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CRYPTOCURRENCY

New opportunities and new challenges for cryptoasset trading platforms

Three trends have emerged this year that will continue to shape the evolution of cryptoasset trading platforms (Platforms) doing business in Canada. First, the Canadian Securities Administrators (CSA) have asserted jurisdiction over Platforms, which are the primary intermediaries through which retail customers purchase and hold bitcoin and other cryptoassets. Second, retail cryptoasset investment products have become available, allowing investors to obtain investment exposure to bitcoin and Ether without going through Platforms. Third, there has been an explosion in the use of decentralized finance (DeFi) protocols. These protocols provide sophisticated cryptoasset market participants with a means of transacting without any intermediaries at all, creating new challenges for Canadian and foreign regulators in the process.

New rules for Canadian cryptoasset trading platforms

The introduction of new regulatory requirements for cryptoasset trading platforms that offer services to Canadians was a key development this year. In January 2020, the CSA released a new [Staff Notice](#) regarding the application of securities laws to Platforms. As described in our Osler Update entitled “[CSA issues guidance that securities legislation likely applies to custodial cryptoasset trading platforms](#)” on [osler.com](#), under this guidance Platforms that do not immediately transfer ownership, possession and control of all purchased cryptoassets to their customers are likely dealing in derivatives or securities. They are, therefore, subject to regulation as dealers or marketplaces under Canadian securities and/or derivatives laws.

Since the publication of the Staff Notice in January 2020, Canadian Platforms that maintain custody of cryptoassets on behalf of their customers have been working with their respective principal securities regulators to agree upon terms for registration under existing securities and derivative laws. This approach is intended to allow flexibility for Platforms to innovate while addressing the CSA’s key investor protection concerns around custody and market integrity.

In July 2020, the Ontario Securities Commission entered into a settlement agreement with Coinsquare Inc., one of Canada’s largest Platforms, in connection with allegations involving artificial trading volumes. At the time of the settlement, Coinsquare had been working toward securities dealer registration.

In addition, as of June 1, 2020, long-awaited amendments to [regulations under Canada’s anti-money laundering laws](#) took effect. These amendments require domestic and foreign Platforms that offer their services to Canadians to register as “dealers in virtual currency.” “Virtual currency transactions” are now included in the reporting obligations that apply to all financial entities. Please see our Osler Update on [osler.com](#) entitled “[Anti-money laundering rules for cryptocurrency dealers finalized by Canadian government](#)” on these amendments, as well as our “[Financial services regulation in 2020: Convergence, disruption and acceleration](#)” article.

There are also indications that CSA members are engaging with, and potentially taking enforcement action against, foreign Platforms available to Canadians. In August 2020, BitMEX, a major cryptocurrency derivatives Platform incorporated in the Seychelles, announced that it would restrict access by Ontario residents to its Platform, stating that the “restrictions are mandated by the Ontario Securities Commission.” Shortly after this announcement, the U.S. Department of Justice and the Commodity Futures Trading Commission initiated criminal and civil proceedings against BitMEX and its principals for, among other things, allegedly evading anti-money laundering laws. These actions highlight the willingness of both Canadian and U.S. regulators to reach outside their borders to require compliance by foreign Platforms dealing with customers within their jurisdictions.

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The arrival of retail cryptoasset investment products

New, regulated products for Canadian retail investors seeking to invest in cryptoassets have emerged in the past year. In April 2020, the initial public offering of The Bitcoin Fund (TSX:QBTC) was completed. The Bitcoin Fund thereby became the first publicly-traded cryptoasset investment fund in the world after the fund's manager, 3iQ Corp., won a contested hearing before the OSC in 2019 (described in our Osler Update entitled "[OSC clears path for publicly traded bitcoin investment fund](#)" on [osler.com](#)). As of November 30, 2020, the net asset value of QBTC is approximately US\$320 million. In October 2020, 3iQ filed a prospectus for The Ether Fund, which replicates the structure of QBTC, but holds Ether instead of bitcoin. These funds allow retail investors to invest in cryptoassets through investment dealers that are regulated by the Investment Industry Regulatory Organization of Canada and to hold the investments in their tax-deferred registered accounts.

In August 2020, the CSA registered Wealthsimple Digital Assets (WDA) as a restricted securities dealer (in Québec, WDA is registered as a derivatives dealer). WDA is the first regulated cryptoasset Platform in Canada, allowing customers to trade and hold bitcoin and Ether using the Wealthsimple Trade application. To address investor protection concerns, the CSA has capped an individual's annual investments in cryptoassets through WDA at C\$30,000, a restriction that may change as the regulatory framework evolves.

The rise of decentralized finance

During the summer of 2020, there was rapid growth of DeFi protocols, namely, smart contracts running autonomously on blockchains, primarily Ethereum, that facilitate trading, lending and other transactions involving cryptoassets, all without an intermediary. In many cases, the developers of these protocols have relinquished all control over the smart contracts and the cryptoassets transacted through them. At the same time, these developers are seeking to establish decentralized governance by distributing blockchain tokens to users of the protocol that allow tokenholders to vote on changes to the protocol.

Over the course of 2020, the value of cryptoassets held or transacted through these protocols grew into the billions of dollars. In early September 2020, the decentralized Uniswap trading protocol built on the Ethereum network had cryptoasset trading volumes approaching US\$1 billion per day, rivaling some of the largest centralized Platforms. Although volumes have declined since this peak, DeFi protocols remain a challenge to the dominance of custodial Platforms in trading and lending of cryptoassets.

DeFi protocols also pose profound challenges for regulators. The trades, loans and other transactions that occur over DeFi protocols may include the types of transactions that the CSA seeks to regulate, but there is no intermediary that can be regulated. Meanwhile, the parties to the transactions are globally dispersed and transact pseudonymously, identifiable only by blockchain addresses that cannot be easily traced to real-world identities. Perhaps most concerning for regulators, security vulnerabilities and software bugs in DeFi

protocols have led to investor losses. The investor protection risks of DeFi protocols are therefore similar to those of custodial Platforms, but they are more difficult to regulate due to the absence of an identifiable intermediary.

Looking ahead to 2021

We anticipate the coming year will see further changes in the Canadian cryptoasset marketplace. More Platforms are expected to follow WDA in securing registrations under Canadian securities laws. When evaluating Platforms for registration, the CSA's primary regulatory focus continues to be on custody and protection of customer assets. Platforms seeking to register as securities dealers or marketplaces should also expect to comply with risk and conflict of interest disclosure, financial reporting and market conduct rules and obtain insurance, to the extent possible, or exemptive relief from the insurance requirements applicable to registrants. Canadian Platforms are working with regulators to adopt best practices for protecting investors, which is expected to professionalize the nascent industry.

At the same time, increased regulation is expected to drive consolidation in the Canadian market. Some Platforms may find regulatory costs are disproportionate to the size of the market, particularly when Canadian retail investors can obtain exposure to cryptoassets through mainstream investment products.

We also expect that the Canada Revenue Agency will continue to pursue customer information from Canadian Platforms with a view to identifying cryptoasset investors or traders who may not have accurately reported cryptoasset-related income.

Finally, increased regulation and professionalization of Platforms and cryptoasset products may stimulate institutional investor interest in cryptoassets. Some Canadian institutional investors showed interest in 2017 and early 2018 as prices and returns skyrocketed. However, this interest waned as the initial coin offering bubble popped and Platforms like QuadrigaCX were revealed to be little more than Ponzi schemes. But now that cryptoasset markets have bounced back, several high profile public companies have made sizable investments in bitcoin. Global financial intermediaries like Fidelity and PayPal are allowing U.S. customers to trade in cryptoassets. We expect that institutional investors and traditional financial services firms may consider participating in the growing cryptoasset market, likely on a small scale to start.

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