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CRYPTO- CURRENCIES AND SECURITIES LAW

Future of Law Lab
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To: Cryptocurrency Podcast Group
Re: When crypto assets are securities
Date: Sunday, February 6, 2022

ISSUE

What are crypto assets and when are they securities? Does this change in any way for emerging cryptocurrencies like NFTs or privacy coins?

SHORT ANSWER

Crypto assets are a special type of digital asset, secured with cryptography. They are securities if the *Securities Act* says so, and its definitions are broad. Crypto asset regulation is new and developing, and the CSA and OSC have said little definitively. Their views are clearest on established cryptocurrencies like Bitcoin, and most other assets are a matter of speculation.

Crypto assets representing claims on real assets or securities are likely securities or derivatives under an enumerated definition; security tokens, ownership NFTs, and possibly stablecoins probably fall into this category.

Otherwise, an asset may be a security because it is an 'investment contract'. The test for an investment contract is the *Howey* test, which requires 1) an investment of money 2) in a common enterprise 3) with the expectation of profit 4) to come significantly from the efforts of others. New cryptocurrencies and non-ownership NFTs likely fall into this category.

Established cryptocurrencies are probably not securities, but are probably commodities. Bitcoin and Ether fall into this category.

ANALYSIS

What is a crypto asset?

A crypto asset is a type of entirely digital asset tracked by a public internet ledger. The ledger records which assets are attached to which 'public keys' (or 'addresses'; essentially, identities). Control of a 'private key' corresponding to a given public key allows control of that address and thus of the assets. A 'wallet' is often used to keep track of one's private and public keys.

It may be helpful to think of a bank (internet ledger), at which you have an account (public key), which you can access using a bank card (private key) which you keep in your wallet (wallet).

The ledger and all transactions are secured by a certain type of cryptographic protocol, hence the term crypto.

What is a security?

In Ontario, securities are defined by the *Securities Act*, s. 1(1). The definition is broad and includes, among other things, 'any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company', 'a bond, debenture, note or other evidence of indebtedness or a share, stock, unit', 'any investment contract', and 'any document, instrument or writing commonly known as a security'.

The classic securities are things like stocks, bonds, and options. Cash is not a security, and neither are precious metals.

The definitions in the Act are not exhaustive¹, and things can be roped in under a number of categories. In practice, however, the 'investment contract' clause does much of the heavy lifting. The governing test is the *Howey* test laid down by the US Supreme Court in *SEC v Howey Co.*², which was adopted in Canada in *Pacific Coast Coin Exchange v Ontario Securities Commission*³. The CSA states the test as whether there was all of 1) an investment of money 2) in a common enterprise 3) with the expectation of profit 4) to come significantly from the efforts of others⁴.

When is a crypto asset a security?

A crypto asset will be a security when it falls under one of the enumerated definitions in the Act, including by passing the *Howey* test and thus being an investment contract. A crypto asset that, for example, entitles the owner to or acts as stock would plainly be a security (or derivative) under the definitions. On the other hand, crypto assets which simply sort of exist are more analogous to actual currency or precious metals, and would not be securities. However, the CSA and OSC refuse to be drawn on specific opinions of whether a given crypto asset is or is not a security, though they do appear to make operate on interim designations. For example, the CSA treats Bitcoin as not a security at the present time⁵.

Established Cryptocurrencies

Established cryptocurrencies are generally not considered securities. The OSC, for example, allows Wealthsimple (among others) to offer clients crypto assets 'that are not each themselves a security and/or derivative'⁶. Among the assets Wealthsimple currently offers to the public are Bitcoin, Litecoin, Ethereum, and Dogecoin, and so it can be concluded that the OSC does not consider those coins securities.

However, Wealthsimple is only able to offer these assets because of time-limited, non-precedential relief given by the OSC, and the very same authorizing document requires Wealthsimple to include with every sale 'a prominent statement that *no securities regulatory*

1 Per s. 1(1), "'security" includes ...', in notable contrast to e.g. "'derivative" means ...' (emphasis added in both cases) in the same section.

2 *SEC v Howey Co* (1946), 328 US 293.

3 *Pacific Coast Coin Exchange v Ontario Securities Commission*, [1978] 2 SCR 112.

4 [CSA Staff Notice 46-307 Cryptocurrency Offerings](#) at 3.

5 [CSA Staff Notice 21-327 Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets](#) [SN 21-327] at 3, giving an example of a situation involving Bitcoin where securities legislation does not apply.

6 [Order in the Matter of Wealthsimple Digital Assets Inc](#) [Wealthsimple] at para 19.

authority in Canada has expressed an opinion about ... the Crypto Assets ... including an opinion that the Crypto Assets *are not themselves securities and/or derivatives*' (emphasis added)⁷.

The OSC is thus reserving the right to change their mind, but for now appear to consider at least some cryptocurrencies not securities. SEC Director of Corporation Finance William Hinman (in his personal capacity) commented that because Bitcoin's network is so decentralized, it fails the fourth branch, which is targeted at a central agent.⁸

Essentially, though profits from investing in Bitcoin (as in gold) depend on the markets and overall investor sentiment (as the price of gold also does), it does not depend on the efforts of any specific party (despite both Bitcoin and gold relying on miners generally). Bitcoin and cryptocurrencies like it are thus not investment contracts, and are also not caught under any of the other enumerated definitions.

Established cryptocurrencies are, however, probably commodities. The *Commodity Futures Act*, also enforced by the OSC, considers any 'currency' to be a commodity, and the CSA notes the possibility of crypto assets that are commodities⁹. The US Commodity Futures Trading Commission explicitly takes the view that Bitcoin is a commodity¹⁰.

New Cryptocurrencies

New cryptocurrencies crop up all the time, often in 'Initial Coin Offerings'. And though established cryptocurrencies are usually not securities, *new* ones may well be. This is because they may be investment contracts *at the time of the offering*, even if they later would not be. The central control that the issuing company has at the start could satisfy the branches of the *Howey* test, with the test failing later on once the network is sufficiently decentralized. Director Hinman suggested this of Ether: that it *was* a security in the past, when there was greater centralization, but is no longer¹¹.

Privacy Coins

Privacy coins (such as Monero) are essentially just cryptocurrencies with additional privacy mechanisms tacked on. The privacy mechanisms are irrelevant to whether the asset is a security or not, and so privacy coins are probably legally in the same bucket as cryptocurrencies in general¹².

7 *Ibid.* at para 37.

8 [Hinman, Digital Asset Transactions: When Howey Met Gary \(Plastic\)](#) [Hinman]

9 *SN 21-327*, *supra* note 5 at 1.

10 [US Commodity Futures Trading Commission, Bitcoin Basics](#)

11 *Hinman*, *supra* note 8, noting that 'based on my understanding of the *present state* of Ether, the Ethereum network and its decentralized structure, *current* offers and sales of Ether are not securities transactions' (emphasis added).

12 That said, given their obvious additional potential for criminality, regulators are likely to be rather more hostile towards them.

Stablecoins

A stablecoin is a crypto asset that is pegged to some other asset, often fiat currency. For example, the Tether stablecoin is pegged 1-1 to USD. The CSA has said almost nothing about stablecoins.

To maintain stability, the coin must be backed by reserves of actual currency (or other assets), and of course must be redeemable for it, as Tether is. It is therefore possible that a stablecoin like Tether would constitute 'evidence of title to or interest in the assets' of Tether's issuing company, making it a security under the Act. This is especially the case if the backing assets are securities, making the stablecoin a derivative. On the other hand, it may be a simple contract and not a full interest.

Further, given the nature of stablecoins (i.e., being stable), especially fiat-backed coins, the expectation of profit is likely not present, making them not investment contracts.

Security Tokens

'Initial Token Offerings' generally attempt to raise capital; the tokens distributed here are sometimes called security tokens. Initial token offerings are similar to initial public offerings for obvious reasons, and so often essentially represent crypto-ized stock. That being the case, security tokens are generally securities, as their name suggests, either by being investment contracts or simply directly stock¹³.

NFTs

An NFT is a 'non-fungible token'. Thus, each token is unique and not interchangeable with another. NFTs are often based on underlying assets (e.g. a piece of art), to which they may give ownership rights. If they do, they are potentially derivatives.

More commonly they do not, and ownership of the NFT does not include ownership of anything else. Even then, however, they may still be securities under the investment contract definition.

The CSA notes that the uniqueness of NFTs may be enough to defeat the 'common enterprise' branch¹⁴. However, it bears mentioning that some popular NFTs (e.g. Bored Ape) are similar to each other and fundamentally related, such that though there may be no common enterprise with respect to a *single* ape, there could be a common enterprise with respect to the apes as a whole.

Uniqueness is also diluted if the NFT is sold in fractions rather than as a whole, in which case those fractions are fungible as between each other, possibly creating a common enterprise.

¹³ [CSA Staff Notice 46-308 Securities Law Implications for Offerings of Tokens](#) [SN 46-308] at 3.

¹⁴ *Ibid.* at 5.

CONCLUSION

The CSA and OSC are reluctant to make definitive statements about the applicability of securities legislation to crypto assets. That said, their interim actions, and the legal standards, allow us to make educated guesses. New cryptocurrencies and security tokens are almost certainly securities; stablecoins are possibly securities, as are NFTs, and established cryptocurrencies like Bitcoin are almost certainly commodities and not securities.

Moving forward, we might wish to conduct further research into the OSC's enforcement and relief actions. We might also want to keep abreast of other jurisdictions' policies and any litigation on the matter, like the SEC's current action against Ripple.

To: Cryptocurrency Podcast Working Group
Re: Crypto Asset Contracts and Securities Law
Date: January 28, 2022

ISSUE

What is a crypto asset contract and when, if ever, is it a security?

- a. What types of contracts or instruments are used in the cryptocurrency market?
- b. What is the legal definition of a security and how does it apply?
- c. Has the CSA or OSC provided any guidance as to when a crypto asset contract will be considered a security?

SHORT ANSWER

A crypto asset contract is a crypto transaction executed via a platform that results in a contractual right of the user to an underlying crypto asset. These transactions will be subject to securities regulation if they meet the definition of an ‘investment contract’. In general, these transactions will not be considered a security if they result in an immediate transfer of the crypto asset to the user’s wallet. However, transactions where the platform retains control of the asset, leaving the user reliant on the platform, may constitute a security and therefore be subject to securities regulation.

ANALYSIS

- a. *What types of contracts or instruments are used in the cryptocurrency market?*

Following the emergence of Bitcoin in 2008 the crypto asset market has grown significantly. Today crypto assets are available in a variety of forms. Common types of assets include cryptocurrencies, asset-backed tokens, utility tokens, security tokens, and non-fungible tokens (NFT).¹ Cryptocurrencies are digital tokens that function as a medium of exchange and derive their value based on supply and demand. Security tokens are similar in nature to traditional securities and often carry the same rights associated with a common share in an entity. Asset-backed tokens, utility tokens and NFTs derive their value based on an underlying asset (either tangible or intangible), service, or product.

As crypto transactions have gained popularity, regulators have stepped in to provide guidance to protect investors. In March 2019, the Canadian Securities Administrators (CSA) and Investment Industry

¹ <https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-16/cryptographic-assets-related-transactions-accounting-considerations-ifrs-pwc-in-depth.pdf>

Regulatory Organization of Canada (IIROC) stated that crypto assets that are securities or derivatives would be subject to securities legislation.² In Ontario, the relevant statute is the *Ontario Securities Act (OSA)* administered by the Ontario Securities Commission (OSC).

In some cases, it is easy to determine whether a transaction falls into the broad categories of a ‘security’ or ‘derivative. For example, a tokenized security with features similar in nature to a traditional equity instrument is clearly a security. Similarly, a crypto transaction will be considered a derivative if a token provides an option to acquire an asset in the future, or if a future or an option provides exposure to a crypto asset. However, whether or not a crypto transaction falls within the jurisdiction of a securities regulator is not always as clear.

To facilitate the purchase and sale of these crypto assets, a number of trading platforms have emerged. While some of these platforms immediately transfer the crypto asset directly to their users upon the completion of a transaction, others merely provide their users with a contractual right or claim to an underlying crypto asset, forming a crypto asset contract.³ Depending on the arrangement between the investors and the platforms, these transactions may also be considered a security and therefore subject to securities regulations.

b. *What is the legal definition of a security and how does it apply?*

Section 1(1) of the *OSA* provides sixteen categories of financial transactions that qualify as a “security”. One such category is “an investment contract”.⁴ The term “investment contract” was first defined in the 1946 by the Supreme Court of the United States in the judgement for *Securities and Exchange Commission v W. J. Howey Co.*⁵ The court held that an investment contract is “an investment of money in a common enterprise, with profits to come solely from the efforts of others.”⁶

Later in *Pacific Coast Coin Exchange v Ontario Securities Commission*, the Supreme Court of Canada (SCC) clarified the definition of an investment contract in the Canadian context.⁷ The SCC ruled that the defendant, Pacific, had effectively created an investment contract by allowing members of the

² https://www.osc.ca/sites/default/files/pdfs/irps/csa_20200116_21-327_trading-crypto-assets.pdf

³ *Ibid.*

⁴ *Ontario Securities Act*, RSO 1990, c S-5, s 1(1).

⁵ *Securities and Exchange Commission v W.J. Howey Co*, 328 US 293 (1946) at para 15 [*Howey*].

⁶ *Ibid.*

⁷ *Pacific Coast Coin Exchange v Ontario Securities Commission*, [1978] 2 SCR 112 at para 59 [*Pacific Coast Coin*].

public to purchase and sell bags of silver coins on margin.⁸ Building on the “Howey Test”, the SCC held that while “form should be disregarded for substance and the emphasis should be on economic reality,”⁹ an investment contract exists where the following four elements are satisfied:

1. An investment of money;
2. in a common enterprise;
3. with an intention or expectation of profit;
4. arising significantly from the efforts made by those other than the investor.¹⁰

The SCC further informed that a common enterprise is defined as an enterprise that is “undertaken for the benefit of the supplier of capital (the investor) and of those who solicit the capital (the promoter).”¹¹

Although the value of the silver was rooted in the market price of the coins, the SCC ruled that Pacific retained control over the success of the enterprise, and investors could only look to Pacific for the performance of their contracts.¹² The SCC also held that the investors had no claim to title of any physical property, but only a claim against Pacific.¹³ These factors therefore indicated that the success of the investment stems from the efforts of Pacific alone, resulting in a benefit that accrued to both the investor and the promoter.¹⁴ Thus, these transactions constituted an investment contract, and were therefore considered securities.

The investment contract test can be applied to crypto asset transactions. In a crypto transaction, it can be safely assumed that most investors invest for the purpose of realizing gains, thus satisfying steps 1 and 3 of the test. Similar to *Pacific Coast Coin*, whether a transaction is an investment contract will turn on the degree of dependency between an investor and the platform. The more control the platform retains over an investor’s investment indicates that the returns accrued to the investor stems more significantly from the efforts of the platform entity. Thus, a platform that immediately transfers ownership of a crypto asset upon settlement will not qualify as an investment contract. However, a platform that retains control of the underlying crypto asset and provides users only with a right to later claim the asset may be considered an investment contract.

- c. *Has the CSA or OSC provided any guidance as to when a crypto asset contract will be considered a security?*

⁸ *Ibid.*

⁹ *Ibid* at para 43.

¹⁰ *Ibid* at paras 46-48.

¹¹ *Ibid* at para 50.

¹² *Ibid* at para 52.

¹³ *Ibid.*

¹⁴ *Ibid* at para 53.

In January 2020, the CSA issued additional guidance on when securities legislation applies to crypto asset contracts. In line with the investment contract test outlined in *Pacific Coast Coin Exchange*, the CSA clarified that platforms that provide users with a contractual right to claim an underlying crypto asset is generally subject to securities legislation.¹⁵ On the other hand, platforms that immediately deliver the crypto asset to its user will generally not be subject to securities regulation. Whether or not there is an immediate delivery will depend on the terms of the contractual arrangement between the platform and the user, considering the intentions of the parties at the time the contract was entered into.¹⁶ The CSA provided specific examples of situations where securities legislation will and will not apply.

When is securities legislation applicable?

Securities legislation, will apply when platforms retain ownership, control and possession of the crypto asset. This is the case when crypto platforms retain custody of a user's crypto assets. These platforms are often used by beginner crypto investors as it eliminates the need for users to set up their own digital wallets. Commonly used exchanges such as the Coinbase app, CoinSmart, and Wealthsimple operate under these business models. Users are able to easily buy and sell crypto assets within their crypto accounts or hosted wallets, while the assets are under the control of a third-party custodian.¹⁷ These assets can either be transferred to user's personal wallets upon request at a later time, or simply converted to legal currency.

Typically, these platforms will pool their user's crypto assets within a common wallet and may make use of the crypto assets while it is under their control.¹⁸ Until the ownership is transferred, the user will be dependent on the platform and be exposed to the insolvency risk, fraud risk, performance risk, and proficiency risk of the platform entity.¹⁹ Platforms that offer margin or leveraged trading will also typically be subject to securities regulations.²⁰

When is securities legislation not applicable?

In general, securities legislation will not apply if the platform immediately transfers ownership, possession and control of the crypto asset to the user. Transfer of ownership requires that the crypto

¹⁵ https://www.osc.ca/sites/default/files/pdfs/irps/csa_20200116_21-327_trading-crypto-assets.pdf

¹⁶ *Ibid.*

¹⁷ <https://www.osler.com/en/resources/regulations/2019/csa-and-iroc-propose-regulatory-framework-for-cryptoasset-trading-platforms>

¹⁸ <https://www.osler.com/en/resources/regulations/2019/csa-and-iroc-propose-regulatory-framework-for-cryptoasset-trading-platforms>

¹⁹ https://www.osc.ca/sites/default/files/pdfs/irps/csa_20200116_21-327_trading-crypto-assets.pdf

²⁰ *Ibid.*

assets purchased from the platform be transferred to a wallet independent of the platform and under the sole control of the user.²¹ This transaction should also be immediately reflected on the blockchain ledger.²² The user is no longer reliant on the platform and free to use the crypto asset without any further involvement of the platform.²³ Furthermore, the crypto platform does not have any custody or control over their users crypto, nor can the platform use the asset for their own purposes.²⁴

This is the case with platforms that allow users to link the trading platforms with a self-custody wallet as opposed to the platform's hosted wallet. For example, Coinbase customers are given an option to store their assets onto the application's hosted wallet, or within a user's own Coinbase Wallet.²⁵ Transactions that settle within the hosted wallet will meet the criteria for a security, while the later transactions will be considered a direct transfer of ownership and therefore not considered a security.

Why is this distinction important?

Platforms that are found to facilitate the trade of securities are known as Crypto-Asset Trading Platforms (CTP). These CTPs would then be required to comply with securities regulations requirements including filing a prospectus, registration, and disclosure requirements, amongst others. To date, there are six CTPs that have registered with or have received exemptive relief from the OSC.²⁶

In recognizing these transactions as securities, the regulator's purpose is to protect investors from the Platform's risks and to minimize potential losses as a result. These regulations ensure that the platforms have controls and procedures that appropriately safeguards their user's assets.²⁷ Disclosure requirements also ensure transparency in the platform's business models and that users are sufficiently educated in manner in which their investments are protected.²⁸ Regulators wish to protect investors from fraudulent platforms that may misappropriate or misuse their assets while under their custody, such as in the case of Quadriga CX where \$168 million of user's assets were lost due to mismanagement.²⁹

CONCLUSION

²¹ *Ibid.*

²² *Ibid.*

²³ *Ibid.*

²⁴ <https://www.osler.com/en/resources/regulations/2019/csa-and-iiroc-propose-regulatory-framework-for-cryptoasset-trading-platforms>

²⁵ <https://www.coinbase.com/learn/tips-and-tutorials/how-to-set-up-a-crypto-wallet>

²⁶ <https://www.osc.ca/en/industry/registration-and-compliance/registered-crypto-asset-trading-platforms>

²⁷ https://www.osc.ca/sites/default/files/pdfs/irps/csa_20190314_21-402_crypto-asset-trading-platforms.pdf

²⁸ *Ibid.*

²⁹ <https://www.osc.ca/quadrigacxreport/index.html#executive-summary>

In conclusion, an entity facilitating the transaction of crypto asset may occasionally be subject to securities regulation if it meets the criteria for an investment contract. This determination largely turns on the timing of the delivery of the crypto assets to the investors and the degree of control retained by the platform over a user's investment. If a contract is found to be a security, these platforms will need to consult with their provincial securities regulations to understand their reporting requirements.

TO: Future of Law
RE: Cryptocurrencies and Securities Law: Regulating Exchange Platforms
DATE: February 7, 2022

ISSUE:

1. What is a CTP and when is it required to be registered?
2. What is the logic behind this regulatory stance?

BACKGROUND

As of February 2022, there are over 17,000 crypto assets that may be traded for fiat currency spanning over 450 platforms with a market capitalization of nearly \$2 trillion USD.¹ To put that in perspective, there were only around 2000 crypto assets traded on approximately 200 platforms in 2019, when the Canadian Securities Administrators (CSA) and Investment Industry Regulatory Organization of Canada (IIROC) published their joint collaboration paper outlining a proposed framework for Crypto-Asset Trading Platforms (CTPs).² The rapid expansion of CTPs, combined with the volatility of the market, has prompted regulatory agencies to evaluate how the trade of crypto assets can best be regulated, considering their similarities with other securities or derivatives while also acknowledging their differences.

In early 2019, CSA and IIROC determined that if crypto assets that are securities or derivatives are traded on a platform, or if a platform trades contracts or instruments that are derivatives based on crypto assets, the platform hosting this exchange would be subject to existing securities legislation.³ Such regulation may also apply to platforms that facilitate the buying and selling of crypto assets (including those that act like commodities) since the purchaser's contractual right to the asset may itself constitute a derivative.⁴ This initial signalling of a more formalized regulatory framework for CTPs has since developed greater structure, culminating in the CSA's Staff Notice 21-329 last year, which elucidated the particular requirements that CTPs must abide by. This memo will discuss what, precisely, a CTP is, the requirements of registration, and the logic behind this regulatory stance.

ANALYSIS

I. What is a CTP?

The CSA defines a CTP as “any entity that facilitates transactions relating to crypto assets, including buying and selling crypto assets.”⁵ Platforms generally perform functions similar to one or more of the following: exchanges, alternative trading systems, clearing agencies,

¹ <https://coinmarketcap.com/charts/>.

² CSA/IIROC, Consultation Paper 21-402.

³ CSA Staff Notice 21-327.

⁴ Ibid.

⁵ CSA Staff Notice 21-327.

custodians, and dealers.⁶ As the market matures and distributed ledger technologies are better understood, other novel functions are also developing.

Crypto assets (sometimes known as “utility tokens”, or just “tokens”) allow purchasers (or “holders”) of the asset to assess or purchase goods or services on a distributed ledger technology network that is developed by creators of the token. The most common form of offering is an investment contract, which is considered a security. However, some crypto assets are tokenized forms of traditional securities or derivatives and may represent an interest in assets or derive their value from an underlying interest.⁷ If tokens that act as securities and/or derivatives are traded on a platform, the platform (or “CTP”) becomes subject to regulatory requirements as would a traditional security.

Crypto assets such as Bitcoin, perhaps the most universally recognized cryptocurrency, functions as a form of payment or means of exchange on a decentralized network, and technically is not a security or derivative in and of itself. Instead, Bitcoin is analogous to traditional commodities (such as fiat currencies or precious metals). However, securities legislation may apply even to Platforms that act as a mode of exchange for commodity-like crypto-assets, because an investor’s contractual right to the crypto asset may constitute a security or derivative.⁸

II. When is a CTP required to be registered?

a. When does a CTP fall under securities legislation?

In short, CTPs fall under the Ontario Security Commission’s (OSC) securities regulations when the Platform facilitates or proposes to facilitate the trading of 1) crypto assets that are securities (“Security Tokens”) or 2) instruments or contracts involving crypto assets (“Crypto Contracts”).⁹ Some Platforms may assume they are exempt since they only facilitate transactions, but many of these Platforms are actually providing token holders with a contractual right to an underlying crypto asset rather than delivering the asset directly, in which case they are subject to securities legislation as well.¹⁰

In some cases, it is very clear that a crypto asset is a security: if it carries voting rights or rights to receive dividends, which are typically attached to common shares, for example. On the other hand, if the crypto asset provides an option to secure an asset in the future, it acts as a derivative.¹¹ However, if the underlying crypto asset falls under neither of these categories, and if the contract for purchase, sale, or delivery of the asset 1) results in an obligation to immediately deliver the asset to the purchaser and 2) is settled by immediate delivery, then the Platform is generally *not* subject to securities legislation.¹² In order to meet the requirements for instant delivery, all terms (both written and unwritten) of the contract will be analyzed and the actual practice observed (if the contract stipulates immediate delivery but the industry standard does not observe this requirement, securities legislation may still apply).

⁶ Consultation Paper 21-402.

⁷ Ibid.

⁸ Ibid.

⁹ Dentons, “Part 1: Securities Regulation of Crypto Asset Trading Platforms in Canada”.

¹⁰ Staff Notice 21-327.

¹¹ Ibid.

¹² Ibid.

The Platform must immediately transfer ownership, possession, and full control over the asset to be exempt from qualifying as a security or derivative, without the Platform retaining any legal right or security interest in the asset.¹³ In summary, Platforms that offer services for users to buy and sell crypto assets but do not offer any margin or leveraged trading, and where the crypto asset purchased from the Platform is immediately transferred to the wallet of the purchaser, securities legislation does not apply.

On the other hand, if Platforms retain ownership, control, and/or possession of the asset after the sale until a user requests that the token be transferred to their wallet, this reliance will trigger a requirement to abide by securities legislation since it can leave the purchaser exposed to insolvency risk, among other concerns.

b. Registration by Platform

Under CSA's Staff Notice 21-329, there are two primary categories of CTPs: Dealer Platforms and Marketplace Platforms. Dealer Platforms only facilitate the primary distribution of Security Tokens and they are the counterparty to every trade in Security Tokens and/or Crypto Contracts.¹⁴ Marketplace Platforms, on the other hand, provide or maintain a market or facility that brings together multiple parties to buy, sell, or trade Security Tokens and/or Crypto Contracts, and they may also take on traditional dealer functions such as holding assets.¹⁵

Some Dealer Platforms may qualify to register as an exempt market dealer if they only facilitate distributions or trading of Security Tokens in reliance on prospectus exemptions, so long as they do not offer margin or leverage.¹⁶ But generally speaking, Dealer Platforms that trade Crypto Contracts must be registered in an appropriate dealer category, as well as registering as investment dealers and obtaining IIROC membership if they trade or solicit trades for individuals.¹⁷

Marketplace Platforms, on the other hand, always operate under the oversight of the CSA and IIROC. In addition, if they conduct activities similar to those performed by Dealer Platforms they will also need the appropriate dealer registration as discussed above. In some cases, Marketplace Platforms may also require regulation as an exchange (if it regulates issuers of the securities it trades, for example).

c. Interim Period

Although CTPs are required to register with the CSA and/or IIROC subject to the specifications above, the CSA has created an interim period to facilitate the development and growth of both platform types, allowing such Platforms to test out novel business ideas before completing the formal registration process. Dealer Platforms can begin with the less stringent registration as a restricted dealer so long as they do not provide leverage or margin trading, but they must take steps during the interim period (generally about two years) to transition to the long-term regulatory framework. Similarly, Marketplace Platforms can seek registration as an exempt market dealer or restricted dealer if they can show that the process of obtaining full

¹³ Ibid.

¹⁴ Staff Notice 21-329.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Ibid.

registration and IIROC membership would impact their business development, so long as it does not offer leverage or margin and is not operating as an exchange, and subject to the same two-year caveat imposed in Ontario.¹⁸

However, it should be noted that this advice has all but expired for existing CTPs, as Platforms were obligated to contact the Ontario Securities Commission (OSC) by April 19, 2021, to discuss compliance with securities legislation, either as a Dealer or Marketplace Platform.¹⁹ The OSC has taken action against several Platforms that failed to contact them, as discussed in a subsequent section.

III. What is the logic behind this regulatory stance?

a. Rationale for regulation

In CSA/IIROC's initial Consultation Paper, they acknowledged that the novel features of CTPs can create risks to investors and capital markets if they are not regulated as traditional securities are.²⁰ However, this novelty requires flexibility and continuing adaptation, hence the development of the interim period. The goal behind this regulatory stance is not to stifle innovation but to promote investor protection and efficient markets while also embracing the benefits that new technologies can bring. The Consultation Paper highlighted several reasons that have led to CTPs being regulated as securities:

1. Investors' crypto assets must be adequately safeguarded, ensuring that processes and controls are in place to ensure that assets are protected.
2. Steps must be taken to ensure that investors' assets are not at risk in the event of the Platform's bankruptcy or insolvency.
3. Investors must be granted information about crypto assets so they can make informed investment decisions.
4. Conflicts of interest must be properly managed, and manipulative or deceptive trading deterred.
5. Cybersecurity risks must be mitigated, ensuring that Platforms are resilient against attack.²¹

As Cassels has outlined in their briefing paper, if Platforms do not take steps to address the above concerns by registering with securities regulators, investors cannot be confident that their interests are safeguarded.²²

b. Enforcement against non-compliance

Recognizing the inherent risks of failing to abide by regulations for such a nascent technology, the OSC has begun to crack down on CTPs that are not compliant with Ontario securities law. They have taken action against such Platforms who failed to contact the OSC in a timely manner to discuss steps ensuring compliance.²³ In the spring of 2021, the OSC published

¹⁸ Ibid.

¹⁹ OSC, "OSC Working to Ensure Crypto Asset Trading Platforms Comply with Securities Law".

²⁰ CSA/IIROC Consultation Paper 21-402.

²¹ Ibid.

²² Cassels, "Controlling the Crypto Craze".

²³ Ibid.

a Statement of Allegations against Polo Digital Assets Ltd., an unregistered foreign CTP that had been encouraging Canadians to use its Platform; Mek Global Limited, another Seychelles-based CTP; and Bybech Fintech Limited, based in the BVI, all three of which failed to meet the deadline to discuss requirements with the OSC. The OSC seeks orders for these entities to cease trading with Canadian purchasers, demonstrating their sincerity in upholding the regulatory framework it has established.²⁴

CONCLUSION

CTPs are any entity that facilitates the trading of crypto assets, and CTPs that offers the trading of Security Tokens or Crypto Contracts must abide by the OSCs securities regulations, subject to several exemptions. Although there is an interim period for CTPs to undertake the full registration process as per the guidelines of CSA and IIROC, any Platforms that did not reach out to the OSC in a timely fashion risk enforcement action for non-compliance. The reason for this regulatory stance is to protect investors and ensure market efficiency while promoting innovation, given the inherent risks involved in the adaptation of a new technology.

²⁴ Ibid.

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Issue 4: Are there any registration requirements that might be particularly onerous for CTPs? How might these requirements be tailored in the context of the cryptocurrency market?

Short Answer:

There are no new registration requirements specifically applicable to CTPs because CTPs are already subject to existing requirements under securities legislation.¹ However, the CSA Staff notice identifies certain requirements that will be tailored in the context of the cryptocurrency market given its unique risks.

a. CTP registration requirements depends on whether it operates as a Dealer Platform or Marketplace Platform

Existing requirements will be tailored through terms and conditions on the registration of CTPs, depending on if the CTP operates as a Dealer Platform or a Marketplace Platform. But may not be mutually exclusive and be subject to regulatory requirements under both designations

Dealer Platforms

A CPT can be characterized as a dealer platform if:²

- It only facilitates the primary distribution of security tokens and
- It is the counterparty to each trade in Securities Tokens and client orders do not otherwise interact with one another on the CTP
- The CPT are engaged in activities marketplaces typically do not undertake, including but not limited to:
 - Onboarding of retail clients onto the CTP
 - Acting as agents for clients for trades in Security Tokens
 - Offering custody of assets directly or through a 3rd party provider

Dealer platforms are generally expected to register an investment dealer and be a IIROC member unless they do not offer margin or leverage for Security Tokens. However, if a dealer platform only facilitates distributions of Security Tokens in reliance on prospectus exemptions and does not offer margin, it may be appropriate to register as an exempt market dealer or restricted dealer.³ As an exempt market dealer, a CTP cannot deal with the general public and are limited

¹ CSA staff notice 21 – 329 pg 1

² CSA staff notice 21 – 329 pg 3

³ CSA staff notice 21 – 329 pg 4

to transactions with exclusively accredited investors – this would require tailored restrictions based on the nature of the CTP’s operations and business model.⁴ Finally, existing registered firms introducing crypto assets must report such changes in their principal regulatory.

Marketplace Platforms

A CPT can be characterized as a Marketplace Platform if it:⁵

- Constitutes, maintains or provides market or facility for bringing together multiple buyers and sellers or parties to trade in Security Tokens
- brings together orders of Security Tokens and/or Crypto Contracts of multiple buyers and sellers or parties of the contracts; and
- uses established, non-discretionary methods under which orders for Security Tokens and/or Crypto Contracts interact with each other and the buyers and sellers or parties entering the orders agree to the terms of a trade.
- The CA notice confirmed that a facility acts as a marketplace if the orders of multiple buyers and sellers or parties are brought together on a third-party facility, and the interaction of those orders results in a trade

A Marketplace Platform will operate under the oversight of the CSA and a self-regulatory entity, as defined in National Instrument 21-101 Marketplace Operation (NI 21-101).⁶ The following will apply to marketplaces:

- NI 21 – 101
- *National Instrument 23-101 Trading Rules* (NI 23-101)
- *National Instrument 23-103 Electronic Trading and Direct Electronic Access to Marketplaces* (NI 23-103)
- Trading activities will also be subject to market integrity requirements in IIROC’s Universal Market Integrity Rules⁷

Generally, CPTs that are Marketplace Platforms should register as an investment dealer and seek IIROC membership unless they are regulated as an exchange.⁸ If a Marketplace Platform that conducts activities similar to a Dealer Platform, it also be subject to dealer registration requirements. If marketplace functions as an exchange, it will apply for recognition as an exchange under existing rules. It will be expected to oversee its issuers’ continuing with the listing requirements of the marketplace platform and will be subject to a public interest mandate.⁹

⁴ <https://www.blakes.com/insights/bulletins/2021/canadian-securities-regulators-deliver-bear-hug-to>

⁵ CSA staff notice 21 – 329 pg 6

⁶ CSA staff notice 21 – 329 pg 7

⁷ CSA staff notice 21 – 329 pg 7

⁸ CSA staff notice 21 – 329 pg 7

⁹ CSA staff notice 21 – 329 pg 8

Ultimately, the notice encourages CTPS to consult legal advisors whether they should be regulated as a dealer or a marketplace. If orders do not interact with each other on the CTP but rather with one counterparty (the dealer), dealer registration is likely appropriate.¹⁰

b. Although similar to securities firms, there are numerous risks in the context of CTPS regulations should be tailored to

CTPs facilitate the trading of crypto assets that are securities (Security Tokens) Instruments or contracting involving crypto assets (Crypto contracts). A key different between CTPs and traditional firms is the use of decentralized finance (DeFi) protocols. Participants can make transactions without any intermediaries at all, creating new challenges for Canadian regulators in the process.¹¹ Another difference is the role that blockchain plays in facilitating CTPs. The CSA Notice outlines ways current regulations can be tailored to address these risks.

Safeguarding investor assets where a dealer platform or marketplace has custody (private key):

A private key is used to sign transactions and prove ownership of a blockchain address.¹² It protects the user from theft and unauthorized access to funds. CSA identifies some key measures CTPs can following to manage the risk of losing assets:¹³

- maintaining policies and procedures to protect participants' assets and private keys from theft or loss, including policies and procedures governing when participants assets are placed in and removed from cold storage and how private keys are created and stored
- conducting due diligence before training a custodian
- requiring CTPs to have access to books and records and monitor the custodian's ongoing performance
- sufficient risk mitigation regarding the custody of Securities Tokens or crypto assets underlying Crypto contracts

System resiliency, integrity, and security controls

Special attention should be paid to potential system failures or inadequate protection against cyber-attacks as this may impede access assets or losses due to theft. Current marketplaces are requires to have adequate internal technology controls over trading and clearing systems by Part 12 of N1 21 – 101. These will apply to CTPs. They must also engage an external auditor to conduct an independent systems review (**ISR**) to assess whether they have adequate internal and information technology processes and controls.

Transparency about CTP's operations and crypto assets traded on the CTP

¹⁰ <https://www.mccarthy.ca/en/insights/blogs/canadian-securities-regulatory-monitor/canadian-securities-administrators-and-iiroc-release-guidance-crypto-asset-trading-platforms>

¹¹ <https://www.osler.com/en/resources/regulations/2020/new-opportunities-and-new-challenges-for-cryptoasset-trading-platforms>

¹² <https://www.investopedia.com/terms/p/private-key.asp>

¹³ CSA staff notice 21-329 pg 14

CTPs will be required to provide adequate transparency regarding, among others, its operations, fees, conflicts of interest policies and procedures and any referral arrangements on its website. This ensures participants on CTP understand its operations and can make informed decisions. Current marketplaces are required to make transparent, on its website, a description of how its orders are entered, interact and are executed, the order and trade information disseminated, and its fees. CTPs will be required to disclose similar information such as:

- A description of the crypto assets trading on the Market Place
- Custodial arrangements and risks
- Conflict of interests i.e especially if the operator will trade on the marketplace against clients' orders
- Rules for trading i.e for choosing with crypto assets will be admitted to or removed from the platform

Market integrity and price discovery

This refers to risks that marketplace platform may be susceptible to deceptive trading that results from the lack of reliable pricing information for crypto assets or fraudulent activity by participants buying/selling crypto assets. N1 21-101 and NI 23-101 set out overarching securities laws Trading rules applicable for a CTP marketplace platform trading securities tokens or crypto contracts are the requirements in UMIR. However, the CSA recognizes that there may be risks not contemplated under UMIR. Thus, broad provisions prohibiting manipulating and deceptive activities apply and other rules would be crafted related specifically to trading securities tokens and crypto contracts.

Direct access by retail investors

If CTPs onboard retail investors directly, there is a risk investors may purchase or trade products that they do not understand. CTPs may also be exposed to participants who are using Marketplace Platform for money laundering – they will be expected to have appropriate anti-money laundering and counter-terrorist financing policies.

Conflict of interest

CTPs may have conflict of interest from commercial interests of the CTPs, its owners and the business that raise capital on the CTP. They will be required to identify, manage and disclose conflicts of interests subject to provisions in N1 31-103 or N1 21-101.

CTPs and Registration Requirements: What are the Consequences and Risks of not Registering? What are the Risks for CTPs? For Investors?

February 7, 2022

Background

The cryptocurrency industry has seen a dramatic rise in popularity over the past several years, with more than \$2-trillion (USD) currently invested in crypto assets globally.¹ This increase in popularity has been accompanied by a proliferation in the number of platforms that allow users to trade crypto assets, known as crypto asset trading platforms (CTPs).²

On March 29, 2021, the Canadian Securities Administrators (CSA) and the Investment Industry Regulation Organization of Canada (IIROC) published a joint Notice to provide guidance on how Canadian securities legislation applies to CTPs.³ On the same day, the Ontario Securities Commission (OSC) released a statement affirming the guidance issued in the CSA/IIROC Notice, and demanded that CTPs must contact the OSC by April 19, 2021 to begin compliance talks.⁴ The OSC warned that for CTPs that failed to initiate discussions by April 19, 2021, steps would be taken to enforce the applicable requirements under Ontario securities law.⁵

¹ David Milstead, “Ontario Issues Warning Over Crypto Trading Platform Binance” (30 December 2021), online: *The Globe and Mail* <<https://www.theglobeandmail.com/business/article-ontario-issues-warning-over-crypto-trading-platform-binance/>>.

² Lara Jackson, Robert Sniderman & Kiyan Jamal, “Controlling the Crypto Craze: The OSC’s Response to the Growing Crypto Market” (24 June 2021), online: *Cassels* <<https://cassels.com/insights/controlling-the-crypto-craze-the-oscs-response-to-the-growing-crypto-market/>>.

³ Canadian Securities Administrators (CSA) & Investment Industry Regulatory Organization of Canada (IIROC), “Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements” (29 March 2021) at 1, online (pdf): *Ontario Securities Commission* <https://www.osc.ca/sites/default/files/2021-03/csa_20210329_21-329_compliance-regulatory-requirements.pdf>.

⁴ Ontario Securities Commission (OSC), “OSC Working to Ensure Crypto Asset Trading Platforms Comply with Securities Law” (29 March 2021), online: *Ontario Securities Commission* <<https://www.osc.ca/en/news-events/news/osc-working-ensure-crypto-asset-trading-platforms-comply-securities-law>>.

⁵ *Ibid.*

Many CTPs operate under a custodial model, where users create an account into which they can deposit fiat currency in order to purchase crypto assets, which are credited to their account.⁶ This account is controlled by the CTP (meaning the CTP has custody over the credited crypto assets) and users must request a withdrawal in order to take possession of the crypto assets.⁷ While crypto assets themselves may not be considered securities, the OSC, along with the CSA and IIROC, have taken the position that a user's contractual right to the crypto asset may constitute a security or derivative and therefore fall under securities legislation.⁸

Two key questions to analyze in light of these announcements are (1) what are the risks and consequences for CTPs who fail to register? And (2) what are the risks for investors who are users of non-compliant CTPs?

The Risks of not Registering for CTPs

The OSC's emphasis on enforcing securities legislation on CTPs who failed to meet the April 19, 2021 deadline brings substantial risks and consequences for non-compliant CTPs. To date, the OSC has launched proceedings against four non-compliant CTPs: Poloniex, KuCoin, Bybit and Aux Cayes. While none of these CTPs are domiciled in Canada, each platform is alleged to have continued providing services to Ontario residents despite not initiating compliance discussions.⁹ All four of these CTPs operate under the custodial model mentioned earlier, where

⁶ Jackson, Sniderman & Jamal, *supra* note 2.

⁷ *Ibid.*

⁸ Zain Rizvi, Geoffrey L. Rawle & Shane Freedman, "Ignore at your own Risk: OSC Accuses Crypto Exchange Poloniex of Disregarding Securities Laws" (4 June 2021), online: *Davies* <<https://www.dwpv.com/en/Insights/Publications/2021/OSC-Takes-Action-Against-Poloniex>>

⁹ Ontario Securities Commission (OSC), "In the Matter of Polo Digital Assets, Ltd.: Statement of Allegations" (25 May 2021) at paras 15-16, online (pdf): *Ontario Securities Commission*

<https://www.osc.ca/sites/default/files/2021-05/soa_20210525_polo-digital.pdf> [*Poloniex*].

Ontario Securities Commission (OSC), "In the Matter of Mek Global Limited and PhoenixFin Pte.: Statement of Allegations" (7 June 2021) at paras 17-18, online (pdf): *Ontario Securities Commission*

<https://www.osc.ca/sites/default/files/2021-06/soa_20210607_mek-global.pdf> [*KuCoin*].

the CTP maintains custody of the crypto assets and users having a contractual right to take possession of the crypto assets by requesting a withdrawal.¹⁰ The OSC alleges in each Statement of Allegations that while each CTP “purports to facilitate trading of the crypto assets in its investors’ accounts, in practice, [the accused CTP] only provides its investors with instruments or contracts involving crypto assets. These instruments or contracts constitute securities and derivatives.”¹¹

In terms of punitive measures, the OSC issued an identical list of orders sought for each of the four accused CTPs. These orders read as follows:¹²

1. That [the accused CTP] cease trading in any securities or derivatives permanently or for such period as is specified by the Commission, pursuant to paragraph 2 of subsection 127(1) of the Act;
2. That [the accused CTP] be prohibited from acquiring any securities permanently or for such period as is specified by the Commission, pursuant to paragraph 2.1 of subsection 127(1) of the Act;
3. That any exemptions contained in Ontario securities law not apply to [the accused CTP] permanently or for such period as is specified by the Commission, pursuant to paragraph 3 of subsection 127(1) of the Act;

Ontario Securities Commission (OSC), “In the Matter of Bybit Fintech Limited: Statement of Allegations” (21 June 2021) at paras 15-16, online (pdf): *Ontario Securities Commission* <https://www.osc.ca/sites/default/files/2021-06/soa_20210621_bybit.pdf> [Bybit].

Ontario Securities Commission (OSC), “In the Matter of Aux Cayes Fintech Co. Ltd.: Statement of Allegations” (19 August 2021) at para 14, online (pdf): *Ontario Securities Commission* <https://www.osc.ca/sites/default/files/2021-08/oth_20210819_Aux_Cayes_Fintech_Co_Ltd.pdf> [Aux Cayes].

¹⁰ *Ibid* at paras 9-12 [Poloniex], paras 11-14 [KuCoin], paras 9-12 [Bybit] and paras 8-11 [Aux Cayes].

¹¹ *Ibid* at para 12 [Poloniex], para 14 [KuCoin], para 12 [Bybit] and para 11 [Aux Cayes].

¹² *Ibid* at paras 20-28 [Poloniex], paras 22-30 [KuCoin], paras 20-38 [Bybit] and paras 18-26 [Aux Cayes].

4. That [the accused CTP] be reprimanded, pursuant to paragraph 6 of subsection 127(1) of the Act;
5. That [the accused CTP] be prohibited from becoming or acting as a registrant, as an investment fund manager or as a promoter permanently or for such period as is specified by the Commission, pursuant to paragraph 8.5 of subsection 127(1) of the Act;
6. That [the accused CTP] pay an administrative penalty of not more than \$1 million for each failure to comply with Ontario securities law, pursuant to paragraph 9 of subsection 127(1) of the Act;
7. That [the accused CTP] disgorge to the Commission any amounts obtained as a result of noncompliance with Ontario securities law, pursuant to paragraph 10 of subsection 127(1) of the Act;
8. That [the accused CTP] pay the costs of the Commission investigation and the hearing, pursuant to section 127.1 of the Act; and
9. Such other orders as the Commission considers appropriate in the public interest.

Two key takeaways from these orders are the financial penalties and the present and future bans on operating in Ontario. In terms of financial penalties, order 6 notes that each accused CTP must pay an administrative fee of not more than \$1 million for each failure to comply with Ontario securities law. While the OSC does not define what constitutes “each failure to comply”, it is possible that each purchase, sale or trade made on the CTP could constitute a “failure to comply” and could therefore lead to significant financial levies.¹³ In regard to present and future bans, orders

¹³ Rizvi, Rawle & Freedman, supra note 8.

1-3 and 5 suggest that the OSC is trying to prevent the four accused CTPs from operating in Ontario at any point in the future.¹⁴

It is clear from the OSC's actions and statements that they are committed to bringing all CTPs operating in Ontario into compliance with Ontario securities law, regardless of the country of origin of the CTP. Furthermore, from the four actions that the OSC has launched so far, it is clear that non-compliant CTPs risk facing significant financial penalties and possibly permanent bans from operating in Ontario.

The Risks for Investors who use Non-Compliant CTPs

One of the primary motivations for the OSC's recent crackdown on non-compliant CTPs is that they may expose Ontario investors to unacceptable levels of risk. The CSA/IIROC Notice specifically singled out custodial platforms as being particularly risky.¹⁵ Where a custodial CTP is not compliant with securities law, the underlying assets held by the CTP could be inadequately safeguarded and expose investors to potential loss, theft and misuse of their assets.¹⁶ The increased risk that non-compliant custodial platforms may place on investors could suggest why the OSC has exclusively filed actions against CTPs operating under this model.

More generally, compliant CTPs would be required to have proper system resiliency and security controls to protect against cyber-attacks, offer investors transparency about the CTPs operations and the crypto assets traded on the CTP, and have protections against manipulative and deceptive trading.¹⁷ On these key issues, unregistered CTPs may have inadequate controls, or they may be non-existent altogether. These risks may be especially pertinent for crypto assets, with

¹⁴ *Ibid.*

¹⁵ CSA & IIROC, *supra* note 3 at 14.

¹⁶ OSC, *supra* note 4.

¹⁷ CSA & IIROC, *supra* note 3 at 15-16.

Gary Gensler, Chairperson of the SEC, warning investors that the industry is “rife with fraud, scams and abuse.”¹⁸

There are currently six CTPs registered in Ontario: Wealthsimple, Coinberry, Netcoins, Coinsmart, Fidelity and Bitbuy.¹⁹ While more CTPs may be approved in the future, investors would be wise to invest their crypto assets with these platforms in order to adequately protect themselves and their assets from the many risks that unregistered CTPs pose.

¹⁸ Milstead, *supra* note 1.

¹⁹ *Ibid.*



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