Cassels

# Crypto Trading Platforms – CSA Introduces New Requirements for Pre-Registration Undertakings

*Maxwell Solomons*

**03/23/2023**

Two months after the Canadian Securities Administrators (the CSA) released updated guidance to crypto trading platforms (CTPs) operating in Canada in the wake of the FTX bankruptcy filing, the CSA published Staff Notice 21-332 *Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection* (the Staff Notice) to introduce new investor protection provisions into the standard form of the pre-registration undertaking (PRU).[1] The PRU is a requirement for unregistered CTPs to continue to operate while they pursue their applications for registration and related relief.

## Motivation Behind the Staff Notice

The Staff Notice responds to "recent insolvencies involving a number of CTPs, including Voyager Digital, Celsius Network, the FTX group of companies, BlockFi, and Genesis Global." The CSA is of the view that these insolvency events "highlight the significant investor protection risks to Canadian investors of trading crypto assets, particularly where such trading is conducted through unregistered CTPs based outside of Canada."

CTPs are required to register with securities regulators in Canada. However, while the CTPs pursue their applications for registration and related relief, they are permitted to continue to operate, subject to the provision of a PRU that fulfills directed requirements for unregistered CTPs. The Staff Notice is intended to further protect investors of crypto assets, particularly during insolvency proceedings.

Unregistered CTPs are required to submit a revised PRU based on the template developed by the CSA within 30 days of the publication of the Staff Notice,[2] which incorporates the new investor protection provisions. They must also implement the systems changes necessary to give effect to the provisions of the PRU in accordance with the timelines set out therein.

## New Provisions

### Custody and Segregation of Crypto Assets

As part of their service offerings, some CTPs accepted fiat and digital assets from their users as 'deposits'

on their respective platforms. As noted by the CSA, and as demonstrated through some of the ongoing bankruptcy proceedings of certain CTPs, these users may be considered unsecured creditors for the assets they transferred to the CTP prior to such bankruptcy filings, depending on the particular facts. In the priority scheme established under the federal laws of Canada, unsecured creditors rank behind most other creditors and are entitled only to a share of those assets that remain after the claims of those creditors with higher priority, such as secured creditors and employees, among others, are fully satisfied.

Where assets are held in trust by the bankrupt debtor for another person, those assets are not considered part of the estate of the bankrupt debtor available for distribution pursuant to the priority scheme. For a more in-depth analysis of trust principles and their application in CTP insolvency events, please see "Trusts in a Trustless System: An Analysis of Entitlement to Digital Assets Held by Bankrupt Third Parties."[3]

To support the segregation of user deposits from the debtor estate, the CSA now requires unregistered CTPs to hold assets of a Canadian client:

- separate and apart from its own property,
- in trust for the benefit of the client,
- in the case of cash, in a designated trust account or in an account designated for the benefit of clients with a Canadian custodian or Canadian financial institution, and
- in the case of crypto assets, in a designated trust account or in an account designated for the benefit of clients with a custodian that comes within the definition of "Acceptable Third-party Custodian".

"Acceptable Third-party Custodians" are defined in the Staff Notice as one of five (5) types of entities, including a Canadian custodian or financial institution and any foreign custodian or entity for which the CTP has obtained the prior written consent from the principal regulator and the regulator of the application jurisdiction(s). They must also adhere to a number of additional requirements, including producing audited financial statements and a Systems and Organization Controls (SOC) 2 Type 1 or Type 2 report (or a comparable report) within the last twelve (12) months.

**Restrictions on Offering of Margin, Credit, or Other Forms of Leverage**

Unregistered CTPs were previously allowed to offer margin, credit, or other forms of leverage to clients that qualified as "permitted clients" as defined in National Instrument 31-103. However, the Staff Notice now prohibits unregistered CTPs from offering such activities entirely, even for "permitted clients."

The Staff Notice provides reasoning for the restriction, stating that "this activity introduces additional and heightened risks to CTPs and has the potential to elevate solvency risk if not managed appropriately, even if margin and leverage were to be restricted to permitted clients only."

**Restrictions on Use of Crypto Assets in Determining Excess Working Capital**

Unregistered CTPs are no longer permitted to include any crypto assets that are not offset by a corresponding current liability in the calculation of their excess working capital. The CSA explained that this requirement is "based on the fact that most crypto assets are speculative in nature and that their value is highly volatile … [with] limited investment history," such that these assets "may lose substantial, if not all, their value in a very short period."

## Value-Referenced Crypto Assets

The CSA has adopted the term "value-referenced crypto assets" (VRCAs) for those digital assets commonly known in the industry as "stablecoins." The Staff Notice additionally provides colour to the potential application of securities laws to VRCAs, stating that a VRCA backed by fiat may constitute "evidence of indebtedness", an enumerated type of security in most CSA jurisdictions (including Alberta, British Columbia and Ontario).

With the Staff Notice, the CSA now requires that CTPs obtain the prior written consent of the CSA before allowing their clients to enter into crypto contracts to buy or deposit VRCAs. The CTPs must also conduct sufficient due diligence to ensure that certain risks are addressed. These include:

- ensuring that the VRCA is a Fiat-Backed crypto asset;[4]
- ensuring that the CTP maintains a reserve of assets with a market value at least equal to the value of outstanding units of the Fiat-Backed crypto assets at the end of each day, to be comprised of highly liquid assets (e.g., cash or cash equivalents) and held by a qualified custodian; and
- ensuring that the reserve of assets is segregated from assets of the issuer and the assets of each class of other crypto asset issued by the issuer.

### Algorithmic Stablecoins

The CSA explicitly states that "we would not expect to provide consent in respect of a VRCA that is not fully-backed by an appropriate reserve but rather maintains its value through an algorithm." This appears to be a full restriction on trading algorithmic stablecoins.[5] However, the CSA's language does leave the door open for the possibility that the trading of an algorithmic stablecoin could be approved under certain circumstances, but it is presently unclear what those circumstances may be.

The CSA also notes that its approach on VRCAs (including algorithmic stablecoins) is "intended to be an interim approach only," indicating that further modifications on either an interim or permanent basis may be introduced in the future.

## Conclusion

The Staff Notice aims to respond to the ongoing insolvencies of CTPs by introducing new provisions that seek to reduce the risk of certain adverse consequences associated with future CTP insolvency events that investors can face.

In light of the new commitments required from unregistered CTPs to satisfy the pre-registration undertaking with the CSA, CTPs are encouraged to consult with our Blockchain & Digital Assets Group for assistance with navigating the regulatory process and maintaining compliance with emerging rules.

---

[1] CSA, "CSA Staff Notice 21-332 Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection" (22 February 2023).

[2] The Staff Notice was published on February 22, 2023.

[3] Alec Hoy and Max Solomons, "Trusts in a Trustless System: An Analysis of Entitlement to Digital Assets Held by Bankrupt Third Parties" (2023), online (article): *Business Law Today* <https://businesslawtoday.org/2023/02/trusts-entitlement-digital-assets-held-by-bankrupt-third-parties-analysis/>.

[4] A Fiat-Backed crypto asset is one in which a crypto asset is pegged to a fiat currency, like the USD, rather than an Asset-Backed crypto asset, in which a crypto asset is pegged to assets other than fiat currency (e.g., gold).

[5] Algorithmic stablecoins are crypto assets whose value/price is designed (or at least intended) to be stabilized through a dynamic supply mechanism that responds to an asset's demand. As a pedagogical example, the algorithm may automatically increase the supply of the crypto asset when demand increases (lowering the price) and decrease the supply when demand decreases (raising the price).

---

*This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.*