
**CRYPTO EXCHANGE: CRYPTO AND BEYOND – DISCUSSING CALIFORNIA DFPI OPINIONS ON MONEY TRANSMISSION AND THE MONEY TRANSMISSION ACT
JULY 6, 2022**

Ethan Ostroff:

Welcome to another episode of the Crypto Exchange, a Troutman Pepper podcast focusing on the world of digital assets and payments. As longtime leaders in the intersecting worlds of law, business, and government regulations, our lawyers can go beyond the buzzwords and headlines to make sense of the emerging legal and regulatory frameworks for operating in the digital asset and payments industries. I'm Ethan Ostroff, one of the hosts of the podcasts and a partner at Troutman Pepper.

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Today I'm joined by my colleagues, Keith Barnett and Carlin McCrory, to discuss the California Department of Financial Protection and Innovation opinions that have been released over the past year involving money transmission and the Money Transmission Act. Keith and Carlin let's dive right in to take a deeper look at the California DFPI's opinions, and how they impact stakeholders in the digital asset and payment spaces. Perhaps we could start by talking a little bit about the California DFPI's opinion involving a platform that referred customers to financial institutions.

Keith Barnett:

I think, Ethan, what you're referring to is a platform that mainly operates as a cryptocurrency exchange. And the unique thing about this particular cryptocurrency exchange is that a firm operates a website that hosts a third-party software platform that customers use to buy, sell, and exchange cryptocurrencies. And when customers use the website for the first time, the website will refer them to a partner money transmitter licensed to engage in these types of transactions, and the customer will fund an account with the financial institution with fiat currency. And when the customers want to trade cryptocurrency on the website, the third-party platform communicates with the financial institution to facilitate the desired trade.

Now, neither the website nor the trading platform ever holds or transmits any of the cryptocurrency, and in fact, not even the fiat currency. Only the financial partner institution does that. The DFPI returned an opinion stating that the actions of the website to act as a referral service for the financial institution does not require a money transmitter license under California law, and its activities do not meet the definition of money transmission, because it does not sell or issue payment instruments, seller issue stored value, receive money for transmission and never holds any type of fiat or cryptocurrency. So as a result, it is not transmitting anything or receiving any money for transmission.

Ethan Ostroff:

So can you tell our listeners a little bit about the agent of the payee exemption and what the DFPI opinion said about it?

Keith Barnett:

To be clear here on agent of the payee; there are approximately maybe between 25 to 35 states that have their own version of the agent of the payee exemption, and agents of the payee are exempt from money transmitter licensure. In this particular case, the firm here plans to process payments for the purchase of software applications. The firm operates a virtual marketplace whereby customers buy applications developed by third parties, and when customers submit payments to the firm, it distributes the money minus certain fees to the application developer, and the developers agree to the terms established that the processor as an agent in the transaction can collect and hold the fees. And there, the DFPI concluded that the firm was an agent of the payee and exempt from licensure because the customer's payment obligations are immediately extinguished at the time of payment to the payment processor, which is deemed to be an exemption for money transmission. That is a consistent, I guess, factor that you see in all of the money transmitter statutes with respect to the agent of the payee exemption.

If the payor obligation to the payee is extinguished, as soon as the payor effects a payment, that is an exemption under the money transmitter statutes, because these are consumer protection statutes. And as consumer protection statutes, given that the consumer's payment obligation is extinguished, then there is nothing to be concerned about going forward.

Ethan Ostroff:

Interesting. Carlin, can you tell us a little bit about the two DFPI opinions regarding digital currency trading platforms?

Carlin McCrory:

All right. Both of these opinions came to the same conclusion, but a little bit of different facts here. But ultimately, both businesses operate digital asset and currency trading platforms where the customers can buy, sell and hold digital currencies. The customers create the accounts on these platforms and deposit their fiat money into them. The businesses then hold that fiat currency in omnibus accounts. The customers then also have their own dedicated wallets to hold their digital currencies. When the customers want to perform transactions, the platforms facilitate these transactions by crediting and debiting the fiat and digital asset wallets as appropriate.

So the DFPI here came to the same conclusion for both businesses that it didn't require money transmitter licensure, because it has not yet decided that digital currency wallets meet the definition of money transmission. In addition to that, the DFPI doesn't require licensure for fiat currency accounts, because they also don't meet the definition of stored value. These are closed loop transactions, meaning that the customer can't transact outside of the current business exchange model. The fiat is solely used to facilitate the trading of digital assets in this context.

Ethan Ostroff:

Carlin, what about the purchasing and selling of digital assets and currencies? Has the DFPI said anything about that in its recent opinions?

Carlin McCrory:

Yeah, so the businesses that facilitate the trading of digital assets and virtual currencies that allow customers to deposit fiat money into accounts, in these situations, the customers purchase the digital assets and currencies directly from these firms with their own fiat currency. And then the businesses either sell the assets and currency directly from their own inventory, or they buy a corresponding amount from a third party if they don't have enough in their own inventory. And then the sold digital asset or virtual currency is held in the designed wallet for the customer and then the customer can sell, hold, transfer any of the contents of that wallet.

In this opinion, the DFPI stated that buying and selling under these circumstances don't require money transmission licensure, because they don't involve issuing or selling stored value or money for transmission. Just like the other platforms we talked about, it's a closed loop system, which does not fall under the money transmission act.

Ethan Ostroff:

So, practically speaking for our listeners, what should they be taking away from these recent opinions by the California DFPI in this money transmission ecosystem?

Keith Barnett:

What this means is that businesses that engage in any type of payments related business must carefully consider whether their actions are deemed money transmission under each state's law. So not just California, not just federal law. Here are some questions that businesses may want to ask themselves. One, do you receive money? Or do you transmit money? Do you receive money for transmission? Do you hold money? If the answers to any of these questions is yes, is that your business? Is the main purpose of your business engaging in any of these acts? Or is your business something else and you just simply transmit money as a part of your main business? These can be complex issues, and they are very hard for the lay person to get a grip of.

For example, another issue is that California has continuously said, at least over the past several years, that crypto transactions are not money transmission, because crypto is not legal tender issued by a government. So even if a company engages in money transmission, under current California law, California will not regulate it even if it amounts to money transmission. But that's about to change. California Governor Gavin Newsom recently issued an executive order expanding the scope, or at least potentially expanding the scope, of California's regulatory supervision over, among other things, cryptocurrencies. So we can expect the state of California to amend its laws and begin regulating cryptocurrencies if it believes that the businesses' acts amount to money transmission under California law. So these are things to definitely look out for, and stay tuned.

Ethan Ostroff:

Thanks, Keith. So it sounds Carlin like right now, companies operating in this space can take some comfort in these recent DFPI opinions, but that they need to keep themselves aware of what's going on with the DFPI's recent invitation for comments and how the commentary that the DFPI receives back could completely upend and change the current regulatory landscape in California. Is that what you're seeing too?

Carlin McCrory:

Yeah, it could completely upend everything, just like you said. I think Keith and I are inclined to state that California wants to open itself up to these innovative businesses, and so it doesn't want to overly regulate or restrict business activities regarding cryptocurrency. But in California and

elsewhere, as Keith mentioned, you really need to stay attuned to the different laws. As we've seen, California is pretty open ended, but there's certain states that are much more restrictive. We see that in New York with the BitLicense as well.

Ethan Ostroff:

Very interesting. So for our listeners out there, if you're interested in understanding what the DFPI has invited comment on, you can always check their website. Please reach out to us as well. We've written about this as well. I believe that the time period for comments back to the DFPI is closing here within the next couple of weeks, so if you're interested, please don't sleep on it.

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