# Recent developments in the digital assets space

**August 24, 2022**

Earlier this year, we reflected on the growth of the digital asset industry and the guidance provided by Canadian securities regulators in 2021. As we pass the halfway point of 2022, we want to continue the dialogue about some recent developments in the digital asset space and how these developments may impact companies operating in Canada.

## Summary

- The Canadian Securities Administrators (CSA) announced a new requirement for crypto asset trading platforms (CTPs) currently operating in Canada that are in the process of seeking registration under securities laws to provide pre-registration undertakings while their applications are under review.
- The Office of the Superintendent of Financial Institutions (OSFI) published interim arrangements for the regulatory capital and liquidity treatment of crypto asset exposures**.**
- The U.S. Securities and Exchange Commission (SEC) brought its first-ever insider trading action involving digital assets.
- The U.S. Treasury sanctioned Tornado Cash, a virtual-currency mixer.

## CSA expect commitments from CTPs pursuing registration

On August 15, 2022, the CSA issued a press release relating to additional steps required to be taken by CTPs currently operating in Canada that are not yet registered. The CSA now expects the operators of such CTPs to provide pre-registration undertakings to their principal regulator to continue operations while their application is under review. By giving these undertakings, CTPs agree to comply with terms and conditions that address investor-protection concerns and are consistent with certain of the requirements applicable to the nine CTPs that are currently registered.

The Ontario Securities Commission (OSC) has published the first two of such pre-registration undertakings given by Coinsquare Capital Markets Ltd. and Foris Dax, Inc. (c.o.b. as Crypto.com). These undertakings require the CTPs to comply with many of

the same requirements applicable to registered CTPs, including “know your client” and “know your product” due diligence, custody of client assets, insurance, risk disclosure, confidentiality of order and trade information, books and records, conflicts of interest management and regulatory reporting, and investment limits.

CTPs operating in Canada should be prepared to discuss and enter into undertakings with CSA members. The CSA is in discussion with other CTPs about providing pre-registration undertakings and may take action if a CTP is not prepared to file an undertaking or does not abide by the terms of its undertaking.

## OSFI announces interim approach to digital assets

On August 18, 2022, the Office of the Superintendent of Financial Institutions (OSFI) announced its interim approach for cryptoassets (which OSFI defines as digital assets that depend primarily on cryptography and distributed ledger or similar technology) held by federally regulated financial institutions (FRFIs).

The published advisory builds on OSFI’s consultative letter provided on July 5, 2021 and outlines OSFI’s expectation that any currently held cryptoassets must be managed prudently and sets limits on their use of cryptoassets by banks and insurers. It also provides further guidance on how to approach the capital and liquidity treatment of cryptoasset holdings. Specifically, the interim approach clarifies the interim regulatory capital and liquidity treatment of Deposit Taking Institutions’ (DTIs) and Insurers’ exposures to cryptoassets.

Additionally, the interim approach defines and categorizes cryptoasset exposures, and outlines DTI credit risk, counterparty credit risk, leverage, market risk, liquidity risk, and the foreign bank branch deposit treatments. The capital requirements for insurer cryptoasset exposures are then clarified, including collateral recognition, and considerations for foreign insurance branches. The last section defines exposure limits for all FRFIs.

The scope of this advisory is limited to the capital and liquidity treatment of a FRFI’s exposures to cryptoassets. The advisory does not address other issues, including whether a FRFI is permitted under the Bank Act, Insurance Companies Act, or Trust and Loan Companies Act to issue any particular cryptoasset, or to acquire or hold a controlling or substantial investment in entities that engage in this activity. FRFIs should be aware that this advisory sets out OSFI’s expectations as to when FRFIs should notify their lead supervisor if they intend to have exposures to cryptoassets.Where a FRFI intends to engage (directly or via a subsidiary) in other cryptoasset activities, OSFI’s expectation is that the FRFI will notify its lead supervisor and provide any information requested by OSFI that will allow OSFI to assess the safety and soundness, and risk implications of such activities.

## SEC charges former Coinbase manager and two others in crypto asset insider trading action

On July 21, 2022, the SEC filed a complaint with the Federal District Court in Seattle, Washington, concerning insider trading allegations in the digital asset space. The

complaint alleges that a former manager of Coinbase Global Inc. (Coinbase) tipped material, non-public information about several digital assets that would soon become available for trading on the platform to his brother and a close friend. The brother and friend then used this information to trade in at least 25 digital assets, earning more than US$1.1 million in profits. Inside information concerning the name of digital assets to be listed or the timing of a listing can be particularly sensitive since the announcement of the listing can cause that digital asset's price and trading volume to rise dramatically. The SEC's action accompanied a criminal indictment by the United States Attorney's Office for the Southern District of New York, charging the same individuals with conspiracy and wire fraud in connection with their alleged insider trading of the same digital assets.

This development is significant because it marks the first time the SEC has brought a complaint concerning alleged insider trading of digital assets. Additionally, the SEC complaint asserted that the following nine digital assets at issue are investment contracts (and therefore, securities) under the Howey Test established by the U.S. Supreme Court in *SEC v W.J. Howey Co*.:

- Amp (AMP)
- Rally (RLY)
- DerivaDAO (DDX)
- XYO (XYO)
- Rari Governance Token (RGT)
- Liechtenstein Cryptoassets Exchange tokens (LCX)
- Powerledger (POWR)
- DFX Finance (DFX)
- Kromatica (KROM)

A ruling supporting the SEC's position would reaffirm the SEC's jurisdiction over digital assets that are securities. While this case is from the U.S., companies operating in Canada should be aware of it, because Canadian regulators may arrive at similar conclusions.

As discussed in our previous bulletin, the Canadian regulators have not been willing, to date, to take a position as to whether a particular digital asset is a security or derivative. Instead, in the context of regulated CTPs, such analysis and determination has been left to the operators of such platforms. See Consultation Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms* for the basic framework for the regulation of digital assets in Canada.

# U.S. Treasury sanctions virtual currency mixer

On August 8, 2022, the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) announced sanctions against virtual-currency mixer called Tornado Cash, over concerns that it is a threat to U.S. national security, as Tornado Cash has been used to launder more than US$7 billion worth of virtual currency since its creation in 2019. This includes over US$455 million stolen by the Lazarus Group, a Democratic People's Republic of Korea state-sponsored hacking group that was also sanctioned in the U.S. in 2019.

Tornado Cash is a virtual currency mixer that operates on the Ethereum blockchain and facilitates anonymous transactions by obfuscating their origin, destination, and counterparties, making them harder to trace. Tornado Cash receives a variety of transactions and mixes them together before transmitting them to their individual recipients. As the OFAC notes in its press release, while the rationale of virtual currency mixers is to increase privacy, smart contracts like Tornado Cash are commonly used by illicit actors to launder funds, especially those stolen during significant heists.

OFAC's sanctions on Tornado Cash include, among others, blocking all the company's property and interests in property that is in the U.S. or in the possession or control of U.S. persons. In addition, any entities that are owned, directly or indirectly, 50 percent or more by one or more blocked persons are also blocked.

# Next steps

These developments show that regulation of the digital asset industry in Canada and abroad is constantly evolving. BLG's Digital Assets Group has been actively involved in the digital asset space since 2017. We have extensive experience in advising private and public investment funds and digital asset companies with public listings on all of the Canadian exchanges. We have firsthand experience assisting with mergers and acquisitions, subscription receipt financings, subsequent private placements and public offerings involving digital assets and distributed ledger technology.

To learn more about the growing digital assets market and how it may affect your business, reach out to the authors or key contacts listed below.

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