June 16, 2023

Office of the Superintendent of Financial Institutions
255 Albert Street 12th Floor
Ottawa, Ontario K1A 0H2

VIA EMAIL: diih-caein@osfi-bsif.gc.ca

RE: Consultation on international recommendations related to, and risks posed by, fiat-referenced cryptoasset arrangements and activities

The Canadian Web3 Council (CW3) is pleased to respond to the Office of the Superintendent of Financial Institutions' (OSFI) consultation on international recommendations related to, and risks posed by, fiat-referenced cryptoasset arrangements and activities.

The CW3 is a non-profit trade association founded by industry leaders to work constructively with policymakers and establish Canada as a leader in Web3 technology[1]. The CW3 represents organizations that have made a critical impact on the development of Web3 technologies across the globe, and who are committed to responsibly building and innovating in Canada. Our membership is diverse, ranging from hackathon organizers to financial products, trading platforms and investors, and open-source blockchain projects.

Consultation with affected stakeholders is essential to effective policy-making and ensuring the regulatory framework and the regulations are fit for purpose. We appreciate the opportunity to provide you with our comments and insights. We look forward to ongoing discussions to establish the appropriate regulatory framework and regulations for fiat-referenced cryptoassets in Canada.[2]

Blockchain technology and digital assets (including fiat-referenced cryptoassets) form the underlying infrastructure and payment mechanism for Web3 applications. Thus, clarification of the underlying regulatory framework and regulations are key to encouraging innovation and greater adoption.

[1] At its core, web3 technology aims to enable direct interactions between users without relying on intermediaries. It emphasizes the use of decentralized applications (dApps) that run on blockchain networks, where data and processes are distributed across a network of nodes, making them resistant to censorship, manipulation, and single points of failure. Overall, web3 technology represents a paradigm shift towards a more decentralized, open, and user-centric internet, empowering individuals and communities with greater control over their digital lives.

[2] Consistent with the focus of the consultation, in this submission, we use "fiat-referenced cryptoasset" to refer to fiat-referenced cryptoassets pegged to a fiat currency, backed at least one-for-one by cash and cash equivalents and issued by an entity other than a national government. We use the term "stablecoin" to refer to cryptoassets that are designed or otherwise intended to maintain a stable value relative to a specified asset, or a pool or basket of assets, or kept stable using algorithmic smart contracts, usually a national currency such as the US dollar. A fiat-referenced cryptoasset is one type of stablecoin.

The Importance of fiat-referenced cryptoassets

A fiat-referenced cryptoasset can function as both a store of value and a digital payment instrument. Currently, fiat-referenced cryptoassets are issued by various non-bank entities, primarily foreign entities, and generally fall outside of any established regulatory frameworks in Canada.

Broadly speaking, fiat-referenced cryptoassets now have a collective market capitalization of around US $128 billion and represent about 12 percent of the total crypto currency market.[3] Fiat-referenced cryptoassets are one of the most widely adopted and fastest-growing use cases of public blockchains.

Fiat-referenced cryptoassets and other stablecoins can provide a store of value that may be less volatile than other crypto assets, depending on their underlying structure and if properly managed. Perhaps more importantly, they are fundamentally new payments technology that offer numerous benefits compared 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 non-digital forms of payment, particularly for cross-border payments thus allowing for real-time settlement.
- Network fees for transferring fiat-referenced cryptoassets may be significantly less than fees for other payment mechanisms given advances in infrastructure and technology.
- As blockchain networks operate continuously, there are no restrictions on when stablecoin payments can be initiated, unlike traditional payment mechanisms that may be unavailable outside of business hours.
- Stablecoin payments 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 conducted on public networks 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.

[3] CoinMarketCap, as of June 16, 2023.

- Stablecoins have the potential to enhance financial inclusion by providing access to digital financial services for individuals who are unbanked or underbanked, allowing them to participate in the global economy.

Various commentators have noted the promise of fiat-referenced cryptoassets as a payment instrument, particularly for cross-border payments.[4] In our collective experience, fiat-referenced cryptoassets are already used by Canadian individuals and businesses to buy goods and services, pay contractors and vendors, and make investments in businesses.

Canadians can currently obtain fiat-referenced cryptoassets from various sources. Virtually all cryptoasset trading platforms (CTPs) servicing Canadians, including many of CW3's member CTPs, allow Canadians to buy, sell, deposit or withdraw one or more fiat-referenced cryptoassets, primarily USD Coin (USDC) issued by Circle Internet Financial, LLC. Besides CTPs, there are many other businesses in Canada that allow Canadians to buy or sell fiat-referenced cryptoassets, such as cryptoasset automated teller machine operators. Canadians can also obtain fiat-referenced cryptoassets using decentralized finance (DeFi) protocols for exchanging cryptoassets.

In addition to their use in Canada for consumer or business payments, fiat-referenced cryptoassets are a valuable tool for Canadian CTPs to ensure they manage counterparty and settlement risk with trading counterparties and reduce systemic risk. As many CTPs essentially aggregate retail client trades with large crypto asset liquidity providers or market-makers, these CTPs will have trading balances with counterparties that must be settled in fiat currency. As crypto asset trading occurs on a 24/7/365 basis, settling these balances outside of traditional banking hours, particularly on weekends or holidays, is challenging, exposing these CTPs to counterparty and settlement risk. Some CTPs use fiat-referenced cryptoassets to settle trading balances to manage these risks, as fiat-referenced cryptoassets can be transferred at any time and transactions are generally confirmed promptly. Additionally, recognizing fiat-referenced cryptoassets as a payment instrument will give consumers access to assets on a 24/7/365 basis.

Responses to Consultation Questions

Question 1: Are the international recommendations and OSFI's existing risk management expectations that relate to prudential regulation appropriate for FRFIs to address the risks associated with fiat-referenced cryptoassets?

In our view the existing risk management framework and the international recommendations sufficiently address financial stability risks as well as operational risks such as counterparty, credit, and liquidity. We encourage OSFI to continue to actively monitor and incorporate

[4] The Relative Benefits and Risks of Stablecoins as a Means of Payment: A Case Study Perspective. Bank of Canada. 2022.

international guidance on fiat-referenced cryptoassets given the borderless nature of cryptoassets and the risk of regulatory arbitrage.

Question 2: What potential gaps to complying with the recommendations listed in Annex A do you see with respect to OSFI's current guidelines and advisories, if any?

We note that certain recommendations listed in Annex A focus on FRFIs as issuers. However, FRFIs may also be distributors of fiat-referenced cryptoassets. In light of the lack of a consistent international categorization of cryptoassets, we encourage OSFI to work with Finance Canada, the Bank of Canada and the Canadian securities regulatory authorities to harmonize rules around the issuance and distribution of fiat-referenced cryptoassets, in particular around consumer protections.

CW3 supports the FSB principle of "same regulatory outcome for the same risk",[5] but emphasizes that policy approaches for cryptoassets, including fiat-referenced cryptoassets, need to consider how risks relating to cryptoassets and open, decentralized networks may be different than risks in other systems and/or that cryptoassets and open, decentralized networks may mitigate risks in different ways.

Question 3: Are there any key inherent risks to FRFIs that should be added to Annex B? Considering OSFI's current guidelines and advisories, where do you see potential gaps to addressing these risks?

The enumerated list of key inherent risks sufficiently covers the majority of risks associated with the issuance and custody of fiat-referenced cryptoasset arrangements. However, for digital assets (including fiat-referenced cryptoassets), there are gaps in the current OSFI guidelines. For technology risk, specific guidance on the unique risks and key management processes presented by decentralized technologies, such as smart contract vulnerabilities and digital wallet technology, is encouraged. In addition, guidance on performing regular attestation reports by professional accounting firms to support the sufficiency and the quality of the assets held in reserve by the issuer to back the fiat-referenced cryptoassets is also needed.

There are a number of entities involved in the various activities of the digital asset ecosystem, not all of which are performed by FRFIs. Similarly, the risks outlined in Annex B do not apply, or do not apply equally, to all entities involved in fiat-referenced cryptoassets. The entities and the activities they perform include:

- **Issuers**: Entities engaged in minting / redeeming fiat-referenced crypto assets and maintaining reserves.

[5] Regulation, Supervision and Oversight of Crypto-Asset Activities and Markets: Consultative report - Financial Stability Board

- **Crypto Trading Platforms**: Entities that facilitate the buying and selling of cryptoassets, including fiat-referenced cryptoassets, without immediately delivering assets to buyers.
- **Distributors, such as virtual currency dealers**: Entities that facilitate the buying and selling of cryptoassets, including fiat-referenced cryptoassets, but immediately make or receive delivery of the cryptoassets with their counterparties and do not provide custody services.
- **Custodians**: Entities that will take custody or control of cryptoassets for users but are not involved in the buying or selling of cryptoassets.
- **Users**: persons that use fiat-referenced cryptoassets as a store of value or means of payment.
- **Wallet Software Providers**: Entities that license “wallet” software that can be used to take custody or control of cryptoassets.
- **Validators**: Transfer function which includes transaction validations

We would expect FRFIs to be directly involved with fiat-referenced cryptoassets as an issuer, as a custodian and potentially as a user. Currently, FRFIs are not involved as a CTP, virtual currency dealer or a wallet service provider, other than through a subsidiary or affiliate. As the industry develops, we foresee that FRFIs may become directly or indirectly involved in these other functions. When this happens, we encourage OSFI to adopt principles consistent with other regulatory frameworks for similar activities, such as the *Retail Payments Activities Act* as well as securities and consumer protection laws.

We acknowledge that FRFIs may have indirect exposure to fiat-referenced cryptoassets to the extent they provide financial services to the entities described above.

Question 4: For what reasons might entities involved in fiat-referenced cryptoassets activities be interested in operating within, or staying out of, OSFI’s regulatory regime?

CW3 believes that OSFI’s regulatory regime may be satisfactory for functions performed by existing federally regulated financial institutions. However, non-bank issuers of fiat-referenced cryptoasset do not typically engage in deposit-taking, commercial lending or maturity transformation activities. For these reasons, OSFI’s regulatory regime is not applicable for these entities. OSFI’s regulatory regime is not applicable when applied to setting standards for payments infrastructure and regulating payment service providers. We believe there are other regulatory frameworks existing in Canada and the international community that are better suited to support the various business models and functions within the digital asset space, including non-FRFI issuers of fiat-referenced cryptoassets.

CW3 submits that non-bank issued fiat-referenced cryptoassets are akin to payment instruments, as opposed to “deposits'' under the oversight of OSFI. As noted above, non-bank stablecoin issuers do not operate like deposit-taking institutions. Similarly, CW3 submits that fiat-referenced cryptoassets used for payments are always fixed directly to the value of a currency, and so they do not offer any profits or expectations of profits to the holder, and therefore are not securities or derivatives, and warrant a different regulatory regime.

Regulating fiat-referenced cryptoassets as a Payments Instrument

We acknowledge that all activities in the financial ecosystem carry some risk. The type of risk is dependent upon how the payment instrument is developed, managed and used and what other activities are performed by the payment service providers. Accordingly, an appropriate regulatory framework for fiat-referenced cryptoassets is extremely important. Indeed, fiat-referenced cryptoassets have been the subject of consideration by policymakers, industry and other stakeholders worldwide. Certain jurisdictions have already introduced legislation to regulate fiat-referenced cryptoassets, such as the e-money provisions of the European Union's Markets in Crypto Assets (MICA) where authorised European credit institutions will not have to obtain additional authorisation to issue fiat asset-referenced tokens.[6]

We assert that fiat-referenced cryptoassets function primarily as a stored value retail payment instrument. Fiat-referenced cryptoassets enable the transfer of value between parties, analogous to other electronic money transfer systems such as those operated by companies like PayPal and Wise. A critical distinction is that the transfer of value occurs on a public blockchain and it uses cryptography to verify and record transfers of value on a distributed ledger, rather than relying on internal ledgers maintained by a payment services provider.

For these reasons, we believe that unless they are FRFIs, issuers of fiat-referenced cryptoassets should be primarily regulated in the same manner as other retail payment systems.

The federal *Retail Payments Activities Act* (*RPAA*) has been enacted to regulate non-bank payment services providers, and public consultations have recently closed on the draft regulations under the *RPAA*. The focus of the *RPAA* and its draft regulations addresses some of the same principles set out in the International Recommendations found in Annex A to the Consultation. Specifically, its focus 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-referenced cryptoassets.

However, we acknowledge that at present, there is a lack of clarity regarding whether the RPAA applies to fiat-referenced cryptoassets. Clarifying the *RPAA*'s application to fiat-referenced cryptoassets and adapting regulations where required would ensure that different non-bank payment systems are regulated consistently, under one piece of legislation, regardless of the

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[6] *Regulation (EU) 2023/1114 of the European Parliament and of the Council of May 31, 2023 on Markets in Crypto-assets, and Amending Regulations (EU) No. 1093/2010 and (EU) No. 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937*, Title III, Articles 16(1)(b) and 17(1) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32023R1114&qid=1686707428073

underlying technology or business model. We therefore encourage OSFI to continue to engage with Finance Canada, the Bank of Canada, Financial Consumer Agency of Canada and industry and other stakeholders to develop an appropriate Canadian regulatory framework governing fiat-referenced cryptoassets under the federal *RPAA*.

Question 5: Are there any other comments or considerations that you feel should inform OSFI's potential development of risk management guidance expectations on fiat-referenced cryptoassets and activities, including with respect to custody issues (e.g., custody of cryptographic keys, tokens, or reserves, etc.)?

When setting a risk management framework for fiat-referenced cryptoasset activities and prudential limits for non-bank issued fiat-referenced cryptoassets, we ask OSFI to consider the joint effort by the Canadian Securities Administrators ("CSA") and the Canadian Investment Regulatory Organization (CIRO) to establish a regulatory framework for Crypto Trading Platforms ("CTPs")[7]. OSFI's regulatory framework should not impede FRFIs from providing services to CTPs and other participants in the digital asset ecosystem.

When considering the exposure that FRFIs may have to entities dealing in fiat-referenced cryptoassets, we ask OSFI to consider the steps taken by the CSA to address the risks that fiat-referenced cryptoassets may pose to CTPs. Recent guidance states that cryptoassets, including fiat-referenced cryptoassets, must be excluded from registered CTPs' calculations of their regulatory capital.[8] Accordingly, to the extent a CTP holds its own inventory of fiat-referenced cryptoassets, the CTP should still have sufficient capital even in the event of failure of the fiat-referenced cryptoasset. Compliance with these requirements can mitigate the risk that the failure of a fiat-referenced cryptoasset would negatively affect CTPs and indirectly affect FRFIs that may have exposure to CTPs.

The current CSA/CIRO framework includes requirements for CTPs to:

- Perform due diligence on all cryptoassets that they make available for trading on the platform;
- provide plain language disclosure regarding listed cryptoassets;
- hold client cryptoassets in trust and segregated from the platform's own assets;
- hold at least 80% (by value) of clients' cryptoassets with appropriate third-party custodians, which must be banks or trust companies subject to prudential regulation, with effective controls, appropriate insurance and sufficient capital, and that generally hold cryptoassets in "cold storage";
- have appropriate systems of controls for cryptoassets within the CTP's own control;
- maintain appropriate insurance for the loss of clients' cryptoassets; and

[7] The regulatory frameworks continue to evolve. The International Organization of Securities Commissions (IOSCO) recently published a consultation paper on Policy Recommendations for Crypto and Digital Asset Markets, with a final paper expected in Q3 2023 that would apply to over 150 jurisdictions.
[8] CSA Staff Notice 21-332, page 8.

- provide fair and reasonable pricing for clients trading in cryptoassets.

These requirements apply to fiat-referenced cryptoassets, as well as other types of cryptoassets.

Recently, the CSA has issued regulatory guidance specific to fiat-referenced cryptoassets and indicated that it intends to introduce further requirements specific to this class of assets.[9] This guidance explicitly addresses the potential conflicts of interest where a CTP, or an affiliate, also issues fiat-referenced cryptoassets.

In addition, CTPs, as well as other dealers in virtual currency, must register with FINTRAC under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. As a result, virtually all purchases and sales of fiat-referenced cryptoassets in Canada, as well as deposits and withdrawals of fiat-referenced cryptoassets to and from CTPs serving Canadians, are subject to the existing AML/CTF regime, thus mitigating the AML/CTF risk identified in Annex B.

Accordingly, it is important for OSFI to take into account these existing regulatory regimes. Although they do not directly address all risks outlined in Annex B, the requirements mitigate certain risks by limiting the fiat-referenced cryptoassets that are available on CTPs serving Canadians, ensuring risks are disclosed to Canadians who use CTPs subject to Canadian securities laws, and ensuring fiat-referenced cryptoassets held for Canadians are properly safeguarded against theft or loss, and addressing AML/CTF risks.

The CSA framework for CTPs may also be instructive to OSFI when considering any requirements for custody of fiat-referenced cryptoassets by FRFIs. As noted above, the CSA framework contemplates that most cryptoassets should be held with regulated and insured custodians and in cold storage (i.e., under arrangements where cryptographic key material is maintained on devices disconnected from the Internet at all times).

Additionally, we believe that the framework for fiat-referenced cryptoassets must strike a balance between regulatory objectives and innovation by Canadian Web3/crypto businesses to promote competition with other payment mechanisms. The approach should be clear, consistently applied and aligned with our international peers so that Canada can be a leader in Web3 technologies. For example, other regulators are looking at the same issue and we encourage OSFI to review the e-money regimes in UK[10] and under MICA[11].

A poorly thought out regulatory approach to stablecoins could put Canadian consumers at risk and jeopardize many Canadian crypto/Web3 companies in the long run by encouraging users to go to jurisdictions that offer more competitive products and services. For example, a regulatory

[9] CSA Staff Notice 21-332 Crypto Asset Trading Platforms: Pre-Registration Undertakings – Changes to Enhance Canadian Investor Protection
[10] UK's Electronic Money regulations
[11] *Crypto-assets: green light to new rules for tracing transfers in the EU*

approach that only allowed banks to issue fiat-referenced cryptoassets would not promote competition in payments, an area currently dominated by banks.

We submit that further exploration and study of the technology underlying decentralized stablecoins is required by regulators, as is being done in the European Union. For example, the final texts of Markets in Crypto Asset regulation in the European Union have currently excluded DeFi, that is, cryptoasset services provided in a "fully decentralized manner without any intermediary."

Maintaining Canada's Competitiveness

We note that competition and innovation in payments is a critically important policy issue within Canada and globally. Two conditions that will help drive competition and support innovation in payments and more specifically, fiat-referenced cryptoassets:

- A clear and appropriate regulatory and supervisory payments framework and standards that accommodate fiat-referenced cryptoassets and that can adapt as the technology evolves; and
- Access to financial services for innovators in the digital asset ecosystem.

We believe there are properly governed and well run operators in the digital payment space currently. These innovators have implemented appropriate governance while various existing regulatory frameworks and standards are being enhanced to accommodate fiat-referenced cryptoasset arrangements. More importantly, OSFI's regulatory framework should not impede FRFIs from providing financial services to this nascent industry. Any such restriction would hinder responsible payments innovation involving fiat-referenced cryptoassets and may have the unintended consequence of constraining greater competition in payments, to the detriment of Canadian consumers and the Canadian economy. The competitiveness of the Canadian dollar is also at stake. Failure to implement an appropriate regulatory framework for fiat-backed cryptoassets in Canada would stifle the development of a Canadian dollar-referenced cryptoasset, thus depriving Canadian businesses and consumers of a digital payment solution for cross-border transactions that offers real-time international payments and settlement. Other currencies would dominate the international payments market and this could undermine the strength of the Canadian dollar.

Conclusion

There are numerous well documented deficiencies in the payments space today. Interchange fees. Security. Reconciliation delays. Consumer preference and lack of convenience. CW3 believes these can be improved with the broader use of cryptoassets as payment methods. We believe that regulating fiat-referenced cryptoasset arrangements is a first step towards a future where payments can be secure, immediate, and convenient.

CW3 would like to offer to make itself and its members available for any further discussion on how to best address this issue, or to answer any questions about the technology that may still exist. We would like to thank OSFI for taking the time to listen to the concerns of the Web3 space in Canada. We believe we can better unlock innovation with policy and regulations that strike the right balance between sector growth and protecting consumers.

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