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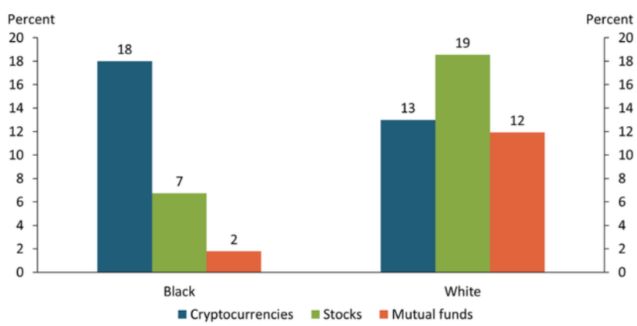
The Greenlining Institute's Comment on Crypto Asset-Related Financial Products and Services Under the California Consumer Financial Protection Law

The Greenlining Institute is a nonprofit advocacy organization that works towards a future where communities of color can build wealth, live in healthy places filled with economic opportunity, and are ready to meet the challenges posed by climate change. Crypto assets can provide an opportunity to build wealth and financial security among communities of color who have historically been denied those opportunities by traditional financial institutions by removing barriers to access, appealing to younger, more diverse investors, providing opportunities for ownership of new types of assets, and as a platform for cheaper remittances abroad. For example, black investors are more likely to own cryptocurrencies than white investors in part because crypto provides an opportunity to close a racial wealth gap created by decades of discriminatory policies such as redlining.[1] However, these assets also pose a significant risk of scams, fraud, wealth destruction and severe environmental impacts.

Chart 1: Black consumers' rate of cryptocurrency ownership is higher than for stocks or mutual funds



Sources: Pew Research Center, Board of Governors of the Federal Reserve System, and author's calculations.

The goals of regulation in this space should be the same as in other financial sectors – to protect investors from fraud, theft, misconduct, manipulation, enforce accountability, preserve market integrity, and manage risks. To properly realize the benefits of crypto assets, the DFPI should focus on developing rules that push centralized exchanges and lending platforms to properly mitigate risks and safeguard consumer funds when engaging in activities such as adding or listing

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[1] Kansas City Federal Reserve Bank, "The Cryptic Nature of Black Consumer Cryptocurrency Ownership," (June 1, 2022). https://www.kansascityfed.org/research/payments-system-research-briefings/the-cryptic-nature-of-black-consumer-cryptocurrency-ownership/

crypto assets for sale on their platforms or taking consumer deposits for staking and lending. The recent high-profile failures of Celsius and Voyager as well as dozens of ponzi schemes, hacks, and similar scams clearly show that we need more consumer protections in this sector.[2] Without new safeguards, there will be significant barriers to realizing the potential of crypto assets to build mainstream credibility, wealth and opportunity.

Topics:

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

The DFPI should protect consumers from scams and fraud by requiring registration, sound risk management practices and clear consumer disclosures from financial institutions that act as custodians to consumer funds or allow conversion or purchase of crypto assets, in particular centralized exchanges or lending platforms such as Binance, Coinbase, Crypto.com and BlockFi.[3] Focusing on centralized exchanges (CEX) first over decentralized exchanges (DEX) is key because (1) most first-time buyers typically rely on CEX's to enter the crypto market and these buyers are most in need of protection; (2) the trading volume is much greater on CEX's compared to DEX's; (3) these entities control access to private keys and act as custodians of user assets and (4) the practical difficulties of enforcing regulations decentralized exchanges.

As part of the registration process, exchanges should be required to have robust processes to identify, measure, monitor, manage and report risks when listing a new crypto asset on their exchange. This should include analyzing the asset for its potential to harm investors, this can include whether the price has been manipulated through illegitimate practices such as insider trading, the risk of hacking, as well as other red flags such as unknown or inexperienced developers,

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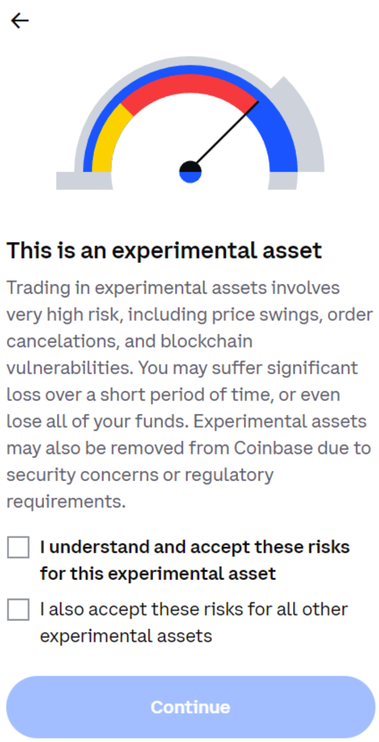
[2] Web3 Is Going Great compiles failures in the crypto sector and calculates that over $10 billion has been lost due to institutional failures, scams, fraud, and theft. https://web3isgoinggreat.com/

[3] The California Legislature is considering requiring registration and licensing requirements for businesses engaging in digital financial asset transactions. *See* AB 2269 (CA, 2022). https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220AB2269

unsustainable tokenomics (e.g. ponzi scheme tokens), stablecoins without sufficient matching reserves, shady market manipulation tactics through social media campaigns or the promise of artificial gains through tactics like "burning" coins without proper validation on the blockchain. Many large exchanges such as Coinbase already have some form of this process and have established listing standards, however these processes have still allowed insider trading[4] and overall require more consistency, scrutiny, and supervision across the sector. Aside from these registration conditions, the DFPI should also require the standard disclosures as part of registration such as the nature of the business, the profiles of the executives and board, the institution's financial health, forecasted earnings and revenue, among other disclosures.

Beyond careful vetting of listings on exchanges, the DFPI should require exchanges and similar crypto platforms to provide clear consumer notice and warnings when purchasing or transferring crypto assets for the first time and when particular assets may carry higher risks. Coinbase has a similar warning for so-called "experimental assets" which requires an acknowledgement by the end user that this asset carries potentially greater risk - the DFPI should ensure that these warning labels are applied more consistently across the industry.[5] These warnings may include mention of (1) volatility and price swings; (2) potential loss of funds; (3) potential of cyberattacks to cause investments to lose value; (4) the risky and speculative nature of these assets; (5) information about whether user funds are protected in case of loss and (6) encouraging investors to do research on the assets



[4] Coinbase, "An update on our asset listing process," (July 1, 2022). https://blog.coinbase.com/an-update-on-our-asset-listing-processes-e74421da21cc
[5] Coinbase, "What is the 'Experimental Asset' Label?" (n.d.). https://help.coinbase.com/en/coinbase/trading-and-funding/buying-selling-or-converting-crypto/experimental

they are purchasing. These warnings are the bare minimum necessary when it comes to protecting consumers from fraud and scams and are a far cry from requirements on other unregulated securities and assets which often require that investors are accredited and have sufficient knowledge, income and net worth to weather significant losses. Overall, the DFPI can protect consumers from scams and fraud by requiring and granting registration only to platforms that have sufficient risk management practices and clear consumer notices to limit the risk of harm to investors. These disclosures can reduce the information asymmetries between investors and issuers of crypto securities or related products, enable the DFPI to evaluate compliance, provide a focus for securities fraud litigation claims and allow investors to assess the merits of investing with a particular financial institution.[6]

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

The DFPI can improve consumer education and outreach for crypto related products by collecting complaints and concerns from the public, best practices, information on risks and publicizing them broadly through press releases, reports and public service announcements on podcasts, radio, television and more. This outreach should be targeted towards the demographics that are most likely to invest in crypto products which typically skew towards an audience that is more male, contains more people of color and is younger.[7] Therefore, in addition to traditional media outreach, the DFPI should endeavor to reach consumers on new media platforms like YouTube, Instagram, Twitter and Tik Tok. This would align the DFPI's outreach with media channels that are more likely to reach crypto's younger demographics. This media outreach should highlight common ways to identify crypto scams such as (1) unrealistic promises of guaranteed returns; (2) little documentation or white papers; (3) excessive marketing to build "hype" rather than actual

[6] Johnson, Kristin N. "Decentralized finance: Regulating cryptocurrency exchanges." *Wm. & Mary L. Rev.* 62 (2020): 1911. https://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=3901&context=wmlr
[7] Momentive.ai, "Are crypto, NFTs, and DAOs changing the demographics of investing?" (April 1, 2022). https://www.momentive.ai/en/blog/are-crypto-nfts-and-daos-changing-the-demographics-of-investing/

fundamentals; and (4) unknown creators. Aside from how to identify scams generally, the DFPI should share best practices on how to conduct research on crypto investments which can cover asking questions around (1) the purpose of the crypto asset; (2) how to identify potential for growth; (3) what value the asset provides; or (4) what the roadmap for the project is. Considering the difficulties in reaching consumers in our media saturated landscape, the DFPI should seek to partner with external agencies with expertise in public campaigns to do this outreach work.

Beyond public outreach by the DFPI itself, the DFPI should focus on relationship building and outreach to media channels or influencers that already have a built-in audience and can publicize authoritative information that may be of interest to their audiences. As part of this effort, the DFPI should conduct research and surveys to identify relevant characteristics of consumers that have purchased crypto, their age, race, ethnicity, income, total investment in the sector, types of assets they invest-in and whether they have been a victim of a scam. After completing and publishing this research, the DFPI should endeavor to share these results with journalists, twitter channels, and content creators in the crypto space who can take the research, contextualize it, and share with their respective followings which will aid in consumer education. This type of educational research is sorely missing in the crypto sector and would provide the data necessary to target the DFPI's outreach efforts and would likely be picked up by other outlets and shared more broadly – reaching more consumers as a result. Aside from demographic research, the DFPI could share best practice guides, content around consumer complaints, information about enforcement actions, and other guidance that may provide educational content that can be turned into a Tik Tok or YouTube video. This approach, while novel among government agencies, acknowledges the reality that agencies like the DFPI or CFPB have minimal reach and influence compared to full time content creators or media companies and lack the personality necessary to build an audience among the public. For example, an FTC video on scams from 2018 has approximately 44 thousand views on youtube compared to over 1 million for a similar tik tok video from 2020.[8]

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?**

Consumer protection regulations are critical to safeguard consumer interests and should be directed at preventing unfair, deceptive, fraudulent and abusive practices that harm the end user. The DFPI should look towards existing consumer protection laws within existing financial products and services and apply similar protections to the crypto context. The risks to guard against include (1) price volatility; (2) lack of protection from fraud, hacking, theft etc.; (3) irreversible transactions; and (4) lack of accountability of bad actors due to the decentralized nature of this asset class.[9] Where users hold their assets and private keys themselves it will be difficult for the DFPI to protect consumers from harm, however this is not the case when it comes to financial institutions that act as custodians of consumer assets. Therefore, the DFPI should focus on requiring consumer protections as noted in questions 1 and 4 at exchanges and other institutions that act as crypto asset custodians.

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 DFPI should apply investor protections from traditional financial products to the analogous products in the crypto sector and seek to adapt them to the virtual currency context where possible to protect investors. For example, like many banks, exchanges should keep consumer funds separate from their own funds and 90%+ in cold wallets to protect against loss; these institutions should conduct cybersecurity audits to protect against scams and hackers; and financial audits should be required to ensure that representations made to investors are accurate. While the DFPI should

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[8] FTC, "How Scammers Get You to Pay" ,Youtube (January 3, 2018). https://www.youtube.com/watch?v=PbiXbIHsTqU; Shub Shub, Tik Tok (August 26, 2020). https://www.tiktok.com/t/ZTRUA8QNf/?k=1.

[9] World Economic Forum, "Navigating Cryptocurrency Regulation," (September 2021). https://www3.weforum.org/docs/WEF_Navigating_Cryptocurrency_Regulation_2021.pdf

endeavor to import as many investor protections as necessary from the traditional financial sector, it should also innovate in how it supervises crypto asset providers. For example, the DFPI can build real-time monitoring tools to conduct audits of financial institutions and their transactions using the immutable and public nature of the blockchain.[10] This effort will require hiring staff with the necessary technical expertise and partnerships with third parties that can build blockchain audit tools – however this type of regulatory innovation can save the DFPI significant time and resources in the long-term.

The DFPI should require stronger investor protections when it comes to financial institutions that act as lending platforms and hold consumer funds in interest bearing accounts. These platforms should have consumer and investor protections analogous to traditional financial institutions that engage in deposits and lending. Lending platforms, like Celsius and BlockFi, act as banks by allowing consumers to borrow and lend money, but unlike banks, they do not have nearly the same level of risk management. Celsius went from $25 billion in assets under management to bankrupt within a year and now owes its users $4.7 billion with a $1.2 billion shortfall at minimum.[11] Celsius took money from consumers, made poor investments and loans with those funds - resulting in its collapse when the crypto market hit a downturn and the potential loss of billions for retail investors. The DFPI should ensure that these institutions that act as banks are required to register to do business with California consumers and require consumer protections and sound fiscal management practices as a condition of registration. These protections should include (1) providing consumers with information on how their deposits are invested and the financials of the platform; (2) prohibitions against misrepresentations and fraud; (3) clear opt-in warnings and disclosures that deposits are not FDIC insured and that funds will be lost in event of a

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[10] AICPA, "Blockchain Technology and Its Potential Impact on the Audit and Assurance Profession," (2017). https://us.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/blockchain-technology-and-its-potential-impact-on-the-audit-and-assurance-profession.pdf

[11] MacKenzie Sigalos, " From $25 billion to $167 million: How a major crypto lender collapsed and dragged many investors down with it," CNBC (July 17, 2022). https://www.cnbc.com/2022/07/17/how-the-fall-of-celsius-dragged-down-crypto-investors.html

default; (4) capital adequacy ratios or other liquidity requirements to cover downturns in the market and (5) crypto lenders should document their underwriting process for loans and demonstrate their risk management processes to the DFPI.

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?**

Financial downturns or hacks or theft of funds can disrupt markets causing financial institutions to default, limit lending activities or cause other negative externalities that can cause systemic market risk. Mitigating these risks will require protecting solvency through the imposition of mandatory capital requirements, limiting the size of or types of assets that institutions carry and limiting risky transactions.[12]

- See also questions 1, 3 and 4 above.

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?**

Cryptocurrencies like Bitcoin and other proof of work cryptocurrencies require large amounts of energy to perform tasks like mining and validating transactions. The United States accounts for the largest share of bitcoin mining globally and California is among the top ten states in terms of electricity consumption due to bitcoin.[13] Preventing climate change, mitigating climate risks, and reaching California's ambitious environmental goals will require addressing the consumption of energy and the resulting pollution from the provision and mining of crypto assets. The DFPI should work with other agencies or universities to estimate the climate and energy costs of popular crypto assets and publish a report identifying the worst offenders and recommendations on how to reduce the climate impact of crypto assets. Once this research is complete, the DFPI should require registered financial institutions providing crypto assets to label and disclose the

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[12] Johnson, Kristin N. "Decentralized finance: Regulating cryptocurrency exchanges." *Wm. & Mary L. Rev.* 62 (2020): 1911. https://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=3901&context=wmlr

[13] Cambridge Bitcoin Electricity Consumption Index. (https://ccaf.io/cbeci/mining_map)

climate impact of different assets to build consumer awareness and potentially shape consumer behavior.

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 strive to harmonize its regulatory approach to crypto by engaging with both state and federal authorities in a regular working group. As the Department of the Treasury and others begin crypto-related rulemaking processes,[14] creating a regular working group with the appropriate regulators would help to align definitions, share technical expertise and develop shared language on concepts such as registration exemptions or whether certain assets should be classified as securities, commodities or an entirely new class of regulated financial products altogether. The DFPI could benefit from the significant prior work from regulators such as the SEC and CFTC who have already begun to offer guidance on how to treat particular classes of crypto assets.[15] An alignment process could also help iron out areas where the DFPI could share enforcement duties with federal authorities and ensure consistency with the format and form of the disclosures required when crypto related financial institutions seek to register with their identified regulator. Where possible and appropriate the DFPI should adopt a parallel regulatory model with federal authorities, this can include initiating additional rulemakings or mechanisms to align DFPI regulation with federal ones. This alignment and harmonization process can reduce burdens on financial institutions as well as on regulators. However, where Californians and the DFPI deems it appropriate to impose more stringent regulatory requirements to protect consumers and the market - it should engage in rulemaking to go beyond the “floor” established by federal authorities.

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[14] Department of the Treasury, “Request for Comment: Ensuring Responsible Development of Digital Assets,” (July 8, 2022). https://www.federalregister.gov/documents/2022/07/08/2022-14588/ensuring-responsible-development-of-digital-assets-request-for-comment

[15] SEC, “Framework for ‘Investment Contract’ Analysis of Digital Assets” (April 3, 2019). https://www.sec.gov/files/dlt-framework.pdf; CFTC, “Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets” (January 4, 2018). https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf

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?**

- See question 7.

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?**

The DFPI can make California a desirable place for responsible companies by allowing for soft regulation and guidance through no-action letters, advisory opinions or safe harbors so that companies can have some regulatory certainty as they seek to innovate and offer financial products to Californians.

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?**

A key innovation of crypto that increases financial inclusion among persistently underbanked individuals is the use of cryptocurrencies to facilitate remittances and cross border transfers for lower fees than traditional institutions like Western Union. The DFPI should ensure that its regulations do not materially impact the ability of individuals and financial intermediaries facilitating remittance payments.

<u>CCFPL Regulation and Supervision Scope and Definitions</u>

11. **Financial Code section 90009, subdivision (a) of the CCFPL authorizes the DFPI to "prescribe rules regarding registration requirements applicable to a covered person engaged in the business of offering or providing a consumer financial product or service." Are regulations needed to require registration of crypto asset-related financial products and services with the DFPI under Financial Code section 90009, subdivision (a) of the CCFPL?**

a. What factors should be considered in determining whether the offer or provision of a crypto asset-related financial product or service should trigger registration?

As noted in question 1, the DFPI should ensure that centralized exchanges and lending platforms that take consumer deposits register with the DFPI. This takes into account that these types of platforms are the entry point for first time investors that would benefit from greater accountability and consumer protections.

13. **Financial Code section 90009, subdivision (c) of the CCFPL authorizes the DFPI to "prescribe rules applicable to any covered person or service provider identifying as unlawful, unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service." Are regulations needed to identify any unlawful, unfair, deceptive, or abusive acts or practices in connection with the offering of crypto asset-related financial products and services?**

Regulations under Financial Code section 90009(c) are needed to rein in the predatory, deceptive and unfair marketing practices that plague the industry. Over half of Americans get their news and information from social media sites like YouTube, Instagram, Telegram and Tik Tok.[16] The FTC noted that there has been over $1 billion lost to crypto related fraud since 2021 and that nearly half of people who were defrauded stated that it started with an ad, post or message on a social media platform.[17] The DFPI should issue regulations and conduct enforcement to ensure that social media marketers can be held accountable for unfair and deceptive marketing practices related to crypto scams, particularly when they receive compensation from crypto asset providers.

<u>Conclusion:</u>

Crypto assets can provide an opportunity to build wealth and financial security among communities of color however for this industry to thrive and realize that opportunity it is necessary to provide a baseline level of accountability and consumer protections. To properly realize the benefits of crypto assets, the DFPI should focus on developing rules that protect investors from

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[16] Pew Research, "News Use Across Social Media Platforms in 2020" (January 12, 2021). https://www.pewresearch.org/journalism/2021/01/12/news-use-across-social-media-platforms-in-2020/
[17] FTC, "Reported crypto scam losses since 2021 top $1 billion, says FTC Data Spotlight" (June 3, 2022). https://www.ftc.gov/business-guidance/blog/2022/06/reported-crypto-scam-losses-2021-top-1-billion-says-ftc-data-spotlight

scams, fraud, deceptive marketing and require greater risk management from financial institutions engaged in the provision of crypto related assets and services.

Sincerely,

The Greenlining Institute