

CRYPTOASSETS

Emerging clarity on cryptoasset regulation

Cryptoassets made headlines in Canada in 2019, and not always for the best reasons. Early in the year, a media hurricane swirled around the QuadrigaCX cryptoasset trading platform, whose founder apparently died while on honeymoon in India, allegedly taking with him the private keys for the platform's cryptoasset reserves. The platform attempted to restructure under court protection but was soon put into bankruptcy. Now, 75,000 customers face a collective loss of potentially more than C\$200 million. Further investigation revealed a complete absence of financial controls, apparent misappropriation and misuse of customer assets, and other business practices that were particularly dubious for an enterprise that customers entrusted with hundreds of millions of dollars of assets.

Regulation may yet rein in the unrulier parts of the cryptoasset sector. Shortly after QuadrigaCX's collapse, Canadian securities regulators proposed a framework for regulating cryptoasset trading platforms, which would include provisions relating to custody, internal controls and business

continuity. In July 2019, the federal government published final regulations that will subject dealers in virtual currency to Canada's primary anti-money laundering statute, the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the PCMLTFA). These regulations will require many cryptoasset businesses to introduce compliance programs, appoint compliance officers and make reports to the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). Finally, retail investors seeking exposure to bitcoin may soon have a regulated alternative to platforms like QuadrigaCX. In October 2019, a panel of the Ontario Securities Commission (OSC) set aside an earlier decision by OSC staff and directed the issuance of a prospectus receipt for The Bitcoin Fund, which could become the world's first publicly traded bitcoin investment fund.

Proposed regulatory framework for cryptoasset trading platforms

In March 2019, the Canadian Securities Administrators (CSA) and the Investment Industry Regulatory Organization of Canada (IIROC) published [*Consultation Paper 21-402 Proposed Framework for Crypto-Asset Trading Platforms*](#), which proposes a regulatory framework for platforms that trade cryptoassets.

The proposed framework draws upon requirements applicable to securities and commodity futures exchanges, alternative trading systems, clearing agencies, custodians and dealers. The framework contemplates various operational requirements intended to protect participants from the counterparty and other risks associated with platforms, such as requirements for market integrity, market surveillance, fair pricing, custody, clearing and settlement, disclosure of conflicts of interest, and systems and business continuity planning. The framework would apply to platforms located in Canada, as well as foreign platforms with Canadian participants, though foreign platforms may be exempt if they are appropriately regulated in their home jurisdiction.

A key threshold issue is how Canadian securities regulators can assert jurisdiction over platforms that trade cryptoassets such as bitcoin that are not, in and of themselves, securities or derivatives. CSA/IIROC acknowledged that some cryptoassets are analogous to fiat currency and precious metals and are more appropriately characterized as commodities. Nonetheless, CSA/IIROC proposed to apply securities legislation to platforms that offer trading in these cryptoassets where the legal arrangement between the platform and its users may itself be a security or derivative.

Currently, however, the framework is only for discussion. CSA/IIROC received numerous comments in response to the consultation paper, and IIROC formed a Crypto-Asset Working Group in October 2019 to recommend how best to tailor securities regulatory requirements for cryptoassets. We expect that the next phase in this process will be publication by the CSA of a draft National Instrument which will be subject to a public comment period.

Long-awaited amendments to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* published in July 2019 will require "dealers in virtual currency" that offer services to Canadian clients to register as money services businesses with FINTRAC as of June 1, 2020.

AML regulation now applies to dealers in virtual currency

Long-awaited [amendments](#) to the PCMLTFA published in July 2019 will require “dealers in virtual currency” that offer services to Canadian clients to register as money services businesses (MSBs) with FINTRAC as of June 1, 2020. MSBs are subject to customer due diligence, record-keeping, monitoring and reporting requirements under the PCMLTFA.

Regulatory guidance states that “dealing in” activities include virtual currency exchange services and value transfer services, which would likely include cryptoasset trading platforms and brokerages/intermediaries for virtual currency transactions. Less clear is whether emerging platforms for cryptoasset-secured lending will be considered “dealing in” activities.

Many Canadian cryptoasset exchanges adopted know-your-client (KYC) procedures consistent with regulations made under the PCMLTFA prior to publication of the final amendments for the purpose of addressing various business risks, including risks identified by potential banking partners. However, FINTRAC generally declined to register these businesses as MSBs or supervise their activities due to lack of jurisdiction. On November 22, 2019, FINTRAC announced that virtual currency dealers are permitted to voluntarily register as MSBs in advance of the June 2020 deadline, which is likely to be welcome news for many Canadian cryptoasset trading platforms seeking to demonstrate compliance to prospective service providers and customers.

Foreign cryptoasset platforms that direct services to Canadians will be subject to the same compliance requirements as domestic platforms, with slightly less onerous record-keeping requirements. Regulatory guidance indicates that targeting, or advertising to, Canadian clients or having a Canadian domain name are indicia that a foreign platform is “directing services” to Canadian clients.

OSC allows first publicly traded bitcoin investment fund

On October 30, 2019, a panel of the OSC released a [decision](#) that will allow 3iQ Corp., a Canadian investment manager, to offer the world’s first publicly traded bitcoin investment fund. The fund is intended to offer retail investors a regulated alternative to purchasing and holding bitcoin.

Since late 2016, 3iQ has been developing The Bitcoin Fund, a proposed non-redeemable investment fund that would invest substantially all of its assets in bitcoin. In February 2019, the Director of the Investment Funds and Structured Products Branch of the OSC declined to issue a receipt for The Bitcoin Fund’s preliminary prospectus. The Director concluded that bitcoin was an illiquid asset and therefore the fund could not comply with regulatory restrictions against holding illiquid assets. In addition, the Director concluded that it was not in the public interest to issue a prospectus receipt because of concerns about the integrity of the market for bitcoin, the security and safekeeping of the fund’s bitcoin, and the fund’s ability to file audited financial statements.

Following a hearing in July 2019, an OSC commissioner set aside the Director's decision. After reviewing the evidence, the commissioner found that there was a liquid market for bitcoin. The commissioner also found that there was insufficient evidence to show that any price manipulation was preventing price discovery for bitcoin, that the fund's custodial arrangements for its bitcoin were inadequate, or that the fund would be unable to comply with requirements for audited financial statements.

In making the decision, the commissioner observed that the fund was innovative and could mitigate risks for investors:

The notion of professionalizing investing in risky assets to mitigate risks should be encouraged, not discouraged. Ontario capital market participants should be encouraged to engage with the Commission, and not incentivized to avoid doing so. Pooling of investor funds under a professional management structure to address and mitigate risks in an underlying asset market is innovative and should be encouraged, especially when it provides an alternative to investors acquiring bitcoin through unregulated vehicles.

The decision directs the issuance of a receipt for a final prospectus of the fund. Upon the issuance of a receipt for the final prospectus and acceptance for listing on a Canadian securities exchange, The Bitcoin Fund would be the first publicly traded bitcoin investment fund in the world. Overall, the decision is encouraging for the development of new fund products that invest in new asset classes and sends a strong message in support of innovation in capital markets in Canada.

Osler represented 3iQ and The Bitcoin Fund before the OSC.

Looking ahead to 2020

One likely effect of new cryptoasset regulations under securities and anti-money laundering laws will be the exit of cryptoasset businesses that are unable to absorb growing compliance costs, particularly when cryptoasset markets are down significantly since the highs of 2017. On the other hand, new compliance requirements will require surviving incumbents and new entrants to ensure they have proper controls in place that will mitigate many of the inherent risks of existing cryptoasset platforms.

Even as regulators take steps to mitigate these risks, new challenges lie ahead. In 2019, we saw rapid growth in asset-backed tokens (often referred to as stable coins), highly leveraged cryptoasset derivatives and cryptoasset-based lending. There is every reason to think these trends will accelerate in 2020. The development of sophisticated financial instruments built on new and rapidly evolving technology and traded on a global scale through unconventional platforms with uneven regulatory oversight suggests there will be more failures of major cryptoasset businesses before regulation becomes firmly established.

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