CANADIAN BLOCKCHAIN CONSORTIUM

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British Columbia Securities Commission
Alberta Securities Commission Financial and
Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumers Services Commission, New Brunswick Superintendent of Securities,
Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities Service Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

RE: VOLUNTEER PRELIMINARY RESPONSE TO REQUEST FOR COMMENTS TO AMENDMENTS TO NATIONAL INSTRUMENT 81-102 INVESTMENT FUNDS AND 81-102CP

To Whom It May Concern:

*This brief response ("**Response**") is submitted by the Policy & Advocacy Committee ("**PAC**") of the Canadian Blockchain Consortium on a volunteer, pro-bono basis in response to the Canadian Securities Administrators' ("**CSA**") Notice and Request for Comments to Proposed Amendments to National Instrument 81-102 Investment Funds and 81-102CP (collectively referred to as the "**Proposed Amendments**"). Terms used but not defined herein have the same meaning as used by the CSA.*

PAC does not make any statement below on behalf of a specific sub-set of the crypto-industry (ex. unregulated foreign crypto custodians vs. regulated domestic crypto custodians),[1] but simply shares this Response to identify statutory gaps and jurisprudential trends that may assist in designing any potential new regulatory framework.

The preliminary comments enclosed in this Response address two general areas of the Proposed Amendments: (a) guidance on "crypto assets" and (b) custody, as a result of concerns raised by private industry directly to PAC, as well as certain introductory concerns with overarching regulation of the Canadian crypto-industry by securities regulators. PAC is available to provide more fulsome thoughts upon direction of the CSA.

For further communication with PAC, please contact Tamie Dolny (Chair) or Anish Kamboj (Co-Chair) via LinkedIn.

[1] For the purposes of disclosure, please note that a current sitting member of PAC is employed by a regulated crypto custodian. However, this Consultation Response is submitted by all members of PAC on a pro bono basis to present a widespread range of industry opinion.

Introduction

(a) Pressing Need for Isolated Crypto Asset Legislation and/or Regulation

The financial services industry is in the midst of a global transition to mainstream adoption of digital assets. The global digital asset custody market has grown as the need for safekeeping these assets has become paramount. Valued at $447.9 billion in 2022,[2] it is poised to explode as the world transitions to a tokenized future. To fully protect investors who want to hold these assets for investment purposes, PAC respectfully submits that securities regulators must create a holistic regulatory framework and roadmap that covers the entire capital market. Securities regulations must also work in concert with other legal and regulatory frameworks (e.g. Payments Canada, property laws, etc.).

Beyond custody concerns, assets under management have been valued close to $20 trillion EUR in collective investments across European finance industries alone; when including North American industry, investment funds have been academically noted to play an important and direly needed role in enhancing the crypto-industry.[3]

PAC raises concerns about the piecemeal approach to rulemaking by the CSA, relying on Staff Notices, which are non-binding guidance,[4] and enforcement actions through existing Canadian judicial and regulatory regimes, rather than establishing a comprehensive, individual framework for crypto-assets. The Canadian crypto asset industry requires separate statutory oversight (and potentially an independent regulator) instead of integrating trading platform requirements into existing securities legislation. The harmonization of the securities regulatory framework across Canada through the CSA as umbrella regulatory body should aim to isolate and demystify the legal classification of various forms of crypto assets. As discussed herein, various forms of crypto assets require clarification by regulators as to whether assets constitute securities, despite the emerging state of the law.

Comments made by Canadian regulators that particular crypto assets are deemed securities via fact-specific and circumstantial situations are generally unhelpful to industry participants and users in Canada. While well-established crypto assets are not securities (such as Bitcoin) but rather commodities, certain other crypto assets may constitute investment contracts and fall into security categorizations. The issue at hand is that the onus inappropriately falls on industry participants to attempt to figure out whether a crypto asset is subject to securities laws, whether in the context of an initial coin offering ("**ICO**") or for the purpose of trading on a crypto-trading platform.

PAC respectfully suggests that clarity and harmonization from legislative bodies and regulators is urgently required to address this issue.

It is a universally accepted truth that certain forms of crypto assets function as commodities, and certain forms of crypto assets function as securities. This dual classification conundrum indicates that prior

[2] Please see Business Research Insights, Digital Asset Custody Market Report, April 2024.
[3] Please refer to Zetzsche et al., "Digital Assets, MiCA & EU Investment Fund Law", Oxford Business Law, accessible here.
[4] Please see Policies and Staff Notices, OSC website at Securities rule-making in Ontario.

existing legal classifications *fail* at appropriately encapsulating crypto assets (as individual securities, commodities, derivatives, etc.). The answer to this issue is simple: a separate regulatory and/or statutory regime for crypto assets is required that isolates out online assets from traditional financial instruments. Without this separation, confusion relating to securities regulation will continue to plague industry concerns.

The Proposed Amendments are aimed at codifying some, but not all, of the existing practices that are already in use by Public Crypto Asset Funds. However, the Proposed Amendments lack the necessary clarity to achieve the stated goals of investor protection and supporting new product innovation, without overarching regulatory harmonization.

1. Guidance On "Crypto Assets" And Regulatory Uncertainty Concerns

The absence of a comprehensive definition of crypto assets that provides the foundation for not just the rules in NI 81-102 but in other areas of securities legislation presents significant and pressing challenges for Canadian crypto-industry participants seeking regulatory oversight, especially where securities legislation intersects with other provincial or Canadian legislation such as retail payments.

The Proposed Amendments do not contain a definition of crypto assets. Rather, 81-102CP contains a description of what the CSA will generally consider to be crypto assets. PAC respectfully submits that this requires further clarification.

Rule making is premised on a consistent set of definitions, within the rule or the relevant statute itself and, and if of more broad application, within National Instrument 14-101 *Definitions* (NI 14-101). Investment funds operate within the broader capital markets which includes marketplaces, registrants, issuers and market participants. *A proper definition of crypto assets is a necessary starting point to achieve consistency across the entire capital markets regulatory framework.* PAC recommends that a definition of "crypto assets" be included as part of this rule-making exercise, and further emphasizes that this definition should be incorporated on a statutory level. This action would permit the evaluation of whether a crypto asset meets the criteria to qualify as a permitted investment under NI 81-102 without imposing undue regulatory burden.

Further, as stated under Section 2.01 of proposed changes to 81-102CP, "the proposed guidance is consistent with terminology used in prior CSA publications and with the general understanding of what constitutes a crypto asset by market participants". However, the CSA initially published CSA Staff Notice 46-307 Cryptocurrency Offerings in August 2017. In the meantime, on a global basis, the general understanding of crypto assets and their use cases have continued to evolve at a breakneck speed. It is the obligation of regulatory bodies to provide clarity on how to apply classification tests to various forms of online assets, rather than place the burden on industry.

As an example, the CSA generally endorses a purposive interpretation of *Pacific Coast Coin Exchange v. Ontario Securities Commission*,[5] with Staff Notice 46-308 setting out the non-exhaustive factors

[5] [1978] 2 SCR 112 [*Pacific*].

implying an investment contract. PAC notes that *Pacific* is complex. Independent and start-up crypto-industry participants are likely unable to access funding for either in-house or independent legal advice to understand whether securities regulation applies. PAC submits that this financial burden on upstart Canadian industry should be considered when developing an easy access framework for crypto-industry that balances investor or creditor protection with growth encouragement.

PAC further refers regulators to descriptions proposed by the board of the International Board of the International Organization of Securities Commissions ("**IOSCO**"), or the Financial Stability Board ("**FSB**"). Other Canadian regulators, such as the Office of the Superintendent of Financial Instruments ("**OSFI**"), have begun adopting the global definitions in their rulemaking. This puts the CSA out of line within the global financial markets, without any explanation of why they are not adopting the global definitions.

PAC respectfully provides three below resources to Canadian securities regulators as potential precedent setting frameworks to approach securities regulation within markets seeking to streamline and clarify trading of online assets:

- *Policy Recommendations for Crypto and Digital Asset Markets Consultation Report*, OICU-IOSCO (May 2023) https://www.iosco.org/library/pubdocs/pdf/IOSCOPD734.pdf;
- *Policy Recommendations for Decentralized Finance (DeFi) Consultation Report*, OICU-IOSCO (September 2023), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD744.pdf; and
- *ISDA Digital Asset Derivatives Definitions*, ISDA (February 2023), https://www.isda.org/book/isda-digital-asset-derivatives-definitions/.

PAC also submits that complex uniform market rules have been adapted in other jurisdictions such as the European Union through the Markets in Crypto-Assets Regulation ("**MiCA**") which provide provisions for issuing and trading crypto assets.[6] As seen in the Regulation (EU) 2023/11144 ("**MiCAR**"), three forms of crypto assets (tokens) are differentiated between utility tokens, asset-referenced tokens and e-money tokens, with categorization performed by the European Banking Authority (the "**EBA**") and triggering the application of stricter requirements to issuers. Significantly, non-fungible tokens are outside the scope of MiCAR, and public offerings are subject to a complex regime. The harmonization present in MiCA is distinct from North American regulation, but provides greater clarity to industry participants than the current framework offered by Canadian regulators. PAC respectfully directs the CSA to MiCA as an example of current harmonization that is occurring in a separate jurisdiction.

2. Concerns Relating to Custody

[6] Please refer to the European Securities and Markets Authority website here.

As it relates to custody, PAC strongly advocates for the advancement of the domestic digital assets ecosystem, recognizing the importance of reliable custodial options for companies such as those governed by NI 81-102.

PAC has received separate comments relating to custody from industry custodians that take somewhat separate positions on the Proposed Amendments.

Accordingly, a summary of anonymized feedback is provided below for the benefit of regulators.

Comment 1 – Anonymized Industry Participant

Reasonable measures that increase the confidence of Canadian investors ought to be supported. The proposal suggests that this could be fulfilled by a SOC 2. SOC 2 should be a minimum standard for a fund custodian, and the CSA should consider mandating other internal control reports, such as penetration testing. These would further ensure that investor funds are indeed secure and provide peace of mind for all stakeholders, which is especially welcome when dealing with a unique asset class. It may well be that as the industry evolves, alternatives to the SOC 2 become market standard, however at present the SOC 2 report has been established as best practice.

As it relates to broader consultation matters, reference is again made to earlier comments about the further development of the Canadian landscape. One manner in which the industry will progress is by having more custodial options. There are indeed more custody companies – primarily organised as trust companies – preparing to come to market. This is not surprising as it is happening in tandem with a surge in institutional interest in cryptocurrencies, as can be seen with the significant inflows into the ETF's recently launched in the US, as an example. As well, it is evident here in Canada with the inclusion of yield bearing cryptocurrency funds in the form of staking rewards, making this new asset class more relatable and attractive to traditional investors. Additional custody entrants ought to be viewed as a positive, as competition will heighten the standards, quality, and choice for Canadian investors.

A further benefit of more Canadian custody providers is that they can serve to dilute the increasing dependency on international custodians, thereby ensuring Canadian assets are secured within our borders. At present, there is a concentration of Canadian investment fund assets that are held in a single international sub-custodian. The CSA ought to consider approaches to stimulate the advancement of local options, as a means of reducing the reliance on foreign offerings.

At present, there is indeed a valuable role being played by legacy international custody providers, however we would advocate for the aim to evolve this space with a national lens. Where there are existing international custodians and/or sub-custodians being used by firms under NI 81-102, the CSA should look for them to replicate the controls of domestic providers. Beyond broad best practices such

as having audited financial statements, this could also include Canadian specific controls such as a Fintrac AML Assessment or an international equivalent.

In summary, regulatory action should focus on the standard for custody providers continue to be set high, as well as measures that encourage greater competition for domestic custodians.

Comment 2 – Anonymized Industry Participant

Although not prescribed, there appears to be insistence on a SOC 2 Type 2 covering all 5 pillars of security, availability, privacy, confidentiality and processing integrity. This bar is somewhat unreasonably high as a SOC 2 Type 1 on the security pillar, an ISO 27001 certification or an independent systems review performed by an auditing firm should be sufficient.

The third bullet referenced at 8.1 re: the use of multi-signature technology to mitigate against single points of failure is overspecified and introduces more ambiguity to market. Multi-part computation schemes and multi-signature schemes implemented at the business logic layer can and are as effective as multi-signature schemes implemented at the blockchain protocol layer. Regulators should note that custodians should not accordingly begin deploying Ethereum smart contracts to implement multi-signatures at the protocol layer to satisfy this requirement.

The ”*reasonably prudent person*” standard with respect to the amount of insurance custodians are required to maintain is too strict an obligation on industry participants. “Commercially reasonable efforts to obtain” or “vigilant owner of similar goods in similar circumstances” may be more appropriate standards for regulators to consider.

As a final point, beyond custody concerns, restricting the asset class to alternative investment funds and non-redeemable funds is an issue. While restrictions around fungibility and the existence of a recognized derivatives market are somewhat sensible, they are needlessly onerous in comparison to other jurisdictions.

As noted above, PAC welcomes further comments or feedback, which can be directed to Tamie Dolny and Anish Kamboj via LinkedIn.