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FAIR POLITICAL PRACTICES COMMISSION
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To: Chair Miadich, Commissioners Baker, Ortiz, Wilson, and Wood

From: Dave Bainbridge, General Counsel
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Subject: Prenotice Discussion of Amendments to Regulations 18237 and 18421.2

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Executive Summary

Proposed amendments to Regulation 18237 and 18421.2 would clarify reporting requirements for cryptocurrency holdings. Regulation 18237 clarifies that cryptocurrency does not fall under the definition of “investment” for purposes of the Act and therefore need not be reported on statements of economic interests. Regulation 18421.2 would clarify that cryptocurrency campaign contributions should be reported as monetary contributions rather than “in-kind” or nonmonetary contributions because after the contribution goes through a payment processor, as required by the Regulation, the funds are received in U.S. dollars.

Reason for Proposed Actions

The Commission has addressed some reporting requirements for cryptocurrency in the past. However, as staff has worked with existing regulations and learned more about cryptocurrency, staff has determined some clarifications are needed to make the regulations conform more accurately to the nature of cryptocurrency. As cryptocurrency gains prevalence in society, it becomes increasingly important to have regulations in place that inform the regulated community how to report these funds.

Background

Cryptocurrency

Currency (also referred to as “real” currency) as defined by federal regulations is “the coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance.”¹ In contrast to real currency, “virtual” currency is a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. Virtual currency includes cryptocurrencies, such as Bitcoin. In particular, virtual currency does not have legal tender status in any jurisdiction, is not backed by a governmental body, and is entirely digital.² Cryptocurrency is a digital, encrypted, and decentralized medium

¹ 31 CFR § 1010.100(m).

² Department of the Treasury, Financial Crimes Enforcement Network, FIN-2013-G001

of exchange. There is no central authority that manages and maintains the value of a cryptocurrency. Instead, these tasks are broadly distributed among cryptocurrency's users via the internet.³

Cryptocurrency can be exchanged in two ways; either directly, person to person, as a “peer to peer” transaction, or through an intermediary such as a cryptocurrency exchange or payment processor. A cryptocurrency exchange is a platform on which you can buy and sell cryptocurrency. Exchanges can be used to trade one crypto for another — converting Bitcoin to Litecoin, for example — or to buy cryptocurrencies using regular currency, like the U.S. Dollar. Exchanges reflect current market prices of the cryptocurrencies they offer. Exchanges can also be used to convert cryptocurrencies back into the U.S. Dollar or another currency on an exchange, to leave as cash within an account or withdraw to a user's regular bank account.⁴

A cryptocurrency payment gateway is a payment processor for digital currencies, similar to a payment processor for a credit card.⁵ Cryptocurrency gateways enable clients to accept digital payments and receive real currency immediately in exchange. They pay the client an amount equal to the digital currency's fair market value at the time of the transaction, and the cryptocurrency payment service instantly converts the payment into the currency of the client's choice, such as U.S. dollars. (*Ibid.*) The money is added to that account with the payment processor and is deposited to the client's designated bank account in intervals decided on in the client's service contract. The client does not need a cryptocurrency wallet and does not need to handle any cryptocurrency conversions when using a payment processor. (*Ibid.*)

While the cryptocurrency network operates outside of the purview of regulators, cryptocurrency service providers, like exchanges and payment processors, do not. This means that most of these services are required to implement some degree of know-your-customer (“KYC”), therefore linking a real-world identity to addresses and transactions. KYC rules are a procedure for verifying a customer's identity. This is standard practice for financial institutions and financial service businesses, including banks, stockbrokers, and is now applicable to cryptocurrency exchanges.⁶ Customers typically need to provide during the KYC process: date of birth, Social Security number, and physical address. In addition, exchanges and payment processors also generally ask for a photo of valid government-issued identification, such as a driver's license, state ID, or a passport. (*Ibid.*) After a user provides the requested information, the exchange or payment processor will use that to verify the user's true identity.

Cryptocurrency as an investment is highly volatile and unlike investments in stocks or bonds, cryptocurrency markets are unregulated and engage in short-term speculative trading.⁷ The value of cryptocurrency is subject to change constantly and dramatically, making it a high-risk investment.⁸ When a person purchases cryptocurrency they are not buying a security or ownership interest in a business. In this way, investments in cryptocurrency are more similar to investments in gold or foreign currency than in stocks or bonds.

³ <https://www.forbes.com/advisor/investing/cryptocurrency/what-is-cryptocurrency/>

⁴ <https://time.com/nextadvisor/investing/cryptocurrency/what-are-cryptocurrency-exchanges/>

⁵ <https://www.investopedia.com/tech/bitcoin-payment-services-introduction/>

⁶ See <https://www.investopedia.com/terms/k/knowyourclient.asp>

⁷ <https://www.fca.org.uk/investsmart/investing-crypto>

⁸ <https://consumer.ftc.gov/consumer-alerts/2018/02/know-risks-you-invest-cryptocurrencies>

Commission's Recent History with Cryptocurrency

In May 2022 staff provided the Commission with a presentation on the background of cryptocurrency in anticipation of the Commission considering whether to permit cryptocurrency campaign contributions. In the presentation staff informed the Commission about issues surrounding the traceability of cryptocurrencies and the benefit of KYC processes in identifying possible donors. Staff then presented the Commission with three options regarding how the Commission could address the issue of cryptocurrency contributions. When the regulation came before the Commission, the option that was chosen was one in which cryptocurrencies could be contributed to a committee through a payment processor that employed KYC procedures, converted to U.S. dollars, and reported as “in kind” (nonmonetary) contributions. It was not contemplated at this time whether cryptocurrencies should be reported on Statements of Economic Interests (SEI) as the focus was primarily on campaign contributions.

While the Commission has yet to address the issue of SEI reporting requirements in a regulation, staff has provided advice numerous times via email as to how to report cryptocurrency holdings. When cryptocurrency was still a new concept, staff took a conservative approach and advised that such holdings should be reported as an investment. However, in 2022, upon further research and given that more information had become readily available regarding cryptocurrency and its' characteristics, staff concluded that, similarly to gold, cryptocurrency is not an “investment” under the Act and began advising it need not be reported on SEIs.

Regulation 18237 – Investment

Under the Act, an “investment” is: “any financial interest in or security issued by a business entity, including, but not limited to, common stock, preferred stock, rights, warrants, options, debt instruments, and any partnership or other ownership interest owned...by the public official...if the business entity... has an interest in real property in the jurisdiction, or does business or plans to do business in the jurisdiction, or has done business within the jurisdiction at any time during the two years prior to the time any statement or other action is required under this title.” (Section 82034.) Section 82005 defines a business entity as “any organization or enterprise operated for profit, including but not limited to a proprietorship, partnership, firm, business trust, joint venture, syndicate, corporation or association.”

Investments under the Act do not include: “a time or demand deposit in a financial institution, shares in a credit union, any insurance policy, interest in a diversified mutual fund registered with the Securities and Exchange Commission under the Investment Company Act of 1940 or in a common trust fund created pursuant to Section 1564 of the Financial Code, interest in a government defined-benefit pension plan, or any bond or other debt instrument issued by any government or government agency.” (Section 82034.) Additionally, under Regulation 18237, an investment under the Act does not include Exchange Traded Funds that are substantially similar to a diversified mutual fund if certain requirements apply.

One of the main draws for purchasers of cryptocurrency is that the system is decentralized, placing the task of managing and maintaining the system on users, not a

centralized authority, there is not one centralized “business entity” through which to purchase the cryptocurrency. Additionally, cryptocurrency is different from financial interest or securities issued by businesses, such as stocks, for many reasons, including the extreme volatility of cryptocurrencies and the lack of regulation surrounding cryptocurrency businesses. When a person purchases cryptocurrency, they are not buying a security in a business, or an ownership interest, they are essentially making an exchange of one type of currency to another that is less stable and subject to constant changes in value. For that reason, staff believes that cryptocurrency is more akin to investing in gold, which is volatile and an exchange from currency to an asset that fluctuates constantly, and like gold, would not be an investment under the Act. If cryptocurrency is not an investment, then it need not be reported on SEIs because it does not fall under any other reportable category.

Regulation 18421.2 – Reporting Cryptocurrency Contributions

Under the Act, a contribution is “a payment, a forgiveness of a loan, a payment of a loan by a third party, or an enforceable promise to make a payment, except to the extent that full and adequate consideration is received or if it is clear from the surrounding circumstances that the payment is not made for political purposes.” (Section 82015.) Contributions include tickets to events, the granting of a discount or rebate not provided to the public, and payments for personal services that benefit the candidate. (*Ibid.*) Contributions can be both monetary, as simple as a payment, and nonmonetary, like a discount or personal service.

As Regulation 18421.2 currently stands, if a contributor wishes to contribute cryptocurrency, they must send the payment through a payment processor that employs KYC procedures. As a result of this requirement, when the contribution is ultimately received by the candidate or committee it is received in U.S. dollars. However, Regulation 18421.2 currently requires the contribution be reported as nonmonetary. It has become apparent to staff that, in practice, these contributions act more as a monetary contribution than an in-kind or nonmonetary contribution because the committee or candidate receives a monetary sum after the conversion through a payment processor. Under the Regulation there is never a circumstance where the candidate or committee would receive a contribution that is an amount of cryptocurrency, like Bitcoin. Because the contribution comes to the candidate or committee through a processor and is received in U.S. dollars, staff believes it is more accurate to report these contributions as monetary contributions.

Proposed Regulatory Actions

Regulation 18237

Staff proposes amending Regulation 18237, which aids in defining “investment,” to reflect that cryptocurrency holdings are not an investment under the Act. To do so staff added in the sentence “(a) For purposes of Section 82034, the term “investment” does not include: (A) Cryptocurrency funds.” Staff had to rework some of the numbering within the existing Regulation to ensure the Regulation is easy to follow, however, these changes do not change the Regulation substantively.

Regulation 18421.2

Staff proposes amending Regulation 18421.2 to reflect that contributions of cryptocurrency should be reported as monetary contributions by removing language requiring the contribution be reported as “in-kind” from the Regulation and adding a sentence stating “(c) In reporting cryptocurrency contributions: (1) The contribution shall be reported as a monetary contribution.”

Conclusion

Staff proposes amending Regulations 18237 and 18421.2 to clarify reporting requirements for cryptocurrency. Regulation 18421.2 would clarify that cryptocurrency campaign contributions should be reported as monetary contributions rather than “in-kind” or nonmonetary contributions. Regulation 18237 clarifies that cryptocurrency should not be treated as an investment for purposes of the Act and therefore need not be reported on statements of economic interests.

Attachment:

Proposed Amendments to Regulations 18237 and 18421.2