August 5, 2022

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

Ms. Dyson:

The Digital Currency Traders Alliance (DCTA) is grateful for this opportunity to share comments and input in response to the Department of Financial Protection and Innovation's (DFPI) Invitation for Comment on Crypto Asset-Related Financial Products and Services resulting from Governor Newsom's Executive Order N-9-22, relating to Blockchain and Web3.0 technology.

In response to this request, we have provided comments and thoughts for each priority topic identified by DFPI. We believe that our input will help to maximize California's impact in guiding the sector to maturation while ensuring that it embraces equity, inclusivity, innovation, and robust consumer protections.

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

In order to better protect consumers from scams and frauds that are seen in the cryptocurrency sector, DFPI should consider the following measures:

Disclosure Requirements

Disclosures are an effective tool to help protect consumers. We all make better decisions when presented with information regarding the full impact of our choices, and this especially applies to the cryptocurrency sector. However, we do not believe in a one-size-fits-all model - instead, we should have a set of basic disclosures that apply to all industry actors and more nuanced ones for specific subsectors.

- **Basic** - Governments should implement basic disclosure requirements comparable to federal Securities Exchange Commission rules 10(b)(5) and 16(3),(4), and(5) for fraud, insider trading, and short-swing profits.
- **Exchanges** - Exchanges should clearly disclose any fees, price quotes, and risks associated with their services. They should also clearly explain their process and due diligence policy for listing tokens.
- **NFTs** - NFT Projects should clearly disclose their timelines, identities of their leadership team, whether they have paid influencers for promotion, and basic information about their tokenomics.

- **Promotions** - We recommend implementing basic disclosure requirements for any individual or entity that wishes to promote a project they have received as compensation in exchange for promotional marketing. These requirements could be as basic as (1) disclosing who they are marketing on behalf of, (2) when this marketing took place, (3) listing the public wallet address where these funds are stored, (4) a prohibition period before selling any tokens that they may have received as compensation, and (5) disclosing when they ultimately sell their tokens.
- **Projects** - Cryptocurrency projects should disclose their leadership teams, whether they have paid any influencers for promotion, and what that compensation entailed. Projects should also disclose basic information about their tokenomics, such as the token's supply, utility, and distribution.
- **Miners** - Mining companies should disclose their energy footprint and the breakdown of their energy sources.
- **Bitcoin ATMs** - Bitcoin ATMs should clearly disclose the fees, price quotes, market source, and any other risks associated with their services to users before they can complete a transaction.

Clear Customer Service Requirements

Establishing minimum customer service standards are an important first step toward effectively protecting consumers.

To start, exchanges and other custodial service providers should create dedicated 1-800 customer service phone numbers, with 24/7 staffing, in order to respond to concerns and questions that customers may have. Providing this real-time support will allow customers to seek immediate relief during emergencies and help ensure that they are accessing legitimate websites and services.

Similarly, service providers should also be required to do their due diligence in identifying and shutting down copycat services and websites that attempt to replicate legitimate sites in order to obtain user login credentials and/or redirect to fake customer service associates.

Both of these steps, taken as a whole, will ultimately strengthen the overall sector by improving the legitimacy of cryptocurrency businesses.

Platform Disclosures

In the early days of COVID, social media platforms like Twitter, Facebook, Tik Tok, and Instagram identified fake or misleading information with disclosure tags. This same practice could be applied to posts promoting cryptocurrency projects to help inform consumers when posts appear suspicious or questionable. We have already seen some social media companies take similar steps or outright prohibit these kinds of advertising and promotions on their platforms.

2. What steps should the DFPI take to improve consumer education and outreach for crypto asset-related financial products and services?

The DFPI could establish criteria for a course that creates a "Crypto Accredited Investor" certification for investors that want to take on more risk, giving preferential or early access to higher-risk investment opportunities. This would be similar to the "accredited investors" classification that we see in traditional markets without needing to meet minimum net worth requirements. This new classification would allow equal access and opportunity to all consumer investors, effectively furthering California's equity goals.

Similarly, consumers should be required to take educational classes before being able to take advantage of leveraged investments. Access to leverage without commensurate education on the potential risks will only harm consumers and contribute to the wider volatility seen in crypto markets. Additionally, to further limit volatility in the wider crypto markets, we suggest limiting the amount of leverage market participants can access.

3. What steps should the DFPI take to better ensure consumer protection in the offering and provision of crypto asset-related financial products and services?
Privacy concerns must be paramount when considering an effective regulatory regime for cryptocurrency. If the state maintains any kind of database with the potential to link individual users with their private wallet keys, that must be subjected to the highest possible security standards. Ideally, this kind of linkage would never occur – especially considering the prevalence of either A. hacks and data breaches or B. the potential for the government to target individual users (e.g., similar to the practices witnessed under the Patriot Act).

DFPI should also mandate that custodial actors maintain 24/7 customer service 1-800 phone lines. To date, this has not been a common practice in the industry and has been a source of consternation for many consumer investors who have either run into difficulties with crypto services or have emergencies that need instant resolution.

4. What steps should the DFPI take to better ensure investor protection in the offering and provision of crypto asset-related financial products and services?
The most important step that DFPI can take to better ensure investor protection in the offering and provision of crypto asset-related financial products and services would be to mandate that exchanges operating in California publish and outline their selection criteria for which projects will be listed on their platforms.

Similarly, DFPI could establish rigorous vetting standards for which tokens will be allowed on exchanges operating in California. This would not only ensure that only the highest quality projects are available to consumers, but it would also effectively address concerns around paid listings and the recent insider trading scandals that have appeared in the news. The criteria for establishing due diligence requirements could be as simple as:

- Is the cryptocurrency a security?
- Does the cryptocurrency have sufficient community demand?
- Does the cryptocurrency pose any undue reputational risk?
- Does the cryptocurrency have a secure blockchain?
- Is the cryptocurrency “decentralized” or “centralized”?
- Has a US federal regulator stated that the cryptocurrency is a security or administrator?
- What is the cryptocurrency’s cybersecurity review?
- What are the risk factors of a stablecoin, and how are they mitigated (stablecoins only)?

Additionally, as we have previously mentioned, service providers should establish dedicated 24/7 1-800 customer service phone lines to give investors an easy avenue to answer common questions or resolve any concerns they may have.

5. 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?

In order to ensure financial stability in cryptocurrency markets by risks posed from crypto asset-related financial products and services, DFPI should consider the following measures:

Audits

To start, DFPI should consider mandating regular, robust audits for every major player to ensure they have ample reserves to sprotect themselves from consumer withdrawals. Until the sector matures, these players should maintain – at a minimum – reserves matching 75% of user deposits. This amount contrasts with the 5-15% required of banking entities.

At the same time, stablecoin actors should be held to a higher standard: asset-based stablecoins should be prioritized and encouraged to hold reserves equivalent to 150% of user deposits. Although algorithmic-based stablecoins show promise, the state must prioritize stablecoin projects that incorporate adequate protections that provide security to everyday consumers.

Leverage & Cross-Collateralization

Concurrently, the state should consider limiting cross-collateralization on cryptocurrency projects – the lack of cross-collateralization controls directly contributed to the massive market fluctuations witnessed over the last 6 months. Limiting or even prohibiting this practice would ensure long-term stability in the sector.

Lastly, consumers should be educated on the risks of leverage before being able to partake in these investment vehicles. There should also be limitations placed on the amount of leverage that average consumers can access.

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

Whenever possible, the state should incentivize the use of renewable energy for cryptocurrency mining and disincentivize the use of coal/gas for Proof-of-Work mining. Bitcoin mining would be greatly enhanced by the state taking whatever steps that it can to decrease the cost of renewable energy in the state. This would attract additional cryptocurrency miners and allow the state to set the agenda and influence the direction of the wider sector.

We would note that the worst possible approach would be to ban proof-of-work mining since that would only drive miners out of the state in order to look for cheap sources of power in other areas of the world. This would prevent the state from influencing the trajectory of PoW efficiency.

7. **How should the DFPI strive to harmonize its regulatory approach to crypto asset-related financial products and services with federal authorities?**
The DFPI should begin by creating best practices that encourage the state to lead by example and then compare methods and protocols with the federal authorities when those guidelines are released in Q3 2022. This allows the DFPI to pick and choose which protocols they would like to embrace. However, the DFPI should prioritize an approach that embraces California's values of equity and inclusivity.

One example of where California can set an example for the federal government to follow would be around the definition of "brokers." Instead of focusing on the aspect of effectuation – providing the mechanism for a transaction – the focus should be on the custodial aspect of holding funds. If a consumer sends funds to a custodial service with the promise of being able to withdraw them in the future, it is fundamentally different from sending funds to a party that is merely enforcing and/or facilitating the transaction. This embraces a risk-based approach while narrowing the regulatory responsibilities that DFPI will have to undertake.

8. **In developing a comprehensive regulatory approach to crypto asset-related financial products and services, how should the DFPI work with other state financial regulators to promote a common approach that increases the reach of DFPI's consumer protection efforts and reduces unnecessary burdens, if any, on companies seeking to operate Nationwide?**
The easiest mechanism for DFPI to work with other state financial regulators when developing a comprehensive regulatory approach to crypto asset-related financial products and services would be to form a consortium with other states. This could follow a similar approach to California's participation in carbon-offset markets. This would also allow California to set the wider agenda in prioritizing consumer protections, common-sense best practices, and promoting California values of equity, inclusivity, etc. This would ultimately enhance California's ability to set the nation's environmental agenda and promote clean energy companies that are instrumental to meeting the state's carbon goals.

9. 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?
To enhance the desirability of California as the hub for responsible companies in the sector, the state should embrace a multi-tiered, risk-based approach to regulation and registration.

The state should, at a minimum, make a critical distinction between custodial actors and non-custodial actors. Since custodial actors hold user funds for an extended set of time with a promise to pay out those funds at a later date, similar to institutional banks, they should be held to a higher regulatory standard based on the inherent risk in their services. Recently, we have seen custodial actors become insolvent because they have gambled user funds on risky projects for the potential promise of securing high rates of return.

In order to operate, these actors should have to secure a license to continue providing services to California consumers. This licensing process should incorporate robust standards that protect consumers while maintaining leniency in accordance with the DFPI's capacity and bandwidth to process licensing applications.

Simultaneously, DFPI should establish an open-registration system for non-custodial actors that allows DFPI to comprehensively understand the full spectrum of cryptocurrency companies within the state. This risk-based approach limits the workload burden on DFPI staff while ensuring that the department has a full registry and impact of crypto businesses operating in California. Concurrently, it establishes a business-friendly precedent that contrasts with the approach of many states in the country, such as the high costs and exorbitant requirements under New York's BitLicense program.

In practice, this structure would create an open-access and gradual process to prioritize the highest-risk actors while limiting the workload on department staff. This would enable California to exert significant influence over national cryptocurrency policy while ensuring that the state is a business-friendly hub for both innovation and robust consumer protections.

10. 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?

In order to incorporate California's values while creating a regulatory framework for this nascent sector, the state should ensure that the following principles are enshrined as core values in DFPI's proposed guidance and requirements for cryptocurrency companies.

To start, privacy must be protected – this should be a core, fundamental value embraced by the state. Robust protections would prevent government overreach – either intentional or unintentional – and prohibit unauthorized e-surveillance of cryptocurrency consumers.

Secondly, the state should take steps to ensure a level playing field. It should ensure funding opportunities are fairly and equitably distributed. Further, educational opportunities should be prioritized and channeled toward historically disadvantaged communities in order to elevate social and economic equity.

By providing an open and level playing field, we fundamentally embrace the state's goal of inclusive innovation for all. In order to fully realize this goal, it is important that California prioritize equitable investments in low-income and historically disadvantaged communities to mitigate the Digital Divide – i.e., disparities in investments in wireless and broadband infrastructure that ultimately limits the competitiveness of these communities – from individual traders to businesses trying to build new platforms and applications.

In accordance with robust and adequate investments, the state should embrace new education pathways – encompassing both CTE and CCC programs – to establish blockchain technology badging, certifications, and degree programs. This would effectively channel the benefits of blockchain technology to the communities that have been historically left out.

To conclude, we appreciate the opportunity to share our thoughts on how to optimize the overall direction and growth of the wider cryptocurrency sector. If you have any questions or comments, I can be reached via email at [redacted].

Sincerely,

[redacted]

Kevin Trommer
Deputy Director