BLG Represents First Bitcoin Market Participant To Be Approved By Canadian Securities Administrators

September 19, 2017

First Cryptocurrency Investment Fund Manager Registration in Canada

On September 6, 2017, the British Columbia Securities Commission (the "BCSC") announced the first registration of an investment fund manager focused on cryptocurrency investments. First Block Capital Inc. ("First Block"), an investment fund manager based in Vancouver, British Columbia, was granted registration pursuant to National Instrument 31-103 — *Registration Requirements, Exemptions and Ongoing Registrant Obligations* in the categories of "investment fund manager" and "exempt market dealer" in British Columbia and Ontario, with the BCSC acting as the principal regulator. The registrations were granted to allow First Block to operate an investment fund that will invest exclusively in bitcoin.

BLG represented First Block with a team led by Jason Brooks that included Rob Wallis in relation to the registration application, and Carol Derk, Craig Webster (Tax), Grace Pereira (Tax), Whitney Bell and Inaki Gomez in relation to First Block's bitcoin investment fund.

The terms and conditions of registration imposed on First Block by the BCSC allow First Block to operate under the current securities regulatory framework while providing securities regulators with the opportunity to continue to assess the potential risks associated with this type of investment vehicle.

The registration approval by the BCSC signals a general willingness by Canadian securities regulators to respond and adapt to the fast-developing asset class of cryptocurrencies.

Regulatory Guidance for Cryptocurrency Market Participants

The registration of First Block followed very closely on the heels of the publication by the Canadian Securities Administrators (the "CSA") of CSA Staff Notice 46-

307 — *Cryptocurrency Offerings* (the "Notice"), which provided the CSA's guidance on the application of securities laws to cryptocurrencies and investment funds that invest in cryptocurrencies. In the Notice, the CSA acknowledges that cryptocurrency offerings provide businesses with an innovative method to raise capital and for investors to access a new asset class, but maintains that entities must consider all relevant securities laws when engaging in an offering of cryptocurrencies or the sale of securities of a cryptocurrency investment fund. In the Notice, the CSA confirmed the following:

- prospectus and registration requirements under securities laws may apply to the distribution or trading of a cryptocurrency that constitutes a "security";
- an investment fund established to invest in cryptocurrency or crypto-assets must comply with prospectus and registration requirements, as well as anti-money laundering and know-your-client requirements; and
- cryptocurrency exchanges may be considered marketplaces under Canadian securities laws and may be subject to regulation.

For a complete discussion of the Notice, please see our previous publication: CSA Increases Regulatory Clarity in the Cryptic World of Digital Currencies.

Practical Considerations for Cryptocurrency Offerings

Canadian securities regulators are sensitive to the interest in obtaining investment exposure to cryptocurrencies and appear to be cautiously balancing their mandate of protecting the public and the integrity of the capital markets with the need to enable new innovative forms of investment. Firms that plan to offer cryptocurrencies or baskets of cryptocurrencies should ensure that they consider and address the following unique issues:

- **Registration** – All cryptocurrency market participants — exchanges offering a trading platform for cryptocurrency, dealers offering an over-the-counter trading solution for cryptocurrency, firms advising on the merits of cryptocurrency or seeking to develop algorithms to navigate the market, and managers of any cryptocurrency fund — have to consider the applicable registration requirements, including dealer, adviser and investment fund manager registration, and should carefully consider which categories of registration are required in light of their service offering, investment and distribution strategy or product structure, how the product will be sold and whether the cryptocurrency assets held are considered "securities". Of note, it is now clear that even a fund that invests solely in bitcoin or another cryptocurrency is considered to be an "investment fund" and, therefore, require a registered investment fund manager.
- **Product development and structuring** – Cryptocurrency market participants also have to consider how the product development, distribution and structure of the cryptocurrency offering impacts the regulatory analysis and whether the utilization of cryptocurrency derivatives is appropriate to achieve the optimal structure.
- **Risk and relationship disclosures** – Market participants are required to carefully consider the appropriate disclosure to provide to clients or investors on cryptocurrency and to tailor the disclosure to address not only the specific risks of the particular cryptocurrencies and the proposed trading or investment strategy, but also the risks associated with the blockchain, the Bitcoin network, security

breaches, the loss or destruction of private keys, relationships with service providers, business continuity and the rise of other digital assets.

- **Due diligence** – To date, cryptocurrency exchanges are largely unregulated and their operations may not be transparent. As a result, securities regulators require managers of cryptocurrency funds to undertake reasonable due diligence on any proposed cryptocurrency exchange, including an analysis of its policies and procedures for identity verification, anti-money laundering, counter-terrorist financing and recordkeeping. Cryptocurrency fund managers should be prepared to address exchange trading volumes and the impact volumes may have on the ability to meet redemption requests.
- **Internal controls and cybersecurity** – Given the potential risks associated with the open-source structure of a cryptocurrency exchange, securities regulators expect cryptocurrency market participants to implement internal cybersecurity risk management programs, risk management systems, and business continuity plans designed to prevent cyber incidents and to limit any loss or liability associated with cyber incidents.
- **Valuation** – Cryptocurrency fund managers must establish appropriate policies and procedures for valuing the securities of their funds and the underlying cryptocurrency assets.
- **Custodianship** – In granting registration to any new cryptocurrency fund manager or allowing an existing manager to expand into this area, securities regulators will very likely prescribe specific requirements for the custody of all cryptocurrency assets and expect these cryptocurrency custodians to have expertise that is relevant to holding cryptocurrencies, including experience with “hot” and “cold” storage and security measures to keep cryptocurrency assets protected from theft.

It is clear that the regulators expect any new or existing fund manager that wishes to establish a cryptocurrency investment fund or to expand the mandate of their existing funds into cryptocurrency investments to reach out to their principal regulator in advance to discuss the details of their plans and how the above issues and other relevant issues will be addressed. Although the CSA has shown a willingness to be flexible in their approach to the application of the existing securities regulatory framework in this area, managers should expect that the regulators will continue to engage in a very thorough and thoughtful review of the related regulatory and investor protection issues.

About BLG's Cryptocurrency Experience

In addition to our experience advising clients in the broader FinTech sector, our lawyers have gained specific hands on experience and expertise advising clients on the formation, structuring and operation of cryptocurrency offerings, the registration and other securities regulatory issues that impact managers of cryptocurrency funds, and the application of Canadian securities laws to those involved in cryptocurrency offerings of various types, including initial coin offerings and initial token offerings.

By

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Expertise

Investment Management, Capital Markets, Derivatives, Banking & Financial Services, Digital Assets

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