

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

AB 1934 (Grayson)
Version: May 23, 2024
Hearing Date: July 2, 2024
Fiscal: Yes
Urgency: No
AWM

SUBJECT

Digital financial asset businesses

DIGEST

This bill adds and clarifies requirements for issuers of stablecoins, as defined, under the Digital Financial Assets Law (DFAL), and delays the effective date of DFLA's licensing, disclosure, consumer protection, and stablecoin provisions, from July 1, 2025, to July 1, 2026.

EXECUTIVE SUMMARY

Last year, the Legislature enacted AB 39 (Grayson, Ch. 792, Stats. 2023), which implemented a licensing and regulation regime for cryptocurrency and other digital assets known as the DFAL. The DFAL requires, beginning July 1, 2025, any person engaging in digital financial asset business activity with residents of the state must have a license obtained from the Department of Financial Protection and Innovation (DFPI). The DFAL also establishes criteria for obtaining a license and grants the DFPI enforcement authority. In the same year, the Legislature enacted SB 401 (Limón, Ch. 871, Stats. 2023), which was incorporated into the DFAL, regulates digital financial asset transaction kiosks – essentially ATMs that accept or dispense cash in exchange for cryptocurrency.

This bill delays the effective date of DFAL's licensing, disclosure, consumer protection, and stablecoin provisions, from July 1, 2025, to July 1, 2026. This bill also clarifies a licensed stablecoin issuer's obligation to maintain records relating to the assets backing the stablecoin, and a stablecoin issuer's ability to obtain the DFPI's approval to engage in stablecoin business if the stablecoin is not fully backed by eligible securities.

This bill is sponsored by the author. The Committee has not received timely support or opposition to this bill. 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 DFAL, which establishes regulations for persons engaging in digital financial business activity in the state, as defined. (Fin. Code, div. 1.25, §§ 3101 et seq.)
- 2) Defines “digital financial asset” as 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. “Digital financial asset” does not include any of the following:
 - a) A transaction in which a merchant 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.
 - b) A digital representation of value issued on or 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 game platform.
 - c) A security registered with or exempt from registration with the United States Securities and Exchange Commission or a security qualified with or exempt from qualifications with the DFPI. (Fin. Code, § 3102(g).)
- 3) Defines “digital financial asset business activity” to mean any of the following:
 - a) 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.
 - b) 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.
 - c) 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 digital representation of value was received, or (2) legal tender or bank or credit union credit outside the online game, game platform, or family offered by or on behalf of the same publisher from which the original digital representation of value was received. (Fin. Code, § 3102(i).)
- 4) Provides that, beginning July 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 of the state unless any of the following is true:
 - a) The person is licensed in this state by the DFPI.
 - b) The person has submitted a timely application for a license and is awaiting a decision.

- c) The person is exempt from licensure, as provided. (Fin. Code, § 3201; *see id.*, §§ 3202-3225 (setting forth requirements for licensure and enforcement).)
- 5) Defines a “covered person” as a person required to obtain a license pursuant to 4). (Fin. Code, § 3102(d).)
- 6) Requires a covered person, when engaging in digital financial asset business activity with a resident of the state, to make specified disclosures to the resident and to the DFPI relating to matters including potential fees and charges, any insurance protection provided, and the covered person’s liability for unauthorized or mistaken transfer or exchanges. (Fin. Code, §§ 3501-3508.)
- 7) Provides that the disclosure requirements set forth in 6) shall be operative on July 1, 2025.
- 8) Defines “stablecoin” as a digital financial asset that is pegged to the United States dollar or another national 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 nominal value that is so stable as to render the nominal value effectively fixed. (Fin. Code, § 3601(b).)
- 9) Imposes additional regulatory requirements for persons engaging in the exchange, transfer, storage, or administration of digital financial assets that are stablecoins, including restricting who may engage in stablecoin activity as follows:
 - a) If the issuer of the stablecoin is a licensee, applicant for a license, or financial entity authorized to do business under federal law, and the issuer at all times owns eligible securities having an aggregate market value computed in accordance with United States, generally accepted accounting principles of not less than the aggregate amount of all of its outstanding stablecoins issued or sold, the issuer need not obtain additional approval.
 - b) If the issuer does not satisfy the criteria in 6)(a), the issuer must obtain approval from the Commissioner of the DFPI. (Fin. Code, §§ 3601, 3603.)
- 10) Establishes factors the Commissioner of the DFPI must consider in its determination of whether to grant approval for a stablecoin under 6)(b), and authorizes the Commissioner to impose additional requirements on the stablecoin issuer or revoke approval, as provided. (Fin. Code, § 3603.)
- 11) Defines the following terms:
 - a) “Digital financial asset transaction kiosk” means an electronic information processing device that is capable of accepting or dispensing cash in exchange for a digital financial asset.
 - b) “Cash” means physical United States currency, both coins and paper currency.

- c) "Licensed digital financial asset exchange" means a digital financial asset exchange that is not an operator and is licensed under New York or California law.
- d) "Operator" means a person who owns, operates, or manages a digital asset transaction kiosk located in the state. (Fin. Code, § 3901.)

12) Requires an operator to do the following:

- a) On or after July 1, 2025, comply with the licensing requirement in 4) to the extent that the operator engages in digital financial asset business activity.
- b) If an operator does not engage in digital financial asset business activity but allows another person to engage in digital financial asset business activity via the digital financial asset transaction kiosk, ensure that the person engaging in the digital financial asset business activity has a license pursuant to 4), beginning July 1, 2025, and ensure that the charges collected from a customer comply with specified limits.
- c) Comply with all other specified provisions of law. (Fin. Code, § 3907.)

This bill:

- 1) Extends the operative date of certain of the DFAL's licensure, reporting, consumer protection, and stablecoin requirements, from July 1, 2025, until July 1, 2026.
- 2) Requires a licensee to maintain, for at least five years, a report at least monthly that demonstrates its compliance with the eligibility criteria for issuing a stablecoin, if applicable.
- 3) Clarifies the approval process for stablecoins to, among other things, make clear that the stablecoin approval process is distinct from the licensing process; and extends the operative date of the stablecoin-related requirements from July 1, 2025, to July 1, 2026.

COMMENTS

1. Author's comment

According to the author:

In 2023, the Governor signed AB 39, which promotes responsible innovation by licensing and regulating crypto companies doing business in California. AB 1934 makes assorted technical changes to this new law in order to promote efficient administration of the program. Specifically, this bill would clarify provisions around so-called "stablecoins," which are digital assets that play a central role in the crypto market, and extends the new law's operative date by an additional year.

2. Cryptocurrency, AB 39, and the status of implementation

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 use 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. 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.

Last year, the Legislature enacted AB 39 (Grayson, Ch. 792, Stats. 2023), which enacted a licensing and regulation regime for cryptocurrency and other digital assets known as the Digital Financial Assets Law (the DFAL).¹ The DFAL requires, beginning July 1, 2025, any person engaging in digital financial asset business activity with residents of this state must have a license obtained from the DFPI.² The DFAL also establishes criteria for obtaining a license and grants the DFPI enforcement authority.³ In the same year, the Legislature enacted SB 401 (Limón, Ch. 871, Stats. 2023), which was incorporated into the DFAL and regulates digital financial asset transaction kiosks – which are essentially ATMs that accept or dispense cash in exchange for cryptocurrency.⁴

The full implementation of the DFAL is expected to be a massive task. The DFPI is currently engaging in a formal rulemaking procedure for regulations to be promulgated under the DFAL,⁵ for regulations that have no precedent elsewhere in state or federal law. Moreover, as explained by the Senate Banking and Financial Institution Committee’s analysis of this bill in greater detail, the DFAL will require the DFPI to bring on staff to conduct the regulatory tasks required by the DFAL, and ensure that they are adequately trained on the technological and financial aspects of cryptocurrencies and other digital assets. S

3. Background on stablecoins

Stablecoins are a subcategory of cryptocurrency. Unlike most cryptocurrencies, whose value is intended to go up over time, the value of a stablecoin is intended to remain fixed to the value of a fiat currency, usually the U.S. dollar. The largest stablecoin is

¹ See Fin. Code, div. 1.25, §§ 3101 et seq.

² *Id.*, § 3201.

³ *Id.*, §§ 3202, 3225.

⁴ *Id.*, div. 1.25, ch. 9, §§ 3901 et seq.

⁵ See DFPI, Digital Financial Assets Law (last updated Apr. 29, 2024), <https://dfpi.ca.gov/dfal/>. All links in this analysis are current as of June 27, 2024.

Tether,⁶ with \$112,780,337 worth of Tether tokens in circulation as of June 27, 2024.⁷ Tether claims that all Tether tokens are backed 100 percent by Tether's reserves.⁸

Stablecoins present two policy issues. The first is whether, and how, stablecoins are backed. In theory, every person holding a stablecoin should be able to redeem that stablecoin for \$1. In practice, however, there have been some dramatic stablecoin failures. In May 2022, the Terra stablecoin – which was backed by another cryptocurrency, Luna – lost virtually all of its value when the algorithm supposedly keeping the two coins balanced failed; tens of billions of dollars vanished in days.⁹ Tether states that its value is backed with verifiable assets, including U.S. currency and Treasury bills,¹⁰ but the company has been fined for holding woefully inadequate assets between 2016 and 2018 while claiming that the coin was backed by U.S. dollars.¹¹

The second issue is the uses to which stablecoins are put. Because the stability is the point of a stablecoin, they don't go up in value – meaning there's no way to make money off of buying and holding a stablecoin in hopes that the number goes up. Yet Tether has the highest trading volume of any cryptocurrency, which means more Tether tokens are traded each day than other cryptocurrencies. Tens of billions of dollars in Tether are exchanged every day; Tether's trading volume is even higher than Bitcoin's, even though there are more than ten times as many Bitcoins in circulation than Tether tokens.¹²

Some of Tether's trading volume arises from Tether's use as an exchange medium: people will change fiat currency for Tether, then use Tether to purchase non-stablecoins such as Bitcoin or Ethereum. And some of Tether's trading volume comes from scams.

As discussed above in Part 2, cryptocurrencies allow value to be exchanged in greater anonymity than traditional banking. The rise of cryptocurrency has facilitated new forms of scams; popular variants include tricking a victim into purchasing cryptocurrency and transferring it to the scammer under false pretenses; and tricking a victim into purchasing cryptocurrency on what turns out to be a fake cryptocurrency exchange, allowing the scammer to keep the cryptocurrency for themselves.¹³ Tether serves as the bridge between the fraudulently acquired cryptocurrency and hard currency: the scammer trades the cryptocurrency for Tether, and Tether for U.S. dollars,

⁶ Investopedia, Tether (USDT): Meaning and Uses for Tethering Crypto (Mar. 10, 2024), <https://www.investopedia.com/terms/t/tether-usdt.asp>.

⁷ Tether, Transparency, <https://tether.to/en/transparency/?tab=usdt>.

⁸ *Ibid.*

⁹ Shen, *How \$60 Billion in Terra Coins Went Up in Algorithmic Smoke*, Bloomberg (May 20, 2022), <https://www.bloomberg.com/graphics/2022-crypto-luna-terra-stablecoin-explainer/>.

¹⁰ Investopedia, Tether (USDT): Meaning and Uses for Tethering Crypto, *supra*.

¹¹ Commodity Futures Trading Commission, Press Release: CFTC Orders Tether and Bitfinex to Pay Fines Totaling \$42.5 Million (Oct. 15, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8450-21>.

¹² Binance, About Tether, <https://www.binance.com/en/price/tether>.

¹³ Faux, *Number Go Up* (2023) pp. 180-181.

giving them fiat currency that is virtually impossible to trace to the original scam.¹⁴ Tether is, in essence, the perfect vehicle for money laundering: unlike an unpegged cryptocurrency, Tether allows scammers to cash out their ill-gotten gains with little risk while hiding their tracks through the anonymity granted by various blockchains.

4. This bill delays implementation of the DFAL and clarifies the DFAL’s stablecoin requirements

This bill delays the effective date of DFAL’s licensing, disclosure, consumer protection, and stablecoin provisions, from July 1, 2025, to July 1, 2026. Given the complex nature of the ramp-up, the author of this bill believes that an added year will allow the DFPI to proceed deliberately and efficiently.

This bill also clarifies certain of the DFAL’s provisions relating to stablecoins.

Specifically, the bill:

- 1) Requires a licensee to maintain records, if applicable, of reports maintained at least monthly, showing compliance with the requirement that a stablecoin issuer at all times owns eligible securities that fully back the stablecoin; and
- 2) Clarifies that a covered person may engage in business activity related to a stablecoin that is not fully backed by eligible securities, if that stablecoin has been approved by DFPI pursuant to a specified process.

SUPPORT

None received

OPPOSITION

None received

RELATED LEGISLATION

Pending Legislation: None known.

Prior Legislation:

SB 401 (Limón, Ch. 871, Stats. 2023) authorized DFPI to regulate digital financial asset kiosks and imposed certain requirement on kiosk operators.

AB 39 (Grayson, Ch. 792, Stats. 2023) enacted the Digital Financial Assets Law, discussed in greater detail in Part 2 of this analysis.

¹⁴ *Id.* at p. 192.

AB 2269 (Grayson, 2022) was similar to AB 39 and would have implemented a regulatory and licensing regime for specified digital financial asset business activities administered by the 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.

PRIOR VOTES:

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

Assembly Floor (Ayes 72, Noes 0)

Assembly Appropriations Committee (Ayes 14, Noes 0)

Assembly Banking and Finance Committee (Ayes 8, Noes 0)
