CALIFORNIA BANKERS ASSOCIATION

Ms. Sandra Navarro, Regulations Coordinator
California Department of Financial Protection and Innovation
2101 Arena Boulevard
Sacramento, CA 95834
regulations@dfpi.ca.gov

RE: Department of Financial Protection and Innovation Request For Comments Regarding Crypto Assets

Dear Ms. Navarro,

The California Bankers Association (CBA) appreciates the opportunity to submit written comments in response to the Invitation for Comments – Crypto Asset-Related Financial Products and Services pursuant to Executive Order N-9-22.

CBA believes that a regulatory framework is needed for crypto digital assets, particularly for those entities who offer products and services that mirror those offered by regulated, commercial banks. We are confident that the Department is well suited to balance consumer protection with the need to allow continued innovation in this space.

As the Department considers the scope of it's rulemaking under the California Consumer Financial Protection Law, and in particular, the types of digital assets it intends to cover, we encourage the Department to exclude licensed subsidiaries and affiliates of commercial banks already subject to federal regulatory oversight.

What steps should the DFPI take to better protect consumers from scams and frauds associated with crypto asset-related financial products and services?

- Theft, fraud, and manipulation of crypto asset markets are troublingly common. The DFPI should thus ensure that regulatory frameworks for digital assets are in place that include requirements for adequate and intelligible disclosure of information to customers, rights of recourse, and standards on protection of customer information, including how a customer's data can be used.

What steps should the DFPI take to better ensure consumer protection in the offering and provision of crypto asset-related financial products and services?

- It is critical to have a regulatory framework for digital assets in place that include requirements for adequate and intelligible disclosure of information to customers, rights of recourse, and standards on protection of customer information, including how a customer's data can be used.

What steps should the DFPI take to better ensure financial stability in the market from risks posed in the offering and provision of crypto asset-related financial products and services?

- To ensure financial stability, the DFPI should promote, clear, and consistent regulatory standards for crypto assets. One particular area of focus should be the mitigation of illicit financial activity. In this respect, the DFPI should encourage other state financial regulators and federal authorities to drive consistent implementation and enforcement of the Financial Actions Task Force (FATF) Travel Rule across all Value-Added Service Providers (VASPs), ATMs, and decentralized exchanges (DEXs), limiting avenues for the facilitation of financial crime and ensuring a balanced compliance burden across all payment types.
- CBA supports the view that the DFPI should promulgate clear and consistent regulatory standards for stablecoins. Such standards are critical to ensure the safety and soundness of stablecoin arrangements, particularly those used for payments. The DFPI should therefore also support efforts to assess and mitigate potential sources of financial instability and systemic risk given the central role of stablecoins as a source of liquidity in the crypto ecosystem.
- The DFPI could play a leading role in informing decisions made by federal policymakers by setting regulatory standards for Decentralized Finance (DeFi) as there is growing urgency to establish and enforce clear and high standards of security and compliance for DeFi activities. The rapid proliferation of DeFi service providers has been accompanied by a significant increase in the frequency of attacks on these platforms. At the same time, a growing number of hacks have been traced to state-sponsored groups, including North Korea's Lazarus Group, suggesting that the proceeds of these thefts may be directly contributing to the circumvention of sanctions[1]. Further, a troubling number of DeFi platforms continue to operate without meaningful Know Your Customer processes or AML/CFT compliance, in spite of clear indications from a variety of regulators (including the SEC) that most DeFi platforms are subject to these requirements[2].

What steps should the DFPI take to address climate risks posed in the offering and provision of crypto asset-related financial products and services?

- Crypto-assets and blockchain networks vary significantly and their energy intensiveness and carbon emissions associated with a given mining process may vary significantly depending on a range of factors including the source of electricity and type of equipment being used by a given miner.
- Despite these complexities, critically assessing the question of how much energy consumption is too much, is a worthy question which is also closely intertwined with debates around our priorities as a society. As the digital assets space continues to evolve, we believe discussions on the climate impacts of cryptos can, and should be a continued area of focus. Before taking any concrete measures, the DFPI should first focus on obtaining good data to assess the true contribution of digital assets to climate risks, as well as potential technological and policy responses that could mitigate these risks – such as the adoption of less energy-intensive blockchains and the use of renewable energy sources.

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[1] https://www.cnas.org/publications/reports/following-the-crypto
[2] https://dilendorf.com/resources/navigating_the_wild_west_of_defi_regulations.html

How can the DFPI make California the most desirable home state for responsible companies when developing guidance and, as appropriate, regulatory clarity and supervision of persons involved in the offering and provision of crypto asset-related financial products and services in California?

- The growth and safety of digital asset businesses depends on clear regulatory standards, so the DFPI should use all its competences to contribute to this aim. The rapid innovation taking place across the crypto-asset ecosystem is creating exciting opportunities, but it also involves serious risks. To mitigate these risks, international standards setters like the FATF, have provided welcome guidance with respect to the compliance expectations of activities involving crypto assets by both incumbent financial institutions and newer VASP's. However, the rapidly evolving nature of this space will demand continuous engagement from regulators and policymakers to ensure a well-founded and clear set of rules for participants in emerging digital currency ecosystems.
- Whereas clear regulatory standards are an important prerequisite for digital asset businesses' competitiveness and the ability of large players to enter the marketplace, regulations without enforcement are not effective. While establishing clear rules is necessary, it is insufficient to induce compliance with them. Absent realistic threat of enforcement, smaller and less risk-averse firms may find themselves with few incentives to invest in appropriate compliance solutions. For example, the U.S. Treasury Department's guidance that the Travel Rule must be implemented by VASPs has not been enforced, despite a range of readily available compliance solutions. Enforcement, or the threat thereof, would dramatically increase the adoption of the Travel Rule, providing financial intermediaries with the ability to better detect and report on illicit crypto transactions. There is a role for states to play in reinforcing the consistent application and enforcement of the Travel Rule across all VASPs, which will in turn, make the ecosystem for virtual assets, and their on/off ramps, more resilient to AML/CFT risks.
- The DFPI should try to tackle regulatory arbitrage, as this is essential to encouraging responsible innovation in the digital asset space. Although crypto assets embody new technology, the function of these assets and services they enable (trading, money transmission, settlement, lending) are often highly analogous to those that exist today. As such, they often present similar risks that regulatory frameworks have already been designed to address. Where regulatory and compliance requirements are not uniformly deployed across activity types, strong incentives will exist for innovators to engage in regulatory arbitrage, perversely harming those organizations, and the products and services that are most in-line with policy objectives of the public sector.
- Ultimately, clear, consistent, and high regulatory standards for digital assets and related activities will help accelerate the best kinds of crypto innovation while mitigating the most concerning risks. One particularly important area in this regard is the regulation of non-bank stablecoin arrangements. Stablecoins function as the primary stored value and collateral for the crypto ecosystem. Establishing regulatory standards for non-bank issued stablecoins will therefore be critically important.
- Effective regulation of non-bank stablecoins is also a necessary pre-condition to developing a robust and well governed DeFi ecosystem, as stablecoins function as the primary source of liquidity within most DeFi systems. Research by the International Organization of Security Commissions observes that stablecoins "have become DeFi's substitute for fiat currency, acting as the "stable" leg in trading transactions involving more or volatile crypto-assets or as

the "collateral" for lending and borrowing". The result is that stablecoins and DeFi have each contributed to the continued exponential growth of the other, potentially resulting in closely intertwined risk factors.

How should the DFPI ensure that California values of inclusive innovation and equity- focused consumer protection are core components of crypto asset-related financial products and services as it develops guidance and, as appropriate, regulatory clarity and supervision of those persons involved in the offering and provision of crypto asset- related financial products and services in California?

- CBA views the potential for digital assets to act as an enabler and accelerator of financial inclusion with a mix of excitement and trepidation. New technologies can play a critical role in unleashing people's full economic potential and helping to drive equitable and sustainable economic growth. However, regulatory oversight of non-bank entities is needed to boost consumer confidence in these technologies and ensure participation in the digital asset ecosystem. One of the cornerstones of financial inclusion is trust and consumer protection. Individuals must have confidence that they are getting what they pay for and that they are protected in the event of fraud, disputes, refunds, or data misuse. While most Americans trust their bank[3], many of today's ~2,600 digital currencies fail to offer the stability, regulatory compliance and consumer protections needed to earn this trust. At the same time, theft, fraud, and manipulation of crypto asset markets remain troublingly common, with some specifically targeting minority and financially excluded communities who may be less resilient to volatility and losses.

Thank you again for the opportunity to comment. We welcome any questions you may have regarding our submission.

Sincerely,

[redacted]

Jason Lane
VP/Deputy Director of Government Relations
California Bankers Association

[3] https://www.aba.com/about-us/press-room/press-releases/survey-americans-trust-banks-most-to-keep-info-safe-want-regulated-institutions-to-handle-finances#