



ELECTRONIC FRONTIER FOUNDATION

Protecting Rights and Promoting Freedom on the Electronic Frontier

August 11, 2016

Sen. Steven M. Glazer
Chairman
Sen. Andy Vidak
Vice-Chairman
Senate Banking and Financial Institutions Committee
State Capitol, Room 405
Sacramento, CA 95814

Oppose A.B. 1326: The Digital Currency Business Enrollment Act is Draconian, Overbroad, and Will Hurt Innovation in the State

Chairman Glazer, Vice-Chairman Vidak, and Members of the Committee:

The Electronic Frontier Foundation (EFF) strongly opposes the newly amended Digital Currency Business Enrollment Act (A.B. 1326). Although the amended bill's overarching goal of protecting consumers is laudable—and something that EFF also cares deeply about as a member-supported non-profit organization working to protect the interests of both technology creators and users in the digital age—it does not accomplish that goal. Instead, it would harm consumers by limiting Californians' access to novel digital currencies that empower users and eliminate or reduce many of the consumer hazards present in fiat currency transactions.

Moreover, the bill will discourage innovation in a burgeoning industry, and its broad terms, including the definition of “digital currency business,” reach much farther than the bill's drafters could possibly have intended, regulating not only digital currency users but also businesses that are far removed from digital currency transactions and have absolutely no control or influence over such transactions. Further, while the bill purports to have a light regulatory touch—it is portrayed as an enrollment pilot program for digital currency businesses—it places unduly burdensome requirements on businesses and provides the Department of Business Oversight (DBO) with nearly unfettered regulatory discretion to pick winners in the digital currency industry.

Neither EFF nor anyone else from the tech or digital currency community was invited to participate in drafting the current language. Unsurprisingly, A.B. 1326 is ill suited for the industry it seeks to regulate. California needs a forward-thinking bill that will encourage innovation while protecting consumers, not a hastily drafted measure that fails on all fronts. Given the bill's significant failures, and the risks it poses to consumers of digital currency and the broader industry, as outlined in detail below, EFF asks this committee to reject A.B. 1326.

A.B. 1326 Harms Consumers by Limiting Their Ability to Use Digital Currencies that Eliminate or Alleviate Many of the Risks Present in Fiat Currency Transactions

Digital currencies are novel financial tools that overcome many of the consumer risks of traditional currencies while also empowering users' autonomy. Despite A.B. 1326's best intentions, however, the bill will actually hurt consumers by applying an outdated fiat currency regulatory model to digital currencies. For example, cryptocurrencies and their networks allow people to transact with others while avoiding many of the pitfalls of fiat currencies. Thus, where

815 Eddy Street • San Francisco, CA 94109 USA

voice +1 415 436 9333

fax +1 415 436 9993

web www.eff.org

email information@eff.org

fiat currency transactions often require intermediaries in a position of trust—and thus pose a consumer risk—math and the architecture of digital currency networks replace or eliminate the need for trusting intermediaries. Similarly, requiring digital currency businesses to maintain capital requirements or possess good character are less necessary when the amount of digital currency anyone controls can be verified mathematically at any time on a public ledger.

Further, without intermediaries, digital currencies can avoid financial censorship from governments or others that pressure fiat currency intermediaries to stop transactions for certain goods or services. Digital currencies also can allow users to transact with more privacy than traditional fiat currency transactions. These currencies thus empower users in ways traditional currencies do not, while also overcoming some of the historic problems of fiat currencies.

Yet, rather than embracing the promise of digital currencies to help empower and protect consumers, A.B. 1326 establishes a government gatekeeper that will determine which digital currencies Californians can use based on an outdated regulatory model. EFF believes consumers deserve access to a wide range of novel digital currencies that can be more secure and beneficial than fiat currencies. A.B. 1326 severely restricts those choices and, as explained below, also sweeps up many consumers of digital currency into its regulations.

Relatedly, even when A.B. 1326 tries to apply a new framework to digital currencies, it regulates the entire industry through the lens of the most popular decentralized currency—Bitcoin. Because future digital currencies may look nothing like what is available today, it is a mistake to lock in rigid regulations based on one type of digital currency. Innovations in digital currencies could vary their structure and function, for example, mooted the need for currency specific regulation or, more likely, altering the relationships between parties using the currency such that the consumer risks are different.

To be sure, there are still consumer risks present in digital currencies. The problem is that A.B. 1326 seems uninterested in identifying those actual risks and addressing them in a way that protects consumers while still promoting innovation. Thus, rather than jumping to quickly regulate digital currencies via A.B. 1326, lawmakers should first understand the technology and actual risks associated with digital currencies.

EFF Also Has Specific Concerns with Several Provisions of A.B. 1326:

1. A.B. 1326's Vague Definitions Will Discourage Innovation and Apply So Broadly That the Bill Will Regulate the Entire Internet Industry.

A.B. 1326's vague and broad definitions of “digital currency business” will chill innovation and levy burdensome obligations on users and completely unrelated technology companies, such as Google and Amazon. The bill defines “digital currency business” as “the business of offering or providing the service of storing, transmitting, exchanging, or issuing digital currency,” and the bill's definitions of “transmitting,” “issuing,” “storing,” and “exchanging” will sweep up hosts of legitimate and innovative conduct that create absolutely no risk for consumers:

A. Under A.B. 1326’s Definition of Transmitting, Every Bitcoin User and Miner Must Register

By its very terms, the definition of “transmitting” would apply to any digital currency user who transmits currency to another person or third party. The definition of “transmitting” applies to any entity that engages in the “transfer of digital currency, by or through a third party, from one person to another person, or from one storage repository of digital currency to another storage repository of digital currency.” Under A.B. 1326, users sending digital currency to anyone else would need to register and comply with all of the requirements of the Act. The same definition could also apply to Bitcoin miners, as the blocks they append to the blockchain are transferring currency between individuals. Although A.B. 1326 purports to exempt Bitcoin miners and others “contributing software, connectivity, or computing power to a digital currency network,” the transmitting definition appears to swallow the Bitcoin miner exemption or, at minimum, creates significant confusion as to whether a Bitcoin miner is subject to the Act.

An analogous bill requiring registration and regulation of any consumer who transmits U.S. dollars to another person would be dismissed out of hand. Yet this is precisely what A.B. 1326 does with respect to digital currency users.

The mere transmission of digital currency, by itself, does not pose a risk to consumers. Thus, there is no need to regulate such activity. Even if there were legitimate concerns regarding the risks of digital currency transmission, the regulation should be limited to circumstances in which the party transmitting the digital currency has the unilateral ability to prevent the transmission.

B. A.B. 1326’s Regulation of Issuing Digital Currency Will Stifle Innovation Without Actually Addressing Conduct that Poses Risks to Consumers

A.B. 1326’s definition of “issuing” digital currency is also problematic because it chills innovation in this space by requiring people to enroll in the program and comply with all of A.B. 1326’s requirements, before beginning any experimentation with digital currency. “Issuing” is defined as any person or business that is “creating, introducing into circulation, controlling and administering digital currency.” Further, Chapter 2 of A.B. 1326 requires any entity engaging in any aspect of digital currency business as defined by the bill to enroll in the program before “issuing” any currency.

As a result, anyone creating a new digital currency would be subject to regulation the moment they mint anything, even before anyone was using or exchanging the currency and thus even when the “issuer” posed any risk to consumers. It is trivially easy for anyone to download the open source software behind Bitcoin, modify it, and create an entirely new currency. Hobbyists and innovators do this all the time. Under A.B. 1326, those individuals, who may be tinkering with software or actually looking to build the next digital currency, will have to obtain a license before starting this work. This will stifle the development new forms of digital currencies. This definitional problem is exacerbated by the fact that the bill contains no start-up exemption or provisional license for new businesses, which is discussed below in more detail.

Further, just like the definition of transmitting, the “issuing” definition could also be read to regulate Bitcoin miners, notwithstanding A.B. 1326’s exemption for parties that provide software and/or network support for a digital currency. Bitcoin miners generate currency when they post transactions to the blockchain. EFF does not believe that issuing digital currency, at least as defined in A.B. 1326, should be regulated, because an entity that issues currency does not pose any risk to consumers until it engages in other activities, such as exchanging the issued currency for something of value or acquiring the authority to transact on behalf of consumers who possess issued currency. Thus, the consumer risks are more properly addressed by focusing on other activities than whether an entity merely issues digital currency. Focusing on those narrow situations would also avoid the troubling breadth of A.B. 1326’s scope while adequately protecting consumers.

C. The Bill’s Storing Definition Could Subject Cloud Services to Regulation

A.B. 1326 defines “storing” as any entity that has “access to a customer’s digital currency credentials.” This broad definition would apply to a host of services, such as Google Drive, Amazon Web Services, and any other services that consumers could use to save their digital currency users’ passwords or credentials. Because the storage would occur at the direction of an individual user, these companies providing storage services may unwittingly become subject to A.B. 1326’s regulations—and the stiff sanctions for non-compliance—merely because they have the technical capability to access saved credentials.

Instead of defining storage so broadly, the definition should be limited to when an entity’s storage of digital currency poses a risk to consumers. This would include when an entity storing digital currency for a user has the unilateral ability to transact on behalf of the customer or to permanently block a transaction the user initiates.

D. The Definition of Exchanging Digital Currency Would Also Apply to Users

A.B. 1326’s definition of “exchanging” regulates “converting or exchanging one form of digital currency to another form of digital currency.” This is problematic because it is common for users to directly engage with others on a decentralized digital currency network to swap different digital currencies. As written, A.B. 1326 could be interpreted as requiring individual digital currency users to enroll with the DBO as “exchangers.”

Relatedly, the “exchanging” definition has the potential to regulate many of the automatic or functional elements that distinguish digital currency networks from fiat currency exchanges. As described above, many digital currency networks prevent or diminish the type of risks associated with fiat currency exchanges. For example, some users rely on blockchain technology to engage in sidechain or cross-chain swaps in which users directly engage with others in the network to either convert one form of digital currency into another or to exchange assets from different blockchains. These activities are done at the request of users and, at least in decentralized networks, have no third party responsible for the activity. Yet this activity would conceivably be regulated under the definition of “exchanging.” Surely this was not the intention of A.B. 1326.

E. A.B. 1326’s Carve-Out for Video Game Digital Currencies is an Exemption in Name Only, Requiring Nearly Every Game Maker With a Currency to Register

A.B. 1326 still fails to properly exempt digital currencies available in video games. EFF flagged this concern more than a year ago and the latest draft still does not adequately address the issue. The bill attempts to exempt online games that use digital currencies but limits the exemption to currencies that “that (i) have no market or application outside of those games or gaming platforms, (ii) cannot be converted into, or redeemed for, fiat currency or digital currency, and (iii) may not be redeemable for real-world goods, services, discounts, or purchases.”

Independent markets for many game currencies exist outside the confines of the games, however, and these markets are often outside of the direct control of the games’ creators. Under A.B. 1326, those markets would require the video game makers to enroll in the program even though they often do not administer or have any ability to control such independent markets. In addition, this legislation would curtail the ability for game companies to allow in-game currency to be used to earn promotional items, such as game-related T-shirts and stickers.

2. A.B. 1326 Contains No Start-up Exemption or Provisional License For New Businesses.

A.B. 1326 provides no space for tinkerers and new entrants to experiment with new types of digital currencies that may transform the industry, and it will therefore kill digital currency innovation in California. Because A.B. 1326 requires any entity engaged in the broadly defined conduct described above to register before beginning those activities, there is no flexibility before the Act would require enrollment and costly compliance.

Compliance with the bill is expensive and will harm nascent digital currency businesses. Although the license application fee is \$5,000 and the renewal costs \$2,500, there are costly auditing, reporting, and investigative requirements for licensed businesses. These compliance costs—including being able to quickly respond to DBO’s investigative demands—will tax the limited resources of start-ups.

Because the industry is still not fully developed to take on these complex regulatory requirements, any innovation friendly regulation of digital currency requires an exemption for start-ups, academics, and hobbyists. A.B. 1326 is thus not only unfriendly to innovation, it is openly hostile to it.

To be candid: government must tolerate some level of consumer risk to so that the industry can innovate. The Internet that we all enjoy today would not exist if it had been regulated in the manner of A.B. 1326. Further, the absence of government regulation does not necessarily mean that consumers are without legal recourse in the event of fraud or financial loss. EFF thus continues to believe that the time is not yet ripe to regulate digital currencies, at least not as aggressively as A.B. 1326 envisions.

At minimum, A.B. 1326 must contain some mechanism that would gradually introduce regulation onto smaller players, such as a provisional license with less burdensome requirements or an on-ramp or grace period that phases in some of the most burdensome requirements over time. Without a clear exemption or a start-up safe harbor, the liability and compliance costs will be prohibitive for nascent businesses. As a result, new digital currency start-ups will simply look

outside of California to locate their business to avoid being saddled with burdensome regulations before they've even exchanged their first digital currency with a single customer.

3. A.B. 1326 Allows DBO, Rather Than Users, to Pick Winners in the Digital Currency Market.

A.B. 1326's broad grant of discretion to DBO will give the agency almost unilateral authority to pick the entities that are allowed to conduct digital currency business in California. DBO's powers would include:

- Unreviewable authority to find an entity was engaged in a digital currency business without enrolling if the entity does not respond to an order within 30 days.
- Power to bring suit and seek civil penalties of \$25,000 (for each violation) against entities it finds were engaged in digital currency business without first enrolling.
- Discretion to deny enrollment to any person DBO determines is "not of good character."
- Discretion to "dis-enroll" an entity for, among other things, failing to respond to an inquiry to DBO's liking or failing to pay fees, penalties.
- Undefined rulemaking authority to implement A.B. 1326.

These broad powers will result in DBO, and not users or the market, determining the type of digital currency businesses that operate in California. For example, the criteria enabling DBO to "dis-enroll" an entity from the program are nebulous and could be selectively enforced. The same can be said of its authority to deny a license to an entity that it determines lacks good character. Because DBO's decision to deny enrollment or dis-enroll an entity would effectively shut down the business in the state, DBO has a veto over the types of digital currencies developed.

The discretion is particularly troubling because A.B. 1326 gives DBO unreviewable authority in some circumstances, limiting judicial review and the due process rights of entities engaging in legitimate business activities in California. EFF does not believe A.B. 1326's provision granting the DBO unreviewable authority would be enforceable under California law. Further, because so many of the statutory terms described above are vague, DBO could easily abuse its rulemaking and interpretive authority to discriminate against certain types of digital currencies or particular entities.

4. A.B. 1326 Misunderstands the Technology Used by Digital Currencies.

A.B. 1326 gets the technology of digital currencies severely wrong. A casual review of the definitions discussed above demonstrates that the bill would regulate a host of activity that poses no risk to consumers or activities that consumers undertake themselves, suggesting that the drafters do not understand how these currencies work.

The technical misunderstanding also leads to misleading regulations that discourage adoption of digital currencies. For example, among the numerous disclosures to customers that a digital currency business must make is the statement that using their services “may lead to an increased risk of . . . cyberattack.” The statement implies that the risk of malicious digital hacking is unique to digital currency, which is simply not true.

Fiat currency banks can be and often are hacked by malicious actors as a result of providing online services to their users. In other words, both fiat and digital currencies can be targets of online attacks for a variety of reasons, as the type of currency is not the determining risk factor. To be sure, the electronic nature of digital currencies presents risks that are different than fiat currencies. The disclosure should adequately describe the potential risks rather than spreading false impressions about digital currencies.

Conclusion: Oppose A.B. 1326

Given all of the problems with A.B. 1326 described above, EFF respectfully asks the Committee to reject the current draft. EFF continues to believe that aggressive regulation of digital currencies such as what is proposed by A.B. 1326 does far more harm than good. We continue to be willing to help draft responsible legislation that narrowly addresses the situations in which digital currencies pose acute risks to consumers while still allowing space for innovation.

Sincerely,

Aaron Mackey
Jamie Lee Williams

Frank Stanton Legal Fellows
Electronic Frontier Foundation

CC: Assemblymember Matt Dababneh