

## *The California Financing Law: Gaining Traction with Both Lenders and Regulators*

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Due to the substantial variation in the regulatory landscapes of various states, both foreign and U.S. lenders making commercial and consumer loans must carefully examine state law before conducting business in a given state. The California Financing Law (“CFL”) imposes licensing requirements on all entities seeking to make as well as broker<sup>1</sup> loans—whether consumer or commercial loans—in the State of California. Though many traditional lenders including banks and trust companies are exempt from the CFL, many alternative lenders may not engage in lending activities without obtaining a finance lenders license from the California Department of Business Oversight (“DBO”). An entity licensed as a finance lender is subject to a regulatory regime that is in some respects less onerous than the complex requirements applicable to banks and other highly-regulated institutions. As such, obtaining a CFL license provides non-traditional lenders—including foreign lenders—a path of entry into the California lending market. However, as the CFL has begun to garner more attention from regulators, any entity engaging in any kind of lending in California should closely analyze the parameters of the CFL to determine whether the entity is exempt from the CFL or whether it is properly licensed and in compliance with the law’s requirements.

### **History of the CFL**

Since July 1, 1995, the CFL has governed those engaged in the business of a finance lender or a finance broker, with several exceptions. Prior to the emergence of the CFL, these lending and brokerage activities were regulated in California under multiple predecessor regulatory regimes—namely, the Consumer Finance Lenders Law, the Commercial Finance Lenders Law, and the Personal Property Brokers Law. The CFL effectively brought consumer lending, commercial lending, and brokerage activities in California under a single legal framework. Notably, however, regulators have incorporated many provisions of these former laws into the structure of the CFL; as such, courts have widely referenced regulatory guidance and legal precedent arising under these former regimes when approaching questions under the CFL.<sup>2</sup>

### **Who Must Be Licensed under the CFL?**

The CFL generally prohibits individuals and entities from engaging in the “business of a finance lender or broker” without becoming a licensed finance lender.<sup>3</sup> The statute defines “finance lender” broadly to include “lending money” and “taking . . . as security for a loan . . . any contract or obligation involving



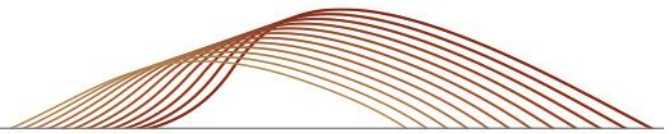
the forfeiture of rights in or to personal property” as long as possession of the property is not retained by the lender, as well as taking a lien on wages.<sup>4</sup>

Several exemptions from the CFL requirements are available, particularly for entities that are regulated under a different regulatory regime or by a different California regulator. For example, exemptions are available for the following types of entities when certain requirements are met:

- U.S. banks, savings and loan associations, industrial banks, and credit unions doing business under applicable state or federal banking law;<sup>5</sup>
- Trust companies;<sup>6</sup>
- Broker-dealers;<sup>7</sup>
- Licensed residential mortgage lenders;<sup>8</sup>
- Public corporations;<sup>9</sup>
- Franchisors when making loans to their franchisees;<sup>10</sup>
- California-licensed real estate brokers, when making or arranging a loan secured by a lien on real property;<sup>11</sup>
- Credit card issuers;<sup>12</sup>
- Venture capital companies, under limited circumstances;<sup>13</sup> and
- Insurance companies.<sup>14</sup>

Two exemptions are also available for certain *de minimis* lending activities. First, a general exemption is also available for a lender making fewer than five California loans in a 12-month period, provided that these loans are commercial loans that are “incidental to the business of the person relying on the exemption.”<sup>15</sup> The bill that expanded this exemption from one commercial loan per year to five commercial loans per year with an “incidental” requirement did not provide guidance detailing under what circumstances lending activities would be determined to be “incidental to the business of the person relying on the exemption”;<sup>16</sup> however, legislative history indicates that the exemption is intended to eliminate “an unnecessary burden on business that may not be engaged in the business of lending but just may make a few loans in a context unrelated to the business of lending.”<sup>17</sup> The legislative history specifically identifies “bridge loans” as a type of lending activity that, when performed by a business that is not typically engaged in lending, would fall within this *de minimis* exemption.<sup>18</sup> Second, effective January 1, 2017, a previously-lapsed exemption was reinstated that exempts a lender making one commercial loan in a 12-month period with no incidental requirement.<sup>19</sup>

In 2016, California regulators took action to shrink the number of entities exempt from the CFL, as demonstrated by revised regulations that narrow the licensing exemption for non-bank affiliates and subsidiaries of banks and bank holding companies within the context of consumer lending.<sup>20</sup> In a 1988 opinion under the CFL’s predecessor statute, the Commercial Finance Lenders Law, the Commissioner held that a wholly-owned subsidiary of a national bank would be exempt from licensing requirements under the exemption applicable to “any person doing business under any law . . . of the United States . . . relating to banks.”<sup>21</sup> The Commissioner reasoned that, as the operating subsidiary of a



national bank would be regulated by the Office of the Comptroller of the Currency, such a subsidiary constituted an entity that “does business under the laws of the United States relating to banks,” and therefore could take advantage of the exception from the Commercial Finance Lenders Law. The Commissioner of Corporations similarly extended the broad interpretation of this exemption to cover subsidiaries of federal savings banks, federally-chartered savings associations, and operating subsidiaries of bank holding companies.<sup>22</sup>

Consistent with Section 1045 of the Dodd-Frank Act,<sup>23</sup> however, the 2016 regulations reverse the DBO’s prior stance with respect to consumer lenders, narrowing the scope of this exemption by adding a regulation clarifying that the provision exempting an entity engaging in consumer lending activity “relating to banks” only applies to a “bank, trust company, savings and loan association, insurance premium finance agency, credit union, small business investment company, community advantage lender, California business and industrial development corporation when acting under federal law or other state authority, or a licensed pawnbroker when acting under the authority of that license.”<sup>24</sup> As such, nonbank operating subsidiaries and affiliates of banks engaging in any consumer lending or brokering activity are required to obtain a CFL license unless otherwise exempt.

## **What Ties with California Bring a Lender within the Scope of the CFL?**

The CFL does not provide guidance on the extent to which a loan transaction must be connected to the State of California in order to trigger the applicability of the CFL and subject a lender to its licensing and ongoing compliance requirements. While the broad language of the CFL provides no geographic limitation to its applicability, California courts have indicated that a loan transaction must involve sufficient contacts with California to support application of the CFL. In several such cases, the CFL or its predecessor statute was found not to apply, even where some connection to California was present, when the lender’s ties to California were minimal. Courts generally conduct a fact-based analysis to determine whether minimum contacts are present, taking into consideration, among other factors: (1) the location of the lender; (2) the location of the borrower; (3) where the loan is negotiated; (4) where any collateral for the loan is located; and (5) where payments related to the loan are remitted.<sup>25</sup>

## **How to Become a California Licensed Finance Lender**

Entities that wish to—or, based on their current activities in California, must—obtain a California finance lenders license must submit an application to the DBO, as well as fulfill other requirements. The application requires information about the applicant and its proposed activities, as well as about the persons who will manage the business, and all persons and entities owning 10% or more of the applicant. A surety bond of \$25,000 is required.<sup>26</sup> The applicant must submit financial statements, as well as a business plan outlining how the applicant will conduct its business consistent with the requirements of the CFL. A licensed finance lender must obtain a license for each branch office through which it conducts business.<sup>27</sup>

Entities making or brokering loans secured by residential real property must apply for a CFL license through the Nationwide Mortgage Licensing System, and must maintain a higher net worth than other licensed finance lenders.

The DBO has estimated the cost of obtaining a license to be \$10,000 and the cost of ongoing compliance to be \$8,500 per year.<sup>28</sup>



## **The Regulatory Regime Governing Licensed Finance Lenders**

Once an entity has obtained a license under the CFL, the entity may make both consumer and commercial loans. Additionally, unlike more restrictive regimes such as the California Real Estate Law,<sup>29</sup> the CFL permits the employees of a CFL-licensed entity to work under such a license without the requirement to obtain additional licenses at the employee level. In addition, loans by licensed finance lenders are exempt from the usury provisions of the California Constitution.<sup>30</sup>

However, a licensed finance lender must also satisfy certain ongoing obligations, including the requirements to submit an annual report and fee to the DBO, maintain books and records, and notify DBO of any changes in its directors and officers.<sup>31</sup> A licensed finance lender is also subject to requirements related to advertising, including limitations on advertising rates of interest and the requirement to make advertising materials available for the DBO's review upon request.<sup>32</sup>

Aside from these ongoing reporting and administrative requirements, licensed finance lenders are also subject to limitations on the types of activities these lenders and brokers may conduct.

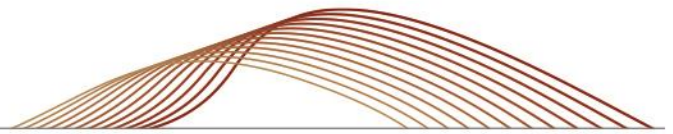
### ***Limitations Applicable Only to Consumer Loans***

Consistent with its stated goal of protecting borrowers,<sup>33</sup> the CFL imposes more restrictive limitations on the activities of consumer lenders and brokers than on those engaging only in commercial lending. Licensed finance lenders engaging in consumer lending activities<sup>34</sup> must comply with interest rate and fee restrictions,<sup>35</sup> and the CFL contains several provisions emphasizing the right of the DBO to enforce such consumer loan restrictions with respect to out-of-state consumer lenders.<sup>36</sup> In addition, as summarized below, *licensed* finance lenders making consumer loans are not authorized to pay referral fees to *unlicensed* entities.

### ***Limitations and Requirements Applicable Only to Commercial Loans***

The provisions specifically applicable to commercial loans, on the other hand, are largely permissive, and do not impose significant restrictions on commercial lending activities. For example, the commercial lending provisions of the CFL authorize a licensed finance lender to sell promissory notes to certain "institutional investors"—including banks, trustees of funds, and corporations—with respect to both real-estate-secured loans and loans not secured by real estate without obtaining a real estate broker's license.<sup>37</sup> Notably, a 2014 California District Court decision—*LFG Nat. Capital LLC v. Alioto*—emphasized the permissive nature of these provisions.<sup>38</sup> In *Alioto*, the court rejected an argument that, because the CFL expressly authorizes commercial lenders to sell promissory notes to institutional investors and does not address assignments of lines of credit, the assignment of a line of credit is invalid. Accordingly, *Alioto* emphasizes that these provisions act to authorize the listed activities and do not restrict activities on which the statute is silent. This interpretation has been reinforced in other cases addressing the interpretation of particular CFL provisions as well.<sup>39</sup> For purposes of the commercial loan provisions, a "commercial loan" means a loan with a principal of \$5,000 or more for use other than for "personal, family, or household purposes";<sup>40</sup> all loans under \$5,000 are subject to the CFL's consumer loan provisions.

However, under statutory amendments to CFL enacted on October 1, 2018, California became the first state to mandate specific disclosures for a broad array of commercial financings (the "California Disclosure Law").<sup>41</sup> As described in our previously published Paul Hastings client alert "[California Adopts First-of-its-Kind Commercial Financing Disclosure Regime](#)," these new disclosure requirements apply to a broader subset of financial services providers than those subject to the CFL's licensing



requirements and would broadly apply to providers of commercial financing in amounts equal to or less than \$500,000.

Statutory amendments effective January 1, 2016, clarify that the CFL limits the compensation a licensed finance lender may pay to entities providing referral services. These recent amendments permit licensed finance lenders to pay referral fees to an entity that does not hold a CFL license only if certain requirements are met.

Specifically, a licensed finance lender may pay referral fees to an unlicensed person if:

1. the referral leads to consummation of a commercial loan;<sup>42</sup>
2. the loan contract provides for an annual percentage rate that does not exceed 36 percent;<sup>43</sup>
3. before approving the loan, the licensed finance lender obtains documentation confirming the borrower's commercial status;<sup>44</sup>
4. before approving the loan, the licensee conducts underwriting and obtains documentation related to ability to repay;<sup>45</sup>
5. the licensed finance lender "maintains records of all compensation paid to unlicensed persons in connection with the referral of borrowers for a period of at least four years";<sup>46</sup>
6. the licensed finance lender "annually submits information requested by the commissioner regarding the payment of compensation in the report required pursuant to Section 22159";<sup>47</sup> and
7. the licensed finance lender provides the prospective borrower with a disclosure statement (the language of which is set forth in the CFL) at the time the licensee receives an application for a commercial loan, and shall require the prospective borrower to acknowledge receipt of the statement in writing.<sup>48</sup>

Importantly, the CFL clarifies that these provisions do not authorize unlicensed entities to engage in activities that exceed the scope of the "introduction of the borrower and the finance lender or the delivery to the finance lender of the borrower's contact information";<sup>49</sup> any other participation of the unlicensed referring entity in the relationship between the borrower and the finance lender is impermissible under the CFL unless the unlicensed entity is exempt from this prohibition.<sup>50</sup> The unlicensed entity is not authorized to, among other activities, prepare any loan documents, communicate lending decisions or inquiries to the borrower, or obtain the borrower's signature on loan documents.<sup>51</sup> The licensee is also responsible for any misrepresentation made to borrowers by the person making the referral.<sup>52</sup>

## **Penalties for Non-Compliance with CFL**

The CFL imposes both civil and criminal penalties for failure to comply with its requirements. For consumer loans, if a lender willfully violates the CFL when making or collecting a loan, the loan contract is "void" and "no person has any right to collect or receive any principal, charges, or recompense in connection with the transaction."<sup>53</sup> For both consumer and commercial loans, a "willful" violation results in a penalty of up to \$10,000 and up to a year's imprisonment; however, no person may be imprisoned without knowledge of the applicable rule or order set forth by the DBO.<sup>54</sup>



## Action Plan

Because of the CFL's broad reach—covering commercial as well as consumer lenders, and foreign as well as in-state entities—all entities currently engaged in lending activities in California and all entities who seek to participate in the California lending market should closely review the statute's requirements and restrictions. While the CFL regulatory regime is less onerous than the requirements applicable to traditional financial institutions, the CFL requires licensure as well as ongoing compliance activities for those lending in California.

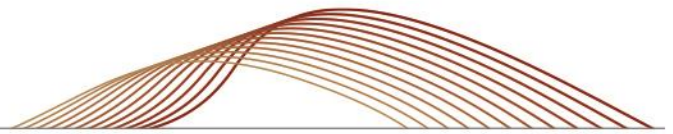
As the CFL casts a wider net than the lending regimes in other states, entities conducting lending activities in California should be sure to consider whether their business activities trigger obligations under its provisions. If an entity is already engaging in activities under the scope of the CFL without a license, a sound strategy is needed for approaching the application process in a way that limits any potential consequences imposed by regulators for conducting unlicensed activities in the past. For example, an entity currently acting as a finance lender without a license may face challenges in addressing question 7(b) on the CFL application, which asks, in relevant part, whether the applicant has "at any time violated the California Finance Lenders Law or regulations." Entities already engaging in lending activities in California without a CFL license should seek legal counsel in developing an action plan to assess the applicability of its provisions, including:

- An analysis of whether your current activities fall within the scope of lending activities covered by the CFL;
- Consideration of whether an exemption from the CFL licensing provisions may be available;
- If a license is required, a strategy for approaching the application process and engaging with the DBO; and
- Development of internal policies and procedures to ensure ongoing compliance with the CFL.

A U.S. or foreign entity seeking to commence lending activities in California as a licensed finance lender should also develop an action plan for approaching the licensing process and ongoing compliance with the CFL, including:

- An analysis of whether your proposed business activities fall within the scope of the CFL;
- Consideration of whether an exemption from the CFL may be available and—if so—a comparison of the requirements and limitations of all potentially applicable regulatory regimes;
- If a license is required, a strategy for approaching the application process and engaging with the DBO; and
- Development of internal policies and procedures to ensure ongoing compliance with the CFL.

In addition to requirements under state law, a foreign lender seeking to engage in commercial lending activity in the United States under the CFL also must consider whether its proposed activities would trigger obligations under the federal laws. These requirements may include, but not be limited to, the commercial lending company rules under the Federal Reserve Board's Regulation K,<sup>55</sup> and will be of particular concern where a foreign lender seeks to locate an office or personnel within U.S. borders.



Paul Hastings attorneys are actively working with clients seeking to obtain licenses under the California Finance Lenders Law and otherwise comply with its provisions.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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- <sup>1</sup> A person is a “broker” under the CFLL if the person “is engaged in the business of negotiating or performing any act as broker in connection with loans made by a finance lender.” Cal. Fin. Code § 22004.
  - <sup>2</sup> See, e.g., Op. Comm’r Cal. Dept. Corp., 1996 WL 616658 (Oct. 22, 1996); Op. Comm’r Cal. Dept. Corp., 1997 WL 116891 (Mar. 11, 1997).
  - <sup>3</sup> Cal. Fin. Code § 22100(a).
  - <sup>4</sup> Cal. Fin. Code § 22009.
  - <sup>5</sup> The CFLL exempts such entities when “doing business under any law of any state or of the United States” and “acting under the authority of that license.” Cal. Fin. Code § 22050(a).
  - <sup>6</sup> Cal. Fin. Code § 22050(a).
  - <sup>7</sup> Broker-dealers acting under a valid certificate issued under Section 25211 of the Corporations Code are exempt from the licensing requirements of the CFLL. Cal. Fin. Code § 22050(d).
  - <sup>8</sup> The CFLL does not apply to a loan made or arranged by a licensed residential mortgage lender or servicer when acting under the authority of that license. Cal. Fin. Code § 22060.
  - <sup>9</sup> Cal. Fin. Code § 22050(f).
  - <sup>10</sup> Cal. Fin. Code § 22063.
  - <sup>11</sup> Cal. Fin. Code § 22057.
  - <sup>12</sup> Cal. Fin. Code § 22052.
  - <sup>13</sup> Cal. Fin. Code § 22062.
  - <sup>14</sup> Insurance companies operating under a certificate of authority issued under the provisions of Article 3 of the Insurance Code are exempt from CFLL licensing requirements. Cal. Ins. Code § 1100.1.
  - <sup>15</sup> Cal. Fin. Code 22050(e).
  - <sup>16</sup> 2013 Cal. Stats., ch. 243 (AB 1091).
  - <sup>17</sup> California Committee Report, 2013 California Assembly Bill No. 1091, California 2013–2014 Regular Session.
  - <sup>18</sup> AB 1091 Assembly Floor Analysis (Aug. 21, 2013).
  - <sup>19</sup> Cal. Fin. Code § 22050.5(a).
  - <sup>20</sup> 10 CCR § 1422.3.
  - <sup>21</sup> Op. Comm’r, Cal. Dept. Corp., OP 5792CM (Dec. 1, 1988).



- <sup>22</sup> Op. Comm'r Cal. Dept. Corp., OP 95/1, 1995 Cal. Sec. LEXIS 3 (Oct. 11, 1995) (exempting the subsidiaries of a federal savings bank); Op. Comm'r Cal. Dept. Corp., OP 6595 CFLL, 1996 Cal. Sec. LEXIS 9 (Nov. 5, 1996) (exempting the subsidiary of a federally-chartered savings association); Op. Comm'r Cal. Dept. Corp., OP 6738 CFLL, 1999 Cal. Sec. LEXIS 1 (Aug. 5, 1999) (exempting the subsidiary of a federally-chartered savings association); Op. Comm'r Cal. Dept. Corp., OP 5792 CM, 1988 Cal. Sec. LEXIS 11 (Dec. 1, 1988) (exempting the subsidiary of a bank holding company); Op. Comm'r Cal. Dept. Corp., OP 5862, 1989 Cal. Sec. LEXIS 3 (Feb. 24, 1988) (exempting the subsidiary of a bank holding company).
- <sup>23</sup> See Notice of Proposed Rulemaking Action, *TITLE 10. CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT* (Oct. 16, 2014), available at [http://www.dbo.ca.gov/Licensees/Residential\\_Mortgage/pdf/03-13\\_ANotice\\_CM\\_OALRevised\\_10-16.pdf](http://www.dbo.ca.gov/Licensees/Residential_Mortgage/pdf/03-13_ANotice_CM_OALRevised_10-16.pdf). The initial PRO was subsequently modified to clarify that this change would apply only to consumer lenders. See California Department of Business Oversight, Notice of Modifications to Proposed Regulations under the California Finance Lenders Law and the California Residential Mortgage Lending Act (July 23, 2015), available at [http://www.dbo.ca.gov/Licensees/Finance\\_Lenders/pdf/03\\_13\\_Notice\\_Of\\_Modifications.pdf](http://www.dbo.ca.gov/Licensees/Finance_Lenders/pdf/03_13_Notice_Of_Modifications.pdf).
- <sup>24</sup> 10 CCR § 1422.3(a).
- <sup>25</sup> For example, the California Attorney General determined that an out-of-state lender would not be required to obtain a CFLL license in order to make loans to government agencies, even where some of these agencies were located within California, because no California residents would be impacted under the program, the lender had no offices in California, the lender negotiated the agreement outside of California, all payments would be remitted outside of California, and no California residents would be parties to the loan agreement. Op. Comm'r, Cal. Dept. Corp. (Apr. 2, 1997) (noting that "[a]ssuming arguendo that [a lender's] activities meet the definition of a finance lender under the CFLL," the lender should not be subject to regulation under the CFLL because "[the lender's] contacts with California are minimal").
- <sup>26</sup> See Cal. Fin. Code § 22101 *et seq.*
- <sup>27</sup> Cal. Fin. Code § 22102.
- <sup>28</sup> Notice of Proposed Rulemaking Action at 2.
- <sup>29</sup> See Cal. Bus. & Prof. Code § 10000 *et seq.*
- <sup>30</sup> Cal. Fin. Code § 22002; *see also* Cal. Const. art. XV, § 1.
- <sup>31</sup> Cal. Fin. Code §§ 22156; 22157, 22158, 22159.
- <sup>32</sup> See, e.g., Cal. Fin. Code §§ 22162; 22164; 22165; 22166; *see also* Cal. Dept. of Bus. Oversight Form 1422—CFLL Application Long Form (Rev. 11/13); available at [http://www.dbo.ca.gov/forms/Finance\\_Lenders/DBO\\_CFLL\\_1422.pdf](http://www.dbo.ca.gov/forms/Finance_Lenders/DBO_CFLL_1422.pdf).
- <sup>33</sup> Cal. Fin. Code § 22001.
- <sup>34</sup> Under the CFLL, the definition of "consumer loan" also includes any loan under \$5,000, even if such loan is not intended for personal, family, or household purposes. Cal. Fin. Code § 22204.
- <sup>35</sup> See generally Cal. Fin. Code ch. 2.
- <sup>36</sup> Cal. Fin. Code §§ 22322; 22323, 22324.
- <sup>37</sup> Cal. Fin. Code §§ 22600; 22600.1.
- <sup>38</sup> *LFG Nat. Capital LLC v. Alioto*, No.CGC13532569 (Cal. Super. 2014).
- <sup>39</sup> See *Skinner v. Mountain Lion Acquisitions, Inc.*, 2014 U.S. Dist. LEXIS 10425 (N.D. Cal. Jan. 28, 2014) (holding that Cal. Fin. Code § 22340, stating that licensees may sell promissory notes evidencing the obligation to repay consumer loans to institutional investors does not prohibit the licensee from selling such promissory notes to entities that do not meet the definition of "institutional investor").
- <sup>40</sup> Cal. Fin. Code §§ 22502; 22204.
- <sup>41</sup> New Section 22780.1 will be added to the California Finance Code. The text of the bill is available at [https://leginfo.ca.gov/faces/billTextClient.xhtml?bill\\_id=201720180SB1235](https://leginfo.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB1235).
- <sup>42</sup> Cal. Fin. Code § 22602(a)(1).
- <sup>43</sup> Cal. Fin. Code § 22602(a)(2).
- <sup>44</sup> Cal. Fin. Code § 22602(a)(3)(A).
- <sup>45</sup> Cal. Fin. Code § 22602(a)(3)(B).
- <sup>46</sup> Cal. Fin. Code § 22602(a)(4).
- <sup>47</sup> Cal. Fin. Code § 22602(a)(5).
- <sup>48</sup> Cal. Fin. Code § 22603.
- <sup>49</sup> Cal. Fin. Code § 22602(g).





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<sup>50</sup> Cal. Fin. Code §§ 22602(c)–(d). The prohibition on activities of an unlicensed entity do not apply if the unlicensed entity is exempt from licensing under the CFL, is a tax-exempt 501(c)(3) organization under the Internal Revenue Code, is a business assistance organization recognized by the United States Small Business Administration, or its activities fall below the *de minimis* threshold. Cal. Fin. Code § 22602(d).

<sup>51</sup> Cal. Fin. Code § 22602(c).

<sup>52</sup> Cal. Fin. Code § 22602(b).

<sup>53</sup> Cal. Fin. Code § 22750(b).

<sup>54</sup> Cal. Fin. Code §§ 22753; 22780.

<sup>55</sup> 12 C.F.R. § 211.21(g).