products and services, and where the small business is the consumer of financial products and services (generally a business with annual gross receipts of less than $2 million, that is independently owned and operated, not dominant in its field, and not a financial institution).

This UDAAP and data collection regulation will be of tremendous value to California's approximately four million small businesses,[47] one million of whom consume credit products in a given year. Using findings from the Federal Reserve's Small Business Credit Survey, we estimate that roughly 750,000 California small nonemployer firms seek financing, as well as 300,000 small businesses with at least one, but fewer than twenty employees.

The RBLC has counted 166 businesses that offer financing to small businesses that would be chiefly affected by Calfiornia's small business financing regulations.[48] Very few of these companies have revenue below $2 million or would qualify as small businesses themselves.

[47] Four million California businesses have fewer than 20 employees. These businesses make up 97.9% of all California businesses, and the vast majority have annual gross receipts of less than $2 million.
U.S. Small Business Administration Office of Advocacy, "2020 Small Business Profile California," https://cdn.advocacy.sba.gov/wp-content/uploads/2020/06/04142955/2020-Small-Business-Economic-Profile-CA.pdf

[48] Responsible Business Lending Coalition, "Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18," January 31, 2020. See pages 2-3.
http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_-_commercial_financing_disclosures_pro_01-18.pdf

Thus, small businesses that use, rather than provide, commercial financial services will make up the vast majority of the businesses affected by the draft language.

2. Whether the draft language impacts California competitiveness.

The draft language, if promulgated, will increase the competitiveness of California's businesses by protecting businesses from the cost and financial ruin caused by predatory lending. This will set California's businesses and economy at an advantage relative to places where businesses are subject to those costs and damages.

If the Department implements Recommendation 3 above to ensure the truth-in-lending law under SB 1235 functions effectively, this regulation will also create price competition through effective price disclosure, thus reducing the cost of financing in California. When advocating for the passage of the 1967 federal Truth in Lending Act, which provides transparency for consumers, sponsoring Senator William Proxmire stated, "Part of our free enterprise system is to disclose the fact to the consumer. When the consumers have the facts they can best make up their minds on whether to buy or not. This is at the heart of our free enterprise system. It insures that in the final analysis business is responsive to the needs of the consumer. Thus, disclosure is in the mainstream of our economic system."[49] Yet, not all competition is welcome. Competition as to which business can earn the most market share and profit through deceptions is not competition we want. The proposed regulations will help eliminate this kind of competition.

A healthy small business financing industry is important for a healthy California economy. Responsible financing is offered by scores of depositories and nonbanks, nonprofit CDFIs, and fintechs in California who are developing some of the most promising innovations in small business financing. Access to these sources of responsible financing suffers when irresponsible segments of the market find unfair advantage in practices that mislead or exploit small businesses and nonprofits.

In sum, competition should reward the businesses offering the best products. When unfair, deceptive, and abusive business practices are left unpoliced, competitive dynamics can penalize financing providers who are transparent and responsible, and thus encourage a "race to the bottom" where companies face pressure to adopt irresponsible practices to survive. This dynamic is one reason why parts of the small business financing market have been compared to the subprime mortgage market before the 2008 crisis.[50] And it is a reason why this coalition includes for-profit small business financing providers, as well as small business, nonprofit, and advocacy groups. By providing guardrails that promote healthy competition instead of exploitation, the proposed

[49] Statement made by Senator William Proxmire on the floor of the United States Senate, July 11, 1967, in support of the Truth in Lending Bill (s.5) that he sponsored and introduced on January 11, 1967. https://books.google.com/books?id=KBRdWzY1ZpsC&pg=PA18403&dq#v=onepage&q&f=false

[50] See, e.g. Shin, Laura, Forbes, "Why Online Small Business Loans are Being Compared to Subprime Mortgages," Dec 2015. https://www.forbes.com/sites/laurashin/2015/12/10/why-online-small-business-loans-are-being-compared-to-subprime-mortgages/#1afdbb592889

rulemaking under section 90009(e) will advance DFPI's dual mission of both financial protection *and* innovation.

3. The total dollar impact of the draft language, including costs and savings.

We estimate that the draft language would have nave a net economic benefit of $18.8 billion dollars, and create or preserve 14,000 California jobs.

Table: Summary of economic impacts of draft language

Affected Party	Benefits	Costs
Estimated 4 million small businesses	Up to $18.8 billion	$0
Estimated 166 covered financing companies	Unestimated benefits to responsible financing companies better able to compete on a level playing field.	Up to $28 million initially, up to $5 million in subsequent years
California jobs	14,000 jobs preserved or created.[51]	Few or zero net job losses at financing providers.
Total	*Up to $18.8 billion in economic benefit and 14,000 preserved or created jobs*	*Up to $28 million initially, and $5 million subsequently, in economic cost.*

This estimate reflects the benefits of reducing unfair, deceptive, and abusive practices in the market, and enabling price-sensitive small businesses to comparison shop for lower-cost financing by preventing MCA companies from "low-balling" the APR estimations disclosed to customers, as described in Recommendation 3.

Using data from the Federal Reserve, we predict that preventing circumvention of the Department's disclosure transparency standards by implementing Recommendation 3 above would enable 127,000 California small businesses to secure a more affordable financing option than they would have selected without access to easily understandable disclosures. We estimate that these businesses would save $617 million to $2.9 billion annually when empowered with the transparency needed to compare products and make informed credit decisions.[52] Moreover, we expect business owners of color, who apply for online financing at higher rates according to the Federal Reserve, to

[51] See Question 8.

[52] Responsible Business Lending Coalition, "Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18," January 31, 2020. see pages 2-3. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_-_commercial_financing_disclosures_pro_01-18.pdf

disproportionately benefit from expected savings. A more thorough explanation can be found in our comment letter from March 2021.[53]

Table: Direct and Secondary Effects of Robust SB 1235 Enforcement Through UDAAP

Economic Benefit	Description	Annual Savings
Switching savings	An estimated 127,000 California businesses may select lower-cost financing as a result of transparent disclosures, enabling them to save on finance charges and fees.	$617 million to $2.9 billion
Preservation of future revenue by avoiding premature, debt-induced business closures	An estimated 6,000 California businesses may be forced to close their doors unexpectedly as a result of unsustainable debt draining their cash flow. If not for the high-cost debt, these businesses may have survived and earned revenue over the average small business life cycle of 8.5 years.	Up to $10 billion
Avoided opportunity costs: time spent refinancing high-cost debt	Up to 127,000 price-sensitive loan applicants may need to refinance out of costly debt after struggling to keep up with higher-than-anticipated repayment schedules that were not clearly disclosed upfront. These business owners then must take time away from running their businesses to apply with new credit providers, complete paperwork, submit supporting documentation, etc.	Up to $100 million
Total		*Up to $13.6 billion*

In addition to enabling price-sensitive borrowers to save billions of dollars per year, we expect that UDAAP enforcement will also benefit small business owners who continue to choose higher-cost credit products after receiving transparent disclosures. Some higher-cost credit providers have

[53] Responsible Business Lending Coalition, "Comments RE: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21). RBLC Encourages DFPI to Swiftly Protect Small Businesses with UDAAP Rulemaking." March 2021. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_to_dfpi_on_ccfpl_rulemaking__pro_01-21__-_march_2021.pdf

been found to use unfair, deceptive, or abusive acts or practices, resulting in significant damages to borrowers. Based on our experience, these harmful practices are not uncommon in a portion of the higher-cost financing market.[54]

To estimate the benefits of UDAAP enforcement for higher-cost credit customers, we estimated the number of California MCA customers per year, the prevalence of UDAAP violations in the MCA market, and the value of one transaction subject to a UDAAP violation. We have used MCAs as a proxy for the size of the market more likely to be characterized by UDAAP concerns because of the prevalence of UDAAP enforcement actions against MCA providers, and the UDAAP concerns identified in the comment letter by the Responsible Business Lending Coalition and allies to the Department on March 8, 2021.[55] We note that MCAs are not inherently harmful to small businesses, and that other products, such as factoring, have also been characterized by the Federal Reserve as "potentially higher-cost and less transparent credit products"[56] and may also be more likely to pose a risk of UDAAP violations.

Our estimation of the annual number of California MCA customers is based on the Federal Reserve's Small Business Credit Survey finding that 9% and 8% of employer and nonemployer firms applied for MCAs in the prior year, and roughly 85% of applicants were approved[57]. For the value of a transaction involving a UDAAP violation, relied on a suit by the New York State Attorney General against several MCA providers, which described "$75 million on more than 1,900 fraudulent, illegal loans."[58] The average collected on these illegal transactions was thus roughly $39,000.[59]

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[54] There have also been several enforcement actions against against high-cost financing companies, based on UDAAP and similar grounds, including the Department's own action regarding Allup Financial (https://dfpi.ca.gov/wp-content/uploads/sites/337/2020/11/Consent-Order-Allup-Finance-LLC.pdf), and a 2020 case by the New York Attorney General against three MCA companies for exceeding state usury caps, charging undisclosed fees, pulling unauthorized ACH payments, and filing false affidavits to obtain judgments against their customers. (https://ag.ny.gov/press-release/2020/attorney-general-james-sues-predatory-lender-threatened-violence-and-kidnapping)

[55] Responsible Business Lending Coalition, "E: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21)." March 8, 2021. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_to_dfpi_on_ccfpl_rulemaking__pro_01-21__-_march_2021.pdf

[56] Zeeuw, Mels de, Federal Reserve Bank of Atlanta, "Small Business Credit Survey: Report on Minority-Owned Firms," Dec 2019. https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf

[57] Ibid.

[58] New York State Office of the Attorney General, "Attorney General James Sues Predatory Lender That Threatened Violence and Kidnapping, and Illegally Collected Millions from Small Businesses," June 10, 2020. https://ag.ny.gov/press-release/2020/attorney-general-james-sues-predatory-lender-threatened-violence-and-kidnapping

[59] New York State Office of the Attorney General, "Attorney General James Sues Predatory Lender That Threatened Violence and Kidnapping, and Illegally Collected Millions from Small Businesses," June 10, 2020. https://ag.ny.gov/press-release/2020/attorney-general-james-sues-predatory-lender-threatened-violence-and-kidnapping

We predict that over 70,000 California small businesses use at least one MCA per year. The total number of MCA transactions per year is likely much higher, as many MCA customers flip or renew their financing before it is paid off. (UDAAP concerns about these flipping practices are discussed in the Responsible Business Lending Coalition comment to the Department on UDAAP rules dated March 8th, 2021.[60]) If we assume that only 1% of the estimated 70,000 transactions is characterized by a UDAAP violation, the direct value of those UDAAP violations per year is nearly $30 million. This value is likely to be highly underestimated. If we assume that the prevalence of UDAAP violations in the MCA market is higher, such as 40%, the estimated direct value of UDAAP violations approaches $1.2 billion per year.

We expect that UDAAP enforcement will also provide extensive indirect benefits by deterring unfair, deceptive, and abusive acts and practices listed under Recommendation 1 above and detailed in our March 8, 2021 letter. Again, we use MCAs as a proxy for the higher-cost credit marketplace due to the prevalence of UDAAP concerns regarding MCA products. We monetize the following indirect benefits: the avoidance of lost future revenues from premature business closures, the value of business owners' time that would have been spent seeking financial relief from financing subject to UDAAP violations, and the future dollar cost of credit score damage due to charge offs caused by UDAAP violations.

UDAAP violations, such as exorbitant fees, unauthorized ACH withdrawals, or collections proceedings on loans that have not actually defaulted may cause financial hardships so significant that they force otherwise stable businesses to close their doors. The average lifespan of a small business is 8.5 years; depending on when the business opened relative to the time the UDAAP violation occurs, premature closure may cause the business to lose out on several years' worth of revenue. Using MCAs as a proxy, up to 1,400 business owners may be forced to close their doors prematurely due to hardships caused by a UDAAP violation. These businesses could lose up to an estimated $2.8 billion annually in foregone future revenue.

UDAAP enforcement will also help small business consumers of higher-cost credit to avoid two common outcomes of debt subject to UDAAP violations: opportunity costs of time spent seeking relief from debt subject to violations, and the future cost of credit score damage from charge offs caused by UDAAPs. Considering MCAs as a proxy, up to 30,000 small businesses may avoid the opportunity costs of time spent applying with new credit providers to refinance out of debt that was subject to UDAAPs. Estimates find that business owners spend an average of 26 hours seeking credit[61] and the average hourly wage for business owners is $27.[62] Total annual benefits for these avoided opportunity costs amount to $900,000 for MCA customers alone. We also estimate that without UDAAP enforcement, around 3,000 small businesses per year would incur higher lifetime

[60] Responsible Business Lending Coalition, "E: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21)." March 8, 2021. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_to_dfpi_on_ccfpl_rulemaking__pro_01-21__-_march_2021.pdf

[61] Federal Reserve Bank of New York, "Small Business Credit Survey," Fall 2013. https://www.newyorkfed.org/medialibrary/interactives/fall2013/fall2013/files/full-report.pdf

[62] Zip Recruiter, "Small Business Owner Salary," https://www.ziprecruiter.com/Salaries/Small-Business-Owner-Salary

interest costs due to credit score damage caused by unnecessary defaults. The lifetime value of these damaged credit scores amounts to over $300 million per year, given the multiplier effect of credit scores on future interest rates charged to UDAAP victims.

Table: Direct and Secondary Effects of Deterred UDAAP Violations

Economic Benefit	Description	Annual Savings
Avoided and deterred costs of UDAAP-characterized financing.	Up to 20,000 California businesses may avoid financing characterized by UDAAPs in amount of approximately $40,000, due to the deterrence of UDAAPs.	$29 million to $1.2 billion
Preservation of future revenue by avoiding premature business closures caused by financing characterized by one or more UDAAP violations	Up to 1,400 California businesses may be forced to close their doors unexpectedly as a result of unsustainable financing that is characterized by a UDAAP violation. If not for unexpected financial challenges, these businesses may have survived and earned revenue over the average small business life cycle of 8.5 years.	Up to $2.8 billion
Avoided opportunity costs: time spent refinancing debt subject to UDAAP violations	Nearly 30,000 California business owners may need to refinance out of debt that threatens their business' financial health due to UDAAP violations[63] These business owners then must take time away from running their businesses to apply to refinance the debt with new credit providers, complete paperwork, submit supporting documentation, etc. The New York Federal Reserve has found that small businesses spend approximately 26 hours searching for credit.[64]	Up to $900,000
Avoided credit score reductions: increased costs of future credit products acquired	An estimated 3,000 California businesses may experience avoidable defaults on high-cost credit products due to UDAAP violations annually. Missed	Over $300 million

[63] Based on scale of MCA industry as a proxy for the scale of financing in California more likely to be characterized by UDAAP concerns. Of course, some MCA products may not be characterized by UDAAPs, and some products other than MCAs may be.

[64] Federal Reserve Bank of New York, "KEY FINDINGS: SMALL BUSINESS CREDIT SURVEY, Q4 2013," 2013. https://www.newyorkfed.org/medialibrary/interactives/fall2013/fall2013/files/full-report.pdf

	payments and/or charge offs are typically reported to credit bureaus and lower the individual's credit score. Thus, credit reductions increase the cost of future credit products acquired by the business owner.	
Total		*Up to $5.2 billion*

This $18.8 billion total estimated benefit to California's small businesses and economy is 670 times greater than the estimated maximum initial compliance costs to providers of financial services of $28 million. These benefits are 3,760 times greater than the maximum estimated $5 million in ongoing compliance costs to financing companies.

4. The total number of businesses impacted by the draft language, and the number or percentage that are small businesses.

California is home to 4.05 million small businesses with fewer than 20 employees. These businesses make up 97.9% of all of California businesses. The overwhelming majority (approximately 3.4 million) do not have any employees. The other 677,000 firms with between one and 20 employees employ approximately five million Californians, accounting for 35% of the workforce. The vast majority of these kinds of small businesses also have annual gross receipts of less than $2 million. Thus approximately 75% - 97% of California's businesses are small businesses with annual gross receipts of less than $2 million and will potentially benefit from a competitive lending environment that discourages unfair, deceptive, and abusive lending practices.[65] Additionally, benefits will accrue to California's nonprofits and family farms, which are not counted here.

In comparison, the RBLC has estimated that about 166 businesses are active financing providers in California. Only a negligible portion of these have less than $2 million in annual revenue. Thus, small businesses who are consumers, rather than providers, of financial services will make up the vast majority of the businesses affected by the draft language.

[65] U.S. Small Business Administration Office of Advocacy, "2020 Small Business Profile California," https://cdn.advocacy.sba.gov/wp-content/uploads/2020/06/04142955/2020-Small-Business-Economic-Profile-CA.pdf

5. Whether the draft language will result in the creation or elimination of businesses in this state, and the numbers of each.

The draft language will also prevent an estimated 6,000 California businesses from closing their doors unexpectedly as a result of unsustainable debt draining their cash flow. If not for the high-cost debt, these businesses may have survived and earned revenue over the average small business life cycle of 8.5 years and earned between $50,000 and 1.6 million annually.[66]

6. Whether the draft language will affect the ability of California businesses to compete with other states by making it more costly to provide services here.

As discussed above, if the coalition's recommendations are implemented and the regulations adopted, the proposed rules will make California small businesses more competitive by making it *less* costly for small businesses to operate here.

The draft proposed regulations will make it less costly for California's small businesses that are affected by predatory financing to do business at a lower cost, which will make those businesses more competitive.

About 6,000 times more small businesses than financing providers will be affected by this regulation.[67] The positive effects of this regulation on those million small businesses each year are meaningful, and the negative effects on financing providers are negligible and offset by the positive effects of creating a more level playing field for responsible financing companies to compete.

7. Whether the draft language will provide benefits, including but not limited to cost savings, to small business consumers.

See Questions 3 and 6.

[66] Responsible Business Lending Coalition, "Comments RE: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21). RBLC Encourages DFPI to Swiftly Protect Small Businesses with UDAAP Rulemaking." March 2021. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_to_dfpi_on_ccfpl_rulemaking__pro_01-21__-_march_2021.pdf See page 28.

[67] 1 million California small businesses affected is 6,000 times the estimated 166 financing providers affected. See Questions 1 and 11.

8. Whether the draft language will result in the creation or elimination of jobs in this state, and the numbers of each.

By preventing small business closures that would have resulted from unfair, deceptive, or abusive credit products, or exploitation of the Department's truth in lending rules to "low-ball" APR disclosures, we estimate these regulations will create an estimated 14,000 jobs per year. This estimation is based on the 7,500 preserved businesses described in Question 5 above and the average number of employees per California enterprise size according to Census Bureau data.[68]

Again, the proposed regulations simply memorialize laws that companies must already comply with. The only job losses we can imagine would be of jobs that rely on using unfair, deceptive, or abusive acts or practices in commercial financing. We expect any such losses to be few, and offset by the creation of new compliance jobs, if these financing companies previously did not have adequate compliance staff to prevent these unfair, deceptive, or abusive practices, and the creation of other jobs at these firms as they "re-tool" to compete without abusing customers. Of course, any such job losses would also be offset by jobs created at small businesses now protected from abuse, and at responsible financing companies who grow as a result of unfair competition being removed from the market.

9. Whether the draft language will result in the expansion of businesses currently doing business in this state.

Yes. Once freed from being subjected to unfair, deceptive, and abusive acts and practices, California's small businesses will earn more profit, hire more workers, and expand.

10. Whether the draft language provides benefits to the health and welfare of California residents, worker safety, and the state's environment.

While the draft language does not directly address the health and welfare of California residents, worker safety, and the state's environment, the language will have indirect effects that are difficult to quantify. The draft language may increase the health and welfare of at least 1.5 million employees by decreasing stress levels because of increased stability of small business employers that are protected from UDAAP practices. Small businesses that are not worried about their businesses going bankrupt are more likely to pay attention to workers' needs, including their safety. Likewise, if their time and energy is free from worry about paying off predatory financing, they will have more time to think about how they can save money by implementing energy efficiency measures.

[68] Link to download data: https://www2.census.gov/programs-surveys/susb/tables/2018/us_state_naics_detailedsizes_2018.xlsx

11. The total statewide dollar costs that businesses may incur complying with this draft language.

For the estimated 166[69] financing commercial financing providers covered by this rule, we generously estimate initial compliance costs to be below $170,000, and ongoing compliance costs to be less than $32,000.

In most cases, the actual compliance costs will be much less than estimated here. Covered finance companies already have compliance programs and staff to support compliance with California's existing unfair competition laws and required annual reporting, as well as the Federal Trade Commission Act and Unfair or Deceptive Acts and Practices (UDAP), the Equal Credit Opportunity Act (ECOA), the Telephone Consumer Protection Act (TCPA), the CAN-SPAM Act, the Fair Credit Reporting Act (FCRA), the Servicemembers Civil Relief Act (SCRA), the Uniform Commercial Code (UCC), Treasury OFAC and Fincen regulations, and a range of other state or federal laws and regulations.

The costs of compliance with this regulation will simply become a part of this work. Based on the experience of coalition members' compliance teams, we believe the required ongoing compliance work would be less than the work of one full-time-equivalent compliance member, and thus likely not require hiring additional staff to a compliance function that is already fully staffed. We estimate that the cost to providers of coming into compliance with the proposed regulations for the first time, if not fully absorbed into the responsibilities of existing staff, could be as high as the following:

	UDAAP	**Data Collection**	**Total**
Initial cost per firm	$95,000	$75,000	$170,000
Ongoing cost per firm	$0	$32,000	$32,000
Total initial cost	$15.5 million	$12.5 million	$28 million
Total ongoing cost	$0	$5 million	$5 million

We thus estimate total initial compliance costs to be up to $28 million, and ongoing compliance costs to be up to $5 million.

[69] Estimate based on 60 providers signed on to the Responsible Business Lending Coalition's Small Business Borrowers Bill of Rights (www.borrowersbillofrights.org/signatories.html), 8 providers in the ILPA (https://innovativelending.org/); 74 merchant cash advance companies listed in the funder directory of the DeBanked trade publication (https://debanked.com/merchant-cash-advance-resource/merchant-cash-advance-directory/); 17 non-bank providers in Equipment Leasing and Financing Association in California, offering debt, conditional sale/money-over-money, or sale/leaseback financing (https://www.elfaonline.org/directories/directories-home); and 7 providers in Financial Innovation Now (https://financialinnovationnow.org/).

This is far below the estimated economic benefit to small businesses who use financial services, which we estimate to be up to $18.8 billion.

Some financing companies opposed to being subject to the Department's UDAAP oversight or to transparent disclosure may argue that the cost of complying will be passed on to their small business customers. This argument would posit that the small business financing market is highly competitive, with price competition fierce enough that financing companies across the market must lower their prices as much as they are able to attract customers. In a market this efficient, additional compliance costs would force a financing company out of business if those costs could not be passed on to the customer.

However, prices in the small business financing market characterized by UDAAP concerns are demonstrably not efficient, and thus can likely be absorbed by financing providers without passing costs on to small business customers, as demonstrated in the Responsible Business Lending Coalition's October 2020 comment to the Department on commercial financing disclosures.[70]

For example, the undisclosed APRs charged by some small business financing companies average 94% in some categories, reaching 350% or more.[71] Studies document excessive and arbitrary fees charged by MCA companies, such as a $249 "risk assessment fee" charged in addition to a $395 "origination fee." It is not clear what cost was incurred by the financing company, and what service rendered to the small businesses, in exchange for the first fee but not the second.[72]

One troubled business shared with the Responsible Business Lending Coalition a contract whose fine print included an "account management fee" which permitted the merchant cash advance company to double-charge the borrower one extra payment per month without applying that payment towards the amount the small business owed.[73] Another contract charged a 10% "due diligence fee," and $495 origination fee in addition to a 50% financing fee.

These prices and fees do not characterize an efficient market, trimmed of fat, with profits earned through innovation and delivery of value. Instead, they demonstrate an ability to price arbitrarily, suggesting an inefficient market where costs need not be passed on to the customer.

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[70] Responsible Business Lending Coalition, "Comment to DFPI EE: Commercial Financing Disclosures Rulemaking, File No. PRO 01-18," October 28, 2020. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/10.28_rblc_letter_pro_0118_%E2%80%93_commercial_financing_disclosures_sb_1235.pdf

[71] St. Louis, Weaver, Donaker Brown, and McShane, Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," May 2016. https://www.opportunityfund.org/wpcontent/uploads/2019/09/Unaffordableand-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf

[72] Woodstock Institute, "Analysis of Business Loan Terms," July 2016. https://woodstockinst.org/wpcontent/uploads/2016/07/Woodstock_Analysis_of_Online_SB_Loan_Terms.pdf

[73] That contract read: ""Account Management Fee - At the end of each month, Merchant will pay to ROYAL BUSINESS GROUP LCC an Account Management Fee. This fee will not be applied towards the reduction of the Purchased Amount. This monthly fee will equal the average of all the payments received as a "Specified Percentage" of the Merchants settle amount for that Month." Without this fee, the APR appears to be 490%. With this fee, it appears to compute to 542%.

Make no mistake, the primary cost these rules introduce to financing companies is not compliance cost, but the cost of facing fair competition. When unfair practices are removed from the market, financing companies that have relied on those practices will need to find ways to compete fairly by providing real value to customers. And when the lack of transparency is dispelled and comparison shopping is enabled, some small businesses will elect to seek lower-priced financing. Every dollar lost by high-cost or irresponsible financing companies for this reason is a dollar saved by a California small businesses.

12. The initial costs for a typical business to comply with the draft language.

There is no compliance cost to the vast majority of businesses affected by this rule, which are the small businesses protected by these regulations. The initial cost to financing companies are generously estimated to be $170,000 each, at most.

For the UDAAP portion of these rules, covered commercial financing companies may choose to conduct an initial review for potentially abusive acts or practices. These companies are already subject to Section 17200 of the California Business and Professions Code and the Fair Trade Commission Act, which both prohibit unfair and deceptive acts and practices. Thus, the review for abusive practices would be an expanded part of their existing reviews for unfair and deceptive acts and practices. Nonetheless, we have estimated the addition of “abusive” could take up to three months of time by compliance staff, and an equal amount of time for staff elsewhere in the business to participate in these reviews.

Form of Cost - Abusive Practices Review	**FTE**	**Estimated Annual Pay**	**Cost**
Compliance staff, to conduct a review for abusive practices	25% (3 mo)	$175,000	$43,750
Business staff, to assist in these reviews	25% (3 mo)	$200,000	$50,000

Based on our assessment of approximately 166 covered firms, we estimate a total cost of $15.5 million in staff time. The estimate here is based on the cost of conducting a typical review without significant findings. If there are findings of abusive acts or practices, ceasing them may require additional cost. We consider those costs out of scope as they are the result of rectifying potential harm to customers instead of the result of these regulations.

For the reporting portion of this rule, the initial compliance costs are generously estimated to be up to $75,000, as described in the table below:

Form of Cost - Establishing reporting systems	Staff time	Estimated Annual Pay	Cost
Compliance staff, to establish reporting process	2 mo	$175,000	$29,167
Data analysis staff, to gather and prepare data	2 mo	$175,000	$29,167
Business staff, to review	½ mo	$200,000	$8,333
Legal staff, to review	½ mo	$200,000	$8,333

Most covered companies already report annually to the Department. For these, initial costs should be much lower, perhaps one tenth as much.

13. The annual ongoing costs for a typical business to comply with the draft language.

There will be no ongoing costs of the UDAAP portion of this regulation for financing companies complying with existing law. The compliance staff of financing companies covered by this law already conduct reviews to prevent unfair and deceptive practices, under Section 17200 of the California Business and Professions Code and the Fair Trade Commission Act. Considering abusive acts and practices would simply become part of these existing reviews to prevent unfair and deceptive practices.

14. Whether any other economic costs may occur from the draft language, beyond the costs to a typical business.

These rules may impose significant costs on financing companies that rely on unfair, deceptive, or abusive acts and practices to extract profits from California small businesses and nonprofits. The cost of ceasing these acts and practices will be a boon to small businesses, nonprofits, the economy, and responsible financing companies who will no longer have to compete against unfair practices.

15. The annual costs a typical business may incur to comply with the reporting requirement in the draft language, including the programming, recordkeeping, reporting, and any other paperwork.

We estimate ongoing reporting costs to be up to $31,000 per financing company.

Form of Cost - Establishing reporting systems	**Staff time**	**Estimated Annual Pay**	**Cost**
Compliance staff, to manage reporting process	½ mo	$175,000	$7,292
Data analysis staff, to gather and prepare data	½ mo	$175,000	$7,292
Business staff, to review	½ mo	$200,000	$8,333
Legal staff, to review	½ mo	$200,000	$8,333

However, most covered financing companies already report much more extensive information annually to the Department. For these firms the marginal cost of several additional data points will be much lower.

Our Recommendation #4 would require collecting several additional data points from merchant cash advance companies voluntarily utilizing the flexible “underwriting method” of estimating APRs. We do not believe this would result in meaningful additional costs because these firms will already have those data under the points under the Department’s proposed SB 1235 regulations, and they will already be reporting very similar data points to the Department under these proposed regulations. Additionally, the reporting of these additional data points would be undertaken only voluntarily by firms who see that option as a business benefit.

16. Whether the draft language duplicates any other reporting requirements.

As the CFPB implements Section 1071 of the Dodd Frank Act, partial duplication could emerge. See Recommendation 4, above.

17. Whether any alternative to the draft language will provide the same protections for small businesses and the same or similar data on market activity in this state, at a lower cost or burden to businesses impacted by the draft language.

Yes. See Recommendation 4 and the proposed text revisions section, above.

18. Whether any alternative to the draft language would lessen any adverse impact on small business.

Yes. See Recommendation 2: APR pricing data must be collected, Recommendation 3: Prevent misleading pricing by requiring reporting, and the proposed text revisions above.

19. The consequences of the draft language on those impacted.

As discussed above, if the recommendations above are accepted, the draft language will result in fewer small business closures, more small business growth and job creation.

Cost to financing providers will be relatively small, and offset by lower financing cost to small business resulting from creating more fair competition in the small business financing market. This increase in fair competition also has the potential to encourage innovation of higher quality, more affordable financing options, especially the minority-owned and small businesses who are disproportionately affected by unfair practices that reduce constrictive competition in the financing markets.

Conclusion

Thank you for affording us the opportunity to comment on the proposed regulations and answer your foundational questions and, in advance, thank you for your consideration of our views and suggestions. If we can be of any assistance, please do not hesitate to contact us at info@borrowersbillofrights.org.

Respectfully submitted:

1. The Responsible Business Lending Coalition

   Executive Committee members include Accion Opportunity Fund, Community Investment Management, Funding Circle, LendingClub, Opportunity Finance Network, Small Business Majority, and the Aspen Institute

2. Access Plus Capital
3. Accion Opportunity Fund
4. Accesity
5. Agriculture & Land Based Training Association (ALBA)
6. AmPac Business Capital
7. American Fintech Council

    Board members include Affirm, Avant, Cross River, LendingClub, Marlette Funding, Prosper, SoFi, Upstart, and Varo
8. AnewAmerica Community Corporation
9. Asian Pacific Islander Small Business Program
10. Bankers Small Business CDC of California
11. Bay Area Development Company
12. California African American Chamber of Commerce
13. California Asset Building Coalition
14. California Association for Micro Enterprise Opportunity (CAMEO)
15. California Capital Financial Development Corporation
16. California Hispanic Chamber of Commerce
17. California Low Income Consumer Coalition (CLICC)
18. California Small Business Development Center - Valley Community
19. CDC Small Business Finance
20. Consultrex
21. Consumer Advocates Against Reverse Mortgage Abuse (CAARMA)
22. Consumer Federation of California
23. California Reinvestment Coalition
24. The COOK Alliance
25. The CraneWorks
26. Economic Development & Financing Corporation
27. El Pajaro Community Development Corporation
28. Fondo Adelante, Mission Economic Development Agency
29. Fresno Area Hispanic Foundation
30. Fresno Metro Black Chamber of Commerce & Chamber Foundation
31. Funding Circle
32. GO LOCAL Sonoma County
33. Halo Business Finance Corp
34. The Greenlining Institute
35. Inclusive Action for the City
36. Inner City Advisors

37. Invest in Women Initiative
38. International Rescue Committee's Center for Economic Opportunity
39. Jefferson Economic Development Institute (JEDI)
40. Latino Business Network & Allies
41. Latino Economic Development Center (LEDC)
42. LendingClub
43. Lighter Capital
44. Main Street Launch
45. Marian Doub Consulting
46. Maximum Reach 4 Economic Equity
47. Multifunding
48. Oakland African American Chamber of Commerce
49. Office of Kat Taylor
50. Pacific Community Ventures
51. Prospera Community Development
52. Prosperity Lab
53. Renaissance Entrepreneurship Center
54. Richmond Main Street
55. San Francisco African American Chamber of Commerce (SFAACC)
56. San Mateo Area Chamber of Commerce
57. Silver Lining
58. Small Business California
59. Small Business Majority
60. Start Small Think Big
61. Wadeco Business Center
62. Women's Business Center at JEDI
63. Women's Economic Ventures
64. Woodstock Institute
65. Working Solutions CDFI

Attached: Responsible Business Lending Coalition, "E: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21)." March 8, 2021

Commissioner Manuel P. Alvarez
Department of Financial Protection and Innovation
2101 Arena Blvd., Sacramento, CA 95834

Via electronic mail - ATTN: Charles Carriere, Senior Counsel

> RE: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21). RBLC Encourages DFPI to Swiftly Protect Small Businesses with UDAAP Rulemaking.

Dear Commissioner Alvarez,

California is facing vast and permanent damage to the small business ecosystem that helps produce our middle class and the fabric of our local communities. When we drive past the closed storefronts in our towns and cities, we need no reminder that small businesses are devastated by the impacts of COVID-

19, desperate for help, and more vulnerable than ever to predation. The California State Legislature has endowed the Department of Financial Protection and Innovation ("DFPI") with unique power to protect small businesses. We encourage the DFPI to quickly provide this protection.

The Responsible Business Lending Coalition (RBLC) is grateful for this opportunity to respond to the DFPI's February 4, 2021 Invitation for Comment on Proposed Rulemaking. The RBLC is a nonprofit/industry coalition of community development organizations, fintechs, consumer and small business advocates, and small business lenders that have come together in response to the growing problem of predatory small business financing. The RBLC, joined by over 45 organizations, worked with the leaders in the Legislature to support the passage of the California Consumer Financial Protection Law (CCFPL), including provision 90009(e) which empowers DFPI to protect small businesses.

The California legislature created the DFPI to fill gaps in financial protection regulation, especially in new and emerging industries that are unaddressed by the Consumer Financial Protection Bureau (CFPB). One of the largest regulatory gaps is in small business financing. Annually, an estimated 127,000 California small businesses may overpay for financing as a result of a lack of fair market competition, resulting in an estimated $1.4 billion to $12.1 billion of direct economic impact.[1] In addition, these 127,000 businesses are impacted by secondary effects of the unregulated commercial financing market, costing them tens of billions in opportunity costs, lost future revenues, and the consequences of damaged credit scores. These small businesses are critical to family economic well-being and employ an estimated 1.5 million Californians. The CFPB lacks authority under the Dodd-Frank Act to protect these small businesses from unfair, deceptive, and abusive acts or practices (UDAAP).[2]

A new and growing industry of high-rate financing companies is exploiting this regulatory gap and destroying community wealth in California. The APRs charged by some emerging financing products can reach over 300%[3] and a troubling record of UDAAP concerns has developed.

This lack of regulatory protection is causing disproportionate harm in communities of color. Federal Reserve research recently concluded that Black and Hispanic entrepreneurs are twice as likely to be affected by "potentially higher-cost and less-transparent credit products."[4] This research specifically identifies merchant cash advance (MCA) and factoring products as "potentially higher-cost and less-transparent credit products."

The California State Legislature's inclusion of § 90009(e) in the CCFPL reflects a recognition that small business owners are also individuals and make many business financing decisions as they would on their consumer mortgage or car loan. If they fall prey to predatory lenders, they may lose their livelihoods and

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[1] Responsible Business Lending Coalition, "Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18," January 31, 2020. See pages 2-3. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_-_commercial_financing_disclosures_pro_01-18.pdf

[2] CFPB's authority in small business financing is focused on the data collection described in Dodd-Frank Act Section 1071.

[3] See, e.g. St. Louis, Weaver, Donaker Brown, and McShane, Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," May 2016. https://www.opportunityfund.org/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/; Clark, Patrick. "How Much is Too Much to Pay for a Small Business Loan," May 16, 2014. Bloomberg. https://www.bloomberg.com/news/articles/2014-05-16/how-much-is-too-much-to-pay-for-a-small-business-loan

[4] Zeeuw, Mels de, Federal Reserve Bank of Atlanta, "Small Business Credit Survey: Report on Minority-Owned Firms," Dec 2019. https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf

possibly their homes. Their employees may lose their livelihoods. However, consistent enforcement of new financial protections could help California small businesses create as many as 25,000 new jobs.[5]

The CCFPL's inclusion of small business protections is also a response to the economic disaster wrought by COVID-19, which has put small business in crisis and exacerbated societal inequities. A report by Yelp found that 19,000 businesses in California had already permanently closed as of September of last year.[6]

The economic pain has not been equal. Black-owned and immigrant-owned businesses have closed at more than double the rate of White-owned businesses, followed closely by Latinx-owned businesses. Asian-owned and woman-owned businesses have closed at 1.5 times the rate of white-owned businesses overall.[7]

Without CFPB protection, DFPI is the only agency that can prevent this evisceration of community wealth and economic mobility, and the disproportionate harm facing communities of color and immigrant communities.

The small business financing industry remains of critical importance to the health of California's economy. Responsible financing is offered by scores of depositories and nonbanks, nonprofit CDFIs, and fintechs in California. In fact, some of the most promising innovations in small business financing are being developed here in California. But access to these sources of responsible financing suffers when irresponsible segments of the market find unfair advantage in practices that mislead or exploit small businesses.

New and better products succeed in the market when competition rewards honest value creation. When unfair, deceptive, and abusive practices are left unpoliced, competitive dynamics can penalize financing providers who are transparent and responsible, and thus encourage a "race to the bottom" where companies face pressure to adopt irresponsible practices to compete. This dynamic is one reason why parts of the small business financing market have been compared to the subprime mortgage market before the 2008 crisis.[8] By providing guardrails that promote healthy competition instead of exploitation, rulemaking under 90009(e) can advance DFPI's dual mission of both financial protection *and* innovation.

In the following letter, we share stories of small businesses and nonprofits affected by predatory lending and provide examples of specific commercial UDAAP problems that DFPI could address. We also recommend that DFPI's data collection authority under § 90009(e) be used in conjunction with the rules that DFPI is promulgating under SB 1235, the first small business truth-in-lending law in the nation.

Also attached is a legal memorandum finding that DFPI has the power to enforce violations of UDAAP as defined in a rulemaking under § 90009(e), written by former CFPB Director and Supreme Court clerk Richard Cordray and California attorney Ed Howard, on behalf of the Office of Kat Taylor. The

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[5] Responsible Business Lending Coalition, "Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18," January 31, 2020. See pages 2-3.

[6] "Yelp: Local Economic Impact Report," September 2020. https://www.yelpeconomicaverage.com/business-closures-update-sep-2020.html

[7] Fairlie and NBER, University of California, Santa Cruz, "The Impact of Covid-19 on Small Business Owners: Evidence of Early-Stage Losses from the April 2020 Current Population Survey," May 2020. https://siepr.stanford.edu/sites/default/files/publications/20-022.pdf

[8] See, e.g. Shin, Laura, Forbes, "Why Online Small Business Loans are Being Compared to Subprime Mortgages," Dec 2015. https://www.forbes.com/sites/laurashin/2015/12/10/why-online-small-business-loans-are-being-compared-to-subprime-mortgages/#1afdbb592889

memorandum also includes suggested language for the § 90009(e) rulemaking, to support DFPI in proceeding quickly to initiate the protections small businesses need.

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Accounts of California Small Businesses and Nonprofits Victimized by Predatory Financing

Several small business owners were brave enough to share their stories of predatory lending for inclusion in this comment. Most of the business owners sharing their stories are still in litigation, or undergoing bankruptcy, and asked that their names remain anonymous. Jim Cook, leader of Antelope Valley Community Health, offered to go on record to share the story about the rise and eventual sale of the clinic due to predatory lending.

Lancaster, California: Antelope Valley Community Clinic

When Jim Cook and other community members came together to start a mobile healthcare clinic in Antelope Valley, California, Mr. Cook had been doing community work for decades. The Antelope Valley Community Clinic opened as a solution to the lack of primary care services for the underinsured and uninsured in the Antelope Valley, which spans over 2,000 square miles and has over 480,000 residents. Antelope Valley also has some of the poorest health indicators in all of Los Angeles County including diabetes, infant mortality, and obesity, congestive heart failure, asthma, and others.[9] The mobile clinic Jim ran became the only clinic available in the area. Almost all the patients were MediCal recipients or uninsured and would otherwise use emergency room services when they needed care.

The ribbon cutting celebrating the opening of the Antelope Valley Community Clinic branch in East Palmdale.

[9] Antelope Valley Community Updates and Events, "Antelope Valley Community Clinic," https://www.antelopevalley.com/antelope-valley-community-clinic.html

By 2010, the clinic had expanded to several offices with an operating budget of $3 million and 245 staff members. To finance taxes that were due during this period of expansion, they took an MCA from a company that offered to help.

After the deal was signed, the financing company delayed disbursement of the funds but began collecting payment. As the Community Clinic's finances became tighter and fell behind on its MCA payments, they took a second MCA that was offered to help pay for the first. This led to a third, and fourth MCA, in a debt-trap cycle of borrowing to repay unaffordable debt.

The financing company set this trap using a series of UDAAP practices sometimes deployed together in the high-rate small business financing industry. It began with a payment beyond the clinic's ability to pay, and a lack of transparent disclosure that could have helped Mr. Cook and his colleagues better evaluate the financing offer.

First, the financing companies repeatedly delayed disbursement of the needed funds, effectively nudging the clinic toward delinquency. Once delinquent, the clinic was required to negotiate from a desperate position where it would be more willing to accept abusive terms.

Second, the financing companies flipped the clinic through multiple loans, each time generating new fees. Having led the clinic into a more desperate situation, the financing company promised a better deal, at a lower rate, if the clinic would refinance. This generated new fee income for the financing company each time and increased their annualized returns by accelerating repayment. MCAs generally require repayment of a fixed amount that does not decrease if the financing is paid off earlier. If the MCA is refinanced as repaid in half the expected time, the MCA company's annualized yield doubles.

Third, each time the new financing is used to repay older financing, the borrower can be "double dipped." This term is used in the high-rate small business financing industry to refer to double charging a borrower during a refinance.

The churn from one financing transaction to the next sometimes ends when the financing company decides the borrower cannot be squeezed further and that it is time to get out. In a practice called "carroting," they may offer one last "great" financing deal as a "carrot," if the borrower will pay off the outstanding MCAs to qualify. That final "carrot" is never delivered, but it enables the financing company to walk away whole from the financially drained business.

In this case, the Antelope Valley Community Clinic was already too drained to pay. And so, the MCA company shifted to collections. MCA company representatives drove across the East Coast contacting the various sources of the clinic's revenue, collecting thousands from various pharmacies that contracted with the clinic.

The MCA company also attempted to take funds from Mr. Cook's personal account. Fortunately, they were unsuccessful, as Mr. Cook's community bank refused. Had the bank not protected Mr. Cook, he could have lost his home.

To try and recover, the Antelope Valley Community Clinic laid off about 25 staff members and outsourced several activities. That wasn't enough. Ultimately, the clinic had to be sold to a larger healthcare provider.

In a seven-month period, Antelope Valley Community Clinic paid out over $2.2 million to the MCA company for an original financing amount of $1.2 million. While we do not know the cadence of payments,

if we assume the payments were made in equal amounts over that period, the APR would have been 233%.

San Diego, California: Emergency response software company

A San Diego-based company building emergency response software had a similar story to tell. Their software helps emergency medical services and fire departments respond to crises more efficiently. The company employed 45 workers.

Several years ago, unable to secure more traditional financing, the business owners' accounting firm referred them to a loan broker who recommended a merchant cash advance. In some correspondences, the broker advised the business owner that signing the contract with an MCA was a "big step towards better lending" with a "real bank". In one instance, the broker said that he would walk the small business owner to the front door of a brick and mortar bank.

Almost immediately after receiving the advance, the broker advised that they could receive a repackaged loan at better rates. The small business owner agreed to take the second advance of $2.35 million. The broker earned a 10% commission of $235,000. This practice of brokers loading up a small business with multiple loans or refinancing is sometimes called "stacking."

The second advance never came, though payments against it were deducted. In a matter of weeks, the software business was behind in payments. The contract with the MCA company kept the software company from seeking more affordable capital. "Non-circumvention clauses" dictated that the small business could not pay other financing companies for a certain period (which can be years). If the small business obtained financing from a different company, the contract dictated that they would be subject to additional fees.

By 2019, the small business had paid $1 million in interest. Throughout this time, the small business was called constantly by the broker who asked her to send funds to different companies under the auspices of a payment they owed. Ultimately the small software business received only $600,000 out of $2.35 million of the original advance.

California: Thirty-three African American Churches

Predatory financing can affect nonprofits and churches as well as small businesses. A particularly stark example was the abuse by two lease financing companies of 193 black churches in fifteen states. Thirty-three of these churches were in California.

According to lawsuit filed in 2011 by then-Attorney General Kamala Harris,[10] as summarized by BET:

> "...two Maryland-based companies—Urban Interfaith Network (UIN) and Television Broadcasting Online (TVBO)—promised 193 black churches in 15 states that they would provide

[10] Harris, Verdugo Jr., Sierra, and Bass, Supreme Court of the State of California, County of Los Angeles, "COMPLAINT FOR RESTITUTION, CIVIL PENALTIES, INJUNCTION AND OTHER RELIEF FOR VIOLATIONS OF BUSINESS AND PROFESSIONS CODE SECTIONS 17200 AND 17500 (UNFAIR COMPETITION AND FALSE ADVERTISING LAWS)," Feb 2011. https://oag.ca.gov/system/files/attachments/press_releases/n2042_complaint.pdf

technologically advanced computer kiosks that would connect the churches to high-profile advertisers who would not only pay for the full cost of the kiosks and generate new revenue, but also bring the churches 'into the 21st century.'

When the 'kiosks' arrived, however, they were normal desktop computers mounted onto cheap wooden podiums, and they very often didn't work the way they were supposed to, according to the lawsuit. What's more, once the kiosks were installed, the checks supposedly coming from benevolent companies to pay the leases on the machines began arriving late, if at all, forcing the churches to foot the bill—sometimes to the tune of more than $47,000. When the churches couldn't afford or refused to pay the leases, Balboa Capital Corporation and United Leasing Associates of America, the leasing companies behind the kiosks scheme, sued the churches for the funds.

It probably won't surprise you to know that two TVBO and UIN employees named in Harris' suit, Willie Perkins and Michael Morris, are currently in prison in Michigan for scamming dozens of churches in that state. Two others, however, Wayne and Tanya Wilson, supposedly reside in Rancho Cucamonga, California…

The saddest irony, it would seem, is that venues of faith were penalized for having that faith in their fellow man."[11]

This predation may be continuing. As of 2020, the same leasing company, Balboa Capital, was suing Pure Word Missionary Baptist Church in the Orange County Superior Court.[12]

This also suggests that DFPI as a can complement the enforcement actions of the Office of the Attorney General by bringing a financial regulator's focus on guiding ongoing market behavior in financial services.

Marin County, California: Woman-owned wine company

A husband-wife team ran a strong wine company business since 1976, until the company ran into a temporary issue with their shipper. Shipping costs tripled overnight, and the business suddenly was unable to fill the existing orders. The shipping issue would be resolved months later.

In a crunch, they reached out to their existing bank and were denied funding. A friend put them in touch with a merchant cash advance company. While the couple had a sense that the financing would be expensive, they did not fully understand the amount they would pay for the emergency cash. Only after the deal was signed, and the winery's payments amounted to approximately $30,000/day, including exorbitant fees for services never rendered, did it become clear how unaffordable this financing was.

Unable to pay, she and her husband fell into default. The financing company quickly exercised liens on all the business's credit card processors, which cut them off from any future revenue. The financing

[11] Jefferson, BET, "California Goes After Church Scammers," March 2011. https://www.bet.com/news/national/california-goes-after-church-scammers.html

[12] Southern California Record, "Case activity for Balboa Capital Corp. vs Pure Word Missionary Baptist Church on Aug. 19," Aug 2020. https://socalrecord.com/stories/549240185-case-activity-for-balboa-capital-corp-vs-pure-word-missionary-baptist-church-on-aug-19

company also placed liens on their personal and business bank accounts. Subsequent litigation describes that a staffer from the financing company at one point impersonated her husband when contacting his personal bank to place a lien on their personal bank account. Without legal defense, both their business and their personal finances could have been destroyed.

Q6: Unfair, Deceptive, and Abusive Acts or Practices (UDAAP) in Small Business Financing

In the request for comment, DFPI asks:

> "6. Unfair, Deceptive and Abusive Acts and Practices (Commercial)
>
> Are there specific acts or practices in the commercial financing market or in the offering and the provision of financial products or services to small business recipients, nonprofits, and family farms that stakeholders believe are unfair, deceptive, or abusive?... (Fin. Code § 90009, subd. (e).)"

The RBLC urges DFPI to issue a regulation under 90009(e) as soon as possible to define UDAAP for commercial financing. At stake is the stability of California's middle class, the ability of immigrant and low-wealth communities to join that middle class, the widening of the racial wealth gap, the destruction of the local character of California's cities and towns, and the loss of local jobs.

This rulemaking should include brief language and begin immediately, irrespective of related rulemakings in process. In fact, suggested language for a small business UDAAP rule is included in the attached memorandum by Mr. Cordray and Mr. Howard. This suggested language is three sentences long, and simply confirms that the existing definitions of unfair, deceptive, and abusive in California law apply to financing of small businesses, nonprofits, and family farms:

> "Amend Title 10, Chapter 3, Subchapter 6, Article 1, section 1404 of the California Code of Regulations ("Definitions") as follows:
>
> (m) (1) "Unfair, deceptive, and abusive" acts and practices as used in Financial Code section 90009(e) in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms are prohibited.
>
> (2) "Unfair, deceptive, and abusive" acts and practices, as used in Financial Code section 90009(e), may include any act that is unfair or deceptive under the Unfair Competition Law, Business & Professions Code section 17200, et seq., and case law thereunder, as interpreted by the California Supreme Court or in a published decision of the California Court of Appeal."

The memorandum attached provides a detailed discussion of this language, its enforceability, and includes suggested language for an initial statement of reasons.

As evident in the suggested rule language above, we believe the DFPI should not define specific practices as UDAAP, but instead reference the longstanding and definitions of unfair, deceptive, and

abusive that exist today through the California Unfair Competition Law, the Dodd-Frank Act, the and the Federal Trade Commission Act.

Predatory practices evolve constantly, and only clear, broad definitions of UDAAP will enable DFPI to protect small businesses, nonprofits, and family farms from newer practices that emerge. Indeed, responding to emerging practices is the special task of the DFPI, and not possible if UDAAP rules are limited to specifically named acts or practices.

Below are several of the specific UDAAP issues that DFPI could pursue under such a principles based UDAAP rule.

I. Mischaracterizing financing as not being credit to evade lending laws

The CCFPL § 90009(e) is wisely written to cover "commercial financing" of all types, including products that are not loans such as some MCAs and factoring. In some cases, products that should be considered loans are sold as if they are not. This sort of evasion of lending law is one of the broad categories of regulatory gaps that DFPI was created to address, across consumer and small business financing. In fact, where these practices are unaddressed in small business financing, they may soon find their way into consumer financing.

DFPI has grappled with this evasion issue admirably in its recent consent order with MCA company Allup Finance.[13] The RBLC commends DFPI for this excellent work. A UDAAP rulemaking would give DFPI additional, and potentially broader powers, to address this type of unfair practice.

II. Failing to comply with SB 1235 Truth-in-Lending rules, including by non-licensees

DFPI has led the nation in establishing small business truth-in-lending rules under SB 1235, enacted in Division 9.5. DFPI's draft rules have inspired specific language in the New York Small Business Truth in Lending Act passed in 2020, and similar legislation is being considered in Maryland, Connecticut, and at the federal level.

Unfortunately, DFPI's rules will not effectively protect small businesses if they are only enforceable against licensed financing companies. A UDAAP rulemaking under § 90009(e) would clarify enforcement of Division 9.5 on unlicensed firms, which would include much of the merchant cash advance industry and other segments of the market that the Federal Reserve describes as "potentially higher-cost and less-transparent credit products."[14] This is where DFPI's enforcement of SB 1235 is needed most.

Section 17200 of the Business and Professions Code defines unfair as follows: "unfair competition shall mean and include any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue

[13] Smith, O'Donnell, and Ross, State of California - Department of Financial Protection and Innovation, "Consent Order," Nov 2020. https://dfpi.ca.gov/wp-content/uploads/sites/337/2020/11/Consent-Order-Allup-Finance-LLC.pdf

[14] Zeeuw, Mels de, Federal Reserve Bank of Atlanta, "Small Business Credit Survey: Report on Minority-Owned Firms," Dec 2019. https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf

or misleading advertising…"[15] Any violation of Division 9.5, whether or not it is enforceable through powers described in Division 9.5, can thus be enforceable through Section 17200. If a violation of Division 9.5 by a nonlicensee is "deceptive" or "misleading," or even simply, "unlawful," it would be considered "unfair competition" under Section 17200.

III. Quoting pricing in misleading ways outside of the required SB 1235 disclosure

The Federal Reserve research has established that certain pricing metrics used by financing companies, such as "simple interest," "fee rate," and "factor rate" are misunderstood by borrowers to be the interest rate or APR. A 2018 Federal Reserve study describes the confusion:

> ■ **Participants were confused by terminology used to describe all three products**. For Product A, "repayment percentage options" was a confusing term for some participants who thought this was an interest rate, rather than a share of sales. For Product B, participants most commonly conflated "simple interest" with the APR. In addition, the phrasing of the statement "this rate *excludes* any fees, *including* a one-time origination fee of 3%" (emphasis added) perplexed some participants. For Product C, the term "factor rate" was the main source of confusion for a majority of participants who stated they had not heard it before.

In short, small businesses often understood any number described in percentage terms to be the interest rate or APR.[16] These other descriptions of cost appear much lower than the actual interest rate or APR, and are used to mislead small businesses into believing that high-cost financing is less expensive than it is.

A 2019 follow-up study by Federal Reserve researchers found that "non-standard terminology" used by some alternative lenders "proved challenging for focus group participants trying to compare online offerings with traditional credit products."[17] The following table from that study illustrates the severity of this confusion. In the left column, the "non-standard terminology" is displayed. As you can see below, the price number presented on the left is markedly lower than the actual APR noted in the right column.

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[15] California Legislative Information, "Law section," 1993. https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=17200.&lawCode=BPC

[16] Lipman and Wiersch Federal Reserve Board of Governors, "Browsing to Borrow: 'Mom & Pop" Small Business Perspectives on Online Lenders," June 2018. https://www.federalreserve.gov/publications/files/2018-small-business-lending.pdf

[17] Lipman, Barbara and Wiersch, Anne Marie, Board of Governors of the Federal Reserve System, "Uncertain Terms: What Small Business Borrowers Fund When Browsing Online Lender Websites," Dec 2019. https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf

Table 3. Estimated APRs for select online products

Rate advertised on website	Product details	Estimated APR equivalent
1.15 factor rate	• Total repayment amount $59,000 • Fees: 2.5% set-up fee; $50/month administrative fee • Term: none (assume repaid in six months) • Daily payments (assume steady payments five days/week)	Approximately 70% APR
4% fee rate	• Total repayment amount $56,500 • Fee rate: 4% (months 1–2), 1.25% (months 3–6) • Fees: none • Monthly payments • Term: six-month term	Approximately 45% APR
9% simple interest	• Total repayment amount $54,500 • Fees: 3% origination fee • Weekly payments • Term: six-month term	Approximately 46% APR

Source: Authors' calculations, based on product descriptions on company websites.

Each of these "non-standard" metrics in the left column is a different name for the same metric. It is a financing charge as a fraction of the financing amount. A more common term for this metric is a "fee."

The first example in the table above, the "1.15 factor rate," is more commonly understood as a 15% fee. The second example, a "4% fee rate," would be more commonly understood as a 4% fee charged monthly. The third example, "9% simple interest," is a 9% fee, and bears little resemblance to the interest rate, which would be 34%. (Combining that 34% effective interest rate with the 3% origination fee produces the 46% APR).

DFPI should address the misleading disclosure of fees as "non-standard" rates as a deceptive practice under UDAAP enforcement. Existing federal UDAAP law and regulation establishes that:

> "A representation, omission, actor practice is deceptive when:
>
> (1) The representation, omission, act, or practice misleads or is likely to mislead the consumer;
>
> (2) The consumer's interpretation of the representation, omission, act, or practice is reasonable under the circumstances; and
>
> (3) The misleading representation, omission, act, or practice is material."[18]

[18] Consumer Financial Protection Bureau, "Unfair, Deceptive, or Abusive Acts or Practices," Oct 2012. https://files.consumerfinance.gov/f/documents/102012_cfpb_unfair-deceptive-abusive-acts-practices-udaaps_procedures.pdf; Federal Trade Commission, "FRC Policy Statement on Deception," Oct 1983. https://www.ftc.gov/system/files/documents/public_statements/410531/831014deceptionstmt.pdf

Therefore, these “non-standard” descriptions of fees are deceptive.

The use of these deceptive practices, to gain advantage against competitors disclosing prices in a more transparent manner, also could be considered an “unfair” business practice under Section 17200,[19] and potentially other definitions of UDAAP. Violation of the Federal Trade Commission Act prohibition on deceptive practices, as defined above, would also be considered “unfair” under the “unlawfulness” prong of the California Unfair Competition Law.

We also encourage the DFPI to address this practice within SB 1235 rulemaking, which may be a faster, more consistent way, when compared to enforcement litigation, to ensure transparent disclosure practices across the market for small businesses.

IV. Double-charging of fees in a practice called “double dipping”

Double dipping occurs when a small business refinances or renews their financing with their current provider, and the proceeds from the new loan or advance is used to pay off the balance from the previous loan or advance including any unpaid or un-accrued interest or fees. In this way, the provider charges the borrower the same fixed fee twice for the balance that was outstanding. The fixed fee is charged once as the outstanding balance is paid off, and then a second time for the same capital in the renewal.

This can be difficult to follow, which is why many small business owners may not realize they are being double charged. The following image from a merchant cash advance company that does not employ the practice suggests how confusing the hidden charge can be. The short video linked in the footnote below may be even more illustrative.[20]

[19] California Legislative Information, “Law section,” 1993. https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=17200.&lawCode=BPC

[20] The Business Backer, “Double Dipping,” 2014. https://www.youtube.com/watch?v=k62kCK5tZwo

This “three card monte” concealment of charges fits clearly within the definition of “abusive” that appears in the Dodd-Frank Act, and is referred to in section 90009(c)(3) of the CCFPL:

“An abusive act or practice:

- Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service or
- Takes unreasonable advantage of:
    - A lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
    - The inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or
    - The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.”[21]

This practice of double dipping could similarly be described as unfair or deceptive.

V. “Carroting” borrowers into prepaying using false promises

“Carroting” is a high-rate financing industry term for inducing a small business to pay off a prior agreement with a false promise of new funding, perhaps at better terms. Once the small business scrapes together financing to pay off the prior agreement, the promised new financing offer evaporates. This deception allows the financing company to walk away “whole,” recouping its principles and high fees from a small business that may not have been able to truly afford the expensive financing.

The practice is described by one merchant cash advance company executive:

> “I was approached by a young employee with a smart idea for collections that he claimed would greatly improve our recovery rate. He suggested calling defaulted merchants and promising them new funding under a fake MCA funder name. After getting all their information, he would claim that they were eligible for greatly expanded funding if only they would pay off the defaulted Pearl funding. Of course, that fictional funding would never occur. I explained to him that although I would love to improve our recovery rates, what he suggested was unethical and we wouldn’t adopt it. When he persisted in advocating for it, I fired him.
>
> I recently spoke with a merchant who was promised $100k in funding with $25k from Pearl and an additional $75k at favorable terms from a second funder that would co fund. A fake contract was created from a fictitious funding company and of course the funding for the additional $75K never occurred. This practice actually has acquired an industry name ‘carroting’.”

This MCA executive advocated for “Requiring licensing, bonding, and disclosure of broker fees.”[22]

Small business owners described similar experiences of financing companies dangling false offers to encourage refinancing, with new fees and double dipping.

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[21] Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. Sec. 5481)

[22] *Id.*

VI. Using "doing business as" names to conceal a lender's identity and avoid accountability for abuse

Some high-rate financing companies operate under multiple assumed names so that the small business owner does not know who they are truly dealing with. One woman, who owns a commercial interiors contractor, summarized her experience saying, "Some of these companies aren't even really financing companies. They're stealing companies. They offer financing, but stealing is their product."

In this small business owner's account, the financing company used misleading identities in a "good cop, bad cop" charade to pull her through the string of multiple refinances. It began when the disbursements of funds was less than the agreed upon financing amount. As her financial situation became more desperate, a new individual contacted her purporting to represent a different company.

"I hear you're working with ABC company," she was told. "Those guys have a terrible reputation for ripping off small businesses. They're a scam. I want to help you though. I can offer a new advance to get you out that mess." When she took the new advance, the same cycle started over until another purported savior called.

Years later through litigation, she learned more and now suspects that this string of "good cop" and "bad cop" salesmen had sat together in adjacent cubicles. The company names they had given were "doing business as" names that belonged to the same financing company.

Because the business used "doing business as" shell names, the financing company escaped accountability from complaints to the Better Business Bureau and social media reviews, and nearly avoided litigation. One after another, these fake front companies stopped returning calls and emails, leaving no way for her to contact them , and vulnerable to the "good cop" act from the next salesman who may have been two cubicles down.

To execute this deception, the "doing business as" names may be very similar to the name of a different company, to create the false appearance of representing that other company.

Several UDAAPs may be employed together. In this example, each time the small business owner was misled into refinancing, they very likely were also "double dipped." This practice of double charging fees, described above, is even more insidious when the small business owner does not know the two financing transactions are with the same company.

VII. Advancing less than the financing amount to apply pressure

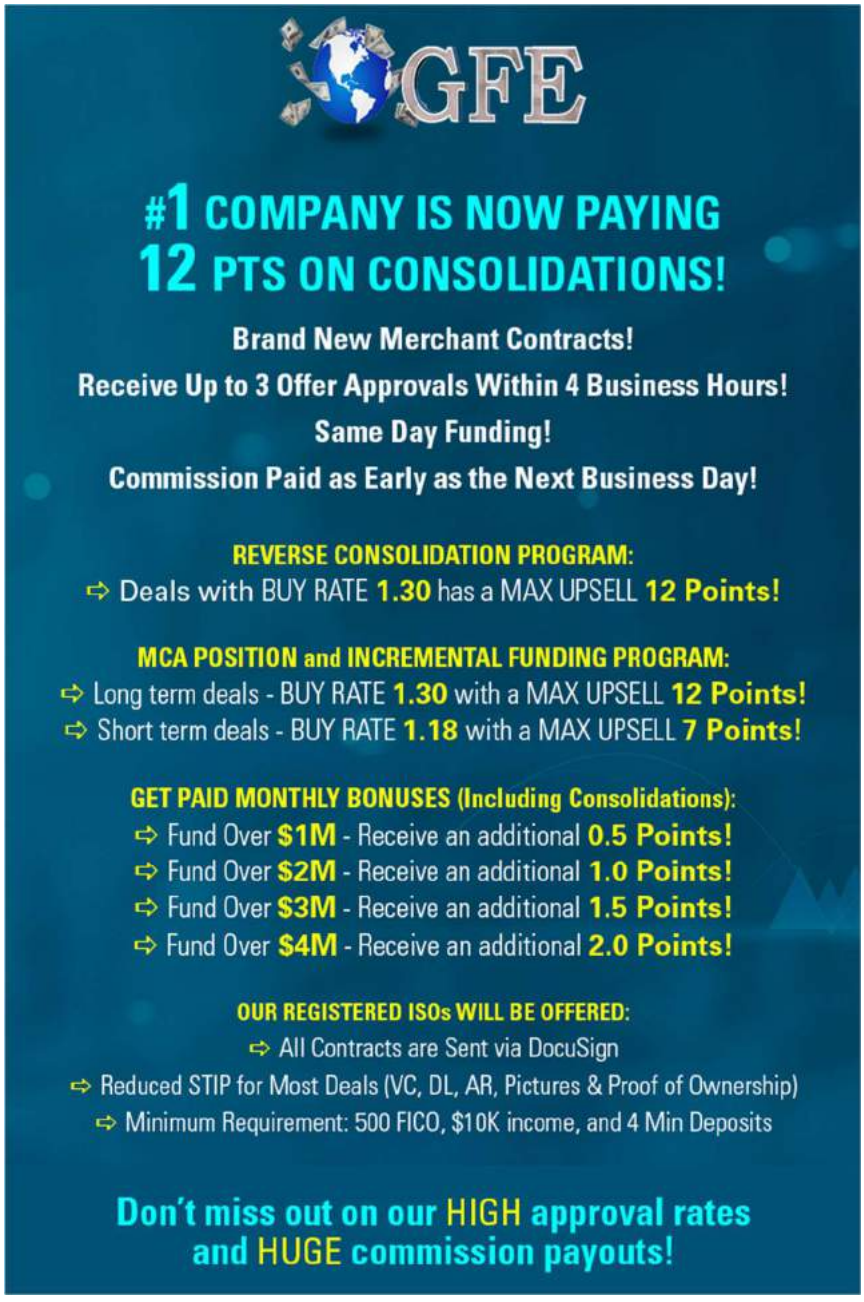
Several small business owners described how the predation of their companies began when the financing company disbursed less than the agreed-on amount. In some cases, the financing company began deducting payments in full, nonetheless. Without the full financing proceeds, these small businesses were forced into a more vulnerable situation, and sought more financing from desperation, subjected to arbitrary fees, high pricing, and being "double dipped" along the way.

A similar trick includes a last-minute change in terms to disbursement of the financing in installments. Each installment is contingent on if now-more-desperate business owner makes the required payments.

This small business owner never receives the cash flow benefit they anticipated from a lump sum disbursement. In a sense, they may accrue financing charges while the money comes in and out, without receiving the capital they needed.

VIII. Brokers steering borrowers into products that pay high, hidden fees to brokers

Some financing companies seek to attract customers not by providing the best prices permitted by their cost structure, but by charging prices high enough to pay brokers "HUGE commission payouts!" to quote an October 2020 advertisement included below:



In this advertisement, the financing company offers brokers “12 PTS ON CONSOLIDATIONS!” (It is not clear how this financing “consolidation” could save a customer money if it includes a 12% fee.)

The advertisement offers brokers “MAX UPSELL 12 Points!” In other words, the broker is permitted to “upsell” the borrower, increasing the price presented to the borrower by up to 12% of the loan amount, without telling the borrower that they have added this fee.

The “buy rate” described above is “1.30,” representing a financing fee of 30%. The broker may add 12 points and present the offer to the borrower as if the price were 1.42, representing a financing fee of 42%. The 12 point commission markup is hidden from the borrower, who likely does not know they have been “upsold.”

The fee has no relationship to the borrowers’ creditworthiness. This same practice in subprime mortgage lending, called “yield-spread premiums,” has been cited as a cause of fraud and racial discrimination in the subprime mortgage lending market, and has been subject to Congressional limits and regulatory sanction.[23]

Text accompanying this advertisement further explains, “You heard it right… 12 POINTS! … but why stop there? … if you want to also earn up to 2 additional points based on your total monthly funding amount (including Consolidations), then start working your way up our MONTHLY VOLUME BONUS structure to maximize your earning potential.”

Making explicit that this is an effort to avoid competition in a manner that raises prices, instead of beating competition by lowering prices, the accompanying test continues: **“With a deal this good, why would you even consider submitting your deals elsewhere?”**

[23] *See, e.g.* Consumer Financial Protection Bureau, “CFPB and Department of Justice Take Action Against Provident Funding Associates for Discriminatory Mortgage Pricing: Harmed African-American and Hispanic Borrowers Will Receive $9 Million,” May 28, 2015. https://www.consumerfinance.gov/about-us/newsroom/cfpb-and-department-of-justice-take-action-against-provident-funding-associates-for-discriminatory-mortgage-pricing/

Other financing companies entice brokers with a golden, rotating image promising “15 POINTS,” representing a 15% commission fee. The more volume the broker steers to this financing company, the higher their commission. “EARN UP TO 19 POINTS!” the financing company proclaims.

This incentive leads brokers to place small businesses into products that may be their least-suitable, most expensive option, and then add hidden charges to expensive products.

A broker may spend several weeks working with a small business to obtain an SBA loan and earn a 1% fee. They may spend part of a day working with that business to obtain an unsecured loan and earn 2%.

Or they might spend less than an hour steering that business into an expensive MCA or high-rate loan and earn 15%. With those incentives, one can imagine the results.

VIII. Broker-driven "flipping" and fee churning

These hidden commission fees can incentivize brokers to "churn" small businesses through multiple financing transactions. The broker can rack up a new commission each time and may charge an additional fee to the borrower for their services. The high-fee refinancing practices recall the "equity-stripping" practices of pre-2008 subprime mortgage markets.

Deceptive practices may be used to assist this churning. Broker commission fees in the merchant cash advance industry are sometimes subject to a "claw back" if the merchant defaults within a certain period, often the first twenty payments. Brokers use false promises of an SBA loan or more permanent financing to encourage a small business to comply with the agreements for the first twenty days, encouraging the business to do whatever is necessary to make the payments over the first twenty days. After twenty days, no permanent financing materializes.

Alternatively, the broker may flip the small business into another short-term financing contract, to pay off the first contract and insure collection of the commission fee. These early repayments add significant costs to the borrower. The broker and financing company earn income because these short-term financing products generally require repayment of the full financing amount, or close to it, even if the

financing is prepaid. In the end, the small business may find themselves in a cycle of debt without knowledge that the broker took advantage of them to earn a commission.

The financing company advertisement below assures brokers, “No Revenue? No Worries!” However, should the incentives created by a “25% commission” paid to brokers give DFPI pause?

This financing company’s advertisement to brokers below demonstrates that some financing companies may forgo altogether this creditworthiness-based “clawback” condition altogether:

IX. "Stacking" of multiple sales-based financing products

Encouraging a small business to take multiple sales-based financing deals simultaneously is known in the industry as "stacking." It can be deleterious for a small business.

Sales-based financing commits a small business to payments of a fixed percentage of each dollar in sales earned. This "split rate" percentage typically ranges from 2% to about 25% of the business's sales. Compare this percentage to typical profit margins of small businesses. Tax preparers were the highest profit-margin small business industry at 18.4%, according to a 2017 report by accounting software company Sageworks.[24] Real estate agents, another industry that avoids significant operating expenses like inventory, high staffing costs, and rent, earned 14.3%. Grocers earned 2.2%, wine and liquor stores earned 2.4%, and restaurants earned 6%.[25] The diversion of 2% to 25% of gross revenue to the sales-based financing company, for one sales-based financing product, may drive these businesses into the ground.

In fact, the average high-rate business financing product *does* drive its borrowers to unprofitability, according to a study of California small businesses by Accion Opportunity Fund. Analysis of over one hundred financing contracts found that the average payment represented 178% of the business's available net income.[26] In other words, the *average* financing contract in this higher-cost category charged almost double what the small business could afford.

Now consider the effect of multiple sales-based financing contracts simultaneously. If a business owner from the most profitable industry, tax preparation, took three sales-based loans or MCAs, and each one diverted 10% of the gross sales revenue coming in the door, the business owner's profit margin has fallen

[24] Steve Nicastro, "Profit and Loss: Why Some Industries Fare Better Than Others," Nerdwallet, October 24, 2017. Accessed at: https://mainstreetlaunch.org/profit-loss-industries-fare-better-others/
[25] *Id.*
[26] St. Louis, Weaver, Donaker Brown, and McShane, Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," May 2016. https://www.opportunityfund.org/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/

to -11.6%. Continuing operations may become difficult or impossible. Some business owners may seek to borrow their way out, and risk falling deeper into a debt trap.

Stacking may become a UDAAP concern in part because of questions about the legality of multiple contracts. If a merchant cash advance is a purchase of future receivables, multiple advances could represent the purchasing the same receivables multiple times. If a finance company knows they are entering into an invalid contract, this may constitute unfair competition.

One merchant cash advance provider wrote that "the failure rate for business owners who take a third merchant cash advance is 100% based on our direct experience of working with these business owners."[27]

In the advertisement below, one sales-based financing company advertises their willingness to fund in "1st-4th position," meaning that they would provide a cash advance to a small business already repaying three different cash advances.

X. Misleadingly marketing short-term products for long-term use

Consumer payday lending is reviled for purporting to offer short-term cash to cover emergencies, while often operating in a business model built on encouraging long-term use of the financing. Some short-term small business financing operates the same way.

Stated marketing claims of short-term small business financing providers can present a high-cost loan as a solution for a short-term emergency. Some examples of product use that financing companies have marketed online have included a pizza shop repairing a broken pizza oven, and a catering company using short-term capital to buy ingredients for a large event just days away. Because the financing is short-term,

[27] Ballentine, Jay, "Stacking: Merchant Cash Advance Funders Jeopardize Main Street" 2/17/14. Buynance. http://archive.is/Kl90X

these examples indicate, it is appropriate to pay an annualized rate that is higher than the profit margin of the business. After all, the cost won't really be annual.

At the same time, these companies may have a stated business practice of encouraging borrowers to use the purportedly short-term financing on an ongoing basis. For example, a short-term lender may employ an inside-sales team with a standard operational practice of calling borrowers before payoff and encouraging them to renew their financing.[28] This may be written into procedure manuals and evident in the calendar notifications of sales agents.

One financing provider advertised the long-term use of their short-term product as a sign of borrower satisfaction: "Approximately 90% of our Merchant Cash Advance clients participate in the program more than once. In fact, the average customer renews about ten times!" The head of marketing for another short-term financing provider explained, "Our goal is to become a permanent part of the customers' balance sheet."

California's Unfair Competition Law, Business & Professions Code section 17200 prohibits "deceptive, untrue or misleading advertising."[29]

XI. Charging exorbitant and arbitrary fees

Fees charged in some segments of the small business financing market do not reflect a finely tuned, market equilibrium cost of doing business, but may be composed of arbitrary, unnecessarily high fees extracted through a lack of transparency. For example, an analysis of small business financing terms conducted by the Woodstock Institute found merchant cash advance companies charging fees such as:

- An $399 "ACH fee," which bears no resemblance to the low cost of conducting payments through ACH. Although the ACH payment process is almost entirely automated, many MCA agreements claim it is "labor intensive" and charge an exorbitant fee to cover the alleged costs. The RBLC has seen so-called "ACH fees" reach as high as $1,995. In other occasions, the fee is charged as a percentage of disbursed amount and can balloon into tens of thousands of dollars.
- A $195 "UCC fee," while the cost of filing a UCC lien in Illinois, where the small business borrower was located, is $20.[30]
- A $249 "risk assessment fee" in addition to a $395 "origination fee." It is not clear what cost was incurred by the financing company, and what service rendered to the small businesses, in exchange for the first fee but not the second.[31]

Other fees of concern include:

- "Account management fee" - One troubled business shared with the RBLC a contract whose fine print included an "account management fee" which permitted the merchant cash advance

[28] See, e.g. Faux, Zeke, "Wall Street Finds New Subprime with 125% Business Loans," Bloomberg, May 21, 2014.

[29] California Legislative Information, "Law section," 1993. https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=17200.&lawCode=BPC

[30] *See*: UCC filing fee schedule published by the Illinois Secretary of State, available here: https://www.cyberdriveillinois.com/publications/business_services/ucc.html

[31] Woodstock Institute, "Analysis of Business Loan Terms," July 2016. "https://woodstockinst.org/wp-content/uploads/2016/07/Woodstock_Analysis_of_Online_SB_Loan_Terms.pdf"

company to double-charge the borrower one extra payment per month without applying that payment towards the amount the small business owed.[32]

- "Due diligence fee" - Another contract charged a 10% "due diligence fee," and a $495 origination fee *in addition* to a 50% financing fee. What additional service could have been rendered for this 10% "due diligence fee"?
- "Collateral monitor fee" - Although small businesses using merchant cash advances are solely responsible for generating and collecting the sales revenue which the MCA considers collateral, some MCA agreements include a monthly "collateral monitoring" fee that could end up being thousands of dollars.
- "Default fees" - Many MCA agreements charge "default fees," in addition to default interest and collection costs imposed under the agreements.
- "Attorney fees" - Some high-rate financing agreements provide for the payment of attorneys' fees based upon a percentage of the outstanding balance. As a result, merchants are often charged attorneys' fees totaling tens of thousands of dollars for minimal legal costs.

These fees are characteristic of a broken market. Instead of healthy price competition driving prices towards market rates for services rendered, financing companies are freely charging California small businesses with abusive and arbitrary fees. DFPI must protect our communities by bringing price transparency and accountability for UDAAP practices to the small business financing market.

XII. Abusing ACH withdrawal authority

We have heard reports of financing companies, documented in litigation, continuing to charge daily ACH withdrawals even after the full financing amount was repaid. Some financing companies may have a practice of continuing to deduct ACH payments until the small business recognizes the abuse and places a stop payment on the account.

XIII. Abusive collection practices

A California gym owner named Jay shared his story of abusive collection practices.[33] Jay has been a trainer for nearly 30 years. He had run a successful business before and put all his savings into opening a new gym.

Improvements needed to be made to the space. To finance some of the project, Jay went to a traditional lender to ask for a small business loan. He was turned away because but didn't meet the revenue requirements, as a startup venture. Jay had received frequent phone calls from the merchant cash advance companies, offering to provide cash quickly. He took one to get the capital he needed to invest in the gym.

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[32] That contract read: ""Account Management Fee - At the end of each month, Merchant will pay to ROYAL BUSINESS GROUP LCC an Account Management Fee. This fee will not be applied towards the reduction of the Purchased Amount. This monthly fee will equal the average of all the payments received as a "Specified Percentage" of the Merchants settle amount for that Month." Without this fee, the APR appears to be 490%. With this fee, it appears to compute to 542%.

[33] Jay provided permission to use his first name, but otherwise asked to remain anonymous.

After taking the financing, Jay was in an accident and broke his femur. He was unable to work for a time, but commercial rent needed to be paid at about $6000/month.

Jay was able to keep up with the payments until COVID hit, and gyms were some of the first establishments to close in California. Soon, Jay's revenue was insufficient to make the payments required by his merchant cash advance. The financing company left threatening messages on his wife's phone, tracked down the information of his customers telling him about his debt. The MCA sent emails to clients of Jay's that the company would 'pursue' them to get the money they were owed. The effect on the gym was devastating.

XIV. Abusing UCC lien notices

One specific form of abusive collection practice involves abusing the Universal Commercial Code ("UCC") lien system. After a small business has defaulted, high-rate financing companies have been documented sending out hundreds of UCC lien notices to the small business owner's family, friends, relatives, and even the merchant's competitors. These lien notices purport to be an effort to collect collateral from the associates of the business owner receiving the notices. However, these are not truly attempts to collect upon the debt from the recipient of the notice, because the financing company cannot have any belief, reasonable or otherwise, that the recipients are account debtors of the merchant. Instead, these letters are plainly intended to humiliate the small business owner into repaying.

Q7: Small Business Data Collection

CCFPL also gives DFPI power to collect data on small business financing. In the Request for Comments, DFPI asks:

> "7. Data Collection and Reporting for Commercial Financing
>
> Should providers of commercial financing and other financial products and services to small business recipients, nonprofits, and family farms be required to collect and report data to the DFPI? (Fin. Code § 90009, subd. (e).) If so, what data should the DFPI require to be collected and why?"

DFPI data collection is necessary for California's first-in-the-nation small business truth-in-lending rules under SB 1235 to work effectively. As RBLC observed in comment to DFPI on that rulemaking, data

collection of the quoted vs. the actual retrospective terms must be undertaken to “Prevent merchant cash advances from low-balling their payment amounts and APRs.”[34]

Without data collection, merchant cash advance providers could disclose unreasonably low payment amounts and APRs, misleading small businesses without concern for consequence. CCFPL § 90009 AB 1864 provides the Department newly defined authority to address this problem.

Here is an example of a hypothetical report that we recommend the Department require providers to submit, reflecting one line per financing account:

	A	B	C	D	E	F	G
1	Account Identifier	Financing Amount	Projected Total Monthly Payments	Actual Avg Total Monthly Payments	Estimated APR	Retrospective APR	APR Spread
2	123456	20,000	2,000	2,400	35%	42%	*18%*
3	123457	25,000	3,000	2,550	33%	28%	*-14%*
4	123458	15,000	1,000	1,050	39%	41%	*5%*
5	123459	40,000	5,000	4,750	24%	23%	*-5%*
6	123460	23,000	1,750	2,188	21%	26%	*23%*
7	123461	30,000	3,000	4,500	35%	51%	*45%*
8	123462	30,000	2,800	1,400	18%	9%	*-48%*
9	123463	30,000	2,500	3,500	40%	55%	*37%*
10	123464	30,000	5,000	10,000	46%	83%	*79%*
11	123465	8,000	3,000	900	31%	11%	*-63%*
12	123466	8,000	600	618	36%	37%	*3%*
13	123467	40,000	5,000	22,500	4%	13%	*226%*
14	123468	40,000	25,000	26,000	400%	412%	*3%*
15							
16	Audited APR Spread						*5%*

Discussion of Economic Impacts

A rulemaking clarifying the applicability of CCFPL § 90009(e) to small business recipients would bring substantial economic benefits to California business owners, when entrepreneurs are most in need of financial relief due to COVID-19. The RBLC estimates that the 400,000 small businesses applying with online lenders are currently overpaying for credit by $665 million to $5.4 billion dollars annually, due to the lack of enforced transparency requirements for financing providers. Robust enforcement of SB 1235 through a UDAAP rulemaking would enable small businesses to comparison shop and select lower-cost credit products when possible. We estimate that the ability to opt into lower-cost financing because of increased transparency will enable 127,000 of the nearly half a million California businesses applying to online lenders to save billions of dollars annually in direct and indirect savings. Business owners will have the ability to save on direct credit costs, as well as the secondary consequences of high-cost debt: opportunity costs of time spent seeking to refinance unsustainable debt, the trickle-down costs of credit

[34] Responsible Business Lending Coalition, “RE: Commercial Financing Disclosures Rulemaking, File No. PRO 01-18,” October 28, 2020. See pages 12-15. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/10.28_rblc_letter_pro_0118_%E2%80%93_commercial_financing_disclosures_sb_1235.pdf

score reductions caused by loan defaults, and lost future revenue resulting from debt-related bankruptcies.

Direct Savings: Access to Lower-Cost Credit

Using data from the Federal Reserve, we estimate that universal transparency standards would enable 127,000 California small businesses to select a more affordable financing option than they would have selected without access to easily understandable disclosures. We estimate that these businesses would save $617 million to $2.9 billion annually when empowered with the transparency needed to compare products and make informed credit decisions.[35] Moreover, we expect business owners of color, who apply for online financing at higher rates according to the Federal Reserve, to disproportionately benefit from expected savings.

Secondary Effects: Avoiding Trickle-Down Consequences of Unaffordable Financing

Universal disclosure standards would also enable business owners to achieve significant savings by preventing the secondary consequences of high-cost credit. For example, by understanding the cost of credit upfront, business owners could avoid opportunity costs of their time spent applying to refinance debt that later proved to be unaffordable and unsustainable. Responsible lenders in our coalition frequently encounter businesses seeking to refinance out of debt from higher-cost financing providers, with terms that were not clearly disclosed upfront. According to the Federal Reserve Bank of New York, businesses spend a whopping 26 hours applying for financing on average.[36] We multiplied this time by the average hourly wage for business owners and by the number of businesses expected to opt for lower cost financing when given clear disclosures, to identify opportunity cost savings in the tens of millions of dollars.[37]

Small businesses may also indirectly save by avoiding credit score damage that could result from defaults on unaffordable credit products. One estimate suggests that individuals who experience a credit score decline from fair to poor may spend an additional $150,000 on commonly-used credit products (e.g. mortgages, auto loans, and credit scores) over their lifetimes.[38] If we assume that ten percent of the small business borrowers who are price sensitive and apply to online lenders would have defaulted on their financing as a result of UDAAP concerns such as the practices described above, affected businesses could save several billion dollars in future credit costs by preserving their credit scores.

In addition, small business owners could achieve substantial indirect savings by avoiding business closures because of unaffordable financing. We estimated these savings by assuming that ten percent of price-sensitive online loan applicants could have risked closure by taking on a high-cost credit product. Of that ten percent, we assume fifty percent would have otherwise remained in business for the average small business life cycle of 7.5 years, if not for the unaffordable credit product forcing the business into bankruptcy.[39] Average annual revenues for employer firms with under 20 employees and nonemployer

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[35] Responsible Business Lending Coalition, "Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18," January 31, 2020. See pages 2-3. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_-_commercial_financing_disclosures_pro_01-18.pdf

[36] Federal Reserve Bank of New York, "Key Findings: Small Business Credit Survey, Q4 2013," 2013. https://www.newyorkfed.org/medialibrary/interactives/fall2013/fall2013/files/full-report.pdf

[37] ZipRecruiter, "Business Owner Salary," March 9, 2021. https://www.ziprecruiter.com/Salaries/Business-Owner-Salary

[38] Holland Sentinel, "You Could Pay $279,000 of Interest Over Your Lifetime," November 13, 2019. https://www.hollandsentinel.com/article/20141114/BUSINESS/311149988

[39] Nav, "Small Business Statistics," January 26, 2021. https://www.nav.com/small-business-statistics/

firms range from $47,000 to over $1.6 million.[40] In multiplying the estimated number of at-risk firms by average revenues, we estimate that business owners may save as much as ten billion dollars annually by avoiding debt traps with access to clear, comparable disclosures.

Table: Direct and Secondary Effects of Robust SB 1235 Enforcement Through UDAAP

Economic Benefit	Description	Annual Savings
Switching savings	An estimated 127,000 California businesses may select lower-cost financing because of transparent disclosures, enabling them to save on finance charges and fees.	$617 million to $2.9 billion
Avoided opportunity costs: time spent refinancing high-cost debt	Up to 127,000 price-sensitive loan applicants may need to refinance out of costly debt after struggling to keep up with higher-than-anticipated repayment schedules that were not clearly disclosed upfront. These business owners then must take time away from running their businesses to apply with new credit providers, complete paperwork, submit supporting documentation, etc.	Tens of millions of dollars annually
Avoided credit score reductions: increased costs of future credit products acquired	An estimated 13,000 California businesses may experience avoidable defaults on high-cost credit products annually. Missed payments and/or collections are typically reported to credit bureaus and lower the individual's credit score. Thus, credit reductions increase the cost of future credit products acquired by the business owner.	Billions of dollars annually
Preservation of future revenue by avoiding premature, debt-induced business closures	An estimated 6,000 California businesses may be forced to close their doors unexpectedly because of unsustainable debt draining their cash flow. If not for the high-cost debt, these businesses may have survived and earned revenue over the average small business life cycle of 7.5 years.	Up to ten billion dollars annually

[40] Fundera, "Small Business Revenue Statistics (2021): Annual Sales and Earnings," December 16, 2020. https://www.fundera.com/resources/small-business-revenue-statistics

Thank you for your critical work to protect Californians while fostering innovation in the financial markets that serve us. If we can be of any service, please do not hesitate to contact us at info@borrowersbillofrights.org.

Sincerely,

1. The Responsible Business Lending Coalition

   Members include Accion Opportunity Fund, Community Investment Management, Funding Circle, LendingClub, Opportunity Finance Network, Small Business Majority, and the Aspen Institute

2. Access Plus Capital
3. Accion Opportunity Fund
4. Accion San Diego
5. ALBA - Agriculture & Land Based Training Association
6. AmPac Business Capital
7. American Fintech Council

   Executive Committee members include Affirm, Avant, Cross River, LendingClub, Marlette Funding, Prosper, SoFi, Upstart, and Varo

8. AnewAmerica Community Corporation
9. Asian Pacific Islander Small Business Program
10. Bankers Small Business CDC of California
11. Bay Area Development Company
12. California Asset Building Coalition
13. CAMEO - California Association for Micro Enterprise Opportunity
14. California Capital Financial Development Corporation
15. California Hispanic Chamber of Commerce
16. SBDC - California Small Business Development Center - Valley Community
17. CDC Small Business Finance
18. The COOK Alliance
19. CAARMA - Consumer Advocates Against Reverse Mortgage Abuse
20. Consumer Federation of California
21. The CraneWorks
22. Economic Development & Financing Corporation
23. El Pajaro Community Development Corporation
24. Fondo Adelante, Mission Economic Development Agency
25. Fresno Area Hispanic Foundation
26. Fresno Metro Black Chamber of Commerce & Chamber Foundation
27. Funding Circle
28. Halo Business Finance Corp
29. The Greenlining Institute
30. Inclusive Action for the City
31. Inner City Advisors

32. Invest in Women Initiative
33. International Rescue Committee's Center for Economic Opportunity
34. JEDI - Jefferson Economic Development Institute
35. LEDC - Latino Economic Development Center
36. LendingClub
37. Lighter Capital
38. Main Street Launch
39. Marian Doub Consulting
40. Maximum Reach 4 Economic Equity
41. Multifunding
42. Prospera Community Development
43. Public Law Center
44. Renaissance Entrepreneurship Center
45. SFAACC - San Francisco African American Chamber of Commerce
46. Silver Lining
47. Small Business California
48. Small Business Majority
49. Wadeco Business Center
50. Women's Economic Ventures
51. Woodstock Institute
52. Working Solutions

Appendix: Memorandum to DFPI from Richard Cordray and Ed Howard on behalf of the Office of Kat Taylor, Regarding The Enforceability of Regulations Protecting Small Businesses Promulgated Pursuant to Financial Code Section 90009(e).

OFFICE OF KAT TAYLOR

MEMORANDUM

December 7, 2020

TO: **BRET LADINE, DFPI GENERAL COUNSEL**

FROM: **RICHARD CORDRAY; ED HOWARD, HOWARD ADVOCACY, INC., ON BEHALF OF THE OFFICE OF KAT TAYLOR**

RE: **THE ENFORCEABILITY OF REGULATIONS PROTECTING SMALL BUSINESS PROMULGATED PURSUANT TO FINANCIAL CODE SECTION 9009(e)**

Questions Presented

1. While the Department of Financial Protection and Innovation ("DFPI") is unambiguously vested with the authority to promulgate regulations that "define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing … or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms" pursuant to Financial Code section 90009(e)[1], does the DFPI actually have the authority to enforce such regulations?

2. If so, what enforcement tools are available?

3. But, shouldn't section 90009(e) be read to apply only to "covered persons"?

4. Could such regulations simply extend UDAAP protections to "small business recipients, nonprofits, and family farms" by adopting a regulation that in part refers to the Unfair Competition Law and case law under it?[2]

5. What deference would courts provide DFPI's regulations adopted under section 90009(e)?

Short Answers

1. Yes, the DFPI has the power to sue in civil court to enforce regulations promulgated pursuant to section 90009(e) and, respectfully, this is not a close question.

2. At minimum, the DFPI has the authority pursuant to section 90013 and other authorities to bring civil actions to enforce any regulation promulgated pursuant to section 90009(e) and obtain injunctions, orders, or writs against businesses that disobey the regulations.

[1] All future "section" references are to the California Financial Code unless otherwise specified.
[2] See, Business & Professions Code section 17200, *et seq*.

3. No. Merely because section 90009(c) applies to "covered persons" does not mean that section 90009(e)'s application is limited to "covered persons." In fact, that is the clear legislative purpose embodied in section 90009(e), to extend similar legal protections not *only* to covered persons, but *also* to "small business recipients, nonprofits, and family farms."

4. Yes. The terms "unfair, deceptive, and abusive acts and practices" may be clarified in a regulation that references California's UCL and California case law interpreting it.

5. A court reviewing the lawfulness of the DFPI's regulations adopted under section 90009(e) would afford them the standard judicial deference to regulations that an agency has adopted pursuant to its lawful authority as conferred by the legislature.

Detailed Analysis

QUESTION 1: ***While the DFPI is unambiguously vested with the authority to promulgate regulations that "define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing … or other offering or provision of financial products and services to small business" pursuant to section 90009(e)[3], does the DFPI actually have the authority to enforce such regulations?***

QUESTION 2: ***If so, what enforcement tools are available?***

ANSWERS 1 AND 2: The DFPI clearly has the authority through civil actions to enforce regulations promulgated pursuant to section 90009(e). This authority at minimum includes the power to seek injunctions, orders, or writs against businesses that are operating in defiance of the regulation. This is true for five reasons:

First, section 90013 plainly and unambiguously vests the DFPI with such "civil action" enforcement power. That statute in relevant part, with emphases added, provides:

> The department may bring a ***civil action*** in accordance with the following:
>
> (a) If a person violates any … ***rule … ,*** the department may ***bring an action*** in the name of the People of the State of California ***in the superior court to enjoin the acts or practices or to enforce compliance with … any rule … herein under***. Upon a proper showing, ***a permanent or preliminary injunction, restraining order, or writ of mandate shall be granted*** …"

Thus, the DFPI may unambiguously in a "civil action" lawfully sue in superior court "to enjoin acts or practices or to enforce compliance with…any rule[.]" The DFPI in such an action may obtain injunctions, restraining orders, or writs. The plain language of this statute entirely and completely answers the first question presented. "When the language of a statute is clear

[3] Section 90009(e) in full provides: "(e) The department, by regulation, may define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms. The rulemaking may also include data collection and reporting on the provision of commercial financing or other financial products and services."

and unambiguous, there is no need for interpretation and we must apply the statute as written." *Lafayette Morehouse, Inc. v. Chronicle Publishing Co.* (1995) 39 Cal.App.4th 1379, 1382.[4]

The clarity of this language makes it extremely unlikely a business could persuade a judge that the DFPI does not have the power to do that which this statute plainly says it has the power to do.

Second, section 90006 in part also clearly and without limitation permits the Commissioner to bring "civil actions" and provides (emphases added):

> (b) In addition to existing functions, powers, and duties, ***the department shall have*** all of ***the following*** functions, ***powers***, and duties in carrying out its responsibilities under this law:
>
> (1) ***To bring*** administrative and ***civil actions, and to prosecute those civil actions before state and federal courts.***

Third, section 326(a), with emphasis supplied, in part also provides that

> The Commissioner … is responsible for the … exercise of ***all powers*** … and the ***assumption and discharge of all responsibilities vested by law in the department and the divisions thereunder***. The commissioner has and may exercise ***all the powers necessary or convenient for the administration and enforcement*** of, among other laws, the laws described in Section 300.

These "necessary "powers include "the authority to … enforce rules and regulations." *Gleason v. Glasscock* (E.D.Cal.2011) 2011 WL 773249. In fact, "an administrative agency is compelled to enforce its own regulations[.]" *Woods v. Superior Court* (1981) 128 Cal.3d 668, 680. Indeed, "any time a State is enjoined by a court from effectuating statutes enacted by representatives of its people, it suffers a form of irreparable injury." *New Motor Vehicle Bd. of California v. Orrin W. Fox Co*. (1977) 434 U.S. 1345, 1351 (1977).

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[4] Courts do not consider legislative history when, as here, the plain language of a statute is unambiguous. "When the words are clear and unambiguous, there is no need for statutory construction or resort to other indicia of legislative intent, such as legislative history." *California Fed. Savings & Loan Assn. v. City of Los Angeles* (1995) 11 Cal.4th 342, 349. Courts do not look to legislative history to create an ambiguity where there is none on the face of the statute. "The proper function of legislative history is to solve, and not create, an ambiguity." *United States v. Rone* (9th Cir. 1975) 598 F.2d 564, 569. Moreover, of all of the kids of legislative history that courts consider, the least relied upon is that based on defeated bills or amendments. *Dyna-Med, Inc. v. Fair Employment & Housing Com* (1987) 43 Cal. 3d 1379, 1396 ("Unpassed bills, as evidences of legislative intent, have little value."); *Gay Law Students Assn. v. Pacific Tel. & Tel. Co.* (1979) 24 Cal. 3d 458, 480, fn. 13 ("California courts have frequently noted, however, the very limited guidance that can generally be drawn from the fact that the Legislature has not enacted a particular proposed amendment[.]") Finally, the legislative history of AB 1864 (Limon) reveals that the Legislature was told the bill would aid small businesses. From page 2 of the Assembly Floor analysis : "(d) Authorizes DFPI to prescribe rules related to the following: iv) Unfair, deceptive, and abusive acts or practices in connection with the offering or provision of commercial financing, as specified, to small business recipients, nonprofits, or family farms." And, from page 4 "Arguments in Support: A coalition of consumer protection groups and legal aid organizations writes: 'SB 819 would … establish California as a national leader in protecting … small businesses… struggling to recover financially from the pandemic…" *Ibid.*

Fourth, section 320(b) in pertinent part and with emphases added, provides:

> (b) The Commissioner of Financial Protection and Innovation shall employ legal counsel to act as the attorney for the commissioner in actions or proceedings brought by or against the commissioner under or ***pursuant to any law under the jurisdiction of the Department of Financial Protection and Innovation***, or in which the commissioner joins or intervenes as to a matter within the jurisdiction of the Department of Financial Protection and Innovation, as a friend of the court or otherwise.

A regulation is a law.[5] A regulation issued by the DFPI pursuant to section 90009(e) is a "law under the jurisdiction" of the DFPI – that is why the DFPI may promulgate regulations pursuant to it. Therefore, as the DFPI is expressly empowered *to retain counsel* to be used "in actions" "brought by … the commissioner" of "any law under the jurisdiction of the" DFPI, then the DFPI must impliedly be permitted *to enforce* "any law under the jurisdiction of the" DFPI using such counsel "in actions," meaning lawsuits.

Fifth, even if none of these four statutory authorities existed, the DFPI *still* would have the power through a civil action to enforce regulations promulgated pursuant to section 90009(e) because "[i]t is well settled in this state that [administrative] officials may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute or as may fairly be implied from the statute granting the powers." *Dickey v. Raisin Proration Zone No. 1* (1944) 24 Cal.2d 796, 810. Thus, the DFPI "may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute, or as may fairly be implied from the statute granting the powers." *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 824.

It is easy to infer the DFPI must be permitted to sue to enforce the regulations promulgated under the authority granted by section 90009(e) because otherwise that statute would be senseless – what policy aim is achieved by granting the DFPI the power to promulgate regulations if the regulations cannot be enforced? And, at the barest minimum the DFPI like every other Californian is not prohibited from and therefore may seek relief under Civil Code sections 527 (preliminary injunction) and 3422 (permanent injunction) and Code of Civil Procedure section 1085(a) ("A writ of mandate may be issued by any court to any … person, to compel the performance of an act which the law specially enjoins[.]")

QUESTION 3: ***But, shouldn't section 90009(e) be read to apply only to "covered persons"?***

ANSWER 3: No. That section 90009(c) applies to "covered persons" does not mean section 90009(e) is limited to "covered persons." In fact, that is the clear legislative purpose embodied in section 90009(e), to extend similar legal protections not *only* to covered persons, but *also* to "small business recipients, nonprofits, and family farms."

[5] A regulation is "every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of any rule, regulation, order, or standard adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it[.]" Gov. Code, section 11342(g).

Section 90009 invokes the UCL in two different ways. As applied to "covered persons" or "service providers" offering products or services to "consumers," section 90009(c), provides:

> (c) The department may prescribe rules applicable to any covered person or service provider identifying as unlawful, unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. Such rules shall consider the relative harm to the consumer, the frequency of the act or practice in question, and whether such act or practice is unintentional or stems from a technical, clerical, or nonmaterial error. Rules under this section may include requirements for the purpose of preventing those acts or practices.
>
> (1) The department shall interpret "unfair" and "deceptive" consistent with Section 17200 of the Business and Professions Code and the case law thereunder.

Section 90009(e), however, applies based upon who receives the financial products or services; namely small businesses, nonprofits, and family farms:

> (e) The department, by regulation, may define unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms….

Thus, two different, freestanding subdivisions of equal dignity in the same statute extend the UCL differently to different classes of persons. The UCL is made applicable to "covered persons" and "service providers" "in connection with" financial products extended *to "consumers"* in section 90009(c). In contrast, the UCL is invoked "in connection with" "commercial financing" or other "financial products and services" offered *not to consumers* (they are entirely omitted) but instead to "small businesses recipients, nonprofits, and family farms." And, unlike in section 90009(c) where the Legislature made that statute applicable to specified businesses based on *two* criteria – who they are ("covered persons or service providers") and who they sell to ("consumers") – section 90009(e) surgically omits the former criteria entirely and applies simply based on who receives financial products and services.

For these reasons, there is every basis in text to conclude that section 90009(e) applies to any business that sells covered financial products or services to the small businesses, nonprofits, and family farms referenced. There is simply no basis in text to infer that section 90009(e) should apply in a more limited manner than the legislature expressly provided in the statute it enacted.

"[W]e have often noted that when Congress includes particular language in one section of a statute but omits it in another—let alone in the very next provision—this Court "presume[s] that Congress intended a difference in meaning." *Loughrin v. U.S* (2014), 573 U.S. 351, 421. *See also*: *City of Port Hueneme v. City of Oxnard* (1959) 52 Cal.2d 385, 395 ("Where a statute, with reference to one subject contains a given provision, the omission of such provision from a similar statute concerning a related subject is significant to show that a different intention existed.")

SUMMARY: There can be no doubt whatsoever the DFPI has the power to initiate civil proceedings to enforce DFPI regulations, including those promulgated pursuant to section 90009(e). The likelihood of a business persuading a judge that the DFPI does not have this civil lawsuit authority is effectively zero if the judge is presented with the statutes and arguments presented above.[6]

Finally, it is unlikely a court would by judicial fiat amend section 90009(e) to include words that would restrain its reach in a manner inconsistent with the express statutory language.

QUESTION 4: ***Could such regulations simply extend UDAAP protections to "small business recipients, nonprofits, and family farms" by adopting without limitation the definitions of "unfair" rendered by California courts interpreting state law and/or federal courts interpreting the similar provisions of the Dodd-Frank Act?***

ANSWER 4: Yes. Section 90009(c)(1) requiring the DFPI to interpret "unfair" consistently with the UCL applies only to rules relating to "covered persons" in section 90009(c). There is no similar requirement in section 90009(e). But the terms "unfair, deceptive, and abusive acts and practices" as used in section 90009(e) may be clarified by referral to the UCL and case law under it allowing the DFPI, if it chooses, with enforcement-facilitating certainty to use the UCL as the basis of an enforcement action.

QUESTION 5: ***What deference would courts provide DFPI's regulations adopted under section 90009(e)?***

ANSWER 5: Courts reviewing the lawfulness of the DFPI's regulations adopted under section 90009(e) would afford them the standard judicial deference to regulations that an agency has adopted pursuant to its lawful authority as conferred by the legislature. Although this is true for various agency actions, it is especially true for any valid exercise of legislative authority that is embraced formally in a regulation. As the leading California administrative law cases teaches:

> It is a "black letter" proposition that there are two categories of administrative rules and that the distinction between them derives from their different sources and ultimately from the constitutional doctrine of the separation of powers. One kind — quasi-legislative rules — represents an authentic form of substantive lawmaking: Within its jurisdiction, the agency has been delegated the Legislature's lawmaking power. … Because agencies granted such substantive rulemaking power are truly "making law," their quasi-legislative rules have the dignity of statutes. When a court assesses the validity of such rules, the scope of its review is narrow. If satisfied that the rule in question lay within the lawmaking authority

[6] Indeed, however, the best reading of the Financial Code is that the DFPI has broader powers to enforce regulations promulgated under section 90009(e) beyond court orders, injunctions, and writs. That is because section 90013 also provides the DFPI two additional enforcement options in "civil actions" brought to "enjoin acts or practices or enforce compliance with" "any rule." The first is the option of seeking judicial appointment of "a receiver, monitor, conservator, or other designated fiduciary or officer of the court [who] may be appointed for the defendant or the defendant's assets". And, second, "any other ancillary relief may be granted as appropriate" in a civil action brought to enforce "any rule."

> delegated by the Legislature, and that it is reasonably necessary to implement the purpose of the statute, judicial review is at an end.
>
> We summarized this characteristic of quasi-legislative rules in *Wallace Berrie & Co. v. State Bd. of Equalization* (1985) [citation]: "[I]n reviewing the legality of a regulation adopted pursuant to a delegation of legislative power, the judicial function is limited to determining whether the regulation (1) is 'within the scope of the authority conferred'" [citation] and (2) is "reasonably necessary to effectuate the purpose of the statute" [citation].' [Citation.] 'These issues do not present a matter for the independent judgment of an appellate tribunal; rather, both come to this court freighted with [a] strong presumption of regularity....' [Citation.] Our inquiry necessarily is confined to the question whether the classification is 'arbitrary, capricious or [without] reasonable or rational basis.' [citations].)"

Yamaha Corp. of America v. State Bd. of Equalization (1998) 19 Cal.4th 1, 10-11. Functionally, the broader the terms being construed through regulation the greater the discretion a regulator has to interpret them free from judicial second-guessing. An instructive example comes from the case of *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 280. In that case, the California Supreme Court upheld as against a vigorously pressed insurance industry challenge a highly complicated, multi-page ratemaking formula statutorily enabled by eye-of-the-beholder," "unfair"-like statutory words commanding that "[n]o rate shall be approved or remain in effect which is excessive, inadequate, or unfairly discriminatory." The administrative law principles and authorities described in *20th Century* that afforded the Insurance Commissioner so much judicial deference in interpreting "excessive, inadequate, and unfairly discriminatory" by regulation would with equal weight compel judicial deference to the DFPI's interpretation of section 90009(e).

Suggested Initial Statement Of Reasons Language and Regulation

Suggested language for the Initial Statement of Reasons:

> Pursuant to Section 90009(e), the Legislature has authorized the department to confer legal protections upon "small business recipients, nonprofits, and family farms" similar to those conferred on "covered persons" pursuant to Section 90009(c) but without restraining the conferred protection to interpretations of the UCL. Accordingly, the department adopts this regulation pursuant to Section 90009(e) to specify that no person shall engage in unfair, deceptive, and abusive acts and practices in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms. The regulation also clarifies that the terms "unfair, deceptive, and abusive acts and practices" may, if the department elects, have the same meaning for purposes of enforcement of Section 90009(e) as those terms are interpreted by California courts, including, in the department's discretion, a California judicial

interpretation that is the most protective of small businesses, nonprofits, and family farms.

Suggested language of the regulation:

Amend Title 10, Chapter 3, Subchapter 6, Article 1, section 1404 of the California Code of Regulations ("Definitions") as follows:

(m) (1) "Unfair, deceptive, and abusive" acts and practices as used in Financial Code section 90009(e) in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms are prohibited.

(2) "Unfair, deceptive, and abusive" acts and practices, as used in Financial Code section 90009(e), may include any act that is unfair or deceptive under the Unfair Competition Law, Business & Professions Code section 17200, et seq., and case law thereunder, as interpreted by the California Supreme Court or in a published decision of the California Court of Appeal.