March 23, 2023

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**RE: CSA Staff Notice 21-332 Crypto Asset Trading Platforms: Pre-Registration Undertakings Changes to Enhance Canadian Investor Protection**

We are writing in response to CSA Staff Notice 21-332 (the Staff Notice). While we are pleased to see CSA staff's ongoing efforts to ensure consistent regulation of crypto trading platforms (CTPs) operating in Canada and consideration of stablecoins, we have concerns with the lack of consultation prior to the publication of the Staff Notice, as well as the substance of the guidance regarding stablecoins.

In particular, we are concerned that the guidance in the Staff Notice regarding stablecoins is based on an uncertain legal position, advances a policy approach that is not fit for purpose and potentially in conflict with approaches in other jurisdictions, suggests an inefficient and unclear approval process and will adversely affect Canadian businesses, competition and innovation in crypto assets while not meaningfully advancing investor protection objectives. We propose that instead of asserting that stablecoins are securities or derivatives, the CSA and its members should work with CTPs and other stakeholders to find ways of enhancing the existing product due diligence and disclosure requirements under the existing CTP regulatory framework to address risks raised by stablecoins.

We are therefore requesting an immediate meeting with leadership of the CSA to discuss the issues outlined below. We feel there is urgency in scheduling this meeting owing to the March 24 deadline imposed by the Ontario Securities Commission and the unlevel playing field this deadline could create for CTPs who fall under the purview of the OSC. In the interim, below are key points we would like to highlight:

**The Importance of Stablecoins**

Stablecoins are one of the most widely adopted and fastest-growing applications of public blockchains. Stablecoins provide a store of value that is less volatile than other crypto assets, but perhaps more importantly, stablecoins are fundamentally a new payments technology that offers numerous benefits to existing payment systems:

- Stablecoin transactions take place on open blockchain networks that are available anywhere in the world with an internet connection.
- Although the speed of a stablecoin payment depends on the underlying blockchain network, in many cases stablecoin payments are much faster and more transparent than other forms of payment, particularly for cross-border payments.
- Network fees for transferring stablecoins may be significantly less than fees for other payment mechanisms.
- As blockchain networks operate continuously, there are no restrictions on when stablecoin payments can be made, unlike traditional payment mechanisms that may be unavailable outside of business hours.
- Stablecoin payments typically cannot be reversed after being confirmed by the underlying blockchain network, providing strong assurances for beneficiaries that the payment will not be recalled.
- Stablecoins generally use open and broadly adopted crypto asset standards (e.g., the ERC-20 token standard), allowing for stablecoins to be more easily integrated into various applications, promoting competition and interoperability.
- Stablecoin transactions are permanently recorded on publicly available blockchains, improving the ability to trace and investigate transactions in appropriate circumstances.
- Stablecoins can be integrated into more complex blockchain financial applications through the medium of smart contracts. For example, they can automate escrow functions and automatically release withheld payment when certain conditions are met.

Various commentators have noted the promise of stablecoins as a payment mechanism, particularly for cross-border payments. In our collective experience, stablecoins are already used for paying for goods and services, paying contractors and vendors, making investments and other purposes unrelated to crypto asset trading. Stablecoins can also be a valuable tool for crypto trading platforms to ensure immediate settlement with counterparties and reduce systemic risk.

We note that competition and innovation in payments is a critically important policy issue for Canada. Regulatory measures that hinder responsible payments innovation involving stablecoins will constrain greater competition in payments, to the detriment of Canadian consumers and the Canadian economy.

We acknowledge that, depending on how they are implemented, stablecoins may pose certain risks to their users and others. Accordingly, an appropriate regulatory framework for stablecoins is extremely important. Indeed, stablecoins have been the subject of consideration by policy-makers, industry and other stakeholders worldwide. Certain jurisdictions have already introduced legislation to regulate stablecoins, such as the e-money provisions of the European Union’s Markets in Crypto Assets.

It is critically important that Canada's policy approach to stablecoins consider their existing and prospective uses and the broader policy context. Indeed, that policy is already underway with the Federal Government's policy consultations on the digitization of money.

**Lack of Industry Consultation**

Given the importance of stablecoins, and the ongoing consultative efforts underway by the federal government, we are particularly disappointed that CSA staff chose to publish their views on stablecoins in the Staff Notice without first consulting with industry and other stakeholders.

We appreciated the opportunity to speak to CSA leadership and staff on October 7, 2022. In that meeting, we noted that the last round of industry consultations on the application of securities laws to crypto assets took place in early 2019, now more than four years ago. Since then, the regulatory framework for crypto trading has evolved through orders for exemptive relief and staff notices. There has been no further consultation, and requirements for CTPs have been established through bilateral discussions with individual platforms.

During this same time period, the industry has significantly evolved. Millions of Canadians have invested in crypto and there have been numerous developments in technology, industry standards/best practices and applications beyond trading and investment - including the growth of stablecoins.

At last year's meeting, we noted the Canadian crypto industry's technical, operational, legal and policy expertise and offered to collaborate productively with the CSA to help it meet its objectives. We proposed that the CSA commit to renewed consultations regarding the regulation of crypto assets during 2023. Regrettably, it appears that the CSA has elected not to consult further with us or other stakeholders and instead has proceeded to develop and publish new requirements by way of the Staff Notice.

The CSA's apparent decision not to to consult or engage with stakeholders contrasts starkly with that adopted by the federal government. As noted above, the federal government is presently conducting the first phase of a financial sector legislative review examining the stability and security of the digitalization of money, including cryptocurrencies, stablecoins, and central bank digital currencies (CBDCs). Numerous industry stakeholders, including many of the undersigned, have participated in that consultation and provided feedback on a variety of issues, including the regulation of stablecoins.

Consultation with affected stakeholders is essential to effective policy-making and ensuring regulation is fit for purpose. In certain circumstances, consultation may be legally required. In Ontario, it bears acknowledging the statements in OSC Notice 11-722 on the important distinctions between policy and staff notices. In the present circumstances, we have assumed that CSA staff have not used the Staff Notice to advance a policy position on stablecoins, given

the requirements for policies prescribed by subsection 143.8(2) of the *Securities Act* (Ontario). We urge the CSA to re-engage in consultation on the regulation of stablecoins and crypto assets more generally prior to forming any policy positions. To underline the need for consultation and advance a productive discussion, we elaborate upon our concerns with the recent Staff Notice below.

**Unclear Legal Basis for Application of Securities Laws to Fiat-Backed Stablecoins**

The Staff Notice suggests that stablecoins, and in particular fiat-backed stablecoins, are subject to securities laws, either because they are "evidence of indebtedness" or "derivatives". We believe this view is legally flawed and open to challenge.

As explained above, fiat-backed stablecoins are essentially stored value payment mechanisms, similar to other payment services such as stored value cards (e.g., gift cards, Starbucks cards) and money transfer systems such as PayPal or Wise. The critical distinction is that stablecoins use public blockchains and cryptography to authorize and record transfers of value, rather than relying on internal ledgers maintained by a payment services provider. There is no principled basis for treating fiat-backed stablecoins differently than other payments systems, simply because stablecoins use a different underlying technology.

Even if fiat-backed stablecoins may involve indebtedness, previous decisions by Canadian courts and regulators confirm that the "evidence of indebtedness" prong of the definition of "security" is not, and should not be, interpreted literally to bring all forms of indebtedness within the scope of securities laws.[1] While there have been other Canadian courts that have interpreted "evidence of indebtedness" more expansively, these cases must be viewed in the context of their specific facts (flagrant breaches of securities laws for personal gain and a desire to punish the offender). The particular factual context likely influenced the outcome, and these cases cannot be relied upon in support of a general legislative intent to bring all forms of indebtedness into the definition of "security[2]."

Interpreting "evidence of indebtedness" literally would also be inconsistent with other provincial legislation that addresses indebtedness, such as consumer protection and payday lending laws. The existence of this other legislation shows that legislatures intended that securities laws would apply only to certain forms of debt. There is also nothing to suggest that legislatures intended that securities laws would apply to payment systems generally. A literal interpretation of "evidence of indebtedness" would bring many forms of non-bank payment services within the scope of securities laws, as indebtedness necessarily arises in the course of providing many payment services.

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[1] See, for example, R v Stevenson, 2017 ABCA 420 (CanLII), at paragraph 20; *Re Aviawest Resorts Inc*, 2013 BCSECCOM 319 (CanLII), at paragraphs 58-65; and *Re FS Financial Strategies*, 2017 BCSECCOM 238 (CanLII), at paragraphs 26-27.

[2] See, for example, *Ontario Securities Commission v. Tiffin*, 2020 ONCA 217 (CanLII).

Interpreting securities laws to extend to payment systems such as stablecoins would create overlapping, if not conflicting, regulation of payments, given that the federal government has historically regulated payments systems, further to its exclusive jurisdiction over currency, banking, bills of exchange and legal tender. The federal government's interest in considering stablecoins within their current legislative review further supports this jurisdictional point. A literal interpretation of securities laws to extend them to payment systems therefore raises constitutional concerns.

The interpretation of "evidence of indebtedness" suggested by the Staff Notice is a literal interpretation inconsistent with prior case law, modern statutory interpretation and the purpose of securities laws in regulating the issuance and trading of investment instruments. The interpretation would bring other payment systems and commercial activities within the scope of securities laws, when there is nothing to suggest that was the legislative intention.

For similar reasons, the term "derivative" under securities laws cannot and should not be interpreted to extend to payment systems such as stablecoins.

**Practical Implications of the Guidance**

We are also gravely concerned that in publishing the Staff Notice, the CSA has not adequately taken into account the adverse impact the guidance will have on individuals and businesses other than CTPs, as well as the impact the guidance will have on innovation in Canada involving stablecoins. By suggesting that all stablecoins may be securities or derivatives, the guidance creates uncertainty that non-CTP businesses that transact in stablecoins for business purposes may be dealing in securities or derivatives contrary to Canadian securities laws.

Examples of such businesses include payments gateways that allow consumers to pay for goods and services using stablecoins and companies that accept stablecoin payments directly and/or use stablecoins to pay vendors or contractors and over-the-counter crypto asset dealers and liquidity providers that make immediate delivery of purchased crypto assets.

Guidance that creates uncertainty or otherwise leads over-the-counter asset dealers and liquidity providers to stop providing stablecoin liquidity to CTPs could have adverse impacts on the Canadian cryptocurrency ecosystem. Over-the-counter asset dealers are the predominant source of stablecoin liquidity for CTPs; reduction in their role in this market will greatly inhibit the ability of CTPs to maintain effective stablecoin markets for clients. Over-the-counter asset dealers also typically accept stablecoins as a form of payment for settlements, allowing CTPs to settle trades and manage risk exposures outside of standard banking hours.

We also note that CTPs may use stablecoins for operational purposes, such as settling trades or paying vendors. The guidance creates uncertainty regarding how CTPs can use stablecoins for these purposes.

Finally, as described above, stablecoins represent a successful and innovative application of public blockchains. Stablecoins are a key ingredient in what a senior Canadian securities regulator has described as the opportunity for blockchain technology "to modernize our capital markets with the possibility of dramatically lower transaction costs and improved efficiency."[3]

**The Regulation of Fiat-Backed Stablecoins**

As explained above, fiat-backed stablecoins are fundamentally payment instruments, not investment instruments, and in our view, they should be regulated consistently with other payment systems.

The federal *Retail Payments Activities Act* (*RPAA*) has been enacted to regulate non-bank payment services providers, and Finance Canada is presently seeking comment on draft regulations under the *RPAA*. The focus of the *RPAA* and its draft regulations is on mitigating the operational risks of payment services providers and ensuring that funds held for users of payment services are adequately protected. The *RPAA* is therefore directed at the same policy concerns raised by fiat-backed stablecoins.

In our view, the *RPAA* can fully address these concerns. Clarifying the *RPAA*'s application to fiat-backed stablecoins and adapting regulations where required would ensure that different non-bank payment systems are regulated consistently, under one piece of legislation, regardless of the underlying technology or business model.

We therefore urge the CSA to engage with the federal government, industry and other stakeholders to develop an appropriate Canadian regulatory framework governing fiat-backed stablecoins under the federal *RPAA*. Further, as an interim measure, we believe that augmenting existing product diligence, which is already required of registered CTPs under their Orders, to address the specific risks outlined in the Notice is the best approach that can be undertaken by regulators until such a time when stablecoins become regulated under the RPAA.

**Regulation of Other Forms of Stablecoins**

As noted in the Staff Notice, there are other forms of stablecoins, including stablecoins that use other crypto assets as a reserve or backing to maintain their value and algorithmic stablecoins that do not have any asset backing and rely solely on an algorithm to maintain value.

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[3] Keynote Address by Grant Vingoe, Chief Executive Officer, Ontario Securities Commission, Economic Club of Canada, October 6, 2022.

These other forms of stablecoins do not necessarily have an issuer or other counterparty and do not necessarily rely on contracts or other enforceable legal rights to maintain their value. Rather, their value may be maintained solely through economic incentives and software running outside the control of any party on public blockchains.

These forms of stablecoins raise novel legal and policy considerations. In particular, the absence of counterparties and enforceable legal rights creates doubt about whether securities or other laws, as presently enacted, can be applied to these systems. We believe it is premature for CSA staff to be suggesting that an entire class of innovative crypto assets is subject to securities laws or is too risky for Canadians, particularly when the CSA has not engaged in any prior consultation with affected stakeholders.

**Using the Existing Regulatory Framework**

To be clear, we share the concern of the CSA that some stablecoins may create undue risks for Canadians and that Canadians may not be fully aware of the risks of certain stablecoins. However, registered Canadian CTPs have always been required to conduct due diligence on crypto assets - including stablecoins - prior to listing them and to monitor listed assets for material changes and new material risks on an ongoing basis. In addition, registered CTPs are required to provide disclosure regarding listed crypto assets, which must include disclosure of the risks of the crypto asset. We understand that CTPs in the process of registering will be required to provide an undertaking to perform similar due diligence and provide similar disclosure.

The existing product due diligence and disclosure requirements therefore provide a framework for ensuring that stablecoins that pose undue risks to Canadians are not listed on CTPs operating in Canada and ensuring that where stablecoins are listed, the risks are properly disclosed to Canadians.

Given the existing framework, the efforts of the CSA and CTPs, both registered and unregistered, would be more productively spent collaborating on ways of refining and enhancing existing due diligence and disclosure for stablecoins, within the context of the existing regulatory framework for CTPs. This alternative approach does not require the CSA to establish that stablecoins are securities or derivatives, would not require an inefficient and duplicative process where each CTP must individually seek permission from regulators to list a stablecoin, and leaves space for ongoing discussion by all stakeholders on the appropriate policy approach for regulating stablecoins in Canada.

We are eager to work with the CSA to better understand its concerns, to share the approaches currently being taken by CTPs to assess and disclose the risks associated with stablecoins, and to find common ground on how those existing obligations can be refined with respect to stablecoins. This approach would more appropriately balance investor protection with innovation.

**New Custodial Requirements**

We also wish to address the aspects of the Staff Notice addressing requirements for "Acceptable Third-party Custodians". The Staff Notice effectively imposes new financial statement disclosure requirements on custodians. This should not be done without consulting CTPs, their custodians and auditing standards bodies and professionals in both the U.S. and Canada.

The Staff Notice suggests that custodians will be required to provide audited financial statements that disclose "on its statement of financial position or in the notes of the audited financial statements the amount of liabilities that it owes to its clients for holding their assets, and the amount of assets held by the custodian to meet its obligations to those custody clients, broken down by asset". A footnote suggests this is "[s]imilar in concept to that described in SEC Accounting Bulletin No. 121 regarding the accounting for obligations to safeguard crypto assets an entity holds for platform users."

We understand that U.S. custodians do not report crypto assets held for clients on their financial statements because they are beneficially owned by clients and therefore, in accordance with U.S. Generally Accepted Accounting Principles, do not need to be reported. We are concerned that U.S. custodians will be hesitant, or unable, to provide audited financial statements that meet this new requirement, potentially disqualifying them as acceptable custodians and leaving the Canadian market without adequate custodial solutions. Additionally, we believe there is a service provider concentration risk if only one or a small number of qualified custodian solutions are available in Canada.

Accordingly, it is critically important that the CSA also undertake further consultation regarding this aspect of the Staff Notice.

**Excess Working Capital Issue**

We are also concerned with the recent excess working capital requirements that were recently announced and put undue financial burden on small-to-medium Canadian CTPs. We recommend that the decision be revisited and tranches developed that assign different market risk thresholds depending on the risk profile of the crypto asset in question.

**Conclusion**

We are concerned that the Staff Notice's guidance regarding stablecoins is not legally sound, advances a policy approach that is not fit for purpose, potentially creates conflict with federal regulatory efforts and regulatory approaches in other jurisdictions, lacks clarity and transparency on process, and will adversely affect Canadian businesses, competition, and innovation in crypto assets.

We once again urge the CSA to undertake industry consultations with interested parties to ensure that public policy is undertaken in a coordinated and transparent manner that is fit for purpose. As an industry, we are working collectively to address these issues. Now is the appropriate time to end bilateral negotiations on important policy issues and instead engage in industry consultation. We would be grateful for the opportunity to meet with you to explain our concerns in more detail and answer any questions.

Sincerely,

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