

Date of Hearing: August 30, 2022

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Timothy Grayson, Chair

AB 2269 (Grayson) – As Amended August 22, 2022

SUBJECT: Digital financial asset businesses: regulation

SUMMARY: Establishes a licensing and regulatory framework, administered by the Department of Financial Protection and Innovation (DFPI) for digital financial asset business activity, as specified.

Specifically, **this bill:**

- 1) Establishes the Digital Financial Assets Law to be administered by DFPI and prohibits a person from engaging in digital financial asset business activity beginning on January 1, 2025, without a license with DFPI, as specified.
- 2) Exempts from the new division activities covered by existing federal and state laws related to securities; banks and credit unions; and persons providing only specified computing, network, data storage or security services, and persons whose digital financial asset business activity is reasonably expected to be valued at \$50,000 or less, among other specified exemptions.
- 3) Establishes requirements of an application for licensure, authorizes DFPI to charge a fee to cover the reasonable costs of regulation, and requires DFPI to investigate specified characteristics of the applicant before making a decision on the application.
- 4) Requires a licensee to maintain a surety bond or trust account for the benefit of its customers in a form and amount as determined by DFPI for the protection of the licensee's customers, as specified.
- 5) Requires a licensee to maintain capital in an amount and form as DFPI determines is sufficient to ensure the financial integrity of the licensee and its ongoing operations based on an assessment of specific risks applicable to the licensee, as specified.
- 6) Establishes a process for a licensee to renew its license on an annual basis.
- 7) Authorizes DFPI to adopt rules necessary to implement the division and issue guidance as appropriate.
- 8) Authorizes DFPI to conduct any time and from time to time, examine the business and any office, within or outside this state, of any licensee, registrant, or any agent of a licensee or registrant in order to ascertain whether the business is being conducted in a lawful manner and whether all digital financial asset business activity is properly accounted for.
- 9) Requires a licensee to file with DFPI a report related to a material change in the information provided in the application for licensure, a material change in the licensee's digital financial

asset business activity, or a change of an executive officer, responsible individual, or person in control of the licensee.

- 10) Provides specified applicable rules in determining whether a person has control over a licensee; requires that, at least 30 days prior to a proposed change in control of a licensee, the proposed person to be in control submit an application with the information required by this division for an application for licensure, as applicable; and requires DFPI to decide whether to approve the application, as specified.
- 11) Provides a process similar to an application related to a proposed change in control for an application of a proposed merger or consolidation of a licensee with another person.
- 12) Defines “enforcement measure” as an action that contains, but is not limited to the following: (a) suspend or revoke a license; (b) order a person to cease and desist from doing digital financial asset business activity; and (c) request the court to appoint a receiver for the assets of a person doing digital financial asset business activity
- 13) Authorizes DFPI to take an enforcement measure against a person as specified.
- 14) Specifies processes related to enforcement actions, including a person’s rights to notice and opportunity for a hearing as appropriate, when revocation of a license is effective, and when a suspension of a license is effective.
- 15) Authorizes DFPI to enter into a consent order with a person regarding an enforcement measure and permits the order to provide that it does not constitute an admission of fact.
- 16) Requires a licensee to provide disclosures, as specified, to its customers. Information required to be disclosed includes but is not limited to the following, as specified: (a) a schedule of fees and charges; (b) whether the product or service provided is covered by insurance or other guarantees from loss; (c) a description of specified terms related to their customers’ rights and responsibilities and processes associated with transfers or exchanges; (d) that no digital financial asset is currently recognized as legal tender by California or the United States; and (e) a list of instances over the past 12 months when the licensee’s service was unavailable to 10,000 or more customers due to a service outage, as specified.
- 17) Provides that a licensee may not, until January 1, 2028, exchange, transfer, or store a digital financial asset or engage in digital financial asset administration, whether directly or through an agreement with a digital financial asset control services vendor, if that digital financial asset is a stablecoin unless the issuer of the stablecoin is licensed pursuant to this bill or is a bank and the issuer at all times owns eligible securities having an aggregate market value calculated in accordance with generally accepted accounting principles of not less than the amount of its outstanding stablecoins issued or sold in the United States.
- 18) Amends definition of “financial institution” in the California Financial Information Privacy Act to include licenses under this division.

EXISTING LAW:

- 1) Establishes the Department of Financial Protection and Innovation (DFPI) as the state agency responsible for licensing, regulating, and supervising a range of financial services companies that provide products or services to California consumers, including but not limited to, securities issuers, broker-dealers, investment advisers, and investment advisers representatives; persons offering or selling off-exchange commodities; persons holding securities as custodians on behalf of securities owners; money transmitters; and persons offering or providing consumer financial products or services. (Financial Code Section 300)
- 2) Provides the Corporate Securities Law of 1968, administered by DFPI, which governs the issuance and sale of securities in California. (Corporations Code Sections 25000 et seq.)
- 3) Provides that it is unlawful for any person to offer or sell any security in this state, unless such sale has been qualified by DFPI, as specified, or the sale is covered by an express exemption from qualification. (Corporations Code Section 25110)
- 4) Provides the Money Transmission Act, administered by DFPI, which requires licensure of persons engaged in the business of money transmission, unless the person is exempt. (Financial Code Section 2000 et seq.)
- 5) Defines money transmission as selling or issuing payment instruments, selling or issuing stored value, or receiving money for transmission. (Financial Code Section 2003(q))

FISCAL EFFECT:

According to the Senate Appropriations Committee, unknown, significant one-time and ongoing costs likely in the low- to mid-tens of millions of dollars for DFPI to stand-up and maintain the new licensing program for digital financial asset business activity. Costs to stand-up the new program would include equipment, software, other IT operating expenses, and workload related to promulgating regulations and training for DFPI staff. Ongoing costs would include additional staffing resources to conduct licensing, examination, investigation, and enforcement activities. Given the size and complexity of the proposed new program, DFPI would likely need specialized staff with technical expertise to support the program's operations.

COMMENTS:

1) Purpose.

According to the author:

AB 2269 will promote a healthy and sustainable cryptocurrency market by licensing and regulating businesses that help Californians buy and sell cryptocurrencies. While cryptocurrency has the potential to empower consumers and disrupt the financial sector in unexpected ways, its high volatility and the prevalence of fraud, illicit behavior, and technical and security vulnerabilities expose California consumers to significant financial harm. AB 2269 strikes a balance between protecting consumers from harm and fostering a responsible innovation environment by establishing clear rules for those companies that help Californians buy, sell, and exchange cryptocurrency.

2) Background.

A digital financial asset (also often referred to as cryptocurrency, a crypto asset, or virtual currency) 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.

The most commonly used technology that produces and supports virtual currency is distributed ledger technology, which is a decentralized database managed by multiple parties within a network. Blockchain is the most well-known type of distributed ledger technology and supports Bitcoin and many other types of virtual currencies on the market today. Blockchain also enables decentralized finance (DeFi), which is an effort to replicate traditional finance systems through the use of blockchain-enabled contracts. DeFi is built on one of a dozen or so blockchains, including Ethereum, and DeFi applications allow cryptocurrency holders to lend or borrow from other users and engage in other financial activities, such as entering into derivative markets.

Cryptocurrency and decentralized finance proponents believe that these products and systems are viable alternatives to those found in the traditional financial system. They argue that cryptocurrency is beneficial because it is decentralized, allows peer-to-peer transactions, makes transactions easy and fast, diversifies portfolios, acts as an inflation hedge, encourages cross-border payments, and provides transactional freedom.

3) **Is cryptocurrency money?**

As cryptocurrency has grown from a small group of early adopters and hobbyists into a trillion dollar market, a lingering question has been: how should policymakers classify cryptocurrency and regulate it?

There is doubt that cryptocurrency, as it works today, could work well as money. First, as a matter of definition, cryptocurrency is not issued by a central government, and there is no obligation for the government to accept it. Moreover, as a practical matter, it remains doubtful that cryptocurrency could be a viable privately-issued legal tender or facilitate everyday payments. Cryptocurrency can act function as a unit of account, a store of value, and a medium of exchange, three necessary features of money. But, unlike most fiat currencies, cryptocurrency also appears to be highly vulnerable to confidence shocks, fraud, and price instability, and consumers must navigate a host of technological and practical obstacles when using it. These are not desirable features of money.

Moreover, many holders of cryptocurrencies use these digital assets to engage in speculative investment activities or other types of financial services activities rather than facilitating payments and conducting everyday transactions. Most cryptocurrency trading happening today treats it as an asset class – a group of investments with particular characteristics – owned for purposes *other than* payments for goods and services.

4) **What are the consumer risks for Californians?**

As cryptocurrency proponents note, digital assets, and the accompanying decentralized network of alternative financial systems that support them, present a number of opportunities that could lead to a more efficient financial system.

However, these assets pose significant risks to consumers given the lack of regulatory clarity and established rules for companies operating in this space. These risks have been highlighted in recent months during the market turmoil that led multiple firms to declare bankruptcy. Those consumer risks include:

- a) **Fraud, hacks, and scams.** Given the newness of the cryptocurrency market and its rapid adoption worldwide, it is not surprising that fraud and scams are widespread. Based on complaints to the Consumer Financial Protection Bureau (CFPB), cryptocurrency wallets and exchanges are often the target of fraud and theft, with some consumers reporting having lost thousands of dollars to unauthorized account access. DeFi is also rife with hacks and theft, with more than \$10.5 billion lost in 2021 alone.¹
- b) **Volatility.** Digital financial assets can see their value decline or increase sharply in short periods of time. Unlike a stock or a treasury bond, a cryptocurrency's value is not derived from the market's faith in the underlying company or country; instead, its value is derived from the number of people who believe it has value. As such, cryptocurrency appears particularly susceptible to sell-offs and scares.
- c) **Insider trading and lack of information.** A significant risk to consumers is their informational disadvantage compared to industry insiders. This informational disadvantage can manifest in acute terms, such as with insider trading. Media reports and federal investigations suggest that insider trading is a widespread problem in markets for digital financial assets.²
- d) **Lack of clear federal and state legal protections.** Traditional financial institutions are subject to a range of federal and state laws that provide legal protections related to the exchange of money, and it is unknown whether these protections apply to cryptocurrency users. For example, the Electronic Funds Transfer Act, the Fair Credit Billing Act, and the Federal Deposit Insurance Act all provide basic protections that consumers now expect, but which may not be available to cryptocurrency users, including mechanisms to address billing errors or unauthorized charges or clarifying a customer's liability on the loss or theft of funds.

5) Will the federal government regulate digital financial assets?

Rapid digital asset adoption has led to calls for greater clarity regarding how the federal government should regulate this new and complex world. In March 2022, President Biden signed an executive order (EO) aimed at ensuring the responsible development of digital assets. The EO calls for measures to: protect U.S. consumers, investors, and businesses; protect U.S. and global financial stability and mitigate systemic risk; mitigate the illicit

¹ Elleptic, *DeFi: Risk, Regulation, and the Rise of DeCrime* (November 2021), available at <https://www.elliptic.co/resources/defi-risk-regulation-and-the-rise-of-decrime>.

² See, e.g., <https://www.wsj.com/articles/crypto-might-have-an-insider-trading-problem-11653084398> and <https://www.coindesk.com/policy/2022/06/14/sec-launches-inquiry-into-insider-trading-at-crypto-exchanges-report/>

finance and national security risks posed by the illicit use of digital assets; promote U.S. leadership in technology and economic competitiveness to reinforce U.S. leadership in the global financial system; promote equitable access to safe and affordable financial services; support technological advances and ensure responsible development and use of digital assets.

The EO includes a number of mandates on federal agencies to coordinate and submit a report to the President on the future of money and payment systems, including the conditions that drive broad adoption of digital assets; the extent to which technological innovation may influence these outcomes; and the implications for the United States financial systems, the modernization of and changes to payment systems, economic growth, financial inclusion, and national security. The report is due in September 2022.

Importantly, the Internal Revenue Service (IRS) has already indicated its own approach with regards to cryptocurrency. The IRS treats cryptocurrency holdings as a capital asset (property) whose appreciation is subject to tax once the cryptocurrency is sold

6) What about California?

Like President Biden, Governor Newsom has used the EO process to explore how the state should provide oversight over the crypto market. The state EO calls for DFPI to use its authority to regulate a broad market of consumer financial products and services under the California Consumer Financial Protection Law (CCFPL), and DFPI initiated on June 1, 2022 an invitation to comment on “crypto asset-related financial products and services” under the CCFPL.³

The CCFPL process is ongoing at the time of this analysis, with comments having been submitted to DFPI. However, it is unclear the breadth of protections that will be developed through this regulatory process and whether the CCFPL provides DFPI the flexibility and authority it needs to quickly address the myriad of consumer and investor protection issues seen in the crypto market.

Some states have licensed cryptocurrency businesses through their money transmitter laws. These laws, which regulate and license money transmitters such as Western Union, impose a number of transparency and licensing requirements for companies, including establishing a minimum net worth requirement and restrictions on how they can invest their cash holdings. However, DFPI has indicated through interpretive opinions that these exchanges do not need to become licensed under California’s Money Transmission Act (MTA),⁴ while experts have raised concerns about the appropriateness of these statutes to govern the activity of companies involved with volatile and potentially risky assets.⁵

³ <https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/DFPI-crypto-invitation-for-comment-5-31-22.pdf>

⁴ DFPI Interpretive Opinion (May 27, 2021), available at <https://dfpi.ca.gov/2021/06/28/specified-cryptocurrency-activities-not-subject-to-licensing-under-the-mta>.

⁵ See Dan Awery, “Bad Money,” *Cornell Law Review*, (2020), at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3532681 for a discussion of existing money transmissions laws and their applicability to, among other financial products, crypto assets.

7) What would AB 2269 do?

AB 2269 would broadly regulate crypto activities through a proposed licensing framework that takes effect on January 1, 2025. The author argues this licensing framework will give DFPI additional tools to address predatory activities in the crypto market while protecting Californians from bad actors in the industry through the licensure application process. AB 2269 also grants some flexibility to companies who can continue to operate so long as they submit their application on time, a provision that is intended to allow for continuity in activities for both businesses and consumers as DFPI rolls out the program.

Many provisions found in AB 2269 originate from model law drafted by the Uniform Law Commission (ULC). In July 2017 the ULC adopted the Uniform Regulation of Virtual-Currency Businesses Act (“the act”) after an extensive stakeholder process and multiple rounds of drafting, review, and amendments. The ULC articulated two key motivations for approving and recommending that states adopt the act. First, the ULC asserted that regulations that are predictable and tailored to this emerging industry would provide assurance (i) to persons using digital financial asset products and services and (ii) to providers that they will in fairness be regulated like other providers of financial products and services. Secondly, the ULC believed that the model act would serve to clarify which state laws – whether existing money transmitter laws or a law specially tailored to digital financial assets – would govern a business’ activities. In summary, the act is intended to provide basic protections for users and regulatory clarity for providers.

In addition to the ULC licensing framework, AB 2269 incorporates concepts from federal and state laws that apply to other financial services and products to address specific risks and harms to consumers and retail investors using digital financial assets. Those provisions include:

- a) **Customer service requirement.** Many digital financial asset businesses operate exclusively online, and some customers have had issues contacting businesses when they have customer service needs, such as being locked out of their accounts.⁶ This bill requires licensees to maintain a toll-free telephone line through which a customer can contact the licensee and receive live customer assistance. Notably, these requirements are in line with proposed DFPI regulations that consumer financial service providers, including those businesses that would be licensed under AB 2269, have available a live representative.⁷
- b) **Protecting customers’ property interests in digital financial assets:** Many consumers who own digital financial assets allow a third party to store the assets in custodial wallets. In some of these arrangements, there is significant uncertainty about whether the customer would have access to their assets if the third party goes bankrupt. AB 2269 establishes a requirement that licensees holding digital financial assets on behalf of customers do so in a manner that protects those assets from bankruptcy proceedings.

⁶ <https://www.cnn.com/2021/08/24/coinbase-slammed-for-terrible-customer-service-after-hackers-drain-user-accounts.html>

⁷ <https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/05/PRO-03-21-Draft-Text-CCFPL-Complaints-5-2-22.pdf>

- c) **“Best Interest” standard:** Businesses that offer to exchange digital financial assets serve a critical role in the digital financial asset economy. These businesses are often the gateway through which consumers discover, buy, and sell assets and are the primary intermediary with whom many consumers interact. Modeled after federal Regulation Best Interest that applies to securities broker-dealers, this bill requires such businesses to serve the best interests of their customers by disclosing and mitigating conflicts of interest, forming a reasonable basis for any recommendations made to customers, exercising reasonable diligence to evaluate specified criteria before listing any specific digital financial asset as available for exchange, and taking efforts to prevent insider trading from occurring on their platforms.
- d) **“Best Execution” standard:** When customers place an order to buy or sell a digital financial asset, they do not have the requisite information to determine whether the business to whom they submit the order is executing their trade at the best price for the consumer. Modeled after FINRA Rule 5310 that applies to securities broker-dealers, this bill requires licensees that exchange a digital financial asset on behalf of a consumer to use reasonable diligence to find the best deal for the consumer and execute the consumer’s order in a manner as favorable as possible under prevailing market conditions.
- e) **Moratorium on unbacked stablecoins:** One of the catalysts that spurred the crypto market turmoil in Summer 2022 was the implosion of a purported “stablecoin” called Terra USD. The issuers of Terra USD aimed for the asset to maintain a 1:1 peg with the US dollar primarily by designing through software code a mechanism that incentivized traders to balance supply and demand at a price of \$1.00. This mechanism failed, the price of Terra USD dropped far below \$1.00, and the asset is essentially worthless today. The failure erased \$40 billion of market value in a matter of days, leaving consumers and investors with substantial losses.

AB 2269 prohibits, until January 1, 2028, licensees from making a so-called “stablecoin” available for exchange, transfer, or storage unless the stablecoin’s value is backed by reserve assets, among other qualifications.

8) Arguments in Support

AB 2269 is sponsored by the Consumer Federation of California and is supported by a coalition of organizations that includes the California Bankers Association, the California Credit Union League, the California Low-Income Consumer Coalition, the California Reinvestment Coalition, Californians for Economic Justice, and SEIU California, and the Greenlining Institute. Their coalition letter argues:

AB 2269 fills the regulatory gap by creating a clear path that would put consumers first and lead to some important ‘rules of the road’ for licensing and regulation in this area. AB 2269 seeks to protect consumers from risky and unsafe transaction by requiring that digital financial asset companies such as cryptocurrency exchanges be licensed and overseen by DFPI, which will provide necessary regulatory clarity for both industry and California consumer. It will also improve critical financial protection for consumers by boosting the transparency of cryptocurrency transactions through new disclosures and threshold requirements regarding price, fees, consumer complaint processes, a licensee’s

history of service outages, anti-hacker security protections and other critical information that other financial products and services currently must follow. The bill also seeks to enhance the safety of cryptocurrency transactions by requiring an exchange to act in the best interest of the customer when requesting, selling, or buying cryptocurrencies. Lastly, the bill will also protect consumers by limiting for 5 years certain types of so-called “stablecoins” that lack sufficient reserve backing and other basic consumer protections

Writing in “support unless amended,” the Chamber of Progress writes:

The United States has been in need of clear rules of the road for the incredibly nascent crypto industry, which has faced recent challenges with fraud, hackers, bank runs and liquidity. This bill gives California a seminal moment to showcase its regulatory model across the nation, testing a permission-based licensing model’s effectiveness of maintaining innovation and attracting competition to the state. With the licensing model, California seeks to establish a veil to protect consumers.

The Chamber of Progress requests amendments to remove the temporary moratorium on unbacked stablecoins and to clarify in more detail which digital assets are subject to licensure.

9) **Arguments in Opposition**

AB 2269 is “opposed unless amended” by a number of industry groups representing digital financial asset companies as well as licensed money transmitters.

The Blockchain Advocacy Coalition (BAC) and the Electronic Transactions Association (ETA) write:

We believe that responsible consumer protections can be achieved without stifling this burgeoning industry and the societal and economic benefits it will bring. While we appreciate the collaborative nature from you and your staff to achieve policy that is beneficial to regulators, companies and consumers, we continue to have serious reservations about the implications of several elements of this bill as currently drafted. Greater flexibility is still needed to ensure it does not disproportionately impact specific facets of the industry or result in diminished services to consumers due to a general lack of tailoring and flexibility. Increased clarity of certain aspects is needed to give licensees the ability to plan and manage compliance and cost and to ensure the Department of Financial Protection and Innovation (DFPI) is able to effectively implement the resulting framework efficiently and fairly.

BAC and ETA cite a number of concerns, including that AB 2269 would result in unpredictable requirements and costs for licensees and that the disclosure remain overly prescriptive.

Also in opposition is The Money Services Round Table (TMSRT), which represents a consortium of non-bank money transmitters. TMSRT argues that AB 2269 is consistent with the Governor’s EO and that existing money transmitters should be licensed under existing law with “targeted changes” to account for digital financial assets.

REGISTERED SUPPORT / OPPOSITION:

Support

California Association for Micro Enterprise Opportunity
California Bankers Association
California Credit Union League
California Low-income Consumer Coalition
California Reinvestment Coalition
Californians for Economic Justice
Consumer Federation of California
Consumers for Auto Reliability & Safety
Older Women's League Sacramento Capitol
Service Employees International Union (SEIU)
The Greenlining Institute

Support If Amended

Chamber of Progress

Oppose

The Money Services Round Table

Oppose Unless Amended

Blockchain Advocacy Coalition
Electronic Transactions Association

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