

**ASSEMBLY COMMITTEE ON BANKING AND FINANCE, SELECT
COMMITTEE ON TECHNOLOGICAL ADVANCES**

Joint Informational Hearing

“Virtual Currency Businesses: The Market and Regulatory Issues”

October 17, 2019, 10:00 a.m.

Rio Hondo Community College

Testimony of

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California Department of Business Oversight

Introduction

Madam Chair Limón, Majority Leader, Calderon, and members of the committees & Rio Hondo community, I’m Manuel Alvarez, Commissioner of the California Department of Business Oversight a role to which I was appointed in May. Thank you for the opportunity to participate in this hearing about virtual currency, an emerging, rapidly changing industry.

The Department of Business Oversight licenses and regulates over 360,000 individuals and entities that provide financial services in California. The Department licenses and regulates money transmitters, issuers of payment

instruments, and stored value cards. As of June 2019, the Department had 102 money transmitter licensees who had a total of over 48,000 agent locations in California. Banking, credit unions, securities, and commodities are the other areas regulated by the Department that may be impacted by the virtual currency industry.

The Committees have asked that I provide insight and expertise related to virtual currency. Specifically, you requested information on: 1) consumer complaints about virtual currency fraud; 2) how current laws apply to virtual currency businesses; 3) requests from virtual currency businesses for regulatory clarity; 4) the Department's views on the Uniform Law Commission model regulatory framework; and, 5) the policy tradeoffs or implementation challenges that the Legislature should consider when contemplating regulation in this space.

I will be offering the Department's perspective on these issues.

I. Consumer Complaints Related to Virtual Currency Fraud

When the Department receives complaints regarding virtual currency, they are reviewed by our Enforcement Division to determine if the Department has jurisdiction to investigate. If not then we refer the complaints to the Securities and Exchange Commissioner or another agency that may have jurisdiction.

Currently, there are approximately 15 investigations pending in the Department's Enforcement Division and year to date 2019 the Department has received 21 complaints, 16 of which are against the same exchange for customer service

issues. In the past three years, the number of complaints the Department received regarding virtual currency fluctuated. Generally, complaints come in waves, based on the prices of well-known virtual currency, such as Bitcoin, and customer demand.

In 2018, we received 63 complaints related to virtual currency, most of which concerned customer service issues like delayed credit of deposits or delayed processing of transactions. This surge in complaints appeared to be related to the sharp run-up in demand for virtual currency around this time last year, worsening customer service response times. However, with respect to these particular complaints, the Department did not have jurisdiction to take action because they were customer service-oriented and not related to a violation of the securities or commodities laws.

In 2015, we issued a desist and refrain order against a company called US Fine Investment Arts, Inc. (USFIA) and three of the firm's executives alleging that they sold securities without a registration and misled investors in offering and selling the securities. The order requires USFIA and the officers to stop further violations. USFIA is based in Arcadia, CA. USFIA operated a multi-level marketing scheme that promised investors their money would be converted into Gemcoin - a virtual currency. DBO settled in December 2018 when the company agreed to stipulate to the desist and refrain order. It was estimated the fraud victimized hundreds of Californians and thousands nationwide.

The Department may have jurisdiction if one of our securities laws is being violated. For instance, a digital asset may be deemed a security if it is sold with the promise that the digital assets will gain value and the purchaser will get a profit in the future. Another example, if a sham crypto-exchange says a customer can buy bitcoin on their website but in fact they do not sell the bitcoin on the website, this is a fraud in the sale of the commodity.

When complaints are received related to consumer service issues or delays in processing of transactions where there is no intent to defraud, they may be referred to the California Attorney General's Office Consumer Law Section for review of unfair deceptive practices. If the complaint involves the securities or commodities law but we have no evidence the company is acting in California and no California complainant, then it is referred to the US Securities and Exchange Commission or the US Commodity Futures Trading Commission.

II. Application of Current State Laws

As of yet, the Department has not determined whether the buying and selling of virtual currency is covered under the Money Transmission Act or any other of the Department's laws.

The Money Transmission Act regulates 1) receiving money for transmission, 2) issuing stored value, and 3) issuing payment instruments. In order to regulate virtual currency under the Money Transmission Act, the Department would need to conclude that virtual currency is money or monetary value. To date, the

Department has not issued a formal order or legal opinion declaring any virtual currency to be a medium of exchange.

It is possible some transactions may fall under the Money Transmission Act. For example, stablecoin – a virtual currency pegged to the U.S. dollar – could be a form of stored value. Another example is an online “wallet” – a secure environment for long-term storage of virtual currency or fiat currency. But the Money Transaction Act would not apply to many other activities related to crypto-currency. And a more comprehensive analysis of the various activities & attended risks may be warranted.

III. Requests for Regulatory Clarity

In 2018, the Department received 23 requests from virtual currency businesses seeking regulatory clarity. So far this year we have received 18 requests for clarity and currently, 5 of those requests are still pending.

If the Department identifies an aspect of the business that falls under the jurisdiction of the Money Transmission Act, we provide written guidance to the requestor about the need for licensure. When the business plan does not implicate activity falling under the Department’s jurisdiction, we issue a letter to the requestor informing that the business model does not appear to require licensure at this time but that the Department continues to study the virtual currency market.

Our written response letters to requestors are redacted in order to protect businesses' proprietary information and then published on our website, so anyone wanting to do business in this area can see what the Department's position is. Our response letters indicate that the Department does not regulate the purchase and sale of virtual currency, such as through a Bitcoin ATM. Our responses are generally issued with the caveat that this is an evolving area of law and that the Department's position is subject to change at any time.

IV. Uniform Law Commission's Model Regulatory Framework

In 2017, the Uniform Law Commission created the Uniform Regulation of Virtual Currency Businesses Act to license businesses that 1) exchange virtual currencies for cash, bank deposits, or other virtual currencies; 2) transfer virtual currencies among customers; or 3) perform certain custodial or fiduciary duties. The model Act does not propose regulating virtual currency itself or owners of virtual currency.

The proposed model proposes some consumer protections and could provide certainty regarding what entities and activities are covered or not covered. The model act states to promote innovation, as the registration option for lower volume virtual currency activity is supportive of startup companies.

But, the Department has several concerns regarding the Uniform Law Commission's framework. First, any regulatory structure must be tailored to California's consumer protection needs – for example, the minimum net worth requirement of \$25,000 may not make sense across the board. By comparison,

money transmitters must maintain tangible shareholders' equity of at least \$50,000, depending on their size. Second, this regulatory framework has not been enacted by any state and therefore is untested, which makes it difficult to anticipate how regulation will affect the virtual currency industry or consumers. Lastly, the virtual currency industry is evolving so rapidly that the model act may already be outdated or soon become outdated.

The Uniform Law Commission model is a good starting point for a regulatory framework for virtual currency businesses. But I think it's important to focus on opportunities we have to optimize existing laws and regulations so as to leverage the good work the department is already doing.

V. Policy Tradeoffs and Implementation Challenges

A predictable and scalable regulatory framework for virtual currency would pose benefits to all stakeholders in California, from consumers and investors, to the companies, on down to the Department as the regulator. Consumers and investors would enjoy increased confidence in their transactions knowing they are protected by appropriate law and regulation. Likewise, the Department and our regulated businesses would benefit by focusing our efforts on the important work of complying with a predictable set of expectations, rather than grouching about a dearth of clarity. Through all of this, California could help lead the way as an innovator in a nascent industry and may help stabilize some of the volatility associated with this asset class.

There would, of course, be challenges. As it stands today, the Department has already observed several risks associated with virtual-currency activities. Some complaints that we have received over the years identify various implementation-challenges including duplicate transactions, processing delays, and incorrect tax forms or other documentation.

There are other fundamentally pernicious risks that would need to be mitigated. Such risks may include: 1) bad actors absconding with customer deposits; 2) lack of appropriate cybersecurity systems to prevent theft of customer funds); 3) lack of appropriate business continuity planning to account for the loss of persons who hold blockchain keys to transact company assets; and 4) obscure or undisclosed fees to consumers or investors.

The encouraging news is that such risks are addressable and the Department has, for sometime, been addressing similar risks across various industries and products. In the case of *this* emerging industry, I think the key is balance: It is important not to be so restrictive or prescriptive as to inadvertently stifle an emerging technology and industry out of California; but no so hands-off as to encourage strident actors that would take advantage of California consumers and investors. Also, important to consider the ways in which CA's existing regulations might be harmonized so as to better apply to this and other emerging industries.

As such, I think the first step in creating a sensible regulatory framework around a new industry is to define the industry itself on a first-principles basis:

- What are the distinct products and services that comprise it?

- What are the attendant risks of each type of product or service?
- And how could each attendant risk be addressed through enacting law or regulation?

For example, the features and risks of an “initial coin offering” – roughly speaking, a method of capital formation through a digital asset – may not be the same as those of a “stable coin,” which is itself pegged to a stable currency or other asset.

After the industry and products that comprise it are cogently defined, then we might turn to the critical work of assessing existing laws and regulations for applicability. This would then help to identify legal or regulatory gaps that are tailored to the risks that a given type of cryptocurrency may pose to California consumers and investors.

Closing

In closing, I would like to thank the Committee for the opportunity to discuss the opportunities and challenges the Department sees with the cryptocurrency industry. So much of this innovation has been born here in California, and so many consumers, investors, and other stakeholders are in our state. The Department will be glad to offer our technical assistance on any policy consideration related to virtual currency.