Date of Hearing: April 1, 2024

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Timothy Grayson, Chair
AB 1934 (Grayson) – As Introduced January 25, 2024

SUBJECT: Digital financial asset businesses

SUMMARY: Clarifies recordkeeping requirements for stablecoin issuers operating under the Digital Financial Asset Law (DFAL).

Specifically, **this bill**:

1) Requires a stablecoin issuer to maintain a report, updated at least monthly, that demonstrates compliance with the DFAL's stablecoin reserve requirements.

2) Makes other assorted technical changes to provisions governing stablecoins.

EXISTING LAW:

Provides for the DFAL (Financial Code Section 3101 et. seq.), administered by the Department of Financial Protection and Innovation (DFPI), which prescribes rules, including a requirement to become licensed beginning on July 1, 2025, applicable to a person engaging in digital financial business activity, as defined.

FISCAL EFFECT: Unknown. This bill is keyed Fiscal by Legislative Counsel.

COMMENTS:

1) **Purpose**

According to the author:

> In 2023, the Governor signed AB 39, which promotes responsible innovation by licensing and regulating crypto companies doing business in California. AB 1934 makes assorted technical changes to this new law in order to promote efficient administration of the program. Specifically, this bill would clarify provisions around so-called "stablecoins," which are digital assets that play a central role in the crypto market.

2) **Background**

A digital financial asset (also referred to "cryptocurrency," "crypto asset," or "virtual currency," terms used interchangeably in this analysis) is a digital representation of value that is not issued or backed by a government or central bank. Unlike the dollar, cryptocurrency is not considered legal tender, but private parties may agree to it to facilitate an economic exchange. Bitcoin, the most well-known virtual currency, and many other virtual currencies are created and tracked via a decentralized protocol, rather than the centralized issuance model that prevails in the world of fiat money.

Proponents of cryptocurrency believe that these products and systems offer viable alternatives to those found in the traditional financial system. They argue that cryptocurrency is beneficial because it is decentralized, allowing for peer-to-peer transactions, easy and fast transactions, portfolio diversification, acts as an inflation hedge, encourages cross-border payments, promotes financial inclusion, and provides transactional freedom.

However, these assets pose significant risks to consumers due to the lack of regulatory clarity and established rules for companies operating in this space. In recent years, market turmoil has exposed a host of consumer and investor risks in the crypto market. These risks include fraud, hacks, scam products, extreme volatility, insider trading, information asymmetry, and a lack of clear federal and state legal protections. Such risks expose everyday investors and consumers to financial losses beyond their control. In late 2022, the well-known company FTX collapsed, and its CEO, Sam Bankman-Fried, was arrested.

3) **AB 39 and implementation so far**

In response to the widespread consumer harm occurring in the under-regulated crypto market, the Legislature passed AB 39, Chapter 792, Statutes of 2023. This legislation created the DFAL and established a licensing program for digital asset companies serving California customers. Under the DFAL, crypto companies must obtain or have applied for a license by July 1, 2025, and adhere to a set of new regulations covering policies and procedures, customer service standards, and financial stability. Additionally, the DFAL includes specific rules for "stablecoins," which are elaborated upon in Comment #4.

When the Governor signed AB 39, his signing message indicated an interest in fine-tuning some of the concepts in the DFAL. His signing message stated:

> I thank the author for the effort to create a clear and comprehensive approach to regulating the digital assets market. Stronger consumer and investor protections will prevent fraud and ensure bad actors are held accountable.
>
> However, ambiguity of certain terms and the scope of this bill will require further refinement in both the regulatory process and in statute to provide clarity to both consumers, regulators and businesses subject to this new licensure framework. It is essential that we strike the appropriate balance between protecting consumers from harm and fostering a responsible innovation and I look forward to working with the author to achieve this.

In December 2023, DFPI sent out an Invitation for Comments to seek public comment on topics related to the DEFAL application, licensure requirements, and stablecoin approval. Those comments were published in March 2024.[1]

4) **Stablecoins**

A stablecoin is a crypto asset whose value is pegged – or is marketed as being pegged – to another asset. For example, a single US Dollar Coin (USDC), issued by crypto company Circle, is worth one actual dollar. While many crypto assets, including Bitcoin, can

---

[1] See https://dfpi.ca.gov/dfal-regulations/ for the Invitation for Comments and links to the submissions.

experience large fluctuations in value in a short time, stablecoins by design are meant to be predictable and, well, stable.

Stablecoins play a crucial role in the digital asset economy. In many ways, they serve as the plumbing of the crypto market: facilitating trades, acting as the underlying asset for loans, and enabling traders to avoid the costs and inefficiencies of converting between fiat and crypto assets. Unlike other crypto assets whose value fluctuate, stablecoins can serve as a reliable means of payment, offering a potential mainstream use case for digital financial assets.

However, stablecoins also pose unique risks for consumers and the overall financial system. The US Department of the Treasury, in a 2021 report, outlines the potential ramifications of widespread adoption of stablecoins, arguing that a loss of confidence in a stablecoin can lead to a "run," which in turn could amplify shocks to the economy and the financial system. The Treasury notes that one major factor supporting consumer confidence in the stablecoin market is the belief that a stablecoin can be redeemed as promised and that its stabilization mechanism will function well during periods of stress.

Treasury's analysis ended up predicting the specific events that would lead to the introduction of AB 39. In 2022, the stablecoin TerraUSD was unable to maintain its 1:1 peg with the US dollar, precipitating a $60 billion crash that reverberated across the crypto ecosystem. In a short period, the collapse of Terra triggered an estimated $300 billion loss industrywide, leading to the failure of crypto companies with exposure to Terra. Celsius, a crypto lender marketed as an alternative to traditional banks, froze withdrawals and eventually filed for bankruptcy the following month. Three Arrows Capital, a crypto hedge fund, was unable to repay its debt obligations, leading to Voyager, another crypto lender, filing for bankruptcy in early July. BlockFi, a third crypto lender, was temporarily saved from bankruptcy by a loan from FTX, but eventually filed for bankruptcy in November, causing further disruption for the lender and its customers.

The DFAL establishes stablecoin rules to address the underlying risks related to redemption. Under the DFAL, there are two distinct ways that a stablecoin can be traded in California, both designed to ensure stablecoins are properly managed or collateralized and can be reliably redeemed by consumers, even in times of massive market disruption. Those ways are:

- The stablecoin issuer complies with Financial Code Section 3601, which among other provisions establishes robust reserve requirements. Specifically, a covered person may not exchange, transfer, or store a stablecoin if the issuer does not own at all times eligible securities, as defined, of not less than the aggregate amount of all outstanding stablecoins issued or sold.

- The stablecoin is approved by the commissioner pursuant to Financial Code Section 3603. Under this approval process, the commissioner may allow a stablecoin to be exchanged, transferred, or stored by a covered person after the commissioner considers specified factors. One factor is the amount, nature, and quality of assets owned by the stablecoin issuer that may be used to fund redemption requests. Those assets do not need to comply with Section 3601’s requirements.

AB 1934 makes assorted changes to DFAL to clarify the scope of the law's rules for stablecoins. First, AB 1934 includes a documentation requirement for stablecoin issuers to show they meet the requirements of Section 3601. Second, AB 1934 makes technical changes and further clarifies that Section 3602's approval process is separate.

REGISTERED SUPPORT / OPPOSITION:

Support

None on file.

Opposition

None on file.

Analysis Prepared by: Luke Reidenbach / B. & F. / (916) 319-3081