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"Know Your Customer, and Other Guidelines for Responsible Merchant Cash Advance Providers"

Presented by AdvanceMe, Inc.

Executive Summary

Small and mid-sized businesses need cash flow to survive. A Merchant Cash Advance ("MCA") is a great tool to help them better manage and grow their businesses. But, like any other powerful tool, if used incorrectly, it can do more harm than good. We continue to hear of a growing number of unscrupulous and predatory "funding" companies destroying their clients' businesses with retrieval rates beyond their abilities to pay, increasing retrieval rates without permission, "dog piling" multiple MCAs on top of one another, and even outright fraud. We understand that some "funding" companies have even gone so far as to sweep the entire merchant account to one over which they exercise control – enabling them to take what they please and leave the merchant with the remaining funds (if any). To the critics who say that this product is potentially harmful, we answer: "When used inappropriately, it can be."

As this industry matures, it is exhibiting many of the traits demonstrated during the development of other innovations in the financial services industry. Early providers found a market niche and went about doing business. As their business models and practices gained acceptance, multiple providers entered the market offering more money, lower rates and extending the market into less predictable customer profiles. As this was going on, "predatory" competitors entered the market also – extending financing in ways that damaged the customers by offering more financing than the customer could repay and/or charging multitudes of often hidden fees and other charges. Many customers lost big in the market frenzy. Although, as explained below, an MCA is not a loan or a financing, the MCA industry has the potential to follow this pattern and develop similar problems in the small and medium size business market.

The challenge facing our industry is simple: "Regulate ourselves, or someone is likely to do it for us." AdvanceMe believes that the Merchant Cash Advance industry needs to establish Best Practices for providing its products, and this White Paper is our invitation to the industry to begin that discussion. We believe that through Best Practices, the industry can ensure the healthy development of robust and ethical competition – and a level playing field safe for the merchants, banks, acquirers, processors and associations that are impacted by this industry.

An electronic version of this document may be found on AdvanceMe's website at www.AdvanceMe.com.

What is a Merchant Cash Advance?

A Merchant Cash Advance (or MCA) involves the purchase of a portion of a business' future card[1] sales at a discount. The purchase price paid by the MCA provider is a lump sum of cash delivered to the business for its use as working capital.

A common and popular way for the MCA provider to collect its purchased receivables is through "batch-splitting" and/or closely related variations through Automated Clearing House ("ACH") transactions. In batch-splitting, the merchant directs its processor to forward an agreed upon, set percentage of the merchant's daily net (post-chargebacks, reserves and other processor-related charges) settlement dollars from card sales (or "batch") to the MCA provider's account and to forward the remainder of the net settlement amount to the merchant's account. In the ACH variation, debits in amounts equal to the agreed upon percentage of covered card sales are instituted by the processor from the merchant's bank account (i.e., demand deposit account) through ACH transactions.[2]

An MCA is not a loan – it is a purchase of a specified amount of card sales that have yet to occur. This distinction is more than semantics and goes straight to the benefits an MCA provides to merchants. A merchant contracts for an MCA because, among other reasons, it has no fixed term. Rather, the MCA provider is entitled to receive a set percentage of its merchant client's daily net settlement batch. This means that the dollar amount received by the MCA provider on a given processing day is based on the merchant's card sales volume. For example, if the merchant and MCA provider agree upon an 8% retrieval percentage, the provider will receive $8.00 with respect to a day on which the merchant had $100.00 in net card sales. With respect to a day on which the merchant had only $50.00 of net card sales, the MCA provider is entitled to receive only $4.00. Because of its structure, an MCA involves no "late payments" or associated charges or penalties and is better aligned with the merchant's cash flow than traditional "fixed payment" style arrangements, in which the payment of a fixed dollar amount is due regardless of the merchant's sales volumes. For these reasons, many MCA providers include in their marketing materials some variation of AdvanceMe's message "We get paid only when you get paid."

On the other hand, these aspects of an MCA (viz., the provider is only entitled to a set percentage of net card sales and the total amount of purchased future receivables is fixed) also make it a risky product for the MCA provider to deliver. If the merchant's future card sales are lower than the MCA provider projected, the provider's collection of the receivables it purchased will take longer than projected – a timing difference that may result in loss of income for the provider. Moreover, the MCA provider will bear the loss if the merchant fails to generate future card sales sufficient to deliver the total amount of receivables sold to the

[1] The cards in question may include any number of bank cards, other payment cards and media (such as credit, debit, charge, smart and "contactless" cards, as well as RFID enabled devices), the transactions with which are handled by processors and other acquirers.

[2] Batch-splitting and substantially similar methods involve multiple benefits, as compared to other collection methods, including greater efficiency, lower costs, and more effective tools for managing risks and losses. By reducing the administrative burden and collection risk on the MCA provider, these methods enable providers to deliver capital to a wider range of merchant types. These methodologies also enhance the MCA provider's willingness to provide capital by enabling the provider to monitor the card sales related cash flow of its merchant clients and to model merchant profiles within SIC codes, geographies, seasonal trends, time in business, size of business, etc. These methodologies also reduce the merchant clients' cash flow risks (and the MCA provider's collection risk), by facilitating a large number of smaller payments with predictable impact on the merchants' cash flow.

provider. For these reasons, responsible MCA providers are careful to set the terms of their transactions based on the particular profiles of their merchant clients. Any miscalculation in the merchant's profile, or unforeseen event (e.g., Hurricane Katrina), can change the collection curve on the MCA transaction – often dramatically.

MCA providers usually require less paperwork than traditional capital sources, and can often go from application to completed funding in a week or less. Those MCA providers, like AdvanceMe, who structure their transactions as "true sales" by merchant clients and not as loans, do not require personal collateral to secure the merchant's obligations. Some MCA providers, including AdvanceMe, require the merchant to provide certain covenants (e.g., to not switch or split their processing, without the provider's consent) and owners to provide guarantees of performance of those covenants.

A Call for Best Practices

AdvanceMe believes that the MCA industry needs to develop a series of "Best Practices" for MCA Providers. These Best Practices will enable growth in our industry that is both fair and robust, benefiting all participants – from merchants, to processors and acquirers, to salespeople and MCA providers. Best Practices will provide market participants, banks, and associations with the benchmarks to distinguish between reputable and disreputable MCA providers using a common taxonomy. This ability to choose amongst providers is certain to become more and more important as the industry grows and attracts greater scrutiny from the press and regulatory entities.

We call for the industry to establish standards against which industry participants may be measured. We have created this paper to begin the conversation that will lead to consensus. We invite open debate, comments and additions to our list of suggestions set forth below. We strongly urge everyone with a stake in the future of the MCA industry to participate in this discussion.

Best Practice Axiom #1 – Do Not Harm the Merchant Customer

1. *Know Your Customer*

   Responsible funding means knowing your customer and using commercially reasonable efforts to ensure that your funding does not harm the merchant's business. Every business has a maximum percentage of its gross revenues that it can afford to pay each month against any financial obligation (the "Safe Retrieval Percentage"). If the merchant has to pay more than that percentage, it risks going out of business. Our experience over the past 10 years leads us to believe there is a strong correlation between the traditional margins associated with a particular type of business and the Safe Retrieval Percentage. So, some SIC codes can support a 2% retrieval per month, and some a 9% retrieval. Our experience is that, except in unusually profitable businesses, in no SIC code does the maximum Safe Retrieval Percentage exceed 9%.

   Some MCA providers may have data showing that the maximum Safe Retrieval Percentage is only 8%, or maybe they can demonstrate that certain businesses in their experience can go to 9.9 %. However, we hear of instances where certain MCA providers have been routinely going to 15%, or even as high as 20+% of gross revenue. We believe, based on the data from over 40,000 MCA transactions we have made to date, that such retrieval percentages will destroy businesses.

   We propose a Best Practice rule that calls upon MCA providers to know the margins of the business types they fund, and to establish internal Safe Retrieval Percentages for each type of business, and adhere to that policy except pursuant to appropriate and documented exceptions.

Other areas that should be considered in establishing Safe Retrieval Percentages within each MCA provider include the following: (i) what percentage of businesses actually grow within a year of entering into an MCA; (ii) what percentage of businesses open a new location during the pendency of an MCA transaction (i.e., while future receivables are owed to the provider); and (iii) what percentage of businesses enter into one or more additional MCA transactions after the provider collects the total amount of receivables purchased in the first/previous MCA transaction?

2. *Fix the Retrieval Percentage*
Responsible funding means honoring your marketing and documented commitments to your customer. One of the most severe breaches of this Best Practice is increasing the retrieval percentage without express consent of the merchant customer. We have heard that certain MCA providers change the retrieval percentage in the event the provider is collecting its purchased future receivables more slowly than it anticipated (i.e., when the merchant's card sales volumes are lower than the provider projected). We believe that this practice hurts merchants and AdvanceMe will not do it.

As described above, alignment between the business's card-related cash flow and the MCA provider's collection of its purchased receivables is the very essence of an MCA and its chief differentiator from other financial products in the marketplace. This feature makes it arguably one of the most cash flow friendly products available today. If MCA providers increase the retrieval percentage precisely when the client's business has slowed, they endanger the business's viability. The MCA product is priced to account for the unknowable timing of revenues, which is precisely the risk MCA providers must assume.

We propose a Best Practice rule that prohibits increasing the retrieval percentage with respect to any MCA, without a new, express, written consent from the merchant customer each time the MCA provider desires to increase the retrieval percentage (i.e., not just a blanket consent in the contract upfront). The consent form should clearly identify the new retrieval percentage and should be dated no more than five business days prior to application of the new retrieval percentage.

3. *Provide Clear Disclosure of Fees*
Fees, rates and automatic deductions and renewals are not necessarily evil. *Unexpected* fees, rate changes, and contract renewals are. Contracts need to clearly specify these items, with bold print instead of the mousetype so common today. Salespeople must adequately disclose and explain them to their customers.

We propose a Best Practice rule that requires clear disclosure of all fees associated with an MCA. We believe the fee disclosure rules currently in place in the card processing marketplace are a good place to start the discussion of appropriate disclosure standards for MCA fees.

4. *Establish Customer Service Standards and Issue Resolution Mechanisms*
Merchant customers should be able to get assistance and answers when needed. Some MCA providers operate without any infrastructure in place to serve their client base, diminishing the overall professionalism of the industry.

We propose a Best Practice rule that requires MCA providers to establish (i) staffed customer service desks, enabling merchant customers to receive answers to their questions and problems within commercially reasonable times; (ii) issue resolution policies, with appropriate escalation procedures; (iii) quality control measures to ensure that the correct amounts are being deducted from the merchant's net settlement batches; and (iv) agreements and processes with processors and other acquirers to ensure that mistakes are corrected quickly.

<u>Best Practice Axiom #2 – Do Not Harm the Industry</u>

1. *Represent the Product Accurately*

   If the MCA is structured as a purchase and sale transaction, then the product should be described accurately in a way that avoids confusion. A true sale transaction cannot have an interest rate or a principal balance and cannot involve repayment, late payment fees, payment guarantees, or any other indicia of a loan. These features must be absent from both the transaction itself as well as any marketing collateral or sales efforts. Mixing the features of a "true" MCA purchase and sale with the features of a traditional loan confuses merchant customers and invites regulatory scrutiny.

   We propose a Best Practice rule that requires MCA providers to accurately describe their products in all communications, especially sales and marketing efforts directed at merchants. This would involve using commercially reasonable efforts to cause independent sales channels to accurately describe such products.

2. *Distinguish the MCA Sale*

   Just as the Card Associations and regulatory agencies have closely scrutinized and discouraged tying the sale of merchant processing to the sale of other products and services, we believe that the merchant community is best served by being able to similarly distinguish the relative merits of an MCA separate from related products or services. For this reason, it is important that the sale of MCAs remain distinct (i.e., separate documentation) from the sale of processing and related products and services.

   We propose a Best Practice rule that requires MCA providers to use commercially reasonable efforts to distinguish (and to use commercially reasonable efforts to cause their independent sales channels to distinguish) the sale of MCAs from sales of any related products or services.

<u>Summary</u>

Merchants should want to work with MCA providers who abide by these Best Practices for obvious reasons. They will receive money that helps their businesses and build ongoing, professional relationships with providers that can save them time and frustration. ISOs benefit because MCA providers that embody these Best Practices have satisfied, happier merchant customers who will take advantage of more fundings over their lifetimes. More fundings means more residuals. The industry benefits because it builds a reputation within the regulatory community that it has the ability to self-regulate, advocate responsible funding practices, and minimize unscrupulous behaviors without the need for government intervention. If a provider sets the retrieval percentage at a rate that the business cannot support, then it will be harmful. Or, if it increases the retrieval percentage when the card sales are not flowing as expected. Or if the merchant agreement is not free from hidden fees.

It is incumbent upon the industry to regulate itself to ensure that it moves forward responsibly. With 10 years of history behind it, AdvanceMe has gained data, knowledge and perspective that can be used to promote Best Practices that help, not hurt, customers, ISOs that sell the product, and others within the industry.

The purpose of this White Paper is to outline Best Practices that responsible providers can adopt, merchants can judge providers against and the industry can promote. We offer this White Paper to start the discussion.