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**DELIVERED VIA EMAIL**

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

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Introduction

We are responding to the Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Consultation Paper 21-401 *Proposed Framework for Crypto-Asset Trading Platforms* (March 14, 2019) (RFC 21-401 or the Proposal)

This letter sets out our general comments, followed by our comments to the specific questions being asked in the Proposal. We have tried to be constructive in our comments and have provided recommendations where we agree and where we think alternative options should be considered. We acknowledge that there may be other options than what we have recommended.

We thank the CSA and IIROC for identifying the issues and seeking comment and input into the regulatory responses being considered.

The Proposal

The Proposal is considering what parts of the regulation relating to marketplaces and regulation of dealers should be applicable to the trading of crypto assets on electronic platforms (Platforms). The Proposal acknowledges that crypto assets often differ in their functions, structure, governance and rights. However, in taking the view that most of the offerings involve investment contracts or commodities, it proposes a combination of the current regulatory requirements that exist for marketplaces and dealers. The starting place for marketplaces is the bringing together of multiple buyers and sellers and the starting point for dealer regulation is the trading of securities.

The Proposal sets forth requirements based on current categories of regulated entities (marketplaces and dealers) rather than considering if the nature of the assets and goal of promoting innovation requires a different approach. We are concerned that this approach sets up barriers to new entrants with new business models because the requirements are not relevant and too costly. The regulatory approach should not cut off opportunities for investors and new business models because of possible risks but rather should focus on actual or probable risks that are likely to have a significant impact.

#### Application of Marketplace Requirements

The marketplace requirements set out in National Instrument 21-101 *Marketplace Operation* are based on the assumption that the securities being traded were securities listed on a stock exchange. Thus, the nature of the asset being bought and sold by the multiple buyers and sellers was an intrinsic part of the regulatory approach underlying those requirements. Whether or not they are investment contracts, crypto assets are very different from common shares or other types of equity securities that are based on companies with operations or derived from shares based on these types of investments. Financial information relating to the operations of a business are the underlying assumption for valuation and trading of these securities, which is not usually the case with many crypto currencies or even other crypto assets in the early stages of the offering(s) or trading. For this reason, starting with current marketplace regulation may not be the best starting point.

In addition, the Proposal does not take into consideration the impact of this level of regulation on innovation and the use of distributed ledger technology.

We suggest that a more open and less intrusive regime be used, at least in the short term, that addresses the actual (verses potential) risks that have been identified. If a Platform is used for exchanging crypto assets among participants (and not directly with the operator of the Platform), we are setting out below recommendations on which and how such risks should be addressed.

**Recommendation for the determination of whether a security or derivative is involved:** The concept of investment contract with some guidance (including clear exceptions) is sufficient. If the proposed list of factors is used, this would create jurisdiction over an excessively broad category of assets.

**Recommendation that requirements for Platforms that are marketplaces should focus on actual and material risks:**

- Risk of lack of clear and complete information to evaluate trading risks – transparency requirements regarding operations of the Platform, its operators, conflicts, trading information, and custodial information to enable investors to understand the risks of using the Platform;
- Risk of assets disappearing – segregation, custodian and insurance (if available) requirements to address the risks that the assets may not be where they are supposed to be; and
- Risks of operational failures – technology system requirements (security processes and disaster recovery) to address security risks such as theft.

A tiered approach should be used to establish the extent of the requirements and additional requirements can be applied as the risks increase and/or other requirements become more relevant (as size of market gets larger, bigger impact, or other risks become known or increase).

#### Application of Dealer Requirements

If the Platform is used for exchanging crypto assets with the Platform operator as the counterparty, the current requirements applicable to dealers are more than sufficient and should address the potential risks identified in the paper. A tiered or proportional approach should also be considered. A dealer should be allowed to operate using a discount broker model where it does not have to provide advice or recommendations and therefore is not responsible for suitability.

#### Responses to Specific Questions

##### 1. Factors used to determine if a security or derivative is involved

The factors suggested in the RFC 21-401 to determine if a security is involved on the trading platform are based on the nature and type of delivery involved, who holds or controls the investors' assets, and rights of investors in case of bankruptcy. These kinds of factors can apply to any type of asset and could suggest that marketplaces that buy and sell any asset should be subject to securities laws. There is the potential for over-inclusiveness if all of these factors are considered.

RFC 21-401 notes that there are differences in functions, structures, governance and most importantly, rights. Due to the broad definition and range of characteristics, it is more difficult to provide the appropriate regulation related to the nature of the assets since different types of assets are and should be treated differently. If a broad definition is used, then a more principled approach to regulation would be less intrusive on innovation.

**Recommendation for the determination of whether a security or derivative is involved:** The concept of investment contract with some guidance (including clear exceptions) is sufficient. Including the proposed list of factors would create jurisdiction over an excessively broad category of assets and would not address the current regulatory uncertainty.

2. What best practices mitigate the identified risks and are there other risks?

We believe that the Proposal has identified the right risks; however, it has not indicated the likelihood of the risk or impact. The list seems to arise from the risks related to any marketplace trading more traditional securities rather than those specific to platforms trading crypto assets. The nature of the asset being traded is relevant and should be considered. If the likelihood or impact is small, then specific regulation may not be required but could be mitigated through an oversight regime that addresses risks as they occur. Based on information reported in the news and other analysis, it seems the current key risks are:

- Transparency (clear disclosure about the platform, its operators, conflicts, and operations including trading information);
- Custody and segregation issues (requirements that will confirm the assets exist and can properly be allocated to the rightful owners); and
- Security Issues (these are similar to the custody issues but focus on operational issues).

Previous research indicated that most of parties involved in trading are young people who are interested in the technology, so it is not clear that suitability needs to be addressed at this time, and would be covered if traded through a dealer. Over time, as trading and acquiring these assets grow, then additional requirements may be appropriate since the impact is greater. The CSA/IIROC should consider a tiered approach based on the size of the marketplace or whether all trades are done through dealers who would provide sufficient protection.

Best practices require finding the appropriate level of regulation that addresses the key risks while enabling innovation.

**Recommendation regarding the best practices which should focus on actual and material risks:**

- Transparency requirements regarding operations of the platform, its operators, conflicts, trading information, and custodial information to enable investors to understand risks of using the Platform;
- Segregation, custodian and insurance requirements to address the risks that the assets may not be where they are supposed to be (safeguarding of assets); and
- System requirements to address operational risks.

A tiered or proportional approach should be used to establish the extent of the requirement as well as whether additional requirements should be applied as the risks increase and/or other requirements become more relevant (i.e., as size of market gets larger, bigger impact, or other risks become known or increase).

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

No comment.

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 participant assets.

When trading securities, custodian risk has usually been very limited and has often been addressed by type of institution and size of assets under control. A similar approach could be used for crypto assets.

However, these are new types of assets, so the suggestion in the Proposal of focusing on internal controls to address operational risks or risks of fraud by getting an appropriate independent audit report is a reasonable requirement. The same requirement can apply whether the Platform does its own custody, or it is done by a third party. Consideration should be given to a tiered approach based on the size of the Platform or custodian. Also there already may be technology solutions that can be identified as providing best practices regarding custody of these assets without requiring independent audit reports.

**Recommendation regarding safeguarding investors' assets:** Using independent audit reports and minimum size tests are reasonable requirements to address risks of safeguarding assets. Consideration should be given to the availability and cost of obtaining the report. This is also an area where the requirement should only apply to later stage or more developed Platforms (proportional requirements). Identifying specific technology solutions as best practices (rather than as a requirement) may achieve the same results in a more cost effective way.

5. Other than 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.

There are numerous companies that specialize in the understanding and application of distributed ledger technology to commercial products. If relevant qualifications concerning independence and expertise could be established, then allowing these qualified experts to provide an independent report might be as or more useful than using auditor reports. The topics that should be covered in the report could also be included in new requirements. This would be similar to how mining experts are used in the prospectus requirements for mining companies. However, any new approach should take into consideration creating overly burdensome costs that are disproportionate to the activities. A tiered and principled approach in terms of the contents of any report could be used to address this issue and therefore not act as a barrier.

**Recommendation for use of alternative specialists to address risks regarding loss of assets:** Requirements regarding expertise and content of reports of third parties should be established but the impact of the costs on the Platform should be considered, including whether a tiered approach is appropriate.

6. Are there challenges associated with a Platform being structured 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?

No comment.

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

Fair pricing is generally determined by supply and demand as determined by market participants. It is assumed to occur in the public markets if there is order and trade transparency and no evidence of unfair trading practices. On the other hand, there are no requirements for the private markets and it is left to the participants to agree on a price. In both cases, the fundamental issue is whether the market participants have access to the information they need to make the appropriate investment decisions. Regulators should only be concerned about the risk of lack of appropriate information or unfair trading practices and not market risk.

**Recommendation regarding determining a fair price to address risk of lack of information:** Requirements regarding transparency of trading information (orders and trades) and information regarding the asset should be established.

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?

Fair pricing depends upon the mechanisms of the trading platform and appropriate transparency. Difference in customers (institutional verses retail), market structure and nature of intermediation on the Platform can create differences in pricing and market data information which do not reflect reliability issues. The reliability of any pricing source depends on what market data it uses and/or how it produces the information. There are many market data sources in the public markets that exist today without any requirements or criteria regarding reliability. Market participants have been able to evaluate and determine their credibility without any regulation. It is not clear that additional requirements are required for alternative pricing sources for crypto assets. A Platform’s pricing should be determined to be fair without reference to alternative sources; however, if third sources are used, any concerns could be addressed by full transparency regarding the source and processing of information by the third party, including any real or potential conflicts.

**Recommendation regarding reliability of pricing sources to address risk of lack of a fair price:** No additional requirements should be put in place since the Platform should be responsible for establishing its own mechanisms for fair pricing.

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?

It is not clear what risk that the CSA and IIROC are trying to address by prohibiting the Platforms from setting requirements and monitoring compliance with the requirements. Platforms that enable any kind of matching or orders will, by necessity, have to set rules of order entry, allocation and matching priorities. In order to attract clients, they will also want to set other rules that will establish fair markets. If they set requirements, they should monitor compliance with the requirements and enforce any breaches. Regulators should encourage them to do this since this encourages investor protection and efficient capital markets.

Uniform requirements or the use of IIROC as a market regulator is not necessary at this time and is likely to act as a barrier to the development of these types of Platforms because it adds unnecessary complexity and costs.

**Recommendations for Platform requirements and monitoring compliance:** Platforms should set requirements and should monitor compliance with the requirements so that they can enforce any breaches and maintain fair markets.

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

At this stage of the development of these types of Platforms, the only requirements should be clear and complete transparency regarding the rules and how non-compliance will be handled. The Platforms could deal with non-compliance issues by limiting or refusing access and/or reversing trades. At this time there is a higher risk of safeguarding assets than trading abuses.

**Recommendations for Platform requirements to address unfair trading practices:** At this time, it should be left to the Platforms since they have the incentive to prevent abuses in order to maintain the reputation of the Platform. Alternatively, the principle of fair and orderly markets could be used provided it is interpreted in the context of these Platforms and not the current rules that are in place for other types of securities marketplaces.

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 response to Consultation Question 10.

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 specific risks relate more to custody than surveillance. See response to Consultation Question 9.

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

From the experience we have seen so far, the most common technology risks facing these types of Platforms have been in relation to cybersecurity issues rather than to capacity and resiliency. Also, the failure of an exchange trading public securities has a more significant impact. The ISR requirement is a significant cost which may not be justified in the early stages of these types of platforms. In addition, it should be confirmed whether the auditing firms are able and willing to provide these reports and opinions.

**Recommendation for requirements to provide ISR to address technology system risk:** Basic technology requirements should be applicable, but an ISR should only be applied when the Platform reaches a certain size (a tiered approach).

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

We agree that the Platforms should be required to identify and manage potential conflicts of interest and to disclose whether they trade against their participants. We do not think it is necessary for the Platforms to be IROC members to address the conflicts or other risks.

**Recommendation for requirements to address conflicts of interest:** There should be requirements to disclose and manage any conflicts.

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?

Since these business models are still evolving, the range of potential conflicts can best be handled by a principled approach which requires that they manage the conflicts and are transparent about them. Regulators should not try to design or limit business models but rather, should set the appropriate requirements.

**Recommendation for requirements regarding conflicts arising out of business models:** There should be a principled base approach to conflicts rather than prescriptive limitations on business models.

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

We agree with requiring appropriate insurance (being insurance that is available, affordable, and addresses issues) because it provides a useful incentive for the operators of the Platform to try to prevent the risk so that a claim does not arise.



**Recommendation for insurance requirements to address risk of loss of assets:** Appropriate insurance requirements should be identified if available at an affordable cost.

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

No comment.

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

Alternatives could include other evidence of funding (for example, bonds, letters of credit or sufficient working capital) to support the Platform being able to cover any liabilities.

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?

Requiring the use of currently available clearing houses or establishing identical requirements for these new Platforms ignores the value and reasons for using distributed ledger. Technology and custodian requirements are sufficient to address the risks.

**Recommendation regarding additional requirements to address settlement risk:** Technology, segregation and custodian requirements are sufficient to address the risks.

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.

The traditional model of clearing and settlement has significant systemic risk due to the concentration of the risk in one entity and requires regulation to confirm that the clearing agent has addressed third party risk appropriately through its risk model and collateral requirements. Also, it involves the central bank in protecting against systemic risk. A decentralized model which emphasizes establishing the provenance of the assets in ways that cannot be fraudulently undermined mitigates and significantly reduces the systemic and counterparty risks. Less regulatory oversight and intervention is required because technology itself can mitigate, if not eliminate, the risks.

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

We are not aware of any additional risks regarding clearing and settlement.

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.

When new services or products are introduced, it is not unusual for the regulators to start with their current categories and requirements as the basis and then eliminate requirements. This

approach places significant burdens on these new solutions, especially if they are attempting to disrupt current models at reduced prices for their solutions. It is also difficult for the businesspeople to understand why traditional requirements are applying to their business when their model attempts to avoid the risks that the traditional models face.

It might be more productive to start with the risks and then identify what are the relevant requirements. We have tried to do that in the recommendations we set forth at the beginning and throughout this letter.

Relevant topics (but not necessarily the detail of the requirements) set out in appendix B for Platforms that are marketplaces are:

- Transparency of operations (No. 2)
- Transparency of orders and trades (No. 3)
- Conflict of interest (No. 7)
- Confidential treatment of trading information (No. 9)
- Recordkeeping (No. 10)
- Systems and business (no. 11)

All of the requirements set out for dealers providing trading services in connection with crypto assets may be relevant with the exception of suitability if the dealer does not intend to provide advice or recommendations regarding the buying and selling of specific crypto assets.

We are happy to discuss any of our comments. Please contact Randee Pavalow at [rpavalow@corpcounsel.ca](mailto:rpavalow@corpcounsel.ca) for any questions.

Please do not hesitate to contact the undersigned with any questions.

Yours very truly,

**CC Corporate Counsel Professional Corporation**

*/s/ Randee Pavalow*

Randee Pavalow, Of Counsel on behalf of the Firm