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By Email (regulations@dfpi.ca.gov)
Department of Financial Protection and Innovation

Re: Invitation for Comments – Crypto Asset-Related Financial Products and Services

To Whom It May Concern:

We submit the following comments in response to Governor Gavin Newsom's Executive Order N-9-22, which directs the Department of Financial Protection and Innovation (DFPI) to solicit comments on the regulation of crypto asset-related financial products and services under a new state law, the California Consumer Financial Protection Law (CCFPL).[1]

Until the enactment of the CCFPL, innovative businesses utilizing digital assets and new payment platforms were primarily governed in California by two existing California laws: the Corporate Securities Law of 1968[2] and California's Money Transmission Act.[3] As discussed below, the application of these two state laws to crypto asset-related businesses has largely been preempted or superseded by active federal regulation of crypto businesses. Preemption of these state laws mitigated the unintended inefficiencies caused by varying state laws. The resulting uniform application of federal law in the areas of securities and money transmission regulation has facilitated capital formation and innovative payment platforms and technologies.

The new expansive CCFPL, however, represents an opportunity for the DFPI to take a much greater role in regulating the crypto asset-related industry. To what extent should the DFPI exercise its new authority over crypto asset-related financial products and services?

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[1] Assem. Bill No. 1864 (2019-2020 Reg. Sess.) §§ 4, 7; see generally Fin. Code, § 90000 et seq.

[2] Cal. Corp. Code § 25000, et seq.

[3] Cal. Fin. Code § 2000, et seq.

In summary, we believe there exist two contrasting state regulatory approaches to the regulation of digital assets and crypto currencies: a comprehensive state regulatory regime (e.g., New York) and a measured coordinated federal and state approach (e.g., Wyoming). We discuss below the current federal regulatory response to regulating the nascent crypto asset-related industry, and we respectfully submit that the coordinated approach adopted by Wyoming will result in an appropriate balance between consumer protection and innovation.[4]

The California Consumer Protection Law and the Governor's Executive Order

On May 4, 2022, Governor Gavin Newsom issued Executive Order N-9-22 to foster responsible innovation, bolster California's innovation economy, and protect consumers. The Executive Order seeks to create a transparent regulatory and business environment for crypto assets, *web3* companies, and blockchain and related financial technologies that harmonizes federal and California approaches, balances the benefits and risks to consumers, and incorporates California values, such as equity, inclusivity, and environmental protection. Specifically, the Executive Order states,

> *"…In anticipation of a harmonized state-federal crypto asset framework, DFPI shall exercise its authority under the California Consumer Financial Protection Law (CCFPL) to develop guidance and, as appropriate, regulatory clarity and supervision of private entities offering crypto asset-related financial products and services ("Companies") in California, in conjunction with input from California stakeholders. In doing so, DFPI shall prioritize the dual goals of California remaining the premiere global location for responsible crypto asset companies to start and grow and ensuring that California values of inclusive innovation and equity-focused consumer protection are core components of the products and services that these Companies offer to the public."*

Under the Executive Order the DFPI may proceed with rulemaking under the authority of the recently enacted CCFPL. The CCFPL, which became effective on January 1, 2021, reorganized the Department of Business Oversight (DBO), renamed it the DFPI, and gave the DFPI sweeping new expanded authority and powers to regulate providers of consumer financial services. Among other provisions, the CCFPL authorizes the DFPI to define unfair, deceptive,

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[4] The authors have practiced securities law in California for a combined six decades, including serving as regulatory attorneys with the U.S. Securities and Exchange Commission for a combined fifteen years. Their varied private practices include representing well-capitalized public and private companies to startups, and their officers and directors.

Mr. Hiraide is a partner in the law firm of Mitchell Silberberg & Knupp LLP, and he is the author of California's blue-sky exemption for seed capital securities offerings (AB 511, effective Jan 1, 2022).

Mr. Morgan is a partner in the law firm of Paul Hastings LLP, and he is the co-founder and President of ICAN (Investor Choice Advocates Network), a non-profit founded to increase opportunities for everyday investors and entrepreneurs.

The opinions expressed herein may not reflect the views of the authors' respective firms or the clients of their firms.

and abusive acts and practices (UDAAP) in connection with the offering or provision of commercial financing or other financial products to small businesses, nonprofits, and family farms.[5] The new law also clarified DFPI's authority to enforce provisions of the federal Dodd-Frank Wall Street Consumer Financial Protection Act of 2010 over existing licensees, to protect consumers from unlawful, unfair, deceptive, or abusive acts or practices, and to expand DFPI's jurisdiction to cover currently unlicensed persons that offer or provide consumer financial products and services in California.[6]

Sometimes referred to as a state version of the federal Consumer Financial Protection Bureau or "mini-CFPB," the CCFPL confers on the DFPI powers similar to those granted to the federal Consumer Financial Protection Bureau under the Dodd-Frank Act, including regulatory authority over "any person that engages in the offering or providing of a consumer financial product or service to a California resident." On June 24, 2022, the DFPI issued proposed regulations under the CCFPL that would expand its UDAAP authority to covered providers of commercial financing to small businesses and other entities and impose annual reporting requirements on covered providers.[7]

State and Federal Regulation of Securities Laws

Before Congress first enacted federal laws regulating the offer and sales of securities in 1933, between 1911 and 1931, 47 of the 48 states had adopted statutes that regulated the sale of securities. They are known as "blue-sky" laws.[8] In deciding to federally regulate securities, Congress provided for both federal and state securities regulation specifically preserving blue-sky laws.

Although the National Conference of Commissioners on Uniform State Laws and the American Bar Association have attempted over the years to promote uniformity among state blue-sky laws, a number of states, including California, have chosen not to adopt the 1956 Uniform Securities Act nor, more recently, the Uniform Securities Act of 2002.[9]

In 1994, Congress began a broad reexamination of the dual system of securities regulation, which culminated in the enactment of the National Securities Markets Improvement Act of 1996 (NSMIA). As was explained in the Act's conference report:

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[5] Cal. Fin. Code § 90009, subd. (e).

[6] Senate Floor Analysis (Aug. 31, 2020).

[7] On June 9, 2022, the California Office of Administrative Law also approved the DFPI's final regulations implementing California's Commercial Financing Disclosure Law (SB 1235), which requires disclosures of key terms in connection with certain non-bank commercial financing offers of $500,000 or less.

[8] Paul G. Mahoney, The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses, 46 J.L. & Econ. 229 (2003).

[9] Louis Loss, (late), Joel Seligman & Troy Paredes, Securities Regulation 1.B.2 (6th Edition 2018).

> *"[T]he system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation. Securities offerings and the brokers and dealers engaged in securities transactions are all currently subject to a dual system of regulation that, in many instances, is redundant, costly, and ineffective."*
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> *"During the course of consideration of this legislation, the Congress received testimony indicating that this duplicative regulation tends to raise the cost of capital to American issuers of securities without providing commensurate protection to investors or to our markets. Testimony also indicated that technological change has transformed the capital raising process, necessitating changes in the regulatory scheme to facilitate the flow of information to potential investors and reduce the marginal costs of capital to firms. The Managers have sought to eliminate duplicative and unnecessary regulatory burdens while preserving important investor protections by reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion between the Federal government and the states."*[10]

Even in the early 1990s, when the internet was just coming online, it was clear to Congress that localized laws and enforcement, once effective in regulating face-to-face campaigns, were increasingly ineffective in protecting citizens from mail-order selling efforts operating across state lines.

Among other areas of preemption, NSMIA preempted blue-sky state securities law in the securities offering and shareholder reporting areas. NSMIA also added what is now §15(i)(1) to the Securities Exchange Act of 1934 to preempt state law from "[establishing] capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under [the Securities Exchange Act]." However, NSMIA preserved states' rights "to investigate and bring enforcement actions … with respect to fraud or deceit, or unlawful conduct by a broker or dealer … in connection with securities or securities transactions."[11]

NSMIA dramatically altered the practice of securities law and the legal costs to clients of conducting interstate securities offerings. Prior to NSMIA, securities lawyers were required to conduct surveys of all 50 state blue-sky securities laws and prepare memoranda addressing the legality of an interstate offering in each state.

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[10] Conference Report on National Securities Markets Improvement Act of 1996, H.R. 104-864, 104th Cong., 2d Sess., 1996–1997 Fed. Sec. L. Rep. (CCH) ¶85,847 at 88,650 (1996).

[11] 15 U.S.C. § 77r(c)(l).

State and Federal Regulation of Money Transmission Laws

Money transmitters began operating in the late 19th century when money was transmitted by telegram. Federal regulation of money transmitters focuses on money laundering (e.g., the Bank Secrecy Act (BSA; P.L. 91-508), some consumer protection (e.g., the Consumer Financial Protection Bureau's (CFPB), and remittances under the Electronic Fund Transfer Act (EFTA; P.L. 95-630)). Money transmitters otherwise are regulated and licensed at the state level.

DFPI's Money Transmitter Division licenses and regulates money transmitters under California's Money Transmission Act. Many state regulators assert expansive and almost unconstrained definitions under these statutes to regulate startups and new businesses offering innovative payment technology platforms. Consequently, state money transmission statutes, which were designed to regulate businesses like Western Union, are often applied expansively to most platforms that accept and disburse money for sales, payment processors who facilitate consumer transactions, and many innovative payment startups.[12]

State regulators interpret jurisdiction under state money transmission laws broadly. California considers a person to be engaging in money transmission "in California" if her business is "physically located in California" or she is transacting "with, to, or from persons located in California." Cal. Fin. Code § 2003(k). State exemptions from money transmission laws vary considerably making it difficult for startups that contemplate transmitting new forms of "money" to serve a nationwide market. Id.

In an effort to clarify grey areas in the applicability of California's money transmission laws to modern payment platforms, in 2014, the California Legislature amended the money transmission law to exempt agents of the payee from the law.[13] Agents of a payee are persons who collect and process payments from a payor to a payee on behalf of a payee. The author of the amendment described it as, "California's legal framework for the growing payments world and potentially developments in crypto-currency."[14]

The DFPI's Money Transmitter Division publishes select Financial Institutions Law Final Opinions Letters interpreting the agents of payee exemption.[15] Although the letters represent the Division's position in the context of the specific facts presented in the letter, the DFPI selects letters for publication because they are generally reliable as an indication how the Division may interpret the law.[16] We commend the DFPI for its publication of the Legal Precedent System

[12] Benjamin Lo, Fatal Fragments: The Effect of Money Transmission Regulation on Payments Innovation, 18 Yale J.L. & Tech. 111 (2016).

[13] See Assem. Bill 2209: Money Transmission Act §3(l), 2013-2014 Reg. Sess. (Cal. 2014).

[14] Assem. Committee on Banking and Financing Floor Analysis (April 28, 2014)

[15] https://dfpi.ca.gov/dfi-opinion-letters/

[16] https://dfpi.ca.gov/dfi-legal-precedent-system/

under the Financial Institutions Law. We encourage the DFPI to interpret the Money Transmitter Act, and the DFPI's recently promulgated final rules relating to the scope of the agent of a payee exemption, broadly as the legislature intended.[17]

Coordination with Federal Regulation

A clear mandate of the Executive Order for California state agencies is to harmonize state regulation and rule making with federal regulations and guidance. While the Governor's Executive Order recognizes the expansive regulatory authority conferred on the DFPI by the CCFPL to protect consumers and respond more quickly to emerging trends, the Executive Order further recognizes that consumers and responsible financial technology businesses are best served by a consistent regulatory approach harmonized between federal and state authorities.

In our dual federal and state regulatory system, except in the area of state blue-sky securities regulation – largely preempted by NSMIA, the activities relating to the issuance and trading of cryptocurrencies are subject to federal and a myriad of state laws governing the same activity. The confusing regulatory landscape today relating to cryptocurrency and digital securities is not unlike the period leading up to the early 1990s, when Congress concluded that the system of federal and state securities regulation resulted in duplicative and unnecessary regulations and, as a result, preempted most state blue-sky laws.

Federal Regulation

Digital or virtual currency is an electronic medium of exchange with characteristics that may subject it to multiple federal laws. Money transmitters may be subject to regulation by the Financial Crimes Enforcement Network (FinCEN) under the Bank Secrecy Act (BSA).[18] Nonbank financial lenders may be subject to federal unfair, deceptive, or abusive acts or practices (UDAP),[19] consumer protection laws, fair lending laws, and the BSA. Issuers of securities are subject to federal securities laws, and issuers of commodities are subject to federal commodities laws. Digital securities businesses are potentially subject to federal regulation by one or more federal agencies - the Department of Treasury, the Consumer Financial Protection Bureau, the Federal Trade Commission, the Securities and Exchange Commission and the Commodities Futures Trading Commission.

To say the federal government has occupied (and will continue to occupy) the field of cryptocurrency regulation would be a significant understatement. Activity has been formidable in both the Executive and Legislative branches.

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[17] For a discussion of the legislative history of agent of payee exemption and AB 2209, see letter by Electronic Transactions Association to Commissioner Jan Lynn Owen (April 9, 2018) [https://dfpi.ca.gov/wp-content/uploads/sites/337/2019/05/PRO-07-17-Electronic-Transactions-Association.pdf]]

[18] See 31 U.S.C. §310 (2012).

[19] See 12 U.S.C. § 5531 (2012).

The Executive Branch Regulates Much of the Digital Asset Landscape

Since at least 2013, federal government agencies including the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Financial Crimes Enforcement Network have firmly asserted their jurisdiction in the digital asset industry—so firmly in some cases that disputes have arisen as to *which* federal regulatory body governs which aspect of the industry. But never have the federal agencies left any room for doubt that the federal government asserts all-encompassing responsibility for most of the digital asset landscape.

In addition to the dozens of federal regulatory enforcement actions over nearly the last decade, the SEC, CFTC, and FinCEN have made the breadth of their jurisdictional intentions clear in numerous pronouncements, including among many others:

- March 18, 2013, FinCEN, "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies."
- September 17, 2015, CFTC finds that bitcoin and other virtual currencies are properly defined as commodities.
- July 25, 2017, SEC DAO Report, "U.S. Securities Laws May Apply to Offers, Sales, and Trading of Interests in Virtual Organizations."
- October 17, 2017, CFTC Primer on Virtual Currencies, noting "Virtual Currencies are Commodities."
- April 3, 2019, SEC Framework for "Investment Contract Analysis of Digital Assets."
- May 9, 2019, FinCEN guidance applying "FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies."
- June 24, 2020, CFTC Interpretive Guidance and Policy Statement Regarding Retail Commodity Transactions Involving Certain Digital Assets.
- December 18, 2020, FinCEN proposed rules for certain transactions involving convertible virtual currency or digital assets with legal tender status.
- March 31, 2022, SEC Staff Accounting Bulletin No. 121, providing interpretive guidance for entities to consider when they have obligations to safeguard crypto-assets held for their platform users.

In light of this long, and comprehensive history of federal regulatory activity, it came as no surprise that in March of this year President Biden issued an Executive Order on Ensuring Responsible Development of Digital Assets. The Order lays out a national policy for digital assets across six key priorities: consumer and investor protection; financial stability; illicit

finance; U.S. leadership in the global financial system and economic competitiveness; financial inclusion; and responsible innovation. The Order listed no fewer than 20 federal, executive branch agencies and offices coordinating on digital assets.

The Executive Branch focus on this subject will continue with the passage of the CHIPS Act of 2022, which directs the Director of the Office of Science and Technology Policy to "establish or designate a blockchain and cryptocurrencies advisory specialist position with the Office to coordinate Federal activities and advise the President on matters of research and development relating to blockchain, cryptocurrencies, and distributed ledger technologies."

Pending Federal Legislation May Increase Federal Regulatory Reach

Among other legislative efforts in process are the following bipartisan proposals that may increase the federal government's involvement in cryptocurrency regulation:

- Digital Commodity Exchange Act of 2022 (H.R. 7614—introduced April 2022), sponsored by Representatives Glenn Thompson (R-Pa), Ro Khanna (D-Calif.), Tom Emmer (R-Minn.); and Darren Soto (D-Fla.), would give the CFTC power to directly regulate digital assets that are commodities and would make it optional for exchanges to register with the CFTC but offer benefits to those that do.

- Lummis-Gillibrand Responsible Financial Innovation Act (S. 4356—introduced June 2022), sponsored by Senators Cynthia Lummis (R.-Wyo.) and Kirsten Gillibrand (D-N.Y.), would establish sweeping rules for the crypto industry broadly covering topics as diverse as stablecoin regulation and delineating which agencies have jurisdiction over particular digital assets.

- Digital Commodities Consumer Protection Act of 2022 (introduced August 2022), sponsored by Senators Debbie Stabenow (D-Mich.), John Boozman (R-Ark.), Cory Booker (D-N.J.), and John Thune (R-S.D.), would give the CFTC exclusive jurisdiction over digital assets that are commodities and would require registration for certain platforms and associated persons as well as directing the study of demographics of consumers and energy consumption.

- House Financial Services Committee stablecoin legislation (not yet released), sponsored by Representatives Maxine Waters (D-Cal.) and Patrick McHenry (R-N.C.), would set guardrails for stablecoins.

California Should Work With, Not Against, Federal Preemption to Promote Local Innovation

Against this backdrop of federal regulatory activity in the cryptocurrency space, two contrasting state regulatory approaches standout: The 2015 New York BitLicense approach—requiring covered entities to obtain a special license to operate and subjecting those entities to comprehensive regulatory oversight—and the Wyoming approach—decreasing regulatory

obligations in areas widely recognized to be within state jurisdiction. See Bender, John T. (2022) "State Crypto Regulation: Competing Priorities Shaping Different Outcomes," Seattle Journal of Technology, Environmental & Innovation Law: Vol. 12: Iss. 2, Article 1.

The New York approach, broadly prohibiting any unlicensed business engaged in "Virtual Currency Business Activity" and broadly regulating the handful of business that have obtained a BitLicense, appears on a collision course with federal efforts. If nothing else, New York's BitLicense requirements appear on their face to "directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer, upon the offer or sale of any" covered security in violation of 15 U.S.C. § 77r.[20]

By contrast, Wyoming's approach identifies areas historically recognized to be within state jurisdiction and then acts in ways that do not conflict with or obstruct federal regulatory efforts. So, for example, states have historically regulated money transmitters, and Wyoming exempted virtual currency businesses from Wyoming statutes on the subject.[21] The same Wyoming statute defines "virtual currency" to mean "any type of digital representation of value that: (A) Is used as a medium of exchange, unit of account or store of value; and (B) Is not recognized as legal tender by the United States government."[22]

Similarly in another area traditionally left to the states, corporate governance and operations, in August 2021, Wyoming updated its Limited Liability Company structure (a structure the state pioneered in 1977) by granting legal company status to decentralized autonomous organizations (DAOs) that operate on a blockchain, provided they are organized as a Wyoming limited liability company.[23]

While New York's BitLicense approach discourages innovation and attempts to usurp the regulatory field dominated by the federal government, Wyoming's federalism approach identifies areas not addressed by federal regulators and permits experimentation. California should follow Wyoming's federalist approach and permit "sandbox" innovation and local experimentation rather than New York's approach that conflicts with the federal regulatory agenda and stifles local innovation.

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[20] It is important to recall that the New York State Department of Financial Services was among the first state agencies to announce a regulatory framework for virtual currencies, announcing its decision to regulate crypto as early as January 2014. New York adopted the framework in large part to address an industry that it described at the time as akin to a "virtual Wild West." [Benjamin M. Lawsky, Superintendent of Financial Services Opening Statement New York State Department of Financial Services Hearings on the Regulation of Virtual Currency January 28, 2014].

[21] Carol R. Goforth, The Case for Preempting State Money Transmission Laws for Crypto-Based Businesses, 73 Ark. L. Rev. 301, 355 (2020).

[22] WYO. STAT. ANN. § 40-22-102(a)(xxii) (2018).

[23] "Wyoming Decentralized Autonomous Organization Supplement," codified at W.S. 17-31-101 through 17-31-115.

Conclusion

In its report "The Promise of Fintech – Financial Inclusion in the Post COVID-19 Era,"[24] the International Monetary Fund concludes that digital finance is increasing financial inclusion and is associated with higher economic growth. Broadening the financial access of low-income households and small businesses will support a more inclusive recovery and mitigate the disparate economic and social impact of the ongoing COVID-19 crises.

The importance of the DFPI in its role as a regulator of the various state law regimes that impact fintech innovation cannot be understated.

[24] The Promise of Fintech : Financial inclusion in the Post COVID-19 Era / Ratna Sahay, Ulric Eriksson von Allmen, Amina Lahreche, Purva Khera, Sumiko Ogawa, Majid Bazarbash, and Kim Beaton (2020). [https://www.imf.org/-/media/Files/Publications/DP/2020/English/PFFIEA.ashx]