Date of Hearing: May 10, 2023

ASSEMBLY COMMITTEE ON APPROPRIATIONS
Chris Holden, Chair
AB 39 (Grayson) – As Amended April 26, 2023

Policy Committee: Banking and Finance   Vote: 11 - 0

Urgency: No   State Mandated Local Program: No   Reimbursable: No

SUMMARY:

This bill enacts the Digital Financial Assets Law under the Department of Financial Protection and Innovation (DFPI), establishing a licensing and regulatory framework for digital financial asset (DFA) business activity.

Specifically, this bill:

1) Prohibits, beginning January 1, 2025, a person from engaging in DFA business activity with, or on behalf of, a resident unless the person is licensed with DFPI. DFPI must determine a nonrefundable license application, investigation, and renewal fee amount to cover the reasonable costs of regulation.

2) Authorizes DFPI to conduct examinations of a licensee and take enforcement action against a licensee or a person that is not a licensee but engaging in DFA business activity.

3) Requires a licensee to maintain certain records, including a general ledger posted at least monthly listing all assets, liabilities, capital, income, and expenses of the licensee, and make certain disclosures to a resident, including a schedule of fees and charges the licensee may assess, before engaging in DFA business activity.

FISCAL EFFECT:

Costs of an unknown, but significant amount, likely in the tens of millions of dollars, to DFPI to establish and maintain the new licensing program for DFA business activity. Costs to establish the new program include equipment, software to analyze blockchain, and other information technology operating expenses, as well as workload related to promulgating regulations and training for DFPI staff. Ongoing costs include additional staffing resources to conduct licensing, examination, investigation, and enforcement activities. Given the program's size and complexity, DFPI will likely need specialized staff with technical expertise in a rapidly evolving field to support the program's operations.

A General Fund (GF) loan is likely necessary in the first several years to establish the program. Revenue from new program fees may offset DFPI's administrative and enforcement costs to some extent. Any actual increase in fee revenue to DFPI will depend on the number of entities seeking to become licensed to engage in DFA business activity.

COMMENTS:

1) **Purpose.** According to the author:

> While crypto assets have the potential to empower consumers and disrupt the financial sector in unexpected ways, their high volatility and the prevalence of fraud, illicit behavior, and technical and security vulnerabilities expose California consumers to significant financial harm. AB 39 strikes a balance between protecting consumers from harm and fostering a responsible innovation environment by establishing clear rules of the road.

2) **Support and Opposition.** This bill is sponsored by the Consumer Federation of California, which notes "In 2022 alone, $3.7 billion was lost to crypto scams, and FTX's bankruptcy was just one of five within the crypto market." This bill is also supported by other consumer groups and banking associations.

   This bill is opposed, unless amended, by the Crypto Council for Innovation, which argues "The legislature must work to increase clarity and improve communication structures in the bill, so that expectations for potential licensees and regulators are better aligned."

3) **Background.**

   DFA. A DFA (also referred to as "cryptocurrency" or "crypto") is a digital representation of value that is not issued or backed by a government or central bank. Unlike the dollar, a DFA is not considered legal tender, but private parties may agree that it is tender to facilitate an economic exchange. The most commonly used technology that produces and supports a DFA is distributed ledger technology, which is a decentralized database managed by multiple parties within a network. Blockchain is the most well-known type of such technology.

   Federal and State Regulatory Efforts. They crypto industry has operated primarily outside of state and federal regulatory frameworks that apply to similar traditional financial products and services, thus posing significant risks to consumers given the lack of established rules for companies operating in the industry. The notorious volatility of the crypto market made major headlines in recent years, most notably the November 2022 collapse of Sam Bankman-Fried's FTX. The federal Securities and Exchange Commission has ramped up enforcement against crypto companies for alleged violations of security laws, but Congress is not near any agreement on how to address crypto-related risks.

   On May 4, 2022, Governor Newsom issued Executive Order N-9-22, with the aim of creating "a transparent regulatory and business environment for web3 companies which harmonizes federal and California approaches, balances the benefits and risks to consumers, and incorporates California values such as equity, inclusivity, and environmental protection." This bill establishes a licensing and regulatory framework administered by DFPI for DFA business activity, providing DFPI additional tools to stem predatory activities in the market.

4) **Prior Legislation.** AB 2269 (Grayson), of the 2021-22 Legislative Session, was substantially similar to this bill. AB 2269 was vetoed by Governor Newsom, who stated:

> 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 [GF] in the tens of millions of dollars for the first several years. Such a significant commitment of [GF] resources should be considered and accounted for in the annual budget process.

In response, this bill incorporates several differences to provide more flexibility to DFPI and licensees. For example, this bill grants conditional licenses to companies with a valid New York BitLicense, New York's robust state-level DFA licensing program. This bill also outlines a more straightforward process by which a company must certify a DFA meets specified standards.

Analysis Prepared by: Irene Ho / APPR. / (916) 319-2081