

CSA publish proposed amendments to Canadian public crypto asset fund rules

JANUARY 19, 2024 7 MIN READ



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On January 18, 2024, the Canadian Securities Administrators (CSA) published for comment [CSA Notice and Request for Comment – Proposed Amendments to National Instrument 81-102 *Investment Funds* Pertaining to Crypto Assets](#) (the Notice). The Notice sets out a series of proposed amendments and changes (the proposals) to reporting issuer investment funds that seek to invest directly or indirectly in crypto assets (public crypto asset funds). The primary objectives of the proposals are to provide greater regulatory clarity on permitted crypto asset investment activities, to prohibit the use of crypto assets in securities lending and (reverse) repurchase transactions and to confirm custodial expectations.

The Notice represents the second phase of the CSA's implementation of a regulatory framework for public crypto asset funds (the project) following the publication of [CSA Staff Notice 81-336 *Guidance on Crypto Asset Investment Funds*](#), which summarized existing securities regulatory requirements and outlined CSA staff's views and expectations regarding the operations of public crypto asset funds within the framework of National Instrument 81-102 *Investment Funds* (NI 81-102).

Since the first prospectus receipt for a Canadian public crypto asset fund on April 1, 2020, the CSA has continued to monitor the crypto asset market, including with respect to liquidity, fund structure and custody arrangements. As of April 30, 2023, there were 22 public crypto asset funds in Canada that collectively had approximately \$2.86 billion in net assets. Such funds only invest in bitcoin and/or ether and achieve this primarily through direct holdings of those assets. The proposals offer to formally incorporate the CSA's comments and findings on the crypto asset market into NI 81-102.

Summary of proposals

'Alternative mutual funds'

The definition of "alternative mutual fund" would be amended to include a mutual fund that invests in crypto assets. Alternative mutual funds are permitted to have greater exposure to certain alternative asset classes and investment strategies compared to traditional mutual funds subject to NI 81-102.

Restrictions on investments in crypto assets

All investment funds, except alternative mutual funds and non-redeemable investment funds, would be restricted from investing directly (or indirectly through derivatives) in crypto assets. However, mutual funds that are not alternative mutual funds would be permitted to invest in crypto assets indirectly through underlying alternative mutual funds or non-redeemable investment funds that invest in crypto assets, subject to the fund of fund restrictions in NI 81-102.

Alternative mutual funds and non-redeemable investment funds would be permitted to invest in crypto assets directly, or indirectly through derivatives, only if the crypto asset or the derivative's underlying interest is listed on an exchange recognized by a Canadian securities regulatory authority. This requirement is not intended to limit crypto asset trading to recognized exchanges but is intended to limit investments to crypto assets for which spot prices can be derived through regulated sources with institutional support. Provided these requirements are met, a public crypto asset fund would continue to be able to acquire such crypto assets from other sources such as crypto asset trading platforms. A list of crypto asset trading platforms authorized to trade crypto assets with Canadians can be found on the [CSA's website](#).

Public crypto asset funds would be prohibited from buying or holding crypto assets that are not fungible, such as non-fungible tokens (NFTs). The CSA views non-fungible crypto assets as incompatible with investment fund products offered to retail investors insofar as they have additional liquidity and valuation risks as compared to other crypto assets.

Securities lending, repurchase transactions and reverse repurchase transactions

Public crypto asset funds would be prohibited from using crypto assets in securities lending, repurchase transactions or reverse repurchase transactions as the loaned securities, transferred securities or collateral posted in connection with these transactions.

'Money market funds'

The definition of "money market fund" would be amended to restrict money market funds from buying or holding crypto assets.

Custodianship of portfolio assets

New provisions applicable to custodians and sub-custodians that hold crypto assets on behalf of an investment fund (crypto custodians) would be added, which would require crypto custodians to do the following:

- Keep crypto assets in offline storage (i.e., "cold wallet" storage), except as needed to facilitate purchases and sales or other portfolio transactions in the fund.
- Maintain insurance with respect to custodied crypto assets of a type and amount that a reasonably prudent person would maintain.
 - The CSA does not propose a specific type of insurance or minimum dollar amount to meet this standard, but expects that crypto custodians consider their custodial

obligations and standard of care to the public crypto asset fund, including taking into account how the insurance compares to industry standards.

- Obtain and deliver to the public crypto asset fund, on at least an annual basis, a report prepared by a public accountant that expresses a reasonable assurance opinion concerning the design and operational effectiveness of the service commitments and system requirements set for the crypto custodian relating to security, availability, confidentiality, processing integrity and privacy controls.
 - For example, a Service Organization Control (SOC) 2 Type 2 Report prepared in accordance with the framework developed by the American Institute of Chartered Public Accountants would meet these requirements. This report would be in addition to the existing annual review and reporting obligations that a primary custodian has in respect of its sub-custodial arrangements under NI 81-102.
 - This report also imposes a direct obligation on sub-custodians that hold crypto assets whereas the existing reporting obligations are solely on the primary custodian. Today, most crypto custodians for public crypto asset funds are contractually required to deliver SOC 2 Type 2 reports to the primary custodian and/or manager of the public crypto asset fund.

The amendments affecting crypto custodians do not significantly alter the current custodial arrangements for public crypto asset funds.

Sale of securities of a mutual fund

Exemptive relief that has been granted to existing public crypto asset funds that permit them to accept crypto assets as subscription proceeds in lieu of cash would be codified. Specifically, the proposals would clarify that an alternative mutual fund can accept crypto assets that are not securities as subscription proceeds. The relief has been historically granted to facilitate primary market activities for exchange-traded public crypto asset funds by allowing designated brokers and market makers to exchange crypto assets for “creation units” of the public crypto asset fund instead of requiring cash transactions which results in increased transaction costs.

Custody standard of care

All custodians and sub-custodians (including crypto custodians), in carrying out their duties concerning the safekeeping of, and dealing with, the portfolio assets of a public crypto asset fund, must exercise (a) the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances; or (b) at least the same degree of care as they exercise with respect to their own property of a similar kind, if this is a higher degree of care than the degree of care referred to in paragraph (a).

The proposals contemplate the companion policy to NI 81-102 being amended to provide additional guidance on meeting this standard of care for both primary custodians and crypto custodians, including

- ensuring the crypto custodian has the requisite expertise to custody crypto assets
- using segregated wallets or omnibus wallets visible on the blockchain, so long as the books and records of the crypto custodian confirm the public crypto asset fund's

ownership of the crypto assets

- using multi-signature technology to limit the risk of a single point of failure
- using strong passwords, multi-factor authentication and encryption of client information to limit the risk of hacking
- maintaining robust cyber and physical security practices to ensure greater security of the crypto assets

This guidance largely reflects existing crypto custody practices for existing public crypto asset funds.

Takeaways

The most significant updates to the existing public crypto asset fund practices include

1. explicit limitations on NFTs
2. mandates for investing solely in crypto assets (or derivatives with crypto asset underliers) that are traded on recognized exchanges while continuing to allow purchases on crypto asset trading platforms
3. requiring crypto custodians to obtain, and deliver to public crypto asset funds, SOC 2 Type 2-like reports

The remainder of the changes generally align with current practices for public crypto asset funds and are not expected to substantially affect their operations.