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Authors:

[Timothy E. Wieher](#)

Operational Considerations for Implementation of the California Commercial Lender Disclosure Law

On April 7, 2021, the Department of Financial Protection and Innovation (DFPI) published revised [regulations](#) for the implementation of [SB 1235](#), which is the commercial lender disclosure law enacted in 2019. Implementation of the disclosures by financing companies operating in California will be required six months after the final regulations are adopted; however, the DFPI may require financing companies to comply earlier.

The revised regulations are extensive (52 pages) and contain many changes, deletions, and additions, which are not summarized in this article. Below is a summary of the general disclosure requirements, followed by several potential operational obstacles that financing companies should start considering to implement the requirements once effective to minimize disruption to their operations.

Requirements

Among many other requirements under the regulations, which include formatting, examples, etc., the below provides a high-level summary of the basic disclosure requirements:

- The disclosure requirements apply to any commercial lender providing financing of \$500,000 or less to a recipient (borrower) in California, except:
 - For depository institutions (but note that any partner of a bank in a bank partnership program would be subject to this law);
 - Lenders regulated by the federal Farm Credit Act;
 - Any financing transaction secured by real estate;
 - Any financing of \$50,000 or more provided to a dealer;or

- Any provider that makes one or less (or five or less if incidental to the business of the provider) applicable financing transactions in California during any 12-month period.
- The law generally requires that providers disclose the following in a separate document prior to the funding of a financing transaction:
 - The total amount of funds provided;
 - The total dollar cost of the financing;
 - The term or estimated term;
 - The method, frequency, and amount of payments;
 - A description of prepayment policies; and
 - The total cost of the financing expressed as an annualized rate.

Operational Obstacles to Consider

There are many considerations that must be addressed to ensure compliance with the law and regulations for the required disclosures. However, based on our experience with small business lenders and financing companies, the below appear to be more significant obstacles to implementing and complying with requirements for small business funders:

- The disclosure must be in writing and be provided “at the time of extending a specific commercial offer,” which means (i) at the time a financing offer is provided to a recipient in writing or (ii) within one business day of a financing offer being communicated verbally to a recipient. For financing companies providing offers in writing directly to recipients, this requirement is likely not a substantial issue since the process is in their control. However, financing companies providing offers through brokers or third-parties would need to establish new processes to implement and comply with the disclosure requirements. For instance, the regulations require that “a broker shall not provide a recipient with a specific

[offer] for commercial financing until the broker transmits the required disclosures, unaltered, to the recipient.” After a broker transmits disclosures to the recipient, the broker must then provide evidence of transmission of the disclosures to the financier, including the time of transmission, which must be maintained by the financier for four years. To ensure compliance, the regulations require that a financier “develop procedures reasonably designed to ensure that recipients receive the disclosures” in compliance with the disclosure requirements at the time the offer is provided to a recipient by a broker. A broker may not communicate specific terms to a recipient until the required disclosure is transmitted to the recipient. Additionally, the regulations require that the following procedures be implemented:

- Contractual requirements that a broker timely provide to the financier documentation of transmission of the disclosure (including timing of transmission) to an applicable recipient;
- Timely investigation of facts that would give a financier reasonable notice that a broker has not provided the required disclosures to applicable recipients; and
- Discontinuation of relationships with any broker who the financier has found non-compliant with the disclosure requirements.

These requirements present several issues for financing companies, with the most significant obstacle being that financiers would be obligated to timely investigate facts that would give a financing company reasonable notice that a broker has not timely provided the disclosures. This puts the burden on financing companies to not only implement contractual requirements with brokers, but to also receive documentary evidence that the required disclosures were provided to each applicable recipient prior to the broker discussing the offer with each such recipient. The regulation does not describe what “facts” would need to be investigated for a financier to have reasonable notice that a broker is not

complying with the disclosure requirements. Once it is identified that a broker has failed to comply with the disclosure requirements, the financing company must discontinue its relationship with such broker. However, the regulation does not make clear whether a single negligent violation of the law would trigger this requirement or if a pattern of known violations would be required to trigger this requirement. Although this may change in the final version of the regulations, it is worth considering how this process will impact a financing company's processes, agreements with brokers, and how a financing party will track compliance of brokers with the disclosure requirements (and be able to demonstrate such compliance to the DFPI).

- The required disclosures must be in a separate document (but may be included in a packet with other documents and agreements), and for any funded transaction, the disclosure must be signed by the recipient (which may be accomplished electronically) **prior** to funding the transaction. Financiers will need to include properly formatted disclosures and ensure that a signed copy is received by the financier prior to any transaction being funded.
- For merchant cash advances, the regulations prescribe methods for calculating estimated future income or sales of a recipient, which would be utilized to calculate the estimated term and effective annual percentage rate (APR) for each transaction. The first method requires a provider to estimate a recipient's income based on an average of the recipient's income based on historical income information of the recipient over a period of not less than four or more than 12 months. Alternatively, a financier may elect to estimate a recipient's income based on the funder's internal underwriting processes. However, a financier that uses internal processes to project income of recipients must audit its projections every four months to compare the disclosed annual rates to the actual annualized rates of such transactions, and if the "APR spread" is greater than 15% for the last three audits or greater than 10% for the last five audits, then the financier may

not use its internal underwriting processes to project income of recipients for 24 months (and must rely on the historical financial information and calculation method for such 24-month period). So, financing companies would either (i) need to project recipients' future income based on the historical statements in compliance with methods prescribed in the regulation, or (ii) establish an audit process to ensure compliance with the APR spread thresholds of the regulations, which would need to be a documented and consistent practice that would hold up to the DFPI's scrutiny.

Conclusions

To keep funding businesses located in California, financing companies will need to plan and prepare in advance to implement the disclosure regulations, including the obstacles noted above. This will take time and careful consideration of the requirements of the law and regulations in relation to their impact on your business. Members of Frost Brown Todd's [FinTech team](#), including the former general counsel and chief compliance officer of one of the largest small business lenders, have deep expertise in small business lending. We are ready to provide business and operational legal advice to assist clients in implementing and adhering to the new disclosure requirements, as well as any other small business financing issues.

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