

May 15, 2019

VIA EMAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

c/o The Secretary

Ontario Securities Commission

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Dear Sirs/Mesdames:

Re: CSA/IIROC Request for Comments to Joint Consultation Paper 21-401

The Jersey Company welcomes the opportunity to comment on Joint Consultation Paper 21-401 dated March 14, 2019 (the “Paper”).

The Jersey Company is a Canadian capital markets and growth company consultancy, with active projects related to the application of distributed ledger technology to securities issuance and trading globally. We are pleased to share our insights below.

The Paper’s broad topic is Crypto-Asset Trading and Platforms, and while we have worked with participants in *cryptocurrency* businesses, our more-relevant expertise is in digital securities and thus our comments hereunder are confined to considerations regarding the trading of “Digital Securities” – transactions of assets traditionally regarded as securities, but using underlying technology and methods similar to those used in cryptocurrency markets. In our Comment we distinguish these assets as **Digital Securities** and to the referenced common underlying technologies and methods as **Crypto Token Systems**.

Utility Token Offerings often masquerade as Asset Offerings

We feel it is useful to first touch on the growing practice of issuing and trading so-called Utility Tokens - a category of transactions leveraging Crypto Token Systems similar to those underpinning cryptocurrencies and Digital Securities, and an area which is often conflated with those Digital Assets discussed in the Paper.

These Utility Tokens are generally contracts based on a service (as-distinct from an ownership right) to be provided by the issuer. In addition to their use of Crypto Token Systems, these Utility Tokens are sometimes exchangeable for Digital Securities or cryptocurrencies or may be marketed as such or in combinations with either.

The issuance of Utility Tokens by corporates has created confusion among investors. We applaud the efforts of Canadian regulators to date in issuing warnings to the public¹. In our view, it is important to confidence in regulated markets that Canadian issuance of Utility Tokens continues to be monitored by CSA members, and that such activity be understood by Canadians as separate and distinct from regulated crypto asset markets. We urge continued broad communication and clarification to the investing public.

On Crypto Currencies and Digital Securities

Your Paper considers the issuance and trading of digital non-fiat “currencies” and the issuance and trading of Digital Securities (defined as securities generally in various provincial securities acts), and there are clearly overlaps, grey areas and sometimes hybrids among these. But while both cryptocurrencies and Digital Securities leverage similar underlying technologies and methods, the two markets are at their cores generally quite distinct. For example:

¹ Notably CSA Staff Notice 46-308 at https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20180611_46-308_securities-law-implications-for-offerings-of-tokens.htm

1. *There exist different legacy market structures for currencies (including cryptocurrencies) versus securities (including Digital Securities).*
 - For example, the inherent value of currencies holdings is typically based on possession of the instrument (effectively, bearer instruments), whereas most securities are contractually-described ledged or certificated structures. This difference of bearer status is a contributor to several differences in investor risk, market structure and regulatory considerations.
 - Digital Securities structures include a ‘manager’ of the asset represented by the security, and that manager (eg; issuer) plays a central role in the market structure.

Several other market structure differences also contribute to the distinctness of each market, and many of these legacy differences survive as we move to a digital world.

2. *Generally, Digital Security ecosystems employ a central authority model while cryptocurrencies are decentralized - often by definition - creating significantly differing oversight challenges.*
3. *There are differing implementations of similar technology which distinguish cryptocurrency markets from those for Digital Securities:*
 - As one example, many Digital Security marketplaces are built on a permissioned and/or proprietary network managed by a central authority, while cryptocurrencies generally exist over decentralized, open networks and thus rely more-heavily on the cryptographic security features of their technology;
 - In another example, Digital Security ecosystems generally make more-advanced use of Smart Contract technology than cryptocurrencies.

Other architectural, technological and workflow choices are often distinct markers of cryptocurrency markets vs those designed for Digital Securities.

Taken together, the differences enumerated above and other identifiers allow us to categorize current and proposed blockchain-based issuance and trading solutions into one or the other category (Cryptocurrency or Digital Security), with perhaps a smaller subset occupying the aforementioned “grey areas”².

² We acknowledge that financial innovation has and continues to create seeming hybrids, including bundling one asset inside another (for example currency futures) or providing for the morphing of one to another (utility tokens with a triggered conversion right). We agree with the CSA that offerings need to be evaluated on their own facts, but feel that on inspection, most offerings can be reduced to discrete and recognizable securities, currencies or utility tokens, even when marketed together.

Why Digital Securities

You, the Paper’s sponsors, collectively oversee much of Canada’s securities activity, maintaining fair and orderly markets and protecting investors. In managing a market environment which is worthy of the public’s trust, you also facilitate capital formation, and thus contribute significantly to improving Canada’s economy.

In a manner analogous to our collective experience of digital correspondence (such as email) replacing letter-writing, Digital Securities hold the promise of significantly better record-keeping and vastly improved auditability, searchability & transparency regarding securities transactions and participants.

These attributes contribute significantly to the regulatory and public policy objectives above. With a shift to Digital Securities, regulators could achieve real-time insights into the detailed actions of individual investors, intermediaries, custodians, clearers, depositors and issuers seen *collectively*, reviewing actions industry-wide - again in real time - by any machine-sortable parameter. Better still, machines could programmatically review activity details that are unavailable today, across the myriad players involved in any transaction or series of related transactions, among all the players whose information now is held in incompatible databases. Issuers could better-reach and better-inform investors whose ownership was registered electronically. Intermediaries could adhere to faster and higher compliance and customer-service standards.

Once Canada achieves clarity on a framework for Digital Securities issuance and trading, follow-on regulations could support imagined innovation such as securitization of asset types that are otherwise difficult to regulate; fractional ownership; improved exempt market mechanisms and liquidity; tenured voting; and more. Doing so would greatly increase the efficiency of capital deployment for Canadians and the Canadian economy and supporting growing and competitive financial and digital industry sectors in Canada – all while improving compliance, oversight and confidence in our markets and financial activity.

But just as digital correspondence brought new challenges (such as spam, phishing and more), Canada needs to be thoughtful as it moves along with the rest of the world to capitalize on the benefits of Digital Securities-based capital markets.

Canada and the World:

The CSA/IROC Consultation Paper comes at a notable moment for Digital Securities. 2018’s global mini-bubble of unregulated Initial Coin Offering activity demonstrated both the opportunity and the potential for investor abuse as cryptocurrency platforms and methods were hurriedly redeployed to raise money selling (real or imagined) assets. Regulators worldwide took note and took action.

More recently, several smaller-economy jurisdictions have encouraged regulated issuance of Digital Securities through “light” regulation, leveraging interest in the benefits of Digital Securities issuance to attract capital markets activity where historically interest was light.

But asset owners strongly prefer jurisdictions where robust legal frameworks provide critical additional protections, and Canada and the US are top-rated in this regard. With the SEC and FINRA maintaining an

indefinite “hold” on any blockchain-based new- or continuing-member applications, Canada – already home to a competitive capital markets industry and a booming digital economy - has an opportunity to extend and improve its position among the world’s preferred capital markets jurisdictions by modifying its existing successful securities regulation model to support Digital Securities.

As described above, it is our view that Canadian regulation of cryptocurrencies markets and Platforms will differ from the regulation of Digital Security markets and Platforms. A framework for regulating Digital Security Platforms is achievable by extending the existing regulatory framework for securities regulation. We sense that establishing (a necessary) regulatory framework for cryptocurrency Platforms will take the authors into new territory, requiring significant learning and discovery, consultation and likely, significant new regulation appropriate to a very different market.

Recommendation. *It is our recommendation that IIROC and the CSA pursue an oversight model and methods which de-couple the work of (a) creating a framework for crypto-currency trading from the work of (b) modifying existing securities regulation to address the subtle differences arising from the use of blockchain technology for securities trades, addressing any outliers as exceptions, thus allowing Canadian issuers and investors to benefit without unnecessary delay.*

Questions posed by the Consultation Paper

Our responses to the questions specifically posed in the Consultation Paper follow:

General Questions

1. Are there factors in addition to those [facts & circumstances of how trading occurs on Platforms] noted above that we should consider [in determining applicability of securities regulation]?

Speaking specifically to the issuance and trading of Digital Securities, we believe the existing criteria regarding applicability of securities regulations can and should apply equally to identifying (traditional) securities activities and Digital Securities activities.

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

Not directly.

As-mentioned, it is our view that Canada is uniquely positioned as a jurisdiction with well-developed and attractive regulatory and legal foundations upon which to build. While we encourage a global view, we would urge caution in adopting approaches from those jurisdictions where accommodative policies seem primarily intended to outweigh the structural advantages of Canada and similar countries.

Nor do we consider the US approach helpful. There, securities regulators have effectively halted new initiatives, offering few insights regarding direction or timeline for issuance or trading of Digital Assets, providing little which is instructive or could be recommended for Canada.

Potential Investor Risks, Risk Mitigation and Investor Protection

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

In our view, new or evolving entities seeking approval to issue or trade Digital Securities in Canada can expect considerable opportunities, and those opportunities are sufficient to outweigh any burden of compliance with existing requirements. We feel that existing securities issuance and trading regulations should, with *in most cases* only slight adjustments, be sufficient to achieve the broad policy objectives of the regulators.

We identify below three areas where this “only slight adjustments” approach may be insufficient:

- a) **Safeguarding Investors’ assets.** While the current custodial model for IIROC brokers represents a good starting point, there is an extra hurdle for clearers to demonstrate possession and control of assets when those assets are represented by code on a public network. Specifically, challenges exist in proving a negative: insuring the custodial holder or holders of a token’s key(s) can prove that no duplicate(s) exist(s).

Leveraging the central authority attribute of Digital Securities, markets, we have seen several models emerge whose approach to this issue is credible, but regulatory approval of these models is a new step.

In our view, demonstrating an appropriate level of possession and control is more-difficult in the decentralized implementations typical of cryptocurrency

- b) **Processes, Policies.** The existing securities framework in Canada is a workable framework for Digital Securities in Canada. But those procedures will necessarily be different in some respects for Digital Securities and the assets they might eventually securitize.

Chief Compliance Officers and overseeing regulators will need to match these changes with training of review staff in order to conduct reviews and audits which are both relevant and meaningful in an emerging Digital Securities industry. In our view this is a significant, not incremental, undertaking (which learning incidentally will also prepare staff for parallel challenges in oversight of all Digital Assets, ie; including cryptocurrency and Digital Securities).

- c) **Security.** Significant parts of the cryptocurrency market arose from - and maintain - a hacker culture. The underlying technology of most Digital Security issuance and trading systems employs Crypto Token Systems which are highly-similar to - and thus seemingly accessible by/ attractive to - crypto hackers.

Registrants pursuing a Digital Securities business model should expect a greater vulnerability to, and targeting by, cyber attacks, and regulators should require more-advanced cyber (and physical) security programs.

We feel the balance of the Risks referenced in the Paper can be addressed through small changes existing securities regulations which should apply and are generally appropriate to Digital Securities.

Some Platforms may wish to operate both as a Digital Securities Platform (issuing or trading Securities in a digital form) and a Cryptocurrency Platform (by pricing and settling those securities trades in a non-fiat cryptocurrency). In our view this amalgam needs to conform both with rules for trading Digital Securities as well as with those for cryptocurrency trading and settlement, meeting the higher standard where there is overlap.

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.

Currently, institutional investors engage institutional Custodians for custody, while retail investors look to their brokers for securities custody. Those brokers in some cases engage a "clearing" broker to provide services including custody, to the introducing broker and end investor.

All of these organizations are Participants in CDS, who provide Participants custodial services for (CDS-eligible) securities.

While Digital Securities are similar to traditional securities, their nature creates those issues regarding assurance of possession and control previously discussed. We believe that several emerging solutions are improving that assurance, and we expect more, and believe there are already models which combine safeguards which deliver a level of assurance equal to or better than existing custody infrastructures.

Separately, we feel that "back office" systems and practices to identify fraudulent transactions may vary on a firm-to firm basis, and suggest regulators consider limiting digital securities trading & custody to a "two-party" system: Institutional broker/Custodian or Introducing Broker/ Carry Broker, for some period, or at minimum, setting high standards for self-custody:

- This would provide a period of separation of people & processes and a time of some duplication of compliance oversight, during which internal best practices and audit skills of Compliance and regulatory staff can develop to accommodate and oversee a dependable self-custody model.
- We also note that practically, many firms who may wish to engage in Digital Securities trading may introduce Digital Securities clearing later, and rely on a few emergent

Digital Securities Clearing Brokers, concentrating expertise development for the new technology.

In a final note on custody, we believe that the types of custodial services such as those provided by CDS and CDCC to their Participants could remain largely as-is while introducing a regulatory framework for issuance and trading of Digital Securities: we do not perceive an immediate industry need to couple a move by such organizations to “Digital Asset-Ready” (although we note that there are benefits of introducing similar technologies in this area, in our understanding these are largely decoupled).

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?

In our view, securities investors are not interested in maintaining wallet technology. In fact, our recommendation would be to make bearer-version Digital Securities not permitted, to the extent that such an action could be made compatible with existing permissive Canadian law regarding bearer securities.

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?

The Jersey Company has a long history of providing institutional investors expert review of broker controls. It has been our experience that diligent evaluations of brokers’ competence and controls decreases both costs and risks, and that there is considerable opportunity for improvement in the securities industry generally.

With regard to the specific challenges or opportunities in auditing the controls and processes of brokers engaging in offering and trading Digital Securities, we would offer the following areas for consideration:

- Regulatory, third-party and/or in-house adoption of Smart Contract audits with specific focus on anti-fraud controls;
- We have worked with third parties who offer independent and ongoing cyber security evaluation services to government and industry and note that the area is one of ongoing significant improvement and innovation.
 - Given the profile and technological dependence of firms using Crypto Token Systems, we feel that Platform’s ISRs should specifically and publicly describe types of continuous cyber security testing the firm is conducting, and that results of this testing should be made privately available to regulators;

- We suggest that regulators consider engaging such a service (alternatively or in addition to the data received indirectly above), and regularly report on overall industry cyber security in a report card format, thus encouraging continued improvement.

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

Due to the nature of Digital Securities and their transparent blockchain-based record of ownership, a Platform handling many orders has access to more information (and one might reason, more tools to collect and analyse that information) and thus can realize significant information asymmetries. Barring suitable deployment of masking or similar tools, we feel that principal trading should not be allowed.

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?

Digital Security Platforms may have significantly-more investor information, including holdings information of previous investors (wallets), and may easily develop the capabilities to devise derivative information. Regulators should strongly consider the ramifications of Platforms' use or sale of this unique information, and should be certain that Privacy policies are adequate and enforced.

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

In our view, Digital Securities which are legally identical to CIPF-covered assets should receive equivalent CIPF protections to equivalent non-digital securities.

Rules and Surveillance

9. Is it appropriate for Platforms to set rules and monitor trading activities on their own marketplace [rather than retaining an RSP]? If so, under which circumstances should this be permitted?

We believe that Platforms are brokers of financial services and agree that they should be subject to obligations of NI 31-103 and (subject to allowed exemptions) Digital Securities Platforms generally should become an IIROC Dealer Member, adhering to the Dealer Member Rules providing investor protection and ensuring confidence in Canada's markets. We note that some Platforms' businesses models may fit better in the current Exempt Market regime, and that some number of models may offer compelling benefits yet not fitting precisely into existing frameworks, requiring some adjustment to their business models and/or limited rule exemptions (from RSPs) in order that these "edge case" Platforms operate within a framework which is substantially-similar to existing securities dealers.

While the full text of Canada’s Universal Market Integrity Rules (UMIR) may not apply to trading some new instruments on new Platforms, many trading rules are common to all well-run markets. Examples include prevention of manipulative & deceptive trading, banning front running, proper handling of client orders (including timely exposure, consistent use of relevant markers), fair & consistent availability of quote and trade information and more. In our view, it is important that Platforms adhere to the accepted standards in these fundamental aspects, and we believe an independent RS provider should continue to be required.

But there are clearly trading rules which may be unique to individual Platforms (for example, how client orders will be handled with respect to time, or size, etc.) or with respect to customer participation (an example here might include institutional-only or IIROC-registrant only marketplaces).

We also understand that practically, there may be no competent independent authority able to provide ‘full’ market oversight of some aspects of Platforms’ trading of some new asset classes (an illustrative example might include digital token-based fractional ownership of sports cars), and that the current model of marketplace membership in IIROC, with full compliance with UMIR, may be impractical.

We encourage IIROC to contemplate RSP relationships which would support a hybrid model where IIROC can contribute oversight of common trading rule while the Platform or a third party – after review and approval by the appropriate regulators – provides surveillance of those asset- or marketplace-specific rules and activities.

Whether in-house or third party, we would expect to see governance of these surveillance organizations achieved in such a manner as to allow them to operate independently/at arms-length from the core Platform. As with RS providers, such Platforms’ surveillance organizations should be regularly audited by the overseeing securities commission.

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

Please see our response to Question 9, above.

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?

The attributes of Digital Securities bring significant opportunities to greatly improve market surveillance. In fact, they provide significant inherent advantages in other regulatory surveillance activities as well. But as most major jurisdictions are on the cusp of approving Digital Securities (and in many cases, the technologies, architectures and processes which will be approved are as-yet not confirmed), there are no significant third party offerings known to us as being developed or being marketed. Once regulators provide clarity on the technologies they will approve, we expect significant growth of Digital Securities surveillance tools, including in-

house development, with both types spurred by the breadth of shared knowledge about Crypto Token Systems.

A recent interesting proposal from the Federal Reserve Bank of Boston illustrates our views and describes the addition of a regulatory node to Crypto Token networks³. While the possible consequences of such a system require deliberation, we feel this illustrates the sort of enhanced supervision we envision as the market and surveillance matures.

Please also refer to our comments regarding Smart Contract audit tools for additional views on surveillance tools.

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.

We can think of no circumstance in which an ISR as contemplated in NI 21-101 at 12.2(1) should not be required, except for the provision included at 12.4(2), given the likelihood that early Digital Securities systems will trade a few unique securities. A different standard may be appropriate.

Indeed, we offer in this Comment Letter suggestions for more transparency in ISR reporting.

We note that this question and our response provide a good example of our view: that often only minimal changes are needed to most existing securities regulation in order to allow for the issuance and trading of Digital Securities in Canada.

Other Questions

The remaining questions include those which are more-relevant to cryptocurrency trading. We have no comments to make on these questions:

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

We have no comment on this question.

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?

We have no comment on this question.

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?

We have no comments on this question beyond those already provided.

³ The Boston Fed's paper is available at <https://www.bostonfed.org/-/media/Documents/one-time-pubs/2019/blockchain-white-paper.pdf>

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

We have no comment on this question.

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

We have no comment on this question.

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?*

We have no comment on this question.

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.*

We have no comment on this question.

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

We have no comment on this question.

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.*

We have no comments on this question beyond those already provided.

Conclusion

We are greatly encouraged by your work to date, as represented by the Consultation Paper and congratulate you on the initiative. The Paper is a significant step in establishing a clear regulatory framework for Digital Assets in Canada and follows a policy-development protocol which has brought Canada respect for advancing well thought-out regulations.

We believe that innovative new Platforms for issuing and trading both Cryptocurrencies and Digital Securities hold significant promise and opportunity for Canadian investors, issuers and the Canadian economy overall. But we do not believe that the similarities in underlying technologies, nor some applicants' practice of conflating assets and currencies, recommend that Canada should pursue a single framework for regulating cryptocurrencies and Digital Securities.

Speaking from our experience with Digital Securities and with Canada's securities regulations, we are confident that Canada's existing securities issuance and trading framework provide excellent foundations upon which to create a framework for the regulation of Digital Securities Platforms. And we believe Canada is well-positioned to benefit significantly from the accomplishment of such a regulatory framework for Digital Securities.



We hope that you find our comments – on a topic that is broad, complex and fast-moving - contribute to your thinking on a framework, and we look forward to next steps.

On behalf of The Jersey Company,

A handwritten signature in black ink, appearing to read "Robert Young". The signature is fluid and cursive.

Robert Young

MANAGING PRINCIPAL



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