Cassels

Legislative Guidance for Crypto-Asset Trading Platforms

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On January 16, 2020, the Canadian Securities Administrators (CSA or Staff) published Staff Notice 21-327 *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto-assets* (the Staff Notice). The Staff Notice describes situations where securities legislation will and will not apply in an effort to help stakeholders better navigate the evolving regulatory regime.

Key Takeaways

- The CSA encourages crypto-asset trading platforms (Platforms) to comply with securities legislation but exempts Platforms of which the underlying crypto-asset is not a security or derivative and the contract or instrument results in an obligation to make immediate delivery of the crypto-asset and is settled by such immediate delivery.
- Immediate delivery of a crypto-asset is considered to have occurred if the Platform immediately transfers ownership, possession and control of the crypto-asset to the user, and as a result, the user is free to use, or otherwise deal with, the crypto-asset without further involvement with the Platform.

Summary and Background

On March 14, 2019, in Joint CSA/Investment Industry Regulatory Organization of Canada Consultation Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms* (the Consultation Paper), the CSA announced the circumstances under which certain Platforms would be subject to securities legislation.

As follow-up to the Consultation Paper, the Staff Notice confirms that securities legislation governs trading in crypto-assets that are clearly securities, but also trading in contracts or instruments that are derivatives based on crypto-assets. Securities legislation will therefore apply to Platforms that facilitate the trading of crypto-assets as commodities, whereby the user's contractual right to the crypto-asset may constitute a derivative.

In an attempt to clarify when a user's contractual right to a crypto-asset *may* constitute a derivative such that a Platform selling the crypto-asset would be subject to securities legislation, the Staff Notice sets out the following conditions under which securities legislation would *not* apply:

- The underlying crypto-asset itself is not a security or derivative; and
- The contract or instrument for the purchase, sale or delivery of a crypto-asset

- results in an obligation to make immediate delivery of a crypto-asset, and
- is settled by the immediate delivery of the crypto-asset to the Platform's user according to the Platform's typical commercial practice.

What Constitutes an Obligation to Make Immediate Delivery of a Crypto-asset

The Staff Notice cautions that there is no "bright-line test" as to whether a contract or instrument results in an obligation to make and take immediate delivery of a crypto-asset such that securities legislation would not apply.

Rather, in each case, the CSA will conduct a fact-specific analysis of the contract or instrument governing the relationship between the Platform and the user, including the written and unwritten terms of the contract or instrument, as well as the surrounding circumstances and typical commercial practice. This analysis is aimed at assessing whether the Platform and the User intend, and, indeed, are contractually obligated, to make and take immediate delivery of the crypto-asset on which the contract or instrument is based.

When is Immediate Delivery Deemed to Have Occurred

The Staff Notice provides that Staff will generally consider immediate delivery to have occurred in the following circumstances:

- the Platform immediately transfers ownership, possession and control of the crypto-asset to the user, and as a result the user is free to use, or otherwise deal with, the crypto-asset without
  - further involvement with or reliance on the Platform or its affiliates, and
  - the Platform or any affiliate retaining any security interest or any other legal right to the crypto-asset; and
- following the immediate delivery of the crypto-asset, the user is not exposed to insolvency risk, fraud risk, performance risk or proficiency risk on the part of the Platform.

Importantly, immediate delivery will not be deemed to occur where the sale of a crypto-asset is merely evidenced by an internal ledger entry that credits the crypto-asset to the user's account with the Platform such that the user may subsequently withdraw the crypto-asset upon his or her later request; rather, the crypto-asset must be physically transferred from the Platform's infrastructure to the user's independent wallet immediately.

A Word of Caution – Substance Over Form

The Staff Notice provides that the CSA will generally consider an obligation to immediately deliver a crypto-asset where the contract or instrument in question expressly sets out such an obligation; however, the Staff Notice cautions that Staff will ultimately prioritize substance over form in conducting its analysis. Thus, a contract or instrument would still be considered a derivative or a security, and subject to securities legislation, even though the contract referenced an obligation to make immediate delivery, if it is not, in fact, the typical commercial practice for the Platform to immediately transfer, and for users to immediately receive, full ownership, possession and control over the crypto-assets they purchase.

Conclusion

The Staff Notice concluded by warning Platforms, including those operating from outside Canada that have Canadian users, to heed its legislative guidelines or risk being the subject of an enforcement action. Indeed, as the CSA continues to publish guidance aimed at clarifying the regulatory regime governing the trading of crypto-assets, we expect enforcement efforts to increase dramatically. It follows that Platforms would be well-advised to ensure that their practices mirror their contracts with respect to the immediate delivery of the underlying crypto-assets to users if they hope to remain unencumbered by securities legislation.

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