

INVESTOR ADVISORY PANEL

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

The members of the Ontario Securities Commission's Investor Advisory Panel (IAP) wish to thank the Canadian Securities Administrators (CSA) and the Investment Industry Regulatory Organization of Canada (IIROC) for this opportunity to comment on how regulatory requirements may be tailored for crypto-asset trading platforms (Platforms) operating in Canada.

The IAP is an initiative by the Ontario Securities Commission to enable investor concerns and voices to be represented in its rule and policy making process. In this capacity, we welcome the proposed regulatory framework for crypto-assets and the focus that has been placed on investor protection in key areas such as custody and verification of assets, price determination, market surveillance, systems and business continuity planning, conflicts of interest, crypto-asset insurance, and clearing and settlement.

The regulatory imperative in light of crypto-assets' uncertain nature

As the consultation paper notes, every crypto-asset is unique, with its own features, attributes, use and value. Consequently, it is difficult to determine whether all crypto-assets are securities. Yet even if a crypto-asset does not fall within the definition of a security, the investor's contractual right to the crypto-asset may constitute a security or derivative; and we believe many investors who trade crypto-assets hold them as if they were securities and would look to the CSA and IIROC if their investments went missing.

For this reason, the IAP fully supports the creation of a sound regulatory framework to govern the exchanges and marketplaces on which investors may trade crypto-assets. We believe it is incumbent upon securities regulators to fashion rules that help protect investors with this emerging asset class while also regulating these new types of marketplaces that are emerging.

We are mindful that overzealous regulation could, inadvertently, encourage these exchanges to go underground and thereby deprive retail investors of any protection and transparency. However, we believe an appropriate and proportionate level of smart regulation can be implemented that will allow innovative firms to succeed in their development stages while adequately protecting investors – and this, in turn, will serve to increase the confidence investors and other market participants have in crypto-assets and the Platforms.

Safeguards for investors

To accomplish these important goals, we strongly support the development of robust rules in the following areas:

Transparency and disclosure

There should be transparency and disclosure of key information so that investors know what they are buying and holding. Key information about each crypto-asset should be provided, including features, attributes, use, value, risk factors, and method of valuation. At the same time, key information about the platform also should be provided, such as operations behind a trade (including how orders are entered and executed and the applicable fees), the order and trade information for crypto-assets traded on the Platforms, and corporate governance.

This level of disclosure will help investors make better-informed decisions to determine:

- Whether crypto-assets are suitable investments compared to other investment vehicles;

- The investor’s preferred crypto-asset(s), given the wide range of features, attributes, use, value and risk factors that are available; and
- The Platform that would be the most suitable place to conduct trades and store the assets.

A robust regulatory framework for custodians

The custodian of the asset(s) must itself be subject to a robust regulatory framework covering both custody and verification of assets. Custodians must be required to follow industry best practices for keeping assets secure, including:

- Maintaining a majority of the crypto-assets in offline cold storages;
- Stringent withdrawal protocols including fragmentation of private keys and quorum of designated individuals to transfer crypto-assets;
- Regular back-ups of key information;
- Appropriate operational policies and procedures around the technology that establishes checks and controls against various risks, such as insider theft and hacks; and
- Verification of assets and reporting by an independent third-party.

Protection from insolvency

Safeguards are needed to protect investors in case of insolvency of any of the parties to the transaction. Client assets must be segregated from the Platform’s assets and provided with a layer of protection to ensure the client assets can be returned in case the Platform becomes insolvent. Also, in the event of insolvency, technology controlling custody of crypto-assets must allow appropriate parties to retrieve the clients’ property.

Third-party verification

All Platforms must have appropriate operational policies and procedures regarding conflict of interest, fair access, insider theft, etc. Perhaps more importantly, independent third parties must provide verification of such internal processes and procedures.

Traditionally, the steps of a trade execution process have been divided among various parties, such as exchange/ATS, dealer, custodian, and clearing agency. One of the dangers with crypto-asset trading is that the Platforms are involved in all aspects of the trade and, therefore, a greater risk of delay in detecting insider fraud exists.

This concern is heightened by the fact that the Platforms generally do not need the majority of their crypto-assets to carry out their day-to-day operations. Instead, crypto-asset balances are often shifted from one user account to another user account, all

within the Platform's internal ledger. In other words, the balance does not actually move from wallet to wallet, but all transactions generally occur within the Platform's own wallets. In practice, this means that even if a Platform is missing crypto-assets, this fact may not be evident to an investor, as there would be no impact on the day-to-day operations of the Platform.

Introducing independent third parties into the process as verifiers will increase the probability of detecting insider fraud earlier. For example, auditors can verify that the assets are actually segregated and that proper controls and processes are being followed.

Regulatory approaches in other jurisdictions

The third consultation question asks whether there are other jurisdictions whose regulatory framework Canada should consider. With regard to crypto-assets, we believe Australia and Japan provide models worth examining, as follows:

Australia

It is our understanding that Australia imposes two different registration requirements for Platforms:

- If the Platform facilitates the trading of crypto-assets that are considered securities, the exchange needs a market license from the Australian Securities and Investment Commission.
- If the Platform converts fiat currencies into digital currencies or vice versa, it must also be registered with the Australian Transaction Reports and Analysis Centre, regardless of whether the crypto-assets are securities.

Obligations imposed on such Platforms include anti-money laundering requirements, customer due diligence, know your customer measures, reporting of suspicious and other reportable transactions, and record keeping.

Japan

To operate in Japan, Platforms must be registered with the Financial Services Agency. In addition, a self-regulatory body has been created called the Japanese Virtual Currency Exchange Association.

It is currently in the process of developing rules and regulations.

Various obligations imposed on Platforms in Japan include establishing security systems to protect information, providing information regarding fees and other terms to their customers, and segregating customers' crypto-assets from the Platform's crypto-assets. The Platforms also are required to have certified public accountants or accounting firms

review and verify the segregation of crypto-assets. We believe these robust regulatory requirements are worth considering, in the context of this CSA/IIROC joint initiative.

Conclusion

As the evolving crypto-asset space continues to involve new investors and other market participants, securities regulators must strive to follow international best practices and understand how technological changes and new innovations need to be regulated and incorporated into the securities regulatory framework.

This will require regulators to continually build knowledge and capacity to stay on top of technological innovation and understand its potential impact on investor outcomes and vulnerabilities.

Again, thank you for the opportunity to participate in this consultation. Please let us know if you require clarification of our comments or any further information.

Sincerely,

A handwritten signature in blue ink, appearing to read "Neil Gross".

Neil Gross
Chair, Investor Advisory Panel