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Bitcoin Investment Fund

Bitcoin, the OSC and the retail asset management market

By **Allan Goodman, Hari Marcovici and Michael Partridge**

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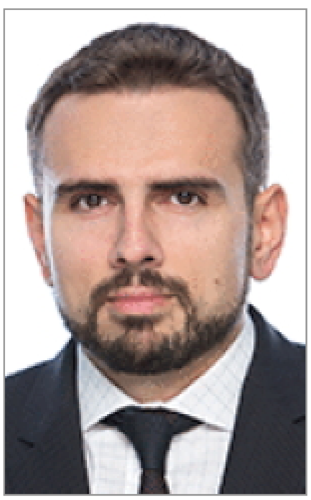

Hari Marcovici

(November 29, 2019, 11:09 AM EST) -- A panel of the Ontario Securities Commission (OSC) has 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 will allow the fund to be listed for trading on major Canadian stock exchanges.

On Oct. 30, 2018, 3iQ Corp., a Canadian investment fund manager, filed a preliminary non-offering long-form prospectus to qualify the fund as a reporting issuer. The fund is a closed-end investment fund that will invest substantially all of its assets in bitcoin. Its objectives are to provide investors with the opportunity for long-term capital appreciation by investing all of its assets directly in bitcoin.

In February of this year, the director issued a decision explaining his prospectus receipt refusal for the fund's prospectus on the grounds that the proposed offering was contrary to the public interest and failed to comply with several securities law provisions. The director cited the following as the basis for refusing to grant the receipt: inadequate custodial arrangements, difficulties with valuation, operational issues and issues surrounding adequate financial reporting. The director also held that bitcoin is an "illiquid asset" as it does not trade on an established and mature trading facility or network that allows for an accurate valuation of the fund's assets.

The decision

Prior to assessing the securities law requirements relevant to the fund, the OSC panel outlined the scope of its review. It expressed that it is not the OSC's mandate to comment on the merits of bitcoin investments nor to insulate investors from risk or loss, noting that while the OSC has jurisdiction to protect the public interest, the mandate is "not infinite" and does not extend to consumer protection.

OSC staff, bearing the burden of proof of establishing that the prospectus receipt should be refused, contended that (i) there are public interest concerns over bitcoin's market integrity, the fund's ability to maintain effective custody of its assets and its ability to provide adequate financial reporting; and (ii) bitcoin is an "illiquid asset" as defined in *National Instrument 81-102 — Investment Funds* (NI 81-102), in breach of the illiquid asset concentration limits found in NI 81-102.

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

1. Bitcoin is not an illiquid asset. The US$900 million in daily bitcoin trading on registered exchanges satisfied the requisite liquidity thresholds under *NI 81-102* — invalidating the director's position that bitcoin is an

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illiquid asset. This robust trading frequency is evidence of a market that is sufficiently liquid to both dispose of a fund's bitcoin and facilitate the accurate calculation of a fund's net asset value. In making this determination, the OSC panel rejected the director's position that for an asset to be liquid, it must trade on an established and mature trading facility or network that allows for a robust valuation of a fund's assets.

2. The fund is not in continuous distribution. Because the fund is a non-redeemable investment fund, subject only to monthly price reporting and annual redemptions, the valuation risk associated with market manipulation is mitigated by the ample time that the fund will have to value its assets — the OSC panel specifically noted that its conclusion may have been different for investment funds in continuous distribution, including exchange-traded funds (ETFs).

3. Auditors of the fund can prepare financial statements. The OSC panel was not persuaded that the fund's auditor would be unable to provide an unmodified audit opinion for the fund's audited financial statements. There was insufficient evidence to make such a determination as auditors for other investment funds, that are not reporting issuers and similarly hold cryptoassets, are able to provide adequate, 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, with normal course remedies for any failures being available to OSC staff.

4. The fund has adequate custody controls to mitigate operational risk. The OSC panel determined that the fund does not have to insure its assets or have its custodians produce "SOC type 2" reports, which audit a custodian's internal controls. The OSC panel held that by retaining a qualified custodian under *NI 81-102*, the fund's assets were subject to a sufficient level of protection.

5. Bitcoin market manipulation. There is insufficient evidence that the price of bitcoin is subject to manipulation, and even if such a risk was material, the fund mitigates this risk by using a third-party index provider to determine the price of bitcoin (which sources prices from 22 trading platforms). The OSC panel also noted that because 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.

6. Bitcoin funds would protect investors from "unfair, improper or fraudulent practices." The fund may assist in the promotion of an efficient capital market by providing retail investors with the opportunity to invest in bitcoin through a professionally managed solution, rather than holding bitcoin directly or investing through unregulated cryptoasset platforms.

7. The OSC will not wait for the Securities Exchange Commission (SEC) to make bold policy moves. The OSC panel rendered its decision shortly after the SEC issued another rejection letter to an ETF that would track the price of bitcoin. The OSC panel noted that the SEC's decision is distinguishable from the fund for two reasons: (i) the securities law regime that applies to the SEC is materially different; and (ii) the fund is not an ETF which as an investment vehicle in continuous distribution, is more susceptible to market manipulation and valuation issues.

Implications

It remains to be seen if this decision will lead to the emergence of more public cryptocurrency or cryptoasset investment funds. While the OSC panel's ruling notes that there are still "back-door" mechanisms for companies holding cryptocurrencies and cryptoassets to become reporting issuers (e.g., a reverse takeover of a public shell), this decision indicates that the "front door" may have opened — sketching a path forward for other non-redeemable crypto investment funds. Certainly, the extent to which this decision is followed will set the tone for the crypto industry for years to come. In any event, this is a helpful indication of the current views of the Canadian regulators when it comes to the regulation of cryptoassets.

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