Cassels

Crypto Trading Platforms - CSA Releases Updated Guidance

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Just in time for the new year, the Canadian Securities Administrators (the CSA) have released additional guidance (the Guidance) for crypto trading platforms (CTPs).[1] The Guidance is timely, coming as a result of recent events in the crypto market that included the collapse of FTX Trading Ltd., one of the largest international exchanges, and a myriad of ongoing bankruptcy proceedings.

Pre-Registration Undertakings

The Guidance supplements the CSA's recent announcement requiring CTPs to deliver a pre-registration undertaking (PRU) to their principal regulator that, among other things, confirms their commitment to abide by prescribed terms and conditions.[2] The terms include "requirements to hold Canadian clients' assets with an appropriate custodian, segregate those assets from the platform's proprietary business, and a prohibition on offering margin or leverage for any Canadian client."[3] These terms correspond with emerging reports of inappropriate business practices and improper mismanagement of client assets by legacy entities in the crypto-asset space.[4] Notably, Ontario regulators had already begun addressing the first two requirements for entities registered as restricted dealers.[5] Similar mandates were also prescribed within the ongoing obligations of Coinsquare, a regulated Canadian crypto exchange, to maintain its registration as a Dealer with the Investment Industry Regulatory Organization of Canada (IIROC).[6]

Jurisdiction

The CSA has confirmed the scope of its rule-making authority by providing that "platforms located outside of Canada that are accessible by Canadians are regarded as operating in Canada for the purposes of securities regulation."[7] While somewhat obvious for policy reasons, this confirmation is nonetheless important in the midst of the recent collapse of international platforms that are registered offshore. With such collapses serving as the impetus for further legislative attention, it is likely that other jurisdictions will adopt Canada's view on the scope of its authority to regulate platforms accessible by its residents. Without speculating further, this expanded viewpoint may serve to necessitate increased international cooperation in crafting appropriate guardrails for CTPs.

Securities Law Policy

The Guidance reminds registered CTPs or those that have delivered a PRU that they are prohibited from permitting Canadian clients "to trade, or obtain exposure to, any crypto-asset that is itself a security and/or a derivative."[8] Furthermore, the Guidance requires CTPs to "have established policies and procedures to

determine whether each crypto-asset they provide exposure to is a security and/or a derivative" (a Securities Law Policy).[9] While specific jurisprudence examining the issue of when and how crypto-assets may be securities is lacking in Canada, given the overlap between Canada's "Investment Contract" test (used to determine whether an asset is a security) and the United States' *Howey* test (used for the same purpose), CTPs that fall within Canada's jurisdiction should be aware of emerging case law south of the border.[10] In particular, a Federal Court in New Hampshire recently ruled that the crypto-asset LBC, the native token of the LBRY blockchain, was sold in violation of federal securities law for reasons that included:

- Forward-looking statements touting the expected value of the token while the token remained in development;
- Private and public statements touting dependency on an identifiable group to maintain and increase the value of the token; and
- Retention of a material portion of the token's total supply by the issuer.[11]

Importantly, the same case highlighted that "nothing in case law suggests that a token with both consumptive and speculative uses cannot be sold as an investment contract."[12] This line of reasoning mirrors that of the CSA, which had previously dictated that "the fact that a token has a utility is not, on its own, determinative as to whether an offering involves the distribution of a security."[13]

Stablecoins

In the Guidance, the CSA provides its interpretation that some "stablecoins, or stablecoin arrangements, may constitute securities or derivatives."[14] This perspective confirms that registered CTPs will need to consider stablecoins under their Securities Law Policy prior to listing such stablecoins on their platforms. While not specifically included in the Guidance, it is possible that different rules may emerge depending on the nature of the stablecoin, as considered in other jurisdictions.[15]

At a high level, an algorithmic stablecoin (Algo Stablecoin) is designed to maintain a stable value relative to a specific asset or group of assets through the use of algorithms and smart contracts. Generally, the mechanics underlying Algo Stablecoins are designed to automatically adjust the supply of the coin in response to changes in demand in order to maintain its stability. Critically, Algo Stablecoins are not backed by asset reserves. An asset-backed stablecoin (Asset Stablecoin) is a type of stablecoin that is backed by a specific asset or group of assets, meaning that the value of the stablecoin is tied to the value of the underlying asset itself held in reserve by the issuer or its custodian.

Custodians

The Guidance provides that, for a custodian to be generally considered qualified, it must be "regulated by a financial regulator in Canada, the United States or a similar jurisdiction with a supervisory regime for conduct and financial regulation."[16] Previously, registered CTPs or those delivering a PRU were permitted to

hold up to 20% of client assets in hot wallets (i.e., wallets with internet connectivity) for trading and settlement purposes. This previous allowance may therefore be clawed back in the future, although the Guidance does not do so explicitly.

In Canada, the Office of the Superintendent of Financial Institutions (OSFI) has previously released an advisory dictating that financial institutions seeking to execute redemptions, transfers, storage or settlement of crypto-assets must be "regulated, supervised and subject to appropriate risk management standards."[17] OSFI has provided "Group 1" and "Group 2" as separate classifications for crypto-assets, with the latter subject to more stringent requirements. Group 1 crypto-assets are those that meet the following set of criteria:

1. They are digital representations of traditional assets using cryptography, distributed ledger technology or similar technology to record ownership;
2. A legal opinion has been obtained confirming that all rights, obligations and interests arising from the crypto-asset are: clearly defined, legally enforceable in all relevant jurisdictions, and consistent with the rights, obligations, and interests associated with comparable traditional assets;
3. A legal opinion has been obtained confirming settlement finality of the crypto-asset;
4. All entities performing transfer, settlement, or redeemability functions of the crypto-asset follow robust risk governance and risk control policies and practices to address all significant risks; and
5. All entities that execute redemptions, transfers, storage, or settlement finality of the crypto-asset, or manage or invest reserve assets, are regulated and supervised, or subject to appropriate risk management standards.

Conclusion

On the whole, the Guidance aims to ensure the proper management of client assets and the adherence of those CTPs accessible by Canadians with securities regulations.

CTPs that are considering making their products and services available to Canadians are encouraged to contact our Blockchain & Cryptocurrency Group for assistance with navigating the regulatory process and maintaining compliance with emerging rules.

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[1] CSA, "CSA Provides Updates to Crypto Trading Platforms Operating in Canada" (12 December 2022).

[2] CSA, "Canadian Securities Regulators Expect Commitments from Crypto Trading Platforms Pursuing Registration" (15 August 2022).

[3] CSA, supra note 1.

[4] Shaurya Malwa, "FTX used customer funds among other assets to prop up Alameda Research" 10 November 2022) online: *CoinDesk*.

[5] Ontario Securities Commission, "Decision: In the Matter of Bitbuy Technologies Inc" (30 November 2021).

[6] IIROC, "Member Notice > New Member "Coinsquare Capital Markets Ltd" (12 October 2022).

[7] CSA, supra note 1.

[8] Ibid..

[9] Ibid.

[10] *Pacific Coast Coin Exchange of Canada v Ontario (Securities Commission)*, [1978] 2 SCR 112.

[11] *US Securities Exchange and Commission v LBRY Inc,* No 1:21-cv-00260-PB (DNH 2022).

[12] Ibid.

[13] CSA, "CSA Staff Notice 46-308 Securities Law Implications for Offerings of Tokens" (11 June 2018).

[14] CSA, supra note 1.

[15] Allyson Versprille, "House Stablecoin Bill Would Put Two-Year Ban on Terra-Like Coins" (20 September 2022) online: *Bloomberg*.

[16] CSA, supra note 1.

[17] OSFI, "Interim arrangements for the regulatory capital and liquidity treatment of cryptoasset exposures" (18 August 2022).

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