eta ELECTRONIC TRANSACTIONS ASSOCIATION
1620 L Street NW, Suite 1020
Washington, DC 20036
202.828.2635
electran.org

February 3, 2022

The Honorable Michael Webert
Chair, Subcommittee #2
Commerce and Energy Committee
Virginia House of Delegates
900 East Main Street
Richmond, Virginia 23219

RE: Opposition to H.B. 1027 – Sales-Based Financing Providers

Chair Webert and Distinguished Members of the Subcommittee,

On behalf of the Electronic Transactions Association (ETA), the leading trade association representing the payments industry, I appreciate the opportunity to share our broad concerns with H.B. 1027.

ETA supports disclosures that promote transparency and accountability for small businesses and is committed to working with the Committee to help shape a disclosure regime that allows small businesses to accurately compare the cost of small business financing amongst providers. In addition, ETA supports increasing, not decreasing, choices in small business financing, thus allowing small businesses to select the best product that suits their needs to secure the capital they need to be successful and a competitive marketplace for small business financing with fair, transparent, and readily understandable financing options. Further, transparency in small business financing disclosures, including providing businesses with the best information to compare costs across products and make informed decisions, is integral to ETA's mission.

However, as drafted, H.B. 1027 could be confusing for both online small business funders and the small business community and does not properly address the needs of small businesses in the state. **Therefore, ETA asks the Committee to reject H.B. 1027 as currently drafted.**

In the past two years, the pandemic has underscored the importance of sustaining, if not increasing, financing options for small businesses. COVID-19 has forced many small businesses to curtail — and in some cases, suspend — many aspects of their business to slow the spread of coronavirus. As a result of these unprecedented decisions, the ability of small businesses to conduct commerce has been negatively impacted, with many experiencing a significant drop in revenue.

> **Sales-Based Financing models, including Merchant Cash Advances (MCAs), are designed to directly tie a small business's repayment obligation to its revenue. This allows small businesses to address unexpected events that could arise and decrease their revenue, such as COVID, that would otherwise threaten a business's viability through no fault of their own.**

Sales-Based Financing models provide a strong alternative to traditional financing for small businesses, especially during a period of stress or if the business ultimately closes for good. Sales-Based Financing options, including MCAs, allow small businesses to obtain necessary funding quickly, which may prevent the business from running out of necessary capital or closing immediately. In the case of closure, payments may not be due for certain types of Sales-Based Financing, and small businesses may not be obligated to pay the remaining portion of their balances because the providers take on the risk that the business may close when offering the finance option. For a more detailed description of MCAs and the benefits they provide to businesses, please review the Background provided at the end of this letter.

Small Business Funding ≠ Consumer Lending

Small businesses are the backbone of the economy. As such, they have different needs and objectives than consumers – often relying on financing to buy inventory, smooth cash flow, expand their marketing, and the ability to obtain financing that enables them to continue to grow. Small business funders have developed credit products specifically designed to meet those needs and objectives. Commercial and consumer credit are distinctly different types of credit, with consumers seeking credit for objectively different reasons than a business seeking commercial financing.

H.B. 1027 would enact a regulatory approach that would largely apply existing disclosure metrics for consumer lending to sales-based financing. ETA cautions that an approach that would apply existing requirements for consumer lending to small business sales-based financing would have detrimental effects for both online small business funders and the small business community, especially those businesses that are traditionally underserved and unable to access financing through more conventional means.

ETA's Concerns with H.B. 1027

- **Definition of Sales-Based Financing.** The proposed legislation's definitions are overly broad and would encompass forms of sales-based commercial financing that ETA believes were not intended to be covered by H.B. 1027. MCAs are just one type of sales-based financing, but other types of sales-based financing operate more like traditional loan products and are already subject to regulatory oversight. For example, certain sales-based financing products have a hybrid structure where repayments are based on the borrower's sales, but also require a minimum payment component that, in essence, creates a "term" loan product. Although the repayment structure for this hybrid type of product is based, in part, on the borrower's sales and, therefore, would fall within the proposed definition of "Sales-Based Financing", we believe the definitions in H.B. 1027 should be more narrowly tailored to expressly exclude these hybrid products, particularly, when the lender is a financial institution otherwise exempt from the provisions of this chapter.

- **Estimated Annualized Percentage Rate.** We are concerned that H.B. 1027, by mandating an estimated annual percentage rate (APR) disclosure for Sales-Based Financing, will create significant confusion and uncertainty for Virginia small business customers trying to make informed decisions about the cost of financing products. Sales-Based Financing products generally do not have a fixed term or fixed payments. Therefore, any disclosed annualized metric must be based on estimates and may not accurately reflect the actual cost of capital. Further, this requirement may actually be misleading to small businesses because as noted, these products often do not have a fixed term or a fixed payment amount given that it is dependent on a business's revenue. This could not only have a negative impact on Virginia small businesses but on the providers themselves as they grapple with trying to comply with this law when a metric that is inapplicable to their product must be utilized in their disclosures.

  Moreover, APR or Estimated APR is used to compare cost of capital; however, H.B. 1027 only requires disclosures for one type of product. Therefore, it is ineffective in comparing different commercial financing products. If one of the goals of disclosing an Estimated APR is to compare cost of capital, this legislation is ineffective because only Sales-Based Financing products will have an Estimated APR. A

small business cannot compare costs of commercial financing if not all commercial financing products require the same disclosures or metrics.

As an alternative to APR, ETA urges the Committee to consider Total Cost of Capital (TCC) as the method for disclosing the cost of financing products, which is what matters to small business owners. TCC captures all interest and fees (for certain products that do not charge interest, but rather a fixed fee for capital) that are a condition of receiving capital. TCC is readily calculable and provides the clearest, most accurate basis for comparison among commercial finance options, no matter how they are denominated.

- **Definitions in General.** H.B. 1027 makes reference to numerous phrases and words such as "finance charge" or "interest accrued," without providing a definition for these important terms. If enacted as is, a provider would be unable to accurately draft the required disclosures if it does not know what must be included. Additional clarity and definitions are needed, so that providers can provide accurate and meaningful disclosures in compliance with the law and for the benefit of small businesses.

- **Required Signature.** H.B. 1027 requires the provider to obtain the recipient's signature "before authorizing the recipient to proceed further with the sales-based financing transaction application." ETA is unclear what this means. It could mean that the recipient must sign the disclosures prior to accepting the offer, in the middle of the application process, prior to funding or some other point in time. Ideally, a recipient will be required to sign the disclosure at any time prior to funding. That way, the recipient will be able to sign the disclosures simultaneously with any other documentation. ETA suggests requiring signatures prior to funding, or prior to consummating, the Sales-Based Financing.

- **Requirements for Civil Action.** H.B. 1027 requires that any action initiated against the recipient of the Sales-Based Financing be initiated in the jurisdiction where the recipient's principal place of business is located regardless of any forum selection provision in the Sales-Based Financing agreement. Virginia has established through its case law that Virginia will honor forum selection provisions in contracts between parties and will uphold those provisions. H.B. 1027 goes against that established precedent and the basic fundamental principle of parties being able to contract.

  Moreover, as many providers have not only choice of law provisions, but forum selection provisions, it would create numerous practical issues wherein a provider would have to have multiple versions of its contracts to specify which forum would apply based on the principal business location of that specific recipient. Although other commercial disclosure laws have been introduced or passed, none have imposed such stringent requirements because other states understand the right of parties to be able to contract and have forum selection provisions in contracts. Therefore, this provision must be removed.

ETA has been engaged with other states that have either passed commercial financing disclosure laws or have introduced bills regarding commercial financing disclosures. ETA has provided guidance and information to those states to convey just how difficult it is to apply consumer disclosures to commercial

financing products. ETA has written numerous comments to both New York and California, who both have passed commercial financing disclosure laws, to provide fixes and concerns with those laws. California passed its disclosure law in 2018 and it has yet to be implement because the Department of Financial Protection and Innovation, who is tasked with finalizing the regulations, has requested over nine comments from industry to try and fix the disclosures and make then accurate and work so they are not misleading. New York's Department of Financial Services, which was tasked with proposing regulations to implement the disclosure law, realized just how complicated this is and has delayed the implementation date for at least six months as it stated how complicated the calculations and disclosures are. Both of these states have met with industry for years to work on disclosure laws and realize that this is complicated and not easily implemented and have therefore pushed back implementation dates and are still trying to work through how to actually implement the disclosure laws. This is a massive undertaking and will require months, if not years, of hard work to think through all the issues that exist in order to create and implement meaningful and non-misleading disclosures.

Sales-Based Financing, including MCAs, is a crucial small business finance lifeline, particularly for new enterprises without pre-established lines of credit with banks. Given how the COVID-19 pandemic continues to threaten the survival of many Virginia small businesses, now is not an appropriate time to pass legislation that would threaten one of their financial lifelines with complex and potentially misleading disclosures. H.B. 1027 needs more thoughtful deliberation and industry input to create a clear, fair, and uniform regulatory structure. Therefore, ETA urges the committee to reject H.B. 1027 in its current form and welcomes the opportunity to work with the sponsor and proponents of the legislation in the interim to develop a legislative proposal that all parties can support.

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Thank you for the opportunity to participate in the discussion on this important issue. If you have any additional questions, you can contact me or ETA Senior Vice President, Scott Talbott at stalbott@electran.org.

Sincerely,

Max Behlke
Director, State Government Affairs
Electronic Transactions Association
mbehlke@electran.org

Background: Purchase of Future Account Receivables or "Merchant Cash Advance"

MCAs are extremely flexible beneficial to businesses as they generally have:

- No set terms.
- No set payments.
- No personal guarantee.
- Funder gets paid only when the business is paid.

The purchasing of future account receivables are not loans, but rather, they are a sale of a portion of the small businesses' future credit and/or debit card receivables. When companies provide funds to businesses in exchange for purchasing a percentage of the businesses' daily credit card income, those funds come directly from the processor that clears and settles the credit card payment. A company's remittances are drawn from customers' debit and credit-card purchases on a daily basis until the obligation has been met. Many purchasers form partnerships with payment processors and take a percentage of a merchant's future credit card sales. Purchasers offer an alternative to businesses who may not qualify for a conventional commercial loan and provide flexibility for merchants to manage their cash flow by fluctuating with the merchant's credit and/or debit card sales volume.

The distinguishing characteristic of a purchase of account receivables is that there is no fixed scheduled payment amount or term. When the merchant makes a sale via credit and/or debit card, a percentage of the transaction is forwarded to the purchaser. This continues until the total amount of purchased receivables has been paid. The MCA provider receives the purchased receivables in one of the following ways: (i) the merchant's processor forwards the purchased receivables directly to the funder; (ii) the merchant's receivables are deposited into a lockbox account that forwards the purchased receivables to the provider and remits the balance to the merchant; or (iii) the provider is notified of the amount of the credit card receivables generated and the funder debits the purchased portion from the merchant's bank account.

For many small businesses, the purchase of future account receivables is an alternative to a traditional commercial loan because the transaction does not require personal guarantees from the business owner, meaning that the owner doesn't have to guarantee repayment. Moreover, unlike a commercial loan which has an absolute right to repay, in the event a business closes, and does not breach the agreement, the business is not held responsible to pay the remaining balance on the agreement. The purchaser takes a risk that a business may close. For example, during COVID, any small business that had to close its doors due to COVID would not be obligated to pay the outstanding balance on the agreement because the business closed, without breaching the contract, as the purchaser assumed the risk in purchasing the future account receivables.