

ASSEMBLY THIRD READING
AB 39 (Grayson)
As Amended May 18, 2023
Majority vote

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.

Major Provisions

- 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) Defines a "covered person" as a person required to obtain a license, and requires a covered person to comply with specified provisions beginning on January 1, 2024.
- 3) Exempts from the new licensing program: registered or qualified securities; banks and credit unions; 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.
- 4) Authorizes DFPI to issue a conditional license to a person with a valid license or charter to conduct virtual currency activity under New York Law, provided that the license or charter was issued or approved prior to January 1, 2023.
- 5) 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.
- 6) Requires a licensee to maintain capital and liquidity 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.
- 7) Requires a covered exchange, as defined, prior to listing or offering a digital financial asset, to certify on a form provided by DFPI that the exchange has conducted a comprehensive risk assessment, established policies and procedures to evaluate the appropriateness of the listing, and provided full and fair disclosure of all materials related to conflicts of interest, among other topics.
- 8) Provides that a covered person may not 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.

COMMENTS

A digital financial asset (also known as cryptocurrency, 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.

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.

Despite its name, there is doubt that cryptocurrency 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. And, 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.

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.

In recent years, market turmoil has exposed a host of consumer and investor risks in the crypto market. Those risks include fraud, hacks, scam products, extreme volatility, insider trading, and information asymmetry, and a lack of clear federal and state legal protections. These risks expose everyday investors and consumers to financial losses outside of their control. More recently, the well-known company FTX collapsed and the head of the company, Sam Bankman-Fried, was arrested.

This bill establishes a licensing framework for a business engaging in digital financial asset business activity, which is the most common regulatory approach to financial services at the state level. DFPI administers licensing laws for a range of companies, including banks, credit unions, money transmitters, lenders and brokers, mortgage loan originators, student loan servicers, and debt collectors. Like those licensing programs, this bill establishes an upfront process, requires companies to maintain adequate financial security to provide assurance that the business can meet its obligations to its customers, and authorizes DFPI to routinely examine businesses for compliance and to take enforcement actions, if needed.

According to the Author

AB 39 will promote a healthy and sustainable crypto asset market by licensing and regulating businesses that help Californians buy and sell these new digital financial products. 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.

Arguments in Support

AB 39 is sponsored by the Consumer Federation of California and is supported by a coalition of consumer advocacy organizations, organizations representing banks and credit unions, and organizations representing retail crypto traders. The Consumer Federation of California argues:

"AB 39 will license digital financial assets companies under the California Department of Financial Protection and Innovation (DFPI), giving industry necessary regulatory clarity on how to operate safely while protecting consumers. Licensing in this area will provide basic consumer protections and is an appropriate and necessary next step to ensure that foundational "rules of the road" are met and followed to do business in the state of California. In 2022 alone, \$3.7 billion was lost to crypto scams, and FTX's bankruptcy was just one of five within the crypto market. AB 39 seeks to boost transparency, adopt a regulatory framework, and, above all, protect consumers."

Arguments in Opposition

The Crypto Council for Innovation (CCI), an alliance of companies whose membership includes Coinbase, Block, Gemini, Paradigm, and Andreessen Horowitz, opposes AB 39 unless amended. CCI states:

"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. In order to ensure regulated entities are best positioned to compete in a crowded marketplace, the legislature should provide concrete application and review timelines, narrow the scope of the overly broad digital financial asset business activity definition, and ensure licensees are provided written notice before examinations. Additionally, the legislature must expand the federal registration exemption to include entities registered with the Commodity Futures Trading Commission (CFTC) and clarify the mergers and consolidation approval authority it is granting regulators."

FISCAL COMMENTS

According to the Assembly Appropriations Committee, 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.

VOTES

ASM BANKING AND FINANCE: 11-0-1

YES: Grayson, Bauer-Kahan, Cervantes, Dixon, Mike Fong, Gabriel, Petrie-Norris, Soria, Waldron, Wicks, Wilson

ABS, ABST OR NV: Chen

ASM APPROPRIATIONS: 11-0-5

YES: Holden, Bryan, Calderon, Wendy Carrillo, Mike Fong, Hart, Lowenthal, Papan, Pellerin, Weber, Ortega

ABS, ABST OR NV: Megan Dahle, Dixon, Mathis, Robert Rivas, Sanchez

UPDATED

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