Crypto Asset Issuer Guidance from the CSA – The information investors need

March 22, 2021

On March 11, 2021, the Canadian Securities Administrators (the CSA) published Staff Notice 51-363 Observations on Disclosure by Crypto Assets Reporting Issuers (the Staff Notice). The Staff Notice provides an outline of key observations of, and guidance by, the CSA to improve the quality of disclosure provided in annual filings of reporting issuers (other than investment funds) that engage materially with crypto assets by mining and/or holding or trading those assets. Additionally, the Staff Notice provides guidance to issuers on navigating certain complex disclosure, accounting and auditing issues.

Key Takeaways

Based on the guidance provided by the CSA, issuers should consider the following key takeaways:

- **Control, control, control** – If issuers hold crypto assets, disclosure relating to how those assets are held, including any assets held through a third party custodian or through a crypto asset trading platform, is likely material to investors. Issuers are expected to provide investors with information they need to understand the risks relating to solvency, integrity and proficiency of the other parties that hold and control an issuer's crypto assets.
- **Investment fund rules may apply** – If a material aspect of an issuer's business is investing in crypto assets and such issuer does not have other substantial operations, certain investor protection considerations that apply to investment funds may also apply.
- **Reporting and disclosure rules apply** – Issuers must consider whether changes or events relating to their cryptocurrency mining activities, holding of crypto assets or other aspects of their business may be material and require immediate disclosure to the market in accordance with continuous disclosure requirements. Issuers will also be expected to disclose risk factors that are specific and sufficiently tailored to the risks that relate to that issuer and its business. Additionally, issuers are expected to refrain from making unsubstantiated material claims about the issuer's business and the corresponding opportunity to profit by investing in the issuer.

- **Financial oversight** – Given the complex accounting and disclosure issues associated with the crypto asset industry, issuers are encouraged to monitor and carefully consider any guidance published by accounting standard setters and regulatory bodies.
- **Payments in crypto assets** – Settling contracts through payment of cryptocurrency, particularly with related parties, requires robust financial controls and disclosure in notes to financial statements and an issuer's management's disclosure & analysis document.

CSA Observations and Guidance

The Staff Notice outlines the disclosure expectations for issuers in the following key areas.

1. Safeguarding crypto assets

Any control adopted by issuers to guard against the risk of loss and/or theft associated with holding crypto assets is a material risk that an investor would want to know. While the appropriate controls for a given issuer will vary depending on the size, type and quantity of crypto assets held, and on the frequency for which such crypto assets are moved or liquidated, CSA staff offer the following guidance:

- For issuers that self custody their crypto assets, the expectation is that they:
  - put in place controls such as multi-signature access for digital wallets, safeguarding of private keys, use of "cold wallets" and/or frequent monetization of crypto assets into fiat currency, and
  - disclose (i) the reasons for not retaining a third-party custodian, and (ii) the details relating to any controls implemented to protect their crypto assets, such as whether multi-signature wallets are used, how private keys are safeguarded, insurance for the crypto assets (and any exclusions under applicable policies), measures taken to mitigate cyber security risks, and the frequency of monetization.
- For issuers that retain third-party custodians to safeguard all or a substantial portion of their crypto assets, the expectation is that details about the custodial arrangement is material information that should be disclosed to investors, and such disclosure should include the following:
  - the identity and location of the third-party custodian and sub-custodian(s) (if one has been appointed by the custodian);
  - a general discussion of the services provided by the custodian (*e.g.*, is the custodian a payment processor or just responsible for holding/ safeguarding the crypto assets);
  - whether the custodian is a Canadian financial institution or a foreign equivalent, and if so, by whom the custodian is regulated;
  - whether the issuer is aware of anything with regards to the custodian's operations that would adversely affect the issuer's ability to obtain an unqualified audit opinion on its audited financial statements;
  - whether the custodian is a related party of the issuer;
  - the quantity or percentage of the issuer's crypto assets held by the custodian as at each reporting period end date;

- whether the crypto assets held by the custodian are insured and any limitations on the custodian's liability in the event of the loss or theft of the issuer's crypto assets;
- any known security breaches or other similar incidents involving the custodian as a result of which crypto assets have been lost or stolen;
- the treatment of the assets in the event of an insolvency or bankruptcy of the custodian; and
- if the custodian operates in a foreign jurisdiction, what due diligence the issuer has performed on the custodian (including the issuer's ability to effectively monitor the custodian and execute contingency plans and exit strategies with minimal impact on the issuer's operation).

Additionally, such issuers are expected to consider whether a custodial arrangement is a material contract, and whether the execution of such agreement or a change of custodian constitute a material change (see additional guidance under "Material changes" below).

2. Use of crypto asset trading platforms

Certain issuers hold their crypto assets through crypto asset trading platforms and therefore, do not hold the private key or have control over their assets. Typically, an account through a crypto asset trading platform represents a contractual claim against the trading platform, and as a result, exposes the issuer to risks related to solvency, integrity and proficiency of operators of the platform. To mitigate those risks, CSA staff expect that issuers' disclosure address, at a minimum, all of the items referenced above under "Safeguarding of Crypto Assets" relating to third-party custodians.

3. Description of business

Continuous disclosure filings must include sufficient detail to enable investors to make informed decisions about whether to buy, sell or hold the issuer's securities. Disclosure must include material information such as the issuer's operations, revenue generation plans, specialized skills and knowledge possessed, competitive conditions faced and the sources, pricing and availability of equipment used, and any reliance on third-party providers (i.e., trading platforms, mining pool operations, liquidity providers, *etc*.).

4. Risk factor disclosure

Issuers are also expected to include risk factors that are specific and sufficiently tailored to the risks that relate to that issuer and its business. The following risks should be considered and disclosed when applicable:

- the availability and/or cost of electricity with respect to cryptocurrency mining activities;
- potential declines in the price of crypto assets;
- decreased rewards for mining a particular crypto asset; and
- risks related to access of crypto assets held at third-party custodians or crypto asset trading platforms.

Additionally, issuers should consider the difference in holding established cryptocurrencies (*i.e.*, Bitcoin or Ether) versus other crypto assets, such as digital tokens, and the risks associated with that.

5. Promotional activities

Issuers are expected to not engage in promotional activities that provide unbalanced or unsubstantiated material claims about the issuer's business and the corresponding opportunity to profit by investing in the issuer. Any claims made should be supported by objective data that provides a reasonable basis for concluding that such a statement is accurate. Issuers are urged to follow previously issued guidance on promotional activities (see CSA Staff Notice 51-356 Problematic Promotional Activities by Issuers).

6. Material changes

Issuers must consider whether a particular event constitutes a material change and, as is the case for all reporting issuers, are expected to comply with the reporting requirements to immediately issue a press release disclosing the nature and substance of the change and file a material change report with respect to that material change (as soon as practicable and in any event within 10 days of the date of such event occurs).

The following changes would require reporting (if material): (i) entering into a custodial agreement with a third-party; (ii) changing custodians; (iii) the loss or theft of crypto assets; (iv) an acquisition or sale of crypto asset mining equipment; or (v) in the case of cryptocurrency mining activities, entering into a mining pool arrangement or an electricity supply agreement.

7. Investing in crypto assets

Many of the investor protection considerations applicable to investment funds may apply to an issuer where a material aspect of such issuer's business is investing in crypto assets and the issuer does not have other substantial operations (even if the issuer does not meet the definition of "investment fund" under National Instrument 81-106 Investment Fund Continuous Disclosure).

For example, absent of any relevant mitigating efforts comparable to those applicable to investment funds, the CSA staff may take the view that it is not in the public interest to issue a receipt for a prospectus. As such, before a prospectus receipt may be issued, the CSA expects issuers to adopt investor protection considerations such as:

- investment concentration risks;
- an undertaking to provide continuous disclosure for underlying investee companies if they represent a substantial amount of the issuer's business; and
- requirements to use a custodian qualified in accordance with Part 6 of National Instrument 81-102 Investment Funds.

Additionally, in connection with an issuer's management's discussion & analysis, any discussion on performance will also include information about an issuer's crypto assets and other portfolio holdings. The CSA refers to CSA Multilateral Staff Notice 51-349

Report on the Review of Investment Entities and Guide for Disclosure Improvements (SN 51-349) for additional guidance on the kind of disclosure that staff would expect.

8. Financial statements

The CSA acknowledges that there are unique aspects of the crypto asset industry that raise novel accounting issues, and encourage issuers to monitor and follow published guidance by accounting standard setters and regulatory bodies. Additionally, there are specific considerations that issuers that hold cryptocurrencies (not tokens or other initial coin offerings) should consider when facing complex accounting and disclosure issues, which include:

- following the International Financial Reporting Standards (IFRS) Interpretations Committee's accounting policies and disclosure expectations with respect to how cryptocurrencies will be considered;
- including disclosure in the notes to the financial statements of an issuer for a reader to understand the valuation techniques and how fair value measurements have been categorized (see also additional guidance on the CSA's disclosure expectations regarding investments recoded at fair value in SN 51-349);
- considering the appropriate accounting policy for an issuer's cryptocurrency mining activities, with the expectation that robust disclosure be included in the notes to the financial statements that describe the issuer's cryptocurrency mining activities (including applicable IFRSs);
- with respect to cryptocurrency mining activities, financial statements should disclose the disaggregation of any mining equipment by the type of crypto assets it is capable of mining; and
- where non-monetary transactions where assets or services received are settled in cryptocurrencies, ensuring that an issuer has robust controls in place regarding the initiation and approval of such transactions (and the management's discussion & analysis include robust discussion of such non-monetary transactions, if they are material to the issuer's business).

For additional information on the accounting issues, please consult your accounting advisor.

Contact us

If you have any questions about the Staff Notice, 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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