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Re: Consultation Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms*

Coinsquare Capital Markets Ltd. (hereinafter "Coinsquare" or "we") appreciates the opportunity to submit feedback to the Canadian Securities Administrators and the Investment Industry Regulatory Organization of Canada (the "Regulators") in connection with Consultation Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms* (the "Paper"). We are committed to participating in the establishment of a regulatory compliant environment for crypto-asset trading platforms ("Platforms") in Canada, and we share the overarching goal of the Regulators to establish a framework that provides regulatory certainty, addresses investor risks and promotes market integrity.

We commend the Regulators for their thoughtful and proactive approach to this matter. Furthermore, we agree in principle with the approach of the Regulators to base the proposed framework on the current framework applicable to dealers and marketplaces in Canada.

1. *When evaluating a token to determine if it is a security, are there factors in addition to those noted above in Part 2 that we should consider?*

   We acknowledge that the way in which the trading of a crypto-asset occurs on a Platform will impact the assessment of whether the investor's contractual right to the crypto-asset constitutes a security. To that end, the factors listed in the Paper are instructive.

   With respect to the underlying crypto-asset, Coinsquare respectfully submits that the determination of what constitutes an investment contract and thus a security is addressed by the four-pronged test set out in the seminal case of *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 S.C.R. 112 ("Pacific Coast"). Specifically, we note that one of the factors in the Pacific Coast test is whether there is an "expectation of profit", and the majority of crypto-asset trading occurring today on Platforms is speculative in nature. An additional factor that should be considered is whether the crypto-asset is widely accepted as a payment method and treated as a currency or is otherwise not a security pursuant to the Pacific Coast test. Circumstances such as a crypto-asset having a distributed development community or utility value should be considered. We expect that this approach will promote regulatory certainty in the market.

2. *What best practices exist for Platforms to mitigate these risks? Are there any other substantial risks which we have not identified?*

   To the extent that Platforms enable the trading of crypto-assets where the investor's contractual right to the crypto-asset constitutes a security or where the crypto-asset is in itself a security, they should be subject to the same requirements as existing regulated securities dealers and marketplaces. For every risk noted in the Paper, a dealer/marketplace standard should be applied. Such standards not only serve to promote a level "playing-field" amongst Platform operators and market participants, but they also serve to provide regulatory certainty and protections for existing and new industry participants.

3. *Are there any global approaches to regulating Platforms that would be appropriate to be considered in Canada?*

   The global approaches set out in the Paper (as well as in other jurisdictions including Gibraltar and Bermuda) provide helpful guidance for consideration in Canada. However, due to the close alignment between Canadian and U.S. markets, we suggest that the Regulators strongly consider the approach of the U.S. Securities Exchange Commission, whose position is that Platforms that are trading in crypto-assets that are securities ought to register with the Financial Industry Regulatory Authority as a broker-dealer. An overarching focus of the Regulators should be harmonizing the regulations for Platforms across multiple jurisdictions.

4. *What standards should a Platform adopt to mitigate the risks related to safeguarding investors' assets? Please explain and provide examples both for Platforms that have their own custody systems and for Platforms that use third-party custodians to safeguard their participants' assets.*

   There is no perfect solution with respect to the custody of crypto-assets and therefore we urge the Regulators to take a balanced and pragmatic approach. We submit that the Regulators should not be too prescriptive, as different custodians have different procedures. Instead, we recommend the Regulators set out minimum standards for custody and as the crypto-asset market evolves, enhance the standards and publish best practices. At present, best practices include holding the majority of crypto-assets in an offline wallet ("cold storage"), requiring multiple signatures to access and move crypto-assets as well as keeping the private key on a computer or hardware device that has never been on the internet and which is physically secured in a vault.

   To the extent possible, existing regulation and standards applicable to marketplaces and dealers should govern how a custody arrangement is structured and operated. That said, we agree that allowances must be made to address the unique characteristics of crypto-assets. To this end, Part 14.5.2 of Division 3 of the Companion Policy to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* is instructive in that it provides that:

   "[w]e recognize that in limited cases, it may not be feasible to hold certain asset types at a qualified custodian. For example, bullion requires a custodian that is experienced in providing bullion storage and custodial services, and is familiar with the requirements relating to the physical handling and storage of bullion. Such a custodian may not meet the definition of a qualified custodian. In those cases, we expect a registered firm that would otherwise be subject to subsection 14.5.2(2), (3) or (4)....to exercise due skill, care and diligence in the selection and appointment (where applicable) of the custodian. This can involve the registered firm reviewing the facilities, procedures, records, insurance coverage and creditworthiness of the selected custodian."

   In the view of Coinsquare it makes sense to specify minimum custodial standards to bolster public confidence in crypto-assets. The Regulators should consider establishing robust standards for safekeeping programs. Such programs should include minimum internal control reports, compliance testing, and special capital requirements or insurance to protect crypto-assets (if financially feasible - see our responses to Questions 16 and 17).

   While we appreciate that the crypto-asset community may protest such requirements for adding cost and friction to an ideally frictionless blockchain ecosystem, until such time when all fraud and bad behavior can be removed from the industry, leveraging minimum standards and controls should be required.

5. *Other than the issuance of Type I and Type II SOC 2 Reports, are there alternative ways in which auditors or other parties can provide assurance to regulators that a Platform has controls in place to ensure that investors' crypto-assets exist and are appropriately segregated and protected, and that transactions with respect to those assets are verifiable?*

We believe that the issuance of SOC 2 Type I and Type II Reports as an industry standard for assessing operational readiness and controls would be appropriate for initial and ongoing operations. However, exemptive relief will be necessary at the outset because SOC 2 Type II Reports require at least a year of operations and many Platforms and custodians are relatively new to the industry. We strongly believe that ongoing oversight, akin to the oversight provided by a Regulatory Services Provider such as IIROC, is also necessary to ensure a "non-static" approach to compliance and supervisory oversight.

6. *Are there challenges associated with a Platform being structured so as to make actual delivery of crypto-assets to a participant's wallet? What are the benefits to participants, if any, of Platforms holding or storing crypto-assets on their behalf?*

   There is no specific challenge associated with the transfer of crypto-assets from a Platform to a third-party wallet. However, "centralized" Platforms and OTC desks (albeit on a short term basis) must custody the crypto-assets or have an intermediary custody the crypto-assets to ensure each participant has sufficient funds to execute on a specific trade. Most, if not all Platforms have the ability to facilitate the actual delivery of crypto-assets to a participant's wallet relatively quickly after a trade has been executed (however, note that crypto-assets may be temporarily withheld by a Platform in order to comply with anti-money laundering or Know Your Customer laws). The main benefit to participants of storing their crypto-assets on a Platform is that they do not have to manage their own wallet, which would require them to be responsible for storing their own private keys. We believe that the tendency for participants to keep assets on a Platform is rooted in convenience, particularly for frequent traders that are impacted by high confirmation times and mining/transaction fees associated with "on-chain" transactions and for participants who lack the technological savvy.

7. *What factors should be considered in determining a fair price for crypto-assets?*

   The determination of what constitutes "fair price" should be based on a comparison of posted transparent prices on regulated marketplaces. This is consistent with the concept of "best price" on "protected marketplaces".

   As is the case with traditional equity markets, "best price" is premised on the available best bid/ask on marketplaces that are subject to the same or similar regulatory oversight.

   In today's crypto-asset market, Platforms, while competing on price, do so in the absence of any obligation to ensure that systems, processes and operations meet minimum regulatory standards and protocols. The lack of regulatory compliant systems used by Platforms creates an uneven playing field insofar as Platforms that have invested in security, systems and oversight are at a competitive disadvantage when pricing against Platforms that have significantly lower overhead and controls.

   In the view of Coinsquare, the determination of what constitutes fair (best) price should be premised on an equity market structure construct - meaning that prices should be based on the best available

bid/ask on a regulated marketplace. The pricing available on unregulated Platforms should not be afforded the same protections as those prices quoted on regulated Platforms. Failure to do so is a failure to "price in" factors such as counterparty, operational and compliance risk.

Furthermore, some Platforms operate exclusively as crypto-asset Platforms, without a fiat on or off ramp. Such Platforms do not afford participants the opportunity to "monetize" back to fiat without a secondary trade on a separate Platform that enables fiat conversion (subjecting the participant to additional cost). These crypto-asset Platforms operate as a "crossing network", and as such, should be limited to "putting up trades" at prices that are equal to or better than those prices determined by protected regulated marketplaces.

8. *Are there reliable pricing sources that could be used by Platforms to determine a fair price, and for regulators to assess whether Platforms have complied with fair pricing requirements? What factors should be used to determine whether a pricing source is reliable?*

Per our response to Question 7 above, reliable pricing sources should be determined exclusively from regulated marketplaces. To the extent that global regulators take differing approaches to the regulation of crypto-assets in their respective jurisdictions, the Regulators should focus on those global markets that afford investors at least the same level of protection and oversight as mandated for Canadian Platforms to arrive at a "consolidated national (global) best bid/offer".

9. *Is it appropriate for Platforms to set rules and monitor trading activities on their own marketplace? If so, under which circumstances should this be permitted?*

Platforms should be required to monitor trading activities on their markets. Specifically, Platforms should be obligated to have policies, procedures and controls in place to identify and prevent manipulative and deceptive methods of trading and comply with all applicable marketplace requirements as set out in the Universal Market Integrity Rules ("UMIR"). To ensure that such monitoring is conducted in a robust manner, Platforms should be required to engage a regulation services provider (such as IIROC) to conduct market surveillance.

10. *Which market integrity requirements should apply to trading on Platforms? Please provide specific examples.*

Per our response directly above, it is the view of Coinsquare that Platforms should be held to the same standards of traditional equity marketplaces, where applicable. Allowances should be made for specific nuanced elements of Platforms (i.e. some Platforms may operate outside of traditional market hours or even on a continuous 24 hour cycle), however it is our view that compliance with at least the following provisions of UMIR should be required:

- Part 2 - Abusive Trading
- Part 3 - Short Selling
- Part 4 - Frontrunning
- Part 5 - Best Execution

- Part 6 - Order Entry and Exposure
- Part 7 - Trading in a Marketplace
- Part 8 - Client-Principal Trading

11. *Are there best practices or effective surveillance tools for conducting crypto-asset market surveillance? Specifically, are there any skills, tools or special regulatory powers needed to effectively conduct surveillance of crypto-asset trading?*

    See our response to Question 9 above. Presently a number of widely-used equity marketplace surveillance providers have customized crypto-asset surveillance tools (i.e. Nasdaq SMARTS).

12. *Are there other risks specific to trading of crypto-assets that require different forms of surveillance than those used for marketplaces trading traditional securities?*

    The majority of surveillance systems in use today by traditional equity marketplaces contain most of the core surveillance alerts applicable to Platforms, with slight nuances to account for the fact that most Platforms operate on a 24 hour basis. As noted in our response to Question 11 above, surveillance vendors such as Nasdaq SMARTS have already leveraged existing protocols to account for these differences.

13. *Under which circumstances should an exemption from the requirement to provide an ISR by the Platform be considered? What services should be included/excluded from the scope of an ISR? Please explain.*

    It is our view that all Platforms be required to conduct and complete a full-scale ISR with any exceptions being very narrow in scope (i.e. to accommodate for the fact that many Platforms are new and have not yet been able to complete a full-scale ISR). The majority of Platforms in existence today are "home-grown", and built on proprietary systems which may be functionally incomplete such that the safety of crypto-assets cannot be guaranteed. These proprietary systems have generally not been fully tested by an independent third-party under crypto-asset market conditions, such as periods of high growth or volatility.

    For those Platforms that leverage well established third-party systems (i.e. cloud-based infrastructure, trade matching engines and surveillance tools developed by traditional equity market providers), increased reliance on third-party attestations and testing should be afforded.

14. *Is there disclosure specific to trades between a Platform and its participants that Platforms should make to their participants?*

    Investors should be afforded the same level of disclosure currently required of marketplaces and dealers in Canada.

15. *Are there particular conflicts of interest that Platforms may not be able to manage appropriately given current business models? If so, how can business models be changed to manage such conflicts appropriately?*

    Platforms should model their operations and corporate structures in a manner that is similar to traditional marketplaces and dealers. At present, the vast majority of Platforms are structured in a manner such that they both accept/manage and execute a client order in a "single platform" structure. This form of organization creates a myriad of potential conflicts that require significant internal measures.

    To this end, it is our view that Platforms should bifurcate their role as a dealer and marketplace. Specifically, Platforms should operate as an IIROC dealer with respect to the acceptance and handling of client orders for crypto-assets but the matching of such orders should be conducted on a regulated marketplace.

    This arrangement is commonplace in the traditional equity market structure, with a number of dealers operating a proprietary marketplace. As a dealer, a Platform would be required to consider (better) prices on other regulated marketplaces prior to routing orders to its own marketplace.

16. *What type of insurance coverage (e.g. theft, hot-wallet, cold-wallet) should a Platform be required to obtain? Please explain.*

    We believe that the type of insurance coverage a Platform should be required to obtain should be no greater than the type of insurance coverage currently required for traditional IIROC broker dealers. This type of coverage would cover, among other things, insolvency, any loss through dishonest or fraudulent acts of employees, etc. We however note that reduced insurance coverage should be appropriate with respect to crypto-assets held in "cold storage", and a "reserve model" where assets are held as a percentage of client liabilities should be required for crypto-assets held in a "hot wallet". Insurance in other industries (such as banking) does not provide full coverage for participants. We believe that the issuance of SOC 2 Type I and Type II Reports to a custodian provides Regulators the assurance that clients' assets are sufficiently protected without the need for insurance.

17. *Are there specific difficulties with obtaining insurance coverage? Please explain.*

    With the current state of the insurance market, it is extremely difficult and expensive for Platforms to obtain any type of insurance ("hot wallet", "cold storage", theft insurance or otherwise). Very few insurance providers are willing to insure crypto-asset Platforms, and those that are willing to insure place high premiums that "price-out" many Platforms from purchasing insurance. While we support the Regulators' approach, we believe the Regulators should take a further look at the insurance market prior to mandating any type of insurance.

18. *Are there alternative measures that address investor protection that could be considered equivalent to insurance coverage?*

By requiring Platforms to register as an IIROC dealer, they would presumably fall under the mandate of the Canadian Investor Protection Fund.

19. *Are there other models of clearing and settling crypto-assets that are traded on Platforms? What risks are introduced as a result of these models?*

At present there is no centralized clearinghouse for crypto-assets. While blockchains are uniquely well suited given their ability to record transactions in an immutable manner, blockchains are not, at present, well suited to the management and reconciliation of bi-lateral transactions by discrete parties. This invariably leads to the need for transacting parties to have assurances and recourse in the event of contra-side failure to deliver/settle. In traditional equity markets, the process of clearing/settlement and custody are closely intermingled concepts - such is not the case with crypto-assets.

In respect of crypto-assets, custody, and the movement between hot- and cold-wallets is the critical point of differentiation from traditional clearing and settlement. In the absence of a centralized clearinghouse, the ability to rely on a counterparty's credit, financial viability, and regulatory status (read as integrity) takes on increased prominence.

While Coinsquare is a vocal advocate for Platforms to generally be subject to the same regulatory requirements applicable to traditional dealers and marketplaces as it relates to trading and oversight, owing to the nature of how crypto-assets are transferred and "stored", traditional market structure is not instructive.

In light of the above, we are of the view that the manner in which clearing/settlement and custody is conducted in the crypto-asset space requires a fundamental paradigm shift. We agree with the Regulators that an exemption from the requirement to report and settle trades through a clearing agency should be considered. We submit that Platforms be regulated as dealers and marketplaces with centralized custody provided by third-party entities. By limiting direct participants to regulated dealers and marketplaces, participants have the ability to manage and account for net flows of crypto-assets through a "closed loop ledger" while concurrently limiting the unnecessary movement of crypto-assets in and out of custody. As the Paper notes, Platforms acting as IIROC dealers will also be required to have policies, procedures and controls in place to address the risks of settling transactions on an internal ledger. Lastly, since participants have the ability to withdraw crypto-assets to their own wallets, where such transaction would immediately be posted on a public ledger, the need for a clearing house is less prevalent.

20. *What, if any, significant differences in risks exist between the traditional model of clearing and settlement and the decentralized model? Please explain how these different risks may be mitigated.*

See our response to Question 19 above.

21. *What other risks are associated with clearing and settlement models that are not identified here?*

See our response to Question 19 above.

22. *What regulatory requirements, both at the CSA and IIROC level, should apply to Platforms or should be modified for Platforms? Please provide specific examples and the rationale.*

See our response to Question 19 above.