Canadian Securities Administrators'

Pragmatic Approach to Regulating Crypto Asset Trading Platforms

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Introduction

Amid the recent developments pertaining to the crypto asset industry in the US,[1] which has so far opted not to develop regulation targeting trades of crypto assets, we aim to provide a summary of the framework that has been established by the Canadian Securities Administrators ("**CSA**") to allow for the development of the crypto asset industry in Canada.

Interestingly, the CSA have not taken a firm position as to whether certain crypto assets constitute securities or derivatives. Despite this, using the imperative of advancing investor protection while fostering fair and efficient capital markets, the CSA have managed to establish mechanisms allowing crypto asset trading platforms ("**CTPs**") to offer crypto assets to the public and investment fund managers ("**IFMs**") to offer public crypto asset investment funds to Canadian investors.

In this guide, we first provide a brief summary of the Canadian approach to the determination of whether a given crypto asset constitutes a security or a derivative. We then provide highlights of the CSA's guidance regarding stable coins. Subsequently, we look at what triggers the obligation for CTPs to register as dealers and question whether recent US case-law could result in a legal challenge to the CSA's framework for forcing CTPs to seek registration as dealers. We then provide details of the requirements CTPs must fulfill to obtain registration as dealers, as well as a synthesis of the OSC's recent report outlining deficiencies it identified among CTPs. Lastly, we look at the roadmap prepared by the CSA for investment funds that wish to invest in crypto assets other than Bitcoin and Ether.

1. See, for instance, *FTX Aftermath From a Canadian Securities Law Perspective*, *'One-Two Punch' Against Crypto Industry: SEC Files Back-to-Back Complaints Against Binance and Coinbase*, and the recent ruling in *SEC v. Ripple Labs et al.*, summarized here.

Determining Whether Crypto Assets Are Securities and/or Derivatives

Pacific Coast Coin

The CSA have not provided extensive guidance regarding the qualification of crypto assets as securities or derivatives, other than to reiterate existing legal principles. Thus, the determination of whether a particular crypto asset constitutes a security requires checking whether the crypto asset falls under an existing category of "security" in each Canadian jurisdiction's applicable securities laws. One category of such laws under which crypto assets likely fall is the "investment contract"[2] category. The Canadian Supreme Court developed a four-pronged test in *Pacific Coast Coin Exchange* v. *Ontario Securities Commission* ("**Pacific Coast Coin**"),[3] to help determine whether a particular form of investment is an investment contract, which test is substantially similar to that established by the United States Supreme Court in *S.E.C.* v. *W.J. Howey Co.* ("**Howey**").[4] Pursuant to the *Pacific Coast Coin* test, an investment contract, and therefore a security, will be considered to exist where the following criteria are met: (i) there is an investment of money, (ii) in a common enterprise, (iii) with the expectation of profit, (iv) to come significantly from the efforts of others.[5]

Derivatives

As to the question of whether a crypto asset constitutes a derivative, each Canadian jurisdiction has its own definition of what constitutes a derivative. In Quebec, the *Derivatives Act* lists several types of contracts as constituting derivatives, including a residual category composed of "any other contract or instrument whose market price, value, or delivery or payment obligations are derived from, referenced to or based on an underlying interest." Other jurisdictions have similar residual categories.[6]

Bitcoin, Ether and Other Crypto Assets

Although an analysis regarding a crypto asset would need to be done to determine if it constitutes a security or a derivative based on the applicable legislation in each jurisdiction, the CSA did note in 2019 that "it is widely accepted that at least some of the well established crypto assets that function as a form of payment or means of exchange on a decentralized network, such as bitcoin, are not currently in and of themselves, securities or derivatives," instead having features that are analogous to commodities.[7]

The CSA's above statement has been presumed to apply to Ether at a minimum, as well as to the numerous other crypto assets offered by CTPs whose initial offerings generally occurred in other jurisdictions and well before regulators were paying attention. This presumption found further support when, in February 2023,[8] the CSA specifically prohibited CTPs that offer crypto assets to their clients through Crypto Contracts (defined below) and that were already registered at the time or planned to sign a Pre-Registration Undertaking ("**PRU**") from offering crypto assets that are themselves securities and/or derivatives. As a corollary of the prohibition,

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2. See subparagraph 1(ggg)(xiv) of the Alberta *Securities Act*; subsection 1(1) of the British Columbia *Securities Act*; subsection 1(1) of the Manitoba *Securities Act*; subsection 1(1) of the New Brunswick *Securities Act*; subparagraph 2(1)(qq)(xiv) of the Newfoundland and Labrador *Securities Act*; subsection 1(1) of the Northwest Territories *Securities Act*; subparagraph 2(1)(aq)(xiv) of the Nova Scotia *Securities Act*; subsection 1(1) of the Nunavut *Securities Act*; subsection 1(1) of the Ontario *Securities Act*; subparagraph 1(1)(bbb)(xi) of the Prince Edward Island *Securities Act*; subsection 1(7) of the Quebec *Securities Act*; subparagraph 2(1)(ss)(xiv) of the Saskatchewan *Securities Act, 1988*; and subsection 1(1) of the Yukon *Securities Act*.
3. [1978] 2 S.C.R. 112.
4. 328 US 293 (1946).
5. In the Howey test, the 3rd and 4th prongs of the Pacific Coast Coin test are presented as one: "a person…is led to expect profits solely from the efforts of the promoter or a third party." Another representation of this prong that is referred to in *SEC* v. *Ripple Labs et al.*, 2023 WL 4507900 (S.D.N.Y. July 13, 2023) is "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."
6. See, for instance, subsection 1 (n.01) of the Alberta *Securities Act*; subsection 1(1) of the British Columbia Securities Act; subsection 1(1) of the Manitoba *Securities Act*; subsection 1(1) of the New Brunswick *Securities Act*; paragraph 2(1)(ja) of the Nova Scotia *Securities Act*; subsection 1(1) of the Ontario *Securities Act*; and paragraph 2(1)(o.1) of the Saskatchewan *Securities Act, 1988*.
7. *Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Consultation Paper 21-402 Proposed Framework for Crypto-Asset Trading Platforms*, March 14, 2019.
8. CSA Staff Notice 21-332 *Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection*, February 22, 2023.

the CSA require CTPs know-your-product ("**KYP**") policies and procedures to include a methodology to determine whether a crypto asset is a security and/or derivative under Canadian securities legislation. At the time of the prohibition, there were already several CTPs registered, all of which offered numerous crypto assets other than Bitcoin and Ether to clients through Crypto Contracts.

While this may be seen as a tacit admission by the CSA that they will not challenge the non-security, non-derivative status of crypto assets already offered through Crypto Contracts, the CSA's use of the term "currently," above, should be noted as it leaves room for an evolving interpretation of whether crypto assets, including Bitcoin, constitute securities or derivatives.

The result of the *Pacific Coast Coin* test is generally that the types of crypto assets that constitute capital-raising processes for their issuers will be considered to constitute investment contracts, and therefore securities under Canadian securities laws. In 2018, the CSA provided examples of circumstances that would lead tokens to satisfy one or more of the conditions of the Pacific Coast Coin test,[9] which would lead to them constituting investment contracts, but have provided no further guidance on whether specific crypto assets constitute securities or derivatives since then, other than in respect of stable coins.

Security Tokens

If a crypto asset constitutes a security (a "**Security Token**"), it can only be distributed to the public if its issuer has prepared, and gotten regulatory approval of, a prospectus in connection with the distribution of such securities. That is, unless an available exemption to the prospectus requirement can be relied upon.[10] We note that, to date, the only Security Tokens launched in Canada were offered through exemptions from the prospectus requirement.[11] Such Security Tokens cannot be traded following the initial offering without triggering the prospectus requirement, or by, again, relying on an exemption therefrom.[12]

Stable Coins

Stable coins, which the CSA have labelled "Value-Referenced Crypto Assets" ("**VRCAs**") in order to stay away from any implication that such coins are indeed stable, have recently been the object of further guidance from the CSA[13]. The CSA identify two types of VRCAs: (i) those that maintain a stable value over time through the maintenance of a reserve of assets, which the CSA call a "**Fiat-Backed Crypto Asset**," although assets other than fiat currencies could be used as a reserve asset, such as gold, and (ii) those that maintain their peg through an algorithm coded into a smart contract.

Since Fiat-Backed Crypto Assets may give holders digital evidence of a claim against the issuer of the VRCA, the CSA consider such VRCAs to constitute "evidence of indebtedness," which is another category of the definition of a security. In light of this, the CSA generally consider Fiat-Backed Crypto Assets, as well as VRCAs backed by other assets, to constitute securities and/or derivatives.

The CSA do not address whether algorithm-based VRCAs are considered securities or derivatives. However, the CSA consider algorithm-based VRCAs to be more risky due to their not being backed by a reserve of assets, instead relying on algorithms and market incentives to maintain the peg.

The CSA recognize that clients of CTPs often use such VRCAs as on-ramps to deposit assets with the CTP, for trading other crypto assets, as a store of value or to avoid converting crypto assets into fiat currency[14]. Consequently, despite indicating that it considers Fiat-Backed Crypto

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9. Examples of tokens that were deemed by the CSA to constitute investment contracts are provided in CSA Staff Notice 46-308 *Securities Law Implications for Offerings of Tokens*, June 11, 2018.
10. See subsection 110(1) of the Alberta *Securities Act*; subsection 61(1) of the British Columbia *Securities Act*; subsection 37(1) of the Manitoba Securities Act; subsection 71(1) of the New Brunswick *Securities Act*; subsection 54(1) of the Newfoundland and Labrador *Securities Act*; section 94 of the Northwest Territories *Securities Act*; subsection 58(1) of the Nova Scotia *Securities Act*; section 94 of the Nunavut *Securities Act*; subsection 53(1) of the Ontario *Securities Act*; section 94 of the Prince Edward Island *Securities Act*; sections 11 and 12 of the Quebec *Securities Act*; subsection 58(1) of the Saskatchewan *Securities Act*, 1988; and section 94 of the Yukon *Securities Act*.
11. For instance, the offering memorandum exemption (s. 2.9 of Regulation 45-106 respecting *Prospectus Exemptions*) was used in 2017 by both Impak Finance Inc. and Token Funder Inc. to facilitate the initial distribution of Security Tokens. In 2019, ZED Network Inc. obtained an exemption from the propsectus requirement by limiting its offering to a very specific type of investor (money transfer operators).
12. In 2019, an affiliate of the abovementioned Token Funder Inc., TokenGX Inc. launched a platform to facilitate secondary trading of Security Tokens, again in reliance on available prospectus exemptions.
13. CSA Staff Notice 21-332 *Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection*, February 22, 2023.
14. CSA Staff Notice 21-332 *Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection*, February 22, 2023.

Assets to be securities, the CSA have provided a framework allowing CTPs to request the CSAs consent to the offering of certain VRCAs to clients on their platform, as well as the possibility for issuers of such VRCAs to contact the CSA to obtain consent to the distribution of the VRCA in Canada.

To obtain the CSA's consent to the distribution of a VRCA in Canada through Crypto Contracts (defined below) entered into with clients, a CTP must conduct sufficient due diligence that addresses applicable risks of the VRCA to Canadian consumers, such as ensuring that

- the VRCA be a Fiat-Backed Crypto Asset, rather than an algorithm-based VRCA;
- the reserve of assets have a market value at least equal to the value of outstanding units of the VRCA; and
- the reserve of assets be held by a qualified custodian, segregated from the assets of the issuer and the assets of each class of other crypto asset issued by the issuer.[15]

As we can see, the issue of custody is a significant component of the protections the CSA wishes to see in order to provide their consent to the distribution of a VRCA in Canada.

The Requirement for a CTP to Register As A Dealer

As early as 2019, the CSA introduced the notion that securities legislation may be applicable to CTPs that offer trading of crypto assets that are commodities, and therefore not securities, "because the investor's contractual right to the crypto asset may constitute a security or a derivative."[16] Although it seemed at the time like this idea would be further developed, it ended up becoming the cornerstone of bringing CTPs under the jurisdiction of the CSA.

Indeed, the notion that a user's contractual right to crypto assets purchased and held through a CTP may itself constitute a security and/or a derivative, even where the underlying crypto assets are not themselves securities or derivatives, was carried through, without further specification or elaboration, into the CSA's next staff notices in 2020[17] and 2021[18] as well as into the wording of every decision rendered by members of the CSA in granting exemptive relief to CTPs that applied for registration as dealers.[19] The CSA decided to call the user's contractual right to the crypto assets a "**Crypto Contract**."

The crucial component of the Crypto Contract, the user's contractual right to the crypto assets, stems from the custodial services provided by a CTP to its clients. More specifically, if a CTP offers crypto assets that are considered commodities, and therefore not securities, but offers the possibility for its clients to custody their purchased crypto assets through the CTP, clients do not have immediate access to their crypto assets, instead having a contractual right to their crypto assets. The CSA consider such a contractual right to crypto assets to possibly constitute a security and/or a derivative, which, as mentioned, has formed the basis for requiring all CTPs that offer custodial services to register with Canadian securities regulators.[20]

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15. For a full list of such conditions, please see pages 12-13 of CSA Staff Notice 21-332 *Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection*, February 22, 2023.
16. *Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Consultation Paper 21-402 Proposed Framework for Crypto-Asset Trading Platforms*, March 14, 2019.
17. CSA Staff Notice 21-327 - *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets*, January 16, 2020.
18. *Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Staff Notice 21-329 Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements*, March 29, 2021.
19. The decisions issued by regulators for each CTP in which exemptive relief necessary to obtain registration was granted can be found on the OSC's website.
20. Indeed, despite the absence of a clear conclusion by the CSA as to whether the client's contractual right to the crypto assets definitively constitutes a security or a derivative, the mere possibility of such contractual right being a security or a derivative has been deemed sufficient in the case of all CTPs currently registered with securities regulators to trigger the application of securities legislation. The decisions issued by regulators for each CTP in which exemptive relief necessary to obtain registration was granted can be found on the OSC's website.

The issue of custody is at the very core of the applicability of Canadian securities legislation to CTPs because by storing their crypto assets with a CTP, clients' assets are subject to risks associated with the CTP, including the risk that the CTP becomes insolvent and risks of fraud, theft or other situations where clients may not be able to recover their crypto assets.

In contrast, if a platform does not offer the possibility for clients to custody their commodity-like crypto assets through the platform, instead requiring clients to immediately store their purchased crypto assets in the clients' own private wallets or with a third-party custodian, with the transfer being immediately reflected on the relevant blockchain and the platform retaining no ownership, possession or control over the transferred crypto asset, such a platform's activities would not trigger the requirement to register as a dealer under Canadian securities legislation.

Most dealer CTPs currently registered in Canada provide custodial services and are either registered as restricted dealers or investment dealers or have committed to completing such registrations. In the latter case, until their registration is obtained, unregistered entities are required to sign a PRU, in which they commit to fulfill many of the same obligations expected of registered CTPs.

Marketplace Platforms and Dealer Platforms

The CSA have identified two types of CTPs, CTPs that operate similarly to marketplaces ("**Marketplace Platforms**") and (ii) dealer platforms, which either enter into Crypto Contracts with their clients to allow them to trade crypto assets or are in the business of trading Security Tokens but are not marketplaces ("**Dealer Platforms**").[21]

The restricted dealer registration is part of an interim approach proposed jointly by the CSA and the Investment Industry Regulatory Organization of Canada (IIROC, which has now become the Canadian Investment Regulatory Organization, or "**CIRO**"). Provided a CTP does not offer leverage or margin trading to its clients, it may initially seek registration as a restricted dealer during an interim period,[22] while ultimately seeking registration as a full-fledged investment dealer as well as CIRO membership.

Dealer Platforms are generally the counterparty to each trade with its clients, such that client orders do not interact with each other.

Marketplace Platforms provide a market for bringing together buyers and sellers of Crypto Contracts and/or Security Tokens, bring together orders of Crypto Contracts and/or Security Tokens, and use established, non-discretionary methods for allowing orders of Crypto Contracts and/or Security Tokens to interact with each other. Marketplace Platforms that do not offer leverage or margin and are not exchanges may seek registration as an exempt market dealer or a restricted dealer during the interim period, while ultimately seeking registration as a full-fledged investment dealer and CIRO membership.[23] As is the case with Dealer Platforms, Marketplace Platforms that offer margin or leverage must automatically apply for registration as an investment dealer and membership with CIRO. It should be noted that marketplace platforms, unlike Dealer Platforms, must seek registration, regardless of whether clients are able to custody their crypto assets on the platform or not.[24]

It also bears mentioning that, so far, there is no registered CTP in Canada, whether a Dealer Platform or a Marketplace Platform, that trades Security Tokens. In other words, all CTPs registered so far, and all those that have signed PRUs, offer crypto assets that are not themselves securities and/or derivatives to the public through Crypto Contracts.

Legal Challenge of the Crypto Contract Notion

We believe the CSA adopted the Crypto Contract notion to satisfy an urgent investor protection need: If Canadian investors were going to entrust their hard-earned savings to CTPs, it would be best to impose regulatory oversight on CTPs as soon as possible, whatever the legal basis. Thus, the Crypto Contract notion is based on the unresolved possibility that a user's contractual right to their crypto assets *may* constitute a security and/or a derivative. Considering this, it is somewhat surprising to note that, as far as we are aware, no

21. *Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Staff Notice 21-329 Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements*, March 29, 2021.
22. The interim period was initially 2 years from initial registration as a restricted dealer, but has been modified to require CTPs to submit their application with CIRO at the latest 6 months following its registration as a restricted dealer.
23. *Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Staff Notice 21-329 Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements*, March 29, 2021.
24. *Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Staff Notice 21-329 Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements*, March 29, 2021. The CTPs that are marketplaces are listed on the OSC's website.

CTP has mounted a legal challenge to the Crypto Contract notion. Some may wonder whether the recent US ruling in *SEC* v. *Ripple Labs et al.*[25] (**"Ripple"**) could change that.

The judge in the Ripple decision went through the exercise of performing the Howey test, equivalent to the Canadian Pacific Coast Coin test, for the XRP cryptocurrency. Interestingly, reasoning that ordinary assets, including commodities, could be sold as investment contracts depending on the circumstances of the sale, the judge in Ripple performed the Howey test separately for each method of sale of XRP.

The judge found that when Ripple sold XRP directly to sophisticated institutional investors (the **"Institutional Buyers"**),

1. there was a payment of money, which satisfies the investment of money prong;
2. the pooling of investors' money under Ripple's control and the fact that the Institutional Buyers' fortunes were tied to the success of XRP and Ripple, as well as to the success of other Institutional Buyers, satisfies the commonality prong; and
3. an objective inquiry into the promises and offers made to Institutional Buyers, rather than a search for the precise motivation of individual investors, reveals that Institutional Buyers understood that Ripple would use the capital derived from their purchase of XRP to improve the market for XRP and develop uses for its blockchain, thereby increasing the value of XRP. As such, Institutional Buyers purchased XRP with the expectation that they would derive profits from Ripple's efforts, which satisfies the third prong.

With respect to Ripple's sales to buyers of XRP on digital exchanges or through the use of trading algorithms (the **"Retail Buyers"**), Ripple did not know who the purchasers of XRP were, nor did the Retail Buyers know who they were buying from. Consequently, whereas the Institutional Buyers could reasonably have expected Ripple to use the proceeds of the sales to improve the XRP ecosystem, the Retail Buyers did not know whether their payments were going to Ripple, and therefore whether the return they expected on their investment would be derived from the entrepreneurial or managerial efforts of others. This is not to say that there were not, among the Retail Buyers, some that expected a profit or some that specifically expected a profit from Ripple's efforts. However, the absence of specific promises to Retail Buyers by Ripple was a determining factor.

As a result of this, the judge in Ripple determined that sales of XRP to Retail Buyers did not satisfy the third prong of the Howey test. This led many in the crypto sphere to rejoice, as the same logic extrapolated to other crypto assets could mean that the SEC does not have jurisdiction over sales to retail investors, so long as promises of a return on investment based on the efforts of others were not made to such retail investors. It also led to surprise at the contradictory outcome whereby retail investors, who are the most in need of regulatory protection, are afforded no regulatory protections but sophisticated institutional investors are.

It bears mentioning that the Ripple decision will likely be appealed by the SEC. As well, in the more recent ruling in the matter *SEC* v. *Terraform Labs Pte. Ltd. et al.* (**"Terraform"**),[26] a judge from the same district as the judge having rendered the ruling in Ripple rejected the distinctive classification of the XRP based on its method of sale. In Terraform, the judge stated that "...*Howey* makes no such distinction between purchasers. That a purchaser bought the coins directly from the defendants or, instead, in a secondary re-sale transaction has no impact on whether a reasonable individual would objectively view the defendants' actions and statements as evincing a promise of profits based on their efforts." We can therefore expect the issue of whether certain crypto assets constitute securities to continue to be debated in US courts.

Ultimately, we believe the decision of Canadian CTPs so far to not challenge the Crypto Contract notion is a pragmatic one. The cost of challenging the notion through the courts would be significant, likely more expensive than falling in line with the basic requirements we outline in the following section. Also to be considered is the business cost of not being registered while other CTPs brandish their registration to the public as a sort of seal of approval. Perhaps most significantly, CTPs must consider the very real possibility that, even in the event of a hypothetical victory for the CTP before the courts, provincial and territorial governments could enact regulation[27] or legislation to declare that Crypto Contracts are subject to each jurisdiction's securities legislation. In the latter case, a judicial victory would be rendered moot.

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25. 2023 WL 4507900 (S.D.N.Y. July 13, 2023).
26. 2023 WL 4858299 (S.D.N.Y. July 31, 2023).
27. For instance, section 1(9) the *Quebec Securities Act* allows the government of Quebec, namely the Minister of Finance, to enact regulation to bring any form of investment within the application of the *Securities Act*.

CTP Basic Requirements

In the absence of the legal challenge described above, CTPs that enter into Crypto Contracts with their Canadian clients, to whom they also provide custodial services, have no choice but to seek registration as a restricted dealer and, ultimately, as an investment dealer.

To be registered as a restricted dealer, CTPs must file an application to that effect with the CSA, as well as seek exemptive relief from two key regulatory requirements by which securities dealers and issuers must otherwise abide under Canadian securities laws:[28] (i) the requirement to issue a prospectus in connection with the distribution of securities to the public[29] and (ii) the requirement to determine that the opening of an account for a client and any investment action taken for a client are suitable for each client.[30]

In order to obtain the necessary exemptive relief and registration as a restricted dealer, a CTP must fulfill, among others, the following requirements to the CSA's satisfaction:[31]

1. **Fiat custody:** Fiat assets (cash) must be held with a Canadian custodian[32] or Canadian financial institution separate and apart from the property of the CTP, and in trust for the benefit of clients.
2. **Cold storage crypto asset custody:** 80% of client crypto assets held through the CTP must be held in cold storage in a designated trust account or in an account designated for the benefit of clients with an Acceptable Third party Custodian,[33] which requires, *inter alia*, that such custodian produce, within the 12 months prior to the CTP's registration, (i) audited financial statements and (ii) a Systems and Organization Controls ("**SOC**") 2 Type 1 or SOC 2 Type 2 or a comparable report.
3. **Hot wallet crypto asset storage:** The remaining 20% of client crypto assets not held in cold storage with Acceptable Third-party Custodians may be held with hot wallet providers which are not Acceptable Third-party Custodians, in a designated trust account or in an account designated for the benefit of clients. Although not required in the latest PRUs signed by unregistered entities, in the latest decisions granting exemptive relief to CTPs, the CSA nevertheless appear to require hot wallet providers to produce SOC 2 Type 2 reports to provide comfort regarding their internal controls for safeguarding client data and how well those controls are operating. In addition to any insurance coverage the hot wallet providers may have, the CSA also requires registered CTPs to license technology to provide additional security for cryptographic keys. This last requirement also does not appear in the PRUs, but is present in the latest decisions issued by the CSA.
4. **In Trust:** In all cases, client crypto assets must be held (i) in an account clearly designated for the benefit of clients or in trust for clients, (ii) separate and apart from the assets of non-Canadian clients, if applicable, and (iii) separate and apart from the CTP's assets, from the assets of any custodial service provider, and from the assets of any custodial service provider's other clients.
5. **KYP policy:** The CTP must have established KYP policies and procedures to determine whether to offer each crypto asset on its platform to Canadian clients, as well as to determine whether a crypto asset is a security and/or derivative under securities legislation in Canada. Although Marketplace Platforms and Dealer Platforms could theoretically trade Security Tokens in some capacity, we note that all CTPs registered so far, including those registered as full-fledged investment dealers, have committed to only offering Crypto Contracts based on crypto assets that are not themselves securities and/or derivatives, with the possible exception of stable coins.[34]

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28. For registration in jurisdictions other than Quebec, exemptive relief from certain trade reporting rules is also necessary, due to the categorization of Crypto Contracts as derivatives in those jurisdictions.
29. See subsection 110(1) of the Alberta *Securities Act*; subsection 61(1) of the British Columbia *Securities Act*; subsection 37(1) of the Manitoba *Securities Act*; subsection 71(1) of the New Brunswick *Securities Act*; subsection 54(1) of the Newfoundland and Labrador *Securities Act*; section 94 of the Northwest Territories *Securities Act*; subsection 58(1) of the Nova Scotia *Securities Act*; section 94 of the Nunavut *Securities Act*; subsection 53(1) of the Ontario *Securities Act*; section 94 of the Prince Edward Island *Securities Act*; sections 11 and 12 of the Quebec *Securities Act*; subsection 58(1) of the Saskatchewan *Securities Act*, 1988; and section 94 of the Yukon *Securities Act*.
30. Section 13.3 of Regulation 31-103 *respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations*, CQLR, c. V-1.1, r. 10. In jurisdictions other than Quebec, this rule is known as National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations.
31. It should be noted that these basic requirements are subject to change.
32. As defined in Regulation 31-103 *respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations*, CQLR, c. V-1.1, r. 10.
33. For the complete definition of an "Acceptable Third-party Custodian," please see , February 22, 2023.
34. CSA Staff Notice 21-332 *Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection*, February 22, 2023. The decisions issued by regulators for each CTP in which exemptive relief necessary to obtain registration was granted can be found on the OSC's website.

6. **Account appropriateness:** Although CTPs generally obtain exemptive relief from the obligation to perform trade-by-trade suitability for their clients, they must nevertheless perform account appropriateness assessments for each Canadian client upon opening an account, taking into consideration each client's (i) experience and knowledge in investing in crypto assets; (ii) the client's financial assets and income; (iii) the client's risk tolerance; and (iv) the crypto assets approved to be made available to a client by entering into Crypto Contracts on the CTP, pursuant to its KYP policy.
7. **Insurance:** CTPs must maintain appropriate insurance that covers a reasonable portion of the loss of client crypto assets.[35] Most insurers are more willing to provide coverage for crypto assets held with Acceptable Third-party Custodians in cold storage, which are more secure, than for assets held in hot wallets. Where a CTP is unable to secure insurance coverage for crypto assets held in hot wallets, the CSA generally require that the CTP maintain a separate cash account, as a measure of self-insurance for amounts held in hot wallets.
8. **Audited financial statements:** Like any dealer registered under Canadian securities laws, CTPs must file annual audited financial statements, provide interim financial information for every non-year-end 3-month period, and prepare and file a calculation of excess working capital, which must always be above zero, four times per year.[36] CTPs must entirely exclude crypto assets from their calculation of excess working capital, such that only non-crypto asset assets will count toward the assets in the calculation.
9. **Policies and procedures:** CTPs must establish, maintain and apply written policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that the CTP and each individual acting on its behalf complies with securities legislation, manage the risks associated with its business, including operations that are not related to trading Crypto Contracts, in accordance with prudent business practices. Among the required policies and procedures, CTPs must have policies related to custodial arrangements, including how the CTP oversees outsourced custody functions, as well as procedures that manage and mitigate custodial risks, such as having an effective system of controls and supervision to safeguard the crypto assets held through the CTP.

Staking

We note that two registered CTPs and six CTPs having signed PRUs allow clients to engage in staking activities, whereby the CTP arranges to stake crypto assets that participating clients allocate for staking, which allows such clients to earn staking rewards.[37]

In order to offer staking to clients, a CTP would direct its custodian of client crypto assets to (i) transfer crypto assets allocated by clients for staking to an omnibus staking wallet and (ii) sign a blockchain transaction confirming that assets in that wallet are intended to be staked with a validator.[38] The CTP can stake and unstake crypto assets on an omnibus basis by calculating the total amount of a crypto asset that clients wish to stake or unstake and adjusting the amount actually staked to reconcile with the net amount that clients have, all told, instructed the CTP to stake or unstake.[39]

While the exemptive relief decisions issued with respect to registered CTPs state that each decision is tailored and not intended to constitute a precedent, the CSA are more likely to grant relief on the basis of conditions already agreed to. With that in mind, the following are the key elements of a framework for allowing clients to stake crypto assets that has been approved by the CSA:[40]

- The CTP can only offer staking services with respect to crypto assets whose blockchains use the proof of stake consensus mechanism;

35. At a minimum, this should cover the $25,000,000, with double aggregate limit or a full reinstatement of coverage, as stipulated in section 12.3 of Regulation 31-103 *respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations*, CQLR, c. V-1.1, r. 10. In jurisdictions other than Quebec, this rule is known as National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.
36. See sections 12.10, 12.11 and 12.12 of Regulation 31-103 *respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations*, CQLR, c. V-1.1, r. 10. In jurisdictions other than Quebec, this rule is known as National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.
37. Please see the exemptive relief decisions issued by regulators with respect to Wealthsimple Digital Assets Inc. (Wealthsimple) and Hibit Technology Ltd., and the PRUs signed by Satstreet Inc., NDAX Canada Inc. operating as NDAX , Payward Canada Inc. et al operating as Kraken, Gemini Trust Company, LLC et al operating as Gemini, Uphold Worldwide Ltd. et al operating as Uphold, Coinbase Canada, Inc. et al operating as Coinbase, on the OSC's website. The information provided here regarding staking activities by CTPs is from the abovementioned Wealthsimple decision, June 23, 2023.
38. Wealthsimple decision, par. 98, June 23, 2023.
39. Wealthsimple decision, par. 96, June 23, 2023.
40. The information provided here regarding staking activities by CTPs is from the abovementioned Wealthsimple decision, June 23, 2023.

- The CTP can only offer staking services with respect to staked crypto assets that are used to guarantee the legitimacy of new transactions that are added to the blockchain by the validator;[41]
- The CTP must be proficient and knowledgeable about staking crypto assets;
- The CTP may not act as the validator. It must engage the services of a third party to act as validator who is proficient and experienced in staking crypto assets and on whom it has conducted adequate due diligence;
- Prior to making them available for staking to its clients, the CTP must review the crypto asset as part of its KYP policy, including its staking protocols, risks of loss, including due to software bugs and hacks of the protocol, and the performance history of its selected validators;
- As part of its account appropriateness assessment and at least annually thereafter, the CTP must evaluate whether staking should be offered to a client;
- In addition to disclosing all risks in connection with staking to clients, CTPs must obtain clients' acknowledgment of such risks before each time a client allocates crypto assets to be staked;
- Subject to any lock-up periods,[42] the CTP must allow the client at any time to instruct the CTP to unstake a specified amount of crypto assets that the client had previously staked;
- The CTP must hold the staked crypto assets in trust for or for the benefit of its clients in one or more omnibus staking wallets in the name of the CTP for the benefit of the CTP's clients with the CTP's custodians separate and distinct from (i) the assets of the CTP, the custodians and the custodians' other clients; and (ii) the crypto assets held for its clients that have not agreed to staking those specific crypto assets;
- The CTP must have policies and procedures to determine how staking rewards, fees and losses are calculated and allocated to clients;
- The CTP and its custodian must remain in possession, custody and control of the staked crypto assets at all times, which means that the custodian remains in control of the private keys and any other cryptographic key material allowing it to stake or unstake the crypto assets, as well as access any staking rewards; and
- The CTP must monitor whether a validator's staking node is often offline and therefore not signing transactions (downtime), if it has a tendency to lose staked crypto assets due to a failure to correctly validate transactions or otherwise ensure the network is running smoothly (slashing), or if its rating drops below a certain level and is temporarily unable to validate transactions (jailed). The CTP must then take appropriate action to protect the its clients' staked crypto assets.

OSC Report

Last July 27th, the OSC published its Summary Report for Dealers, Advisers and Investment Fund Managers[43] in which it identified numerous deficiencies among Ontario CTPs related to custody and compliance and supervision structure.

In connection with custody, OSC staff found the following omissions:

- Certain CTPs did not always hold client assets separate and apart from the CTP's property;
- In connection with the obligation to ensure that client assets are held in trust for clients, certain CTPs entered into agreements with custodians whereby client assets were held in trust for the CTP, rather than in trust for the CTP's clients;

41. As specified in CSA Staff Notice 81-336 *Guidance on Crypto Asset Investment Funds that are Reporting Issuers*, "A validator, in connection with a particular proof-of-stake consensus algorithm blockchain, is an entity that operates one or more nodes that meet protocol requirements for a crypto asset and participates in consensus by broadcasting votes and committing new blocks to the blockchain. Validators are incentivized to add legitimate transactions to a proof-of-stake blockchain through rewards and can be penalized for breaching protocol requirements, including through having staked crypto assets "slashed" (i.e., removed from the offending validator)."
42. Lock-up periods refer to lock-up, unbonding, unstaking, or similar periods imposed by a crypto asset protocol, custodian or validator, where such crypto assets are not accessible to the client or will be accessible only after payment of additional fees or penalties or forfeiture of any rewards.
43. OSC Staff Notice 33-755 *Compliance and Registrant Regulation Branch Summary Report for Dealers, Advisers and Investment Fund Managers*, July 27, 2023.

- In connection with the obligation to have policies and procedures related to custodial arrangements and how the CTP oversees outsourced functions, certain CTPs did not
  - have policies to regularly monitor that the third-party custodian continues to be acceptable; and
  - implement appropriate policies and procedures to ensure that the CTP maintained a minimum of 80% of client crypto assets with an Acceptable Third-party Custodian, rather than in hot wallets; and
  - CTPs did not always maintain an effective system of controls and supervision to address custodial risks and safeguard crypto assets held in the CTP's custody.

As mentioned, custody is a key component of the regulatory framework developed by the CSA, given its importance in securing the protection of investors. In light of this, it is especially crucial for CTPs to abide by rules relating to custody.

Investment Funds

Last July 6, the CSA issued a staff notice detailing its guidance on investment funds that are reporting issuers that invest in crypto assets.[44] After providing the results of their review of the 22 publicly-offered crypto asset investment funds that exist as of April 30, 2023, all of which invest in either Bitcoin or Ether, the notice provides a roadmap for investment funds that wish to invest in crypto assets other than Bitcoin and Ether. We provide below a few highlights of the roadmap.

Custody

Unsurprisingly, custody is a major component of the roadmap. Specifically, the IFM of a public crypto asset investment fund must ensure that

- its custodian must be qualified custodian in accordance with Part 6 of Regulation 81-102 *respecting Investment Funds* ("**NI 81-102**"), and must possess the necessary expertise and experience to safely custody the crypto assets on behalf of the investment fund;[45]
- crypto assets must be held primarily in cold wallets, with hot wallets being used only to facilitate purchases and redemptions;
- the custodian must use segregated wallets or an omnibus wallet visible on the blockchain, so long as the custodian's books and records show that the investment fund is the beneficial owner of the crypto assets;
- the custodian must have strong cybersecurity measures to protect the investment fund's crypto assets from cyberattacks;
- the custodian must have insurance covering the loss of the crypto assets; and
- the custodian must generally provide a SOC 2 Type 2 report.

As noted in the notice, "these practices and expectations are substantially similar to the proposed terms and conditions for entities that seek to act as custodians for CTPs in Canada."

44. CSA Staff Notice 81-336 *Guidance on Crypto Asset Investment Funds that are Reporting Issuers*, July 6, 2023.
45. Regulation 81-102 *respecting Investment Funds*. In Canadian jurisdictions other than Quebec, this rule is known as National Instrument 81-102 – Investment Funds.

Valuation

The CSA notice also indicates that, in selecting a crypto asset other than Bitcoin and Ether in which a public investment fund wishes to invest, it should focus on crypto assets that have

- An active market of regular transactions between unrelated parties,
- A regulated futures market; and
- Publicly available indices, administered by regulated index providers, that aggregate pricing from several sources.

This will allow the IFM to adequately determine the fair value of the crypto asset, which, in turn, will allow it compute the net asset value of the investment fund on a daily basis.[46]

Liquidity

Before investing in a crypto asset, the investment fund must conduct due diligence to determine if the crypto asset is sufficiently liquid to comply with restrictions against holding illiquid assets contained in NI 81-102.[47] Where a crypto asset' market becomes one-sided for various reasons, including as a result of significant redemption requests, it may not be possible to liquidate holdings of the crypto asset. IFMs must carefully monitor the liquidity of the investment fund's underlying portfolio assets in order to avoid a potential mismatch between the fund's underlying assets and the redemption terms offered to investors. IFMs must have robust liquidity risk management policies and procedures to mitigate this risk.

Staking

Should a public crypto asset investment fund wish to engage in staking with client crypto assets, the CSA provide the following guidelines, based on the framework developed for CTPs:

- The fund can only stake crypto assets whose blockchains use the proof of stake consensus mechanism;
- The fund can only stake crypto assets that are used to guarantee the legitimacy of new transactions that are added to the blockchain by the validator;[48]
- As an investment fund must not seek to exercise control over, or become actively involved in, the management of an entity in which it invests, neither the IFM nor the investment fund may act as the validator. They must instead engage the services of a third party to act as validator;
- The IFM must have policies and procedures to determine whether the staking activity results in the issuance of a security or a derivative;
- The custodian of the investment fund's crypto assets must remain in possession, custody and control of the staked crypto assets;
- Staked crypto assets must be held in cold storage;
- While being staked, crypto assets will often be subject to a lock up period or a slow unstaking process that will result in the crypto assets being inaccessible. Investment funds need to keep track of the impact of staking on the fund's liquidity, keeping in mind the aforementioned restrictions in section 2.4 of NI 81-102; and
- The IFM must monitor whether a validator's staking node is often offline and therefore not signing transactions (downtime), if it has a tendency to lose staked crypto assets due to a failure to correctly validate transactions or otherwise ensure the network is running smoothly (slashing), or if its rating drops below a certain level and is temporarily unable to validate transactions (jailed). The IFM must then take appropriate action to protect the investment fund's staked crypto assets.

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46. As required by Part 14 of Regulation 81-106 - *Investment Fund Continuous Disclosure*. In Canadian jurisdictions other than Quebec, this rule is known as National Instrument 81-106 – *Investment Fund Continuous Disclosure*.
47. See section 2.4 of Regulation 81-102 *respecting Investment Funds*. In Canadian jurisdictions other than Quebec, this rule is known as National Instrument 81-102 – *Investment Funds*.
48. As specified in CSA Staff Notice 81-336 *Guidance on Crypto Asset Investment Funds that are Reporting Issuers*, "A validator, in connection with a particular proof-of-stake consensus algorithm blockchain, is an entity that operates one or more nodes that meet protocol requirements for a crypto asset and participates in consensus by broadcasting votes and committing new blocks to the blockchain. Validators are incentivized to add legitimate transactions to a proof-of-stake blockchain through rewards and can be penalized for breaching protocol requirements, including through having staked crypto assets "slashed" (i.e., removed from the offending validator)."

Takeaways

Seeing the fallout from the US *Ripple* decision, some may wonder if it would have been worthwhile to mount a legal challenge to the notion that a user's contractual right to crypto assets custodied through a CTP justifies the requirement for CTPs to register as dealers. However, industry players surely knew that such a battle would be lengthy, costly, and would ultimately lead to the same result: The CSA were tapped to bring the crypto trading industry within their jurisdiction and their respective governments are unlikely to let a judicial loss stand in the way of the imposition of regulatory oversight.

The resulting framework for CTPs sets a high barrier to entry for any player wishing to offer crypto assets through Crypto Contracts to the public. However, the benefits of this framework must also be acknowledged: The framework established by the CSA provides necessary assurances to the public that the entities they invest with are subject to strict regulatory oversight, while allowing some degree of innovation and access to the crypto asset market.

Similarly, although no investment funds currently exist that invest in crypto assets other than Bitcoin and Ether, the CSA have provided the rules for IFMs to move in that direction.

Fasken Contacts

Marcelo Ciecha
Associate
+1 514 397 7444
mciecha@fasken.com

Daniel Fuke
Partner
+1 416 865 4436
dfuke@fasken.com

Kosta Kostic
Partner
+1 514 397 7458
kkostic@fasken.com

Mike M. Stephens
Partner
+1 604 631 3162
mstephens@fasken.com

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VANCOUVER	550 Burrard Street, Suite 2900	+1 604 631 3131	vancouver@fasken.com
SURREY	13401 - 108th Avenue, Suite 1800	+1 604 631 3131	surrey@fasken.com
TSUUT'INA	11501 Buffalo Run Boulevard, Suite 211	+1 403 261 5350	tsuutina@fasken.com
CALGARY	350 7th Avenue SW, Suite 3400	+1 403 261 5350	calgary@fasken.com
TORONTO	333 Bay Street, Suite 2400	+1 416 366 8381	toronto@fasken.com
OTTAWA	55 Metcalfe Street, Suite 1300	+1 613 236 3882	ottawa@fasken.com
MONTRÉAL	800 Victoria Square, Suite 3500	+1 514 397 7400	montreal@fasken.com
QUÉBEC	365 Abraham-Martin Street, Suite 600	+1 418 640 2000	quebec@fasken.com
LONDON	6th Floor, 100 Liverpool Street	+44 20 7917 8500	london@fasken.com
JOHANNESBURG	Inanda Greens, 54 Wierda Road West, Sandton 2196	+27 11 586 6000	johannesburg@fasken.com

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