WILMERHALE

Crypto Currently: California Enacts Landmark Crypto Licensing Law

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I. Introduction

On October 13, Governor Gavin Newsom signed into law a comprehensive licensing regime for digital asset companies operating in California. Until this point, California had refrained from taking a definitive position on whether a broad swath of digital asset businesses required licensure under California's existing money transmission law, contrary to the approach taken by most other states.[1] Under the Digital Financial Assets Law, A.B. 39 (the Law), certain digital asset companies will now be barred from operating in California effective July 1, 2025, unless they hold a license from California's Department of Financial Protection and Innovation (DFPI). The Law is California's first comprehensive framework for regulating digital assets as well as the first state-level statutory crypto licensing framework in the United States to include specific provisions for stablecoins. The Law also comes amid an ongoing debate over the role of federal versus state oversight of an industry still reeling from a series of high-profile scandals and a long "crypto winter."[2]

[1] *See, e.g.*, California Dep't of Financial Protection and Innovation, *Request for Interpretive Opinion – Purchase and Sale of Digital Assets; Payment Processing Services* (Dec. 6, 2021), https://dfpi.ca.gov/2022/03/21/purchase-and-sale-of-digital-assets-payment-processing-services/ (noting that, at that time, DFPI "[has] not yet determined that payment processing transactions involving digital assets constitute receiving money for transmission" such that it "does not require licensure under the [Money Transmission Act] for [a] company to receive fiat currency from [a] customer for transfer in the form of digital assets to [a] merchant"); California Dep't of Financial Protection and Innovation, *Request for Interpretive Opinion* (Apr. 8, 2022), https://dfpi.ca.gov/2022/04/15/purchase-and-sale-of-virtual-currency ("The Department has not concluded whether the issuance of a wallet storing virtual currency is money transmission activity that is subject to regulation.").

[2] *See, e.g.*, Billy Bambrough, *A Wall Street Giant Has Suddenly Declared Crypto 'Winter' Over*, forbes (Oct. 24, 2023), https://www.forbes.com/sites/digital-assets/2023/10/24/a-wall-street-giant-has-declared-crypto-winter-over-as-bitcoin-smashes-30000-and-the-price-of-ethereum-and-xrp-suddenly-soar/?sh=8f330e3917f1.

Under the Law, a person[3] is generally required to obtain a license from DFPI and comply with various safety and soundness requirements, recordkeeping rules and disclosure requirements to engage in (or hold themselves out as engaging in) "digital financial asset business activity" (defined in the statute and described in detail below) with or on behalf of a California resident. Licensees and those required to obtain a license (covered persons) under the Law will also be prohibited from exchanging, transferring, storing or engaging in the administration of stablecoins—whether directly or indirectly—unless the stablecoin is issued by a bank or is licensed by DFPI.[4] Further, the Law grants DFPI broad examination and enforcement powers, including the authority to bring enforcement proceedings against an entity that "has engaged, is engaging, or is about to engage in" digital financial asset business activity.[5]

II. Key Provisions

Below, we lay out notable provisions of the Law, along with a comparative analysis relative to other crypto regulatory regimes (in particular, the New York BitLicense). We also identify/discuss certain provisions that may require additional clarification from California regulators and lawmakers.

Licensing Trigger. Unless exempt, licensure is required under the Law for any person engaged in "digital financial asset business activity," or holding themselves out as being able to engage in such activity, with or on behalf of a resident of California.[6]

"Digital financial asset business activity" is broadly defined to include:[7]

(1) 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;

(2) 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; or

(3) exchanging one or more digital representations of value used within one or more online games, game platforms, or family of games for either a digital financial asset offered by or on

[3] "Person" means "an individual, partnership, estate, business or nonprofit entity, or other legal entity." Digital Financial Assets Law § 3102(p).

[4] Digital Financial Assets Law § 3601(a).

[5] Digital Financial Assets Law § 3403(a) (emphasis added).

[6] Digital Financial Assets Law § 3201.

[7] Digital Financial Assets Law § 3102(i).

behalf of the same publisher or legal tender or bank or credit union credit outside the online game, game platform, or family of games offered by or on behalf of the same publisher.

A "digital financial asset," in turn, is "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."[8] This definition may not capture certain categories of digital assets, such as non-fungible tokens (NFTs) that do not serve as a store of value, medium of exchange or unit of account. The term "digital financial asset" also expressly excludes, among other things,[9] securities registered with or exempt from registration with the Securities and Exchange Commission (SEC) and securities qualified with or exempt from qualifications with DFPI—meaning that if an asset is deemed a security under federal or California law, activities involving that asset would not trigger the Law. While past SEC guidance makes clear that compliance with state licensing requirements should be evaluated separately from compliance with federal securities laws, this specific carve-out serves as a reminder of this obligation.[10] Market participants should closely monitor statements and actions from the SEC and other securities regulators to determine to which aspects of their business the Law will apply.

The Law further defines "digital financial asset control services vendor" as a person with "control" of a digital financial asset "solely under an agreement with a person that, on behalf of another person, assumes control of the digital financial asset."[11] "Control" here refers to the power to "execute unilaterally or prevent indefinitely" a transaction involving digital financial assets.[12] Notably, this conceptualization of control appears to align with the criterion of "independent control" used by the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) to assess the Bank Secrecy Act obligations of persons that act as intermediaries for the owners of digital assets (e.g., hosted wallet providers).[13]

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[8] Digital Financial Assets Law § 3102(g).

[9] This definition also excludes (1) 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; (2) 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 game platform; and (3) a security registered with or exempt from registration with the SEC or a security qualified with or exempt from qualifications with the department. *Id.*

[10] *See, e.g.*, Securities and Exchange Commission, Re: Proposed Coin Listing Policy Framework (Jan. 27, 2020), https://www.sec.gov/files/staff-comments-to%20nysdfs-1-27-20.pdf ("Market participants should not rely on a model framework, whitelist, or state license when evaluating compliance with the federal securities laws – without also undergoing careful legal analysis under the federal securities laws.").

[11] Digital Financial Assets Law § 3102(j).

[12] Digital Financial Assets Law § 3102(c).

[13] US Dep't of the Treasury, Financial Crimes Enforcement Network, *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies* § 4.2 (May 9, 2019), https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-certain-business-models ("The regulatory interpretation of the BSA obligations of persons that act as intermediaries between the owner of the value and the value itself is not technology dependent. The regulatory treatment of such intermediaries depends on four criteria: (a) who owns the value; (b) where the value is stored; (c)

Lawmakers' inclusion of agreements with a "digital financial asset control services vendor"—as opposed to only "direct[]" forms of activity—in the definition of "digital financial asset business activity" appears to have been motivated in part by the collapse of crypto custodian Prime Trust this past summer. Prime Trust is a Nevada-chartered trust company that served as a custodian for several crypto firms, including FTX and Celsius, before it collapsed and filed for bankruptcy in August.[14] Indeed, earlier versions of the Law included an exemption covering "digital asset control services vendors," but lawmakers later removed the provision, expressly noting Prime Trust's collapse and the need for "state oversight of non-customer-facing custodians and other service providers."[15] In the coming months, California regulators will likely need to clarify the full scope of "digital financial asset control services vendor[s]" in addition to answering the first-order question of what types of specific "agreement[s]" with these businesses qualify as "digital financial asset business activity."[16]

Out-of-State Entities. Entities licensed under either the New York BitLicense regulatory regime as a "BitLicensee" or the New York Banking Law as a limited purpose trust company with approval to conduct a virtual currency business *may* obtain a conditional license from DFPI so long as (i) their New York license or charter was issued or approved on or before January 1, 2023, and (ii) the applicant pays all appropriate fees and substantively complies with the requirements of the Law.[17]

Although this provision is intended to reduce regulatory friction between the New York and California regimes by effectively grandfathering in certain BitLicensees and New York limited-purpose trust companies, critics point out that only large and well-capitalized entities are likely to be BitLicensees or qualifying trust companies in the first place[18]—possibly placing smaller companies that are outside the New York market at a relative disadvantage under California's Law. Moreover,

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whether the owner interacts directly with the payment system where the [convertible virtual currency] runs; and (d) whether the person acting as intermediary has total independent control over the value.").

[14] Caitlin Ostroff & Vicky Ge Huang, *Crypto Custodian Prime Trust Files for Bankruptcy Protection*, The Wall Street Journal (Aug. 14, 2023), https://www.wsj.com/articles/crypto-custodian-prime-trust-files-for-bankruptcy-protection-7f28553f.

[15] California Senate Banking and Financial Institutions Committee, Bill Analysis (Jul. 3, 2023), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=202320240AB39.

[16] *See* Digital Financial Assets Law § 3102(i)(1) (defining "digital financial asset business activity" to include "[e]xchanging, 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").

[17] Digital Financial Assets Law § 3205.

[18] *See, e.g.,* Ryan Deffenbaugh, *After Hosting the Crypto Party, New York Is in the Middle of the Cleanup*, Crain's N.Y. (Apr. 20, 2023), https://www.crainsnewyork.com/technology/new-york-driving-crypto-regulation-debate (noting critics "who say the regulations disadvantage startups in favor of larger players"); *see also Veto of California Crypto Law Cold Comfort for State's FinTech Sector*, Pymnts (Sept. 26, 2022), https://www.pymnts.com/cryptocurrency/2022/california-crypto-law-veto-cold-comfort-states-fintech-sector/ ("[G]etting [a BitLicense] is so cost- and labor-intensive that industry opponents say it is not doable for startups and smaller firms.").

the statute does not *require* DFPI to grant a conditional license to New York-chartered entities, raising significant questions about the circumstances in which it will choose to do so.

Surety Bond and Capital Requirements. Licensees under the Law must "maintain a surety bond or trust account in United States dollars in a form and amount as determined by the department for the protection of residents that engage in digital financial asset business activity with the licensee" and "maintain at all times capital and liquidity in an amount and form" that DFPI determines.[19] This is generally consistent with the New York BitLicense regime, which similarly requires a BitLicensee to "maintain a surety bond or trust account in United States dollars for the benefit of its customers in such form and amount as is acceptable to the [Superintendent of the New York Department of Financial Services] for the protection of the Licensee's customers."[20] These requirements are particularly salient in light of the liquidity crisis experienced by many crypto firms in the summer and fall of 2022.

"Best Execution" Requirement. Exchanges covered by the Law must use "reasonable diligence" to obtain the most advantageous execution terms available for customer orders, given prevailing market conditions.[21] The quality of execution terms can be assessed by looking at the character of the market for the digital asset, including price and volatility; the size and type of transaction; the number of markets checked prior to executing the order; and the accessibility of appropriate pricing, among other factors. Relatedly, at least once every six months, covered exchanges must conduct a review of aggregated trading records for California customers against benchmarks to evaluate execution quality and must investigate and promptly remediate any issues identified in the review.[22] Whereas the New York BitLicense regime does not impose a similar requirement, this obligation seems to be derived from the "best execution" requirement imposed on securities broker-dealers. Historically, the best execution regime was set forth by the self-regulatory organization for broker-dealers—the Financial Industry Regulatory Authority (FINRA); however, in December 2022, the SEC proposed a federal best execution framework for broker-dealers as well as other market participants.[23]

Stablecoins. The Law prohibits covered persons from engaging in certain activity with respect to stablecoins,[24] unless the stablecoin is issued by a bank or is licensed by DFPI. The Law further

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[19] Digital Financial Assets Law § 3207.

[20] 23 NYCRR 200.9(a).

[21] Digital Financial Assets Law § 3505(b)(1)–(2)(A).

[22] Digital Financial Assets Law § 3505(b)(2)(B).

[23] *See* WilmerHale, Client Alert, "The SEC Proposes Regulation Best Execution" (Feb. 22, 2023), https://www.wilmerhale.com/-/media/files/shared_content/editorial/publications/wh_publications/client_alert_pdfs/20230222_the_sec_proposes_regulation_best_execution.pdf.

[24] "Stablecoin" means "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

requires stablecoin issuers that hold securities as a reserve to have an amount "not less than the aggregate amount of all of [their] outstanding stablecoins issued or sold [in the United States]," which must be computed using generally accepted accounting principles (GAAP).[25] Moreover, DFPI has broad discretion under the Law to approve stablecoins for exchange, transfer or storage, including considering the "amount, nature, and quality of assets" owned or held by the stablecoin issuer.[26] Stablecoin issuers operating in California or offering their tokens to California residents should take particular note of these new requirements.

Consumer Disclosures. The Law requires covered persons to make certain disclosures when transacting with California residents, including through the provision of a schedule of fees and charges that may be assessed, how fees and charges will be calculated if not set and disclosed in advance, and the timing of the fees and charges.[27] Meanwhile, covered exchanges under the Law will be required to certify that they have, among other things, provided "full and fair disclosure of all material facts relating to conflicts of interest that are associated with the covered exchange and the digital financial asset."[28] Exchanges are required to make this certification on a form provided by DFPI prior to listing or offering a digital financial asset to California residents.[29] Failure to do so—or making a material misrepresentation in the certification process—will result in DFPI requiring the exchange to cease offering or listing the digital financial asset.[30] DFPI can also assess a civil penalty of up to $20,000 for each day that any violation occurred.[31] Exchanges should keep these forthcoming certification requirements in mind, especially as DFPI finalizes its exact specifications and releases the accompanying certification form.

Exempt Entities. Certain entities are expressly exempt from the Law, including, but not limited to:[32]

- US and foreign governments, and their agencies and instrumentalities;
- certain financial institutions (e.g., banks and savings associations, trust companies, credit unions);
- persons engaged in providing processing, clearing or performing settlement services solely for transactions between or among persons that are exempt from licensure;

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general public that the instrument will retain a nominal value that is so stable as to render the nominal value effectively fixed." Digital Financial Assets Law § 3601(b)(3).

[25] Digital Financial Assets Law § 3601(a)(2).

[26] Digital Financial Assets Law § 3603(b)(2)(B).

[27] Digital Financial Assets Law § 3505.

[28] Digital Financial Assets Law § 3505(a)(1)(B).

[29] Digital Financial Assets Law § 3505(a)(1).

[30] Digital Financial Assets Law § 3505(a)(3).

[31] *Id.*

[32] Digital Financial Assets Law § 3103(b).

- persons that provide only data storage or security services for a business engaged in digital financial asset business activity;
- persons using a digital financial asset or obtaining a digital financial asset as payment for the purchase or sale of goods or services, solely for personal, family or household purposes or for academic purposes;
- persons whose digital financial asset business activity with, or on behalf of, California residents is valued at $50,000 or less annually;
- persons that do not receive compensation for providing digital financial asset products or services or for conducting digital financial asset business activity;
- entities registered under the federal Commodity Exchange Act, are actually regulated by the Commodity Futures Trading Commission, and are entitled to preemption; and
- entities registered under federal or state securities laws as a securities broker-dealer.

Examination and Enforcement. The Law empowers DFPI to examine the business and any office, within or outside of California, of any licensee, or any agent of a licensee, to determine that the business is being conducted in a lawful manner.[33] Licensees would be required to pay "reasonable and necessary costs" associated with this examination.[34] DFPI may bring enforcement actions against licensees for violations of the Law, including through suspension or revocation of a license, cease and desist orders, and the imposition of civil monetary penalties.[35] Covered persons that materially violate a provision of the Law may be assessed a civil penalty of up to $20,000 for each day of violation or for each act or omission in violation.[36] DFPI may also seek restitution on behalf of California residents and may impose conditions on future digital financial assets business activities.[37]

Notably, the Law grants DFPI broad authority to bring enforcement proceedings against a licensee or a person that is not a licensee but that "has engaged, is engaging, or is about to engage in" prohibited digital financial asset business activity.[38] The Law does not prescribe any standards for determining when a person "is about to engage in" prohibited digital financial business activity. This provision could pose risks for new businesses planning to operate in California and may require additional clarification from California regulators and lawmakers, especially when it is not clear whether such new businesses are covered by the Law.

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[33] Digital Financial Assets Law § 3301.

[34] Digital Financial Assets Law § 3301(b).

[35] Digital Financial Assets Law § 3401(a)–(f).

[36] Digital Financial Assets Law § 3407(b).

[37] Digital Financial Assets Law § 3401(g)–(h).

[38] Digital Financial Assets Law § 3403(a) (emphasis added).

III. Looking Forward

With the enactment of the Law, California joins New York in adopting a comprehensive digital asset licensing regime. While many observers have dubbed the Law the "West Coast" version of New York's BitLicense framework, there are notable differences between the two—chief among them being the stablecoin-specific provisions in the Law.

This is not the first time California has tried to enact such a framework for digital asset companies. A prior version of the bill, A.B. 2269, was vetoed by Governor Newsom in September 2022. At that time, Governor Newsom explained that it was "premature" to establish a state-level licensing structure without considering, in part, future federal legislation or regulations.[39] FTX collapsed shortly thereafter, causing the political dynamics around crypto to shift dramatically.[40] California Assembly member Tim Grayson then refiled his legislation, adding greater flexibility for DFPI.[41] In his signing statement, Governor Newsom said the Law "will require further refinement in both the regulatory process and in statute."[42] It is clear that policymakers in California view the Law's passage as a first step in an iterative process of regulating the state's digital assets sector. For this reason, policymakers in California are expecting a lengthy and expensive implementation timeline. DFPI expects implementation costs of approximately $14 million in Year 1, $17 million in Year 2 and $21.2 million in Year 3, followed by "a multi-year build-up of the program" to include significant new staffing and logistical requirements.[43]

The size and prominence of California's economy, as well as the expansive nature of the Law, make this new development impossible to ignore. The Law's enactment also comes at a time of heightened crypto enforcement activity at both the federal and state levels.[44] As 2023 comes to a close, digital asset companies should review their existing procedures and assess their potential

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[39] Office of the Governor, Ltr. to Members of the California State Assembly (Sept. 23, 2022), https://www.gov.ca.gov/wp-content/uploads/2022/09/AB-2269-VETO.pdf.

[40] For example, the Consumer Federation of California, as well as other advocacy groups and lawmakers, began to cite the collapse of FTX and other crypto companies in their advocacy of the law. *See, e.g.*, California Assembly Floor Analysis (Sept. 12, 2023), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=202320240AB39; California Senate Committee on Appropriations, Bill Analysis (Sept. 1, 2023), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=202320240AB39.

[41] California Assembly Committee on Appropriations, Bill Analysis (May 8, 2023), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=202320240AB39.

[42] Office of the Governor, Ltr. to Members of the California State Assembly (Oct. 13, 2023), https://www.gov.ca.gov/wp-content/uploads/2023/10/AB-39-Signing-Message.pdf.

[43] California Senate Committee on Appropriations, Bill Analysis (Sept. 1, 2023), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=202320240AB39.

[44] To date, 39 states, Puerto Rico and the District of Columbia either have introduced or have pending legislation for digital asset regulation in their 2023 legislative session. Five states—North Dakota, South Dakota, Utah, Virginia and Wyoming—already have enacted legislation to regulate the activities of various digital asset industry participants. *See, e.g.*, Cryptocurrency 2023 Legislation, NCSL (Mar. 26, 2023), https://www.ncsl.org/financial-services/cryptocurrency-2023-legislation.

exposure under the Law. In early 2024, DFPI will likely begin providing guidance and feedback in response to questions and requests for clarification, and additional regulations may be promulgated. As digital asset companies consider the impact of these emerging proposals on their operations, WilmerHale stands ready to help.

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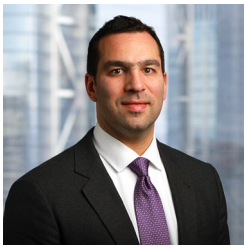

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