

May 15, 2019

Delivered via email:

comments@osc.gov.on.ca

Consultation-en-cours@lautorite.qc.ca

vpinnington@iiroc.ca

Investment Industry Regulatory Organization of Canada
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 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

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

Thank you for the opportunity to comment on the Consultation Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms* (the Consultation Paper) published jointly by the Canadian Securities Administrators (CSA) and the Investment Industry Regulatory Organization of Canada (IIROC, and together with the CSA, the Regulators), which seeks input from the public regarding how existing regulatory requirements should be adapted for crypto asset exchange platforms operating in Canada or that have Canadian participants.

Payward Canada Inc., together with its affiliates (referred to herein as Kraken), operates an international digital currency exchange and custody platform. As an industry leader, Kraken supports efforts to ensure that the crypto marketplace is fair and orderly. That said, it is important to recognize, as the Regulators have done, the difference between crypto assets that are securities under existing Canadian law and crypto assets that operate solely as a form of payment, which we refer to herein as crypto currencies. For the reasons explained below, we believe that exchange platforms on which crypto currencies are traded (Exchanges) should not be substantively regulated under the framework applicable to securities or derivatives.

We wish to provide input on several of the consultation questions asked by the Regulators. The questions below reflect the numbering in the Consultation Paper.

Part 2. Nature of crypto assets and application of securities legislation

Question 1. Are there factors in addition to those noted [in Part 2 of the Consultation Paper] that we should consider?

The assertion of jurisdiction over Exchanges is premised on the concept that even if a crypto currency is not itself a security, the contractual arrangement between an Exchange user (whom we refer to as a customer) and the Exchange operator may be deemed to be a security (or derivative). This premise implies that a customer's interests or holdings on the Exchange are fundamentally different than the assets underlying the holdings, giving rise to risks that are separate and apart from those inherent to the asset itself. We respectfully disagree. This premise is faulty with respect to reputable¹ Exchanges. As described below, most reputable exchanges operate as custodians or bailees. As such, the assets are legally owned by the customer and not the Exchange operator. This means, critically, that the customer's interest is not *derived* from the underlying asset - it IS the underlying asset. The application of a securities law framework, accordingly, is both unnecessary and inappropriate to this structure.

Operation of Exchanges. Exchanges typically hold customers' assets on their behalf, which assets are not used to fund the operations of the Exchange operator. Although there are of course variations in the market, Exchanges typically hold customers' crypto assets in an omnibus wallet, which may consist of numerous addresses.² All transactions are typically done "off chain," which means that ownership changes are represented only on the books and records of the Exchange. Only when virtual currency is transferred off of the Exchange (or onto the Exchange) are transactions broadcast to the underlying public network. Models for fiat funding vary and include: (a) fiat held in segregated omnibus bank accounts held for the benefit of clients, and (b) fiat held in individual client-owned bank accounts over which the Exchange has contractual rights.

Indicia of Direct Ownership. Although each Exchange may describe its operating model differently, there are a few key elements that suggest that the assets held by an Exchange are owned by the customers directly, as opposed to underlying a derivative interest:

1. Contractual terms indicating that the relationship is in the nature of a custodial relationship;
2. Customer has the right to dispose of the assets at any time by transferring them off of the Exchange;
3. Contractual terms governing escheatment of the underlying asset; and

¹ Throughout this Letter, we will refer to "reputable" Exchanges. In general, these Exchanges are those defined in the March 19, 2019 presentation of Bitwise Asset Management, Inc. ("Bitwise") to the Division of Trading and Markets of the U.S. Securities Exchange Commission, in connection with NYSE Arca, Inc.'s proposed rule filing to list and trade shares of the Bitwise Bitcoin ETF Trust (the "Bitwise Presentation"). See <https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5164833-183434.pdf>. As discussed in more detail in this Letter, the Bitwise Presentation identified ten exchanges that formed a uniform, highly connected market with extremely limited deviations in price. Other features of these Exchanges are described in the Bitwise Presentation.

² Although crypto currencies belonging to different customers may be held in a single wallet for operational purposes, each customer's holding is separately accounted for on the books and records of the Exchange. Accordingly, customers' holdings are not "pooled" in a traditional sense, as the participants do not hold a percentage interest in a pooled fund and their holdings do not fluctuate with the holdings of other customers.

4. With respect to bank accounts holding customer funds, titling of the bank account as a “for the benefit of” (FBO) or “custodial” account, or similar wording.

One final indicia of direct ownership relates to market valuation. In general, if the market price of a crypto asset held on an Exchange is consistent with the market price of that same crypto asset at other Exchanges, that is strong evidence that the “interest” offered by the Exchange is the underlying asset. In other words, features that are unique to an interest held at a particular Exchange, such as lack of redeemability, value guarantees or exposure to a pool of assets, should be reflected in the pricing of the interest. Accordingly, where the price of an interest held at an Exchange is generally aligned (and not just correlated) with the value of the corresponding crypto asset on the broader market, it is likely that the customer’s interest is in the underlying asset.

We have set forth below commentary specific to the factors identified by the Regulators in connection with the securities law analysis.

- **whether the Platform is structured so that there is intended to be and is delivery of crypto assets to investors**
- **if there is delivery, when that occurs, and whether it is to an investor’s wallet over which the Platform does not have control or custody**

If customers cannot obtain actual delivery of crypto currency held on an Exchange, that may be an indicia that the customers’ interests are derivative in nature (i.e., that the customers have a financial instrument tied to the value of the underlying asset, but not the asset itself). That said, we believe that the factors, as described in the Consultation Paper, place too much emphasis on how delivery currently occurs as opposed to the customer’s *right* to delivery to an address controlled by the customer. This is important because customers may elect to hold assets “on platform”.³ Assets held on platform generally are still available for delivery to an address controlled by the customer, which should be the key criteria. Specifically, most reputable Exchanges permit customers to remove crypto currency from the Exchange at any time.

- **whether investors’ crypto assets are pooled together with those of other investors and with the assets of the Platform**

Clearly, comingling of assets where the Platform operator uses customers’ assets for its own funding could be an indicia of a security interest. That said, we caution the Regulators about concluding that there is pooling among customers based solely on the storing of multiple customers’ crypto currencies in a single wallet. This omnibus structure is common at Exchanges and reflects operational and security requirements rather than actual co-ownership of assets. Specifically, although a single address may hold crypto currencies in omnibus, the internal records of an Exchange will reflect client ownership on an individual basis.

Part 3. Risks Related to Platforms

³ Customers may elect to hold assets on a platform where the platform holds the private key for numerous reasons, as described in more detail in response to Question 6.

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

The Consultation Paper identifies numerous risks, including risks relating to safeguarding of private keys, risks relating to specific assets, conflicts of interest and market manipulation. We have provided feedback on certain identified risks below.

- **Investors' crypto assets may not be adequately safeguarded.**

As the Exchange marketplace evolves, there is increasing demand for assurances about internal controls. In response, many Exchanges are in the process of pursuing SOC certification to assure customers and other stakeholders of the effectiveness of internal controls. As with other risks described below, the way that each Exchange addresses internal controls will be a key competitive differentiator going forward. Although some Exchanges may elect not to pursue SOC certification, we believe that the trend is in the direction of greater controls and transparency. As the public demands greater assurances regarding internal controls, the market will respond accordingly and this risk will diminish.

- **Each crypto asset has its own functions, associated rights and risks.**
- **Investors may not have important information about the crypto assets that are available for trading on the Platform.**
- **Investors may purchase products that are not suitable for them.**

This risk is premised on the idea that government (and Exchanges, for that matter) is in a better position to assess an individual's risk tolerance than the individual. Regulators have often used a "suitability" model that is based on income or assets, thereby denying many financially or technologically sophisticated investors the ability to invest in accordance with their risk appetite. Even a more complex and nuanced approach to suitability runs afoul of the general ethos of the crypto industry, which supports broad, fair access to stores of value. Rather than focusing on how to "protect" people from themselves, we advocate for educating people - and allowing them to make smart decisions that meet their own requirements and risk tolerances.

- **Conflicts of interest may not be appropriately managed -- There may be conflicts of interest between the Platform's operator and participants who access the Platform, including the inherent conflicts of interest where Platforms act as market makers and trade as principal.**

There have been numerous assertions of conflict of interest at Exchanges, most of which represent a misunderstanding of the mechanics of crypto currency exchanges. These purported conflicts of interest include: (1) proprietary trading by Exchanges on their own venues, (2) trading by Exchange employees on the basis of non-public information, and (3) receipt of payment for listing.

Proprietary Trading by Exchange. Although proprietary trading could have the impact of confusing customers about the depth of liquidity on an Exchange, it can function to stabilize otherwise thin and volatile markets. Specifically, some Exchanges may conduct limited proprietary trading to add liquidity to their markets, allowing customers to receive a better price than would be otherwise available. It is important to note that an Exchange doing such proprietary trading does not “step in front of” its clients, thereby depriving them of the ability to transact. The order book determines which orders are matched, so if a customer has a lower offer or higher bid, those orders will be matched first.

Trading on Insider Information. Unlike traditional securities markets where there is a significant amount of material nonpublic information generated, such as in the case of pending mergers, earnings announcements and divestitures, information about decentralized networks is inherently public. There is no “Bitcoin” company that holds secret Bitcoin information; all of the information about the network (such as a proposed fork) is both publicly determined and publicly available. Material nonpublic information in the crypto currency marketplace is generally limited to advance knowledge of an Exchange’s listing or delisting of a crypto currency (which likely would only move the market price for a very thinly traded asset). This risk is addressed by both Exchange prohibitions on insider trading and the enforcement of laws regarding the same.

Receipt of Payment for Listing. Although Kraken does not accept listing fees, listing fees need not represent a meaningful conflict of interest. Listing fees are common for securities marketplaces and can be quite large.⁴ Although some Exchanges may generate revenue from listing fees, in many cases listing fees are assessed merely to cover the cost of supporting a new crypto currency (such as development of secure wallet solutions). The problem with listing fees arises if there is an expectation that Exchanges make merit-based decisions about the value of a particular crypto currency (beyond the ability to support it and the market demand for the asset). In that case, it can easily appear that the potential revenue from the listing fee outweighs the merit-based decision to list the asset. This is one of many reasons that we believe that Exchanges should not be in the business of making merit-based assessments of crypto currencies and should clearly disclose the same.

- **Manipulative and deceptive trading may occur -- Platforms may be susceptible to manipulative and deceptive trading given the market volatility, lack of reliable pricing information for crypto assets, the fact that they trade 24 hours daily and the fact that trading on many Platforms is not currently monitored.**

In conjunction with a proposed rule change to list and trade shares of the Bitwise Bitcoin ETF on NYSE Arca, Bitwise Asset Management presented an extensive analysis⁵ of the global Bitcoin market, showing that it was far more orderly and less subject to manipulative trading tactics than previously understood. Specifically, the analysis concluded that of the approximately \$6 billion in reported Bitcoin volume per day, 95% is fake and/or non-economic wash trading. By applying various analyses to trading information,

⁴ For example, NYSE imposes a minimum listing fee of \$150,000 the first time an issuer lists a class of common shares. See Section 902.02 of the Listed Company Manual.

⁵ See Bitwise Presentation, *supra* note 1.

such as trade size histograms (which look at the percentage of volume by each trade size bucket), trade volume by time (which looks at when trades occur) and spreads, the authors of the analyses concluded that a significant number of Exchanges were reporting false volume.⁶ Critically, of the ten Exchanges that were not deemed suspicious (of which Kraken was one), Bitcoin prices were nearly uniform, indicating that any deviations were quickly arbitrated.⁷ This means that market manipulation on any of the “true” Exchanges would be prohibitively expensive (and practically impossible) as it would be necessary to manipulate the price on all of the “true” Exchanges at the same time, lest the profits from the manipulation be arbitrated away.

Regarding the assertion that the 24-hour trading cycle contributes to the risk of market manipulation, we would argue the contrary. The fact that there are not artificial obstacles to trading (i.e., when the market is open) enhances price discovery, thereby reducing the risk of market manipulation.

- **System resiliency, integrity and security controls may be inadequate.**

Security is clearly the most significant risk in the industry. The reputational costs of a hack are enormous, as are the direct costs of the hack itself. The magnitude of this risk has the effect, however, of closely aligning the interests of the Exchange and its customers. An Exchange that doesn’t earn its customers’ trust is unable to succeed in the market. In fact, the race to prove security represents a functioning market - providing customers the security they require at a cost they are willing to bear. To this point, immediately after Mt. Gox, major Exchanges launched auditing initiatives to reassure customers that they had reserves supporting customer balances.⁸ Accordingly, we believe that this risk is largely addressed by the functioning marketplace for Exchange services. Moreover, as the market continues to evolve, we believe that security differentiators will become more significant from a competitive perspective.

Question 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?

As described above, retail customers often prefer to hold their crypto assets in wallets controlled by the Exchange. Exchanges have technology and security resources that individuals simply don’t have. It still takes some level of technical sophistication to establish a secure wallet, particularly a multi-signature wallet. Beyond establishment of the wallet, most individuals are unable to meet the same level of security standards established by the large Exchanges. Finally, maintaining assets at an Exchange allows customers to retrieve the asset if the customer can identify himself or herself sufficiently. In contrast, if the customer loses his or her private key to a personal wallet, the crypto currency is irretrievable.

⁶ An Exchange may exaggerate its volume to attract listing fees for new coins.

⁷ “Average deviations from the aggregate price for the ten exchanges is well within the expected arbitrage band when you account for exchange level fees (~ 30 basis points), volatility and hedging costs,” Bitwise Presentation.

⁸ See *Kraken Bitcoin Exchange Passes Proof-of-Reserves Cryptographic Audit*, Nermin Hajdarbegovic (March 24, 2014).

From a privacy perspective, any requirement that Exchanges settle trades through delivery to segregated wallets would have significant implications, potentially revealing participants' holdings, trades and counterparties.

In addition, the maintenance of crypto assets on Exchanges facilitates a clearance and settlement model that offers significant risk reduction over securities clearance and settlement. Whereas the securities market is built on layers of intermediaries, none of which hold the actual underlying securities but rather hold "securities entitlements" or other contractual rights, the crypto market is built on exchanges of actual assets. Specifically, Exchanges hold the actual assets that are transacted, effectively eliminating rehypothecation risk and settlement risk generally. Accordingly, whereas the intermediated securities model concentrates settlement risk by adding layers of potential claims to an asset, the disintermediated crypto asset model eliminates settlement risk by removing such layers. The trade is the settlement.

Part 5.2.3 Surveillance of Trading Activities

Question 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?

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

Question 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?

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?

In order for the industry to continue to flourish, marketplaces must be fair and orderly. Deceptive practices, like wash trading and spoofing, have the potential to undermine the integrity of the market, and accordingly, we believe it is incumbent on Exchanges to monitor their marketplaces for this type of activity. That said, crypto currency marketplaces have a number of characteristics that make market manipulation particularly unlikely. As described in the Bitwise Presentation, low transaction costs together with near-zero transportation costs mean that the bitcoin market (as an example) is a "textbook definition of an arbitrable good".⁹ In fact, pricing for bitcoin among a series of ten exchanges shows that the exchanges trade as a uniform, highly connected market with very limited average deviations from the aggregate price. In other words, among exchanges with real transactions, price discrepancies are quickly arbitrated, meaning that to effectively manipulate the market, someone would need to manipulate numerous exchanges globally - which would be prohibitively expensive.

With respect to the Consultation Paper's questions regarding best practices, the industry employs a mix of market surveillance solutions developed in-house and commercial products adapted from the securities marketplace. Kraken is happy to speak directly to the Regulators about its views on the various solutions available in the industry.

⁹ See page 19 of the Bitwise Presentation, *supra* note 1.

In addition to surveilling for market manipulation, we also believe that it is important that our employees cannot take advantage of nonpublic information that may impact the price of a virtual currency, such as a proposed listing on our Exchange. Because fair access is fundamental to the industry, we believe that Exchanges should monitor for employee trading that violates this principal. To this end, Kraken has adopted a Market Fairness policy that prohibits insider trading.

Part 5.2.6 Insurance

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

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

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

Insurance coverage for cyber-theft/hacking continues to be extremely expensive and does not provide a significant degree of protection for customers, so many Exchanges may elect to “self-insure” or maintain capital sufficient to cover losses. We think that allowing the market to decide as to the right mix of insurance and security will yield the best results as long as the market has adequate information for the determination. Moreover, we expect that as the industry continues to evolve, Exchanges will elect different approaches, and that the market will dictate the appropriate balance between different means of protecting assets.

Conclusion

The crypto asset industry has the potential to give people greater control over their assets and greater privacy for their transactions. Fundamental to delivering on this potential is a clear and sensible legal framework. We appreciate that regulators globally are working to create this framework to ensure that the industry operates in a safe manner that does not stifle innovation. As we have described above, the industry is maturing, and the expectations of the public with respect to security, transparency, auditability and controls are driving positive changes. Without the cudgel of regulation, Exchanges are developing proof-of-reserve techniques, obtaining SOC certifications and enhancing their security and internal controls. As more Exchanges embrace these features, the competitive expectations for all of the Exchanges increase - for the better.

Imposing a security law framework on crypto currency Exchanges would neither achieve the goal of regulatory clarity, nor protect Canadian consumers. Rather it would add a level of complexity that would force Canadian Exchanges to move off-shore, which would reduce rather than enhance the protections for Canadian consumers.

We would be remiss if we did not acknowledge the few un reputable fringe Exchanges, whose operations have posed risks to their users and the industry in general. These businesses exist, unfortunately, in all industries. We caution the Regulators from addressing specific abuses in the crypto marketplace with broad-brush rules designed for other marketplaces (like securities markets). Rather, we advocate for continuing thoughtful engagement with the industry and the application of existing laws to address any wrongdoing.

Thank you for the opportunity to comment on the Consultation Paper. If you have any questions on our comment letter, please feel free to contact us at the email address separately provided.