The Regulation Of Virtual Currencies In Canada

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Canada is engaged in an important effort to reform its payment system. In recent years, there have been important legislative measures to enhance the payment system including the adoption of the *Payment, Clearing and Settlement Act*, and the *Payment* Card Network *Act*. There was the appointment of an expert task force (the "Task Force") that has offered a vision for a new payments system architecture in a final report entitled Moving Canada into the Digital Age. Following the final report of the Task Force, the Government of Canada created a senior-level advisory committee made up of public and private sector stakeholders referred as FinPay. More recently, the 2014 budget plan of the Government included a commitment to protect consumers and ensure public confidence in the use of electronic payment methods, to develop a comprehensive risk-based approach to the oversight of the Canadian payments system and to consult publicly on the oversight of retail payments systems, including virtual currencies.

As decentralized, math based virtual currencies, particularly Bitcoin, have garnered increasing attention both in Canada and abroad, policy makers and regulators, internationally and in Canada, have sought to clarify the rules and regulations relevant to virtual currencies.

In the June 2014, Report of the Financial Action Task Force ("FATF") a comprehensive definition of virtual currency is offered. The FATF report defines a virtual currency as a digital representation of value that can be digitally traded and functions as (i) a medium of exchange and/or (ii) a unit of account and / or (iii) a store of value, but does not have legal tender status in any jurisdiction. Further, FATF indicates that a virtual currency is not issued or guaranteed by any jurisdiction and fulfils the above functions only by agreement within a community of users. FATF notes that a virtual currency is to be distinguished from e-money which is a digital representation of fiat currency used to electronically transfer value denominated as fiat currency. Digital currency is defined by FATF as a digital representation of virtual currency (non-fiat) or e-money (fiat).

The FATF report highlighted some of the legitimate uses and potential risks of virtual currencies. The report noted that virtual currencies offer many benefits such as increased payment efficiency and lower transaction costs. In addition, virtual currencies have the potential to facilitate international payments and provide payment services to populations that do not have access or limited access to regular banking services. At the

same time, the FATF Report noted that other characteristics of virtual currencies, coupled with their global reach, present potential AML/ATF risks, such as: (i) the anonymity provided by the trade in virtual currencies on the internet; (ii) the limited identification and verification of participants, (iii) the lack of clarity regarding the responsibility for AML/ATF compliance, supervision and enforcement for these transactions that are segmented across several countries, and (iv) the lack of a central oversight body.

Recent Developments

One of the challenges that Canadian policy makers and regulators face is in determining whether virtual currencies should be regulated as commodities or as currencies.

The Canada Revenue Agency (CRA) views virtual currencies as a commodity. To the extent that virtual currency can be used to buy goods and services, these transactions are treated like barter transactions. Virtual currency received represents business income, and the value of the virtual currency in Canadian dollars is required to be included in business income for the year. If sales tax applies on the purchase of the goods or service the value of the virtual currency in Canadian dollars would determine the GST payable. The second broad category of transactions involving digital currency that can lead to income tax implications is where digital currency is bought and sold as a commodity. The CRA treats buying and selling virtual currency in the same way as buying and selling any other commodity. If a taxpayer is in the business of buying and selling virtual currency the gain is fully taxable as an income transaction. If it is an investment only half of the gains are taxable as a capital transaction.

Currently, FINTRAC is of the view that Bitcoin exchanges are not considered to be money service businesses since Bitcoin exchanges do not remit or transfer funds as a principal activity. Rather, in the view of FINTRAC, the transfer of funds is seen to be a corollary to the actual service of buying and selling virtual currency, which is not currently subject to regulation.

However, the omnibus bill enacted to implement the 2014 federal budget (Bill C-31) (Economic Act Plan 2014, No.1) included amendments to the Proceeds of Crime (Money Laundering) *T*errorist *F*inancing *Act* ("PCMLTFA"). Section 5 as amended by Bill C-31, sets out the persons and entities to which Part 1 of the *Act* applies – record keeping, verifying identity, reporting of suspicious transactions and registrations. As amended, Section 5 (h) provides, in relevant part, that persons and entities that have a place of business in Canada and that are engaged in the business of dealing in virtual currencies, as defined in the regulations are subject to Part 1 of the *Act*. As amended Section 5 (h.1) provides, in relevant part, that persons and entities that do not have a place of business in Canada, that are engaged in the business of dealing in virtual currencies, as defined in the regulations are subject to Part 1 of the *Act*. Further, pursuant to Subsection 9.31 (1), generally, in relevant part, no bank, federal or provincial trust company or credit union shall open or maintain an account for, or have a correspondent banking relationship with, a person or entity dealing in virtual currency that does not have a place of business in Canada unless that person or entity is registered with FINTRAC. The implementation of the amendments to the PCMLTFA awaits the adoption of regulations. The Department of Finance has indicated that these proposed regulations would extend the PCMLTFA's requirements for money services businesses to entities in the business of

dealing in virtual currencies. The Government would aim, in these regulations, to cover virtual currency exchanges, but not individuals or businesses.

In addition to requirements of federal law, dealing in virtual currencies is also subject to provincial law. Earlier this year, the Autorité des marchés financiers ("AMF") issued a notice indicating transactions involving virtual currency, also known as cryptocurrency, are not covered by the financial services compensation fund or the deposit insurance fund. Further, the AMF also noted that it is closely monitoring the introduction of virtual currency in Québec in terms of the Securities *Act*, the *Derivatives Act* and the *Money-Services Businesses Act*. Further, the AMF indicated that it will take action in the event of violations under any of these statutes. Above and beyond provincial laws related to securities, derivatives and money service businesses, those dealing in virtual currency are also subject to provincial laws of general application including consumer protection laws.

Moving Forward

In addition to the expected Department of Finance public consultation on the oversight of retail payments systems, including virtual currencies, and the planned regulations under the PCMLTFA, in March of this year the Standing Senate Committee on Banking, Trade and Commerce began hearings as part of its study of the use of digital currency, including the potential risks, treats and advantages of these new electronic forms of exchange. The Senate plans to report on their risks, threats, and advantages by June 30, 2015. The Senate Banking Committee has received testimony from academic, financial, and government experts from across Canada including the Department of Finance, the Bank of Canada, the Canadian Payments Association, INTERAC and the Canadian Bankers Association. It has also heard from international cryptocurrency experts and virtual currency industry participants. As has been true many times in the past on other issues of emerging importance to the Canadian financial system, the Senate Committee is well positioned to make some important recommendations to the Government on the future regulation of this emerging alternative payment regime.

Beyond the issues noted above, there is also the question of whether Bitcoin, or other digital currencies, can be provided as security for borrowing. For purposes of provincial personal property security legislation, it would appear that Bitcoin would be considered an "intangible". To perfect a security interest in an intangible, a registration has to be made. However, registration will not prevent the borrower from later accessing the Bitcoin that is subject to the security interest. Lenders will need to explore practical ways to ensure that the security objective is achieved.

We will continue to monitor regulatory developments and report as circumstances require.

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