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Seven Things to Know About California's New Crypto Licensing Bill

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As the world's fifth-largest economy, the state of California plays a critical role in technological innovation globally, including in the areas of blockchain and financial technology. However, until now, the California Department of Financial Protection and Innovation (the "DFPI") has not played a major role in the *regulation* of digital asset firms, which historically have not been required to obtain a money transmission license to operate in California as they have in other states.

That is changing, however. On October 13, 2023, Assembly Bill 39 (AB 39), also known as the "Digital Financial Assets Law" (the "Act"), was signed into law by California's Governor Gavin Newsom. The Act is intended to safeguard consumers and promote innovation within the blockchain sector, drawing in part from language proposed by the Uniform Law Commission. Given that California is the largest economy in the U.S. and is home to many digital asset firms, this legislation has significant implications for digital asset firms and beyond. Importantly, the DFPI has been charged with drafting regulations to implement the Act, which will be published before the Act comes into force on July 1, 2025. Accordingly, we can expect to see additional details on the various requirements imposed under the Act, and impacted firms should follow the DFPI's discussion of implementing regulation closely, in case there is an opportunity to comment on or otherwise shape such regulation.

The Act contains many detailed and nuanced requirements, but we have identified seven important takeaways:

1. Engaging in "digital financial business activity" with or on behalf of a California resident (broadly including any entity with a place of business in California) may require a license after July 1, 2025.

Under the Act, "digital financial asset business activity" includes, among other activities, exchanging, transferring, or storing a "digital financial asset," and exchanging one or more digital representations of value used within one or more online games if that digital representation of value can be exchanged for a digital financial asset offered by the game publisher or legal tender offered by the game publisher. The Act defines "digital financial asset" to mean a 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, but generally excludes securities.

Licensees will be subject to supervisory examinations as well as record-keeping, mandated disclosures, annual reporting, policy and procedure, capital adequacy, and other prudential requirements. These are

similar to, but in many cases more stringent than, similar requirements for licensed money transmitters in California and other states. Certain of the prudential requirements imposed by the Act, such as the disclosure requirements, are similar to those imposed on licensees under the New York State Department of Financial Services' ("NYDFS") BitLicense regime, and so will be familiar to digital asset firms that are already licensed in New York.

"Covered persons" (e.g., those that are required to obtain a license under the Act) are required to apply for licensure by July 1, 2025.

2. Exchange, transfer, and storage of stablecoins by licensees is only permitted for stablecoins issued by certain regulated entities that meet specific conditions.

Licensees can only exchange, custody, or transfer stablecoins if the issuer is licensed under the Act, or is a bank, a California-licensed trust company, or a national association authorized under federal law to engage in a trust banking business. The stablecoin must be fully reserved and such reserves are limited to those "eligible securities" listed in the California Money Transmission Act. One unique provision of the Act is that stablecoin issuers may not represent that the stablecoin is as safe as a bank credit or stored value product.

3. Digital Asset Exchanges will be required to identify the likelihood that a digital financial asset would be deemed a security by federal or California regulators.

Prior to listing a digital asset, a covered exchange must certify that it has conducted a thorough risk assessment on the asset, including the likelihood that the asset is a security under California or federal law. While the self-certification requirement will be familiar to BitLicensees, and most U.S. exchanges engage in some formalized listing process whereby digital assets that are clearly securities may not be listed, the requirement to risk-rate the digital asset under a securities law rubric is unique to the Act.

4. Change of control approval requirements will have implications for the timing and structure of mergers, acquisitions, and other strategic transactions involving California licensees.

Mergers, certain acquisitions, and changes of control will require advance approval by the DFPI. While most state money transmitter statutes require licensees to seek prior approval of any change of control, typically defined as the acquisition of more than ten percent of a licensee, the Act is unique in its requirement that licensees must also seek approval of any acquisition by the licensee that involves "substantially all of the assets of a person," even if that person is not itself a licensee. This means that even routine technology provider acquisitions by the licensee would require the prior approval of the DFPI, which could significantly slow deal momentum.

5. Existing BitLicensees and New York State Chartered Limited Purpose Trust Companies may receive a conditional approval to operate in California.

BitLicensees licensed by the NYDFS and limited purpose trust companies chartered prior to January 1, 2023, may apply for and receive a conditional approval to operate under the Act. As details within the Act regarding conditional licensure are scant, licensees may need to wait for DFPI's implementing regulations for additional information regarding the application process and powers granted to a conditional versus unconditional licensee. However, we encourage entities to engage with DFPI now, rather than wait for implementing regulations.

6. Certain game publishers may require licensure under the Act.

Under the Act, the definition of “digital financial asset” does not include a digital representation of value issued by or on behalf of a game publisher that is used solely within an online game, game platform, or family of games sold by the same publisher or offered on the same game platform. However, game publishers that issue in-game tokens which can be exchanged for cash or digital assets may require a license under the Act, even though they may not hold a BitLicense or consider themselves to be engaged in virtual currency activity under the federal Bank Secrecy Act.

7. Licensees will be limited from using market makers.

The Act contains a unique provision requiring licensees to ensure that the outcome of any particular trade is as favorable as possible to the customer under prevailing market conditions. In particular, this provision burdens licensees to prove that executing trades through a third party (e.g., a market maker) provides an advantage to the customer over interacting directly with an exchange. This provision may come in reaction to headlines accusing various exchanges of self-dealing to the detriment of customers. Accordingly, digital asset firms with affiliated market makers will need to tread carefully in California.

Conclusion

In signing the legislation, Governor Newsom acknowledged the potential need for further refinement and clarity of this and other digital asset regulation, emphasizing that the ambiguity of certain terms may require additional regulatory adjustments. Our experience working with the DFPI also leads us to believe that robust implementing regulations will be in place prior to the effective date of July 1, 2025.

Please do not hesitate to reach out to us if you would like to discuss the Act and its potential implications for your business.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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