

# What To Expect From California's Digital Assets Regime

By **Laurel Loomis Rimon, Benjamin Seelig and Gina Shabana** (November 8, 2023)

After prolonged deliberation, California has finally decided to enter the virtual currency regulatory arena by adopting two virtual currency regulatory bills into law, most notably a broad licensing, oversight and enforcement framework applicable to digital asset activity.

To date, digital asset platforms operating in California — one of the most desirable and active markets for digital assets in the U.S. and the home base of numerous digital asset companies — have operated in a regulatory gray space. For years, there have been no laws on the books specifically including digital assets in, for instance, existing money transmitter laws.

Although concepts of fraud and other consumer protection provisions can still be enforced against digital asset platforms, no affirmative regulatory requirements currently apply, meaning no California-specific licensing, compliance, safety and soundness, or consumer disclosure thresholds must be met to legitimately operate in California.

Now this is all set to change in 2025, when California will suddenly jump to the head of the line and join New York in administering one of the most comprehensive digital asset frameworks on either the federal or state level. The California Digital Financial Assets Law, or DFAL, originally introduced as A.B. 39, and the Digital Financial Asset Transaction Kiosks bill, introduced as S.B. 401, were signed into law on Oct.13 by Gov. Gavin Newsom.

The DFAL establishes a virtual currency regulatory regime similar to the New York Department of Financial Services' BitLicense framework by instilling regulatory authority, licensing and oversight in California's Department of Financial Protection and Innovation, or DFPI.

Meanwhile, the accompanying Digital Financial Asset Transaction Kiosks law imposes licensing and consumer disclosure requirements on crypto ATM operators in the Golden State. The DFPI is now tasked with regulatory rulemaking and implementation for the next year and a half, with the new virtual currency regulations set to take effect by July 1, 2025.

## California Digital Financial Assets Law

### ***Who falls under the new DFAL jurisdiction?***

The DFAL authorizes the DFPI to regulate certain virtual currency activity, referred to as the digital financial asset business activity, "of a person ... who engages in or holds itself out as engaging in [digital financial assets] with or on behalf of a [California] resident."



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While defined slightly differently, the scope of the DFAL's jurisdiction appears consistent with New York's BitLicense regulation, which covers "virtual currency business activity" and also broadly includes the exchange, transfer, storing and administration of digital financial assets.

Specifically, the DFAL defines "digital financial asset" as the "digital representation of value that is used as a medium of exchange, unit of account, or store of value, and that is not legal tender, whether or not denominated in legal tender."

Certain activities or entities are explicitly excluded from the DFAL's purview, including, but not limited to:

- Tokens issued as part of a rewards program or used solely in online games, subject to certain conditions;
- The administration, exchange, transfer or storage of digital financial assets already subject to the jurisdiction of the U.S. Securities and Exchange Commission or within the purview of the Electronic Fund Transfer Act;
- Digital financial asset activity of federal and state government agencies;
- Banks, credit unions and digital asset control services vendors, defined as "a person that has control of a digital financial asset solely under an agreement with a person that, on behalf of another person, assumes control of the digital financial asset;"
- Payment processors and those engaging in clearing and settlement services solely "for transactions between or among persons that are exempt" from the DFAL's licensing requirements;
- Data storage or security service providers who provide their services to a business engaged in digital financial assets, without engaging in digital financial asset business;
- Transactions in digital financial assets as payment for the purchase or sale of goods or services, solely for personal, family, household or academic purposes;

- Digital financial asset business activity connected to California of less than \$50,000 in annual aggregate value; and
- Digital financial asset activity that does not involve compensation, or that is for testing products or services with a person's own funds.

### ***What does the DFAL say about stablecoins?***

Like the New York Department of Financial Services, the new California law imposes a separate set of regulations to govern stablecoins.

Specifically, unless otherwise approved by the DFPI, the new law prohibits exchanging, transferring or storing of stablecoins unless the stablecoin issuer (1) is a bank or is licensed by the DFPI, and (2) "owns 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" in the U.S.

### ***What does the DFAL require?***

The DFPI will establish a regulatory framework, under a statutory construct largely similar to New York Department of Financial Services' virtual currency regulation, relating to: (1) licensing those who engage in digital financial asset business, (2) supervising the licensee's activities, (3) investigating and taking enforcement actions against licensees who fail to abide by the DFAL's requirements and the corresponding regulations to be established by the DFPI, (4) coin listing requirements, and (5) consumer disclosure expectations.

#### *Licensing Requirements*

Effective Jan. 1, 2025, those engaging in digital asset business with or on behalf of a California resident must be licensed with the DFPI unless (1) they do not fall under the DFAL's purview, or (2) they are awaiting approval or denial of an application submitted on or before Jan. 1, 2025.

The law includes reciprocity for those who were already licensed with the New York Department of Financial Services as of Jan. 1, 2023, allowing BitLicensees to receive a conditional license from the DFPI provided they satisfy certain fee requirements and comply with the DFAL's requirements.

The conditional license expires if (1) an applicant receives approval for its California DFPI digital asset business application, (2) the DFAL denies the application, or (3) the New York Department of Financial Services revokes the applicant's virtual currency license.

Further, the DFAL imposes licensing renewal requirements.

A licensee may renew its license annually, on or before Sept. 15, by paying the required fees and submitting a renewal report to the DFPI containing specific licensee information including, but not limited to, certain financial reports, material changes in business, financial conditions, material litigations, federal or state investigations, and data security breaches involving the licensee.

Finally, the new law gives the DFPI the authority to take enforcement actions against licensees for failing to pay annual renewal fees or to file renewal reports.

### *Supervisory Expectations*

The new California law instills the DFPI with the authority to establish regulatory expectations for its licensees, including adopting rules and regulations to implement the requirements of the DFAL, and the authority to conduct announced and unannounced examinations.

The DFAL also authorizes the coordination of joint exams with other states, and record- and information-sharing with certain regulatory agencies.

Further, the new law requires the licensee to, among other things:

- File certain changes with the DFPI — e.g., material business changes and changes to executive officers or control persons — within 15 days after their occurrence.
- Obtain the DFPI's approval for ownership and control changes including filing an application at least 30 days prior to a proposed merger or consolidation with another DFPI licensee.
- Retain its digital financial asset business records — e.g., customer and transaction information — for 5 years, and make these records readily available upon DFPI's request.
- Establish policies and procedures to include, but not be limited to, information and operational security, business continuity plans, disaster recovery plans, anti-money laundering programs, the Bank Secrecy Act, OFAC compliance, and applicable rules and regulations under federal and state digital asset laws.

### *Enforcement Authority*

The DFAL authorizes the DFPI to issue enforcement actions against a licensee for DFAL violations, violations of the DFPI's rules or regulations, a licensee's failure to cooperate in investigations or exams, or for engaging in unfair or deceptive practices, or unsafe or unsound acts or practices, among others.

Enforcement actions may include suspension; revocation of licenses; issuing cease-and-desist orders; requesting court appointment of a receiver; issuing temporary, preliminary or permanent injunctive relief; assessing penalties; and seeking restitution, among other measures.

The DFAL includes significant penalty provisions for any nonlicensee who "has engaged, is engaging or is about to engage in digital financial asset business activity" with a California resident in violation of the DFAL of up to \$100,000 per day for violations. Licensees or other covered persons who are found to have materially violated the DFAL can face civil penalties of up to \$20,000 per day.

#### *Disclosure Requirements*

The DFAL requires licensees to make certain disclosures to their customers relating to, among others, fees and charges, including notice for changes to fees and charges, irrevocability of transfers, and order confirmations — e.g., trade date, value and associated fees.

#### *Listing Requirements*

The DFAL requires a covered exchange — i.e., an exchange required to obtain a DFPI license — to certify its performance of certain actions to the DFPI prior to listing or offering a new coin. However, covered exchanges with digital financial assets approved for listing by the New York Department of Financial Services on or before Jan. 1, 2023, are exempt from this certification requirement. Otherwise, covered exchanges must certify to performing the following:

- Determining the likelihood that a federal or state regulator would deem the digital asset a security;
- Self-disclosing to the DFPI, in writing, all material facts relating to conflicts of interest that are associated with the covered exchange and the digital financial asset;
- Conducting a comprehensive risk assessment;
- Establishing policies and procedures "to reevaluate the appropriateness of the continued listing or offering of the digital financial asset, including an evaluation of whether material changes have occurred;" and
- Establishing coin delisting policies.

### **Digital Financial Asset Transaction Kiosks Law**

On the same day that Newsom signed the DFAL into law, he also approved the Digital Financial Asset Transaction Kiosks bill. While the law applies to operators of crypto or bitcoin ATMs that are not otherwise licensed under the DFAL, operators must disclose the locations

of all their kiosks to the DFPI to be published on the department's website.

The law takes effect on Jan. 1, 2025, and limits an ATM operator from accepting or dispensing more than \$1,000 a day to a customer. Charges and fees are capped at the greater of either \$5 or 15% of the total dollar equivalent of the transaction.

Most notably, ATM operators must provide the terms and conditions of a withdrawal or deposit prior to the transaction, and include the following information:

- The amount of a digital financial asset involved in the transaction;
- The amount of any fees, expenses and charges;
- The difference between the value of the digital asset charged to the customer and the price of that asset "as listed by a licensed digital financial asset exchange"; and
- Whether the transaction can be reversed, with a warning if the transaction cannot be reversed.

The law further prescribes certain information that must be included in transaction receipts, including:

- The customer's name;
- Basic transaction information;
- Any charges or fees;
- The difference or spread between the dollar price of the crypto-asset charged to the customer and the price of the asset as listed by a licensed digital financial asset exchange; and
- The name of the licensed digital financial asset exchange used by the operator to fix that price.

## **Conclusion**

California's foray into digital assets regulation will likely have a sweeping impact on the digital asset space and touch most digital asset companies doing business in the U.S. While the DFPI's rulemaking process, set to take place over the next 18 months, will define the exact contours of the regulation, it is not too soon for digital asset businesses to start preparing for compliance under the new regulatory regime.

Although California is only now beginning to affirmatively regulate digital assets, it has had a number of years to watch, learn from other states, and gain experience and expertise in digital asset use cases and risks, making it poised to strongly enforce the DFAL soon after it goes into effect.

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