

May 15, 2019

To: **Joint Canadian Securities Administrators/ Investment Industry Regulatory Organization of Canada (IIROC)**

Re: **Consultation Paper 21-402 on the Proposed Framework for Crypto-Asset Trading Platforms**

Dear Joint Canadian Regulatory Team,

We support efforts by global standard setters, national authorities and regulators to consult and work with the nascent global digital/virtual asset industry.

To that end, we are hereby providing input to the **Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Consultation Paper 21-402 on the Proposed Framework for Crypto-Asset Trading Platforms.**<sup>1</sup>

The input has been drafted and led by the GDF Advisory Council.

## About GDF

Global Digital Finance (“GDF”) is a not-for-profit industry body that promotes the adoption of best practices for crypto and digital assets and digital finance technologies through the development of conduct standards, in a shared engagement forum with market participants, policymakers and regulators.

Established in 2018, GDF has convened a broad range of industry participants, with 300+ global community members—including some of the most influential digital asset and token companies, academics and professional services firms supporting the industry. GDF is proud to include Circle, ConsenSys, DLA Piper, Diginex, Hogan Lovells, Huobi and R3 as patron members.

The GDF Code of Conduct is an industry-led initiative driving the creation of global best practices and sound governance policies, informed by close conversations with regulators and developed through open, inclusive working groups of industry participants, legal, regulatory and compliance experts, financial services incumbents and academia. Code principles undergo multiple stages of community peer review and open public consultation prior to ratification.

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<sup>1</sup> [https://www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20190314\\_21-402\\_crypto-asset-trading-platforms.htm](https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20190314_21-402_crypto-asset-trading-platforms.htm)

# Consultation Inputs

## 1. Are there factors in addition to those noted in Part 2 that we should consider?

We suggest that more elaboration is added as to why each of these factors cited are determinative as to the remit of securities law, as several of these factors do not appear determinative under the laws of other jurisdictions.

We refer in this regard for example/ comparison to the interpretation given under UK law in the **FCA Guidance on Crypto Assets** that can be accessed [here](#).

## 2. What best practices exist for Platforms to mitigate the risks outlined in Part 3? Are there any other significant risks which we have not identified?

The list appears comprehensive.

We also refer you to the GDF paper on **Crypto Asset Safekeeping and Custody** that can be accessed [here](#), in case it may be helpful.

## 3. Are there any global approaches to regulating Platforms that are appropriate to be considered in Canada?

The IOSCO website contains a more comprehensive list of measures taken by various markets. We would note, for example, the tailored frameworks of **France, Malta, Abu Dhabi, Bahrain, Gibraltar, Bermuda and Bahamas**.

It appears that mostly non-G20 countries have adopted tailored frameworks that create more reasonable room for innovation to take root. This may be due to the fact that these countries have less legacy regulation in place and, therefore, more room to create and adopt more tailored frameworks.

While evaluating which licensing regime to apply for, reputable platforms consider amongst others the following factors:

- Is the regulator genuinely embracing Fintech innovation, actively engaging with it and seeking to adopt a balanced approach to regulation?
- Is the approach of the jurisdiction towards innovation welcoming/ positive or instead mostly punitive/ enforcement driven/ negative?
- Is there a tailored regime or tailored guidance for crypto assets and, if so, does it match the characteristics and the needs of the crypto asset industry?
- Does the tailored regime allow retail investors to buy and sell crypto assets on platforms?
- Does a transaction tax apply and what is the tax treatment of crypto assets in the country?

We welcome the fact that the **Proposed Platform Regime** seems to take into consideration many of the above.

**4. What standards should a Platform adopt to mitigate the risks related to safeguarding investors' assets? Please explain and provide examples both for Platforms that have their own custody systems and for Platforms that use third-party custodians to safeguard their participants' assets.**

We refer you to the GDF paper on **Crypto Asset Safekeeping and Custody** that can be accessed [here](#), in case it may be helpful.

**5. Other than issuance of Type I and Type II SOC 2 Reports, are there alternative ways in which auditors or other parties can provide assurance to regulators that a Platform has controls in place to ensure that investors' crypto-assets exist and are appropriately segregated and protected, and that transactions with respect to those assets are verifiable?**

We refer you to the GDF paper on **Crypto Asset Safekeeping and Custody** that can be accessed [here](#), in case it may be helpful. It mentions SOC 2 reports, amongst others. We would note for completeness that while SOC 2 reports are commonly requested in the traditional financial markets, it has not excluded the existence of material control issues.

**6. Are there challenges associated with a Platform being structured so as to make actual delivery of crypto assets to a participant's wallet? What are the benefits to participants, if any, of the Platforms holding or storing crypto assets on their behalf?**

Crypto exchanges typically have no settlement period (no T+2) as settlement is instant. The balance is immediately credited to the user's balance on the Exchange's internal ledger and immediately becomes available to withdraw. This could be viewed to constitute actual delivery.

If the proposal is to transfer funds to an address specific to the customer's account on the Exchange, this would be challenging. It would result in a massive increase in on-chain transactions, which would be accompanied by transaction fees, and this increase in transactions could also/ further increase fees. It would also likely increase the number of UTXOs, which is not great for blockchain throughput optimization for applicable coins.

**7. What factors should be considered in determining a fair price for crypto assets?**

We make reference in this regard to the recent Bitwise submission.<sup>2</sup>

We would also note that GDF recently started a working group on market integrity, that will report back at the July 2019 GDF mini-summit.

**8. Are there reliable pricing sources that could be used by Platforms to determine a fair price, and for regulators to assess whether Platforms have complied with fair pricing requirements? What factors should be used to determine whether a pricing source is reliable?**

There is no set standard yet. It could conceptually be a weighted-average across a number of "reputable" Exchanges that provide full trade history and order book data in real-time and

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<sup>2</sup> <https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5164833-183434.pdf>

have good depth of book. Good depth of book is more helpful than trading volume as volume can easily be boosted fraudulently as many studies have demonstrated.<sup>3</sup>

Brave New Coin has a few indices that are supported by NASDAQ.<sup>4</sup>

### **9. Is it appropriate for Platforms to set rules and monitor trading activities on their own marketplace? If so, under which circumstances should this be permitted?**

Under most national laws other than those of Canada, ATS and MTF must implement their own surveillance systems.

At current the industry is engaging similar market integrity surveillance vendors to those used in traditional asset classes, as these vendors have extended their solutions to apply the market misconduct rule set to crypto assets.<sup>5</sup>

### **10. Which market integrity requirements should apply to trading on Platforms? Please provide specific examples.**

In order to conduct effective surveillance, retaining a complete order audit trail for all orders and trades is necessary.

### **11. Are there best practices or effective surveillance tools for conducting crypto asset market surveillance? Specifically, are there any skills, tools or special regulatory powers needed to effectively conduct surveillance of crypto asset trading?**

There are a number of different vendor options, but in-house programs can be built as well with the requisite expertise.

As noted above, at current the industry is engaging similar market integrity surveillance providers to those used in traditional asset classes.

### **12. Are there other risks specific to trading of crypto assets that require different forms of surveillance than those used for marketplaces trading traditional securities?**

In addition to traditional market integrity surveillance, the crypto asset industry has seen the emergence of specialised surveillance tools focussed on tracking the movement of assets through the crypto asset addresses. We refer in this regard to the latest **GDF submission to FATF** that can be accessed [here](#) as in it we provide more insight into these tools.

An earlier GDF letter to FATF that can be accessed [here](#) also listed in its Annex various types of systems used in the crypto asset industry based on a survey conducted by GDF.

### **13. Under which circumstances should an exemption from the requirement to provide an ISR by the Platform be appropriate? What services should be included/excluded from the scope of the ISR? Please explain.**

We refer you to the GDF paper on **Crypto Asset Safekeeping and Custody** that can be accessed [here](#), in case it is helpful. It mentions security audits, amongst others.

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<sup>3</sup> See footnote above.

<sup>4</sup> <https://bravenewcoin.com/enterprise-solutions/indices-program/blx>

<sup>5</sup> See here relevant news: <https://www.apnews.com/99e1f16676704fc28ca39867be8b7f1a> ; <https://business.nasdaq.com/mediacenter/pressreleases/1728735/gemini-to-launch-market-surveillance-technology-in-collaboration-with-nasdaq>

#### **14. Is there disclosure specific to trades between a Platform and its participants that Platforms should make to their participants?**

While market practice is diverging in this regard, Exchange should probably disclose if they are trading as principal, or if there are formal market maker agreements.

#### **15. Are there particular conflicts of interest that Platforms may not be able to manage appropriately given current business models? If so, how can business models be changed to manage such conflicts appropriately?**

Exchanges often act as a “one-stop-shop”, where the Exchange acts as issuer, listing venue, custodian, prime broker, settlement agent and/or market maker. Without legal separation, “chinese walls” and tailored policies and procedures, conflicts may arise.

For example, practices are diverging in respect to access by proprietary desks to customer information, and arrangements around firms making markets on it's own Exchange.

Additional conflicts of interest may also arise when an Exchange or other VASP issues a crypto asset and may have an incentive to see it more widely-adopted or see the price rise.

#### **16. What type of insurance coverage (e.g. theft, hot-wallet, cold-wallet) should a Platform be required to obtain? Please explain.**

We list below important types of insurance in the context of the crypto market. We, however, caveat this by what is said under 17 below about the difficulties obtaining material insurance coverages.

- Cyber insurance can be used to protect against impacts of potential damages to their computer systems (outages, failures, etc.), along with business interruption coverage to compensate for lost revenues related to these outages.
- Crime insurance can be used to cover both own and customers assets stored both online and offline.
- Specific to offline storage, incremental insurance coverages may be available in the specie market.
- Directors & Officers and Errors & Omissions coverages may be used to protect their Directors and Officers against potential claims related to actions taken by that Platform, for example in the face of an uncertain and evolving regulatory landscape.

#### **17. Are there specific difficulties with obtaining insurance coverage? Please explain.**

There are some difficulties obtaining material insurance coverages as the global insurance market for crypto assets is limited in capacity and maturity. Large insurance companies are reluctant to price the risk, due to the small size of the overall market.

In addition, to the limited capacity in the global insurance market, costs are quite high vis-a-vis like coverages for traditional assets. Further, many nascent companies in the space are also limited by their own balance sheet and budget for insurance spend.

As a result, the industry is looking to facilitate a syndicate to address some of the above points, such as balance sheet size.

**18. Are there alternative measures that address investor protection that could be considered that are equivalent to insurance coverage?**

Key is best in class security infrastructure (both hot and cold storage measures).

**19. Are there other models of clearing and settling crypto assets that are traded on Platforms? What risks are introduced as a result of these models?**

Centralized crypto Exchanges do not utilize clearing services since trades are all completed in-house.

**20. What, if any, significant differences in risks exist between the traditional model of clearing and settlement and the decentralized model? Please explain how these different risks could be mitigated.**

Most crypto Exchanges are centralized and as indicated above, do not utilize clearing services since trades are all completed in-house.

For Decentralized Exchanges (DEX), the risks concern the difficulty of recourse in case funds are lost, as well as risks of bugs in the smart contracts.

**21. What other risks could be associated with clearing and settlement models that are not identified here?**

Other areas still subject to technology evolution and study include: immutability of the blockchain and how settlement finality is/can be achieved.

**22. What regulatory requirements (summarized at Appendices B, C, and D), both at the CSA and IIROC level, should apply to Platforms or should be modified for Platforms? Please provide specific examples and the rationale.**

We apologize but we have not been able to study or comment in detail on the full standing law. We are happy to conduct a **Community Survey** in case the joint regulators would like to receive more industry input on specific topics/ areas of industry knowledge/ expertise.

## Other comments

### Canadian participants

We note the following language:

*“The Proposed Platform Framework will apply to Platforms that are subject to securities legislation and that may not fit within the existing regulatory framework. It will apply both to Platforms that operate in Canada and to those that have Canadian participants.”*

We do not believe that Canadian regulators will be reasonably able to monitor compliance with “and to those that have Canadian participants” and propose this be removed.

## Margin

We took note of the following language:

*“To reduce the risks of potentially manipulative or deceptive activities, in the near term, we propose that Platforms not permit dark trading or short selling activities, or extend margin to their participants. We may revisit this once we have a better understanding of the risks introduced to the market by the trading of crypto assets.”*

Many platforms offer margin trading and derivatives, including several for many years already. Not allowing margin trading and derivatives may stifle the industry and may prevent hedging. Similarly short selling is important for price discovery.

Maybe as an alternative approach IIROC could consider limiting these activities to Platforms with adequate controls and surveillance solutions.

## Internal Ledger

We note the following language:

*“As indicated above, we understand that on some Platforms, transaction settlement occurs on the Platform's internal ledger and is not recorded on the distributed ledger. We are considering whether an exemption from the requirement to report and settle trades through a clearing agency is appropriate. In these circumstances, Platforms will still be subject to certain requirements applicable to clearing agencies and will therefore be required to have policies, procedures and controls to address certain risks including operational, custody, liquidity, investment and credit risk.”*

We welcome the consideration of an exemption.

## DEX

We note the following language:

*“Some Platforms may operate a non-custodial (decentralized) model where the transfer of crypto assets that are securities or derivatives occurs between the two parties of a trade on a decentralized blockchain protocol (e.g. smart contract). These types of Platforms will be required to have controls in place to address the specific technology and operational risks of the Platform.”*

As for DEX, it may be hard for IIROC to determine where it operates from. IIROC may need to add criteria defining this.

## PFMI

We note the following language:

*“NI 24-102 also sets out the ongoing requirements applicable to recognized clearing agencies. This includes the requirement to meet or exceed applicable principles as set up in the April 2012 report Principles for financial market infrastructures published*

*by the Committee on Payments and Market Infrastructure and the International Organization of Securities Commissions (PFMI). The PFMI cover all areas associated with activities carried out by a clearing agency: systemic risk, legal risk, credit risk, liquidity risk, general business risk, custody and investment risk and operational risk. Clearing agencies are required to:*

- *have appropriate rules and procedures on how transactions are cleared and settled, including when settlement is final;*
- *minimize and control their credit and liquidity risks;*
- *have rules that clearly state their obligations with respect to the delivery of securities traded; and*
- *identify, monitor and manage the risks and costs associated with the delivery of crypto assets, including the risk of loss of these crypto assets.”*

We apologize but we have not been able to study or comment in detail on the PFMI. We are happy to conduct a **Community Survey** in case the joint regulators would like to receive more industry input on specific topics/ areas of industry knowledge/ expertise. Nevertheless, we would hereby like to share the high level thoughts in respect to the consideration of application of the PFMI:

1. The PFMI were drafted after the Global Financial Crisis when, pursuant to the learnings from the collapse of Bear Stearns and Lehman Brothers and the near collapse of other leading financial institutions, a decision was made that OTC derivatives caused systemic risk and should be centrally cleared, leading in turn to CCPs becoming increasingly “systemic”. In comparison, the crypto asset industry is currently very small, nascent and not “systemic”. Seen from this perspective, applying the PFMI appears premature.
2. Crypto assets clear instantly. As such, there is no context of a CCP. This means that the PFMI cannot be considered relevant in full and that, instead, a tailored approach may need to be developed in consultation with the industry.

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We hope you may find this helpful. Please do not hesitate to contact us at [www.gdf.io](http://www.gdf.io).

**GDF**