

Goodmans^{LLP} Update

OSC Cites Public Interest Concerns to Refuse Prospectus Receipt for Bitcoin-Fund

On February 15, 2019, the Ontario Securities Commission (OSC) refused to issue a prospectus receipt to 3iQ Corp. (the “**Manager**”) for its prospectus for The Bitcoin Fund (the “**Fund**”), raising the novel issue of whether an investment fund that invests substantially all of its assets in bitcoin should be offered to the public. The OSC refused to issue the receipt because (a) it was not in the public interest to do so, and (b) the Fund’s prospectus did not comply in a substantial respect with a requirement of the regulations under the *Securities Act* (Ontario) (the “**Act**”).

Facts

The Fund is a non-redeemable investment fund (NRIF) that would invest in long-term holdings of bitcoin purchased from various sources including bitcoin exchanges. The Fund’s objectives are to provide its investors with exposure to bitcoin and the daily price movements of the U.S. dollar price of bitcoin, as well as the opportunity for long-term capital appreciation. As of the date of the OSC’s decision, there were no publicly offered investment funds in Canada or the U.S. that invest substantially all of their assets in bitcoin, although there are a number of private funds that do.

As an NRIF, the Fund would not be in continuous distribution like a mutual fund or an exchange-traded fund (ETF). An NRIF would also have more limited redemption rights relative to a mutual fund, and investors in the Fund would not have the right to redeem their units on demand at the net asset value (NAV). Instead, the investors would have a right to redeem annually at the NAV, or at a monthly discount to the NAV. Cidel Trust Company (the “**Custodian**”) would be appointed custodian of the Fund’s assets. However, due to its inability to hold bitcoin on the Fund’s behalf, the Custodian would need to appoint a sub-custodian capable of holding bitcoin.

OSC Staff Submissions

The OSC outlined several reasons as to why it was not in the public interest to issue a receipt for the Fund’s prospectus under subsection 61(1) of the Act.

The OSC’s concerns stemmed from the nature of bitcoin as an underlying asset and the lack of a mature regulatory infrastructure, viewing bitcoin as novel and in a nascent state. The OSC stated that more time is required for the bitcoin regulatory infrastructure to develop before it would be considered an acceptable underlying asset for a publicly offered investment fund.

Given its early stage of development as a currency, the OSC noted the lack of consistent regulation over its treatment by financial institutions and as a means of payment. Additionally, the OSC had concerns about the risks around the market integrity of bitcoin that make it unsuitable for a retail investment fund. The OSC also commented that the nature of bitcoin also makes it particularly vulnerable to cybercrime and fraudulent activity.

The OSC noted other concerns such as the fragmented market for bitcoin and the lack of protection of client funds and assets, as well as a lack of confidentiality safeguards for personal information and reliable processes for pricing and trading in bitcoin. The OSC felt that the risk of price manipulation in this market on less reputable exchanges would impact the trading of bitcoin on more reputable exchanges.

The OSC was also of the view the Manager had not provided sufficient comfort regarding the security and safety of the bitcoin to be held on the Fund’s behalf by its sub-custodian. It was not clear if the sub-custodian would be able to provide certain required reports (Service Organizational Controls, or “**SOC**” reports), as none had yet been provided. If the sub-custodian was unable to provide such reports, then the Fund may not be able to file annual audited financial statements as required by NI 81-106 (*Investment Fund Continuous Disclosure*).

Additionally, the Fund had not taken the appropriate steps to protect investors against the loss of bitcoin. The Custodian would not assume liability for the sub-custodian in the event of loss of the Fund's bitcoin, and neither the Custodian nor the sub-custodian would have insurance for the Fund's bitcoin held off-line in cold storage.

Staff also took the stance that bitcoin is an "illiquid asset", as defined in NI 81-102, as it does not trade on market facilities on which public quotations in common use are widely available. Therefore, the Fund does not comply with the regulations as an NRIF is limited to investing no more than 20% of its net asset value in illiquid assets. In this case, the Fund intended to invest substantially all of its assets in bitcoin.

Manager Submissions

The Manager made submissions as to why it would not be contrary to the public interest to issue a receipt for the Fund's prospectus.

First, the Manager, through its fund, would provide access to bitcoin through a regulated and professionally managed investment fund. This would provide Canadian retail investors with a safer method of investing in bitcoin rather than investing directly on unregulated exchanges and through automatic teller machines. Additionally, the fund units would only be sold through a syndicate of IIROC dealers, meaning Canadian investors would be subject to the Know Your Client requirements of IIROC members as well as applicable securities laws.

The Manager would also mitigate the risks associated with trading bitcoin on unregulated platforms. The Manager would perform due diligence on the source of its bitcoin purchases to confirm its stability and reputation. The Manager would also determine where to place its bitcoin orders based on the prices and volumes available through each potential bitcoin source with a view to achieving the best possible execution for the Fund. The Manager would further ensure the sub-custodian placed the purchased bitcoin in cold storage. In addition, the Fund would not receive bitcoin from a source associated with illicit activity, in part by dealing with sources that use exchange surveillance systems. The Manager would also use forensic software to analyze each bitcoin purchased to identify any illicit or illegal activity associated with the bitcoin. The argument was that this high level of control over the asset would help mitigate the risks associated with bitcoin.

The Manager suggested the pseudonymous nature of bitcoin makes it easier to trace than cash. The Manager would purchase financial compliance software to review the sources of bitcoin, and block bitcoin transactions from countries subject to economic sanctions or other restrictions.

The Manager argued the volatility of bitcoin is not higher than other assets classes, and there are no restrictions against investment funds investing in volatile assets.

With regard to the valuation of bitcoin, the Manager stated the Fund would be able to value its investments based on the MVIS CryptoCompare Bitcoin Index (MVBTC). MVBTC is intended to be an index of the U.S. dollar price of one bitcoin, and represents the bids and offers of market participants to buy or sell bitcoin. The MVBTC is focused on timeliness and is an unbiased estimator of the bitcoin price. It is regulated by MV Index Solutions GmbH (MVIS), a company that is based in Frankfurt, Germany and regulated as an index administrator by the German Federal Financial Supervisory Authority.

The Manager argued that both the Custodian and sub-custodian would meet the requirements of NI 81-102. The Manager argued there is no requirement for a custodian or sub-custodian to provide a fund with SOC reports, and no insurance would be maintained against risk of loss of bitcoin because such insurance is not currently available on commercially reasonable terms. Furthermore, the prospectus contains clear disclosure regarding such risks. The Fund would file the required audited financial statements, and had retained an auditor (MNP LLP).

Finally, the Manager submitted that bitcoin is not an "illiquid asset" as defined in NI 81-102. The Manager had provided data regarding the trading volumes and liquidity expectations for bitcoin reported by various bitcoin sources, as well as data indicating that bitcoin has a relatively large market capitalization compared to other publicly traded asset classes. The Manager also submitted that the definition of "illiquid asset" does not specify that the "market facilities" through which liquid portfolio assets are readily disposable must be regulated.

Director's Decision

The Director did not issue a receipt for the Fund's prospectus, citing the purposes of the Act outlined in section 1.1: (a) to provide protection to investors from unfair, improper or fraudulent practices; (b) to foster fair and efficient capital markets and confidence in capital markets; and (c) to contribute to the stability of the financial system and the reduction of systemic risk.

The Director had concerns about certain aspects of the Fund. First, the Director agreed with Staff that there are issues with accurately valuing bitcoin due to the fragmented and unregulated environment in which it generally trades. The Director accepted Staff's submission that trading activities on less reputable platforms could impact pricing on more reputable platforms. Therefore, despite the Manager's attempt to address these concerns by valuing bitcoin based on the MVBTC, the level of risk associated with valuation of bitcoin is higher than traditional portfolio assets.

The Director stated the level of risk due to the lack of SOC reports and lack of insurance against the risk of loss of bitcoin held on the Fund's behalf in cold storage was unacceptable for a prospectus qualified fund offering. Though not normally required for publicly offered investment funds, the SOC reports would likely be needed in this case due to the novel custodial arrangements required. It may also be the case that the sub-custodian eventually selected may not qualify under NI 81-102.

With regard to audited annual financial statements, the Director stated there was a material risk the Fund would not be able to file these statements. It was unclear to the Director how the Fund's auditor would be able to provide an unqualified opinion of the Fund's financial statements in accordance with NI 81-106 without receiving the SOC reports from the sub-custodian.

Although the Director acknowledged the Manager invested significant resources into mitigating and disclosing the relevant risks for retail investors, he was not convinced these efforts were sufficient, and due to the nascent state of bitcoin and the lack of established market regulation, there was not enough evidence investor protection issues would be adequately addressed.

The Director agreed with Staff that bitcoin is an "illiquid asset", and was thus obligated to refuse a receipt for the Fund's prospectus under subsection 61(2)(a)(i) of the Act. Although the Director agreed with the Manager that the term "market facilities" does not, on its face, require that an asset be readily disposable through a regulated exchange or marketplace, the term implies some form of established and mature trading facility or network to promote a robust valuation of a fund's assets. Since that market does not yet exist for bitcoin, a receipt for the prospectus could not be issued.

Conclusion

Due in part to the fledgling nature of bitcoin and the lack of consistent regulation across markets, the OSC did not issue a receipt for the Fund's prospectus, citing public interest concerns. In addition, the OSC classified bitcoin as an "illiquid asset", and thus could not issue a receipt on that basis. It is unclear how robust and established the market for bitcoin will need to be for the OSC to accept it as an underlying asset for a fund, but this decision is an indicator of how the Canadian securities regulators view the state of the cryptocurrency markets. If and when these markets mature and become more robust, it is possible the Canadian regulators could view these facts differently.

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