

August 11, 2016

The Honorable Steven Glazer, Chair
Senate Judiciary Committee
State Capitol, Room 405
Sacramento, CA 95814

Via E-Mail

Re: Assembly Bill 1326 (Dababneh) —Oppose

Dear Senator Glazer:

The National Consumer Law Center (on behalf of its low income clients), and Consumers Union, the nonprofit publisher of *Consumer Reports*, oppose AB 1326 (Dababneh).

Virtual currency protocols have the potential to increase financial inclusion¹ and lower the cost of important services on which underserved consumers often rely.² While it appears that many virtual currency users today are well-heeled,³ that is unlikely to remain the case. Virtual currency businesses are likely to eventually target underserved consumers, and therefore it is essential that strong consumer protections are in place *before* consumers patronize these providers.

AB 1326 would set a worrying precedent, allowing financial services businesses to operate in California without even the barest safety and soundness requirements. Moreover, the enrollment program envisioned by AB 1326 creates rather than alleviates consumer confusion about the risks of virtual currencies, and compounds regulatory confusion for businesses. We ask for a NO vote on AB 1326.

AB 1326 Fails to Require Basic Safety and Soundness

Many of the businesses that are being built around or on virtual currency protocols are acting as financial intermediaries, accepting consumers' value with the promise of storing, transmitting or exchanging it. Whenever businesses come between consumers and their value, businesses must be accountable, and basic consumer protections must be in place, regardless of the technology used. Safety and soundness requirements are fundamental to the financial services eco-system.

The failure to ensure safety and soundness, for example by specifying required permissible investments and securities such as cash, digital assets, or surety bonds, leaves consumers vulnerable to a loss of value that is unacceptable. The risks are real. In the last ten days, more than \$65 million in virtual

¹ See for example, Isaac Pflaum and Emmeline Hateley, A BIT OF A PROBLEM: NATIONAL AND EXTRATERRITORIAL REGULATION OF VIRTUAL CURRENCY IN THE AGE OF FINANCIAL DISINTERMEDIATION at 1187-1188, available at <http://www.law.georgetown.edu/academics/law-journals/gjil/recent/upload/zsx00414001169.PDF> ("Low transaction cost in combination with cryptographic security is particularly beneficial to persons in the United States and other OECD countries sending remittances to foreign jurisdictions where banking services are not commonly available or widely adopted."); Laura Shin, Who Will Benefit From Digital Currency? Bitcoin Experiment Gives A Glimpse, <http://www.forbes.com/sites/laurashin/2014/11/26/who-will-benefit-from-digital-currency-bitcoin-experiment-gives-a-glimpse/> (Quoting Stanford Business School professor and virtual currency company Ripple board member Susan Athey: "Where I see the greatest need are international payments and developing countries where people don't have bank accounts or the ability to create banks accounts, and so are completely cut out of international financial markets and participating in the global economy.").

² Brock Cusick, How can Bitcoin be Used for Remittances, A Backgrounder for Policymakers, <https://coincenter.org/2014/12/remittances/>.

³ Tyler Durden, The Demographics Of Bitcoin, <http://www.zerohedge.com/news/2013-03-10/demographics-bitcoin>.

currencies was stolen from the virtual currency exchange Bitfinex.⁴ California would be setting a dangerous precedent if it allows companies offering financial services to do so without this most basic protection in place.

AB 1326 Disclosure Requirements May Increase Consumer Confusion

AB 1326 may confuse consumers about the type of supervision and examination that DBO would do of enrolled businesses. This confusion is likely to arise due to the vast differences between enrollment as described in AB 1326 and licensing of money services businesses currently required by the Department of Business Oversight.

Specifically, we are concerned that the requirement that enrolled businesses disclose enrolled status with the disclaimer that “enrolled” status means that no traditional oversight is being done is potentially misleading. The concern is that the required disclosure of participation in an enrollment scheme “*administered by the Department of Business Oversight*” followed by the seemingly contradictory statement that “*neither the DBO nor any other government agency has reviewed the safety and soundness of our business or the digital currencies in which we transact*” obfuscates rather than illuminates potential risks to consumers. It creates the illusion of a government imprimatur where none exists.

The problem that disclosure of “enrolled” status creates is compounded when viewed against the vast differences in state regulation. For example, such a disclosure may lead consumers to believe that enrollment is similar to being licensed in a state such as New York, when exactly the opposite is true, since New York has a full licensing program specifically for virtual currency businesses.⁵

We Urge the Legislature to Adopt a Licensing Regime with Strong Consumer Protections

We believe that virtual currency financial services providers should be licensed and supervised. Some claim that any regulation of virtual currencies is regulation of technology. We disagree. Our worries about virtual currency businesses providing financial services are not specific to virtual currency technology. From our point of view, any regulation of virtual currency financial service providers should be about protecting consumers, and not about regulating technology.

Contrary to complaints that regulation kills innovation,⁶ appropriately tailored regulation ultimately benefits businesses.⁷ While financial services regulation is essential for protecting consumers from harm, strong and consistent regulation and supervision of consumer financial services benefits industry by promoting consumer confidence and thereby driving adoption.⁸ Additionally, strong and consistent regulation ensures that businesses that take care to provide consumer protections are not at a competitive disadvantage to those businesses that do not. All financial services businesses should be held to the same high standards. We believe that AB 1326 fails to provide essential consumer protections, and ask that the legislature pause to create appropriate activities-based virtual currency regulation.⁹

⁴ Josh Horwitz, The \$65 million Bitfinex hack shows that it is impossible to tell a good bitcoin company from a bad one, <http://qz.com/753958/the-65-million-bitfinex-hack-shows-that-it-is-impossible-to-tell-a-good-bitcoin-company-from-a-bad-one/>.

⁵ See <http://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf>.

⁶ Ashe Schow, People who don't understand Bitcoin want to regulate Bitcoin, <http://www.washingtonexaminer.com/people-who-dont-understand-bitcoin-want-to-regulate-bitcoin/article/2543375>

⁷ Daniel Carpenterreggo, Justin Grimmer, Eric Lomazoff, Approval regulation and endogenous consumer confidence: Theory and analogies to licensing, safety, and financial regulation, available at

<file:///C:/Documents%20and%20Settings/tetrch/Desktop/Virtual%20currencies/CarpenterGrimmerLomazoff.pdf> at 398: “Our results are also consistent with recent arguments in law and economics scholarship that approval regulation regimes may not blunt innovation but enhance it.”

⁸ *Id.* at 403. (Contrary to libertarian analyses of entry regulation and licensure, consumers “will more readily enter the marketplace created by approval regulation and will more readily rely upon quality data to switch to the products that present them with the most value.”)

⁹ A floor for consumer protections in a virtual currency licensing program is contained in the Conference of State Bank Supervisor’s Model Regulatory Framework for State Regulation of Certain Virtual Currency Activities, available at [https://www.csbs.org/regulatory/ep/Documents/CSBS-Model-Regulatory-Framework\(September%2015%202015\).pdf](https://www.csbs.org/regulatory/ep/Documents/CSBS-Model-Regulatory-Framework(September%2015%202015).pdf).

For the above reasons, we urge a no vote on AB 1326.

Please do not hesitate to contact us should you have any questions regarding our position.

Sincerely,

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