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Time to Talk: CSA Threatens Enforcement Against Unregistered Crypto Trading Platforms

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The regulation of crypto asset trading platforms (CTPs) has been a recent focus of Canadian securities regulators, due in part to the popularity of crypto assets among new investors, high profile failures of Canadian CTPs and the heightened risks related to the loss and theft of crypto assets. Yet despite attracting the attention of Canadian regulators, CTPs largely continue to operate in Canada without appropriate regulatory oversight, owing to the notion that the innovative technology that CTPs promote does not fit cleanly within the established set of rules governing Canadian capital markets.

But change is on the horizon. On March 29, 2021, the Canadian Securities Administrators (CSA) and Investment Industry Regulatory Organization of Canada (IIROC) published Joint CSA/IIROC Staff Notice 21-329 – *Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements* (2021 Notice), providing the clearest direction to date as to how securities laws will apply to CTPs that facilitate the trading of crypto assets. The 2021 Notice describes the willingness of Canadian regulators to consider tailoring the existing rules in order to accommodate these novel businesses, and it provides a two-year transition period during which CTPs that have started the registration process can take interim steps to continue operating in Canada as they prepare to fully integrate into the Canadian regulatory structure.

Following release of the 2021 Notice, the Ontario Securities Commission (OSC) issued a statement advising CTPs that offer trading in crypto-based derivatives or securities to persons located in Ontario to contact the OSC by April 19, 2021, to discuss how to bring their operations into compliance or risk potential enforcement action.

Background

On March 14, 2019, the CSA and IIROC published Joint CSA/IIROC Consultation Paper 21-402 – *Proposed Framework for Crypto-Asset Trading Platforms* (2019 Proposed Framework), in which they outlined a proposed regulatory framework for CTPs based on the existing rules applicable to traditional securities trading systems and solicited comments to better understand the industry. The 2019 Proposed Framework affirmed the regulators' stated position on CTPs that facilitate trading of crypto assets that constitute securities and/or derivatives – namely, that such platforms are subject to the regulatory requirements applicable to traditional dealers, marketplaces or exchanges. Additionally, CTPs that facilitate the trading of crypto assets that are not considered securities or derivatives, but instead have features similar to commodities (such as bitcoin), may still be subject to securities legislation because an investor's contractual right to the crypto asset itself may constitute a security or derivative.

On January 16, 2020, the CSA issued Staff Notice 21-327 (2020 Notice) to provide further guidance on the factors to be considered when determining whether securities legislation applies to CTPs. According to the 2020 Notice, CTPs that are merely providing users with a contractual right to an underlying crypto asset, rather than immediately delivering the crypto asset to its users, are subject to securities laws, even if the underlying asset itself is not a security or a derivative. Staff will generally consider "immediate delivery" to have occurred if the CTP immediately transfers ownership, possession and control of the crypto asset to the user, and that user is free to use, or otherwise deal with, the crypto asset without further involvement or reliance on the platform.

Practically, most CTPs maintain custody and control of users' crypto assets without immediately delivering these crypto assets to a user-controlled wallet unless the user specifically instructs the platform to do so. Accordingly, industry commentators suggested that Canadian regulators were, relative to their international counterparts, taking a more restrictive approach, which could not only stifle the

development of these new technologies but also result in CTPs withdrawing from Canada to avoid having to incur the expense and burden of registration.

Despite this backdrop, the 2021 Notice does not further elaborate on the concept of immediate delivery; nor does it introduce new rules specifically applicable to CTPs. Instead, the 2021 Notice reaffirms that CTPs are subject to Canadian securities legislation and sets out a path to compliance. The 2021 Notice also states that the requirements of Canadian securities laws will be tailored to each CTP collaboratively with regulators through terms and conditions on registration and discretionary exemptive relief.

Below is a summary of the key considerations for CTPs, as outlined in the 2021 Notice.

Dealer or Marketplace?

The requirements that are applicable to a given CTP will depend on how it operates. Broadly speaking, CTPs are categorized either as platforms that facilitate the trading of crypto assets that are securities or contracts involving crypto assets (dealer platforms) or as platforms that operate in a similar manner to marketplaces (marketplace platforms).

If a CTP only facilitates the primary distribution of crypto assets, is a party to each trade in those securities, and client orders do not otherwise interact with one another, the CTP is likely to be considered a dealer platform, as opposed to a marketplace. Dealer platforms may also be engaged in other activities that marketplaces typically do not undertake, including onboarding retail clients onto a CTP, acting as agent for clients for trades of crypto assets and offering custody of assets, either directly or through a third-party provider.

Marketplace platforms, on the other hand, are those that provide a facility for bringing together multiple buyers, sellers or parties to trade in crypto assets that are securities or contracts involving crypto assets, and that use established, non-discretionary methods under which orders for such transactions interact. Where a marketplace performs certain dealer-like functions, it would also be subject to appropriate dealer requirements, which, depending on the activities, may have to be conducted through a separate legal entity or business unit to meet applicable regulatory requirements.

Key Features of Dealers

CTPs that facilitate distributions or trading of crypto assets that are securities or contracts involving crypto assets must register as dealers. CTPs that facilitate such trades in reliance on prospectus exemptions and do not offer margin or leverage may qualify to register as an exempt market dealer, or in certain cases as a restricted dealer. However, dealer platforms are not permitted to offer margin or leverage for these crypto assets until they are registered as investment dealers and are IIROC members.

In addition, dealer platforms that trade crypto contracts on behalf of retail investors will also need to register as investment dealers and become IIROC members. However, such platforms will be able to access the “interim period” discussed below by seeking restricted dealer registration, provided that such platforms do not offer leverage or margin trading to its users.

Key Features of Marketplaces

CTPs that operate as marketplaces will operate under the oversight of the CSA and IIROC, similar to the way alternative trading systems are regulated today. Existing securities laws and IIROC market integrity requirements applicable to marketplaces will be applied to marketplace platforms. However, the CSA/IIROC anticipate tailoring such requirements as appropriate to accommodate the novel aspects of CTPs, and will consider discretionary exemptions from existing rules when the platform can demonstrate that it can comply with the policy intent of the existing regulatory requirements in alternative ways or its operational model is such that compliance with specific requirements is impractical and the risks can be appropriately managed in other ways.

Marketplace platforms that trade security tokens and regulate the issuers of the securities or that discipline participants beyond simply denying access may be considered an exchange and subject to additional requirements under securities laws. In such cases, the CTP will be expected to apply for recognition, or exemption from recognition, as an exchange, oversee its issuers’ continuing compliance with its listing requirements, and regulate the operations and standards of business conducts of its members.

The CSA/IIROC acknowledge that marketplace platforms may wish to conduct a pilot to test a novel business idea or a proposed new market without having to delay operations in order to obtain registration and IIROC membership. Accordingly, similar to dealer platforms, certain marketplace platforms may be able to access the “interim period” discussed below by seeking registration as an exempt market dealer or restricted dealer, provided that they do not offer leverage or margin trading and are not considered to be exchanges.

Interim Relief

In order to foster innovation and provide flexibility, and recognizing the time and resources required to obtain the necessary registrations and IIROC memberships contemplated by the 2021 Notice, the CSA/IIROC offer an interim regulatory approach that may be pursued by CTPs trading in crypto contracts.

The interim period is expected to be roughly two years, during which time CTPs that have taken advantage of this approach will be expected to initially register as a restricted dealer and actively transition to a long-term regulatory framework – namely, investment dealer registration and IIROC membership. During the interim period, CTPs may seek exemptions from existing requirements and may also be subject to additional terms and conditions tailored to their business model that address key risks to clients.¹

Conclusion

The 2021 Notice provides long-awaited guidance following the CSA/IIROC’s prior pronouncements on the regulation of CTPs. Canadian regulators, including the OSC, have sent a strong message that CTPs looking to start or continue operating in Canada must reach out and engage in discussions regarding compliance or risk being subject to enforcement actions. Regulators appear open to providing discretionary exemptive relief and tailoring the requirements to accommodate novel businesses. However, the question remains whether CTPs, whether based in Canada or abroad, will be willing to bear the expense and regulatory burden that such discussions with the CSA will entail.

¹ Eligible CTPs that operate in Ontario, Québec, New Brunswick and Nova Scotia will need to apply for investment dealer registration and IIROC membership, or recognition or exemption from recognition as an exchange, during this time period. Regulators in Alberta, British Columbia, Manitoba and Saskatchewan have indicated that they will consider other regulatory approaches during the interim period, but that CTPs are expected to start the registration, membership or recognition processes, and may be required to take other steps in consultation with the regulators to transition to an acceptable long-term regulatory framework.

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