

## Canadian Securities Administrators Staff Notice 21-332

### *Crypto Asset Trading Platforms: Pre-Registration Undertakings*

### *Changes to Enhance Canadian Investor Protection*

**February 22, 2023**

#### **1. Purpose of this Notice**

The Canadian Securities Administrators (the **CSA** or **we**) are publishing this notice (the **Notice**) to describe a change in the CSA staff practice in connection with our expectation that crypto asset trading platforms (**CTPs**) that continue to operate in Canada while they seek registration and related exemptive relief file a pre-registration undertaking (a **PRU**) with the CSA, and to provide additional guidance to CTPs.

In light of recent insolvencies involving a number of CTPs, including Voyager Digital, Celsius Network, the FTX group of companies, BlockFi and Genesis Global (collectively **recent CTP insolvency events**), we are introducing important new investor protection provisions into the standard form of PRU. The PRU is required by CSA members as a precondition to CSA members allowing unregistered CTPs to continue to operate while the CTPs pursue their applications for registration and related relief. PRUs contain commitments by CTPs that the CTPs will operate in a certain manner during the registration process. These commitments are generally consistent with requirements currently applicable to registered CTPs and are intended to address investor protection and level-playing-field concerns, as explained below.

The new commitments we are now requesting from unregistered CTPs relate to the following areas:

- enhanced commitments in relation to the custody and segregation of crypto assets held on behalf of Canadian clients;
- enhanced commitments to preclude the unregistered CTP from pledging, re-hypothecating or otherwise using crypto assets held on behalf of Canadian clients;
- a prohibition on the part of the CTP offering margin, credit or other forms of leverage to any type of client in connection with the trading of crypto contracts or crypto assets on

- the CTP's platform;
- new commitments from controlling mind(s) and global affiliates that affect the CTP entity seeking registration and relief;
  - restrictions on the part of the CTP relying on crypto assets, including proprietary tokens issued by the CTP or an affiliate of the CTP, in determining the capital of the CTP for excess working capital purposes and in determining the capital base of the CTP;
  - enhanced commitments in relation to the filing by the CTP of financial information with the CSA on a regular basis;
  - enhanced commitments in relation to the retention of a qualified Chief Compliance Officer (**CCO**) during the pre-registration process;
  - a prohibition on the part of the CTP in respect of clients buying or depositing Value-Referenced Crypto Assets (commonly referred to as stablecoins) through crypto contracts without the prior written consent of the CSA; and
  - a prohibition on the part of the CTP in respect of trades in crypto contracts based on proprietary tokens, except with the prior written consent of the CSA.

We believe the recent CTP insolvency events noted above highlight the significant investor protection risks to Canadian investors of trading crypto assets, particularly where such trading is conducted through unregistered CTPs based outside of Canada.

We remind investors that trading in crypto assets comes with elevated levels of risk that may not be suitable for many investors, in particular retail investors. Generally speaking, purchasing crypto assets is a speculative activity and the value and liquidity of crypto assets are highly volatile. Unregistered CTPs accessible by Canadians may not have essential safeguards that help protect investors' assets from loss, theft or misuse.

CTPs that operate in Canada and trade securities or derivatives are required to comply with Canadian securities law requirements, including registering<sup>1</sup> with securities regulators. While this regulatory oversight plays an important role in investor protection, investors should know that registration cannot eliminate all risks associated with CTPs.

Accordingly, unregistered CTPs that are continuing to operate in Canada while pursuing applications for registration and related relief are expected

- to give a revised PRU based on the template set out by CSA staff (the **enhanced PRU**) within 30 days of the publication of this Notice, and
- to implement such systems changes as may be necessary to give effect to the provisions of the PRU within timeframes set out in the PRU.

PRUs given by CTPs will be posted on the CSA Website<sup>2</sup> and may also be posted on local websites

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<sup>1</sup> <https://www.securities-administrators.ca/crypto-trading-platforms-regulation-and-enforcement-actions/>

<sup>2</sup> <https://www.securities-administrators.ca/resources/regulatory-sandbox/decisions/>

maintained by individual members of the CSA.<sup>3</sup>

As explained below, where an unregistered CTP is unable or unwilling to provide an enhanced PRU in a form acceptable to CSA staff or implement the required systems changes within these timelines, we will expect the CTP to take appropriate steps to identify and off-board existing users in Canada (**off-boarding**), to impose meaningful restrictions to prevent access to products and services offered by the CTP to users in Canada (**access restrictions**) and to provide notice and timelines to the principal regulator (**PR**) and other members of the CSA for the implementation of such steps and restrictions. Nothing in this Notice should be interpreted as limiting any enforcement recourse the CSA may take against any CTP<sup>4</sup>.

The focus of this Notice is on unregistered CTPs that continue to operate in Canada while they seek registration and related exemptive relief. However, some of the guidance in this Notice may be relevant to registered CTPs and to investment funds that invest in crypto assets. Staff of the PR for a registered CTP will separately contact the registered CTP to discuss whether any changes to the registered CTP's registration or related relief may be required.

## 2. Background

On August 15, 2022, the CSA published<sup>5</sup> an important update in respect of CTPs that continue to operate in Canada while they take steps to comply with applicable securities legislation.<sup>6</sup>

The CSA announced that CSA members now expect unregistered CTPs to provide a PRU to their PR while their applications for registration and related relief are reviewed. By giving these undertakings, unregistered CTPs agree to comply with provisions that address investor protection concerns and are consistent with requirements currently applicable to registered CTPs.

The CSA introduced the PRU to address

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<https://www.autorites-valeurs-mobilieres.ca/ressources/bac-a-sable-reglementaire-des-acvm/decisions/>

<sup>3</sup> See, e.g., <https://www.osc.ca/en/industry/registration-and-compliance/registered-crypto-asset-trading-platforms>; or <https://lautorite.qc.ca/grand-public/registres/plateformes-de-negociation-de-cryptoactifs>

<sup>4</sup> For greater certainty, this includes any recourse the OSC may take against CTPs that did not contact the OSC by the April 19, 2021 deadline set out in its March 29, 2021 announcement. See <https://www.osc.ca/en/news-events/news/osc-working-ensure-crypto-asset-trading-platforms-comply-securities-law>.

<sup>5</sup> <https://www.securities-administrators.ca/news/canadian-securities-regulators-expect-commitments-from-crypto-trading-platforms-pursuing-registration/>.

<sup>6</sup> As defined in National Instrument 14-101 *Definitions*. The term securities legislation includes legislation related to both securities and derivatives. For more information about when and in what circumstances a CTP may be subject to securities legislation, please refer to CSA Staff Notice 21-327 *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets* and Joint CSA/IIROC Staff Notice 21-329 *Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements*.

- investor protection and risk management concerns in relation to the activities of unregistered CTPs that have submitted a substantially complete application to be registered and are continuing to operate while they proceed through the registration process and seek related exemptive relief; and
- level-playing-field concerns in relation to CTPs that have obtained registration as a restricted dealer or investment dealer and that are operating in accordance with their obligations as a registered firm and the terms and conditions applicable to their registration and exemptive relief.

The provisions of the standard form of PRU represent a number of core business conduct and risk management obligations (**core obligations**) that are consistent with the core obligations that would apply to the unregistered CTP if the CTP becomes a registered firm and pursuant to the terms and conditions set out in recent exemptive relief decisions granted to registered CTPs.

Specifically, the current standard form of PRU includes, among other things, a public commitment by the unregistered CTP to comply with the following:

- core business conduct obligations as set out in Schedule I in relation to
  - acting fairly, honestly and in good faith
  - system of controls and supervision, including policies and procedures relating to material, non-public information and personal trading by employees
  - conflicts of interest
  - restrictions on products and services
  - restriction on margin and leverage for retail clients
  - no recommendations or advice
  - advertising and social media use
  - account opening
  - investment limits
  - account appropriateness assessment
  - risk statement
  - custody of crypto assets
  - insurance
  - confidentiality of clients' order and trade information
  - books and records
- reporting provisions as set out in Schedule II
- marketplace provisions as set out in Schedule III (applicable only if the CTP is a marketplace)
- an obligation to notify the PR of any material change affecting the CTP that may reasonably be considered material by the PR or a client
- an obligation to notify the PR of any breach or failure of the CTP's systems of controls (e.g., a hack) and steps taken to address such breach or failure
- an obligation to notify the PR if any regulatory authority initiates compliance or enforcement action against the CTP

- an obligation to notify the PR if the CTP becomes subject to any bankruptcy or insolvency proceedings
- a commitment to work diligently to advance the applications for registration and relief and an acknowledgement that if this cannot be achieved within 12 months, the CTP will cease to carry on registerable activities in Canada
- certain other acknowledgements and commitments as set out in the PRU

The standard form of PRU includes an acknowledgement that the filing of the PRU by the CTP does not mean that the CTP has been or will be granted registration in any CSA jurisdiction or that the relief requested in the application for relief will be granted in any CSA jurisdiction. There is no assurance that the CTP will be registered or be granted its requested relief, and if it fails to become registered or obtain the necessary exemptive relief within a specified period, it will have to cease carrying on registerable activity in each jurisdiction of Canada in which it is not registered.

### **3. New Provisions**

On December 12, 2022, the CSA announced<sup>7</sup> that, in light of recent CTP insolvency events, expanded commitments would be expected in the standard form of PRU. These commitments are a precondition to CSA staff considering an application for registration and related relief.

#### *(a) Custody and segregation of crypto assets held on behalf of Canadian clients*

The existing standard form of PRU includes a number of principles-based representations and commitments as follows:

- The Filer is proficient and experienced in holding Crypto Assets and has established and will maintain and apply policies and procedures that manage and mitigate custodial risks, including but not limited to, an effective system of controls and supervision to safeguard the Crypto Assets. The Filer also maintains appropriate policies and procedures related to IT security, cyber-resilience, disaster recovery capabilities and business continuity plans.
- The Filer has and will retain the services of third-party custodians to hold not less than 80% of the total value of Crypto Assets held on behalf of clients.

In light of recent CTP insolvency events as noted above, and in light of the concern that Canadian investors, who believe they are purchasing Bitcoin or other crypto assets on a CTP, may find themselves as unsecured creditors in the event the CTP becomes insolvent, we are introducing additional commitments under this heading.

Specifically, the enhanced PRU will include additional commitments from the CTP to hold assets, including cash, securities and crypto assets that are not securities, of a Canadian client

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<sup>7</sup> <https://www.securities-administrators.ca/news/csa-provides-update-to-crypto-trading-platforms-operating-in-canada/>

- (a) separate and apart from its own property,
- (b) in trust for the benefit of the client,
- (c) in the case of cash, in a designated trust account or in an account designated for the benefit of clients with a Canadian custodian or Canadian financial institution, and
- (d) in the case of crypto assets, in a designated trust account or in an account designated for the benefit of clients with a custodian that comes within the definition of “Acceptable Third-party Custodian”.

“Acceptable Third-party Custodian” means an entity that

- (i) is one of the following:
  - a. a Canadian custodian or Canadian financial institution;
  - b. a custodian qualified to act as a custodian or sub-custodian for assets held in Canada pursuant to section 6.2 [*Entities Qualified to Act as Custodian or Sub-Custodian for Assets Held in Canada*] of National Instrument 81-102 *Investment Funds*;
  - c. a custodian that meets the definition of an “acceptable securities location” in accordance with the Investment Dealer and Partially Consolidated Rules and Form 1 of New Self-Regulatory Organization of Canada (**New SRO**);
  - d. a foreign custodian for which the Filer has obtained the prior written consent from the PR and the regulator or securities regulatory authority of the Applicable Jurisdiction(s); or
  - e. an entity that does not meet the criteria for a qualified custodian and for which the Filer has obtained the prior written consent from the PR and the regulator or securities regulatory authority of the Applicable Jurisdiction(s);
- (ii) is functionally independent of the Filer within the meaning of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103)*;
- (iii) has obtained audited financial statements within the last twelve months which
  - a. are audited by a person or company that is authorized to sign an auditor’s report under the laws of a jurisdiction of Canada or a foreign jurisdiction and that meets the professional standards of that jurisdiction,
  - b. are accompanied by an auditor’s report that expresses an unqualified opinion, and
  - c. discloses on its statement of financial position or in the notes of the audited financial statements the amount of liabilities that it owes to its clients for holding their assets, and the amount of assets held by the custodian to meet its obligations to those custody clients, broken down by asset;<sup>8</sup> and
- (iv) has obtained a Systems and Organization Controls (**SOC**) 2 Type 1 or SOC 2 Type 2 report within the last twelve months or has obtained a comparable report recognized by a similar accreditation board satisfactory to the Filer’s PR and the regulator or securities regulatory authority of the Applicable Jurisdiction(s).

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<sup>8</sup> Similar in concept to that described in SEC Accounting Bulletin No. 121 regarding the accounting for obligations to safeguard crypto assets an entity holds for platform users.

In addition, the CTP commits to provide an authorization and direction in a form acceptable to CSA staff that allows CSA staff to obtain information about the status of Canadian client accounts directly from the custodian(s) and without going through the CTP.

*(b) Restrictions on the ability of unregistered CTPs to pledge, re-hypothecate or otherwise use crypto assets held on behalf of Canadian clients*

The existing standard form of PRU includes a principles-based representation as follows:

- The Filer will hold Crypto Assets in trust for the benefit of clients separate and apart from its own assets and from the assets of any custodial service provider. The Filer will not pledge, re-hypothecate or otherwise use any Crypto Assets owned by its clients.

The enhanced PRU will maintain this commitment. In the context of our reviews of the applications by the CTPs for registration and related relief, CSA staff will be asking for evidence of meaningful compliance systems and corporate governance controls to provide reasonable assurance that the CTP complies with this provision.

*(c) Restrictions on the offering of margin, credit or other forms of leverage*

The existing standard form of PRU includes a prohibition on the CTP offering margin, credit or other forms of leverage to clients other than clients that are “permitted clients” (as defined in NI 31-103) in connection with the trading of crypto contracts or crypto assets on the CTP’s platform.

The existing prohibition is based on the restriction on registered dealers offering margin, credit or other forms of leverage to clients as set out in section 13.12 [*Restriction on borrowing from, or lending to, clients*] of NI 31-103. However, section 9.3 of NI 31-103 provides an exemption from the restriction in section 13.12 for IIROC investment dealers provided they comply with the IIROC requirements (now New SRO requirements).

In light of the recent CTP insolvency events as noted above, the enhanced PRU includes a commitment that the CTP not offer or provide margin, credit or other forms of leverage to any client, including both retail and permitted clients. This activity introduces additional and heightened risks to CTPs and has the potential to elevate solvency risk if not managed appropriately, even if margin and leverage were to be restricted to permitted clients only.

*(d) Commitments from controlling mind(s) and global affiliates that affect the Canadian Filer*

To ensure the independence of the Canadian Filer, the Filer’s global affiliates, parent entities and/or their controlling minds will be expected to co-sign the enhanced PRU.

In co-signing the enhanced PRU, the Filer’s global affiliates, parent entities and/or their controlling minds will undertake

- Not to interfere with the Canadian Filer’s activities and its directors’ independent judgment;
- To ensure that their activities will not undermine the Canadian Filer’s activities and its compliance with Canadian regulatory obligations.

To the extent possible, the enhanced PRU will include a provision that the Canadian Filer’s board of directors be independent from that of its global affiliates, its parent entities and/or their controlling minds.

- (e) *Restrictions on the use of crypto assets, including proprietary tokens issued by the CTP or an affiliate of the CTP, in determining the capital of the CTP for excess working capital purposes, including acceptance of these assets for collateral purposes.*

For the purpose of the minimum excess working capital requirement applicable to registered firms, CSA staff will expect a 100% reduction on all crypto assets which are not offset by a corresponding current liability, such as crypto assets held for the clients as collateral to guarantee obligations under crypto contracts.

This will result in the exclusion of all the crypto assets held by the CTPs from the excess working capital calculation (Form 31-103F1).

This provision is based on the fact that most crypto assets are speculative in nature and that their value is highly volatile. As a new class of assets, crypto assets have limited investment history which indicates that they may lose substantial, if not all, their value in a very short period. CTPs must consider those risk elements when calculating their excess working capital to ensure their solvency.

- (f) *The filing by CTPs of financial information with the CSA members on a regular basis*

The enhanced PRU will require from the Filer delivery of financial information as provided under section 12.12 [*Delivering financial information – dealer*] of NI 31-103.<sup>9</sup>

- (g) *A provision for CTPs to retain/employ a qualified CCO*

The enhanced PRU will require that the CTP designate an individual as its CCO and that individual must generally meet the requirements of a CCO for a registered exempt market dealer. The CCO will be responsible for the following:

- (i) maintaining policies and procedures for assessing compliance by the Filer, and individuals acting on behalf of the Filer, with securities legislation,

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<sup>9</sup> To comply with section 12.12 of NI 31-103, we refer the Filer to sections 12.10 and 12.11 of NI-31-103. Pursuant to subsection 12.10(2) NI 31-103, annual financial statements must be audited.



(ii) monitoring and assessing compliance by the Filer, and individuals acting on behalf of the Filer, with securities legislation, and

(iii) directly accessing the board of directors, or individuals acting in such capacity for the Filer, at such times as the CCO may consider necessary or advisable in view of the CCO's responsibilities.

#### **4. Crypto Assets Available to Canadian Clients on CTPs**

CTPs that are registered, or that have entered into or will be entering into a PRU, are reminded that, subject to the potential exclusion noted in respect of Value-Referenced Crypto Assets below, such CTPs are prohibited from permitting Canadian clients to enter into crypto contracts to buy and sell any crypto asset that is itself a security and/or a derivative.

##### *(a) General*

Registered CTPs are required to have established policies and procedures to determine whether each crypto asset they permit Canadian clients to enter into crypto contracts to buy and sell is a security and/or derivative under securities legislation in Canada.

A registered CTP's policies and procedures to determine whether a crypto asset is a security and/or derivative should include a process for independent analysis of the crypto asset and consideration of statements made by any regulator or securities regulatory authority about whether the crypto asset, or generally about whether the type of crypto asset, is a security and/or derivative. We expect that CTPs that have entered into a PRU would have similar policies and procedures.

Pursuant to the terms of registration and exemptive relief of a registered CTP, if such registered CTP is made aware or is informed that a crypto asset is viewed by a regulator or securities regulatory authority to be a security and/or derivative, the registered CTP is required to promptly stop permitting its clients to buy or deposit such crypto asset through a crypto contract, except to allow clients, in an orderly manner, to liquidate their positions in those crypto contracts or transfer such crypto assets to a blockchain address specified by the client. We expect that CTPs that have entered into a PRU would take similar steps if they were made aware or informed that a crypto asset is viewed by a regulator or securities regulatory authority to be a security and/or derivative.

##### *(b) Value-Referenced Crypto Assets*

As outlined in its business plan,<sup>10</sup> the CSA continues to monitor and assess the presence and role of stablecoins in Canadian capital markets and work collaboratively to identify and respond to

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<sup>10</sup> 2022-2025 CSA Business Plan. See: [https://www.securities-administrators.ca/wp-content/uploads/2022/10/2022\\_2025CSA\\_BusinessPlan.pdf](https://www.securities-administrators.ca/wp-content/uploads/2022/10/2022_2025CSA_BusinessPlan.pdf).

regulatory implications and risks. As a result of this ongoing work, the CSA is of the view that stablecoins, or stablecoin arrangements, may constitute securities and/or derivatives.

There is no generally accepted definition of “stablecoin” and there are various iterations of stablecoin arrangements. In this Notice and the enhanced PRUs, we use the term “Value-Referenced Crypto Asset”, or “VRCA”, since the use of the term “stablecoin” may be misleading in that these types of assets can also experience volatility and there have been several instances over the past year where crypto assets purported to be “stablecoins” did not maintain their “peg” on trading platforms.

Generally, a VRCA is a crypto asset that is designed to maintain a stable value over time by referencing the value of a fiat currency or any other value or right, or combination thereof.<sup>11</sup> The mechanism through which a VRCA is designed to maintain its value, also commonly known as its “peg” to the reference value, may be through maintaining a reserve of assets or through an algorithm coded into a smart contract. Whether a particular VRCA is a security and/or derivative will depend on the specific facts and circumstances.

The most common form of VRCA is intended to replicate the value of a single fiat currency and may give holders digital evidence of a direct or indirect claim on the issuer.<sup>12</sup> The issuer<sup>13</sup> may attempt to maintain the value of the VRCAs by setting aside a reserve of assets, which is denominated in the fiat currency and may or may not be in a segregated reserve account (a **Fiat-Backed Crypto Asset**). Staff are of the view that Fiat-Backed Crypto Assets generally meet the

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<sup>11</sup> In its Consultative Report Review of the Financial Stability Board (FSB) [High-level Recommendations of the Regulation, Supervision and Oversight of “Global Stablecoin” Arrangements](https://www.fsb.org/wp-content/uploads/P111022-4.pdf) (October 2022), the FSB highlighted that “stablecoins” include two characteristics that distinguish them from other Crypto Assets—the existence of a stabilisation mechanism and the usability as a means of payment and/or store of value. See [https://www.fsb.org/wp-content/uploads/P111022-4.pdf at p 1](https://www.fsb.org/wp-content/uploads/P111022-4.pdf).

<sup>12</sup> Many VRCAs limit the circumstances in which a holder can make a claim against the issuer for the underlying asset (*e.g.*, the holder may have to hold or request redemption of a certain value of VRCAs). We do not consider such conditions on redemption to alter the conclusion that the VRCA is a security and/or derivative.

<sup>13</sup> This Staff Notice uses the term “issuer” to describe the creator of a VRCA, and also “distribution” in reference to the first sale of such assets by the issuer. These terms are generally used in respect of securities. As noted, certain VRCAs, including Fiat-Backed Crypto Assets, constitute derivatives in certain jurisdictions. The use of “issuer” and “distribution” should not, therefore, be read to exclude the application of securities legislation in respect of derivatives in such jurisdictions.

Generally, the issuance of Fiat-Backed Crypto Assets includes all the functions performed by its issuer. Among other things, the issuer of a VRCA is the entity responsible for designing the Fiat-Backed Crypto Asset, managing the minting, issuance, redemption and supply of tokens, and maintaining the crypto asset’s peg through the coordinated management of the reserve assets and token supply. The issuance in Canada of a Fiat-Backed Crypto Asset that meets the definition of security may constitute a distribution in accordance with the securities legislation.

definition of “security”<sup>14</sup> and/or would meet the definition of “derivative” in several jurisdictions.<sup>15</sup>

Other similarly structured VRCAs are pegged to and backed by assets other than fiat currency (e.g., gold, other crypto assets) or a basket of types of assets (e.g., a basket of fiat currencies). Similar to Fiat-Backed Crypto Assets, we would generally consider VRCAs pegged to or backed by assets other than fiat currency to be a security and/or derivative.

VRCAs remain primarily used to facilitate the trading, borrowing and lending of other crypto assets. Their design and use could give rise to a variety of risks in the financial system, particularly if the risks of VRCAs are not adequately addressed.

The transparency of VRCA arrangements about their reserves of assets, the stabilization mechanisms of their value and their governance are generally key issues that require appropriate regulation to protect VRCA holders. Currently, VRCA holders may not receive important information about the issuer or key features of the VRCA. Thus, they may not be aware of their rights and risks when trading such assets. In addition, consumers may be misled into believing that VRCAs are risk-free, that their price will not deviate from its reference value (both in the normal markets and during difficult events) or that they have a direct claim on the reserve of assets. We generally note that the redemption rights on VRCAs are left to the discretion of the issuer and are not always clearly disclosed.

Some of the significant risks associated with VRCAs are related to the stabilization mechanism associated with the maintenance of the peg to their reference value, the management, and custodianship of their reserve of assets and their governance. In addition, the risk that is most likely to have an impact on the financial system as a whole, relative to other risks, is the redemption risk or “run” risk.

There are also VRCAs that attempt to maintain their value based on an algorithm coded in a smart contract instead of holding a dedicated reserve of assets.<sup>16</sup> These are generally riskier than other

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<sup>14</sup> For instance, Fiat-Backed Crypto Assets would generally constitute an “evidence of indebtedness” under the definition of “security” in several jurisdictions and may also be a security under other clauses of the definition of “security”.

<sup>15</sup> Depending on the specific facts and circumstances a VRCA may also be a deposit under provincial and federal legislation and may be subject to another regulatory oversight regime in Canada. For example, if the issuer is a Canadian financial institution, or the equivalent in a foreign jurisdiction, there may be existing exemptions from securities legislation that may be applicable or may be appropriate.

<sup>16</sup> The Bank of Canada’s Staff Discussion Paper *Stablecoins and Their Risks to Financial Stability* dated November 28, 2022, described algorithmic VRCAs as seeking to achieve price stability through algorithms that regulate the supply and demand of the VRCA in response to market conditions, often relying on incentives of actors in the secondary market to stabilize the price, using mechanisms that vary and include allowing the VRCA to be freely converted against a second unbacked Crypto Asset or a periodic rebasing of the VRCA through adjustments in the VRCA supply. See <https://www.bankofcanada.ca/wp-content/uploads/2022/11/sdp2022-20.pdf> at p 5.

types of VRCA, as they are typically not collateralized and rely on algorithms and market incentives to peg their price to the reference value.

Although the existing standard form of PRU and the exemptive relief decisions for registered CTPs already include restrictions on clients entering into crypto contracts in respect of crypto assets that are securities and/or derivatives, we recognize that VRCA may be used by the clients of CTPs as an on-ramp to deposit assets with the CTP, for the trading of other crypto assets, as a store of value during times of volatility in the crypto asset markets or to avoid converting their crypto assets into fiat currency, or they may be used for other purposes, such as a means of payment.<sup>17</sup>

We also recognize that the core provisions and the new provisions in the enhanced PRU may mitigate certain risks associated with VRCA. Accordingly, the enhanced PRU includes a prohibition on CTPs allowing their clients entering into crypto contracts to buy or deposit VRCA without the CTP obtaining the prior written consent of the CSA. Such consent may be subject to terms and conditions imposed on the CTP and the issuer of the VRCA.

If a CTP requests written consent from the CSA for its clients to enter into crypto contracts to buy or deposit a particular VRCA, we expect the CTP to conduct sufficient due diligence to ensure that applicable risks in respect of the VRCA are addressed, including that:

- the VRCA is a Fiat-Backed Crypto Asset;
- where distributions of the Fiat-Backed Crypto Asset are made in Canada, such distributions are made in compliance with applicable Canadian securities legislation;
- the issuer of the Fiat-Backed Crypto Asset maintains a reserve of assets with a market value at least equal to the value of outstanding units of the Fiat-Backed Crypto Asset at the end of each day;
- the reserve of assets is comprised of highly liquid assets, such as cash or cash equivalents;
- the reserve of assets is held by a qualified custodian in favour of the Fiat-Backed Crypto Asset holders;
- the reserve of assets is segregated from assets of the issuer and the assets of each class of other crypto asset issued by the issuer;
- the reserve of assets is subject to a monthly attestation and an annual audit from an independent auditor, copies of which are made publicly accessible in a timely manner;
- the redemption rights of the VRCA holder, directly or indirectly, against the issuer of the Fiat-Backed Crypto Asset, or the reserve of assets, are clearly articulated in policies and procedures and publicly disclosed;
- the issuer of the Fiat-Backed Crypto Asset maintains a plan for recovery and to support an orderly wind-down in case of a crisis or failure by the issuer or an affiliate of the issuer;
- the issuer of the Fiat-Backed Crypto Asset maintains effective governance practices;

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<sup>17</sup> The Relative Benefits and Risks of Stablecoins as a Means of Payment: A Case Study Perspective, Bank of Canada, December 19, 2022. See <https://www.bankofcanada.ca/2022/12/staff-discussion-paper-2022-21/>.

- key accurate information about the Fiat-Backed Crypto Asset is made publicly accessible in plain and non-technical language; and
- the CTP is not otherwise prohibited from allowing clients to enter into crypto contracts in respect of the Fiat-Backed Crypto Asset.<sup>18</sup>

We would also expect that the issuer of the VRCA that is proposed to be offered to Canadian clients of a CTP would take appropriate steps to address applicable risks, including those noted above.

For greater certainty, we would not expect to provide consent in respect of a VRCA that is not fully-backed by an appropriate reserve but rather maintains its value through an algorithm. Also, a CTP providing a PRU, or a registered CTP, may not be able to satisfy their PRU commitments or regulatory obligations in respect of VRCAs that maintain their value through an algorithm, including know-your product, account appropriateness or other PRU commitments or regulatory obligations to clients.

If a registered CTP wishes to allow clients to enter into crypto contracts to buy or deposit a particular VRCA, they should contact their PR. Additionally, we invite issuers of VRCAs that would like a VRCA for which they are the issuer to be distributed in Canada or are seeking consent for a VRCA for which they are the issuer to be bought or deposited on a CTP through crypto contracts to contact a member of the CSA. Such issuers of VRCAs would be expected to explain the steps they have taken to comply with applicable Canadian securities legislation and address the applicable risks, including those noted above.

We caution that Fiat-Backed Crypto Assets, including any that we may consent to be traded on a CTP, are subject to various risks and are not the same as fiat currency. The fact that a regulator or securities regulatory authority may provide written consent to a CTP for its clients to enter into crypto contracts to buy or deposit a particular VRCA, should not be viewed as our endorsement or approval of the VRCA or an indication that the VRCA is risk-free. Further, any consent given should not be viewed as a statement that the VRCA has been distributed in accordance with Canadian securities legislation.

The CSA will continue to monitor and assess the presence and role of VRCAs in Canadian capital markets and work collaboratively with other Canadian authorities, as well as international organizations and standard-setting bodies, to respond to the regulatory implications and risks of such crypto assets.

This approach in respect of VRCAs is intended to be an interim approach only, as the CSA continues its work in this area. We will consider whether any modifications to this approach are required both on an interim basis and for a longer-term framework, and whether any amendments are needed to existing exemptive relief decisions for registered CTPs.

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<sup>18</sup> For example, the PRUs, and the exemptive relief decisions for registered CTPs, include prohibitions for crypto assets that have been the subject of certain regulatory action.

## 5. CSA Response if a CTP is unable or unwilling to provide a revised form of PRU

As set out above, nothing in this Notice should be interpreted as limiting any enforcement recourse the CSA may take against any CTP. If a CTP currently operating in Canada engages in registration discussions with a CSA member but is not prepared to file a revised form of PRU in a form acceptable to CSA staff, files the PRU but does not abide by the provisions of the PRU, or does not make bona fide attempts to progress through the registration process as quickly as possible, or if other information comes to the attention of CSA staff that raises investor protection or other public interest concerns, CSA staff will consider compliance and/or enforcement action against the CTP and its principals. This compliance and enforcement action may include, without limitation,

- the CTP being named on a CSA Investor Alert and/or Investor Warning List;<sup>19</sup>
- the CTP being directed to implement off-boarding and to impose access restrictions;
- an order that the CTP and its principals cease trading and/or an order denying exemptions under securities law to the CTP and its principals; and
- other penalties or sanctions against the CTP and its principals, as may be determined by Canadian securities regulatory authorities or regulators.

## 6. Questions

Please refer your questions to any of the following CSA staff:

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<sup>19</sup> See, e.g., <https://www.securities-administrators.ca/investor-alerts/>; <https://checkfirst.ca/wp-content/uploads/2022/05/ASC-Investors-Guide-Cryptocurrencies.pdf>; <https://www.asc.ca/news-and-publications/investment-caution-list>; <https://www.bcsc.bc.ca/enforcement/early-intervention/investment-caution-list>; <https://lautorite.gc.ca/en/general-public/fraud-prevention/illegal-on-line-trading-platforms/warning-list-of-websites-and-companies-that-solicit-investors-illegally> and <https://www.osc.ca/en/investors/investor-warnings-and-alerts>

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