
SENATE COMMITTEE ON APPROPRIATIONS

Senator Anthony Portantino, Chair
2023 - 2024 Regular Session

AB 39 (Grayson) - Digital financial asset businesses: regulatory oversight

Version: July 13, 2023

Urgency: No

Hearing Date: August 21, 2023

Policy Vote: B. & F.I. 6 - 0, JUD. 10 - 0

Mandate: No

Consultant: Janelle Miyashiro

Bill Summary: AB 39 establishes a licensing and regulatory framework, administered by the Department of Financial Protection and Innovation (DFPI), for digital financial asset business activity, as specified.

Fiscal Impact: Unknown, significant one-time and ongoing costs likely in the tens of millions of dollars for DFPI to stand-up and maintain the new licensing program for digital financial asset business activity. Costs to establish program would include equipment, software, other IT operating expenses, and workload related to promulgating regulations and training for DFPI staff. Ongoing costs would include additional staffing resources to conduct licensing, examination, investigation, and enforcement activities. Given the size and complexity of the proposed program, DFPI will likely need specialized staff with technical expertise to support its operations.

Generally, when DFPI establishes a new regulatory program it will cover those start-up costs through the Financial Protection Fund. Once the program is fully operational, the DFPI will recoup those costs through that program's licensing fees. However, given the scope of the program proposed in this bill, DFPI will likely require General Fund support until the program is able to collect adequate fee revenue to support its administrative and enforcement operations.

Background: This bill is similar to AB 2269 (Grayson, 2022) which proposed a licensing law for digital financial asset businesses that would be administered by DFPI. Governor Newsome vetoed AB 2269, stating in his veto message:

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.

While similar to AB 2269, the bills are not identical. 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.

Proposed Law:

- Establishes the Digital Financial Assets Law (DFAL).
- Defines relevant terms for the DFAL, including the following:
 - “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:
 - 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.
 - 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.
 - 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.
 - “Digital financial asset business activity” means any of the following:
 - 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.
 - 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.
 - 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.
 - “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 creditor, 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.
- 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:
 - Various governmental entities.
 - Banks and financial institutions regulated federally, internationally, or under other State laws.
 - Persons providing connectivity software or similar assistance to a business engaged in digital financial asset business activity.
 - 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.
 - Entities and persons governed by specified federal commodities and securities laws.
- 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.
- 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:
 - The person is licensed under the DFAL.
 - The person has submitted an application for a license under the DFAL and is awaiting approval or denial of the application.
 - The person is otherwise exempt from licensure under the DFAL.
- 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).

- Authorizes the DFPI to approve, conditionally approve, or deny an application, as specified.
- 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.
 - Additionally requires 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.
- 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.
- Provides procedures by which a licensee may apply for renewal of a license on an annual basis.
- Provides that a DFAL license is not transferable or assignable.
- 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.
- 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.
- 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.
- Authorizes the DFPI to coordinate or share information with other regulatory organizations, including federal and state agencies and law enforcement.
- 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. Authorizes DFPI to approve, approve with conditions, or deny the application for change of control or merger or consolidation, as specified.

- Authorizes the DFPI to make an enforcement measure, as defined, against a licensee or a person who has engaged in, is engaging in, or is about 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.
 - 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.
- Provides that DFPI may assess civil penalties as follows:
 - 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.
 - 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.
 - The civil penalties accrue until the violation ceases.
- 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.
- Authorizes the DPFI 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.
- 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.
- 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.
- 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.
 - Provides that a covered person who has control of a digital financial asset for another person, 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.

- 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.
- 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.
- 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.
- 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.
- 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.
- Includes a severability clause.

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