Crypto Council for Innovation

August 5, 2022

Via Email: regulations@dfpi.ca.gov

Araceli Dyson, Regulations Coordinator
Department of Financial Protection and Innovation, Legal Division
2101 Arena Boulevard
Sacramento, CA 95834

Re: Invitation for Comments – Crypto Asset-Related Financial Products and Services[1]

Dear Ms. Dyson,

The Crypto Council for Innovation (CCI)[2] is submitting this letter with respect to the invitation document from the Department of Financial Protection and Innovation titled, “Invitation For Comments On Crypto Asset-Related Financial Products And Services Under The California Consumer Financial Protection Law.”

Crypto Council for Innovation (CCI) is an alliance of crypto industry leaders with a mission to communicate the benefits of crypto and demonstrate its transformational promise. CCI members include some of the leading global companies and investors operating in the crypto industry. CCI members span the crypto ecosystem and share the goal of encouraging the responsible global regulation of crypto to unlock economic potential, improve lives, foster financial inclusion, protect national security, and disrupt illicit activity.

CCI and its members greatly appreciate the objective of the Governor’s Executive Order N-9-22 (Executive Order) to “foster responsible innovation, bolster California’s innovation economy and protect consumers.” We also greatly appreciate the Executive Order’s goal to “create a transparent regulatory and business environment for web3 companies which harmonizes federal and California approaches, balances the benefits and risks to consumers, and incorporates California values such as equity, inclusivity, and environmental protection.” We at CCI stand ready and willing to work with the DFPI to accomplish these goals and ensure that

1 https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/DFPI-crypto-invitation-for-comment-5-31-22.pdf

2 CCI’s members are A16z, Block, Coinbase, Electric Capital, Fidelity Digital Assets, Gemini, Paradigm, and Ribbit Capital.

the most transformative innovations of this generation and the next are anchored in the United States.

We appreciate the DFPI's recognition of the range of topics relating to cryptocurrency and the blockchain that are ripe for policy discussion. To that end, the below recommendations are predicated on the notion that transparent, well-regulated, and state-based frameworks that prioritize consumer protection will allow for the continued integrity and vibrancy of the U.S. cryptocurrency markets. We applaud the DFPI's forward leaning ways in engaging with the crypto industry and look forward to continued engagement and collaboration.

This letter outlines the following [question number(s) addressed in brackets]:

- Regulatory and disclosure regimes should consider the unique properties of crypto and blockchain technology. [11, 12, 14, 15]
- DFPI should coordinate closely with federal and state regulatory counterparts. [7,8]
- California should take a leadership position in constructing a regulatory framework, taking into consideration lessons learned from other states. [9]
- Consumer protection considerations are key; DFPI should take a proactive and holistic approach. [1, 2, 3, 4]
- DFPI should take a nuanced approach to understanding financial stability. [5]
- DFPI should recognize the potential of new approaches to financial services and study the experiences of historically excluded customers for equity and inclusion-focused policy-making. [10]
- Currently, UDAAP and other consumer protection rules provide a lot of protections. [13]

We provide more detail on each of these points below. We also highlight the following high-level considerations:

Caution Against Outright Bans
CCI cautions the Department to be wary of outright or blanket bans at any stage of the regulatory process, especially in this early phase. Such a step would stifle the course of innovation and encourage unregulated underground channels for any product or category of product that is subject to an outright ban, resulting in a bifurcated ecosystem of regulated and unregulated behavior.

Opportunities for DFPI to Implement Blockchain RegTech/Government Services
CCI would like to recommend that DFPI consider the plethora of blockchain-based government services available to assist in these efforts to regulate and respond to consumers and businesses in the crypto industry. In 2020, the California Blockchain Working Group report provided numerous recommendations of government opportunities to utilize blockchain technology to streamline authentication, payment automation, revenue tax collection and much more.[3] CCI believes that investment in this space may assist DFPI when developing business requirement frameworks.

[3] https://www.govops.ca.gov/wp-content/uploads/sites/11/2020/07/BWG-Final-Report-2020-July1.pdf

Transition Period If Any New Framework is Established
A critical component of consumer protection is ensuring that service providers have sufficient time to transition, should any new regulatory framework be established. This will help to avoid unnecessary impacts to services and ensure that customers are able to access their assets without interruption. Accordingly, CCI recommends that California and DFPI consider an appropriately lengthy transition time period prior to requiring any existing company to comply with new requirements for crypto asset services and product offerings.

Regulatory and disclosure regimes should consider the unique properties of crypto and blockchain technology. [11, 12, 14, 15]

First, US financial regulation has historically been based on an entities-based approach requiring licensing or chartering of a legal entity to conduct permissible financial activities. An entities-based approach, however, is less suited to blockchain-based financial services and products, which are more distributed than traditional finance and may have no specific entity with unilateral control of the financial product or service.

Second, a licensing regime may not be suitable for many crypto products and services. Rather it may be more fruitful to identify who are the key parties involved with the provision of the crypto asset-related product or service. These key parties, such as the development team, blockchain infrastructure, banks, token holders, validators, etc., may not have unilateral control over the service or product, but they can provide important information about the roles they play in the provision of the service or product.

Third, a licensing regime may not be suitable for all crypto-related financial services or products because in the near future a large portion of the US financial system will be running on blockchain technologies. Crypto will be mainstream and will not be considered a category apart from traditional financial services. Thus, a separate licensing regime for crypto asset-related entities may not be a future-proof approach to regulation.

DFPI should coordinate closely with federal and state regulatory counterparts. [7,8]

To facilitate a national digital assets market, it is vitally important for DFPI to coordinate closely with the US Treasury Department and federal regulators as well as with state regulatory counterparts. As a comprehensive federal framework is yet to be adopted at the national level, California is in a position to be a thought leader on the regulation of crypto asset-related financial activities. We hope California will lead again as it has with the California Consumer Privacy Act of 2018 (CCPA). As a thought leader through state legislation, we hope that DFPI will lead by example and inspire Congress, federal regulators and other states to adopt a similar framework and strive to harmonize to the greatest extent possible.

An unnecessary patchwork of regulations across the country presents challenges to industry compliance and, in turn, could lead to increased risk of consumer harm. To combat this, the Department should consider a “harmonization without full adoption” approach when proposing and implementing new regulations or other compliance requirements. We suggest that DFPI identify and implement provisions from existing regulations in other jurisdictions that have been successful towards protecting consumers and encouraging innovation. At the same time, the DFPI should refrain from adopting components of another state’s framework that have proven to be ineffective, inefficient, or a source of harm to consumers or to innovation. For example, California could set the model for streamlining multi-state examinations that allow businesses to operate in other jurisdictions with regulatory regimes that meet the high expectations of the DFPI. California and DFPI should continue to partner with the Conference of State Banking Supervisors when it comes to such issues. Such an approach with like-minded states could also lead to opportunities for reciprocity and/or passporting, which will allow for a more efficient and harmonized state-based regulatory system.

California should take a leadership position in constructing a regulatory framework, taking into consideration lessons learned from other states. [9]

California is one of the leading states in the US digital economy, and we encourage its continued leadership in crypto innovation. California stands at a pivotal moment when the federal approach is being iterated, and only a handful of states have adopted crypto legislation. We encourage California to take a leadership role in constructing and adopting a regulatory framework that protects customers and improves resiliency of the financial system while attracting responsible innovation.

California can build off of existing regulatory frameworks, but it is important during this pivotal time for regulation to keep pace with innovation. Accordingly, it is paramount that agencies have sufficient resources and qualified staff in order to ensure effective implementation of any framework established.

Clear and transparent governance
Any potential DFPI framework must include clear objectives, timelines, and expectations. As an example, the CFTC establishes a 180-day timeframe to review new applications for designation as a contract market.[4] In addition, the CFTC has specific Procedures for Listing Products,[5] which specifies a 45-day period to review and approve a proposed new rule or rule amendment by a designated contract market (DCM) or registered derivatives transaction execution facility (DTEF).[6]

As has been the DFPI’s ethos, transparency on governance, policies and procedures will help ensure market certainty and allow the industry to innovate responsibly. The Department should

[4] https://www.cftc.gov/IndustryOversight/TradingOrganizations/DCMs/dcmhowto.html
[5] https://www.cftc.gov/IndustryOversight/ContractsProducts/ListingProcedures/listingprocedures.html
[6] https://www.cftc.gov/IndustryOversight/RuleAmendments/rulerequestapprovaldcmdtef

take into consideration the resources it would need to issue those approvals. Clear governance and procedures are necessary components in ensuring market certainty and resilience. DFPI should clearly specify in advance what items of information it needs from firms in order to approve any applications, issue rules and make supervisory decisions in a clear and timely manner.

Having these clear timelines and approval processes help the private sector plan ahead of time to bring to market these products. Good governance is good for government, consumers, and industry. CCI would be pleased to assist the Department and its staff in developing a government-business partnership to establish responsible and feasible frameworks that ultimately benefit consumers.

After implementation of any framework, an ongoing effort towards leadership and transparency could be supported by email newsletters and an online portal or DFPI-monitored help desk. DFPI should also facilitate consultations for edge cases that do not fall neatly into current regulations, issue transparent guidance that is not company specific, provide alerts of new and proposed requirements and their respective timelines, share updates on enforcement trends, and offer information on retroactive compliance or right-to-cure procedures.

Consumer protection considerations are key; DFPI should take a proactive and holistic approach. [1, 2, 3, 4]

CCI and its members hold consumer protection as a foundational mandate.

CCI believes that education is critical to the success and responsible adoption of the nascent crypto industry. To achieve a functioning and vibrant crypto economy in California, both consumers and businesses will benefit from a better understanding of their options and responsibilities under a continuously developing regulatory framework.

To that end, CCI recommends that DFPI develop a public education program for schools about not only crypto but financial health more broadly. In addition to public school programs, we suggest a public campaign to educate Californian consumers about crypto asset-related products and services. Californians should be educated on how to manage their wallet keys and to assess the risk profiles of crypto asset-related products and services, including where their funds are held and who has control of the protocol, etc.

DFPI should take a nuanced approach to understanding financial stability. [5]

CCI and its members believe that blockchain technologies enhance financial stability in the market. If there were an outage in one part of the blockchain, the rest of the chain could still continue to operate. It is important for policymakers to recognize that there is a large amount of variance with the crypto space. Projects have different functions, governance structures, and incentive mechanisms that can all contribute to vastly different outcomes – as seen in recent events. Any framework should take a nuanced approach to evaluating a project's risk. As with other industries, there are distinctions to be made between high-quality and compliance-seeking projects and those that are not as robust.

It is also worth assessing the interconnections between traditional finance and the crypto sector. Currently, traditional finance poses a greater financial stability risk to the crypto sector than the other way around. Historically, many banks have been reluctant to bank crypto firms due to regulatory uncertainty, which has led to an outcome whereby most of the US crypto sector is now banked by the same bank: Silvergate Bank. A handful of banks have since entered this space. Nonetheless, this concentration of exposure to only a few banks could pose financial stability risks for the digital assets industry as a whole.

DFPI should recognize the potential of new approaches to financial services and study the experiences of historically underserved customers for equity and inclusion-focused policy-making. [10]

First, values of equity, transparency and efficiency are core components of crypto finance. DFPI should encourage the industry to develop decentralized finance (DeFI), which embodies these core components. Allowing the industry to be dominated by first movers would undermine these core components.

Second, we commend the example set by the Digital Commodities Consumer Protection Act of 2022 that was recently introduced in the US Senate.[7] The Act places an explicit focus on historically underserved customers and commissions a report that "will impact the Commission's rulemaking, education and outreach efforts, and other related activities."

Currently, UDAAP and other consumer protection rules provide a lot of protections. [13]

Blockchain technologies, as is the case with any useful new technology such as a knife, automobile, or airplane, can be used for bad as well as for good. It is important to have rules that reduce bad behavior while encouraging productive and sustainable applications of blockchain technologies. Currently, federal and state criminal laws, consumer protection regimes along with the unfair, deceptive, or abusive acts and practices (UDAAPs) rules provide many protections. They are tech-neutral and, thus, apply to crypto asset-related financial services and products. Technology is ever-changing, so it is important to surveil changes in technology along with adopting rules that are future-proofed to withstand technology's continuously changing nature.

Conclusion

[7] https://www.agriculture.senate.gov/imo/media/doc/crypto_bill_section_by_section1.pdf

As a $3.1 trillion economy – and the United States' largest – California is a significant player. Promoting clarity for the crypto industry, driving recognition of the technology's promise and supporting innovation puts California on the front foot. We appreciate the high standards and inclusive values that the state prioritizes and encourage those same components to be applied to a fair and responsible regulatory environment for crypto. CCI applauds both Governor Newsom's engagement via his Executive Order and the DFPI's leadership in strengthening consumer financial protections and cultivating responsible innovation that provides value for consumers. We recognize that these efforts build on years of dialogue between the government, experts and the industry.

While this document offers a summary of our recommendations, we look forward to continued discussions and engagement with DFPI as California moves forward in this space. We believe we are at a pivotal moment in the crypto industry's development and look to California to continue to lead the way in innovation.

CCI appreciates the opportunity to provide comment on these issues and applauds the thoughtful effort DFPI is undertaking to develop effective and fair regulation. Please do not hesitate to contact us for further information about any of the comments in this document or other inquiries.

Respectfully submitted,

[redacted]

Sheila Warren
Chief Executive Officer
Crypto Council for Innovation