

Date of Hearing: August 27, 2015

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Matthew Dababneh, Chair
SB 197 (Block) – As Amended August 20, 2015

SENATE VOTE: 36-0

SUBJECT: Finance lenders: commercial loan: referral

SUMMARY: Allows a licensee under the California Finance Lenders Law (CFL) to pay compensation to an unlicensed person or company in connection with the referral of one or more prospective borrowers to the licensee. Specifically, **this bill:**

- 1) Permits compensation to be paid, when all of the following conditions are met:
 - a) The referral by the unlicensed person leads to the consummation of a commercial loan between the licensee and the borrower;
 - b) The loan contract provides for an annual percentage rate (APR) that does not exceed 36%; and,
 - c) Before approving the loan, the licensee does both of the following:
 - i) Obtains documentation from the prospective borrower documenting the borrower's commercial status. (Examples of acceptable forms of documentation include, but not limited to, a seller's permit, business license, articles of incorporation, income tax returns showing business income, or bank account statements showing business income); and,
 - ii) Performs underwriting and obtains documentation to ensure that the prospective borrower will have sufficient monthly gross revenue with which to repay the loan pursuant to the loan terms, and does not make a loan if it determines through its underwriting that the prospective borrower's total monthly expenses, including debt service payments on the loan for which the prospective borrower is being considered, will exceed the prospective borrower's monthly gross revenue. (Examples of acceptable forms of documentation for verifying current and projected gross monthly revenue and monthly expenses include, but are not limited to, tax returns, bank statements, merchant financial statements, business plan, business history, and industry specific knowledge and experience. Permits a credit report if the prospective borrower is a sole proprietor or a corporation and the loan will be secured by a personal guarantee.
- 2) Requires the licensee to maintain records of all compensation for a period of at least four years.
- 3) Requires the licensee to annually submit information requested by the Commissioner of Business Oversight (Commissioner) in a report.
- 4) Provides that a licensee shall be liable for any misrepresentations made to a borrower in connection with a commercial loan made to that borrower by that licensee.

- 5) Defines "referral" as the introduction of the borrower and finance lender or the delivery to the finance lender of the borrower's contact information.
- 6) Provides that an unlicensed person may not engage in the following activities in performing commercial loan referral service:
 - a) Participate in loan negotiation;
 - b) Counseling or advising the borrower about a loan;
 - c) Participate in the preparation of any loan documents, including credit applications;
 - d) Contacting the licensee on behalf of the borrower other than to refer the borrower;
 - e) Gather loan documentation from the borrower or deliver the documentation to the licensee;
 - f) Communicate lending decisions or inquires to the borrower;
 - g) Participate in establishing any sales literature or marketing materials; or
 - h) Obtaining the borrower's signature on documents.
- 7) Exempts from the prohibitions above, an entity recognized as a 501(c) (3) by the Internal Revenue Code, a business assistance organization recognized by the Small Business Administration or a person that engages the activities above in connection with five or fewer commercial loans in a 12-month period.
- 8) Allows the commissioner to adopt regulations to impose conditions of referral activity.
- 9) Prohibits the payment of a referral fee to an unlicensed person for a residential mortgage loan or payment to a person required to be licensed under the Real Estate Law.
- 10) Provides that any person that receives compensation in connection with a referral that leads to a consummated commercial loan may not do the following:
 - a) Make a material false or misleading statement or representation to a prospective borrower about the terms and conditions of a prospective loan;
 - b) Engage in false, misleading or deceptive marketing;
 - c) Omit material information;
 - d) Engage in an act that constitutes fraud or dishonest dealings; or,
 - e) Fail to safeguard a prospective borrower's personally identifiable information.
- 11) Gives the commissioner authority to issue desist and refrain orders to persons engaged in the business of soliciting borrowers and not in compliance with sections authorizing referral activity.

- 12) Requires a licensee that receives an application for a commercial loan from a prospective borrower who has been referred to that licensee by an unlicensed person or company to provide the following written statement to the borrower, in no smaller than 10-point type, and ask the borrower to acknowledge receipt of the statement in writing: "You have been referred to us by [Name of Unlicensed Person]. If you are approved for the loan, we may pay a fee to [Name of Unlicensed Person] for the successful referral. [Licensee], and not [Name of Unlicensed Person] is the sole party authorized to offer a loan to you. You should ensure that you understand any loan offer we may extend to you before agreeing to the loan terms. If you wish to report a complaint about this loan transaction, you may contact the Department of Business Oversight (DBO), Division of Corporations at 1-866-ASK-CORP (1-866-275-2677), or file your complaint online at www.dbo.ca.gov."

EXISTING LAW:

- 1) Defines, pursuant to the CFLL, a commercial loan as a loan with a principal amount of \$5,000 or more, or any loan under an open-end credit program, whether secured by either real or personal property, or both, or unsecured, the proceeds of which are intended by the borrower for use primarily for other than personal, family, or household purposes. For purposes of determining whether a loan is a commercial loan, the lender may rely on any written statement of intended purposes signed by the borrower. The lender is not required to ascertain that the proceeds of the loan are used in accordance with the statement of intended purposes. (Financial Code Section 22502)
- 2) Requires each finance lender and broker licensee to file an annual report with the commissioner, on or before the 15th day of March, giving the relevant information that the commissioner reasonably requires concerning the business and operations conducted by the licensee within the state during the preceding calendar year for each licensed place of business. The individual annual reports filed pursuant to this section shall be made available to the public for inspection except, upon request in the annual report to the commissioner, the balance sheet contained in the annual report of a sole proprietor or any other nonpublicly traded persons. A licensee shall make other special reports that may be required by the commissioner. (Financial Code Section 22159)

Existing Regulation prohibits a licensed finance lender from paying any compensation to an unlicensed person or company for soliciting or accepting applications for loans, except for an employee regularly employed at a licensed place of business of the finance lender, or if the payment is made to a person or company licensed as a real estate broker, a bank, savings and loan association, or any other financial institution exempted from the CFLL. (California Code of Regulations Title 10, Chapter 3, Subchapter 6, Article 4, Section 1451)

FISCAL EFFECT: Unknown

COMMENTS:*Recent amendments:*

SB 197 was previously passed out of the Assembly Banking and Finance Committee 12-0. On August 20th substantive amendments were taken at the request of DBO. Those amendments were not considered by the committee in its previous hearing and thus why the bill is again under consideration.

The new amendments do the following:

- 1) Provide that a licensee shall be liable for any misrepresentations made to a borrower in connection with a commercial loan made to that borrower by that licensee.
- 2) Define "referral" as the introduction of the borrower and finance lender or the delivery to the finance lender of the borrower's contact information.
- 3) Provide that an unlicensed person may not engage in the following activities in performing commercial loan referral service:
 - a) Participate in loan negotiation;
 - b) Counseling or advising the borrower about a loan;
 - c) Participate in the preparation of any loan documents, including credit applications;
 - d) Contacting the licensee on behalf of the borrower other than to refer the borrower;
 - e) Gather loan documentation from the borrower or deliver the documentation to the licensee;
 - f) Communicate lending decisions or inquires to the borrower;
 - g) Participate in establishing any sales literature or marketing materials; or
 - h) Obtaining the borrower's signature on documents.
- 4) Exempt from the prohibitions above, an entity recognized as a 501(c) (3) by the Internal Revenue Code, a business assistance organization recognized by the Small Business Administration or a person that engages the activities above in connection with five or fewer commercial loans in a 12-month period.
- 5) Allow the commissioner of the DBO to adopt regulations to impose conditions of referral activity.
- 6) Prohibit the payment of a referral fee to an unlicensed person for a residential mortgage loan or payment to a person required to be licensed under the Real Estate Law.
- 7) Provide that any person that receives compensation in connection with a referral that leads to a consummated commercial loan may not do the following:
 - a) Make a material false or misleading statement or representation to a prospective borrower about the terms and conditions of a prospective loan;
 - b) Engage in false, misleading or deceptive marketing;
 - c) Omit material information;
 - d) Engage in an act that constitutes fraud or dishonest dealings; or,

- e) Fail to safeguard a prospective borrower's personally identifiable information.
- 8) Give the commissioner authority to issue desist and refrain orders to persons engaged in the business of soliciting borrowers and not in compliance with sections authorizing referral activity.

Need for the bill:

This bill is co-sponsored by Opportunity Fund and the California Association for Micro Enterprise Opportunity (CAMEO) to remove a competitive disadvantage that applies to CFLL licensees making commercial loans. In doing so, the co-sponsors wish to improve the ability of microlenders to identify underserved small businesses, and help them access credit.

This bill would allow CFLL licensees making commercial loans to pay fees for the successful referral of business, thus eliminating their competitive disadvantage in customer acquisition relative to other entities that extend credit to small businesses in California. According to this bill's co-sponsors, companies that are not subject to the CFLL often offer less favorable terms to small businesses than CFLL licensees, but small business borrowers never learn about these more favorable loans, because the CFLL lenders cannot compensate entities to refer business to them.

Background:

The existing CFLL prohibits CFLL licensees from paying any compensation to any person or company that is unlicensed, in exchange for the referral of business. This places CFLL licensees that make commercial loans at a competitive disadvantage relative to their direct competitors, whom are not required to hold CFLL licenses. As described in more detail below, two types of direct competitors that are not required to hold CFLL licenses include merchant advance companies (not required to be licensed under the CFLL, because they are advancing, rather than lending money) and companies that partner with banks (not required to be licensed under the CFLL, because the loans are made under the banks' charters). CFLL licensees may offer better loan terms to businesses than competitors that lack CFLL licenses, but often lose customers to those competitors, because the competitors can compensate those from whom they receive referrals, while the CFLL licensees are prohibited from doing so.

According to small business lending experts, referrals are the single most efficient way for commercial lenders to acquire small business customers. Because general purpose advertising is not targeted, it is very inefficient at reaching customers. Word of mouth is by far the most efficient use of marketing dollars, but is an avenue that is closed off to CFLL licensees by California's regulations.

Non-CFLL Entities:

Merchant Advance Companies: Merchant advance companies that serve small businesses represent the most common form of direct competition to commercial lenders licensed under the CFLL. Unlike commercial lenders, merchant advance companies do not offer loans. Instead, they offer a variety of non-loan financing options, which include cash advance, purchase order finance, accounts receivable finance, or a combination of these. Generally speaking, business arrangements between merchant advance companies and the firms they fund involve the following: The merchant advance company advances a certain amount of money to a business.

In return, the business agrees to remit a certain percentage of its future revenue (typically sales receipts) to the merchant advance company until the advance is paid back. Some merchant advance firms purchase future revenue at a discount; others purchase future sales revenue on a dollar for dollar basis, but charge the business a fee for the transaction. Some contracts require that money be repaid on a daily basis; others require different repayment schedules. There is considerable variety in the ways in which advance transactions are set up; with most being structured in ways that do not require a California lending license.

Rent-A-Charter: Companies that offer loans in partnership with banks represent another type of competition to CFLL licensees. Companies that partner with banks to offer loans can often avoid having to become licensed in the states in which the companies operate, because the loans are technically being made by the bank. This so-called rent-a-charter model has several different variations, but often involves a company that lacks a lending license acquiring customers and underwriting prospective borrowers, referring qualified borrowers to a bank, allowing the bank to lend to those qualified borrowers, and then purchasing the consummated loans from the bank. Because the bank is technically the lender, the company which partners with it is not required to hold a lending license. As such, it is not restricted in its ability to compensate third parties for the referral of business.

Consumer Protections:

California's existing prohibition against payment of referral fees by licensed lenders is intended to protect borrowers, by ensuring that they are not steered to loans with unfavorable terms by unlicensed individuals whose referrals are based entirely on the compensation they generate, and not on the extent to which the loan makes sense for the borrower being referred. This bill is designed to eliminate the possibility that referral fees paid to unlicensed individuals will result in predatory lending. The bill allows the payment of referral fees only upon consummation of a loan, and requires all loans for which referral fees are paid to adhere to specified best practices for business lending (verify the commercial status of the borrower, maximum APR of 36%, and underwriting).

Amendments:

The recent amendments to SB 197 need further clarification and revision. First, the California Mortgage Bankers Association suggested a clarifying amendment concerning payments to unlicensed persons and liability for misrepresentations, specifically to ensuring that the provision applies to referral services as specified. Therefor the following amendment is necessary on page 4, lines 5-7

A licensee that pays compensation to a person that is not licensed pursuant to this division in connection with a referral for a commercial loan made by that licensee to a borrower shall be liable for any misrepresentation made to that a borrower in connection with that a loan ~~made to that borrower by that licensee~~.

The committee also recommends clarifying amendments concerning the new language preventing various types of brokerage activity. These changes would begin on page 4, line 8.

~~(c) For purposes of this section, "referral" means either the introduction of the borrower and the finance lender or the delivery to the finance lender of the borrower's contact information.~~ The following activities by an unlicensed person are not authorized by this

~~section, unless the unlicensed person is exempt from licensure under this division, is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code, is a business assistance organization recognized by the United States Small Business Administration, or the person engages in one or more of the following activities in connection with five or fewer commercial loans in a 12-month period made by persons licensed under this division:~~

- (1) Participating in any loan negotiation.
- (2) Counseling or advising the borrower about a loan.
- (3) Participating in the preparation of any loan documents, including credit applications.
- (4) Contacting the licensee on behalf of the borrower other than to refer the borrower.
- (5) Gathering loan documentation from the borrower or delivering the documentation to the licensee.
- (6) Communicating lending decisions or inquiries to the borrower.
- (7) Participating in establishing any sales literature or marketing materials.
- (8) Obtaining the borrower's signature on documents.

(d) The prohibitions in (c) do not apply if the unlicensed person meets one or more of the following criteria:

- (1) Is Exempt from licensure under this division,
- (2) Is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code.
- (3) Is a business assistance organization recognized by the United States Small Business Administration.
- (4) Engages in one or more of the activities in paragraphs (1) through (8) of subdivision (c) in connection with five or fewer commercial loans in a 12-month period made by persons licensed under this division:

~~(e)~~ (e) The commissioner may adopt regulations under this section to impose conditions on the referral activity authorized under this section. The commissioner may classify persons, loans, loan terms, referral methods, and other matters within his or her jurisdiction, and may prescribe different requirements for different classes of loans.

~~(e)~~ (f) Nothing in this section shall authorize the payment of a referral fee to an unlicensed person for a residential mortgage loan, nor the payment of a referral fee to a person required to be licensed under Section 10131 or 10131.1 of the Business and Professions Code, unless such person is licensed by the Bureau of Real Estate pursuant to Division 4 (commencing with Section 10000) of the Business and Professions Code.

(g) For purposes of this section, "referral" means either the introduction of the borrower and the finance lender or the delivery to the finance lender of the borrower's contact information.

REGISTERED SUPPORT / OPPOSITION:

Support

California Association for Micro Enterprise Opportunity (CAMEO) – Co-Sponsor
Opportunity Fund – Co-Sponsor
3CORE, Inc.
Academies for Social Entrepreneurship
Accion San Diego
California Asian Pacific Chamber of Commerce
California Black Chamber of Commerce
California Disabled Veteran Business Alliance
California Metals Coalition (CMC)
Capitol Impact Partners
CDC Small Business Finance
El Pajaro Community Development Corporation
Genesis LA
Liberty Capital Group
Microenterprise Collaborative Inland Southern California
Mission Asset Fund
National Federation of Independent Business (NFIB)
Nehemiah Community Reinvestment Fund
Northern California Community Loan Fund
Pacific Community Ventures
Small Business California (SB-Cal)
Small Business Majority
TriTech Small Business Development Center
Valley Economic Development Center (VEDC)
West Company
Woman's Economic Ventures (WEV)
2 Individuals

Opposition

None on file.

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