CSA seeks comments on proposed amendments to public crypto asset fund rules

February 13, 2024

On Jan. 18, 2024, the Canadian Securities Administrators (CSA) published for comment *CSA Notice and Request for Comment – Proposed Amendments to National Instrument 81-102 Investment Funds Pertaining to Crypto Assets* (the Notice), which sets out proposed amendments and changes (the Proposed Amendments) to National Instrument 81-102 *Investment Funds* (NI 81-102), and the Companion Policy to NI 81-102 (CP 81-102), in relation to reporting issuer investment funds that seek to invest directly or indirectly in crypto assets (Public Crypto Asset Funds). The Notice represents the second of three phases in the CSA's development of a regulatory framework for Public Crypto Asset Funds and expands on the CSA's guidance in the staff notice from July 6, 2023 (the Staff Notice) regarding Staff's views and expectations on the operations of Public Crypto Asset Funds within the requirements in NI 81-102. It is expected that the third phase will involve further public consultation concerning a more comprehensive regulatory framework for funds investing in crypto assets.

The Proposed Amendments are intended to provide greater regulatory clarity and to codify routinely granted exemptive relief regarding the types of crypto assets that may be purchased or held by Public Crypto Asset Funds, the restrictions on investing in crypto assets, and custodial requirements for crypto assets held on behalf of such funds.

While the Proposed Amendments do not define the term "crypto asset", the changes to CP 81-102 provide that the regulators will generally consider a crypto asset to include any digital representation of value that uses cryptography and distributed ledger technology, or a combination of similar technology, to create, verify and secure transactions. The Proposed Amendments are open for comment until April 17, 2024.

Summary of the Proposed Amendments

Below is a summary of the Proposed Amendments:

Definition of "alternative mutual fund" – The CSA propose to amend the definition of "alternative mutual fund" to include a mutual fund that invests in crypto assets. This change reflects how existing Public Crypto Asset Funds are currently structured.

Restrictions on investments in crypto assets – To address:

- the concern detailed in the Staff Notice about determining the suitability of a crypto asset held as a portfolio holding of a Public Crypto Asset Fund (such as market integrity and price discovery), the Proposed Amendments limit the types of crypto assets that can be invested in to those that are listed for trading on, or are the underlying interest of a specified derivative that trades on, an exchange that has been recognized by a member of the CSA; and
- Staff's view is that non-fungible crypto assets, such as NFTs, are incompatible with investment fund products offered to retail investors because of their liquidity and valuation risks. As a result, under the Proposed Amendments, Public Crypto Asset Funds are prohibited from buying or holding non-fungible crypto assets.

Other mutual funds are only able to gain exposure to crypto assets through fund-of-fund structures.

Prohibiting securities lending, repurchase transactions and reverse repurchase transactions – The CSA propose to prohibit Public Crypto Asset Funds from using crypto assets in securities lending, repurchase transactions or reverse transactions in any capacity.

Money market funds – The definition of “money market fund” will be amended to clarify that such a fund cannot buy or hold crypto assets.

Sale of securities of a mutual fund – The CSA is proposing to codify exemptive relief that permits existing Public Crypto Asset Funds to accept crypto assets as subscription proceeds in lieu of cash. This relief facilitates the functioning of Public Crypto Asset Funds that are exchange-traded mutual funds (ETFs) by allowing their designated brokers and market makers to exchange crypto assets for “creation units” of the ETF instead of requiring cash transactions.

Custodianship of portfolio assets – The CSA will codify the practices and policies of existing Public Crypto Asset Funds in respect of their custodial arrangements with custodians and sub-custodians that hold crypto assets on their behalf (a Crypto Custodian), by requiring the Crypto Custodian to:

- hold the crypto assets in offline storage (*i.e.*, “cold wallet” storage), except as needed to facilitate purchases and sales or other portfolio transactions;
- maintain the type of insurance with respect to the crypto assets it custodies that a reasonably prudent person would maintain – no specific type or minimum amount of insurance coverage is suggested;
- on an annual basis, obtain and deliver a report , to the Public Crypto Asset Fund that is prepared by a public accountant assessing the Crypto Custodian’s internal management and controls relating to security, availability, processing integrity, confidentiality and privacy controls. Although not prescribed, a SOC 2 Type 2 Report prepared in accordance with the framework developed by the American Institute of Chartered Public Accountants would meet these requirements. This report would be in addition to the existing annual review and reporting obligations that a primary custodian has in respect of its sub-custodial arrangements under NI 81-102.

Custody standard of care –The Proposed Amendments would also expand on the guidance for meeting the standard of care requirement in relation to Crypto Custodians. The proposals largely reflect existing custody practices of crypto assets for existing Public Crypto Asset Funds, which include:

- Ensuring the Crypto Custodian has the requisite expertise to custody crypto assets;
- Using segregated wallets or omnibus wallets visible on the blockchain, so long as the books and records of the Crypto Custodian confirm the Public Crypto Asset Fund's ownership of the crypto assets;
- Using multi-signature technology to limit the risk of a single point of failure;
- Using strong passwords, multi-factor authentication and encryption of client information to limit the risk of hacking; and
- Maintaining robust cyber and physical security practices to ensure greater security of the crypto assets.

Transition/Coming into force

The Proposed Amendments will come into force approximately 90 days after the final publication date, subject to comments received and obtaining required approvals.

Our commentary

While the Proposed Amendments largely reflect the regulatory framework that has been developed by the CSA in respect of the existing Public Crypto Asset Funds, they provide greater regulatory clarity on Staff's expectations in certain areas.

We do, however, have the following observations about the Proposed Amendments that we will raise in a written submission to the CSA. For instance, we have concerns about the proposed limits on the types of crypto assets that Public Crypto Asset Funds can invest in, as these funds are restricted to investing only in crypto assets that either trade on a recognized exchange or that are the underlying interest of a specified derivative that trades on a recognized exchange. As no crypto asset itself trades on a recognized exchange, this limits possible investments to those crypto assets for which futures are offered on an exchange that is recognized in Canada. This seems to be unnecessarily restrictive, given the much larger number of crypto assets that can be purchased by retail investors on the crypto asset trading platforms that are currently registered or that operate under a pre-registration undertaking in Canada. We appreciate the suitability concerns of the regulators, but suggest that investors may be better protected if they purchase a regulated investment product rather than purchasing crypto assets directly.

We note that the Proposed Amendments do not address the ability of Public Crypto Asset Funds to engage in the staking of crypto assets and will ask the CSA to include commentary on their ability to do so. Further, the Proposed Amendments are silent on the ability of investment funds to purchase and hold value-referenced crypto assets, which are generally known as stablecoins. The statement made in CP 81-102 as to what is generally considered to be a crypto asset for purposes of the Proposed Amendments does not seem to be entirely consistent with the statements made by the CSA that value-referenced crypto assets are derivatives and/or securities.

How BLG Digital Assets can help

BLG's Digital Assets team helps clients to determine their regulatory status and to work closely with the regulators to obtain appropriate registrations or exemptions. We understand the digital asset business and we work with our clients to put into place a plan that balances investor protection concerns with the need for innovation while securing a feasible business model. We are also aware that domestic and global participants may be faced with different challenges and obstacles and need to plan accordingly.

For more information on the digital assets industry, reach out to any of the key contacts listed below.

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