INITIAL STATEMENT OF REASONS
FOR AMENDMENTS TO REGULATIONS UNDER THE
ESCROW LAW

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner (Commissioner) sets forth below the reasons for the proposed adoption of Section 1718.1 to Chapter 3 of Subchapter 9, Article 4 of Title 10 of the California Code of Regulations (10 C.C.R. Section 1718.1).

SPECIFIC PURPOSE OF REGULATIONS

The Department of Corporations (Department) licenses and regulates escrow agents under the California Escrow Law (Financial Code Section 17000 et seq.). The California Escrow Law prohibits a person from engaging in business as an escrow agent within this state unless licensed by the Commissioner of Corporations (Commissioner) as an escrow agent. In order to obtain licensure as an escrow agent, an applicant must apply in writing to the Commissioner and, among other things, obtain and maintain a surety bond. In addition, an escrow agent must be a member of the Escrow Agents' Fidelity Corporation if it processes specified escrow transactions. The Escrow Agents' Fidelity Corporation indemnifies its members against specified losses and administers a member audit program.

The Commissioner is authorized to prescribe the form of the application for an escrow agent license, which an applicant must complete and submit to the Department. Additionally, the Commissioner may, among other things, make forms that are necessary to carry out the Escrow Law statutory provisions and define any related terms. Specifically, the Commissioner may specify the form of the bond that must be submitted by an applicant at the time an application is filed with the Commissioner.

In particular, each escrow agent is required to file a surety bond of at least $25,000 with the Commissioner. The surety bond must be increased by $5,000 for each additional licensed office location. The required amount of the bond may increase up to a maximum of $50,000 depending on the escrow liability of the company. The Commissioner may use the surety bond to pay any amount that is due to the state or to pay claims against the escrow agent.

A surety bond is a three-party contract between a principal, oblige, and a surety company. It is issued by a surety bond company on behalf of a principal, guaranteeing that the principal will fulfill its legal obligations, as required by the oblige. In the event that the obligations are not met, the oblige can recover its losses via the bond by making a claim on the bond to recover losses.

The Escrow Agents' Fidelity Corporation, a mutual-benefit nonprofit corporation, is a type of nonprofit corporation chartered by state government that exists to serve its members. The Escrow Agents' Fidelity Corporation’s members are California escrow agents that process the following types of escrow transactions: real property, bulk sale escrows, reservation deposits, fund or joint control escrows, promissory notes that are secured by deeds of trust, and the sale or transfer of manufactured or mobile homes. Escrow Agents' Fidelity Corporation membership is required for agents processing these transactions, and Escrow Agents' Fidelity Corporation indemnifies its members against losses that are the result of an officer or employee's fraudulent actions.

The Escrow Agents' Fidelity Corporation must maintain a membership fund, an operations fund, and a fidelity fund for payment of claims and costs of administration. In particular, the fidelity fund must be used for the payment of claims and for the payment of the premium for the fidelity bond or insurance policy, if any. All claims must be paid from the fidelity fund, provided that, to the extent that the fidelity fund balance is not sufficient to pay claims, the claim must be paid from the membership fund by charging each member's membership account a pro rata share of the excess. All interest earned on the membership fund and the operations fund must be credited to the fidelity fund.

The Escrow Agents' Fidelity Corporation, after noticing the Department, may audit an escrow company to investigate claims filed by members by examining or investigating the business practices of a member's handling and processing of trust obligations or failure to pay an assessment, as specified. The result of every investigation or examination must be reported to the Commissioner with recommendations. The Escrow Agents' Fidelity Corporation may submit reports and make recommendations to a member of its findings based on an examination or investigation. A copy of either must be submitted to the Department. The costs and expenses for any examination by the Escrow Agents' Fidelity Corporation must be paid for by the member and the Fidelity Corporation may maintain an action for recovery of those examination costs and expenses.

Surety Bond Form

The Department requires escrow agents to submit a surety bond using a designated form for a specified amount based on state statutes when applying for licensure. While the bond amount and some of the bond form language is specified by statute, the Commissioner is permitted by law to include additional language in the bond form that clarifies what the Department needs from its licensees in order to satisfy the bond requirement.

This regulatory action would incorporate the surety bond form used by the Department into the California Code of Regulations. The proposed bond form contains the most current and accurate statutory requirements. Adding the bond form to the regulations may better enable applicants and escrow agents to access the form and obtain bonds that comply with state licensure requirements.

Notice of Bond Cancellation

The purpose of the Escrow Law is to protect members of the public who entrust their money or other assets to independent escrow agents in California. To that end, the surety bond requirement for escrow agents helps protect the public's money and assets by insuring escrow agents against loss of those monies and assets. Requiring a surety bond company to provide notice of a bond cancellation to the Department and the Escrow Agents' Fidelity Corporation, prior to a cancellation, may further help ensure the public is reimbursed for any losses and potentially prevent losses in the first place by providing an early indication that an escrow agent is experiencing financial problems.

Currently, the Department receives a notice of a bond cancellation from a surety bond company thirty days prior to a bond cancellation. The notice enables the Department to send out a letter with a reminder of the pending cancellation to each escrow agent licensee with

adequate time to renew its bond. A notice of cancellation could be an indicator of several things, including but not limited to: (1) an escrow company is experiencing a financial problem and cannot afford the bond premium; (2) an escrow company is delaying its renewal because it is seeking a more affordable premium; (3) an escrow company simply allows a bond to expire and in turn the bond company does not desire to renew it; (4) an escrow company is not sure if it wants to renew its bond due to poor business prospects; (5) an escrow company may not be able to renew a bond because the surety bond company had to pay out for it in the past; or (6) due to the economy, an escrow company may not be able to renew a surety bond because its surety bond company rejected the renewal request or charged a higher premium based on the financial statements of the escrow agent's owners. However, many of the escrow companies that are in these situations and receive bond cancellation notices are able to reinstate them prior to a cancellation taking effect.

If an escrow agent's surety bond expires, the Department sends an Order to Cease New Business to the escrow agent. The Order allows a company to continue to work on or close any open escrows, including receiving funds to do so, but prevents it from opening any new escrows until its bond is reinstated. The Department provides a copy of the Order to Cease New Business to the Escrow Agents' Fidelity Corporation. Once a bond is reinstated, the Department sets aside the Order to Cease New Business.

Due to the current economy and housing crisis, the need for escrow business has declined and in turn caused many companies to reduce expenditures and in some cases struggle financially. As a result, a greater number of companies have submitted claims to the Escrow Agents' Fidelity Corporation. However, in many of these cases the companies have still been able to reinstate their bonds prior to a bond cancellation taking effect.

Providing a notice of bond cancellation to the Escrow Agents' Fidelity Corporation would enable it to conduct a "mini" audit on an escrow agent licensee to determine if it is experiencing financial problems that may jeopardize its bond renewal. If an audit indicates an escrow agent is experiencing a financial problem, it can help the Escrow Agents' Fidelity Corporation guard against a claim. The information would be provided to the Department of Corporations for subsequent action, which may include an Order to Cease New Business that may encourage a prompt renewal of the bond.

This regulatory action would codify the Department of Corporations' current practice of requiring surety bond companies to provide a notice of a bond cancellation thirty days prior to the cancellation and add a new requirement to require surety bond companies to provide the same notice to the Escrow Agents' Fidelity Corporation. Adding this requirement to the regulations may reduce or prevent some claims against the Escrow Agents' Fidelity Corporation.

BENEFITS OR GOALS OF REGULATORY ACTION

The benefits anticipated from this regulatory action include nonmonetary benefits derived from improving economic welfare. The regulatory action to add the escrow agent surety bond form to the regulations would make it more accessible to applicants and licensees and help ensure that they comply with the statutory requirements for the bond, required for licensure. Having a standard bond form would likely discourage companies from creating their own forms that may not satisfy the Department of Corporations' requirements. If the

Department of Corporations had to review individualized forms it could result in staff spending hours reviewing each policy to ensure all elements are present. Lastly, it would be a cost savings to the Department of Corporations because it would reduce costs associated with printing, mailing and faxing forms to licensees and new applicants. While there could be future costs associated with revising and readopting the form, it would likely be minimal as the current form has been used for many years without changes.

ECONOMIC IMPACT ANALYSIS

The Commissioner has made an initial determination that the proposed regulatory action on escrow agent requirements will not have a significant adverse impact on business, and may in fact have a positive impact on the health and welfare of California residents and licensees by ensuring that independent escrow agents remain a viable industry in California, and by protecting California consumers from financial harm through earlier reviews of the status of licensees' surety bonds to better identify potential abuses. Notably, the Department was asked to prepare this regulatory action by a representative of the Escrow Agents' Fidelity Corporation, based on a request of its leadership. So while the proposed regulatory action to include requirements that surety bond companies provide notice of bond cancellations to the Escrow Agents' Fidelity Corporation may have an adverse economic impact on escrow agents, namely from examination and investigation costs, industry is essentially self-imposing the regulation and related costs on itself. However, if the Escrow Agents' Fidelity Corporation intends to investigate and/or examine every escrow agent that receives a bond cancellation notice, even if it doesn't have any other indicator of financial hardship, then the proposed regulation may subject escrow companies to unjustified costs.

The regulatory action requiring the surety bond form to include requirements that surety bond companies provide notice of bond cancellations to the Department is not likely to increase costs for licensees. It is simply codifying a current practice.

The Department has not relied upon any other reports or facts to support the initial determination that the regulation will not have a significant adverse economic impact on business, or any other impact described in Government Code Section 11346.3.

TECHNICAL, THEORETICAL AND/OR EMPIRICAL STUDIES, REPORTS OR DOCUMENTS

The Department did not rely upon any technical, theoretical, or empirical study, report, or other similar document in proposing this regulatory action.

STATE REGULATIONS NOT DUPLICATIVE OF FEDERAL/STATE LAW

The proposed regulatory action is consistent with existing escrow regulations, the Escrow Law and other Department regulations that set forth surety bond requirements for escrow agents. The Department's existing regulations generally require escrow agent licensees to submit surety bonds that satisfy the Commissioner. This proposed rule clarifies its surety bond requirements for escrow agent licensees and new applicants, which in turn may help streamline its licensure process for escrow agent licensees and new applicants. It is consistent with the intent of the escrow law to help protect consumers and government entities from fraud and malpractice.

The notification requirements of the proposed regulatory action concerning are consistent with existing regulations and Escrow Law requiring escrow agents to satisfy the Commissioner's surety bond requirements. These are also consistent with the intent of escrow law to protect the public from financial harm by providing the Escrow Agents' Fidelity Corporation an opportunity to investigate or examine escrow agents to determine whether they are experiencing financial problems prior to the expiration of their surety bonds.

REASONABLE ALTERNATIVES AND REASONS FOR REJECTING THOSE ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Department must determine that no reasonable alternative it considered to the regulation or that has otherwise been identified and brought to its attention would either be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposal described in this Initial Statement of Reasons.

REASONABLE ALTERNATIVES THAT WOULD LESSEN ANY ADVERSE IMPACT ON SMALL BUSINESSES

No reasonable alternative considered by the Department or that has otherwise been identified and brought to the attention of the Department would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small business.

FACTS, EVIDENCE, DOCUMENTS, TESTIMONY OR OTHER EVIDENCE RELIED ON BY THE AGENCY

The proposed regulation will not have a significant adverse economic impact on business because the regulation clarifies the Escrow Law requirements for a surety bond and makes the application consistent with existing law.