OSC Refuses Prospectus Receipt for Bitcoin Fund

March 27, 2019

On February 15, 2019, the Director of the Ontario Securities Commission (OSC) published a letter (Letter) outlining his view on the issuance of a receipt to 3iQ Corp. (Manager) for a preliminary prospectus in respect of The Bitcoin Fund (Fund). This filing raised the issue of whether a non-redeemable investment fund (NRIF) that would invest substantially all of its assets in bitcoin should be offered to retail investors. The OSC refused to issue a receipt, citing the lack of established regulation for the bitcoin market, which the director believed raised investor protection issues regarding the valuation, safeguarding and liquidity of bitcoin.

Facts

The Fund proposed to invest in long-term holdings of bitcoin purchased from various sources, including bitcoin exchanges. The investment objective of the Fund was to seek to provide investors with: (i) exposure to bitcoin and the daily price movements of the U.S. dollar price of bitcoin; and (ii) the opportunity for long-term capital appreciation.

As an NRIF, investors would have limited redemption rights —*i.e.*, the right to redeem annually at net asset value (NAV) or monthly at a discount to NAV. Cidel Trust Company, the proposed custodian of the Fund, indicated that it did not have the capacity to hold bitcoin, and intended to appoint a sub-custodian to do so.

OSC Submissions

The OSC refused to issue a receipt on the basis that: (i) it was not in the public interest to do so; and (ii) the Fund's prospectus did not comply in a substantial respect with the requirements of the *Securities Act* (Ontario) (Act) or the regulations.

Public Interest

The OSC outlined several reasons as to why it would not be in the public interest to issue a receipt for the prospectus of the Fund.

In particular, staff of the Investment Funds and Structured Products Branch of the OSC (Staff) expressed concerns about the nature and nascent stage of development of the

bitcoin market, which make it an unsuitable investment for a retail investment fund. Staff believed there is a lack of established regulation for the bitcoin market, as well as uncertainty over its treatment by financial institutions. As well, Staff believed the bitcoin market is inherently vulnerable to market abuse and manipulative behaviours, as well as cybercrime and fraudulent activity.

The OSC also commented on the investor protection issues raised because bitcoin trades across several platforms. In particular, the OSC addressed issues of price discovery and manipulation, noting that manipulation on less reputable exchanges would have a direct impact on the price of bitcoin on more reputable exchanges or that provided by OTC counterparties.

The OSC found that the Manager had not provided sufficient comfort regarding the safety and security of the bitcoin assets to be held by the Fund. Staff cited concerns regarding the ability of the sub-custodian to provide certain customary assurance reports that would enable the Fund to file its annual audited financial statements, as required by National Instrument 81-106*Investment Fund Continuous Disclosure*(NI 81-106). Such reports would serve as confirmation of the existence, ownership and internal controls over the bitcoin assets held by the sub-custodian.

Finally, Staff concluded that the Fund had not taken sufficient steps to protect investors from the potential loss associated with its bitcoin assets, as the custodian would not assume liability for the sub-custodian in the event of loss of the assets, and neither the custodian nor the sub-custodian would have insurance for any bitcoin asset held offline in cold storage.

Compliance with the Act and the Regulations

It is Staff's view that bitcoin is an "illiquid asset" as defined in National Instrument 81-102*Investment Funds*(NI 81-102), as it "does not trade on market facilities on which public quotations in common use are widely available." As the Fund intended to invest substantially all of its assets in bitcoin, Staff found that it would not comply with the 20 per cent limit on investments in illiquid assets.

Manager Submissions

Public Interest

The Manager noted that bitcoin and other cryptocurrencies are already readily available to retail investors, both directly and through securities of issuers that have bitcoin or other cryptocurrencies as their primary assets and that have completed reverse takeovers of shell issuers on the TSXV. The Manager maintained that it sought to provide a safer method through which to acquire and dispose of bitcoin through a professionally managed and regulated investment fund.

As well, the Manager submitted that any risk associated with trading bitcoin would be mitigated by the Fund. The Manager proposed to conduct due diligence on each bitcoin source to evaluate its reputation and stability, with a view to achieving best execution for the Fund. Certain other controls would also be implemented, including: (i) review and approval by the Manager of each bitcoin order; (ii) immediate transfer of the bitcoin by the custodian to cold storage and allocation of the bitcoin to the Fund's account on a

segregated basis; (iii) trading limits to ensure no bitcoin comes from a wallet associated with illicit activity or from dark or money laundering sites; and (iv) use of forensic software to identify entries that are known to be linked to illicit or illegal activity. The Manager noted that it intended to purchase financial compliance software to review each bitcoin source and to block any transaction from countries subject to economic sanctions.

The Manager argued that while the volatility of bitcoin is not higher than other asset classes, there is no restriction against an investment fund investing in a volatile asset.

The Manager planned to value its bitcoin investments based on the MVIS CryptoCompare Bitcoin Index. The Manager also maintained that the Fund's assets would be held appropriately, as: (i) the proposed custodian meets the requirements of Part 6 of NI 81-102; (ii) there is no requirement for the custodian or the sub-custodian to provide the assurance reports referenced above; (iii) insurance against loss of bitcoin held offline in cold storage is not currently available on commercially reasonable terms, nor is obtaining such insurance consistent with industry practice for custodians of bitcoin; and (iv) the prospectus of the Fund contains clear disclosure regarding the risk of loss and lack of insurance.

Finally, the Manager expected that it would be able to file the audited annual financial statements required under NI 81-106 and that the auditor would be able to provide an unqualified audit report on receipt of available documentation from the sub-custodian, although it is unclear whether that includes the assurance reports.

Compliance with the Act and the Regulations

The Manager argued that a receipt for the prospectus of the Fund should not be refused, as bitcoin is not an "illiquid asset" as defined in NI 81-102. The Manager noted that its bitcoin sources have reported high daily trading volumes and liquidity expectations. It was further noted that the definition of "illiquid asset" does not specify that the "market facilities" through which liquid portfolio assets are readily disposable must be regulated "marketplaces."

Decision

As stated above, the director refused to issue a receipt for the prospectus of the Fund. He acknowledged the importance of innovation in publicly offered investment funds, but did not believe that the operational risks and investor protection issues arising from the Fund's investments would be adequately managed by the Manager's processes and controls for the operation of the Fund.

The director agreed with Staff's submissions relating to the valuation of the Fund's assets, maintaining the importance of appropriate valuation as a means to benchmark the trading price of units of the Fund on an exchange, determine the price at which investors can redeem their investment and act as an input in certain aspects of the Fund, including the management fee.

He also accepted Staff's submissions relating to the safeguarding of Fund assets to the extent that the sub-custodian is unable to provide the assurance reports. He was concerned that an investment in the Fund presents a novel and unacceptable risk in the

absence of these reports and insurance against the risk of loss of bitcoin held in cold storage. He also raised issues of the Manager retaining a sub-custodian that does not meet the requirements under Part 6 of NI 81-102, noting that he would need to consider whether the associated risks could be sufficiently mitigated.

The fact that the auditor would be unable to provide an unqualified opinion on the Fund's annual financial statements in accordance with NI 81-106 without receiving the assurance reports from the sub-custodian was also a concern. As a result, the director believed there was a material risk that the Fund would not be able to file its audited annual financial statements. He noted that the audit experience of pooled funds investing in bitcoin may serve as useful information regarding these challenges.

Lastly, he agreed with Staff that bitcoin is an illiquid asset. He believed that the term "market facilities" implies "some form of established and mature trading facility or network," which does not yet exist for bitcoin.

Implications

On March 15, 2019, the Manager filed an application for hearing and review of this decision. In its application, the Manager asserts that the OSC has set more onerous standards for the Fund than those applicable to other investment funds, particularly with respect to valuation, custody and liquidity. The Manager also maintains that it is in the public interest to provide investors with access to bitcoin assets through a regulated investment fund. A public hearing will be held on April 3, 2019, which will provide clarity on these matters. However, it may be some time before a publicly offered bitcoin fund is available in Canada.

Contact Us

If you have any questions about the decision or cryptocurrency funds, please contact one of the authors of this bulletin or any other member of BLG's Cryptocurrency and Blockchain Group. Our Cryptocurrency and Blockchain Group leverages BLG's expertise in legal areas, such as investment management, corporate finance, derivatives and fintech, to provide advisory and transactional support right from the start.

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