Date of Hearing: April 18, 2022

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Timothy Grayson, Chair
AB 2689 (Cunningham) – As Introduced February 18, 2022

SUBJECT: Virtual currency: payment for goods and services

SUMMARY: Authorizes private and public sector entities to accept payments via cryptocurrency.

Specifically, **this bill**:

1) Authorizes a private or public entity in California to accept virtual currency as a method of payment for the provision of any good or service, including any governmental service.

2) Defines a "public entity" as including a state and every state entity, including the Legislature, the judicial branch, the University of California, and the California State University, as well as a political subdivision of the state, such as a city, county, charter city, school district, joint powers authority, or any public agency, authority, board, commission or district.

3) Defines "virtual currency" to be a digital representation of value that functions as a medium of exchange, unit of account, or store of value, and is often secured using blockchain technology.

EXISTING LAW:

1) Establishes state agencies for various purposes, including to provide certain services to the public for which payment is required.

2) Defines "state agency" to include every state office, officer, department, division, bureau, board, and commission. "State agency" does not include the California State University unless explicitly provided.

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

COMMENTS:

1) **Background.**

A virtual currency (also known as cryptocurrency or digital asset, all 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, virtual currencies are not considered legal tender, but private parties may agree to use a virtual currency 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 the traditional financial payments system. They argue that cryptocurrency is beneficial because it is decentralized, allows peer-to-peer transactions, makes transactions easy and fast, diversifies portfolio, acts as an inflation hedge, encourages cross-border payments, and provides transactional freedom.

2) **Is cryptocurrency money?**

As cryptocurrency has grown from a small group of early adopters and hobbyists into a market with a more than $3 trillion market cap, 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. AB 2689 proposes clarifying that the government *can* accept it, but would not obligate the government to.

But even with this clarification, it remains doubtful that cryptocurrency could be a viable legal tender. 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 a government-approved legal tender.

Moreover, many holders of cryptocurrencies use digital assets to engage in speculative investment 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 the purpose of generating returns either by trading on short-term price fluctuations or betting on long-term appreciation.

Businesses that have embraced cryptocurrency payments have seen mixed results. For example, when the digital video game marketplace Steam accepted Bitcoin as a form of payment, the company reversed this decision because of the price fluctuations and the high rate of fraud."[1] In contrast, when the automobile manufacturer Tesla began accepting Bitcoin as a form of payment, the company generated significant profit by selling the Bitcoin it collected from customers. According to one news report, in the first quarter of 2021 the

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[1] Wes Fenlon, "50% of transactions were fraudulent when Steam accepted Bitcoin for payments, says Gabe Newell," PC Gamer (February 26, 2022), available at https://www.pcgamer.com/50-of-transactions-were-fraudulent-when-steam-accepted-bitcoin-for-payments-says-gabe-newell/.

company made more profit from selling its Bitcoin holdings than it did from selling cars.[2] These two anecdotes suggest that Bitcoin may work better as an investment than a form of payment.

The rapidly changing types of available cryptocurrencies and their different uses further complicate the question of whether cryptocurrency can function as legal tender. Today, there are more than 12,000 types of virtual currencies available, either through peer-to-peer trading or exchanges, and consumers can now purchase a smorgasbord of digital assets with different designs, use-case philosophies, strengths, and risks. Most digital assets appear to be issued to help an entrepreneur raise money, suggesting they function as a security. Other digital assets, such as established cryptocurrencies like Bitcoin, are most similar to a commodity, though the exact classification of Bitcoin is likely up for debate. Digital assets generally do not appear to be designed specifically for the purpose of being used the same way that consumers use money in their everyday lives.

3) **Example: Stablecoins**

The example of stablecoins highlights the difficulty of both categorizing a type of digital asset and incorporating that digital asset into the mainstream payments system.

A stablecoin is a virtual currency whose value is pegged to something else, usually another fiat currency like the dollar. The introduction of stablecoins into the cryptocurrency market has renewed hope that a digital currency can work as a widely used means of payment because, in theory, a stablecoin has many of the benefits of a virtual currency (faster and more efficient payments) without the volatility associated with other types of cryptocurrencies on the market (because its value is tied to fiat currency).

However, at the moment stablecoins are not used for payments. Instead, the stablecoin market, which today is valued at around $183 billion, is typically used to invest in and trade other virtual currencies. Stablecoins allow investors to operate in cryptocurrency investment markets without cashing out into dollars, which can take time, thereby allowing investors to more quickly make multiple cryptocurrency investments. And because stablecoins are backed by reserve assets, which allow the issuer to honor requests to redeem the stablecoin into dollars, they have features similar to a money market fund.

Stablecoins are illustrative because even with positive features, such as reduced volatility, their susceptibility to misuse still raises significant concerns for federal policymakers. The Working Group on Financial Markets, which is chaired by the secretary of the U.S. Treasury and includes other federal policymakers such as the chair of the Securities and Exchange Commission (SEC), issued a report in November 2021 that identified a number of risks related to market integrity and investor protection, including fraud, market manipulation,

[2] Georgina Tzanetos, "Tesla Makes More Money From Bitcoin Than It Does From Cars – What Does That Means for Your Stock?" Yahoo! News (May 4, 2021), available at https://www.yahoo.com/video/tesla-makes-more-money-bitcoin-163841265.html?

illicit finance, and concerns about whether stablecoin issuers can adequately meet their obligations to honor requests for redemption in dollars.[3]

4) **What is happening at the federal level?**

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 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 finance and national security risks posed by the illicit use of digital assets; promote U.S. leadership in technology and economic competiveness to reinforce U.S. leadership in the global financial system; promote equitable access to safe and affordable finical 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 of this year.

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.[4]

5) **Technology-neutral regulation**

Some federal regulators, in response to the President Biden's EO, have already laid out core principals in public comments. One common theme emerging from these comments is that the federal regulatory approach should not differ based on the underlying technology used to develop and distribute cryptocurrency, suggesting that the Biden administration is not seeking to soften or carve out parts of its federal oversight authority to accommodate cryptocurrency.

US Treasury Secretary Janet Yellen said in a speech that rules around cryptocurrency "should be guided by the risks associated with the services provided to households and businesses, not the underlying technology."[5] And SEC Chairman Gary Gensler reiterated a similar point in comments made in April 2022:

> New technologies come along all the time; the question is how we adjust to that new technology. But make no mistake: We already live in a digital age. That's not what's new here. We already can buy a cup of coffee with money stored in an app

[3] President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, *Report on STABLECOINS,* (November 2021), available at https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf .

[4] See IRS Notice 2014-21 for additional information: https://www.irs.gov/pub/irs-drop/n-14-21.pdf

[5] Remarks from Secretary of the Treasury Janet L. Yellen on Digital Assets (April 7, 2022), available at https://home.treasury.gov/news/press-releases/jy0706?msclkid=505807b1b68e11ecb0516e78c4e93c87.

> on our smartphones. The days of physical stock certificates ended decades ago. There's nothing new about people raising money to fund their projects. Crypto may offer new ways for entrepreneurs to raise capital and for investors to trade, but we still need investor and market protection.

These comments track with work done by others that make a case that the regulation of cryptocurrency can be folded into existing frameworks. A February 2022 report by the Center for American Progress, for example, lays out its vision of which federal agency oversees which type of digital asset and argues that "Congress must act cautiously and deliberately when considering crypto legislation and should not enact regulatory carveouts that provide special treatment to new versions of old products."[6]

6) **Can California already regulate cryptocurrency?**

California may already have the authority to provide some oversight over cryptocurrency entities. As the federal government begins its review of its existing oversight capabilities and how best to regulate cryptocurrency, California also may need to engage in a similar process to provide clarity to industry actors.

Some states have licensed cryptocurrency exchanges – the companies that help customers buy and sell digital assets - 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 work 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).[7]

California may also be able to take action against firms that engage in certain unfair, deceptive, abusive acts or practices against consumers. AB 1864 (Limon), Chapter 157, Statutes of 2020, established the California Consumer Financial Protection Law (CCFPL) and provides DFPI with the authority to regulate a broad market of consumer financial products and services, which may include firms that do work in the cryptocurrency space. While DFPI has not formally released any information about how it would use its UDAAP authority in the context of cryptocurrency, DFPI's Office of Financial Technology Innovation has previously indicated that cryptocurrency is a topic that DFPI is looking at.[8]

California also could track with SEC's approach to require the registration of cryptocurrency securities offerings. States typically have securities laws (called Blue Sky laws) that provide safeguards for investors against securities fraud and to give investors the information they need to make sound investment decisions.

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[6] Todd Phillips and Alexandra Thornton, *Congress Must Not Provide Statutory Carveouts for Crypto Assets*, Center for American Progress (March 1, 2022), available at https://www.americanprogress.org/article/congress-must-not-provide-statutory-carveouts-for-crypto-assets/.
[7] 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.
[8] Benjamin Pimentel, "California wants to regulate crypto. Meet the woman in charge." Protocol. https://www.protocol.com/fintech/california-ofti-christina-tetreault

7) **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, there remain some practical challenges to bringing cryptocurrency into mainstream, government-sanctioned use in everyday transactions. Before moving forward with an effort to make cryptocurrency a state-embraced legal tender, the committee may wish to consider how the below issues can first be resolved:

a) **Fraud, hacks, and scams**. Given the newness of the cryptocurrency markets 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.[9]

b) **Tax implications.** As noted earlier, the IRS treats virtual currency as a capital asset whose appreciation is subject to federal income tax. This means that using virtual currency carries significant tax risks for those who pay and accept virtual currency payments.

   For example**:** If the Franchise Tax Board (FTB) facilitates payment of state income taxes via virtual currency, a taxpayer may end up owing more tax than they otherwise would if the fair market value of the digital asset they are paying with has appreciated since its original purchase. Thus, most holders of cryptocurrencies are facing significant tax risks when engaging in payments to either the state or other private parties.

c) **Volatility.** The volatility of the price of many digital assets undermines the consumer's ability to rely on it as a stable form of payment. For example, El Salvador became the first country in the world to adopt Bitcoin as legal tender. On that same morning, the value of Bitcoin dropped by 17%. Since then, many merchants have stopped accepting it because of Bitcoin's ups and downs, which has left customers with uncertainty about their payment options.[10]

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.

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[9] 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.
[10] Pete Gannon, "El Salvador's bitcoin experiment tests its limitations." Axios (April 12, 2022), available at https://www.axios.com/el-salvadors-bitcoin-experiment-tests-its-limitations-c9fa305f-1603-46e7-ba2d-8215763caa47.html.

8) **Support.**

The Santa Cruz Board of Supervisors writes in support of AB 2689, stating the following:

> Virtual currencies are growing rapidly both as a form of payment and overall financial asset, with California leading the way in this new form of wealth exchange. While there's nothing in California law that explicitly prohibits transactions in virtual currencies, there are no guidelines or explicit permission within the law either. Lack of clarity in regulation and law leads businesses to shy away from establishing themselves in our communities, thus depriving the state of a valuable opportunity for economic development. This regulatory vacuum also leaves consumers without strong guidelines for handling virtual currencies, which prevents ordinary Californians from reaping the equity and access benefits of virtual currencies.

The Digital Currency Traders Alliance (DCTA), a nonprofit coalition of retail investors, consumers, traders, businesses, and thought leaders, also writes in support, arguing:

> Digital currencies are an untapped, nascent sector of the fourth industrial revolution, one that is only now beginning to be fully explored and embraced. Despite their relatively recent appearance since first being proposed by Satoshi Nakamoto in 2009, digital currencies have revolutionized the financial sector, the technology sector, and the very concept of currency itself…
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> A digital currency is a distributed payment network of nodes maintained and operated by individuals around the world. Transactions and payments made over this network are recorded in a public ledger – aka the blockchain. The key to this innovation lies in the number of advantages it provides – it is immutable, transparent, and highly secure, allowing parties to have trust in an otherwise trustless transaction. Undergirding this entire process is critical digital infrastructure, which has been overlooked for far too long. This is critical to securing California's long-term position as an integral component as a hub of technological innovation. However, in the last few years, many states have drastically increased their efforts to convince California tech companies to relocate to their states with incentives such as lower taxes and reduced regulatory requirements. By providing clarity on what types of currency can be accepted, this bill will attract more businesses to California and boost economic opportunities across various industries

9) **Opposition.**

California State Controller Betty Yee submitted a letter of opposition that expressed concerns about the impact of AB 2689 on consumers and on the ability for her office to produce timely and accurate financial reports, stating:

> Given the newness of blockchain technology and cryptocurrencies, prevailing accounting principles were established at a time when digital currencies were not yet contemplated. If California were to have cryptocurrencies on its ledger, state agencies would be left without accounting guidance and would need to apply arcane accounting standards to a new technology.

> Moreover, because of the extreme fluctuations in cryptocurrency value, there will undoubtedly be discrepancies inherent with reconciliations made in financial reports forwarded to SCO for year-end financial reports. If responsibly regulated for consumers' protection, California may embrace the use of cryptocurrency, however, it must be done in a fiscally responsible manner to ensure our ability to accurately measure and account for performance.

The California Association of County Treasurers and Tax Collectors also writes in opposition, citing issues around safety and soundness of county treasuries, noting:

> ...virtual currency is not backed by the full faith of any government, as it not issued through a public treasury. The determination of any virtual currency is subjective, even within the category of virtual currencies. Finally, virtual currency is a tool for those engaged in illicit activities seeking to avoid detection and monitoring as it is difficult to track. Entities and individual who transact in virtual currency create additional burdens for public safety agencies and investigators trying to solve crimes. If a public agency accepts virtual currency as payment, that public agency could then be pulled into those investigations, subpoenas and other important – but disruptive – law enforcement activities. The collective sense of county treasuries was that the risk of such events is high.

10) **Recent legislation.**

SB 838 (Hertzberg), Chapter 889, Statutes of 2018, among other things, temporarily authorized corporations to include a provision in their articles of incorporation authorizing the use of blockchain technology to record and track the issuance and transfer of stock certificates.

AB 2658 (Calderon), Chapter 875, Statutes of 2018, among other things, established a blockchain working group to evaluate the uses of blockchain in state government, the risks and benefits of blockchain in state government, legal implications associated with the use of blockchain, and best practices for enabling blockchain technology to benefit the state.

SB 549 (Hall), Chapter 509, Statutes of 2015, authorizes eligible organizations, as defined, to conduct a 50/50 raffle, as specified, and prohibits those organizations from accepting Bitcoin or any other cryptocurrency in exchange for a raffle ticket

REGISTERED SUPPORT / OPPOSITION:

Support

Digital Currency Traders Alliance
Santa Cruz County Board of Supervisors

Oppose

California Association of County Treasurers and Tax Collectors
California State Controller
Consumer Federation of California

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