Goodmans LLP Update

The Front Door is Open: OSC Panel Reverses Director Decision and Orders the Issuance of a Prospectus Receipt to a Bitcoin Investment Fund

A panel of the Ontario Securities Commission (OSC) recently reversed a decision of the Director of the Investment Funds & Structured Products Branch of the Commission (the "**Director**") that denied the issuance of a receipt for a final prospectus of The Bitcoin Fund (the "**Fund**"). The decision allows the Fund to proceed with a proposed public offering, which will create the world's first publicly traded Bitcoin investment fund.

Background

3iQ Corp., a Canadian-based investment fund manager, filed a preliminary non-offering long-form prospectus to qualify the Fund as a reporting issuer on October 30, 2018. The Fund is a non-redeemable investment fund that will invest substantially all of its assets in Bitcoin. Its objectives are to provide investors with: (i) exposure to Bitcoin and the daily price movements of the U.S. dollar price of Bitcoin; and (ii) the opportunity for long-term capital appreciation. To achieve its investment objectives, the Fund would invest in Bitcoin directly – i.e., not through any specified derivatives.

On February 15, 2019, the Director refused to issue a receipt for the prospectus on the basis that the proposed offering was contrary to the public interest and that the prospectus did not comply with substantial aspects of securities law. The Director cited five grounds for refusing to grant the receipt, including operational issues, difficulties with valuation, inadequate custodial arrangements and financial reporting matters. Somewhat curiously, the Director also concluded that Bitcoin is an "illiquid asset" because it does not trade on an "established and mature trading facility or network in order to promote a robust valuation of a fund's assets".

The Decision

Before examining the technical securities law requirements that apply to the Fund, the OSC panel noted that it is not opining on the merits of the Fund or Bitcoin generally, nor is it the OSC's mandate to immunize investors against risk or loss. The panel further noted that the OSC does not have a "consumer protection" mandate. In fact, the panel determined that the OSC's "public interest" jurisdiction cannot be extended for that purpose, noting that "the public interest jurisdiction under the Act is broad, but it is not infinite".

OSC Staff, bearing the burden of proof to establish that the prospectus receipt should be refused, argued that (i) Bitcoin is an "illiquid asset" as defined in National Instrument 81-102 – *Investment Funds* ("**NI 81-102**") such that the Fund would breach the illiquid asset concentration limits found in NI 81-102; and (ii) there are public interest concerns over Bitcoin's market integrity, the Fund's ability to sufficiently maintain custody of Bitcoin that it owned, and the Fund's ability to provide adequate financial reporting.

In rejecting all of these arguments, the OSC held that:

1. *Bitcoin is not an "illiquid asset".* - The panel determined that the US$900 million in daily Bitcoin trading on registered exchanges (which is in addition to any unregulated trading) is sufficient to establish that Bitcoin is not an "illiquid asset" under NI 81-102. In doing so, the panel rejected the

Authors

Allan Goodman
agoodman@goodmans.ca
416.597.4243

Michael Partridge
mpartridge@goodmans.ca
416.597.5498

Hari Marcovici
hmarcovici@goodmans.ca
416.849.6894

Director's position that for an asset to be liquid, it must trade on an "established and mature trading facility or network in order to promote a robust valuation of a fund's assets", noting instead that a market that "provides sufficient liquidity for disposition of a fund asset and that promotes price discovery for calculating an asset's net asset value" is sufficient. The panel found that the current Bitcoin market satisfies this threshold as the trading volume is large and price discovery is sufficiently reliable.

2. *Bitcoin market manipulation.* - The panel held that there is insufficient evidence to determine that the price of Bitcoin was being manipulated and, in any event, to further mitigate this risk the Fund will use a third party index provider to determine the price of Bitcoin (which sources prices from 22 trading platforms). The panel also noted that since Bitcoin is a commodity, it is subject to the same market manipulation risks as other commodities and there is no suggestion that investment funds that are reporting issuers cannot invest in commodities.

3. *The Fund is not in continuous distribution.* - The panel noted that because the Fund is not in continuous distribution (such as an Exchange Traded Fund (ETF)), the valuation risk associated with market manipulation is further mitigated as the Fund will have ample time to value its assets to satisfy any annual redemptions.

4. *Adequate custody and operational risk.* – The panel determined that it is not imperative that the Fund insure its assets or that its custodians produce "SOC type 2" reports (which audit a custodian's internal controls). The panel held that by retaining a qualified custodian under NI 81-102, the Fund's assets were subject to an adequate level of protection.

5. *Financial statements.* - The panel was not convinced that the Fund's auditor would be unable to provide an unmodified audit opinion for the Fund's audited financial statements, noting there was insufficient evidence to make that determination and the auditors for other investment funds, that are not reporting issuers and that hold cryptoassets, are able to provide unmodified audit opinions in respect of those audits. The Fund would have an ongoing obligation to disseminate such audited financial statements with an unmodified audit report and it should be presumed that such unqualified statements can and will be prepared.

6. *Bitcoin funds would protect investors from "unfair, improper or fraudulent practices"*. – The panel held that the Fund would promote efficient capital markets by providing retail investors with the option to obtain exposure to Bitcoin through a professionally managed solution rather than holding Bitcoin directly or investing in unregulated vehicles.

7. *The OSC will not wait for the Securities Exchange Commission (SEC) to make bold policy moves* - The panel rendered its decision shortly after the SEC issued another rejection letter to an ETF seeking to track the price of Bitcoin. The panel noted that the SEC's decision is distinguishable from the facts that apply to the Fund for two primary reasons: (i) the securities law regime that applies to the SEC is materially different; and ii) the Fund is not an ETF, thereby limiting and mitigating market manipulation and valuation issues.

Implications

It remains to be seen if this decision will be the catalyst for more public cyptocurrency or cryptoasset investment funds. While the panel noted that there are numerous "backdoor" ways for companies holding cryptocurrencies and cryptoassets to become reporting issuers (e.g., a reverse takeover of a public shell), the panel's decision shows how the "front door" may also be open for non-redeemable investment funds that propose to invest in cryptocurrencies and cryptoassets. The extent to which OSC Staff applies this kind of thinking to other (non-Bitcoin) cryptocurrency and cryptoasset-focused public offerings will likely set the tone for the industry for years to come and will provide further insight into exactly how open the "front door" really is. In any event, this is a helpful step forward in assessing the temperature of the Canadian regulators when it comes to their views on the regulation of cryptoassets.

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