CONCURRENCE IN SENATE AMENDMENTS
AB 39 (Grayson)
As Amended September 8, 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.

Senate Amendments

1) Delay the operative date of the licensure requirement and other specified requirements to July 1, 2025.

2) Authorize the commissioner to approve stablecoins that do not comply with specified rules.

3) Authorize the commissioner to exempt, by regulation or order, any person or transaction if the commissioner finds such action to be in the public interest and that the regulation of such persons is not necessary.

4) Clarify an exemption for entities or futures commission merchant, swap dealer, or introducing broker registered under the federal Commodity Exchange Act.

5) Replace the license renewal reapplication process with an annual report and fee based on a licensee's or conditional licensee's pro rata cost share, as specified.

6) Clarify the fingerprinting submission process.

7) Specify in "best execution" requirements that a covered exchange must, at least once every six months, review aggregated trading records or residents against benchmarks to determine execution quality, investigate the causes of any variance, and promptly take action to remedy any issued identified.

8) Add contingent enactment language providing that this bill will become operative only if SB 401 (Limón) of the current legislative session is also enacted.

9) Make other clarifying and technical changes.

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
Crypto Council for Innovation (CCI), an association whose members include Andreessen Horowitz, Block, Coinbase, Electric Capital, Fidelity Digital Assets, Gemini, OpenSea, Paradigm, and Ribbit Capital, writes in an "oppose unless amended" position:

"CCI is grateful for the progress the Committee has made in addressing industry concerns following Governor Newsom's veto of AB 2269, including the expedited licensing pathway for businesses operating in compliance with New York's virtual currency business activity regulations and the exemption for smaller digital asset businesses…

CCI continues with requests for various amendments, some of which have been incorporated by the author in the current version of the bill and some of which are reflected in proposed amendments in the subsequent comment. Outstanding items of concern for CCI include, but are not limited to, the requirement that stablecoins are fully backed by high-quality assets, a desire for an entities-based exemption for entities registered with the Commodities Futures Trading Commission, an increase in the exemption threshold for small companies to $2 million of business activity, and a desire for more concrete application and review timelines."

FISCAL COMMENTS

According to the Senate Appropriations Committee, DFPI reports costs of approximately $14.0 million in year one, $17.0 million in year two, and $21.2 million in year three and ongoing for a multi-year build-up of the program and for continued administration and enforcement workload (Financial Protection Fund). Costs to establish the 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.

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, fines, penalties, settlements, or judgements. DFPI does not anticipate the need for additional General Fund support, and will likely be able to cover its administrative costs through the Financial Protection Fund until the program is able to collect adequate fee revenue to support this program's operations.

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

ASSEMBLY FLOOR: 70-1-9
YES: Addis, Alanis, Alvarez, Arambula, Bains, Bauer-Kahan, Bennett, Berman, Boerner, Bonta, Bryan, Calderon, Juan Carrillo, Wendy Carrillo, Cervantes, Chen, Connolly, Davies, Mike Fong, Friedman, Gabriel, Gallagher, Garcia, Gipson, Grayson, Haney, Hart, Holden, Irwin, Jackson, Jones-Sawyer, Kalra, Lackey, Lee, Low, Lowenthal, Maienschein, McCarty, McKinnor, Muratsuchi, Stephanie Nguyen, Ortega, Pacheco, Jim Patterson, Pellerin, Petrie-Norris, Quirk-Silva, Ramos, Reyes, Luz Rivas, Robert Rivas, Rodriguez, Blanca Rubio, Sanchez, Santiago, Schiavo, Soria, Ta, Ting, Valencia, Villapudua, Waldron, Wallis, Ward, Weber, Wicks, Wilson, Wood, Zbur, Rendon
NO: Dixon
ABS, ABST OR NV: Aguiar-Curry, Megan Dahle, Essayli, Flora, Vince Fong, Hoover, Mathis, Papan, Joe Patterson

UPDATED

VERSION: September 8, 2023

CONSULTANT: Luke Reidenbach / B. & F. / (916) 319-3081 FN: 0002419