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Calif. Banking Brief: All The Notable Legal Updates In Q4

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As 2023 came to an end, we continued to see developments in California that are certain to have an impact on the financial services industry this year. This article summarizes three noteworthy developments from the last quarter of 2023.

REQUEST BY DFPI FOR COMMENTS ON DIGITAL FINANCIAL ASSETS LAW

California passed its landmark Digital Financial Assets Law, or DFAL, in October, when Gov. Gavin Newsom signed into law A.B. 39 and S.B. 401.

The DFAL prohibits an entity from engaging in digital financial asset business activity, or holding itself out as being able to engage in digital financial asset business activity, with or on behalf of a California resident unless certain criteria are met, including that the entity is licensed by the California Department of Financial Protection and Innovation, or DFPI.

The DFAL additionally contains certain disclosure and recordkeeping requirements for licensees, requires licensees to enact various policies and procedures, imposes requirements on the operators of digital financial asset transaction kiosks, and provides the DFPI with broad rulemaking, examination and enforcement authority to implement, and ensure compliance with, the law. The law is set to take effect on July 1, 2025.

In advance of the effective date, and in order to ensure that it creates a regulatory framework that is tailored to the crypto-asset industry and protects consumers, the DFPI has invited the public to submit comments by Jan. 12.

With this request, the DFPI is specifically seeking comments related to the DFAL license application, licensure requirements and stablecoin approval, including the following:

- The type of information that the DFPI should be permitted to require of an applicant for a DFAL license pursuant to the catchall "any other information" category of Section 3203(a)(2)(X) of the California Financial Code;

- Whether aspects of the fees and costs for application review and investigation under Sections 3203(a) and 3203(b) of the California Financial Code should be clarified via rulemaking, and/or if there are certain factors for the DFPI to consider when determining fees and costs;
- The factors for the DFPI to consider in determining the dollar amount and other features of the surety bond or trust account that it may require of a licensee under Section 3207 of the California Financial Code;
- The capital minimums required by licensees under Section 3207 of the Financial Code and whether those should vary by the type of activity requiring licensure;
- Criteria for the DFPI to consider when evaluating the "quality of assets" pursuant to Section 3603(b)(2)(B) of the California Financial Code, that are owned or held by the issuer of stablecoins that may be used to fund any redemption requests from California residents;
- The extent to which the DFPI should consider an issuer's liabilities in its determination of whether to approve a stablecoin under Section 3603(b)(2)(F) of the California Financial Code, and whether the DFPI should consider whether the stablecoin is listed on the "Greenlist" maintained by the New York State Department of Financial Services.

The full list of questions posed by the DFPI can be found in its "Invitation for Comments on Proposed Application-Related Rulemaking Under the Digital Financial Assets Law (PRO 02-23)," dated Nov. 20.

The DFPI has also indicated that it will be hosting a "virtual informal listening session with stakeholders" on Jan. 8 to "discuss feedback on [its] informal invitation for comments."[1] The DFPI has indicated that it may seek comments on other topics related to the DFAL in the future.

It will be interesting to see how the public comments shape the DFPI's promulgation of rules under the DFAL.

DFPI'S MOTION FOR SUMMARY JUDGMENT GRANTED IN CHALLENGE TO CALIFORNIA'S COMMERCIAL FINANCING DISCLOSURE LAW

On Dec. 4, U.S. District Judge R. Gary Klausner provided a win to the DFPI by granting its motion for summary judgment in Small Business Finance Association v. Clothilde Hewlett — a case filed in December 2022 in the U.S. District Court for the Central District of California that challenged the validity of regulations promulgated by the DFPI pursuant to the California Commercial Financing Disclosure Law, or CFDL.[2]

Codified at Sections 22800-22805 of the California Financial Code, the CFDL was passed in 2018 and requires, among other things, that an offer for commercial financing in an amount of $500,000 or less be accompanied by disclosures of the amount of funds provided, the total dollar cost of financing, the term or estimated term, the method, frequency, and amount of payments, a description of prepayment policies, and the total cost of financing expressed as an annualized rate.

The statute also required the DFPI to promulgate rules to administer the disclosure requirements. In June 2022, the DFPI passed regulations that established the required disclosures for (1) closed-end loans, (2) open-end lines of credit, (3) factoring transactions, (4) sales-based financings, (5) leases, (6) asset-backed lending, and (7) all other financial transactions that do not meet the definitions of any of the products set forth in the other six categories.

The Small Business Finance Association, or SBFA, a nonprofit, advocacy organization whose members consist of online financers that offer commercial financing products to small businesses, subsequently brought suit against the DPFI.

The SBFA alleged that the disclosures required by the regulations violate its members' First Amendment free speech rights and are preempted by the Truth in Lending Act insofar as the annual percentage rate and finance charge disclosures are inconsistent with TILA's requirements.

In response, the DFPI filed for summary judgment on the grounds that (1) the plaintiff lacked standing to challenge the regulations, (2) the regulations do not violate First Amendment rights based on the test for "compelled

commercial speech" established by the U.S. Supreme Court in 1985 in Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio, and (3) the regulations are not preempted by TILA.

The court denied the DFPI's motion as to the standing claim, but granted summary judgment as to the First Amendment and preemption claims.

The court noted that in order for the DFPI to prevail on the First Amendment claim under Zauderer, it would need to prove that the disclosures are purely factual, noncontroversial, not unduly burdensome and reasonably related to a substantial government interest.

The SBFA argued that the disclosures could not satisfy the Zauderer test with respect to products such as sales-based financing and open-end credit.

It argued, among other things, that:

- Disclosures for those types of products would be "wildly inaccurate," and would be misleading because the estimated figures for payment, term and annual percentage rate could vary from actual results;
- The disclosures are controversial because there is debate in the commercial financing industry as to whether an "estimated APR" should be disclosed in connection with a sales-based financing transaction; and
- That the regulations are unduly burdensome because financial entities required to comply with the CFDL and implementing regulations would have to spend hundreds of thousands of dollars to comply, and would need to dedicate hundreds of its employees' hours to remain compliant.

The court disagreed with the SBFA's arguments, ultimately finding that the regulations would help small businesses understand the cost of sales-based financing and open-end lines of credit, that the estimates would not be misleading, and that the disclosures were neither subjectively controversial nor unduly burdensome.

Regarding the plaintiff's preemption claim, the court noted that Congress provided the Consumer Financial Protection Bureau with the authority to determine whether state law conflicts with federal law.

The CFPB exercised this authority when it issued a decision on March 31, 2023, that S.B. 1235 — the statute from which the DFPI's regulations arise — and similar laws enacted by Virginia, New York and Utah do not conflict with TILA. The court afforded judicial deference to the CFPB's determination, and declined to overrule the agency's analysis.

The DFPI has since touted Judge Klausner's order as "a significant victory for small business owners and consumer protection in the State of California."[3]

CALIFORNIA'S CONTINUED ENFORCEMENT ACTIONS AGAINST DEBT COLLECTORS

In continuation of its self-described "yearlong crackdown on unscrupulous debt collectors," the DFPI issued enforcement actions against four entities for unlicensed debt collection activity in violation of California's Debt Collection Licensing Act; unfair, deceptive, or abusive acts or practices in violation of the California Consumer Financial Protection Law; and violation of federal laws and regulations such as the Fair Debt Collection Practices Act.[4]

The DFPI alleged that, among other things, the four entities — Centennial Services, Bellgate Associates, Moss Westinghouse and Associates, and Prodigy Portfolio Management:

- Engaged in debt collection in California without a license from the DFPI;
- Failed to identify themselves as debt collectors in their communications to consumers;
- Contacted consumers at prohibited times of the day;
- Made false claims of pending lawsuits;

- Threatened to sue for time-barred debt;
- Made false claims about the amount or legal status of a debt and misleading statements about payment requirements; and
- Failed to provide debt "validation" required under federal law.

The DFPI's orders require the entities to desist and refrain from the foregoing activities, and to pay penalties totaling $87,500.

The recent enforcement actions follow debt collection action sweeps issued by the DFPI on Oct. 11, 2022, Jan. 30, 2023, and June 5, 2023.

It is likely that the DFPI will continue to bring enforcement actions against debt collectors in 2024, as the DFPI has indicated that debt collection comprises "one of the DFPI's top complaint types,"[5] that the agency has seen "an increase in fake debt collector scams" since 2022,[6] and that the DFPI is "committed to rigorous, ongoing enforcement efforts to protect Californians from these deceitful practices."[7]

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[1] State of California Department of Financial Protection and Innovation, Invitation for Comments on Proposed Application-Related Rulemaking Under the Digital Financial Assets Law (PRO 02-23), Nov. 20, 2023, https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/11/DFAL-Invitation-for-Comments-11-20-2023.pdf.

[2] Small Business Finance Association v. Clothilde Hewlett, case no. 2:22-cv-08775-RGK-SK, Dec. 4, 2023, https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/12/97-2023-12-04-Order-Granting-MSJ.pdf.

[3] State of California Department of Financial Protection and Innovation, Federal Court Upholds DFPI Protections for Small Businesses, Dec. 5, 2023, https://dfpi.ca.gov/2023/12/05/federal-court-upholds-dfpi-protections-for-small-businesses/.

[4] State of California Department of Financial Protection and Innovation, DFPI Continues Yearlong Effort Targeting Unlawful, Deceptive, Debt Collectors with Four New Actions, Oct. 23, 2023, https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/10/23-10-23-Debt-Collection-DR-Sweep.pdf.

[5] State of California Department of Financial Protection and Innovation, DFPI Sanctions Debt Collector in First Action Under the California Consumer Financial Protection Law, Sept. 22, 2021 https://dfpi.ca.gov/2021/09/22/dfpi-sanctions-debt-collector-in-first-action-under-the-california-consumer-financial-protection-law/.

[6] State of California Department of Financial Protection and Innovation, DFPI continues Crackdown on Debt Collection Scams, Jan. 30, 2023, https://dfpi.ca.gov/2023/01/30/dfpi-continues-crackdown-on-debt-collection-scams/.

[7] Id.

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