

# UNDER CONSTRUCTION: THE CANADIAN SECURITIES ADMINISTRATORS (CSA) PUBLISH PROPOSED REGULATORY FRAMEWORK FOR PUBLIC INVESTMENT FUNDS SEEKING TO INVEST IN CRYPTO ASSETS

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**Categories:** [Insights](#), [Publications](#)

The Canadian Securities Administrators (“**CSA**”) recently published [proposed amendments](#) introducing proposed regulatory requirements for reporting issuer investment funds that seek to invest in crypto assets (“**Public Crypto Asset Funds**”). The proposed amendments are in respect to National Instrument 81-102 Investment Funds (“**NI 81-102**”) and Companion Policy 81-102CP (collectively, the “**Proposed Amendments**”). The CSA has invited interested parties to provide their comments on the Proposed Amendments by April 17, 2024.

## Background

The Proposed Amendments follow a significant development in the crypto industry in the United States. On January 10, 2024, the U.S. Securities and Exchange Commission (the “**SEC**”) [approved](#) 11 bitcoin exchange-traded funds (ETFs) for trading on several U.S. stock exchanges. The approval is significant as the SEC previously declined approving over 20 applications for spot bitcoin exchange-traded products filed between 2018 and March 2023.<sup>[1]</sup>

In contrast, the first Public Crypto Asset Fund was approved by Canadian securities regulators in 2020, while the first crypto ETF was approved in 2021. As of June 30, 2023, there were 21 Public Crypto Asset Funds in Canada, with net assets totalling approximately \$3 billion.<sup>[2]</sup>

Consistent with their regulatory approach to other crypto-related matters generally, such as, among others, the regulatory framework being developed with respect to crypto asset trading platforms (CTPs) and stablecoins (for further details, please see our bulletins [here](#) and [here](#)), the CSA continue to actively seek to build a regulatory framework for Public Crypto Asset Funds designed to address investor protection concerns. The Proposed Amendments constitute the next phase in building this framework, and demonstrate the continued stance of the CSA that Canadian securities regulation needs to be adapted to address the unique

considerations raised by crypto assets as an investment product. There are three projected phases to the CSA's work in this area:

1. **CSA Staff Notice.** The first phase, which focused on communicating guidance regarding CSA staff expectations and new developments relating to Public Crypto Asset Funds, was previously completed on July 6, 2023 with the publication of [CSA Staff Notice 81-336 Guidance on Crypto Asset Investment Funds that are Reporting Issuers](#). CSA Staff Notice 81-336 outlined the CSA's views and expectations regarding the operation of Public Crypto Asset Funds within the currently established regulatory framework.
2. **The Proposed Amendments.** The Proposed Amendments, introduced as part of the second phase, are intended to introduce specific changes to address key areas of concern for the CSA with respect to funds investing in crypto assets. This phase seeks to codify policies and practices of existing Public Crypto Asset Funds, including routinely granted exemptive relief related to these products.
3. **Further Consultation and Possible Future Amendments.** The CSA intend for the third phase of the project to involve a public consultation concerning a broader and more comprehensive regulatory framework for funds investing in crypto assets.

## Summary of Proposed Amendments

### ***Definition of "Crypto Asset"***

Notably, the Proposed Amendments will introduce a definition of a "crypto asset", a term not presently defined by NI 81-102 or its Companion Policy. Although the Proposed Amendments only directly impact investment funds that are reporting issuers (and related industry participants), this definition could have broader application as the CSA continue to regulate other market participants active in the "crypto asset" industry, and could impact securities regulation applicable to other crypto industry participants. The Proposed Amendments will clarify that the Canadian securities regulatory authorities will consider a crypto asset to be "any digital representation of value that uses cryptography and distributed ledger technology, or a combination of similar technology, to create, verify and secure transactions"<sup>[3]</sup> for the purposes of NI 81-102.

### ***Restrictions on Investing in Crypto***

The Proposed Amendments will restrict the types of investment funds that may invest in crypto assets. Only alternative mutual funds and non-redeemable funds will be permitted to buy, sell, hold, or use crypto assets directly, or indirectly through the use of specified derivatives. Conventional mutual funds would only be able to invest in crypto assets indirectly, through investments in underlying alternative mutual funds and non-redeemable funds that invest in crypto assets (subject to the existing fund of fund restrictions in NI 81-102). The Proposed Amendments will also clarify that money market funds cannot buy or hold crypto assets.

The Proposed Amendments will also restrict the types of crypto assets Public Crypto Asset Funds may invest in. These investments will be restricted to those crypto assets that are listed for trading on, or are the underlying interest for specified derivatives that trade on, an exchange that has been recognized by a Canadian securities regulator. Currently, this requirement would restrict investment to Bitcoin and Ethereum. This restriction is being proposed to reflect regulatory concerns about determining the suitability of a crypto asset as a portfolio holding of a Public Crypto Asset Fund, such as market integrity and price discovery, and has been specifically flagged as a provision in respect of which the CSA is seeking feedback. This limitation is intended to restrict the type of crypto asset in which Public Crypto Asset Funds can invest, not how such crypto assets are purchased. Funds will be able to purchase permitted crypto assets from other sources, such as crypto asset trading platforms (CTPs).

Public Crypto Asset Funds will also be prohibited from investing in non-fungible crypto assets such as Non-Fungible Tokens (more commonly known as NFTs). This has also been highlighted in the consultation as a proposed amendment in respect of which the CSA is seeking feedback.

### ***Prohibiting the Use of Crypto Assets in Certain Transactions***

The Proposed Amendments will prohibit the use of crypto assets in securities lending, repurchase transactions or reverse transactions.

### ***Allowing for the Acceptance of Crypto Assets as Subscription Proceeds***

The Proposed Amendments will permit Public Crypto Asset Funds to accept non-security crypto assets as subscription proceeds, subject to certain conditions. Under the current regulatory framework, mutual funds are only permitted to accept securities instead of cash and therefore previously sought exemptive relief to accept crypto assets. Such exemptive relief was granted primarily to facilitate the functioning of exchange-traded mutual funds.

### ***Custody Requirements***

The Proposed Amendments will require custodians and sub-custodians that hold crypto assets on behalf of an investment fund ("**Crypto Custodians**") to adopt practices intended to enhance investor protections and protect crypto assets. The Proposed Amendments require that Crypto Custodians:

- hold crypto assets in offline storage (i.e., cold wallets), except as needed to facilitate portfolio transactions in the fund;
- maintain insurance over the crypto assets custodied. Notably, no specific type of insurance or minimum dollar amount has been proposed at this time. The Proposed Amendments require the insurance be of a type and amount that a reasonably prudent person would maintain; and

- on an annual basis, obtain and deliver to the fund a public accountant's report assessing the Crypto Custodian's internal controls and management relating to security, availability, processing integrity, confidentiality and privacy controls. A SOC-2 Type II Report has been identified as a type of report that will be considered to comply with this requirement, and the CSA is seeking specific feedback on other types of comparable reports that they should also consider sufficient.

The Proposed Amendments also set out additional expectations applicable to Crypto Custodians, including guidance on "best practices". This includes expectations regarding policies and procedures, including:

- ensuring the Crypto Custodian has the requisite expertise to custody crypto assets;
- using hardware devices to hold private cryptographic keys that are subject to robust physical security practices, with effective systems and processes for private key backup and recovery;
- maintaining robust systems and practices for the receipt, validation, review, reporting and execution of instructions from the investment fund; and
- maintaining website security measures that include two-factor authentication and strong password requirements that are cryptographically hashed.

The CSA have consistently signalled that custody is one of their key areas of focus in regulating the crypto industry (for further details, please see our bulletins [here](#) and [here](#)). Although the Proposed Amendments only apply to custodians and sub-custodians that hold crypto assets on behalf of Public Crypto Asset Funds, the custodial requirements set out in the Proposed Amendments may influence industry practice generally as this area continues to evolve.

Although subject to change following the comment period, the Proposed Amendments provide significant insight into the CSA's intended approach to the regulation of Public Crypto Asset Funds. We will continue to keep you apprised of further developments in this area. Please contact any member of McMillan LLP's Crypto Group or McMillan LLP's Investment Funds and Asset Management Group for more information.

### **McMillan Crypto**

McMillan has a comprehensive understanding of blockchain, cryptocurrency, digital assets and other decentralized technologies. We use an integrative, pragmatic, and proactive approach when providing counsel in connection with an ever-changing regulatory landscape. Our cross-disciplinary team brings together specialists across many fields, including litigation, securities regulation, capital markets, investment funds and asset management, mergers and acquisitions, derivatives, technology, privacy and cybersecurity, intellectual property, consumer protection, anti-money laundering, financial services, tax, and bankruptcy and insolvency.

### **McMillan's Investment Funds & Asset Management Group**

Our Investment Funds & Asset Management team is highly regarded for the depth of its expertise, at both transactional and regulatory levels, as well as in related practice areas including regulatory affairs, derivatives and tax. We provide business-critical legal solutions and consultation services to Canadian and foreign financial institutions, fund managers, portfolio managers, dealers and service providers, helping them prepare, adapt and satisfy their regulatory obligations while taking a proactive approach to running their business.

[1] See [Statement on the Approval of Spot Bitcoin Exchange-Traded Products](#), US Securities and Exchange Commission.

[2] See Appendix of [CSA Notice and Request for Comment – Proposed Amendments to National Instrument 81-102 Investment Funds Pertaining to Crypto Assets](#) at page 16.

[3] Proposed subsection 2.01(4) of Companion Policy 81-102CP. See [CSA Notice and Request for Comment – Proposed Amendments to National Instrument 81-102 Investment Funds Pertaining to Crypto Assets](#) at page 10.

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#### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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