

SENATE JUDICIARY COMMITTEE
Senator Thomas Umberg, Chair
2023-2024 Regular Session

AB 39 (Grayson)
Version: July 6, 2023
Hearing Date: July 11, 2023
Fiscal: Yes
Urgency: No
AWM

SUBJECT

Digital financial asset businesses: regulatory oversight

DIGEST

This bill establishes a licensing and regulatory framework, administered by the Department of Financial Protection and Innovation (DFPI) for digital financial asset business activity, as specified.

EXECUTIVE SUMMARY

It's been a rough year and a half for digital financial assets, the most famous of which are cryptocurrencies. At the beginning of 2022, crypto exchanges were purchasing Super Bowl ads and riding an overall market capitalization of close to \$3 trillion. By the end of 2022, multiple digital financial assets and crypto exchanges had collapsed, trillions of dollars in value were lost, and many consumers discovered that their assets were simply gone due to bankruptcies, unscrupulous comingling of funds, or outright fraud. The bad news has continued into 2023; among other things, the Securities Exchange Commission (SEC) has declared at least 55 crypto assets to be unregistered securities and the top two exchanges to be unlicensed securities exchanges.

In 2022, the Legislature passed AB 2269 (Grayson, 2022), which would have established a licensing and regulatory framework for digital financial asset businesses being conducted with California residents. Governor Newsom vetoed the bill, stating he believed it was premature to regulate the digital financial asset industry.

This bill is similar to AB 2269: it establishes a licensing and regulatory framework, administered by the DFPI, for digital financial asset business activity and is intended to provide regulatory clarity to businesses and legal protections for consumers and retail investors in this emerging industry. The bills are not identical, however; the author has made several changes in response to stakeholder comments and the changing cryptocurrency landscape, such as eliminating the sunset on the requirement that so-

called “stablecoins” back their value with reserve assets. The author has agreed to a minor amendment to clarify DFPI’s enforcement authority with respect to imminent violations or other imminent fraudulent or unsound digital financial asset business activity.

This bill is sponsored by the Consumer Federation of California and is supported by the California Bankers Association, the California Credit Union League, the California Low-Income Consumer Coalition, CAMEO, Consumer Reports, Consumers for Auto Reliability, the Digital Currency Traders Alliance, the Los Angeles Democratic Party, and Oakland Privacy. This bill is opposed by Crypto Council for Innovation. The Senate Banking and Financial Institutions Committee passed this bill with a vote of 6-0.

PROPOSED CHANGES TO THE LAW

Existing law:

- 1) Establishes the Securities Exchange Act of 1934, which regulates the secondary trading of interstate securities and is administered by the SEC. (15 U.S.C. §§ 78a et seq.)
- 2) Establishes DFPI as the state agency responsible for licensing, regulating, and supervising a range of financial services companies that provide products or services to California consumers, including but not limited to, securities issuers, broker-dealers, investment advisers, and investment advisers representatives; persons offering or selling off-exchange commodities; persons holding securities as custodians on behalf of securities owners; money transmitters; and persons offering or providing consumer financial products or services. (Fin. Code, div. 1, ch. 3, §§ 300 et seq.)
- 3) Establishes the Corporate Securities Law of 1968, which governs the issuance and sale of securities in California, except for securities covered by specified federal securities laws. (Corp. Code, tit. 4, div. 1, §§ 25000 et seq.)
- 4) Establishes the Money Transmission Act, which generally prohibits a person from engaging in money transmission without a license from the Commissioner of the DPFI. (Fin. Code, div. 1.2, §§ 2000 et seq.)
- 5) Establishes the California Consumer Financial Protection Law, which prohibits providers of financial products or services in the state from engaging in unlawful, unfair, deceptive, or abusive acts or practices with respect to consumer financial products or services and authorizes the DFPI to regulate the offering and provision of consumer financial products or services under California financial laws, to the extent the bill is not preempted by federal law. (Fin. Code, div. 24, §§ 90000 et seq.)

This bill:

- 1) Establishes the Digital Financial Assets Law (DFAL).
- 2) Defines relevant terms for the DFAL, including:
 - a) “Bank” means a bank, savings bank, savings and loan association, or industrial loan company chartered under the laws of this State or any other state or the United States.
 - b) “Digital financial asset” means a digital representation of value that is used as a medium of exchange, unit of account, or store of value, and that is not legal tender, whether or not denominated in legal tender; it does not include:
 - i. A transaction in which a market grants, as part of an affinity or rewards program, value that cannot be taken from or exchanged with the merchant for legal tender, bank or credit union credit, or a digital financial asset.
 - ii. A digital representation of value issued by or on behalf of a publisher and used solely within an online game, game platform, or family of games sold by the same publisher or offered on the same platform.
 - iii. A security registered with or exempt from registration with the United States Securities and Exchange Commission (SEC) or a security qualified with or exempt from qualifications with the DFPO.
 - c) “Digital financial asset business activity” means any of the following:
 - i. Exchanging, transferring, or storing a digital financial asset or engaging in digital financial asset administration, whether directly or through an agreement with a digital financial asset control services vendor.
 - ii. Holding electronic precious metals or electronic certificates representing interests in precious metals on behalf of another person or issuing shares or electronic certificates representing interests in precious metals.
 - iii. Exchanging one or more digital representations of value used within one or more online games, game platforms, or family of games for either (1) a digital financial asset offered by or on behalf of the same publisher from which the original representation of value was received, or (2) legal tender or bank credit union credit outside the online game, game platform, or family of games offered by or on behalf of the same publisher from which the original digital representation of value was received.
 - d) “Digital financial asset services vendor” means a person that has control of a digital financial asset from, or on behalf of, a resident, at least momentarily, to trade, sell, or convert either (1) a digital financial asset for legal tender, bank or credit union credit, or one or more forms of digital financial assets; or (2) legal tender or bank or credit union credit for one or more forms of digital financial assets.
 - e) “Resident” means any of the following, but excludes a licensee or an affiliate of a licensee:
 - i. A person who is domiciled in this State.

- ii. A person who is physically located in this State for more than 183 days of the previous 365 days.
 - iii. A person who has a place of business in this State.
 - iv. A legal representative of a person that is domiciled in this State.
 - f) "Store," except in the phrase "store of value," means to maintain control of a digital financial asset on behalf of a resident by a person other than the resident.
 - g) "Transfer" means to assume control of a digital financial asset from, or on behalf of, a resident and to subsequently do any of the following:
 - i. Credit the digital financial asset to the account of another person.
 - ii. Move the digital financial asset from one account of a resident to another account of the same resident.
 - iii. Relinquish control of a digital financial asset to another person.
 - h) "United States dollar equivalent of digital financial assets" means the equivalent value of a particular digital financial asset in United States dollars shown on a digital financial asset exchange based in the United States for a particular date or period specified.
- 3) Provides that the DFAL, subject to enumerated exemptions, governs the digital financial asset business activity of a person doing business in this State or, wherever located, who engages or holds itself out as engaging in the activity with, or on behalf of, a resident. The exempted entities include:
- a) Various governmental entities.
 - b) Banks and financial institutions regulated federally, internationally, or under other State laws.
 - c) Persons providing connectivity software or similar assistance to a business engaged in digital financial asset business activity.
 - d) A person whose digital financial asset business activity with, or on behalf of, residents is reasonably expected to be valued at \$50,000 annually or less.
 - e) Entities and persons governed by specified federal commodities and securities laws.
- 4) Permits the DFPI, by regulation or order, either unconditionally or under specified terms and conditions or for specific periods, to exempt from all or part of the DFAL any person or transaction or class of persons or transactions, if the Commissioner of the DFPI determines that such action is in the public interest and that regulation of such persons or transactions is not necessary for the purpose of the DFAL; the DFPI must post on its website all persons, transactions, or classes or transactions or persons so exempted, and may, by regulation or order, rescind any such exemption.
- 5) Provides that, beginning January 1, 2025, a person shall not engage in digital financial asset business activity, or hold itself out as being able to engage in digital financial asset business activity, with or on behalf of a resident, unless any of the following is true:

- a) The person is licensed under the DFAL.
 - b) The person has submitted an application for a license under the DFAL and is awaiting approval or denial of the application.
 - c) The person is exempt from licensure under 3-4).
- 6) Establishes requirements of an application for licensure, authorizes DFPI to charge a fee to cover the reasonable costs of regulation, and requires DFPI to investigate specified characteristics of the applicant before making a decision on the application. Information provided pursuant to an application is protected under the California Public Records Act (CPRA).
 - 7) Authorizes the DFPI to approve, conditionally approve, or deny an application; a license shall take effect on the later of the following of (1) the date the DFPI issues the license, or (2) the date the licensee provides the security required in 8).
 - a) The DFPI may issue a conditional license to an applicant who holds or maintains a license to conduct virtual currency business activity in the state of New York, provided the license was issued or approved no later than January 1, 2023. A conditional license expires on the earlier of (1) issuance of an unconditional license, (2) denial of a license, or (3) upon revocation of the New York license.
 - 8) Requires a licensee to maintain a surety bond or trust account in a form and amount as determined by DFPI for the protection of residents with whom a licensee engages in digital financial asset business activity, as specified.
 - 9) Requires, in addition to the security required in 8), a licensee to maintain at all times 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, in light of an assessment of the specific risks applicable to the licensee, as specified. The liquidity may be maintained in the form of cash, digital financial assets other than the digital financial assets over which it has control for a resident, or high-quality liquid assets, as defined, in proportions determined by the DFPI.
 - 10) Requires the DFPI to issue a license to an applicant if specified conditions are met; an applicant may appeal a denial under procedures set forth under the Administrative Procedure Act, Government Code section 11370.
 - 11) Provides procedures by which a licensee may apply for renewal of a license on an annual basis.
 - 12) Provides that a DFAL license is not transferable or assignable.
 - 13) Authorizes the DFPI to adopt rules necessary to implement the DFAL and prepare formal written guidance to be issued to persons seeking clarification; all formal

written guidance shall be made public on the DFPI's website, with redactions for certain proprietary or confidential information.

- 14) Authorizes the DFPI to examine the business and any office, within or outside the State, of any licensee, to ascertain whether the business is being conducted in a lawful manner; the examination may be conducted without prior notice to the licensee, and shall be paid for by the licensee.
- 15) Requires a licensee to maintain specified information relating to all digital financial asset business activity with, or on behalf of, a resident for five years after the date of the activity. The records are subject to inspection by the DFPI and must be maintained in a form that enables the DFPI to determine whether the licensee is in compliance with applicable requirements.
- 16) Authorizes the DFPI to coordinate or share information with other regulatory organizations, including federal and state agencies and law enforcement.
- 17) Requires a licensee to inform the DFPI of certain material changes in the licensee's business that give rise to regulatory or operational concerns, as specified, including a proposed change in control or a proposed merger or consolidation of the licensee with another person.
 - a) For a proposed change in control or proposed merger or consolidation, the licensee must provide specified information about the proposed control person or the merger plan.
 - b) The DFPI may approve, approve with conditions, or deny the application for change of control or merger or consolidation, as specified.
- 18) Defines "enforcement measures" under the DFAL to include any of the following:
 - a) License suspension or revocation.
 - b) A cease and desist order.
 - c) Requesting a court to appoint a receiver for the assets of a person doing digital financial asset business activity.
 - d) Requesting injunctive relief against a person doing digital financial asset business activity.
 - e) Assessing a penalty, as specified in 21).
 - f) Recovering on the security set forth in x) and initiating a plan to distribute the proceeds for the benefit of a resident injured by a licensee's violation.
 - g) Imposing necessary or appropriate conditions on the conduct of digital financial asset business activity.
 - h) Seeking restitution on behalf of a resident if the DFPI shows economic injury due to a violation of the DFAL.
- 19) Authorizes the DFPI to make an enforcement measure against a licensee or a person who has engaged in, is engaging in, or proposes to engage in unlicensed digital

financial business activity with, or on behalf of, a resident, in specified circumstances, including unsafe, unfair, or deceptive acts or practices, fraud, misappropriation of legal tender or digital financial assets, and, in the case of a licensee, becomes insolvent or makes a material misrepresentation to the DFPI.

- 20) Generally requires the DFPI to take an enforcement measure only after providing notice and an opportunity to be heard; however, if the circumstances require action before notice can be given, DFPI may take action other than assessing a civil penalty and the subject of the action must be provided an expedited postaction hearing.
- 21) Provides that DFPI may assess civil penalties as follows:
 - a) For a person who engages in unlicensed digital financial asset business activity with a resident in violation of the DFLA, the DFPI may assess a civil penalty of up to \$100,000 per day of the violation.
 - b) For a licensee or covered person who materially violates the DFAL, the DFPI may assess a civil penalty of up to \$20,000 per day of the violation.
 - c) The civil penalties accrue until the violation ceases.
- 22) Specifies processes related to enforcement actions, including a person's rights to notice and opportunity for a hearing as appropriate, when a revocation of a license is effective, and when a suspension of a license is effective.
- 23) Authorizes the DFPI to enter into a consent order with a person regarding an enforcement measure, which may provide that it does not constitute an admission of fact by a party.
- 24) Provides that the enforcement mechanisms in the DFAL shall not be construed to provide a private right of action to a resident, except that a resident may bring an action to enforce their rights to recover assets from a licensee who falls into financial trouble while holding the resident's property; and that the duties and obligations in the DFAL are cumulative and do not relieve any party from any duties or obligations imposed under other law.
- 25) Requires a licensee, before engaging in digital financial asset business activity with a resident, to make certain disclosures, as specified, and pursuant to any additional disclosure requirements that the DFPI adopts, and to provide a transaction confirmation, as specified.
- 26) Requires a covered person that has control of a digital financial asset for one or more persons to maintain in its control an amount of each type of digital financial asset sufficient to satisfy the aggregate entitlements of the persons to the type of digital financial asset, and provides criteria for how such digital financial assets must be maintained and how a covered person may comply with this requirement.

- 27) Provides that a covered person who has control of a digital financial asset for another person under 26), those digital financial assets are deemed to be held in trust for the benefit of the other person, even if the assets are comingled with other assets of the covered person, and requires a covered person to at all times own eligible securities, as defined, with an aggregate market value of not less than the aggregate amount of all its outstanding U.S dollar-denominated liabilities owed to its customers.
- 28) Requires a covered exchange, prior to listing or offering a digital financial asset that the covered exchange can exchange on behalf of a resident, to certify that the covered exchange has conducted specified due diligence related to the digital financial asset, including the likelihood the asset would be deemed a security by federal or state regulators, provided a full disclosure relating to conflicts of interests, and conducted a comprehensive risk assessment of the asset, among other things, unless the covered exchange has been approved for listing, on or before January 1, 2023, by the New York Department of Financial Services, as specified.
- 29) Requires a covered exchange to make every effort to execute a resident's request to exchange a digital financial asset in a manner so that the outcome to the resident is as favorable as possible under prevailing market conditions, as specified.
- 30) Prohibits a covered person from exchanging, transferring, or storing a stablecoin unless the issuer of the stablecoin is a licensee, a person that applies for a license, or a bank and the issuer of the stablecoin at all times owns eligible securities that fully back the stablecoin, as specified.
- 31) Defines a "stablecoin" as a digital financial asset that is denominated in U.S. dollars or denominated in or pegged to another national or state currency and is marketed in a manner that intends to establish a reasonable expectation or belief among the general public that the instrument will retain a redemption value that is so stable as to render the value effectively fixed.
- 32) Requires a prospective licensee, prior to seeking approval from DFPI, to create and, during licensure, maintain policies and procedures related to information security, operational security, business continuity, disaster recovery, antifraud, money laundering prevention, terrorist financing prevention, and compliance with applicable laws, as specified.
- 33) Provides that 25)-32) will be effective on January 1, 2024.
- 34) Includes a severability clause.

COMMENTS

1. Author's comment

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.

2. What are digital financial assets?

A digital financial asset is, broadly speaking, 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. Also unlike the dollar, there is no physical manifestation of a digital financial asset that can be possessed in the physical realm; it exists only virtually.

Although there are many types of digital financial assets, there are a few more specific concepts that are often conflated with the broader category. The first is cryptocurrency; while not all digital assets are cryptocurrency, the terms are frequently used interchangeably because cryptocurrencies have received the most widespread attention. Cryptocurrencies are often styled as “coins” (e.g., Bitcoin, Dogecoin) to be used in lieu of fiat currencies for digital transactions. The second general concept is decentralization; “decentralized finance,” or “defi,” refers to the ability to use digital financial assets to conduct transactions without the intermediary of a bank or other third-party firm. The third is distributed ledger technology, the most famous (infamous?) of which is blockchain. Blockchain is a system of recording information on a digital ledger maintained by an online network; the ledger is distributed across the network, making it very difficult to hack or manipulate, and, consistent with the defi principle, prevents gatekeepers from exercising control over transactions.

Although digital financial assets have been marketed as an obvious bet – ads in the 2022 Superbowl portrayed crypto investments as a no-brainer way to make money – a majority of cryptocurrency purchasers have lost money.¹ Moreover, the losses appear to be disproportionately felt by small-dollar investors (derisively referred to as “krill”),

¹ Bank of International Settlements, BIS Bulletin No. 69, Crypto Shocks and Retail Losses (Feb. 20, 2023), p. 1.

who were left holding the bag when the big-money “whales” cashed out when they recognized early signs of trouble.² This is partly due to “crypto’s high price volatility and the lack of productive real-world use cases,”³ which is to say, it remains unclear what crypto is *for*, other than financial speculation. It is also because the lack of regulation surrounding digital financial assets, coupled with pitches from digital asset companies that make them *sound* safe, have led to an environment where unsophisticated investors do not appreciate the true that come with purchasing digital financial investments.⁴

3. Take one: AB 2269

There is no consensus on whether, or how, digital financial assets should be regulated. Gary Gensler, the Chair of the SEC, has taken the position that most cryptocurrency products fall within the SEC’s jurisdiction.⁵ In March 2022, President Biden signed an executive order requiring various federal agencies to report on the effects of digital financial assets on financial markets and to provide policy recommendations on how to protect U.S. consumers, investors, and businesses.⁶ Governor Newsom followed with an executive order issued in May 2022, which instructed DFPI to “engage in a public regulatory approach to crypto assets harmonized with the direction of federal regulations and guidance.”⁷

Shortly after Governor Newsom executed his executive order, two prominent cryptocurrencies collapsed and the crypto market lost approximately \$500 billion in value.⁸ The month after, in June 2022, the Celsius Network – a prominent cryptocurrency lending company and wallet⁹ – declared bankruptcy.¹⁰

June 2022 is also when the Legislature decided it was time for the State to take action on digital financial assets. AB 2269 (Grayson, 2022) would have implemented a Digital Financial Assets Law similar to the one contained in this bill. The Legislature enacted AB 2269, but Governor Newsom vetoed it. His veto message stated:

² *Id.* at pp.2-3.

³ *Id.* at p. 1.

⁴ E.g., Ensign & Au-Yeung, *They Thought ‘Crypto Banks’ Were Safe, and Then Came the Crypto Crash*, Wall Street Journal (Jul. 23, 2023), <https://www.wsj.com/articles/they-thought-crypto-banks-were-safe-and-then-came-the-crash-11658568780>. All links in this analysis are current as of July 7, 2023.

⁵ Sutton, *SEC’s crypto crusade at risk in looming legal battles*, Politico (Jan. 29, 2022), <https://www.politico.com/news/2022/01/29/crypto-industry-lawsuits-sec-00002580>.

⁶ Exec. Order No. 14067, 87 Fed.Reg. 14143 (Mar. 9, 2022).

⁷ Governor’s Exec. Order No. N-9-22 (May 4, 2022).

⁸ Mark, *The companies that helped create 2022’s ‘crypto winter’*, Washington Post (Dec. 5, 2022; updated Dec. 13, 2022), available at <https://www.washingtonpost.com/business/2022/12/05/crypto-ftx-collapse-bankruptcy-companies/>.

⁹ A crypto “wallet” holds the credentials necessary to access the holder’s digital financial assets.

¹⁰ *The companies that helped create 2022’s ‘crypto winter’*, *supra*.

AB 2269 would establish a licensing and regulatory framework, administered by the Department of Financial Protection and Innovation, for digital financial asset activity. Digital assets are becoming increasingly popular in our financial ecosystem, with more consumers buying and selling cryptocurrencies each year. I share the author's intent to protect Californians from potential financial harm while providing clear rules for crypto-businesses operating in this state.

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.¹¹

4. Developments in the digital financial asset world since the veto of AB 2269¹²

In November 2022, FTX – one of the two largest cryptocurrency exchanges at that point – declared bankruptcy.¹³ Federal prosecutors indicted FTX's founder, Samuel

¹¹ Governor's veto message to Assem. on Assem. Bill No. 2269 (Sept. 23, 2022) Recess J. No. 10 (2021-2022 Reg. Sess.) p. 6753.

¹² This section presents a non-exhaustive list of events; for additional information, see the Senate Banking and Financial Institutions Committee's and Assembly Banking and Finance Committee's analyses for this bill.

¹³ E.g., Yaffe-Bellany, *Embattled Crypto Exchange FTX Files for Bankruptcy*, N.Y. Times (Nov. 11, 2022), available at <https://www.nytimes.com/2022/11/11/business/ftx-bankruptcy.html>.

Bankman-Fried (known colloquially as “SBF”) for a range of financial crimes, described as “an alleged wide-ranging scheme by the defendant to misappropriate billions of dollars of customer funds deposited with FTX... and mislead investors and lenders to FTX and to Alameda Research, the cryptocurrency hedge fund also founded by” SBF.¹⁴

In December 2022, the DFPI and three other agencies released the report requested in Governor Newsom’s May 2022 executive order. The report generally suggests that the DFPI’s existing statutory and rulemaking authority – including the authority to “qualify” crypto assets under the California Securities Law of 1968 – would be provide a sufficient regulatory framework for digital financial assets.¹⁵

In January 2023, the Bankruptcy Court in the Celsius Network case ruled that the \$4.2 billion worth of cryptocurrency assets that Celsius Network had been holding on behalf of customers were assets of the bankruptcy estate, not the people who had entrusted Celsius Network with their property.¹⁶ The court determined that, in the absence of any existing regulation protecting customers’ crypto accounts, Celsius Network’s terms of service governed the terms of the contract; Celsius Network’s clickwrap Terms of Use transferred customers’ ownership of cryptocurrency assets held in Celsius, so the customers were out of luck.¹⁷ This is far from the only time consumers lost out when digital financial assets firms collapsed under the weight of their overly ambitious promises.¹⁸

At the beginning of June 2023, the SEC filed two crypto-related securities fraud lawsuits in two days. The first lawsuit was filed against Binance – the largest cryptocurrency left standing after FTX’s bankruptcy – and alleged that Binance had engaged in a slew of federal law violations, including offering securities market functions without registering with the SEC, impermissibly comingling customer funds with those of companies owned by Binance’s founder, and engaging in an elaborate scheme to avoid U.S. regulators.¹⁹ The following day, the SEC filed a lawsuit against Coinbase, yet

¹⁴ United States Attorney’s Office, Southern District of New York, Press Release: United States Attorney Announces Charges Against FTX Founder Samuel Bankman-Fried (Dec. 13, 2022), <https://www.justice.gov/usao-sdny/pr/united-states-attorney-announces-charges-against-ftx-founder-samuel-bankman-fried>.

¹⁵ See Governor’s Office of Business and Economic Development, et al., *Towards Responsible Innovation: An Interagency Web3, Crypto Asset, and Blockchain Progress Report to the Governor of California* (Dec. 2022), pp. 19-20.

¹⁶ *In re Celsius Network* (Bankr. S.D.N.Y. 2023) 647 B.R. 631, 660.

¹⁷ *Id.* at p. 658.

¹⁸ Voyager Digital Holdings, a cryptocurrency broker, declared bankruptcy in 2022; the liquidation plan approved by the Bankruptcy Court will return to consumers about 36 percent of the value of their claims against the firm. (Randles, *Failed Crypto Broker Voyager Digital Cleared to Start Repaying Customers’ Frozen Funds*, Bloomberg (May 17, 2023), <https://www.bloomberg.com/news/articles/2023-05-17/voyager-cleared-to-liquidate-start-repaying-customers-crypto>).

¹⁹ See *SEC v. Binance Holdings Limited, et al.*, Complaint, Case No. 1:2-cv-01599 (S.D.N.Y., Jun. 5, 2023), pp. 2-5.

another cryptocurrency exchange platform, alleging that it had been operating as an unregistered broker since 2019.²⁰

Both SEC complaints highlighted the SEC's position that many, if not most, digital assets financial assets ought to be categorized as securities. Supreme Court case law establishes that parties have entered into an "investment contract" covered by the Securities Act when the contract, transaction or scheme is one "whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promotor or a third party."²¹ Since so few digital financial assets involve more than consumers buying and selling the assets in hopes that they will become more valuable over time, it seems probable that the SEC could end up with jurisdiction over a significant portion of the digital financial asset market. Or, in the alleged words of Binance's COO, "we are operating as a fcking [sic] unlicensed securities exchange in the USA bro."²²

The analysis of the Senate Banking and Financial Institutions Committee, which is incorporated herein by reference, addresses these events in greater detail and discusses additional examples of crypto businesses found to be insolvent.

5. Take two: AB 39

This bill is similar to AB 2269, except that the author has made targeted changes to improve on AB 2269 in response to feedback from stakeholder and, most recently, the Senate Banking and Financial Institutions Committee. The overall structure and purpose of the bill – to provide a workable licensing and oversight framework for digital financial asset business activity in the State – remain unchanged. As highlighted by the author, key changes include:

- Under AB 39, consumer protections (but not the licensing framework) take effect January 1, 2024; under AB 2269, consumer protections would not have taken effect until 2025.
- AB 39 provides conditional licensing for entities that have already obtained a license under New York's digital asset licensing regime, which AB 2269 did not do.
- This bill allows exchanges to self-certify that their digital financial assets meet certain standards, whereas AB 2269 imposed a "best interest" standard on exchanges.
- AB 39 requires licensees to have live customer service available 10 hours per day, 5 days a week; AB 2269 required live customer service 24 hours per day, 7 days a week.

²⁰ See *SEC v. Coinbase, Inc. and Coinbase Global, Inc.*, Complaint, Case No. 1:23-cv-04738 (S.D.N.Y., Jun. 6, 2023), p. 2.

²¹ *SEC v. Howey* (1946) 328 U.S. 293, 298-299.

²² *SEC v. Binance Holdings Limited, et al.*, Complaint, *supra*, at p. 29.

- Under AB 39, stablecoins must be fully backed by reserves; AB 2269 imposed the same requirement on stablecoins, but only until January 1, 2028.

The overarching issue of whether, and how, to regulate digital financial asset transactions was covered by the Senate Banking and Financial Institutions Committee.²³ This analysis, therefore, focuses on a few specific issues that fall within this Committee’s jurisdiction.

a. Federal preemption

Although digital financial assets have existed for nearly 15 years,²⁴ there is still no consensus on whether, how, or by whom they should be regulated. This may be partly because there is no consensus on what digital financial assets are for – are they simply a means of storing value online? An investment? A means of evading existing financial regulations? A great tool for crime? It’s still hard to say. At the federal level, both the SEC and Commodities Future Trading Commission have asserted jurisdiction; and states, including this one, have indicated that digital financial assets may be properly regulated by state governments.

To the extent that digital financial assets are covered by existing financial regulations – such as securities laws – the Supremacy Clause would prevent the state from implementing an overlapping or contradictory regulatory scheme.²⁵ To that end, this bill includes a range of exemptions for digital financial asset activity that is already covered by federal law, for example, exempting from the definition of “digital financial asset” a security registered or exempt from registration with the SEC and exempting broker-dealers registered with the SEC or under state securities laws. Accordingly, this bill gives digital financial assets businesses the option of regulation under state or federal laws, but it does not allow them to evade regulation entirely.

b. Consumer protection

As set forth in Parts 2-4 of this analysis, consumers – particularly individuals – have been hit hard by crypto losses, often due to the gap between the hype surrounding

²³ Certain non-fungible token (NFT) companies have expressed concern that non-financial NFT products, such as digital baseball cards, will fall within the ambit of this bill. This appears unlikely because the bill specifically regulates *financial* assets, not all financial assets, and the definition of “digital financial asset” is clearly limited to products that are used as a medium of exchange, unit of account, or store of value. The stakeholders also note that Wyoming’s digital assets law has a carve-out for “digital consumer assets,” but the Wyoming’s law applies to *all* digital assets, not just digital financial assets. (Wy. Stat. § 34-29-101.) Moreover, to the extent that a truly consumer-focused NFT were inadvertently swept into the bill’s scope, the bill grants the DFPI the authority to exempt the NFT from regulation.

²⁴ Bitcoin, the first cryptocurrency, launched in 2009. (Pinkerton, *The History of Bitcoin, the First Cryptocurrency*, U.S. News & World Report (May 10, 2023),

<https://money.usnews.com/investing/articles/the-history-of-bitcoin>.

²⁵ U.S. Const., art. VI, cl. 2.

cryptocurrencies and the actual degree of risk involved. The regulatory scheme set forth in this bill is intended to give DFPI the power to ensure that players in the digital financial asset space are sufficiently safe and sound before they can offer services to Californians. To be sure, the bill will not protect people from themselves when it comes to risky bets; if a consumer is hell-bent on using their life savings to buy up the latest memecoin, they can still do so. But the bill will prevent fly-by-night exchanges from operating in the state, ensure that digital financial asset businesses retain adequate capital to cover their liabilities, and give the DFPI the ability to prevent bad actors from continuing to operate.

c. Enforcement

AB 39 gives DFPI the exclusive right to enforce the Digital Financial Assets Law, and expressly states that there is no private right of action to enforce the bill's requirements; however, that a resident may enforce their rights if a covered digital financial asset business fails to maintain adequate capital to allow a resident to retrieve their assets stored with the business. The bill also clarifies that AB 39's duties and obligations are cumulative, so to the extent that a digital financial asset business violates other laws that provide a private right of action, a consumer may still proceed with a lawsuit under those laws. The DFPI's enforcement tools include licensure suspension or revocation, seeking injunctive relief or a cease-and-desist order from the court, and seeking civil penalties and restitution on behalf of residents. As discussed further below, the author has agreed to a minor amendment to clarify the scope of the DFPI's authority to seek enforcement action to prevent a violation from occurring.

6. Amendments

As currently in print, AB 39 authorizes the DFPI to take an enforcement action against a licensee or unlicensed person who has engaged, is engaging, or proposed to engage in violations of the bill or engage in other deceptive, unfair, or unsound business practices arising from digital financial asset business activity. In order to clarify that the DFPI's authority to take action to prevent violations or other actions that have yet to occur is limited to imminent violations or other prohibited conduct, the author has agreed to replace the phrase "proposes to engage" with "is about to engage" in Section 4 of the bill.

7. Arguments in support

According to the Consumer Federation of California, the bill's sponsor:

Digital financial assets, including cryptocurrencies and crypto exchanges, have exponentially grown over the past few years without proper regulation or consumer protections. This has directly led to massive scams, so-called "rug pulls" where asset prices are manipulated, investment-related frauds, and

substantial losses that significantly target low-and-moderate income communities and communities of color. Overall evaluation of the crypto market went from approximately \$3 trillion before crashing down to less than \$1 trillion in less than a year.

In November of last year, FTX, one of the largest global cryptocurrency trading and exchange companies, filed for bankruptcy with a debt of about \$8 billion to clients. FTX's founder, 30-year-old Sam Bankman-Fried, was arrested and is facing a myriad of federal charges alleging that FTX was a fraudulent endeavor for most of its existence. With other crypto-related companies such as Celsius and Genesis also filing for bankruptcy, tens of thousands of investors have been locked out of their accounts and will be lucky to see pennies on the dollar.

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.

8. Arguments in opposition

According to the Crypto Council for Innovation:

Burdensome and expensive compliance requirements, including complex reporting criteria for covered exchanges and short turnaround times go beyond what is traditionally expected of financial services institutions, including by the NY virtual currency licensing regime...All application, reporting, disclosure, and recordkeeping requirements should be also limited to information pertaining to licensed digital financial asset business activity.

We urge the legislature to preserve the state's competitive edge by continuing to foster innovation. In this regard, CCI applauds the author for including an exemption for smaller digital financial asset business activity. We encourage the legislature to increase this exemption to \$2,000,000 to accommodate early stage digital asset startups. The legislature should also consider expanding its conditional licensing approach to allow reciprocity for entities licensed or chartered under the New York virtual currency licensing regime.

Lastly, the proposed ban on algorithmic stablecoins unnecessarily paints all algorithmic stablecoins with a broad brush and ignores the complexity in this

space. Risks posed by these stablecoins are better attributed to the design of their collateralization than their use of algorithms. Transparent standards in this regard could eliminate the risk of systemic harm without hindering innovation. A blanket ban on stablecoins may also result in other unintended consequences, such as disrupting financial markets and causing significant user losses.

SUPPORT

Consumer Federation of California (sponsor)
California Bankers Association
California Credit Union League
California Low-Income Consumer Coalition
CAMEO
Consumer Reports
Consumers for Auto Reliability
Digital Currency Traders Alliance
Los Angeles Democratic Party
Oakland Privacy

OPPOSITION

Crypto Council for Innovation

RELATED LEGISLATION

Pending legislation:

SB 95 (Roth, 2023) makes changes to the California Uniform Commercial Code, including adopting a division relating to digital financial assets (known as “controllable electronic records” in the bill. SB 95 is pending on the Assembly Floor.

AB 1336 (Low, 2023) requires an NFT marketplace, as defined, to make specified disclosures to users at the time of a transaction. AB 1336 is pending before the Assembly Banking and Finance Committee.

Prior legislation:

AB 2269 (Grayson, 2022) was similar to this bill and would have implemented a regulatory and licensing regime for specified digital financial asset business activities administered by the Department of Financial Protection and Innovation (DFPI), to take effect January 1, 2024. AB 2269 was vetoed by the Governor, who stated in his veto message that it was premature to implement a licensing structure for digital financial

asset activity in statute in light of work being conducted by the executive branch and by the federal government.

AB 1489 (Calderon, 2019) would have enacted the Uniform Regulation of Virtual Currency Businesses Act, which would have implemented a cryptocurrency regulation scheme under the then-DBO; the bill included some of the same measures as AB 2269, but there were significant differences between the two bills. AB 1489 died in the Assembly Banking and Finance Committee.

PRIOR VOTES:

Senate Banking and Financial Institutions Committee (Ayes 6, Noes 0)

Assembly Floor (Ayes 70, Noes 1)

Assembly Appropriations Committee (Ayes 11, Noes 0)

Assembly Banking and Finance Committee (Ayes 11, Noes 0)
