

CSA Members Set Terms and Conditions for Crypto-Based Investment Fund Managers

Gregory Hogan

February 12, 2018

With the rise in popularity of cryptocurrencies over the last 12 months, investors have been looking for ways to enter the market through legitimate, regulated vehicles. Several portfolio and investment fund managers (Managers) have entered the market and are or will offer cryptocurrency funds to qualified purchasers. Given the novel nature of blockchain technology and the associated cryptocurrencies – as compared to traditional asset classes – these funds present unique challenges, particularly with respect to valuation and security of the assets. Accordingly, these Managers have worked with the members of the Canadian Securities Administrators (the CSA) as part of the CSA Regulatory Sandbox initiative to ensure that appropriate measures are implemented to protect investors in this new asset class.

To date, only a handful of firms have been registered as investment fund managers (IFMs) for funds investing in cryptocurrencies (the Funds). Canadian securities regulators have imposed special “terms and conditions” on such registrations in an attempt to address this novel asset class and to ensure continued transparency and security. Each Manager has had similar terms and conditions (Terms) imposed on their registrations.

Forming a Cryptocurrency Fund in Canada

If you are considering forming a cryptocurrency fund in Canada or have a cryptocurrency fund that will be managed from Canada, these are some of the types of terms and conditions that you can expect.

Permitted Cryptocurrencies

Under the Terms, each Fund is limited to investing in those cryptocurrencies that will form part of its initial portfolio. Presently, the only cryptocurrencies that the Funds are targeting are one or more of Bitcoin, Ether and Litecoin, all of which are arguably in the nature of a currency/commodity and not a security. If a Manager desires to invest the Fund it manages in a “specified cryptocurrency” in addition to those in its initial portfolio, the Manager will be required to obtain permission of the regulator. A “specified cryptocurrency” refers to Bitcoin, Ether and anything commonly considered to be a cryptocurrency or a digital or virtual currency or digital or virtual token.

Cryptocurrency Custodians and Brokers

Cassels

Under pending amendments to National Instrument 31-103 - *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, a registered firm may not act as a custodian for cash and securities of the investment funds it manages and any custodian will be required to be independent of the IFM. Generally, as for all other investment funds, the Funds will require independent custodians. The Funds will also have an independent entity that will be responsible for the Fund's trading in cryptocurrencies.

Under the Terms, the Managers will be required to exercise oversight over their cryptocurrency custodians and brokers, including by entering into written agreements indicating that said custodians and brokers are registered and/or licensed to conduct their respective activities with regards to cryptocurrencies on behalf of the Manager, as applicable, and that there are appropriate compliance systems in place to provide sufficient assurance that all applicable regulatory requirements are continuously being complied with.

Oversight will also come from subjecting the Fund's custodian to an annual audit each calendar year. In particular, the Managers are required to provide annual audit reviews of the security measures and custody practices that have been implemented by the Fund's custodian. In addition, the Manager will be required to submit any documentation with respect to regulatory compliance reviews, inspections or investigations that have been conducted on the relevant custodians and brokers during the previous calendar year. Custodians and brokers must also notify the Manager in the event of a material change to the operations or regulatory status of said custodian or broker, or if there is a material change to the insurance policies, contingency reserves or other loss mitigation arrangements implemented to protect the custodian or broker's customers or users.

Financial Reporting Requirements

The Funds in question are not (or are not intended to be) mutual funds or reporting issuers, and, as such, are not, or will not be, subject to regulated disclosures to unitholders. The Terms recognize the special need for transparency with regards to cryptocurrency by imposing reporting requirements on the Managers. Managers will have monthly, quarterly and annual reporting requirements to both regulators and unitholders. Annual audited financial statements must be provided to unitholders within 90 days of December 31st of each year, and the net asset value (NAV) of the Fund must be provided on at least a monthly basis. A quarterly report must also be provided to the relevant regulators addressing the Fund's inflows and outflows of capital, the NAV for each month in the quarter and specific details relating to the investors in the fund, including information pertaining to the number of investors, the aggregate amount of capital raised and the prospectus exemptions that were relied upon by each investor. All trades that are made through entities other than the Fund's broker must be identified and specified, and the proportion of trades made through each such entity must be provided.

Manager Valuation and Trading

Managers are required to make their own determinations as to the reasonable and fair price of the

Cassels

cryptocurrency that it proposes to trade prior to each and every trade. If the Manager's valuation is materially different than the trading price, the Manager will be required to provide details in their quarterly report to the regulators, including whether the trade was completed.

Material Changes to the Fund

Each Manager has been registered, and the Terms imposed, on the basis of the particular structure for their Fund. As such, the Manager's ability to materially change the Fund is significantly restricted. In particular, Managers will require regulatory approval to:

- Add a new cryptocurrency
- Manage another fund investing in cryptocurrency
- Amend the Fund's investment objectives
- Make a material change to valuation policies or procedures
- Change the Fund's cryptocurrency custodians or brokers – unless the new party is a subsidiary of the previous custodian or broker

Timing

Where a Manager is registered in Ontario, the OSC has imposed a limit of two years during which the Manager may manage their Fund, unless the OSC extends the date. This is consistent with the OSC's approach to applicants to its sandbox initiative, which is to provide time limited relief, permitting it to reassess the relief (and in this case the Terms) as fintech, cryptocurrency and blockchain develop and as the OSC refines its policy approach to the area.

We Can Help

For more information about how Cassels can assist with your business, please contact Greg Hogan, Michael Weizel or another member of our firm's cross-disciplinary Emerging Companies or Securities Groups.

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