OSC Clears Pathway for the First Publicly Offered Bitcoin Fund

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On October 29, 2019, the Ontario Securities Commission (OSC) issued reasons for its decision to allow 3iQ Corp. (3iQ), a Canadian investment fund manager, to offer the first publicly offered bitcoin fund in Canada. The OSC Panel ordered that the Director issue a receipt for a final prospectus of The Bitcoin Fund (the Fund), setting aside an earlier decision of the Director to deny the receipt.[1]

The OSC Panel explained that although the concerns about bitcoin expressed by the Director and OSC staff (Staff) had merit, their concerns did not warrant denying a receipt. The OSC Panel's reasons are notable because they provide insight into the OSC's perception of the risks associated with bitcoin, and the regulator's expectations on managers of prospective bitcoin investment funds in recognizing these risks and employing safeguards to mitigate them.

The Fund is a proposed non-redeemable investment fund (NRIF) that would invest substantially all of its assets in long-term holdings of bitcoin purchased from various sources, including bitcoin exchanges. Investors in the Fund would have limited redemption rights – the right to redeem annually at NAV or monthly at a discount to NAV.

The OSC Panel considered two fundamental issues raised by Staff and reflected by the Director's decision:

1. Is bitcoin an "illiquid asset" within the meaning of such term in National Instrument 81-102 *Investment Funds* (NI 81-102), such that the Fund would not comply with the restriction against holding illiquid assets set out in NI 81-102?
2. Would it be in the public interest for the Director to issue a receipt for the Fund's prospectus?

Pursuant to NI 81-102, an NRIF is limited to holding no more than 20 per cent of its NAV in illiquid assets (as defined in NI 81-102). Staff submitted that bitcoin is an illiquid asset because there is no central source for trading data concerning bitcoin. Staff argued that any publicly available trading volume data for bitcoin may be inaccurate and the Fund would have difficulties acquiring or liquidating its assets. As such, Staff argued the Fund would not comply with the illiquid asset restriction in NI 81-102.

However, the OSC Panel accepted 3iQ's evidence of the real volume and trading activities in bitcoin on trading platforms holding a BitLicense (New York State) in large dollar sizes, which 3iQ submitted promote reliable price discovery and provide sufficient liquidity. The OSC Panel concluded that Staff had not demonstrated that bitcoin was an illiquid asset for the purposes of NI 81-102 and, therefore, the Fund could comply with the NI 81-102 restriction against holding illiquid assets.

Staff also argued that it was not in the public interest to issue a receipt for the Fund's prospectus due to concerns about the operational risks inherent in the Fund, including:

1. the Fund's ability to reliably arrive at a NAV given market integrity concerns regarding the trading of bitcoin;
2. the security and safekeeping of the Fund's assets (being bitcoin); and
3. the Fund's ability to prepare and file audited financial statements.

Staff argued that the Fund would not be able to arrive at a NAV that satisfies securities regulatory requirements, citing allegations of price distortion caused by market manipulation in the crypto-asset market, such as wash trading and spoofing.

Although the OSC Panel acknowledged that the risks of price manipulation in the bitcoin market exist, it found that 3iQ mitigated the potential impact on the Fund's valuation because of the Fund's investment parameters and restrictions, as well as its decision to use a specific index to calculate the NAV of the Fund. In particular, the Fund's prospectus states that the Fund would: (i) invest in bitcoin only, not in all crypto-assets; (ii) pursue a buy and hold strategy, not an active trading strategy; and (iii) only buy and sell bitcoin on regulated exchanges.

Staff raised concerns regarding security and safekeeping of the Fund's bitcoin due to security risks associated with crypto-asset trading platforms, such as hacking and insider thefts. Although the OSC Panel recognized the fact that bitcoin can be stolen or lost, it concluded that Staff had not demonstrated that the Fund's bitcoin would be inadequately safeguarded. It referenced several factors in reaching this conclusion, such as the fact that the Fund's proposed custodian and sub-custodian, Cidel Trust Company and Gemini Trust Company, LLC, respectively, are regulated and experienced custodians, and the absence of reliable evidence to suggest that professional, qualified crypto-asset custodians, such as Gemini, have suffered losses of customer assets.

Staff submitted that because Gemini did not currently have a System and Organization Controls of Service Organizations Type 2 report (SOC 2 Type 2 Report) – a customary assurance that Gemini's security controls are working effectively – the Fund's auditor would be unable to complete its report for the Fund's financial statements in accordance with generally accepted auditing standards (GAAS).

The OSC Panel accepted 3iQ's submission that despite the fact that Gemini did not have a SOC 2 Type 2 Report, a qualified auditor could still conduct an audit based on other evidence obtained from third parties and comply with GAAS. Although the Fund may ultimately fail to deliver the required audit report, the OSC Panel noted that Staff would have access to normal course measures to address this deficiency.

The OSC Panel also observed that denying investors the opportunity to invest in bitcoin through a public fund would not promote fair and efficient capital markets and confidence in those markets, but may instead lead to the suggestion that investors should acquire bitcoin through unregulated vehicles. The OSC Panel commented on 3iQ's stated intention to operate and manage the Fund in a prudent manner and to take steps to mitigate against the concerns associated with bitcoin, and remarked that the notion of professionalizing investing in risky assets (through a publicly regulated fund) to mitigate risk should be encouraged.

The OSC Panel concluded that, having considered the risks identified by Staff, ordering the issuance of a receipt for the final prospectus of the Fund was not contrary to the public interest. Contrary to the submissions of Staff, the OSC Panel rejected any notion that terms and conditions be imposed on 3iQ or the Fund noting that it "did not wish to impose conditions that may unduly restrict or constrain 3iQ's ability to exercise its professional judgment" in the matters at hand.

On November 27, 2019, 3iQ filed an updated preliminary prospectus in respect of an initial public offering of units of the Fund, and a receipt for that prospectus was issued on the same day. It will be interesting to see when 3iQ actually launches the Fund and whether investors are convinced that the risks identified by Staff have been properly addressed. We expect that other fund managers may be interested in launching similar investment vehicles now that digital asset funds, or at least bitcoin funds, appear to be permitted in Canada.

Contact Us

If you have any questions about the decision or digital assets generally, 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 from start to finish.

[1] We reported on the Director's decision in our March 2019 bulletin.

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