Date of Hearing: May 19, 2020

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Monique Limón, Chair
AB 2150 (Calderon) – As Amended May 4, 2020

SUBJECT: Corporate securities: exception: digital assets

SUMMARY: Exempts a digital asset that meets specified criteria from being deemed an investment contract within the definition of a security.

Specifically, **this bill**:

1) Amends the definition of "security" under the Corporate Securities Law of 1968 to exempt a digital asset from being deemed an investment contract if the digital asset meets any of the following criteria:

   a. The asset is not acquired by the holder in exchange for the payment of fiat currency or another digital asset.

   b. The asset is used on a fully operational network and the purpose of the asset is for a consumptive purpose, such as the access or consumption of goods, services, data, or the performance of useful functions other than as a medium of exchange or store of value.

   c. The asset does not rely on the managerial efforts of others for its success, with the lack of managerial efforts of others evidenced by the absence of any identifiable person, project team, or management entity that is responsible for the development, improvement, oversight, or promotion of the asset or the related network, and either:

      (I) Any changes to the software code underlying that asset may be made by network participants.

      (II) Voting rights over the functioning of the network are conferred to each holder of the asset.

2) Provides that the presumption that a digital asset is not an investment contract based on the specified criteria may be rebutted upon good cause shown by clear and convincing evidence by the Commissioner of Business Oversight.

EXISTING FEDERAL LAW:

1) Provides the Securities Act of 1933, which establishes a framework for regulating the offer and sale of securities and ensuring the protection of investors that purchase those securities.

2) Requires the offer or sale of all securities to be registered with the Securities and Exchange Commission (SEC) and to be structured as prescribed in federal law and regulation, unless the offer or sale is covered by an exemption.

3) Requires those who offer (i.e. advertise or market) and sell securities to be licensed as investment advisers or broker-dealers, unless either the transaction or the activity being undertaken is exempt from the licensing requirement.

EXISTING STATE LAW:

1) Provides the Corporate Securities Law of 1968, which governs the issuance and sale of securities in California. The law is administered by the Department of Business Oversight (DBO). (Corporations Code Sections 25000 et seq.)

2) Provides that it is unlawful for any person to offer or sell any security in this state, unless such sale has been qualified by DBO, as specified, or the sale is covered by an express exemption from qualification. (Corporations Code Section 25110)

3) Provides that, unless a person is otherwise exempt from licensure as a broker-dealer, no person may effect any transaction in, or induce or attempt to induce the purchase or sale of any security in California, unless that person has obtained a certificate from the commissioner, authorizing that person to act in the capacity of a broker-dealer. (Corporations Code Section 25210)

FISCAL EFFECT: Unknown.

COMMENTS:

1) PURPOSE

According to the author:

> Virtual currency, or cryptocurrency, continues to be an emerging technology that provides consumers with greater accessibility to financial markets, gives more flexibility to businesses, and provides California with new economic opportunities. Current law lacks legal clarity for regulators, businesses, and consumers alike regarding which virtual currencies are subject to state securities law. AB 2150 would provide additional clarity to this issue by creating a clear exemption for virtual currencies that do not meet the requirements to be considered a security. This would eliminate certain grey areas in the oversight of virtual currencies and provide businesses with more confidence and knowledge of whether or not they should expect to be subject to securities law.

2) BACKGROUND

The emergence of Bitcoin in 2009, and the cascade of digital assets[1] that followed, caught policymakers and regulators unprepared to deal with a new class of financial products. The underlying technology that supports a digital asset is often intriguing, but also confusing to policymakers. Some of these digital assets are not controlled by a centralized entity, which complicates the typical approach of regulating and examining a company that offers a specified product. Partially due to these reasons, many activities related to digital assets – including creation, sale, transfer, and custody – occur outside the scope of government oversight that is often present in markets for traditional financial products.

---

[1] This bill does not define "digital asset." For the purposes of the Comments section of the analysis, Committee staff uses the term to refer to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

Regardless of the technology that underpins a digital asset, the appropriate regulatory approach should consider the functions that a digital asset serves. For example, a digital asset that functions as a means of benefiting from the enterprise of others should be treated as a security. A digital asset that serves as a medium of exchange and does not constitute a claim on the issuer of the asset should be treated as a currency or payment method. A digital asset that represents a claim on the issuer should be treated as a debt instrument. While an analysis of the functional use of a digital asset is informative to the proper regulatory approach, such analysis is often not dispositive, and policymakers should consider how the digital asset is marketed, sold, and distributed.

Some digital assets do not fit neatly into the functional categories familiar to financial regulators. For example, a digital asset can represent a right to use a blockchain-enabled service (this type of digital asset is sometimes known as a utility token). Functionally, this digital asset may be more akin to owning a software license key than to owning a financial product. But what if such a digital asset is sold to users prior to full development of the blockchain-enabled service, in exchange for US dollars that are used to finish development of the service, with a promise that the purchaser of the digital asset could receive a higher-level of access to the service if the final product successfully attracts other users to the platform? If marketed and distributed in this manner, the digital asset would likely be classified as a security, given the asset now resembles a means of benefiting from the enterprise of others, not simply a license to access a defined service.

It can be difficult to regulate digital assets in a manner that balances the potential benefits of innovation with the potential risks to consumers and investors. Regulators can use their existing authorities in cases where a digital asset serves a similar function as a traditional, regulated financial product. Challenges arise when a digital asset does not fit neatly into an existing regulatory paradigm. In these cases, it can be difficult to find the balance between innovation and protection.

Despite popular coverage in the media, digital assets have not been widely adopted by the public. As outlined in the briefing document for this Committee's informational hearing on October 17, 2019, industry surveys indicate that fewer than 10% of Americans hold a digital asset, and many of those consumers appear to be speculating on the future value of the asset.[2] At current levels of adoption, a reasonable approach to regulation may be to prioritize strong anti-fraud measures that protect vulnerable populations, while holding off on widespread examinations and regulation until the market matures.

Fraud in the digital asset space is a serious concern. According to a 2018 report, Satis Group, a digital asset advisory firm, found that 81% of initial coin offerings (ICOs) were scams.[3] FINRA, a self-regulatory organization for investment professionals, issued an investor alert in August 2018 that warned of the lax regulatory oversight of ICOs with many issuers failing to properly register securities with the federal Securities and Exchange Commission (SEC).

---

[2] https://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/Background%20for%20Assembly%20Banking%20hearing%20on%20virtual%20currency%20businesses%20-%2010.17.19.pdf

[3] https://research.bloomberg.com/pub/res/d28giW28tf6G7T_Wr77aU0gDgFQ

3) OVERVIEW OF STATE AND FEDERAL ROLES IN SECURITIES REGULATION

The federal government plays the primary role in regulating securities activity. Prior to enactment of the National Securities Market Improvement Act of 1996 (NSMIA), states had broader authority to require registration and review of securities and offerings. NSMIA preempted a variety of state laws, but preserved the state's role in registering some specified offerings, such as intra-state offerings, offerings extended to small numbers of sophisticated investors, and offerings of lower dollar amounts. The role for states in regulating securities is primarily focused on anti-fraud enforcement, rather than registering offerings.

In cases where offering a digital asset is subject to federal securities law, many issuers must comply with SEC registration requirements. This fact reduces the effect of a state's determination of whether a digital asset is a security because the issuer of the digital asset would need to comply with federal law. Federal law provides several exemptions from registration that make a state's policy more meaningful for a relatively narrow set of issuers, but the federal exemptions are too limited to make them attractive for many potential issuers.

4) ACTION AND INACTION AT THE FEDERAL LEVEL

Congress has not enacted a comprehensive approach to regulating digital assets. This means federal regulatory agencies must rely upon their existing statutory authority to oversee digital assets and related business activity that falls under the agencies' jurisdictions. Regulatory agencies have clarified their approaches to digital assets through a variety of methods, including interpretative guidance or opinions, rulemaking, and enforcement actions, but uncertainty remains. Participants in the digital assets industry have asked Congress to clarify existing laws, including laws related to securities regulation, but those efforts have yet to succeed.[4]

The SEC has taken an active role in regulating digital assets that the regulator deems securities. The agency generally takes a case-by-case approach when reviewing digital assets, similar to what the DBO does today at the state level under the Corporate Securities Law. Some of the more popular digital assets, such as Bitcoin, have been viewed as "likely not securities" by the SEC. In other instances, the agency has brought actions against a number of issuers of digital assets for allegedly engaging in fraud and for violating the registration provisions of the federal securities laws.

5) THE INVESTMENT CONTRACT QUESTION

Federal securities law does not provide statutory criteria that would exempt a digital asset from being deemed a security. The SEC and the federal courts frequently use the "investment contract" analysis to determine whether unique or novel instruments or arrangements, such as digital assets, are securities subject to the federal securities laws. The U.S. Supreme Court's *Howey* case and subsequent case law have found that an investment contract exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. To help stakeholders navigate the complexities of how the SEC analyzes the investment contract question, the SEC's Strategic

[4] https://www.cnbc.com/2018/09/26/crypto-leaders-to-congress-figure-out-regulation-or-innovation-leaves.html

Hub for Innovation and Financial Technology published a framework paper that exceeds 5,000 words, which analyzes the application of *Howey* to digital assets.[5]

This bill takes a different approach than federal law. This bill would codify three criteria that, if any one criterion were satisfied, would exempt a digital asset from being deemed an "investment contract," which would have the effect of exempting such a digital asset from being deemed a "security."

This approach poses a substantial drafting challenge for the author of the bill. The bill language must reflect the complex legal and policy issues posed by digital assets in the securities context, while also protecting against the creation of loopholes that may be exploited by a person seeking to evade regulation. In other words, the goal is to distill the complexities outlined in the SEC framework into a few sentences of legislative text without creating unintended consequences that could harm investors. The author has done a commendable job in attempting to tackle this complexity by applying the key considerations of *Howey* in the digital asset context, but it is unclear whether the language is adequately narrow to prevent an unscrupulous actor from exploiting any of the enumerated criteria.

6) IS "CLEAR AND CONVINCING" THE APPROPRIATE STANDARD?

This bill may place an unreasonable burden on DBO to show that an alleged issuer of a security is attempting to sidestep existing state law. The bill creates a rebuttable presumption that a digital asset is not an investment contract if specified criteria are met. In order to overrule the presumption, DBO must show clear and convincing evidence that the digital asset is an investment contract. The "clear and convincing" standard places a burden of proof on DBO that exceeds the typical standard of "preponderance of the evidence" that applies in many civil and administrative law contexts.

This higher burden of proof could create negative outcomes for unsophisticated investors. Under existing law, DBO may use its administrative authority or seek a court-imposed injunction to stop a person from offering or selling a security in violation of the law. If held to a higher standard of proof, DBO may be reluctant to pursue enforcement actions when a digital asset is involved. This dynamic could lead to higher rates of fraud and monetary losses, which will likely disproportionately affect unsophisticated investors. To the extent that this bill inhibits DBO's ability to address fraud in this area, good actors in the digital asset space may suffer reputational harm due to the bad actions of others. Ultimately, effective regulation of securities benefits both investors and issuers.

7) CONSIDERATIONS FOR THE AUTHOR

Several concepts and phrases used in the bill have no significant precedent in state law, and the bill does not define the terms. While the author intends to clarify instances where a digital asset is not an investment contract, the codification of exemption criteria that includes undefined terms may lead to greater confusion on behalf of businesses and the DBO. Conflicting views of the law's effect could lead to lawsuits that leave statutory interpretation to a judge who will be unable to rely on preexisting case law to inform their analysis.

---

[5] https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets

The author has expressed his commitment to continue working to define terms and further clarify the intent of the bill. Committee staff acknowledges that the bill is a work in process and has identified the following terms and phrases that the author may desire to specify, in order to achieve the intent of the bill.

- Digital asset
- Holder
- Useful functions
- Managerial efforts of others
- Network participants
- Voting rights over the functioning of the network

8) RECOMMENDED AMENDMENTS

In addition to the considerations for the author summarized in the preceding section, Committee staff recommends the following amendments to the bill:

a. Sunset the provisions of this bill on January 1, 2026.

b. Replace the "clear and convincing" standard with "preponderance of the evidence"

c. Add a subdivision to Section 25531 of the Corporations Code stating the following:

Notwithstanding the rebuttable presumption provided by subparagraph (L) of paragraph (1) of subdivision (a) of Section 25019, the authority of the Commissioner to investigate a person for a potential violation of this division shall not be constrained by the rebuttable presumption.

REGISTERED SUPPORT / OPPOSITION:

Support

Blockchain Advocacy Coalition

Opposition

None received.

Analysis Prepared by: Michael Burdick / B. & F. / (916) 319-3081