

To:

Clothilde V. Hewlett
Commissioner of the California
Department of Financial Protection
and Innovation
2101 Arena Boulevard
Sacramento, CA 95834

January 12, 2024**Re: Proposed application-related rulemaking under
Digital Financial Assets Law (PRO 02-23)**

Coinbase Global, Inc. and its US subsidiary Coinbase, Inc. (together, **Coinbase**) welcome the opportunity to respond to the California Department of Financial Protection and Innovation's (**DFPI's**) call for comments on rulemaking under California's Digital Financial Assets Law (the **Act**).

Coinbase started in 2012 with the idea that anyone, anywhere, should be able to send and receive Bitcoin easily and securely. Today, we are publicly listed in the US and provide a trusted and easy-to-use platform relied on by millions of verified users in over 100 countries around the world to access the broader crypto economy.

Our years of experience provide an important example that DFPI could consider in regulating the digital financial asset industry. Coinbase is the platform of choice for many of the largest, most sophisticated participants in crypto markets, who demand high standards of compliance, risk management, and investor protection. The practices developed at Coinbase provide useful insights that inform our comments.

By passing the Act, California has taken a significant step toward establishing a comprehensive regulatory scheme for digital financial assets. We appreciate DFPI's openness to dialogue and the thoughtful and strategic approach it is taking to regulating the sector. We stand ready to support DFPI as it develops a regulatory framework that puts California on a strong competitive footing for embracing the growing digital assets economy.

Yours sincerely,

Faryar Shirzad
Chief Policy Officer

Introduction

Blockchain technology is the backbone of a new financial architecture. While nascent, it is already bringing efficiency, transparency, and resiliency to the existing financial system.

Blockchain applications enable people to transfer value quickly and at lower cost, particularly for cross-border transfers. Stablecoins that put fiat currencies on digital rails will drive competition in the payments space. Decentralized finance, smart contracts, and related new technologies will drive further innovation and exponentially expand opportunities for the financial system. Yet, digital financial assets are more than a financial innovation; they have the potential to transform every sector of the economy. Today's internet is dominated by a handful of companies that profit from monetizing their users' personal data. The next phase of the internet's development will be owned by builders and users and will be driven by tokens, creating a more decentralized and community-governed version of the internet.

California, home of the largest digital financial asset market in the U.S. and a deep talent pool, stands to play a crucial role in the development of crypto. A well-designed and implemented digital financial asset regulatory framework can put California at the forefront of the digital finance revolution. While the Act represents an important effort to implement a comprehensive regulatory framework for digital financial assets, other states have also made significant headway in delivering legal and regulatory certainty to the market. It is time for California to seize the opportunity and implement a tailored regulatory framework that promotes responsible innovation.

Key principles for a regulatory framework

In this letter, we provide a number of concrete suggestions to improve California's proposed digital asset regulatory regime. Our preference is that these be addressed in amendments to the Act to have maximum regulatory clarity, and we look forward to working with the legislature and DFPI on the clarifying legislation that the Governor has indicated is appropriate.¹ However, if it is not feasible to make the relevant changes to the Act itself, we suggest that these issues be considered by DFPI when implementing regulations under the Act. We understand that, in certain cases, DFPI will be bound by provisions of the Act that will not allow them to implement our suggested concepts, absent changes to the Act. As an initial matter, we wish to highlight four key concepts:

1. The concept of "control" should not capture innovative wallet solutions

Technological advances in the digital asset industry, like multiparty computation (**MPC**) and other so-called "multi-sig" configurations, allow industry participants to provide wallet services to customers that protect customers' assets while leaving customers in

¹ See Letter from Gov. Gavin Newsom to Members of the California State Assembly (Oct. 13, 2023).

control of their digital financial assets. By requiring multiple parties to sign a transaction, MPC and multi-sig configurations provide an additional safeguard against theft. The wallet service provider could, for example, have the ability to prevent a fraudulent transaction without infringing on the customer's ultimate control over the assets. These solutions also protect users in the event that the wallet service provider is hacked.²

MPC and multi-sig providers (**MS Providers**) do not "control" their customers' digital financial assets like a standard custodian does. A standard custodian often has unilateral authority to move customer assets between accounts and may even be able to rehypothecate customer assets (a practice in which Coinbase does not engage). This is not the case with an MS Provider. An MS Provider's private key is necessary to effect a transaction. But it is not sufficient.

By broadly defining "control," however, the Act may improperly subject MS Providers to requirements that should only apply to "true" digital financial asset custodians—i.e., entities that, like traditional custodians, have sole practical control over a customer's assets.³

We do not think the Act intends to treat MS Providers as controlling customer assets. The commentary to the Uniform Regulation of Virtual-Currency Businesses Act (**URVCBA**),⁴ which appears to have been a reference point for these provisions of the Act and defines "control" similarly, explicitly states that the definition of "control" is not intended to reach multi-sig arrangements where keys are shared among various parties.⁵ DFPI should incorporate this same guidance. Otherwise, wallet service providers could be considered as engaging in "digital financial asset business activities" and required to comply with the Act's provisions that are aimed at financial intermediaries and custodians.⁶ As currently drafted, the inclusion of MS Providers in this definition would result in substantive complications that the Act surely did not intend to create.

Moreover, if MS Providers fall within the scope of the Act, then their wallet services could be considered a "covered exchange" if they allow their users to trade digital financial

² For more information on MPC and Coinbase's efforts to provide simple and safe wallets, see [Building user-focused web3 wallets at Coinbase](#) (June 20, 2023).

³ See Financial Code § 3102(c)(1) (defining "control" to mean the "power to execute unilaterally *or prevent indefinitely* a digital financial asset transaction") (emphasis added).

⁴ The URVCBA is a piece of model legislation drafted by the Uniform Law Commission. Many of the URVCBA's provisions are included in the Act. See generally Uniform Law Commission, [Regulation of Virtual Currency Businesses Act](#).

⁵ URVCBA prefatory note; § 102 cmt.

⁶ See Financial Code §§ 3102(i)(1) (defining "digital asset business activity" to mean, in part, "storing a digital financial asset"); 3102(w) (defining "store" to mean "maintain control of a digital financial asset on behalf of a resident by a person other than the resident").

assets between their wallets.⁷ As operators of a covered exchange, MS Providers would need to comply with the Act's listing requirements for each digital financial asset exchanged by their users.⁸ These requirements include, among others, a costly and complex legal analysis of the status under federal or state law of any supported digital financial assets. That requirement may make sense in the context of an exchange, but not for an MS Provider, which is more akin to a pure software developer, or a provider of data storage services, and should be similarly exempt.

2. No one type of trade execution is most favorable

Traders of digital financial assets - like in many other markets - vary in the importance they place on price, volume, and immediacy of execution. Traders may even hold different preferences depending on the type of transaction they wish to execute. Digital financial asset exchanges have created unique ways for traders' preferences to be implemented, allowing traders to dictate the terms of their transactions. For example, some automated market makers, like Uniswap, allow users to select the trading pair, amounts, and slippage they are willing to accept. The users' orders will only be executed if all of their selected preferences are met.

The Act requires covered exchanges to "use reasonable diligence to ensure that the outcome to the resident is as favorable as possible under prevailing market conditions."⁹ It then lists a number of non-exclusive factors, including the "accessibility of appropriate pricing" and "the number of markets checked," that will be used to determine whether a covered exchange complies with the Act's execution requirements.

We urge DFPI not to prescribe specific trade routing rules as it decides how best to implement the Act's trade execution provisions. We believe that trade routing rules will only inhibit innovation, reduce flexibility, and increase complexity and fees for users. Certain rules, used in traditional financial markets, would be counterintuitive if implemented in digital financial asset trading markets. For instance, Regulation NMS requires national securities exchanges to prevent "trade-throughs," or instances when an exchange performs a trade at a price lower than that displayed on another exchange.¹⁰ The application of trade-through rules to traditional equity securities has drawn controversy in traditional finance (TradFi) due to the layers of complexity that trade-through rules add, even though equity securities are typically fungible and should

⁷ See Financial Code §§ 3505(c)(2) (defining "covered exchange" to mean "a covered person that exchanges or holds itself out as being able to exchange a digital financial asset for a resident"); 3102(d) (defining "covered person" to mean "a person required to obtain a license pursuant to" the Act); 3102(k) (defining "exchange" to mean "assume control of a digital financial asset from, or on behalf of, a resident, at least momentarily, to sell, trade, or convert").

⁸ See Financial Code § 3505(a)(1) (requiring a covered exchange to comply with the Act's listing requirements before "offering a digital financial asset that the covered exchange can exchange on behalf of a resident").

⁹ Financial Code § 3505(b)(2)(A).

¹⁰ See Regulation NMA Rule 611; SEC, Regulation NMS, at 22 (Aug. 29, 2005).

have similar prices across exchanges. Trade-through rules would be even less suitable for digital financial assets markets, where traders value outcomes other than price.

We believe that DFPI should require covered exchanges to disclose their execution practices to their customers. Customers can use these disclosures to make informed choices about the covered exchanges and types of orders they would like to use.

3. Licensing fees and supervisory assessments should be tailored to the burden placed on DFPI

The licensing fees and supervisory assessments imposed by the Act are intended to recover the costs incurred by DFPI to review license applications and supervise licensees. DFPI will expend significant time and effort supervising licensees with less-developed compliance systems and controls. DFPI will need less time supervising licensees for which compliance systems and controls are already a priority. For example, DFPI will likely spend less time supervising licensees that engage in order matching without taking control of customer assets or custody customer property in a manner that effectively preserves the customers' title and rights to the assets.

DFPI should accordingly tailor the licensing fees and annual examination assessment charged to applicants and licensees to the risks posed by each applicant and licensee.

First, and as further discussed below in response to Question 2, DFPI should tie the nonrefundable fee paid by an applicant to the risk posed by the applicant's activities.

Second, the legislature or DFPI should adjust the assessment fee charged to licensees to account for the costs actually incurred by DFPI to examine each licensee. The Act's current assessment formula requires a licensee to pay its pro rata cost share of DFPI's supervisory costs. This is a good approach in principle. But the Act would measure these costs by the number of residents with whom the licensee conducts digital financial asset business activities compared to the overall number of residents with whom all licensees conduct digital financial asset business activities.¹¹ We think this is not the right approach and it is likely to lead to several issues in practice:

- The actual supervisory costs borne by DFPI for each licensee is unlikely to correlate closely with the number of residents with whom the licensee serves. Although it would be impractical to expect DFPI to individually charge each licensee based on the precise efforts it took to supervise the licensee's particular affairs, DFPI can better tailor the assessment so that entities that require more supervision (e.g., because they offer riskier services) bear more of DFPI's supervisory costs. One option could be to develop tiers of fees based on an

¹¹ Financial Code § 3211(c)(2).

assessment by DFPI on the resources expended to examine any particular licensee.

- Moreover, even if tying assessments to the number of residents served by a licensee were the proper approach, there are likely to be significant measurement issues with the current assessment formula. This is because some market participants technically only have a handful of customers, even if many end users ultimately use their services and products through those customers. As drafted, such a market participant would only be required to pay a small fraction of the supervisory costs it would otherwise be charged were the formula to consider all the true underlying users of the market participant's products or services.
- Charging licensees' fees based on the size of their user base incentivizes digital financial asset market participants to reduce their user base rather than bring more customers into the fold. When choosing which customer accounts to retain, licensees will likely select their most profitable accounts (e.g., institutional clients or high net-worth individuals). In fact, some digital financial asset companies have already created two-tiered models, where the companies interface with a small set of intermediaries that then do business with a larger set of users. These actions serve to put more power in a small number of intermediaries, upsetting the promise of blockchain technology and permissionless protocols to create further decentralization.

4. California should provide interstate reciprocity

Coinbase and many other market participants are already subject to other states' comprehensive regulatory and supervisory schemes for digital financial asset business activities.¹² New York's license for entities conducting virtual currency business activities (the **BitLicense**) is a good example. We encourage California and DFPI to incorporate concepts of reciprocity and substituted compliance in the Act. Cross-state cooperation would avoid imposing conflicting requirements. It is also in the best interests both of the DFPI, who would save on its own investigation and monitoring costs, and digital financial asset market participants, who face less regulatory uncertainty and save on compliance costs by not being required to comply with multiple sets of duplicative rules. DFPI has a successful history of participating in such inter-state cooperation. For example, California participates in the MSB Networked Supervision program, which allows a money transmitter to be examined by one participating state and thereby satisfy the examination

¹² These include, for example, Louisiana's Virtual Currency Business Act and New York's BitLicense regime, with other states expected to adopt detailed frameworks in the years to come. Due to the similarities between the two frameworks, we make frequent comparison and reference in this response to the New York BitLicense regime, but would encourage the DFPI to work collaboratively with the Louisiana Office of Financial Institutions and other state supervisors as adoption of crypto-asset regulatory frameworks increases.

requirements for all participating states.¹³ DFPI should apply a similar approach for digital financial asset businesses, such as by coordinating with the New York Department of Financial Services (**NYDFS**) in its examination of BitLicensees. Particularly in a rapidly developing new industry, it is important to develop harmonized rules that do not stifle well-intending new upstarts. We urge DFPI to recognize the efforts of other states that already subject Coinbase and other market participants to rigorous application reviews and examinations. We also suggest that DFPI recognize other state regulators' decisions regarding digital financial asset listings.

In particular, DFPI should:

- Apply a presumption that any digital financial asset that has been approved for listing through a process approved by NYDFS (e.g., digital financial assets certified using a NYDFS-approved self-certification process or digital financial assets on the NYDFS "Greenlist") should be approved, or conditionally approved, for listing by a covered exchange;
- Grant conditional licenses to any entity that is licensed to conduct digital financial asset business activity (or a comparable term) by another state's regulators; and
- Work with other states' digital financial asset regulators to conduct joint examinations, similar to those done for money transmitters under MSB Networked Supervision.

The legislature could also promote interstate reciprocity by amending the Act to exempt state-chartered trust companies from the Act's licensure requirements.¹⁴ Currently, the Act provides an exemption only for trust companies chartered by California or national associations authorized to engage in trust business.¹⁵ Yet, numerous businesses already offer safe and responsible custody solutions to customers through trust companies chartered in other states.¹⁶ These trust companies are subject to strict regulation and rigorous supervision.¹⁷ They also provide an essential custody service to retail and institutional customers. Rather than duplicate other states' supervisory efforts, California

¹³ Conference of State Bank Supervisors, [State Regulators Roll Out One Company, One Exam for Nationwide Payments Firms](#) (Sept. 15, 2020). As a separate example at the national level, the SEC and CFTC each have a long history of applying substituted compliance, both with each other and with non-U.S. regulators.

¹⁴ While we recognize that the DFPI cannot make amendments to the Act itself, throughout this letter we suggest changes to the Act and encourage the DFPI to use its expertise to work with the Legislature and Governor and provide technical assistance in making these amendments.

¹⁵ Financial Code § 3103(b)(3).

¹⁶ For example, Coinbase Custody Trust Company, LLC is a NY-chartered trust company. Coinbase, Licenses.

¹⁷ For instance, NYDFS imposes capital requirements on limited purpose trust companies and prohibits changes in ownership. See NYDFS, Organization of a Trust Company for the Limited Purpose of Exercising Fiduciary Powers.

should allow these trust companies to conduct digital financial assets business activity in California under their existing license.

Moreover, we recommend that DFPI use its authority under the Act to exempt licensees from certain disclosure requirements if the licensees participate in the Nationwide Multistate Licensing System and Registry (**NMLS**). NMLS streamlines the reporting obligations of certain financial institutions, allowing them to fulfill multiple states' reporting requirements through reports filed with NMLS. Many state regulators are likely to use NMLS to collect information on regulated entities that conduct digital financial asset business activities. For example, NYDFS already uses NMLS to manage BitLicenses.¹⁸ We believe that there are particular reporting and disclosure requirements that could be collected through NMLS rather than requiring a licensee to file a separate report with DFPI. These requirements include:

- The event-reporting disclosures included in a licensee's annual report;¹⁹ and
- The current event reports that must be filed with DFPI.²⁰

The next section of this letter addresses DFPI's specific questions.

¹⁸ NYDFS, [Virtual Currency Businesses: Information for Applicants](#).

¹⁹ See Financial Code § 3211(b)(3)

²⁰ See Financial Code § 3307.

Chapter 2 License application form and related fees

1. **Financial Code section 3203, subdivision (a)(2)(X) requires the license application to include “any other information” the DFPI reasonably requires by rule. In addition to the information that is listed in the law, what other information should the application include?**

The information to be requested by DFPI under Financial Code section 3203, subdivision (a)(2) will provide DFPI with the information it needs to conduct a comprehensive review of an applicant. To further enhance the ability of DFPI to assess applicants, DFPI should consider requiring:

- A list of all of the applicant’s affiliates and an organization chart illustrating the relationship among the applicant and such affiliates; and
- An explanation of the methodology used to calculate the value of a digital financial asset in fiat currency.

2. **Financial Code section 3203, subdivision (a)(3) requires the license application to be accompanied by a nonrefundable fee to cover the reasonable costs of application review. Additionally, Financial Code section 3203, subdivision (e) requires the applicant to pay the reasonable costs of the DFPI’s investigation under section 3203, subdivision (b).**

- a. **Are there aspects of the costs and fees in Financial Code section 3203 that should be clarified through rulemaking?**

DFPI should consider clarifying the typical costs incurred during an application review, and how the costs may differ across different applicants. In particular, DFPI should:

- Provide a cost estimate for a typical application investigation; and
- Limit application investigation costs that would need to be reimbursed to \$5,000 per investigation. Capping the investigation costs that any one applicant would need to reimburse would establish clear policies up front regarding the maximum possible costs applicants could incur in relation to an application. Applicants that have never applied for a money transmitter or digital financial asset license may be unaware of the costs they may incur during an examination and might otherwise be dissuaded from applying due to a lack of clarity as to the costs. Moreover, DFPI will likely be able to cover most of its investigation costs, even if it places a limit on how much it can be reimbursed for its investigation costs—meaning the up front clarity for applicants will not materially limit DFPI’s efforts. We note that other state regulators do not require applicants to pay any costs beyond their initial application fee, which suggests that the nonrefundable fee may be sufficient to cover the

regulators' investigation costs. For example, the application fee for licensing under part 200 of Title 23 of the New York Code of Rules and Regulations (the BitLicense Regulations) is \$5,000 and covers NYDFS's investigation costs related to the licensing application.

b. Are there factors the DFPI should consider in determining these reasonable costs and fees? For example, should the DFPI charge every applicant the same application fee, or charge different fees depending on the type or complexity of the application? Where applicable, please provide information about the methodology and impact of costs and fees in other state or federal regulatory environments.

DFPI should charge every applicant the same application fee. That is what DFPI does for the application fee under both Division 1.2 of California's Financial Code (the **CA Money Transmission Act**) and NYDFS does for BitLicenses.²¹ This would provide certainty for applicants and be equitable. However, if DFPI decides to charge different application fees to applicants, it should take into consideration whether the applicant is already subject to a comparable regulatory regime. An applicant that has already undergone a similar application process under another state's digital financial asset regulatory regime, such as New York's BitLicense Regulations may not require significant further investigation, as they have already been examined, and are subject to continuing supervision and examination, by another state regulator (e.g., NYDFS). They accordingly should be subject to lower fees.

If DFPI decides to charge different application fees to applicants, it should also avoid charging an application fee that depends, in part or in whole, on the number of users or residents with whom the applicant engages in digital financial asset business activity. As discussed above, a fee that varies based on an applicant's user base may cause unwanted outcomes, such as incentivizing an applicant to offboard certain users. A user-based fee would also have the effect of causing an applicant to subsidize the application review of its competitors, including significantly more complex competitors, if the applicant happens to have a larger user base. Moreover, merely counting the number of residents for whom an applicant performs digital financial asset activities may lead to inaccurate results. Some applicants may technically conduct business with a small number of users but, in reality, offer products or services that are used by a much larger share of users.

²¹ See Financial Code § 2032(a); 23 NYCRR § 200.5.

Chapter 3 Surety bond or trust account

3. What factors should the DFPI consider in determining the dollar amount of surety bond or trust account it may require under Financial Code section 3207, subdivision (a)?

DFPI should follow the approach set forth in the [CSBS Model Money Transmission Modernization Act \(MTMA\)](#). The MTMA accounts for a licensee's financial condition by limiting the surety bond required for a licensee to \$100,000 if the licensee's net worth exceeds 10% of its total assets. If a licensee's net worth does not exceed 10% of its total assets, then the MTMA ties the amount required to be held as surety to the amount of customer funds being transmitted, a widely adopted approach. The MTMA provides that an applicant's surety bond should be equal to one hundred percent of the licensee's average daily money transmission liability in a particular state. The MTMA also caps the amount that could be potentially held as surety at \$500,000. DFPI should follow this same approach.

4. Should the DFPI require a minimum amount of surety bond or trust account? Please explain.

The amount required for a surety bond or trust account should be tailored to the risk of each licensee. While a minimum amount of surety bond or trust account may be useful for purposes of providing an estimate for potential applicants, DFPI should be careful not to establish a minimum amount that is overly onerous for licensees that pose little risk to customers.

In addition to considering a minimum amount of surety bond or trust account, DFPI should consider whether to limit how much a licensee can be required to hold as surety bond or in a trust account. A maximum surety bond requirement, which could either be a flat amount or based on a ratio to the licensee's total assets, would create clarity for licensees and ensure that a licensee does not need to suddenly respond to a surety bond raise notice from DFPI.²² A cap on a licensee's surety bond requirements would align with the MTMA, which limits how much a money transmitter licensee can be required to hold as surety.²³

5. Should surety bond or trust account amounts vary by the type of activity requiring licensure? Please explain.

As noted in our response to Question 3, DFPI should consider the type of activity requiring licensure when determining the amounts to be held by licensees in surety bonds or trust accounts.

²² See Financial Code § 3207(d) (stating that a licensee has 30 days to increase its capital in response to a revised requirement from DFPI).

²³ See MTMA § 10.02.

6. How should specific activity requirements provided for in DFAL, such as the custody requirements of Financial Code section 3503 or the reserve requirements of Financial Code section 3601, impact surety bond or trust account amounts?

Many custodians, like Coinbase, ensure that they hold enough digital financial assets to meet their customers' claims. The custody requirements under Financial Code section 3503 enshrine this practice into law. The reserve requirements under Financial Code section 3601 also reflect the practice of many payment stablecoin issuers to hold highly liquid reserves on a 1:1 basis with their outstanding redemption obligations.

Each of these requirements lower the risk to customer funds posed by certain licensees (i.e., custodians and stablecoin issuers). As a result, DFPI should consider lowering the amount that licensees subject to these requirements should hold in surety bonds or in trust accounts and place reasonable caps on each requirement.

Chapter 4 Capital

- 7. Financial Code section 3207, subdivision (b) requires a licensee to maintain capital “in an amount and form as the [DFPI] determines is sufficient to ensure the financial integrity of the licensee and its ongoing operations based on an assessment of the specific risks applicable to the licensee.” It provides nine factors the DFPI may, but is not required to, consider when determining the minimum amount of capital required of a licensee. Are the factors provided in Financial Code section 3207, subdivision (b) sufficient, or are additional factors needed and if so, what should those potential additional factors be and why?**

DFPI, consistent with our call for regulatory cooperation above, should take into consideration the capital requirements already imposed by other states. Many licensees may already be subject to net worth or minimum capital requirements due to various states’ regulatory requirements for conducting money transmission or digital financial asset business activities. As a result, many licensees are likely to be well-capitalized and able to meet the capital requirements set forth by DFPI.

However, the Act imposes new compliance obligations on licensees that do not have parallels with other states’ regulatory regimes. First, it implies that DFPI may create liquidity requirements for licensees.²⁴ Second, it only allows a licensee 30 days to comply with a requirement to increase its capital or liquidity from DFPI.²⁵

In order to bring clarity to market participants, we urge DFPI to publicly disclose the methodology and calculations it will use to determine a licensee’s capital and liquidity requirements. Licensees should be able to plan for any potential increases in their capital and liquidity requirements rather than wait for a DFPI notice. By providing its methodology and calculations, DFPI will encourage licensees to manage their capital and liquidity on a proactive, rather than reactive, basis.

We also request that DFPI clarify that digital financial assets held in custody for a licensee’s customers should not be included in the licensee’s total assets and liabilities when determining a licensee’s required capital.²⁶ Many auditors do not include these types of digital financial assets on a custodian’s balance sheet. However, publicly reporting custodians are required under SAB 121 to report customers’ assets held in custody on their balance sheet.

- 8. Should capital minimums vary by the type of activity requiring licensure?**

Certain activities related to digital financial assets pose less of a risk to customer funds than others. As noted above in response to Question 6, many digital asset custodians

²⁴ See Financial Code § 3207(b).

²⁵ See Financial Code § 3207(d).

²⁶ See Financial Code § 3207(b)(1)–(2).

hold their customers' digital financial assets on a 1:1 basis. Additionally, many custodians comply with Article VIII of the Uniform Commercial Code to ensure that their customers hold title to their digital financial assets held at the custodian, free of any claims. The Act makes clear that digital financial assets held by a custodian that conducts these practices are "deemed to be held in trust for the benefit of the [custodian's] customers" in the event of a bankruptcy or action by one of the custodian's creditors.²⁷

We urge DFPI to limit the amount of capital a digital asset custodian needs to hold if it already holds customers' digital financial assets on a 1:1 basis. The Act's provisions make clear that, even in the event of a custodian's bankruptcy, digital financial assets held by a custodian on customers' behalf should be considered "customer property" and returned to customers. As a result, little-to-no additional capital should be necessary to secure customers' claims.

²⁷ Financial Code § 3503(d).

Chapter 5 Stablecoin approval process

9. **Under Financial Code section 3603, subdivision (b)(2)(B), in determining whether to approve a stablecoin the Commissioner must consider “[t]he amount, nature, and quality of assets owned or held by the issuer of the stablecoin that may be used to fund any redemption requests from residents.” Subdivision (a)(2) of Financial Code section 3601 requires that the “issuer of the stablecoin at all times own[] eligible securities having an aggregate market value computed in accordance with United States generally accepted accounting principles of not less than the aggregate amount of all of its outstanding stablecoins issued or sold.” Subdivision (b)(1) of Financial Code section 3601 specifies that “eligible securities” means those described in subdivision (b) of Financial Code section 2082 or foreign currency eligible securities described in subdivision (c) of section 2082.**
- a. **Given that Financial Code section 3601 already restricts the types of assets that qualify as eligible securities (and can therefore be used to fund redemption requests) that an issuer may hold to those assets described in Financial Code section 2082, are there other criteria that the DFPI should consider in evaluating “quality of assets” under Financial Code section 3603, subdivision (b)(2)(B)?**

The assets listed as eligible securities that can be held as reserves are appropriate for this purpose because they are high-quality, highly liquid, low-risk, and have demonstrated resilience during market downturns. However, regulators should recognize that there are other types of assets that, while not listed as “eligible securities” by the CA Money Transmission Act, also have these characteristics and should be eligible stablecoin reserves. Repurchase agreements with eligible security underliers (e.g., US Treasuries) are a key example. If needed, DFPI should use its rulemaking authority under the CA Money Transmission Act or this Act to include repurchase agreements in the list of “eligible securities.”²⁸ Repurchase agreements are both low-risk and highly liquid, and stablecoin issuers should be allowed to hold repurchase agreements as reserves for their outstanding obligations. Nearly every legislative proposal to date would allow for stablecoin issuers to hold repurchase agreements as reserves.²⁹

Additionally, the legislature or DFPI should consider limiting the Act’s stablecoin provisions to the subset of stablecoins that are backed by traditional financial assets denominated in a fiat currency (e.g. US dollars), similar to the approach used in all of the leading legislative proposals to date. Users hold and trade this type of stablecoin, often called “payment stablecoins” by the legislative proposals and other regulators, on the belief that

²⁸ See Financial Code § 2082(b)(11) (including in the list of “eligible securities . . . [a]ny other security or class of securities that the commissioner has by regulation or order declared to be eligible securities”).

²⁹ See Clarity for Payment Stablecoins Act § 4(1)(A)(iv) (2023); Discussion Draft from Maxine Waters § 102(b)(4)(A)(iii) (2023).

they can redeem their payment stablecoins for fiat currency on a 1:1 basis. Maintaining consumer confidence in payment stablecoin issuers' ability to redeem stablecoins at par is crucial for a well-functioning digital financial asset market. Therefore, it makes sense for regulators to subject payment stablecoin issuers to more rigorous regulations, like reserve requirements, and enhanced supervision.

On the other hand, users hold other types of stablecoins, such as overcollateralized digital financial asset-backed stablecoins (e.g., DAI), for different reasons and hold different expectations about their redeemability. The difference in use cases explains why U.S. regulators have limited, or proposed to limit, stablecoin regulations to "payment stablecoins." For example, NYDFS has specified that its stablecoin guidance only applies to dollar-backed stablecoins.³⁰ Meanwhile, the bills released by Representatives McHenry and Waters both limit their provisions to payment stablecoins.³¹

The legislature or DFPI can require that covered exchanges and stablecoin issuers provide clear disclosures as to whether a particular stablecoin is a payment stablecoin. Transparency and disclosures will help customers make informed decisions.

b. Regarding the amount and nature of assets, is there particular information that the DFPI should consider?

A payment stablecoin issuer's reserves should (1) be worth at least the outstanding obligations of the issuer and (2) be composed of high-quality, highly liquid assets, to make sure that customers' redemption requests can always be satisfied through periods of market stress.

10. Under Financial Code section 3603, subdivision (b)(2)(C), in determining whether to approve a stablecoin the Commissioner must consider "[a]ny risks related to how the assets described in subparagraph (B) are owned or held by the issuer that may impair the ability of the issuer of the stablecoin to meet any redemption requests from residents." Are there particular risks regarding how assets are owned or held that the DFPI should consider?

Stablecoin issuers should take measures to make sure that the reserve assets underlying the stablecoin are bankruptcy-remote, i.e. that such reserves are available only to meet redemption requests from holders of the stablecoin and are not available to satisfy any claims that other creditors of the stablecoin issuer may have in an event of insolvency. Provided that this standard is satisfied, we believe that DFPI should consider the risks noted in this question to be sufficiently addressed.

³⁰ See NYDFS, Guidance on the Issuance of U.S. Dollar-Backed Stablecoins (June 8, 2022) (stating that the guidance "applies only to stablecoins backed by the U.S. dollar") (emphasis in original).

³¹ See Clarity for Payment Stablecoins Act §§ 2(13); 3 (2023); [Discussion Draft from Democratic Members of House Financial Services Committee](#) §§ 101(16); 102(a)(1) (2023).

11. Under Financial Code section 3603, subdivision (b)(2)(F), in determining whether to approve a stablecoin, the Commissioner must consider “any other factors the commissioner deems material to making their determination.”

a. To what extent should the DFPI consider the amount and type or quality of the issuer’s other liabilities before approving a stablecoin?

Provided that a stablecoin meets the standards discussed in this Chapter – including for issuers to make sure that outstanding stablecoins are fully backed by safe, liquid reserve assets, and to hold the reserve assets in a bankruptcy remote manner – other liabilities of the issuer or its affiliates are not material to the DFPI’s consideration.

b. What “other factors” should the DFPI consider?

We believe the factors described above are adequate to assess stablecoin issuers.

c. Should the DFPI consider whether the stablecoin is listed on the “Greenlist” maintained by the New York State Department of Financial Services? Please explain why or why not.

DFPI should apply a presumption that any stablecoin listed, either currently or in the future, on the “Greenlist” by NYDFS should be approved for listing in California. NYDFS places heightened requirements on stablecoin issuers and will only approve a stablecoin if:

- The stablecoin’s reserves are equal to, or greater than, “the nominal value of all outstanding units of the stablecoin as of the end of each business day”;
- The stablecoin issuer adopts redemption policies that disclose what a “redemption” is and the timing of “timely” redemption;
- The stablecoin issuer holds, as reserves, certain assets that are also found in the list of “eligible securities” in Financial Code section 2082; and
- The stablecoin issuer receives a monthly and annual attestation from a licensed Certified Public Accountant.

Stablecoins that have been approved by NYDFS meet the requirements established by the Act. Approving stablecoins that appear on the “Greenlist,” DFPI would be an effective method for advancing interstate reciprocity and reduce the costs faced by compliant industry participants.

Just because a stablecoin is not listed on the “Greenlist,” does not, however, mean that it does not satisfy the Act’s requirements. DFPI should independently consider stablecoins not listed on the “Greenlist.”

12. Under Financial Code section 3603, subdivision (c), the Commissioner may impose conditions, restrictions, or other requirements on an issuer or a covered person as a condition of approval of a stablecoin.

a. Are there restrictions or requirements that should be imposed generally on all issuers or covered persons? If so, why?

The Act provides adequate safeguards to stablecoin holders. We do not believe that any additional restrictions or requirements are warranted.

b. Should there be a general requirement that all issuers certify that they meet requirements similar to those for covered exchanges under Financial Code section 3505, subdivision (a)?

While the certifications required by the Act for covered exchanges are important, we do not believe a similar certification requirement would meaningfully benefit stablecoin holders in light of the protections already established under Chapter 6 of the Act.

Chapter 6 Additional comments

13. Are there any additional matters related to the DFAL license application, licensure requirements, or stablecoin approval that the DFPI should consider when proposing regulations?

License application

- Timeline to review:** DFPI should establish a timeline for a required response to an application. The URVCBA, for example, states that if a state virtual currency regulator does not respond to an application within 30 days, the application is deemed denied.³² Applicants would likely be concerned with the time it takes for DFPI to conduct its review and investigation of the applicant because the Act provides that an applicant must reimburse DFPI for its reasonable investigation costs. Longer reviews would likely lead to higher costs borne by the applicant. Before the 30 day period ends, DFPI could indicate to an applicant its intended decision. If DFPI intends to conditionally approve or deny the applicant, it could provide that, alternatively, the applicant could resubmit and reopen the 30 day window. The applicant would then be empowered to decide whether it wishes to incur another 30 days of investigation costs. If the applicant chooses to reapply, DFPI should not charge the applicant an additional application fee for its resubmission.
- Responsible individual:** DFPI should clarify what individuals are captured by the “responsible individual” term within the Act and limit the number of responsible individuals required to submit information as part of the licensure application process. Without further guidance, it is unclear which individuals fall within the scope of this term.

Licensure requirements

DFPI should provide additional clarity regarding the trust accounts where licensees can hold security required under the Act. First, DFPI should clarify that under the Act, DFPI only needs to provide prior approval for the bank, trust company, credit union, or federal credit union in which an applicant places its trust account.³³ DFPI should clarify that it does not need to pre-approve the specific trust account arrangement between the applicant and the bank, trust company, credit union, or federal credit union.

Second, DFPI should indicate how a bank, trust company, credit union, or federal credit union can receive prior approval from DFPI to hold trust accounts for licensees. In tandem,

³² URVCBA § 202(e).

³³ See Financial Code § 3207(a)(1)(B).

DFPI should provide factors it will use when determining whether to approve a bank, trust company, credit union, or federal credit union to hold the trust accounts of licensees.

14. What future rulemaking actions related to the administration of the DFAL should the DFPI consider, and why?

In addition to the topics noted above, we respectfully suggest that DFPI consider the following rulemaking actions.

Coverage of the Act

- **Digital asset gaming tokens:** DFPI should clarify that “digital financial asset business activity” does not cover (1) the issuance of web3 gaming tokens by web3 gaming companies; and (2) the exchange of web3 gaming tokens on secondary marketplaces.
 - Issuance: The Act states that “digital financial asset” does not include 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.”³⁴ However, web3 gaming is built on the premise that users can port in-game assets across games, including games sold by different publishers and offered on different platforms. Without clarity from DFPI, many web3 gaming tokens may fall within the scope of “digital financial asset,” meaning that the exchange, transfer, or storage of these web3 gaming tokens will constitute “digital financial asset business activity.” Many web3 gaming companies, which transfer and store web3 gaming tokens for their users, will be subject to the Act’s provisions related to conducting a digital financial asset business activity. We think that many of these requirements would be unduly burdensome for gaming companies and would stifle innovation.
 - Exchange: The Act brings much of the exchange of web3 gaming tokens within the scope of regulated “digital financial asset business activity.”³⁵ DFPI should limit the extent to which the exchange of web3 gaming tokens, on web3 gaming platforms and through secondary exchanges, is treated as “digital financial asset business activity.” Otherwise, DFPI risks subjecting the burgeoning web3 gaming industry to regulations aimed at financial issuers and intermediaries.

Reporting requirements

To the extent a licensee is not exempt from making certain disclosures already provided

³⁴ Financial Code § 3102(g)(2)(B).

³⁵ See Financial Code § 3102(i)(3).

in NMLS (see Key Principle No. 4), DFPI should clarify the disclosures a licensee is required to include in the annual report required under the Act.

- **Event disclosures:** The Act requires a licensee to include in its annual report “[a]ny international, federal, state, or local investigation of the licensee, where permitted by applicable law” and “[any] data security breach or cybersecurity event of the licensee.”³⁶ DFPI should clarify that a licensee only needs to include material investigations and material data security breaches or cybersecurity events in its annual report, similar to the Act’s requirements that only material changes to a licensee’s financial conditions and material litigation events need to be included.³⁷
- **Quantifying residents engaged by a licensee:** In several places, the Act requires a licensee to identify the number of residents with whom a licensee has engaged in digital financial assets business activity.³⁸ However, it will be difficult for licensees to determine whether a customer is a “resident” for purposes of the Act. The Act defines a “resident” as “[a] person who is physically located in [California] for more than 183 days of the previous 365 days.” Coinbase, like other financial institutions, keeps records of where its customers are domiciled. Those records, though, will not provide insight onto a particular customer’s physical location throughout the year. Instead, a licensee would need to monitor where its customers are physically located on a daily basis in order to determine if any of them are “residents.” We request that DFPI clarify that relying on tax documents or customer certifications is sufficient to determine whether a particular customer is a “resident.”

DFPI should also indicate what changes to the information included in a licensee’s application or annual report would be considered “material” and required to be disclosed in a current event filing.³⁹

- **Bank changes:** DFPI should clarify that a licensee depositing funds into a new bank, unless the deposited funds relate to the licensee’s trust account or stablecoin reserve requirements, is not material. Like many companies, licensees are likely to enter into new banking relationships. However, most new deposit arrangements will not harm the ability of a licensee’s customers to recover their property if the licensee became insolvent. Moreover, it would be onerous for licensees to disclose each time they deposit funds into a new bank. DFPI should

³⁶ Financial Code § 3211(b)(3)(C)–(D).

³⁷ See Financial Code § 3211(b)(3)(A)–(B).

³⁸ See, e.g., Financial Code §§ 3201(c)(2)(V) (requiring an applicant to disclose “[t]he number of residents with whom, or on behalf of, the applicant engaged in digital financial asset business activity in the month preceding the month in which the applicant submits an application for a license under this division to the department”); 3211(b)(10) (requiring a licensee to disclose in its annual report “[t]he number of residents with whom, or on behalf of, the licensee engaged in digital financial asset business activity” in the year covered by the report).

³⁹ See Financial Code § 3307(a)(1).

weigh the benefits of disclosure against its costs. For most new deposit arrangements, the requirement that a licensee keep records of all of its bank statements should be sufficient.⁴⁰

Consumer disclosures

To avoid imposing duplicative obligations on licensees, DFPI should align the disclosures required under the Act with the requirements imposed by other jurisdictions. Furthermore, DFPI should clarify certain ambiguous disclosure requirements.

- **Form of disclosure:** DFPI has authority under the Act to determine the form of a licensee’s disclosure.⁴¹ Other state regulators typically require digital asset companies to provide disclosures either on the companies’ websites or on transaction receipts. DFPI should consider requiring a form of disclosure similar to that required by other jurisdictions. Creating additional disclosure forms could cause consumer confusion as residents of different states will need to refer to different places to find their relevant disclosures.
- **Outages:** DFPI should clarify how long an outage must be in order for it to be included in the calculation provided for in the Act.⁴² One way to accomplish this would be to add a materiality threshold for outage reporting, similar to how the SEC’s new cybersecurity disclosure rules require a reporting company to disclose any material cybersecurity event in Item 1.05 of Form 8-K.⁴³
- **Indirect charges:** DFPI should indicate what “indirect charges” should be disclosed under the Act.⁴⁴ Under the BitLicense Regulations, persons licensed to conduct virtual currency business activities (**BitLicensees**) need to only disclose the fee charged to a consumer and the exchange rate.⁴⁵ DFPI should consider whether requiring the disclosure of additional costs would create additional, unnecessary burdens on licensees.

The legislature should also consider providing DFPI with more criteria that DFPI must consider before imposing additional consumer disclosures on licensees. Currently, DFPI can require a licensee to disclose anything DFPI deems reasonably necessary to protect residents.⁴⁶ However, DFPI should also consider the potential costs to licensees by, as well as the potential to overload customers with, additional disclosures.

⁴⁰ See Financial Code § 3211

⁴¹ See Financial Code § 3501(a).

⁴² See Financial Code § 3501(b)(10).

⁴³ See SEC, [SEC Adopts Rules on Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure by Public Companies](#) (July 26, 2023).

⁴⁴ See Financial Code § 3501(c)(3).

⁴⁵ See 23 NYCRR § 200.19(c)(2).

⁴⁶ Financial Code § 3501(a).

Statutory trust

DFPI should confirm that the statutory trust created under the Act is compatible with Article VIII of the Uniform Commercial Code.⁴⁷ Coinbase uses Article VIII to protect customers' assets from Coinbase's creditors in the unlikely event of a Coinbase insolvency. Securities intermediaries also rely on Article VIII, which has been adopted by every state. DFPI should leave in place the time-tested, uniform legal protections that have served millions of investors rather than questioning their sufficiency or efficacy.

Listing procedures

DFPI should clarify what constitutes a conflict of interest for purposes of a covered exchange's listing procedures, and under what circumstances a conflict of interest may arise as a result of a covered exchange having a financial interest in a listed digital financial asset. DFPI should further clarify that this potential conflict of interest may be addressed with appropriate disclosure on the relevant listing page that identifies the licensee's interest.

DFPI should also clarify that any conflicts disclosures can be made at the time a covered exchange lists a digital financial asset.

Merger review

DFPI should create a timeline for a decision to approve, conditionally approve, or deny a merger under the Act. The current version of the Act does not establish a timeline for DFPI to respond to a proposed merger or consolidation involving a licensee.⁴⁸ The lack of a timeline creates unnecessary uncertainty and does not hold DFPI appropriately accountable for responding to proposals in a timely manner. The BitLicense Regulations, in contrast, require that NYDFS make a decision on a proposed merger within 120 days of a BitLicensee's application to NYDFS.⁴⁹

Examinations and penalties

DFPI can properly oversee licensees while reducing the burden imposed on regulated entities. DFPI should (1) provide licensees with written notice prior to an examination and (2) cap the possible penalties that can be imposed on a licensee.

- **Examination notice:** The Act allows DFPI to conduct an exam of a licensee at "any time and from time to time."⁵⁰ Providing licensees with written notice prior to an examination would allow a licensee to collect the proper records and materials necessary for DFPI to conduct an examination.

⁴⁷ See Financial Code § 3503(d).

⁴⁸ See Financial Code § 3311(d).

⁴⁹ 23 NYCRR § 200.11(a)(4).

⁵⁰ Financial Code § 3301 (a)(1)(A).

- **Cap on penalties:** The Act allows DFPI to impose civil penalties on persons that conduct digital financial asset business activity without a license and on licensees and covered persons for material violations of the Act.⁵¹ These penalties accrue on a daily basis and can be imposed retroactively for past violations.
 - DFPI can maintain the deterrent effect of the civil penalties provided for in the Act while limiting the total dollar amount of civil penalties that can be imposed on a single person. Otherwise, persons face unlimited amounts of penalties for ongoing violations that began in the past and were only discovered after a significant time period had elapsed.

Policies and procedures

Both the legislature and DFPI should consider whether, and to what extent, a licensee's policies and procedures should be disclosed to the public rather than to DFPI.

- **Extent of disclosure:**
 - Licensees should not be required to disclose their internal policies and procedures to the public.⁵² The Act currently requires licensees to disclose policies and procedures for sensitive programs run by the licensee, including policies and procedures for the licensee's antifraud, AML, and anti-terrorism programs.⁵³ The public disclosures could be exploited by bad actors attempting to find gaps in a licensee's policies and procedures, or enable bad actors to manipulate licensees in ways that harm consumers.
 - If the Act is not amended, DFPI should use its rulemaking authority to limit the disclosure to the public of information that would enable a person to exploit a licensee's defenses against fraud, crime and other potential consumer harms.⁵⁴ DFPI should take care in considering whether the disclosure of certain policies and procedures to the broader public would pose security risks to a licensee. In many cases, such information should only be disclosed to the DFPI.
- **Form of disclosure:** Separately, DFPI should clarify the form of disclosure for a licensee's policies and procedures. Each of these policies and procedures are likely to be contained in different sources as they address a wide range of compliance programs.

⁵¹ See Financial Code § 3407(a)-(b).

⁵² See Financial Code § 3701(a)(7)(A).

⁵³ See *also* the policies required by Financial Code § 3505(a)(1)(D)-(E), which, if published, would enable bad actors to manipulate a covered exchange into continuing to list an asset or allow bad actors to frontrun a delisting announcement.

⁵⁴ See Financial Code § 3701(k)(2)(B).