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Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Joint Consultation Paper 21-402: Proposed Framework for Crypto-Asset Trading Platforms

Comments from the National Crowdfunding & Fintech Association of Canada (NCFA)

Introduction

The NCFA welcomes this consultation. We are in favour of the regulation of crypto asset platforms as long regulation is:

- principles based and outcomes focused,
- proportionate,
- risk based,
- not unduly limiting of innovation and competition,
- consistent with global regulation and international best practices,
- fully harmonized across Canada, and
- technology neutral to the extent reasonably possible.

Whether Platforms are trading securities or not, they should be covered by KYC/AML/CFT legislation. Apart from that, regulators should be nimble yet cautious as global approaches remain unclear and the landscape remains unsettled. We also know that overly prescriptive regulation can severely limit innovation and competition. At this stage, less is more.

Questions:

1. Are there factors in addition to those noted in Part 2 that we should consider?

- We have nothing to add to the remarks of other commenters.

2. What best practices exist for Platforms to mitigate the risks outlined in Part 3? Are there any other significant risks which we have not identified?

- ASIFMA Best Practices for Digital Asset Exchanges June 2018

(<https://www.lw.com/thoughtLeadership/ASIFMA-best-practices-digital-asset-exchanges>)

- Cryptocurrency security standard (<https://cryptoconsortium.github.io/CCSS/Details/>)

- <https://www.bitcoinmarketjournal.com/ico-investment-best-practices/>

- ISDA CDM on representing derivatives trade events and processes

(<https://www.isda.org/2019/03/20/isda-publishes-cdm-2-0-for-deployment-and-opens-access-to-entire-market/>)

The risks have been highlighted in the CP, but we think that regulators should give equal status to the opportunities (as well as the threats) – for example: democratisation of investment opportunities, the advantages that come from dis-intermediation, more product/services innovation and efficiencies, access to wider sources of capital, more liquidity, and so on.

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

- We prefer the less restrictive and prescriptive (and more supportive and collaborative) approaches in

the United Kingdom and Germany, which are clearly working.

4. What standards should a Platform adopt to mitigate the risks related to safeguarding investors' assets? Please explain and provide examples both for Platforms that have their own custody systems and for Platforms that use third-party custodians to safeguard their participants' assets.

- Market participants have responded to this question. Standards should vary depending on the size, functions, risks, etc of each Platform. Each platform should have a duty to protect the digital assets, security of its users, and their data; however following regulatory standards through on-boarding should remain the responsibility of the custodian(s) of capital.

- We note that for permissioned/centralized issues, there is lower custody risk as the issuer can freeze when potential threats occur, burn and reissue if the threat is confirmed.

5. Other than issuance of Type I and Type II SOC 2 Reports, are there alternative ways in which auditors or other parties can provide assurance to regulators that a Platform has controls in place to ensure that investors' crypto-assets exist and are appropriately segregated and protected, and that transactions with respect to those assets are verifiable?

- For a period of time, finding enough competent internal and external auditors or other sources of assurance may be tough. We assume that CSA is collaborating with the relevant accounting and auditing bodies in Canada and internationally on education and standards. It may be that auditors will need to retain the support of skilled persons to provide them with the necessary confidence to sign off on the Reports, or should perhaps be able to rely on an ISR. The comments of the CPA in this consultation are helpful. Auditors may also collect a list of "best practices" to understand what common virtual checklists may include throughout the vetting/assurance of a Platform.

- Having said that, we understand that some auditors are today offering these services in Canada and are competent to do so.

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 the Platforms holding or storing crypto assets on their behalf?

- These questions are better answered by market participants, but one obvious benefit is that holding or storing crypto (safely) should reduce the costs (and risks) of moving the assets on and off the Platform.

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

- We suggest that regulators should usually leave this question to the market, subject to full disclosure and regulatory and audit oversight.

8. Are there reliable pricing sources that could be used by Platforms to determine a fair price, and for regulators to assess whether Platforms have complied with fair pricing requirements? What factors should be used to determine whether a pricing source is reliable?

- Market participants have responded to this question in this consultation.

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?

- Yes, subject to regulatory access and oversight, where the activities are relatively straightforward, and the Platforms are relatively small and low risk. As the risks increase, so will the regulatory requirements and oversight. Platforms that have a built in trust systems (eg, smart contracts) or hashes of transactions, or any other type of verifiable audit trail will require less oversight as their process will be more transparent.

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

- This question is best answered by market participants.

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?

- This question is best answered by market participants.

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?

- Yes (dis-intermediation, global reach, speed, highly technical nature of the business, security issues, anonymity of wallets – FATF guidance on a risk-based approach for the regulation of virtual asset service providers is coming, and FinCEN is here – <https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf>. Recent FINTRAC Guidance on the Interpretation of Money Services Business is also broadly helpful.

13. Under which circumstances should an exemption from the requirement to provide an ISR by the Platform be appropriate? What services should be included/excluded from the scope of the ISR? Please explain.

- Once again, it depends on the risks to the regulatory objectives. Each situation must be evaluated on its own facts.

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

- As above, question 13.

15. Are there particular conflicts of interest that Platforms may not be able to manage appropriately given current business models? If so, how can business models be changed to manage such conflicts appropriately?

- None that we are aware of.

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

- Platforms should obtain insurance that is adequate/ appropriate. The appropriate nature and extent of the insurance will vary with the circumstances, taking into account the nature of the risks, other forms of risk transfer and risk mitigation mechanisms used, whether an insured custodian is involved, etc.

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

- Yes. Most insurers and brokers have inadequate experience with crypto assets, cyber security, DLT, etc, so insurance cover (if available at all) is unlikely to be wholly adequate at this time and may cost too much. CSA guidance might be helpful here, drawing on global sources. (We note the more positive comments in the submission of the Wall Street Blockchain Alliance.)

- One option is to start with eg D&O insurance and add to that as the insurers become more confident.

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

- Yes. EG, security bonds, guarantees, letters of credit, catastrophe bonds (being used in an ever widening variety of situations), ring-fenced capital, investor's own insurance, an industry fund.

19. Are there other models of clearing and settling crypto assets that are traded on Platforms? What risks are introduced as a result of these models?

- We agree with what CSA/IIROC propose in this section.

- We understand that in a permissioned/centralized Platform, which will be standard for all regulated securities exchanges, clearing and settlement will be instant, enabled by initial security token programming (assuming that the AML/KYC requirements are met by both the seller and the buyer).

20. What, if any, significant differences in risks exist between the traditional model of clearing and settlement and the decentralized model? Please explain how these different risks could be mitigated.

- There are increased risks in a decentralized model, but it appears that these can be mitigated. It is crucial that the programming of the securities ensures that CFT/AML/KYC requirements will be met.

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

- Best answered by market participants.

22. What regulatory requirements (summarized at Appendices B, C, and D), both at the CSA and IIROC level, should apply to Platforms or should be modified for Platforms? Please provide specific examples and the rationale.

- This would be an enormous (but valuable) exercise which the NCFE is not resourced to perform. We support calls for a collaborative ongoing discussion about this (and regulation generally) among regulators and market participants.

Sincerely

Craig Asano, CEO
On behalf of NCFE

About NCFA

The **National Crowdfunding & Fintech Association** (NCFA Canada) is a financial innovation ecosystem that provides education, market intelligence, industry stewardship, networking and funding opportunities and services to thousands of community members and works closely with industry, government, partners, and affiliates to create a vibrant and innovative fintech and funding industry in Canada. For more information, please visit: ncfacanada.org