



Joint Oversight Hearing
Senate Committee on Banking and Financial Institutions
Assembly Committee on Banking and Finance

Harmful Innovation: What FTX’s Collapse Means for Consumers and California’s Approach to Crypto.
Wednesday, February 22, 2023
10 AM, 1021 O Street, Room 1100

Purpose of the hearing:

The Senate Committee on Banking and Financial Institutions and the Assembly Committee on Banking and Finance (“the Committees”) will convene an oversight hearing on February 22, 2023, to evaluate the state’s approach to regulating the provision of digital financial asset products and services (also known colloquially as the “crypto industry”). Last year, the crypto industry experienced a series of high-profile bankruptcies that negatively affected California consumers, in addition to the seemingly constant stream of hacks, scams, and frauds that plague this relatively new industry. The purpose of the hearing is to review the state’s recent actions in regulating the crypto industry and to examine how the state can act in the future to better protect Californians from financial harm perpetrated by the crypto industry.

During the hearing, the Committees will hear from the following witnesses:

- Avy Mallik, General Counsel, Department of Financial Protection and Innovation
- Brian Korn, Partner, Manatt, Phelps and Phillips
- Robert Herrell, Executive Director, Consumer Federation of California
- Sheila Warren, Chief Executive Officer, Crypto Council for Innovation

What are digital financial assets?

The term “digital financial asset” describes a range of money-like, digital representations of value that are not considered legal tender and are not issued by a central bank of a sovereign nation. Similar terms used to describe this concept are *cryptocurrencies*, *digital currencies*, *virtual currencies*, *crypto assets*, and *digital assets*, among others.

The first and most widely known digital financial asset is Bitcoin, which was created in 2009. The stated motivation behind Bitcoin was the creation of a peer-to-peer version of electronic cash. In the digital world, there was no method – until the creation of Bitcoin and the blockchain technology that underpins it – to ensure that a digital representation of value had not been copied and sent to multiple parties

without relying on a trusted third party to mediate the transaction between payor and payee. In the years since Bitcoin's creation, thousands of digital financial assets have been created, with some of the most prominent ones being ether (created by and recorded on the Ethereum blockchain), tether, USD Coin, XRP (issued by Ripple), and Dogecoin.

A large majority of digital financial assets interacts with or depends on distributed ledger technology. Distributed ledger technology (DLT) describes a database storage system that is spread across a network, rather than attached to a common processing unit, that provides a protocol for network participants to arrive at a common understanding of the shared facts to record in the database system – even though those network participants may not know one another. The most prominent form of DLT in the digital financial asset space is the *blockchain*, which allows for network participants to add a new group of transactions (a “block”) to the database. By linking the blocks together in order from the oldest block to the newest block, one can create a “ledger” that shows the current balances of all accounts that have engaged in transactions. This technology replaces the functions of a centralized bookkeeper, like a bank or money transmitter, who records how money changes hands and updates the balances of accountholders after transactions are completed.

How and why do people use digital financial assets?

In spite of descriptions that crypto is a “peer-to-peer” system, many crypto-related activities are conducted by consumers primarily through intermediaries, especially trading platforms. These intermediaries provide similar functions within the crypto financial system as traditional intermediaries – such as banks, money transmitters, and stock brokers and exchanges – provide in the traditional financial system. Similar to the traditional financial system, crypto intermediaries are trusted by their customers to operate honestly, safely, and transparently with customers' assets. Unlike the traditional system, however, crypto intermediaries are operating outside of federal and state laws designed to protect consumers and investors through prudential supervision and regulation, disclosure requirements, and segregation of activities to address potential conflicts of interests. Examples of prominent crypto intermediaries include Coinbase, Kraken, FTX, Celsius, Circle, Binance, Crypto.com, and Gemini.

People in the United States use digital financial assets primarily as a speculative activity, betting on whether a particular asset will appreciate relative to the US dollar.¹ Unlike traditional stocks and bonds, many digital financial assets provide no claim to an underlying stream of cash flows or physical assets, so purchasers of digital financial assets base their speculations on how they believe others will value a given asset in the future. In other words, many purchases of digital financial assets are based on the belief that someone else will buy the asset in the future at a higher price.

In addition to speculation, relatively smaller use cases for US-based users of digital financial assets are privacy and payments. Blockchain technology allows permissionless and pseudonymous access for users to transfer digital assets, which attracts users with strong preferences for shielding their identities from banks and other financial intermediaries who are charged with aiding the federal government's efforts to combat money laundering and the financing of terrorism. Additionally, there are limited use cases where people deeply involved in the crypto ecosystem transact with crypto in exchange for goods and services, but this use case is significantly smaller than speculative transactions.

¹ <https://www.surveymonkey.com/curiosity/cnbc-invest-in-you-august-2021/>

2022: the year crypto crashed

The notorious volatility of the crypto market made major headlines in 2022. The year began on a high note for many industry participants with token prices near all-time highs and venture capital investment pouring into the space. Awareness of crypto was also at an all-time high among the general public, buoyed by an eye-popping marketing push capped by a reported \$39 million spent on television ads during last year's Super Bowl. But the good times were short-lived.

A few weeks after the Super Bowl ad blitz, North Korean hackers exploited a top crypto application, stealing over \$600 million of digital assets.² Several weeks later, the so-called "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. By mid-May, the Terra collapse had triggered an estimated \$300 billion loss industrywide.³

In June, crypto companies with exposure to Terra began to fail. Celsius, a crypto lender that marketed itself as an alternative to traditional banks, froze withdrawals and would eventually file for bankruptcy the following month. Three Arrows Capital, a crypto hedge fund, was the next shoe to drop as it was unable to repay its debt obligations, which triggered Voyager, another crypto lender, to file for bankruptcy in early July. BlockFi, a third crypto lender, was saved from bankruptcy by a loan from FTX, a reprieve that would prove only temporary for the lender and its customers as the company would eventually file for bankruptcy in November.

By mid-summer, the fears of continued contagion had begun to calm, and crypto companies responded to the lower level of token prices and trading volume by cutting their workforces and operating costs. While business activity slowed, hackers remained active, especially in the decentralized finance ("DeFi") space. Blockchain analytics firm Chainalysis reported that October 2022 was the "biggest month in the biggest year for hacking activity" with \$776 million stolen in hacking attacks.⁴ By the end of the year, an estimated \$3.8 billion was lost to crypto hackers. At the forefront of the charge, North Korean-linked hackers were responsible for over \$1.65 billion in stolen crypto in 2022, which many experts believe are being used to fund North Korea's nuclear weapons program.⁵

FTX fraud revealed

As if the problems of the crypto industry had not been sufficiently exposed in the first ten months of the year, November 2022 revealed the largest crypto fraud to-date with the meltdown of Sam Bankman-Fried's FTX and Alameda Research empire. Over the previous year, Bankman-Fried had been the most prominent face of the crypto industry in U.S. policy circles – he testified to Congressional committees, shaped proposed legislation, and lobbied regulatory agencies to amend their rules to allow his firms to operate in regulated commodity markets. Bankman-Fried and his business partners were also major political donors with nearly \$80 million donated to political campaigns and committees from September 2020 to November 2022.⁶ The full scope of Bankman-Fried's attempts to influence policy and politics

² <https://www.coindesk.com/tech/2022/03/29/axie-infinitys-ronin-network-suffers-625m-exploit/>

³ <https://www.bloomberg.com/news/articles/2022-05-19/luna-terra-collapse-reveal-crypto-price-volatility>

⁴ <https://blog.chainalysis.com/reports/2022-biggest-year-ever-for-crypto-hacking/>

⁵ <https://theconversation.com/north-koreas-nuclear-program-is-funded-by-stolen-cryptocurrency-could-it-collapse-now-that-ftx-has-195559>

⁶ <https://www.usatoday.com/story/news/politics/2022/12/16/ftx-reclaims-sam-bankman-fried-political-donations/10902327002/>

may never be known, as he admitted to donating to both political parties in ways both transparent and secret, with some secret donations being disguised in allegedly illegal ways.⁷

Owing both to his activities in political lobbying and advocacy and his stature within the crypto industry as owner of one of the largest crypto trading platforms in the world, the revelations of November 2022 shook the crypto industry to its core. At their essence, the closely tied companies that Bankman-Fried controlled, led by FTX and Alameda Research, were little more than a fraudulent scheme to steal money from customers and investors. While the specific details of the scheme are currently under investigation by law enforcement across the globe, Bankman-Fried and his co-conspirators apparently had been duping their customers and investors for years and using their customers' assets to make risky bets in crypto markets and to support lavish spending on advertising, international real estate, and political contributions.

The full repercussions of Bankman-Fried's alleged fraud remain unclear. FTX is currently navigating the bankruptcy process, but it is likely that the company owes billions of dollars more to its customers and creditors than the value of assets it holds.⁸ Bankman-Fried faces charges of fraud, conspiracy, campaign finance law violations, and money laundering, and several business partners and employees will likely enter plea deals or be charged with crimes.⁹ But while the final accounting of harms and consequences remains to be determined, it seems likely that the crypto industry and the laws and regulations that apply to it will look markedly different because of Bankman-Fried's and his co-conspirators' behavior.

How has the state of California responded to the crypto collapse?

Since its inception, the crypto industry has operated primarily outside of state and federal regulatory frameworks that apply to similar products and services in the traditional financial system. In some instances, the choice to operate outside of the law has been intentional with businesses knowingly accepting risk of regulators' enforcement. In others, businesses may unknowingly have found themselves in a legal gray area that is difficult to navigate. Irrespective of intent, the crypto industry appears to prioritize product development (i.e., what products or services can we create using blockchain technologies) over legal compliance (i.e., how can we ensure that our products or services do not run afoul of any laws), resulting in clashes with regulators and policymakers.

Until 2022, the state of California had not taken a proactive stance on regulating crypto, but the activities in the crypto market last year sparked action from the Newsom Administration ("Administration") and Legislature. The remainder of this section summarizes the Administration's activities pursuant to an executive order issued in May 2022 and concludes with a brief summary of actions taken by the Legislature.

Governor Newsom's executive order

On May 4, 2022, Governor Newsom issued Executive Order N-9-22 ("executive order") with the aim of "creat[ing] a transparent regulatory and business environment for web3 companies which harmonizes federal and California approaches, balances the benefits and risks to consumers, and incorporates

⁷ <https://time.com/6241262/sam-bankman-fried-political-donations/>

⁸ <https://www.coindesk.com/policy/2023/01/11/ftx-has-recovered-over-5b-in-assets-bankruptcy-attorney-says/>

⁹ <https://www.axios.com/2022/12/13/sam-bankman-fried-criminal-fraud-money-laundering>

California values such as equity, inclusivity, and environmental protection.”¹⁰ The following paragraphs summarize the content of the executive order and the Administration’s progress in implementing it.

The executive order begins with declarations suggesting the Governor’s views that the crypto industry has great potential for the global economy, that California is uniquely positioned to benefit from the industry’s growth, and that the state should minimize regulatory uncertainty with the goal of establishing a comprehensive, thoughtful, and harmonized regulatory and business environment for crypto assets. The executive order then outlines the activities of executive branch agencies focused on four workstreams: collecting input from stakeholders, creating a regulatory approach to crypto assets, exploring and establishing public-serving use cases, and building research and workforce pipelines.

Of particular interest to the Committees, the executive order tasked the Department of Financial Protection and Innovation (DFPI) with the following:

- Engage with federal agencies and work with other state regulators to promote a common regulatory approach.
- Develop guidance and, as appropriate, regulatory clarity and supervision of crypto companies based on public comments and information provided voluntarily by such companies.
- Provide guidance to state banks and credit unions regarding crypto assets.
- Initiate enforcement actions as appropriate and enhance complaint handling efforts.

Other state agencies tasked with activities under the executive order include the Governor’s Office of Business and Economic Development (“GO-Biz”) and Government Operations Agency.

In December 2022, the Governor’s Office released an interagency report reflecting the Administration’s work to implement the executive order.¹¹ The report summarizes stakeholder input received pursuant to an outreach process led by GO-Biz. The input summarized in the report is not attributed to any particular individuals, companies, or organizations. Where input from stakeholders conflict with one another, there are no clear recommendations for how such conflict should be resolved. Furthermore, input from stakeholders appears to be taken at face value, even where specious assertions or assumptions are made. Overall, it is not clear how the input should be considered in developing public policy.

The report summarizes DFPI’s work aimed at creating clear and responsible regulatory frameworks. The department met with a variety of federal regulatory agencies and other states’ financial regulators to align with government agencies beyond California. DFPI also solicited public comments for feedback on how California should regulate the crypto industry. Additionally, the department enhanced its consumer education and complaint handling processes in light of turmoil in the crypto markets. And in response to illegal behavior, DFPI initiated enforcement actions to stop four unregistered securities issuers, 13 unlawful investment schemes, and referred two crypto issues to law enforcement agencies.

Framed as “next steps,” the report provides the following six recommendations to the Governor:

- Continue engagement with stakeholders.

¹⁰ <https://www.gov.ca.gov/2022/05/04/governor-newsom-signs-blockchain-executive-order-to-spur-responsible-web3-innovation-grow-jobs-and-protect-consumers/>

¹¹ <https://www.govops.ca.gov/wp-content/uploads/sites/11/2022/12/Blockchain-Report-12-2-22.pdf?emrc=838140>

- Promote consumer protections and consumer education regarding blockchain and crypto products.
- Work with the Legislature to identify gaps and clarify statutory authority as needed with respect to regulating crypto assets.
- Explore and develop more government use cases.
- Encourage more environmentally efficient blockchain technologies and environmental protections.
- Leverage California’s unparalleled higher education systems to build a best-in-class workforce and drive additional research and innovation.

To better understand the progress reported under the executive order and how the Administration intends to follow through on next steps, the Committees may consider asking the following questions during the hearing:

1. How should the Committees consider stakeholder input that is not attributed to any specific sources and devoid of context within a deeper policy conversation? In other words, of what value is the stakeholder input provided in the progress report?
2. Going forward, how can the Administration ensure that stakeholder input be communicated in a clear and meaningful way to the Legislature?
3. The executive order contemplates alignment of California’s regulatory approach with the federal government’s. With a divided Congress and a Biden administration that appears increasingly skeptical of the crypto industry, how does the Administration intend to maintain alignment with the federal government?
4. Does the Administration intend to work with the Legislature on developing a state-level regulatory approach to crypto assets, as recommended by the progress report? If so, how does the Administration expect to engage with the Legislature on this topic?
5. Has the Administration considered any specific policy options to incentivize more environmentally efficient blockchain technologies, and if so, how does the Administration plan to pursue any of those policy options?

Legislative proposal: licensing framework

As the Administration conducted its activities under the executive order, the Legislature considered its own response to the crypto chaos of 2022. In June 2022, Assemblymember Grayson introduced AB 2269 which would have established a licensing law for a broad set of crypto-related business activities. Licensing is a common approach in financial services regulation to ensure that bad actors are prevented from doing business in a covered jurisdiction, and the bill proposed a licensing program, modeled after a model law drafted by the Uniform Law Commission as well as provisions from New York’s BitLicense program and federal securities regulations, that was tailored to crypto companies and the specific risks for investors and consumers. Major provisions included:

- *Permissioned entry and ongoing supervision:* Before interacting with California consumers and retail investors, crypto companies would be required to apply for and obtain a license to operate. This initial gatekeeping can serve to keep bad actors out of the California market, just as New York’s BitLicense program kept FTX, Celsius, Voyager, and other now-bankrupt companies from being able to legally provide products to New Yorkers. In addition to upfront gatekeeping, AB 2269 would have authorized DFPI to conduct ongoing supervision to examine

crypto companies for compliance with consumer protection laws and clear authority to pullback those companies' license to operate if they broke the law.

- *Financial protection*: AB 2269 would have established various requirements to protect consumers and retail investors from losses, such as surety bond and capital requirements and segregation of assets to protect customer funds in a bankruptcy process.
- *Customer service standards*: AB 2269 would have required companies to maintain a customer service line through which customers could contact the company for help.
- *No unbacked stablecoins*: The TerraUSD collapse in May 2022 not only set off a series of company failures within the crypto industry, but it directly caused the loss of billions of dollars of assets held by consumers and retail investors. Inspired by the collapse of TerraUSD, AB 2269 would have prohibited crypto companies from offering so-called "stablecoins" that were not backed 1:1 with high quality liquid assets.

The Legislature broadly supported AB 2269, with the Senate passing the bill 31-6 and the Assembly supporting it 71-0. The bill was supported by a broad coalition of consumer groups and trade associations representing banks and credit unions and was opposed by groups representing crypto industry stakeholders. AB 2269 was vetoed by the Governor, whose veto message read in part:

On May 4, 2022, I issued Executive Order N-9-22 to position California as the first state to establish a transparent regulatory environment that both fosters responsible innovation, and protects consumers who use digital asset financial services and products - all within the context of a rapidly evolving federal regulatory picture. Over the last several months, my Administration has conducted extensive research and outreach to gather input on approaches that balance the benefits and risk to consumers, harmonize with federal rules, and incorporate California values such as equity, inclusivity, and environmental protection.

It is premature to lock a licensing structure in statute without considering both this work and forthcoming federal actions. A more flexible approach is needed to ensure regulatory oversight can keep up with rapidly evolving technology and use cases, and is tailored with the proper tools to address trends and mitigate consumer harm. Additionally, standing up a new regulatory program is a costly undertaking, and this bill would require a loan from the general fund in the tens of millions of dollars for the first several years. Such a significant commitment of general fund resources should be considered and accounted for in the annual budget process.

I am committed to working collaboratively with the Legislature to achieve the appropriate regulatory clarity once federal regulations come into sharper focus for digital financial assets, while ensuring California remains a competitive place for companies to invest and innovate.

Since the Governor's veto, the crypto industry has continued to experience significant volatility and upheaval. The most notable event was the collapse of FTX, but other significant events include the bankruptcies of major crypto companies BlockFi and Genesis. Moreover, the federal policy environment has only grown less clear, with a Congress divided and a Biden Administration that is increasingly cracking down on the crypto industry.

In light of this uncertainty and the continued pervasive risks for California consumers, the Legislature remains interested in passing robust consumer protection laws that provide rules of the road for industry and entrepreneurs. In the current legislative session, Assemblymember Grayson introduced AB 39, a modified version of AB 2269, and Senator Limón introduced SB 401, a measure to establish rules for so-called crypto ATMs or kiosks.

Given the impending debates around legislative proposals and the best strategy to protect California consumers, the Committees may be interested to hear feedback from witnesses on the following:

1. What has the Administration learned from the process of implementing the EO that the Administration did not know when the EO was published on May 4, 2022?
2. Given the litany of business failures and outright fraud that perpetrated throughout the crypto industry in 2022, should California take more aggressive action in bringing the crypto industry under greater oversight?
3. Unlike the innovation that California fostered in the personal computing, software, and internet industries, the crypto industry relies on everyday Californians entrusting them with their hard earned savings. Can the crypto industry be viewed through the same lens as Intel, Apple, Salesforce, and Yahoo!? Or is the crypto industry better viewed through the same lens as financial services companies who are required to obtain licenses or charters and be regularly subject to oversight with the aim of preventing consumers' funds from being gambled away?
4. Is a licensing program, like what was proposed in AB 2269, appropriate and necessary? What are the benefits and drawbacks of a licensing approach compared to the status quo?

How has the federal government responded to the crypto collapse?

As cited in Governor Newsom's executive order, President Biden issued on March 9, 2022, an executive order that initiated a whole-of-government assessment of key issues raised by crypto assets and related financial technologies. In the second half of 2022, the White House published several reports that generally focus on the risks created by the crypto industry and signaled that an increase in enforcement actions may be an important step to mitigate those risks.

In January 2023, the White House published its roadmap to mitigate risks in the crypto industry.¹² The focus of the Biden administration is "on continuing to ensure that cryptocurrencies cannot undermine financial stability, to protect investors, and to hold bad actors accountable." The Biden administration signals its intent to use all authority vested in the Executive Branch to mitigate the risks of crypto and calls for Congress to do more to protect consumers, investors, and our national interests by:

- Expanding regulators' powers to prevent misuses of customers' assets and to mitigate conflicts of interests.
- Strengthening transparency and disclosure requirements for crypto companies.

¹² <https://www.whitehouse.gov/nec/briefing-room/2023/01/27/the-administrations-roadmap-to-mitigate-cryptocurrencies-risks/>

- Strengthening penalties for violating illicit-finance rules and prohibit crypto companies from tipping off criminals.
- Limiting crypto-related risks to the financial system.

In line with President Biden’s direction, federal regulators have significantly strengthened and accelerated their response to crypto-related risks in 2023. The top three bank regulators jointly issued a sharp warning on January 3rd to banks about crypto activities, which stated that issuing or holding crypto is “highly likely to be inconsistent with safe and sound banking practices.”¹³ The Federal Reserve followed on January 27th with a rejection of an application from a crypto-focused bank to gain access to the central bank’s payment system.

In addition to the federal banking regulators, the Securities and Exchange Commission (SEC) has stepped up its efforts to enforce laws designed to protect investors and bring transparency to capital markets. The SEC has brought four cases in 2023 against prominent crypto companies Kraken, Genesis, Gemini, and Nexo, as well as charges against the company behind the Terra/Luna ecosystem that crashed in May 2022. The agency also proposed a rule in February 2023 that would strengthen safeguards around the custody of crypto assets.

Congress, on the other hand, does not appear to be nearing any particular agreement on how to address crypto-related risks. Several bills received considerable attention in 2022, including a bill to regulate stablecoins and a bill to regulate the spot markets of certain crypto assets. Neither bill was taken up by either the House or the Senate. In the current Congress, several crypto-related bills have been introduced, but the prospects of any becoming law are unclear given the partisan divide in leadership and increased skepticism of the crypto industry due to the bankruptcy of FTX.

The development of federal law – whether through enacting new legislation, promulgating new regulations, or the interpretation and enforcement of existing laws – may affect how California decides to regulate the crypto industry. Furthermore, Governor Newsom’s executive order indicates that California should harmonize its approach with the federal approach. As such, the Committees may ask witnesses to respond to the following to better understand the path forward for California:

1. What is the likelihood and nature of any federal regulation of digital financial assets that has not already been enacted by Congress or promulgated by federal regulatory agencies?
2. With the aggressive posture of the federal government in addressing crypto-related risks, how can California harmonize its approach and complement the feds in working towards President Biden’s objectives to ensure that crypto cannot undermine financial stability, to protect investors, and to hold bad actors accountable?
3. If Congress does not quickly work towards President Biden’s request to expand regulators’ powers to prevent misuses of customers’ assets, to mitigate conflicts of interests, and to bring more transparency to crypto markets, what can California do to step into gaps left by a divided Congress?

¹³ <https://www.occ.gov/news-issuances/news-releases/2023/nr-ia-2023-1a.pdf>

2022: the year crypto crashed

Major events in the crypto industry and California's policy response

