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California passes digital asset regulatory framework

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Center for
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Executive summary

On October 13, 2023, California Governor Gavin Newsom signed into law the Digital Financial Assets Law (DFAL), which establishes a tailored regulatory framework for digital financial asset companies in California.¹ The law, which takes effect on July 1, 2025, prohibits a person from engaging in digital financial asset business activity—or holding itself out as being able to engage in digital financial asset business activity—without first obtaining a license from the California Department of Financial Protection and Innovation (DFPI).

The DFAL comes after the California State Legislature previously attempted to pass a similar digital asset regulatory framework in August 2022, which Governor Newsom vetoed, describing it as “premature” and requiring a “more flexible approach.”² The updated DFAL grants the DFPI significant powers and rulemaking authority to guide the state’s approach to regulating digital assets.

The law includes an 18-month implementation period, during which market participants are expected to come into compliance with the new regulatory framework. In the meantime, the public was able to submit comments over a two month period for the DFPI to consider while it implements the law.³

Key takeaways:

- Digital asset firms have until July 2025 to become licensed.
- Licensees will need to comply with capital and liquidity requirements, anti-money laundering (AML) measures, cybersecurity requirements, fraud prevention, detailed financial record keeping requirements, and reporting requirements.
- Noncompliance carries strict penalties, including fines of up to \$100,000 per day of violation.
- Exemptions from the DFAL licensing requirements are provided for 17 identified categories of persons, including banks, certain trust companies, and credit unions, with the DFPI having additional exemptive authority.
- Applicants holding a BitLicense or trust company charter from the New York State Department of Financial Services (NYDFS) are eligible for a conditional license.⁴
- The DFAL provides the DFPI with broad examination authority over licensees.

Given the size and influence of the California economy and the current absence of comprehensive federal law and regulation addressing digital assets, this legislation should have a significant impact on the digital asset industry. While potential federal legislation still looms large, the DFAL and the importance of the California market will have an impact on many industry participants and stakeholders.

It is expected that firms operating in California, of all sizes, that intend to interact with digital assets will need to take appropriate actions and measures to ensure they are in compliance with DFAL. This includes, but is not limited to: demonstrating an end-to-end risk and compliance framework; providing a detailed business model including projections of client user base and activity; enhancing firm policies and procedures for digital asset activity; performing comprehensive risk assessments to identify gaps in control coverage; and implementing adequate client disclosures, among others.

Applicability

Digital financial asset

Similar to other states' definition of digital assets,⁵ the DFAL defines a "digital financial asset" as 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."⁶ The law exempts several assets from this broad definition, including:

- Digital value representations granted by a merchant within an affinity or rewards program, which cannot be converted into legal tender, bank or credit union credit, or a digital financial asset.
- Digital representations of value issued exclusively for use within online games, game platforms, or a family of games by a publisher.
- Securities registered or exempt from registration with the US Securities and Exchange Commission (SEC), or securities qualified or exempt from qualifications with DFPI.

Digital tokens such as bitcoin and ether, which the SEC has indicated are not securities, will likely fall under the scope of the DFAL.⁷

Covered business activity

Covered "digital financial asset business activity" includes the exchange, transfer, or storage of digital financial assets, whether conducted directly or through an agreement with a digital financial asset control services vendor.⁸ It also encompasses the custody of electronic precious metals or electronic certificates representing interests in precious metals on behalf of others and the issuance of shares or electronic certificates representing interests in precious metals.

Licensure exemptions

The DFAL exempts 17 types of persons from the law's licensing requirement and DFPI supervision,⁹ including:

- FDIC-insured depositories.
- Foreign banks with a licensed state or federal agency or branch office in California.
- An insured federal or state credit union with an office in California.
- A California or federally chartered trust company.
- A person that provides processing, clearing, or settlement services solely for transactions between or among persons that are exempt from the licensing requirements.
- A person that contributes only connectivity software or computing power to securing a network that records digital financial asset transactions or to a protocol governing transfer of the digital representation of value (e.g., miner or validator).
- A person that provides only data storage or security services for a business engaged in digital financial asset business activity and does not otherwise engage in digital financial asset business activity on behalf of another person.
- A person that provides only to an otherwise exempt person a digital financial asset as one or more enterprise solutions used solely among each other and that does not have an agreement or a relationship with a resident that is an end user of a digital financial asset.



- A person using a digital financial asset as payment for the purchase or sale of goods or services, solely on the person's own behalf for personal, family, or household purposes or for academic purposes.
- A person whose digital financial asset business activity with California residents is reasonably expected to be valued, in the aggregate, on an annual basis at \$50,000 or less.
- An attorney or title insurance company to the extent of providing escrow services to a resident.
- Any entity or futures commission merchant, swap dealer, or introducing broker registered regulated by the US Commodity Futures Trading Commission (CFTC) or registered securities broker-dealer.
- A merchant that accepts a digital financial asset as payment for the purchase or sale of goods or services, which does not include digital financial assets.

The DFAL also authorizes the DFPI Commissioner, by regulation or order, to exempt any additional person or transaction or class of persons or transactions if the commissioner finds such action to be in the public interest.¹⁰

Conditional licensing

Those entities that already hold or maintain a BitLicense to conduct virtual currency business activity in the State of New York, or a New York State limited purpose trust company charter with approval to conduct a virtual currency business, may be issued a conditional license by the DFPI commissioner, provided the New York State BitLicense or charter was issued or approved no later than January 1, 2023.¹¹ Other state licensees, such as money transmitters, are not exempted or afforded a conditional license option.

Applicants who seek a conditional license will be required to pay all appropriate fees and submit fingerprints to DFPI, while the Department evaluates the applicant's compliance with all relevant laws and regulations. Once issued, a conditional license will expire at the earliest of:

- The applicant being issued an unconditional license by DFPI.
- The applicant being denied a license application by DFPI.
- Upon revocation of a New York State BitLicense or disapproval or revocation of a charter as a New York State limited purpose trust company with approval to conduct a virtual currency business under New York law.

Regulatory obligations



Under the DFAL, licensees are subject to a number of regulatory obligations and supervisory expectations. Below are select, notable provisions digital asset firms should be aware of.

Application process

The DFAL sets forth a detailed license application process. Application requirements include the submission of descriptions of products and services, projected user base, and marketing targets.¹² Applicants must provide a list of officers, regulatory disciplinary history, criminal history, litigation history, and any bankruptcy or receivership proceedings in the past 10 years.¹³

The application process requires the DFPI to determine the applicant has a reasonable promise of business success

Applicants will need to demonstrate they have sufficient capital and liquidity as required by law, and the approval process requires that the Department determine that “the applicant has a reasonable promise of success in engaging in digital financial business activity.”¹⁴ Applicants must provide audited financial statements for the most recent fiscal year and for the two-year period next preceding the submission of the application, as well as a copy of the applicant’s unconsolidated financial statements for the current fiscal year, whether audited or not. Beyond business model details and financial prerequisites, applicants will also need to demonstrate to the DFPI that senior management are appropriately competent, experienced, and of good character and general fitness.¹⁵

The DFAL also provides the commissioner with authority to waive or modify—by rule, regulation, or order—any or all of the requirements set forth in the law, including application requirements, necessary to participate in the Nationwide Multistate Licensing System and Registry (NMLS).¹⁶ Therefore, the DFPI application process may leverage the NMLS and provide a known pathway for digital financial asset firms with multiple state licenses.

Policies and procedures

The DFAL specifies a number of programs that a prospective licensee must establish before submitting an application and must subsequently maintain following licensure, with the policies and procedures covering the following:¹⁷

- An information security program and an operational security program
- A business continuity program
- A disaster recovery program
- An antifraud program
- AML/combatting the financing of terrorism (CFT) program
- A program designed to ensure compliance with state or federal laws applicable to the digital financial asset business activity

As a leading practice, policies and procedures should be tailored to an entity’s operations, size, and complexity. Policies and procedures should set forth how the licensee identifies and assesses material risks, establish clear lines of responsibility, document any material decisions and actions, include detailed monitoring and reporting, and, as appropriate, provide for periodic evaluation and revisions.



Financial asset listing requirements

Prior to listing or offering customers a digital financial asset, licensees must certify to the DFPI the entity has undertaken the following actions:¹⁸

- Identified the likelihood that the digital financial asset would be deemed a security by federal or California regulators
- Provided, in writing, full and fair disclosure of all material facts relating to conflicts of interest that are associated with the licensee and the digital financial asset
- Conducted a comprehensive risk assessment designed to ensure consumers are adequately protected from cybersecurity risk; risk of malfeasance, including theft; risks related to code or protocol defects; or market-related risks, including price manipulation and fraud

- Established policies and procedures to reevaluate the appropriateness of the continued listing or offering of the digital financial asset, including an evaluation of whether material changes have occurred
- Established policies and procedures to cease listing or offering the digital financial asset, including notification to affected consumers and counterparties

Entities found violating the state's listing requirements will be required to cease offering or listing the digital financial asset and may be assessed by the DFPI a civil penalty of up to \$20,000 per day the violation has occurred.

Disclosures

The DFAL requires licensees to provide customers with extensive disclosure details, which must (i) be made separately from any other information provided by the licensee,

(ii) be in a clear and conspicuous manner, and (iii) be in a record form the resident may keep.¹⁹ These disclosures include, among others:

- A schedule of fees and charges;
- Details on insurance or protective measures for the product or the service provider;
- A notice of the irrevocability of a transfer or exchange and any exception to irrevocability;
- The licensee's liability for an unauthorized, mistaken, or accidental transfer or exchange; and
- Notice to California residents of their right to a 14-day notice for changes in fees, terms, or account policies with significant impacts on digital financial asset activities.

Recordkeeping and reporting

Licensees are subject to detailed recordkeeping requirements, which must be maintained for at least five years.²⁰ Beyond customer transaction records, licensees must maintain a monthly ledger of all assets, liabilities, capital, income, and expenses, as well as bank statements and bank reconciliation records—all of which are subject to inspection by the DFPI.

Licensees are required to submit an annual report to DFPI containing the following, among other things:²¹

- The most recent annual financial statement
- Description of any material change in financial condition
- Description of any material litigation
- Description of any international, federal, state, or local investigation of the licensee
- The number of residents and number of digital financial asset business activity transactions with, or on behalf of, residents, since the last annual report was submitted
- The amount of US dollar equivalent of digital financial assets in the control of the licensee
- Evidence that the licensee maintains, at all times, a sufficient amount of each type of digital financial asset it holds on behalf of customers to satisfy all aggregate entitlements

Stablecoins

Stablecoin issuers are limited to (i) persons licensed under the DFAL, (ii) a bank (as defined in the law), or (iii) a California or federal trust company. These permitted stablecoin issuers are required to maintain, at all times, a portfolio of eligible securities that have an aggregate market value equal to or greater than all outstanding stablecoins issued or sold.²² The DFAL defines “eligible securities” to include insured deposits, US Treasury or agency bonds, and rated US state bonds or other obligations.²³

The commissioner of the DFPI must approve a stablecoin before it can be exchanged, transferred, or custodied.²⁴ As part of that review process, the commissioner is required to consider:

- Any legally enforceable rights provided by the issuer of the stablecoin to holders of the stablecoin, including—but not limited to—rights to redeem the stablecoin for legal tender or bank or credit union credit.
- The amount, nature, and quality of assets owned or held by the issuer of the stablecoin that may be used to fund any redemption requests from residents.
- Any risks related to how the assets that back the stablecoin are owned or held by the issuer that may impair the ability of the issuer of the stablecoin to meet any redemption requests from residents.
- Any representations made by the issuer of the stablecoin related to the potential uses of the stablecoin.

- Any representations made by the issuer of the stablecoin related to the risks of using the stablecoin as payment for goods or services or as a store of value.
- Any other factors the commissioner deems material to making their determination.

The commissioner may impose additional requirements, restrictions, or prohibitions on the activities of an issuer that the commissioner determines necessary in order to protect the interests of residents. The conditions may cover activities including exchanging, transferring, or storing an approved stablecoin or engaging in digital financial asset administration of an approved stablecoin.

Stablecoins
must be backed,
at all times, by
insured deposits,
US treasury or
agency bonds,
and rated US
state bonds

Considerations and next steps

Firms that offer, or are planning to offer, digital financial asset services in California should take proactive steps to achieve compliance with the DFAL upon its effectiveness on July 1, 2025, including the following:

1. Understand the regulatory framework:

Firms should thoroughly understand the legal and regulatory framework created by the DFAL. This includes licensing requirements, compliance obligations, and relevant exemptions. Firms should also familiarize themselves with key terms and definitions to ensure they understand which aspects of their operations fall under the new law.

2. Prepare for licensing and compliance:

Firms should determine if they will require a license (de novo or conditional) to operate in California under the DFAL. If a license will be required, firms should start the application process now to meet the July 1, 2025, deadline. This includes establishing protocols and processes that align with the DFAL's requirements.

3. Engage with regulators and legal

counsel: Firms should stay informed of any changes or clarifications in the DFAL regulatory framework as it evolves during the 18-month implementation period, seeking guidance from the DFPI as necessary to be compliant with the new law. Legal counsel specializing in digital asset regulation should be consulted to obtain definitive advice on interpreting and complying with the law.

4. Assess current operations: Firms should evaluate current operations and practices and identify areas where changes will be necessary in order to meet the requirements of the DFAL. This may include changes in financial recordkeeping, security measures, or compliance with anti-money laundering and cybersecurity standards.

5. Implement risk mitigation and

security processes: Given the strict cybersecurity and data breach notification requirements in the DFAL, firms should review and—where necessary—enhance cybersecurity measures and data protection protocols. If not already in place, a program should be developed to provide for the prompt response to and reporting of security breaches.

A way forward

Based on our experience and understanding of the evolving digital asset regulatory requirements at both state and federal levels, as well as anticipated developments derived from recent trends, it is our belief that the application of expectations and practices currently in place for regulated U.S. banks, exchanges, and broker-dealers will be extended to digital asset businesses. The question, in our view, is not if, but when this will occur.

If you have questions on how your firm can plan for and come into compliance with the DFAL and other state and federal requirements, please reach out to the contacts listed below to explore how Deloitte may be able to assist your firm across the following areas:

- Business model definition
- Regulatory applicability
- Regulatory application process
- Licensing requirements
- Operating model design
- Risk and control assessment (including AML, cyber, IT and other risks)
- Current versus future-state

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Endnotes

1. Office of the Governor of California, [AB39 Signing Message](#), October 13, 2023; California Assembly, [Assembly Bill No. 39](#), October 2023 (“Digital Financial Assets Law”).
2. Office of the Governor of California, [AB 2269 Veto Message](#), September 23, 2022.
3. California Department of Financial Protection and Innovation (DFPI), [“DFPI releases first invitation for comment for the Digital Financial Assets Law,”](#) press release, November 20, 2023.
4. New York State Department of Financial Services (NYDFS), [Part 200 Virtual Currency Regulation \(23 CRR-NY 200\)](#), July 2015.
5. Illinois General Assembly, [HB 3479/SB 2233](#), February 2023 (“Fintech-Digital Asset Bill”) (“Digital asset” means a digital representation of value that is used as a medium of exchange, unit of account, or store of value, and that is not fiat currency, whether or not denominated in fiat currency.); 23 CRR-NY 200.2(p): “Virtual currency means any type of digital unit that is used as a medium of exchange or a form of digitally stored value.”
6. California Financial Code § 3102(g).
7. US Securities and Exchange Commission (SEC), Remarks by William Hinman, director, Division of Corporation Finance, [“Digital Asset Transactions: When Howey Met Gary \(Plastic\),”](#) San Francisco, California, June 14, 2018.
8. California Financial Code § 3102(i).
9. California Financial Code § 3103. Note, under the Digital Financial Assets Law, “person” is defined as an individual, partnership, estate, business or nonprofit entity, or other legal entity. This definition does not include a government-sponsored enterprise, government, or governmental subdivision, agency, or instrumentality.
10. California Financial Code § 3103(c).
11. California Financial Code § 3205.
12. California Financial Code § 3203(2)(c).
13. California Financial Code § 3203(2)(d)-(g).
14. California Financial Code §§ 3203(2)(j), 3207, 3203(b)(1)(E).
15. California Financial Code § 3203(3)(b).
16. California Financial Code § 3217.
17. California Financial Code § 3701.
18. California Financial Code § 3505.
19. California Financial Code § 3501.
20. California Financial Code § 3303(a).
21. California Financial Code § 3211.
22. California Financial Code § 3601.
23. California Financial Code §§ 2802(b), 3601(b).
24. California Financial Code § 3603.

Center for Regulatory Strategy US

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