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**THE CONSUMER FINANCE PODCAST – CA DFPI REQUEST FOR COMMENT ON CRYPTOCURRENCY-RELATED FINANCIAL PRODUCTS AND SERVICES**

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HOST: CHRIS WILLIS

GUESTS: KEITH BARNETT AND ETHAN OSTROFF

**[CHRIS WILLIS]**

Welcome to the consumer finance podcast. I'm Chris Willis, the co-practice leader of Troutman Pepper's Consumer Financial Services Regulatory Group. And today we're going to be talking about a recent California DFPI request for comment on cryptocurrency related financial products and services. But before we jump into that topic, let me remind you to visit and subscribe to our blog, [ConsumerFinancialServicesLawMonitor.com](https://ConsumerFinancialServicesLawMonitor.com), where you're going to find daily updates about everything that's happening in the consumer finance industry.

And don't forget to check out our other two podcasts. First, the *FCRA Focus*, which as the name suggests is all about the fair credit reporting act, and our privacy and data security podcast, *Unauthorized Access*, both of which are released monthly on all the popular podcast platforms. And if you like our podcast, let us know, leave us a review on your podcast platform of choice.

Now, as I said today, we're going to be talking about a really interesting development relating to cryptocurrency, and I'm welcoming back my two partners, Keith Barnett, and Ethan Ostroff, who are our resident crypto experts to talk about what's happened. Thus far, at least it's been my perception that the New York department of financial services has been the most active of the state regulators in talking about cryptocurrency related issues. But now the California Department of Financial Protection Innovation, the DFPI looks like it's ready to wade into this. Because it recently released a request for information about how it should handle various crypto related financial products and services. And gentlemen, thanks for being on the podcast to talk about what seems like a really important development.

**[KEITH BARNETT]**

Great to be here, Chris. Thanks.

**[ETHAN OSTROFF]**

Yeah, Chris. Great to join you again.

**[CHRIS WILLIS]**

Guys, and I guess I'll start with you, Keith, the California DFPI put out this request for information and asked for feedback on how it should approach crypto related assets and harmonize its approach with both federal and other state authorities. Which seems like a thoughtful thing for them to ask. What are your impressions about what that means, Keith?

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**[KEITH BARNETT]**

I found it to be really interesting, actually for two reasons. One is California stating that it wants to be a leader in this area, and that it is a leader in the area. But that hasn't necessarily been the case because both the federal government and the states have already taken efforts to regulate cryptocurrency.

And then the second takeaway I have from this is that the request from the DFPI is broad enough to include anything that involves crypto. My particular area of expertise is money transmission. So, I would focus on that. The question there is whether California will amend its state money transmission law to include cryptocurrency as one of the items that it's going to regulate.

And I say that because California has traditionally stayed away from regulating cryptocurrencies within its money transmission statute, that goes back as far as 2018, and maybe even before that. And the reason why is because California had concluded that cryptocurrency may not be a form of money, and so therefore it was not going to regulate cryptocurrency within its money transmission laws.

Not only does the announcement from Governor Newsom recognize a shift, but also this request from the department further recognizes the shift that California is going from saying that cryptocurrency is not money, so therefore we're not going to regulate it under our money transmitter statute, to, hey everyone, there's this thing out there called cryptocurrency, and we want to be a leader on this. What do you think we should do?

Like I said, California is not the first. They're not the innovator here. The federal government through FinCEN already has cryptocurrency under its money transmitter statute. If a company or person qualifies or falls within the definition of an exchanger or an administrator, then they would fall within the statute. And, also the states, there are several states that already regulate crypto in its money transmitter statute, Hawaii, Oregon, North Carolina, New Mexico, Connecticut, Georgia, Alabama, and others.

And then also last year, the CSBS, which stands for the Conference of State Banking Supervisors. They issued a model money transmitter law that also includes crypto. And later this year, Arizona, among other states, are going to substantially adopt this CSBS money transmitter law. So, there's a lot going on here and keep in mind, this is also a request for comment from the state of California. So, it's very important for players or even non players in this industry to comment. Because the last thing you want is a law that stifles innovation, or is so draconian that it's hard to comply with without getting in any type of trouble.

**[CHRIS WILLIS]**

Keith, that sounds like a pretty significant change in California's, at least potential regulatory attitude with respect to crypto. Going from, "It's not money," to, "We need to be a leader on this." And that signals potentially some very big changes might be coming as a result of this inquiry in California. Ethan, I'm curious as to what you think may come of this?

**[ETHAN OSTROFF]**

I completely agree with Keith. The reality is this invitation for comments comes as if there hasn't already been a lot of activity, both at the federal and state level. As Keith mentioned, there are a number of states where this has come into play. And it was a little odd from my perspective that

there's no mention or reference to the CSBS model money transmitter law at all. It's as if they're completely unaware of it. Yet other states have taken actions to adopt it, at least in part. And so there seems to be traction there amongst other states.

One of the things that I think caught me as well is that they use this term repeatedly of crypto asset related financial products and services, but I haven't seen the definition of that. And I think that could cause a lot of people to scratch their head to say, is this broad enough to cover what my company is doing? And I think that's one of the reasons why industry stakeholders really do need to take the time to submit comments on this. And those comments are due pretty quickly. They're due August 5th, 2022. It's something that we've helped a lot of people in this space and other industries do in responding to these types of comments from the California DFPI and other state and federal regulators.

I think this comes directly at the request, and the direction of Governor Newsom's executive order, which specifically directed DFPI to do this. But it also, interestingly comes on the heels of a number of DFPI opinions on money transmission over the last, I'd say six to nine months. Which I think, from our perspective, have generally concluded, they do not consider cryptocurrency within the scope of the money transmission act, while other states have decided to regulate cryptocurrency and deem it money.

And they also don't presently regulate digital wallets. So, if anything, what you may see is quite the sea change coming here, where we've got numerous opinions from recent times, giving people in this space some comfort as to whether or not their activities are falling within the scope of the MTA in California, and whether or not they need to be licensed as a money transmitter. And that may all change within the next 12 to 24 months.

#### **[CHRIS WILLIS]**

That's really interesting. And there was another question, or another comment in connection with this request from DFPI that really stuck out to me. And it is that the DFPI asked for opinions on how its regulatory approach could make California the most desirable home state for firms that are in the crypto industry, while maintaining California's values of equity and inclusion, making it the most desirable home state. Do they want to become the South Dakota of crypto is what I was thinking. But Ethan, let me stay with you. What are your thoughts on this statement from DFPI about desirable home state while upholding our values?

#### **[ETHAN OSTROFF]**

I think on the one hand, they do certainly want to attract businesses, similar to how Wyoming has done with DAOs, and they're being at the forefront of permitting DAOs in that state and creating a regulatory and supervision regime for that. I think number one, the most important thing they can do is not make it prohibitively expensive. Not just with the cost of getting licensed and continuing to be licensed.

They're going to have to answer the question of whether or not they're going to require companies to have a bond as part of that. But then the ongoing requirements to maintain those licenses, there's certainly the possibility that companies in this space may look at the type of regulatory regime that California puts in place and decide to go elsewhere because of the California state laws that may be in place. And we see in other consumer facing industries in California, that

businesses have a difficult time dealing with and complying with California law, because they can be so different than other state laws, and in some instances federal laws.

And we've had within the past year or two, a significant change, for example, in the California requirements for the licensed debt collection space. But at the same time, the DFPI has been completely unable to process and deal with the deluge of licensing applications they've gotten as a result of that. How are they going to function in this space, dealing with licensing of anyone who's interacting with or engaging with crypto asset related products or services? That is such a broad catchall, it makes me scratch my head as to what they're trying to understand and do here.

**[CHRIS WILLIS]**

Keith, what do you think? What do you make of this, we want to be the best home state comment?

**[KEITH BARNETT]**

Well, I'm from California as people who know me know that, and I still practice a lot out there. And I'm speaking from experience, California is known as a state that heavily regulates every industry. It is not employer friendly. Tech jobs are leaving California. And to me, this is California realizing that you can find tech talent in places other than California. I feel like the state recognizes that it's losing that edge.

As Ethan mentioned earlier, this is actually a perfect opportunity for tech companies to let California know these things, among other things. And also to piggyback off of what Ethan said, California needs to make sure that it is not prohibitively expensive to do business in California. And one of the areas where California may go awry with everyone else is having an overly expansive definition of cryptocurrency or money transmission.

What do I mean by that? What I mean here is a lot of crypto transactions are made wallet to wallet, so user to user. Chris, if I want to exchange Bitcoin with you or some other cryptocurrency, the way things are now, we could have peer to peer transfers, and I could just send it to your wallet, and I'm not in any commercial industry selling it or anything like that. And so, California needs to make sure that it's not regulating every single person under the sun. If we are just two friends who are doing a peer-to-peer transfer, that should not fall within the definition of money transmission.

And so, California should really look into the federal definition of money transmitter and cryptocurrencies for guidance here. To make sure that they're not overly inclusive with respect to whether or not someone is a money transmitter. And then, when California talks about maintaining its values of equity and inclusion, I find that to mean that California wants to make sure that there is not only ethnic diversity with respect to people who are participating in the crypto industry, but also geographic, at least within California, and economic diversity. And the only way you can get to all of those goals is to make sure that you do not have an overly draconian manner in which you're regulating this particular industry.

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**[CHRIS WILLIS]**

Keith, that seems like a natural segue into the next thing I was going to ask, because it looks like the DFPI may be interested in having firms register crypto related products and services with the DFPI under Financial Code section 90009. What should we make of that? What do we think the factors are that the DFPI may weigh in deciding what triggers registration, the very thing you were just talking about?

**[KEITH BARNETT]**

I'm not completely clear on what the DFPI wants with respect to registration. I do know, with respect to other FinTech innovations like earned wage access, the DFPIs talked about registration there. They want to know whether products under EWA amount to loans. And so here, I'm not exactly sure how the DFPI would do that, especially in light of the fact that neither the federal government, nor am I aware of any state regulators that require crypto innovators to register all of their digital assets, or register their ideas any more than a foreign country is required to register its currency with the state of California, or any other state.

That is just something that the state is going to have to wrestle with, right? Because on the one hand, they want to be able to regulate what goes on within California's borders. And they feel like registration is an answer to that, but you also don't want to stifle innovation. I'd be willing to bet, given all of the startups that reach out to me about crypto related issues, I'd be willing to bet that these startups and the people that California wants to attract. They're not looking at any DFPI related rules and saying, "Oh, hey, let me hurry up and register while I'm working on this idea."

No, people want to work on their ideas, they want to be innovators, and registration might slow that process down. And another interesting thing that I'd want to know from California is whether or not people would be penalized if they don't register, and what would these penalties look like? California really needs to do a good job with striking the balance there between stifling innovation, or potentially stifling innovation, but also protecting what's within its borders.

**[CHRIS WILLIS]**

Ethan, what's your take on this?

**[ETHAN OSTROFF]**

I totally agree with Keith. I think it's not clear at this point, what, in this circumstance, the DFPI would deem to be a covered person. There's certainly lots of peer-to-peer activity going on here, and certainly you wouldn't expect individuals who are transferring virtual currencies through their own digital wallets to be considered a covered person with some sort of registration requirement.

The question is, what happens if you don't register? And how is the DFPI going to identify people who are covered persons, who they believe should register and haven't? But I think, given our experience with the regulators in California, it seems a likely outcome that there's going to be some type of registration requirements. And so, from our perspective, companies in this space really need to think hard over the next 35 days or so into providing informed comments to the FBI, specifically about this idea of registration, what triggers a registration requirement, what's actually

required to register and to keep the registration active? And what should happen if a company is deemed to be a covered person who should be registered, but is not.

Those are all open questions, and it's really going to depend on industry stakeholders to lay out the groundwork to the DFPI about what the industry thinks is appropriate. And perhaps more importantly, what it believes is inappropriate and why.

**[CHRIS WILLIS]**

Ethan, both you and Keith have struck this theme of making sure that the regulations aren't too burdensome and too broad in terms of who they cover and who's required to be registered. But there's another aspect that I think also bears on the, is it too burdensome or too restrictive question? And that is the DFPI is explicitly seeking comment on what it should include in potential regulations regarding unfair or deceptive practices, or full and accurate disclosure of a given product or service. How do you see that going?

**[ETHAN OSTROFF]**

Number one, I think it's becoming exceptionally clear that we're going to see regulations surrounding unlawful, unfair, otherwise deceptive practices in the crypto space. And I think we both expect that from the DFPI, but I think we also expect that from federal regulators, specifically the FTC and the CFPB. The FTC and the CFPB have been requested by President Biden's executive order to do some work in this space as well. And we see them focusing there.

We've already seen a lot of activity by the FTC specifically in trying to educate consumers about various types of scams involving cryptocurrencies. Particularly, there's been a lot of activity with respect to scams that involve people going to crypto ATMs and making withdrawals and sending money right there and then. And so, I think we expect to see more of the same in this space, with focus also on types of disclosures that are required depending upon the type of product or service that's involved.

**[CHRIS WILLIS]**

Keith, what about you? Where do you think the DFPI may go? And how far do you think it may go with regulations on disclosures and UDAP considerations with this?

**[KEITH BARNETT]**

Chris, I'm smiling. I guess people can't see me smiling, but I think Chris, from your own practice that the CFPB uses UDAP as a catchall. And I can completely see that. And as you know, the CFPB, for example, has said, a violation of state law could be a UDAP violation under federal law. And so, where is California going to go with this? They're going to say, "Well, hey, you violated federal money transmitter law, or the money transmitter laws with another state. And even though that law is not explicitly in a California statute, we kind of like that. So, we're going to consider that to be UDAP here."

I really hope that they don't go there, but I am concerned that anytime you have an undefined UDAP statute, that the regulators will sometimes go too far and back into a decision where they really have no legal grounds to do so.

**[CHRIS WILLIS]**

And certainly, it would be the fear of an expansive undefined UDAP statute would probably not be super consistent with the goal of making California the most preferred home state for these kinds of businesses. I assume you would agree, right?

**[KEITH BARNETT]**

No, that's absolutely right. Totally.

**[CHRIS WILLIS]**

So, we're getting towards the end of the podcast. And I want to give each of you the opportunity to just give a parting thought. What is your overall takeaway from the California DFPI's request for comment? Keith, you go first.

**[KEITH BARNETT]**

I'll make this brief, but at the risk of sounding like captain obvious here, California is taking cryptocurrencies seriously. And California clearly believes that crypto is here to stay. I make that comment because so many colleagues of mine said 10 years ago, that Bitcoin was just a fad and would go the way of the dinosaur. And even with the recent market fluctuation we've had on cryptocurrencies, that's clearly not the case.

And even California's gone from saying, it's not worth their time to regulate this, to now seeking comments. Like we said, at the beginning, it's very important for players in this space, potential players in this space to make sure that you comment to California and give your input. And when you do provide your comments, make sure that you always include a consumer protection bend to it. Don't talk about explicitly, "Oh, hey, this is going to make it more expensive for me to run my business." California doesn't necessarily care about that. They care about consumer protection. If you can manage to weave that in when you do your comments, that will go a long way.

**[CHRIS WILLIS]**

Ethan, how about you? What's your parting shot on this?

**[ETHAN OSTROFF]**

I think we're going to see a sea change in California. I think the comfort that people, particularly in the money transmission space have seen through the recent DFPI opinions, touching on crypto related issues is going to get flipped on its head. And we're going to see California fall more in line with the other states that already regulate some of the activity in the space.

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This is all part and parcel of a continuing evolution of the laws and regulations on the federal level as well. So, there's a lot of things that are in flux, and I think the effective and accurate disclosures to consumers is going to become a bigger and bigger issue for everyone in this space.

**[CHRIS WILLIS]**

Gentlemen, thank you very much for being on the podcast today, and talking us through this very interesting, I think, and I think the listeners will think as well, development in California with respect to the regulation of cryptocurrency related products and services. And of course, I want to thank our audience for listening to today's episode as well.

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