TETRA

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumers Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities Service Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Dear Sirs/Mesdames,

RE: Proposed Amendments to National Instrument 81-102 Investment Funds Pertaining to Crypto Assets (the "Proposed Amendments")

Tetra Trust Company ("Tetra") appreciates the opportunity to provide comments to the Canadian Securities Administrators ("the CSA") on the Proposed Amendments.

Tetra is Canada's first and only licensed digital asset custodian, providing enterprise-grade custody of digital assets for institutional clients. Tetra is registered as a trust company under the Loan and Trust Corporations Act (Alberta), which means it is a fiduciary, obligated to act in the best interests of its clients. Additionally, Tetra meets the requirements to custody registered entities as a "qualified custodian" under National Instruments 81-102 and 31-103. As a trust company with fiduciary obligations, all digital assets are held in trust for the benefit of our clients, who retain ownership of their assets without the risk of holding the assets themselves. Tetra provides custodial services for accredited investors, including public crypto asset funds, cryptocurrency exchanges, and family offices, and has nearly two billion in assets under custody.

The digital asset industry is evolving at an exponential pace, and Tetra is well-positioned to provide insight into best practices, industry issues and opportunities, regulatory frameworks, and policy relating to the custody of digital assets.

Page five of the notice issued by the CSA on January 18, 2024 makes a request for comment on five specific issues. Below are Tetra's response to issues four ("Custody") and five ("Broader Consultation").

Tetra's submission includes six specific recommendations, each of which are offered with the overall intention of strengthening investor protection in the Canadian market by furthering both the standards and prevalence of domestic custodianship of domestic assets held within Public Crypto Asset Funds under NI 81-102. Canadian crypto asset funds – and by natural extension, individual Canadian investors – have become dependent on a custody model that is resulting in an increasingly large concentration risk to international custodians. Despite significant growth in digital assets, Canadian offerings are not growing rapidly enough to keep pace. The recommendations in this submission serve to provide the CSA considerations on how to strengthen the industry with a Canadian focus.

Response to Issue Four: Custody

"The Proposed Amendments include a requirement that custodians or sub-custodians that hold crypto assets on behalf of an investment fund obtain an annual assurance report prepared by a public accountant that assesses the design and effectiveness of various internal controls and policies concerning their obligations to custody crypto assets. The CP Changes clarify that obtaining a SOC-2 Type 2 will be considered to comply with the requirement, without prescribing that specific report. We are seeking feedback regarding other assurance reports that may be comparable to a SOC-2 Type 2 that we should also consider sufficient for complying with this requirement. We are also seeking feedback regarding the appropriate scope of any reporting to be provided under this requirement."

We are pleased to see that the CSA is highlighting the security and controls of a custodian as a topic of importance and an essential part of safekeeping the crypto assets of investment funds. Overall, we are supportive of the further requirements, albeit with some comments and clarifications.

Timing of the SOC Report

First, we believe that specifically requiring a SOC 2 Type 2 report to be completed "within 60 days *after* the end of [the custodian's] most recently completed financial year" creates an unnecessary burden as entities often schedule their SOC 2 Type 2 reports to be completed just prior to year end for audit and due diligence purposes. Many auditors refuse SOC reports that are done too early in the year, and thus would request bridge letters to fill the gap between the finalization of the SOC report and the fiscal year-end. **Recommendation number one:** We instead recommend that the wording be changed to 'within 60 days *of* the end of [the

custodian's] most recently completed financial year' to allow for better alignment with existing SOC schedules.

Other Standards of Control and Expertise

Delving deeper, we believe that a SOC 2 Type 2 report should be considered an essential requirement of digital asset custodian as this has become a standard safeguard within the digital asset industry. Given that dealers are required to ensure their custodians have SOC 2 Type 2 reports,[1] investment funds under NI 81-102 should have to adhere to the same standard for consistency. We believe that specifying a SOC 2 Type 2 report as an example of control effectiveness is not only necessary, but should evolve further, which leads to **Recommendation number two**: digital asset custodians should be expected to obtain additional, proportional specified assurances that test the effectiveness of essential functions within the business. One such additional protection would be requiring proof of reserves audits for custodians, which would assure stakeholders, such as investment funds, that the assets a custodian holds are confirmed to be accurate by a third-party auditor. Another reassurance for both regulators and investment funds alike would be to specify that the custodian should undergo penetration testing on their systems to certify the security of both crypto assets and any stored information. Finally, custodians should have to provide evidence of having undergone AML effectiveness reviews. In Canada, these are required by FINTRAC to be undertaken every two years. Domestic custodians should be held to this standard, and international custody providers should be held to an equivalent standard.

As the digital asset industry continues to grow with both institutional and retail interest, the demand for custody is increasing in parallel and both traditional custodians and financial entities are attempting to provide this conventional service in a unique technological space. It is then very important to ensure that any custodian that holds digital assets has taken into account the specific digital asset knowledge, considerations, and controls that are needed for safekeeping assets given the immutability of blockchains. This is rapidly increasing in importance as digital asset custodians are now expected to provide several ancillary services as blockchain technology develops and the industry continues to create new use cases and financial tools. One such example specific to investment funds is the expectation placed on a custodian to provide staking services, which allows for ETFs that utilize staking services for client assets. In our view, any custodian providing such services should be able to provide assurance to the investment fund that it has the proven expertise, performed due diligence on any validators or staking service providers, and that it continually monitors these counterparties for any adverse events. **Recommendation number three**: when an investment fund utilizes an ancillary service from a

[1] Coinsquare Capital Markets Ltd., 11.
https://www.osc.ca/sites/default/files/2022-10/oth_20221012_coinsquare-capital-markets.pdf

custodian that involves client funds, it should be required to ensure that the custodian has the necessary controls in place specifically for those services.

We strongly believe that the CSA should consider custodian and sub-custodian standards to be evolving and a continued point of interest, and in turn continue to ensure investment funds store their assets with custodians that have the proven knowledge and controls rather than outsource the controls and necessary expertise to its international sub-custodians. This can be done through regulations that evolve alongside the dynamics of the digital asset industry.

Response to Issue Five: Broader Consultation

"We are seeking comments on other issues or considerations relating to investment funds that invest in crypto assets that the CSA should also be considering. This feedback will help inform the broader consultations for the third phase of the Project."

In addition to the custodial standard of controls and the audit reports that should be obtained as assurance, we believe there are several other custody related items that the CSA should consider when regulating investment funds and other participants in the digital asset industry.

Domestic Custodian Importance and Systemic Concentration Risk

With digital assets, the assets themselves remain on a decentralized blockchain. Because of this, where the private keys to the assets reside is the most relevant consideration in a default situation due to the legalities of retrieving the assets. If the private keys reside with a domestic, regulated custodian, investment funds can rest assured that the wind up of the custodian will follow a predictable course of action as established under Canadian laws. Furthermore, if the custodian is a trust company, the investment fund has certainty that the legal title to the assets remain with them and will therefore be returned to the investment fund as part of any default proceedings. Given regulations and legal proceedings from another jurisdiction would take precedence with an international custodian, there is an inherent and unavoidable level of extraterritorial risk.

While it may seem that there is a healthy diversity of custodians given that per CSA data[2] there are five custodians and three sub-custodians that custody on behalf of crypto asset investment funds, all sub-custodians are U.S. based. This creates a systemic concentration of risk for Canadian investors, whose assets would be subject to U.S. courts and regulations in the case of any defaults as the sub-custodians hold the private keys – and therefore access to the assets. We note that a specific intended outcome as stated by the Ontario Securities Commission of these

[2] CSA Notice and Request for Comment – Proposed Amendments to National Instrument 81-102 Investment Funds Pertaining to Crypto Assets, 13. https://www.osc.ca/sites/default/files/2024-01/csa_20240118_81-102_rfc_crypto-assets.pdf

proposed amendments to NI 81-102 was a reduction of systemic risk[3], and as such we feel it is critical to consider how to mitigate this risk.

Compounding the international jurisdictional risk is that the regulatory environment in the U.S. at present is far less aligned with industry participants when compared to Canadian regulation. The largest digital asset custodian in the U.S., who is also actively providing custody for Canadian investment funds, is in litigation with the Securities and Exchange Commission. While their affiliate has received restricted dealer status in Canada, the custodian arm remains outside of Canada. In contrast to Canada, the certainty of the custody ecosystem is in question and this has a direct risk implication on those using U.S. based services. By the time that Tetra, the first regulated Canadian digital asset custodian, became operational in 2021, Canadian digital asset investment funds operating under NI 81-102 were already using U.S. custody solutions that were available prior. This legacy usage has carried through to 2024, despite the fact that a domestic solution that eliminates this cross-jurisdictional risk has been available for several years, with domestic competition for custody increasing. We suggest this dependence on U.S. based providers should be reduced.

There are two poignant examples of the U.S. cryptocurrency environment failing both retail and institutional investors. Following the insolvency of Celsius, a U.S. cryptocurrency lender, court rulings determined that certain client deposits belonged to the company and not the clients. In such situations, Canadian regulators or court of law enforcement agencies face difficulties in protecting domestic users. Another relevant and noteworthy event was the collapse of Prime Trust. Prime Trust was a large and well capitalized digital custodian, who was also considered a "qualified custodian" and regulated by the State of Nevada. While there were several reasons for its collapse, a root cause was that its master agreement with clients gave Prime Trust the right to pledge, rehypothecate or otherwise transfer client fiat currency with no liquidity backstop or collateral obligations. With a Canadian regulated custodian, this would not be possible under current regulations.

It is clear in this case that U.S. regulations, while similar to Canadian regulations in terms of principles, often vary in practice. Relying on U.S. companies for services exposes Canadian investors to the real risks that are created with foreign jurisdictions and courts. Not all regulated trust companies are built equally, and relying on regulations from foreign jurisdictions can create a false sense of security. Furthermore, these risks should be disclosed to the investors. This disclosure would be in line with the International Organization of Securities Commissions (IOSCO) recommendations for digital assets. In IOSCO's *Policy Recommendations for Crypto and Digital Asset Markets* report[4], which heavily focuses on Crypto Asset Service Providers

[3] Ibid 8.
[4] Policy Recommendations for Crypto and Digital Asset Markets Final Report, 36. https://www.iosco.org/library/pubdocs/pdf/IOSCOPD747.pdf

(CASPs) such as digital asset investment funds, they state, “the regulator should require the CASP to disclose to its clients whenever Client Assets are to be held or placed in a foreign jurisdiction, as well as the name of such jurisdiction, and thus may become subject to the client asset protections and/or insolvency regimes of that foreign jurisdiction.”

Finally, for reasons of national security, the Patriot Act and the Foreign Intelligence Service Act (FISA) allow for the U.S. government to collect data and information held by its corporations. By using U.S. based custody solutions, investment funds expose Canadian retail investors to the U.S. data collection laws and their associated risks. Conversely, Canadian solutions not only keep investor funds in Canada, but the rights to investor data as well.

In Tetra’s view, the proposed amendments to NI 81-102 can impact real change in the national interest regarding how Canadian’s digital assets are held in custody. **Recommendation number four**: NI 81-102 should include measures to address and reduce the systemic risk to international custodians and support the continuing evolution of the domestic custody landscape. Recommendation number five in the below section provides a tangible suggestion on how to implement recommendation number four.

Supporting Regulated Domestic Custodians

We have outlined broader risks such as the extraterritorial and systemic concentration risks that result from dependence on international custodians. Tetra believes that for market participants and underlying investors in all regions of Canada, the ideal construct is for a custodian to be domestic, regulated by a Canadian body, and to have demonstrated specialized capability in handling digital assets to provide appropriate safeguarding.

Last year in June, the House of Commons Standing Committee on Industry and Technology (INDU) analyzed the blockchain industry within Canada and created a comprehensive report, which consisted of five meetings, six briefs, and the consultation of 31 witnesses. Within the *Blockchain Technology: Cryptocurrencies and Beyond* report[5], one of the sixteen recommendations from INDU was to support Canadian cryptocurrency custodians due to their important role of safeguarding the industry. They stated, “the Committee believes that there are growth opportunities that could be promoted through regulatory reform.” Tetra echoes the belief that regulatory intervention is necessary to both evolve the Canadian custody ecosystem and reduce the aforementioned systemic and extra territorial risks that exist in the current construct. **Recommendation number five**: NI 81-102 should include requirements for a certain minimum percentage of digital assets to be held with regulated domestic custodians.

[5] Blockchain Technology: Cryptocurrencies and Beyond, Report of the Standing Committee on Industry and Technology, 42. https://www.ourcommons.ca/Content/Committee/441/INDU/Reports/RP12522346/indurp15/indurp15-e.pdf

Custody and Sub-Custody

In traditional finance, custodians are the main point of contact for the client. They perform duties such as reconciling positions with the sub-custodian, monitoring and managing asset positions, and providing client reporting – all while relying on the on market expertise of the sub-custodian. Simultaneously, the sub-custodian safekeeps the assets and settles trades, is responsible for completing market activity, owns the relationship with clearing and depositary agencies, and acts on behalf of the custodian in the local market.

Like in traditional finance, sub-custody arrangements are common in the digital asset ecosystem, though the details vary considerably. Digital asset custodians are closer to a bank vault than a traditional custodian given that transactions cannot be canceled or reversed due to the nature of blockchain technology. This heightens the importance of having custodians with specialized operational knowledge and technological capability to adequately secure digital assets. Unlike traditional assets, an entity has custody of a digital asset simply by holding the private key on behalf of the asset holder, ensuring that it cannot be accessed by any other party. Due to these special circumstances, the digital asset sub-custodian is solely responsible for safekeeping the private keys for cold and hot wallet infrastructure, and actioning instructions upon approval of the primary custodian. This means the primary custodian is responsible for not only monitoring and client interaction as in traditional finance, but also for approving client instructions on chain, managing the governance and the set-up of accounts, and performing the due diligence on any new assets or services.

Given that the custodian holds a major role in the digital asset sub-custody arrangement, we believe that the digital asset custodian should meet certain qualifications to ensure it has the unique capability of providing oversight of sub-custodian activities. **Recommendation number six**: the digital asset custodian of an investment fund should be required to demonstrate their capability to custody unique and nuanced asset classes such as cryptocurrencies which require specialized knowledge and involvement, rather than depend on the knowledge and capability of a sub-custodian. This will ensure the existence of purpose built controls, with input by Canadian regulators; specialized policies, procedures, training, and monitoring; expert knowledge and understanding to identify red flags and respond to concerns; and activity specific audits by digital asset experts. In this case, the aforementioned foreign regulatory risk is eliminated, along with the risks that come with digital asset inexperience and inadequate handling of digital assets.

Summary of Recommendations and Concluding Remarks

Tetra is purpose built as a Canadian regulated digital asset trust company and qualified custodian with the goal of protecting Canadian investors and their assets, and since inception, we have actively sought to create an industry leading standard for the safekeeping of these assets. Over

the years that Tetra has been operating, we have been closely following the global custody markets and learning from both successes and failures abroad. As such, we have noticed several deficiencies in the Canadian ecosystem that have exposed domestic investors to unnecessary risk. We would like to specifically highlight the two main custodial issues that Canadian investors face today when investing in digital assets. First, a lack of digital asset expertise is present with the primary custodian of record of numerous investment funds, exposing investor funds to unnecessary risks given the specialized knowledge and controls required to custody this unique asset class. Where this expertise is seemingly present, there can be a lack of certifications and audits to validate it. Second, investors face unavoidable extrajurisdictional risks with U.S. custodial solutions which Canadian investment funds continue to disproportionately utilize. Currently, if a Canadian investor feels uncomfortable with the foreign risk, they would be unable to invest in the Canadian publicly traded crypto asset funds as all of the Canadian funds have major exposure to the U.S. jurisdiction. In the unlikely event of a custodian default, a domestic custodian would ensure certainty of an orderly wind up as it would follow a predictable course of action as established under Canadian laws. An international custodian, by contrast, would have uncertainties relating to cooperation of foreign courts and law enforcement agencies, and domestic regulatory reach would be limited.

Tetra believes it is in the best interest of all market participants, including the regulatory bodies, to strengthen and support the domestic custody offering available to Canadian public crypto asset funds, and the CSA has the ability to make material steps towards this through the proposed changes to NI 81-102. Below is a summary of the recommendations that we have made throughout this comment paper which we believe would move the domestic industry forward towards a safer and stronger operating model.

1. For practical purposes, Tetra recommends a minor wording be changed to ‘within 60 days of the end of [the custodian’s] most recently completed financial year’;
2. Beyond a SOC 2 report, digital asset custodians should be expected to obtain additional, proportional specified assurances that test the effectiveness of essential functions within the business, such as proof of reserves and Fintrac standard AML effectiveness reviews;
3. A custodian should have to demonstrate specific expertise to offer ancillary services which require subject matter expertise;
4. NI 81-102 should include measures to address and reduce the systemic risk to international custodians, and support the continuing evolution of the domestic custody landscape;
5. NI 81-102 should include requirements for a certain minimum percentage of digital assets to be held with regulated domestic custodians; and
6. The digital asset custodian of an investment fund should be required to demonstrate their capability to custody unique and nuanced asset classes such as cryptocurrencies which

require specialized knowledge and involvement, rather than depend on the knowledge and capability of a sub-custodian.

Tetra is passionate about custody in the digital asset space and ensures its services are both industry leading and align with what is expected from regulators and clients alike. We hope our comments are insightful and assist with further modernizing the Canadian financial ecosystem.

We thank the CSA for the opportunity to provide comments on the Proposed Amendments and we would be pleased to further discuss.

Yours truly,

Tetra Trust Company

(signed) “Stephen Oliver”

Stephen Oliver
Chief Compliance Officer
Tetra Trust Company