

Goodmans^{LLP} Update

Canadian Securities Regulators Propose to Regulate Crypto-Asset Platforms

The Canadian Securities Administrator (CSA) and the Investment Industry Regulatory Organization of Canada (IIROC, together with the CSA, the “Regulators”) are soliciting insight on how Canada should best regulate crypto-asset trading platforms (“Platforms”).

On March 14, 2019, the Regulators jointly released Consultation Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms* (the “Paper”), which proposes a framework of tailored regulatory requirements (the “Proposed Framework”) to address novel features and risks of trading in crypto-assets.

The Paper notes there are over 2,000 crypto-assets trading on over 200 Platforms, many of which operate with no regulatory oversight. Existing securities legislation may apply to certain Platforms if the investor’s contractual right to the crypto-asset is found to constitute a security or a derivative, however the evaluation of whether a security or derivative may be involved is unclear.

The desire for improved regulation is timely as fraud cases continue to come to light in several jurisdictions. In 2018 alone, billions of dollars in crypto-assets were lost or stolen. A recent case involving QuadrigaCX (“Quadriga”), formerly a Vancouver-based crypto exchange and one of Canada’s largest crypto exchanges, expedited the call for market oversight. Following the freezing of Quadriga’s assets by Canadian Imperial Bank of Commerce and the sudden death of Quadriga’s CEO who was the only person with access to the platform’s encryption passcodes, Quadriga now owes its customers over \$200 million, most of which is inaccessible due to encrypted keys. The absence of standardized codes of conduct or a regulatory framework leaves open the potential for unfortunate incidences such as Quadriga’s to occur again. A regulatory framework would not only provide protection for investors, but would also benefit Platforms by building consumer confidence.

The Proposed Framework builds on the existing securities regulatory regime and recognizes modifications are necessary to address the unique features and risks of crypto-asset trading. The Proposed Framework is intended to apply to Canadian Platforms, as well as all Platforms with Canadian participants. The Paper identifies key risks related to Platforms and asks 22 specific consultation questions falling into eight key risk areas:

1. *Custody and verification of assets:* The ownership of crypto-assets is evidenced by private keys. In many instances, Platforms have custody of their participants’ assets, including the private keys required to execute transactions. The Regulators ask what standards should be adopted to best safeguard these private keys and assets.
2. *Price determination:* A fair price is key to efficient capital markets and investor confidence. The Regulators ask what factors should be considered in determining price.
3. *Surveillance of trading activities:* Exchanges are responsible for the surveillance of trading activities and the enforcement of market integrity rules. Crypto-assets present a unique challenge as they trade globally, on and off Platforms, outside regular trading hours and are prone to volatility. The Regulators ask what surveillance tools and market integrity requirements are appropriate.
4. *Systems and business continuity planning:* System resiliency, reliability and security controls protect investors from security threats and cyber-attacks. Traditional marketplaces are required to conduct an independent systems review (ISR) on information technology and related internal controls. The Regulators ask whether Platforms should be required to provide an ISR and if so, to what extent.
5. *Conflicts of interest:* Platforms present both traditional and unique conflicts. For example, participants may not be aware that a Platform operator trades in the same marketplace against such participant. The Regulators ask what disclosure a Platform should be required to make and whether Platforms can adequately manage conflicts of interest.

6. *Insurance:* Many Platforms have custody over investors' crypto-assets but do not have insurance coverage. With the high risk of cyber-attacks, the Regulators ask what type of insurance coverage should be required.
7. *Clearing and settlement:* All marketplace trades must be reported and settled through a clearing agency. However, there are no regulated clearing agencies for crypto-assets. Further, some Platforms operate a non-custodial model where trades are performed on a decentralized blockchain. The Regulators ask about the available models for clearing and settling crypto-assets and the associated risks.
8. *Applicable regulatory requirements:* Platforms are subject to existing marketplace regulatory requirements. The Regulators ask which existing regulatory requirements should apply to Platforms and which should be tailored appropriately.

The Paper seeks feedback from the fintech community, market participants, investors and other stakeholders. The Regulators invite interested parties to submit written comments by May 15, 2019. The Regulators are also looking to international securities and financial regulators in the U.S., Europe, Singapore, Hong Kong and Malaysia for additional input. To the extent you or your organization are interested in making a submission and require assistance, please contact a member of the Goodmans Technology team who can assist.

Goodmans Tech Group

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