FACT GUIDE

Investor's guide: Cryptocurrencies

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What are crypto assets?

Crypto assets are digital coins or tokens that can be utilized to solve a variety of problems, including being a more efficient medium of exchange over the internet for goods and services, albeit not yet widely available everywhere as a payment method. Judging the inherent value in any crypto asset can be difficult, with its value largely determined by its evolving utility, public interest and the current levels of supply and demand. As such, determining the fair value of a given crypto asset at any one time can be difficult or even impossible.

Generally speaking, the vast majority of crypto assets are designed to be decentralized as they are not issued or controlled by any central authority or government, with transfers of value taking place without the need of a middleman like a financial institution or payment processor. While not adopted as legal tender in Canada, some countries, such as El Salvador, and central banks have adopted Bitcoin as legal tender. Investors should be mindful that although many crypto assets are designed with the aspirational goal of being decentralized, some are operated with elements that are increasingly centralized and controlled by one or more parties.

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Blockchain technology and crypto assets

Often confused for one another, these two terms describe different things. Blockchain technology is the online infrastructure that permits and records the transactions of crypto assets for all participants securely using cryptography, hence the term "crypto." As a transaction of crypto assets takes place on the blockchain, a peer-to-peer network confirms and validates the transaction and adds it to a growing list of records called blocks. Once a block is complete, it is linked to the previous block in the chain in chronological order and is irreversible and visible to anyone on the system.

The key feature of blockchain is decentralization through the use of distributed ledger technology. Decentralization means that the secure settlement and clearing of crypto assets in a transaction are done without the involvement of a central third party such as a financial institution or government.

Cryptocurrencies or crypto assets?

While digital coins and tokens are commonly referred to as "cryptocurrencies," crypto assets is a more appropriate term as cryptocurrencies are classified as a sub-set of digital assets. Additionally, most cryptocurrencies are not currencies in the true sense of the term and none are recognized as legal tender under the *Currency Act* (Canada). They can also serve multiple purposes beyond acting as money. These purposes include acting as a digital representation of an ownership interest in an asset or business, commonly called a security token or a utility token enabling the owner to participate in a particular ecosystem or access online networks and services.

Buying and selling crypto assets

Crypto assets can be traded in several ways, including directly through an unregulated peer-to-peer (P2P) transfer or more commonly through a crypto asset trading platform. Investors should also be aware that they may incur tax on income from transactions involving crypto assets.

To learn more about tax considerations, investors should consult the [Canada Revenue Agency website](https://www.canada.ca/en/revenue-agency.html).

Securities law for crypto assets and crypto asset trading platforms

Whether a crypto asset is subject to securities laws is not determined by its name, it is determined by its substance. When crypto assets are shares or other forms of securities or derivatives, they are subject to securities law in the province they are traded in. If a crypto asset is not a security or derivative, securities law will still apply to platforms that provide a trading venue and hold custody of the crypto assets for clients. If the platform does not hold custody of crypto assets for clients or facilitate the trade of crypto assets that are securities or derivatives, securities law may not apply.

The regulation of crypto assets continues to evolve and improve. Currently, many crypto asset trading platforms accessible by Canadians are subject to securities law and are seeking to be registered as securities dealers to bring themselves into compliance. It is strongly advised that Canadians do not allow unregistered crypto asset trading platforms to have custody or control over their crypto assets. If a crypto asset trading platform is not registered there is no assurance that any of the typical protections that may exist when using a registered dealer are present. These protections are intended to address matters such as secure handling of client funds, safekeeping of client assets, protection of personal information, pre-trade disclosures, and measures against market manipulation and/or unfair trading. Investors should be aware that some crypto asset trading platforms, including foreign platforms, dealing with Canadians may try to evade the requirement of regulation.

Investors should always check whether the crypto asset trading platform they choose is registered in the province or territory they reside in if it holds custody of crypto assets or facilitates the trade of crypto assets that are deemed securities or derivatives. This check can be conducted with the national registration search provided by the Canadian Securities Administrators.

Visit the website of the securities regulator in your province or territory to learn more about how securities law applies to crypto assets where a security or derivative exists or is created.

Holding your crypto assets

Investors can hold their crypto assets in several ways:

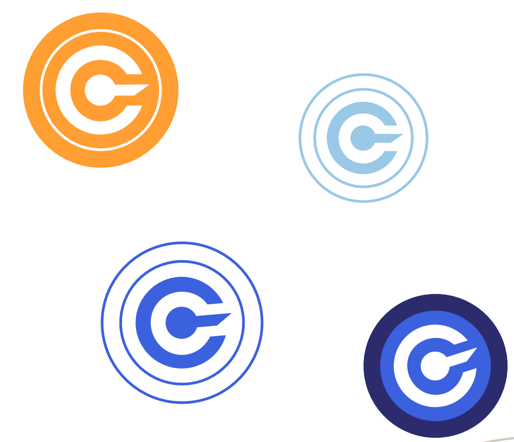
Crypto asset trading platforms: Many investors do not hold their crypto assets themselves but rather through crypto asset trading platforms that hold custody of their crypto assets. In this case, the platform typically holds the private key (similar to a password) that allows the crypto asset to be transacted. According to the blockchain, the trading platform, not the client, is the owner of the crypto asset. The client will have a contract with the platform that gives them a right to be delivered that crypto asset. Many investors prefer using a crypto asset trading platform for the convenience of not having to create their own "wallet" and securely maintaining the private key. However, this requires investors to rely on their chosen platform and trust that it can deliver the crypto asset when requested, and that it has sufficient resources and controls to continuously operate and protect against hacking and theft. Investors should be mindful that registered crypto asset trading platforms are required to hold the majority of a client's crypto assets in cold storage with a custodian.

Digital wallets: Investors also have the option to hold their crypto assets in a digital wallet and maintain the private key. Digital wallets come in two main forms:

Hot wallets: Also known as online wallets, run on connected devices like computers, mobile phones, tablets and through exchange custody wallets. Maintaining crypto assets in a hot wallet allows them to be conveniently traded, but increases the risk that the device can be hacked and the crypto assets stolen.

Cold wallets: Are wallets that are not connected to the internet and offer fewer opportunities for potential hacking of a user's address and private key. Similar to a USB drive, cold wallets allow users to view their portfolio without connecting to the internet and putting their private key at risk, and connecting to the internet only at the time of trading. Cold wallets face the risk of physical loss, damage or the loss of the permanent seed phrase password, making the drive inaccessible.

Other ways to invest in crypto assets



Investors can invest in certain crypto assets without holding the digital coins directly. There are now several exchange-traded funds (ETFs) that have exposure to Bitcoin and Ethereum, two of the most highly traded crypto assets. Publicly traded funds are generally required to hold predominantly liquid assets, so investors can sell their funds when needed. Private investment funds typically only allow redemption annually and therefore may invest in less liquid assets. While more readily accessible and regulated under securities law, crypto asset investment funds are still susceptible to the inherent risks of the crypto assets they invest in, including market volatility, cyber-attacks and crypto asset trading platform default.

Some companies also offer crypto-mining services, which typically consist of agreements through which the company mines cryptocurrencies for the benefit of third parties. Contracts whereby investors agree to fund these mining operations may themselves constitute securities. As such they carry risks similar to those outlined above in addition to the risk of unprofitable mining if the underlying crypto asset loses value, rising electricity costs and fraud.

Crypto-related investment scams and fraud

Crypto assets have seen significant growth and interest from the public as their accessibility increases. As this trend continues to generate excitement, fraudsters take advantage of the popularity of crypto assets to promote crypto scams to potential investors. Remember the following tips:

Check the registration of the crypto asset trading platform before investing

Before investing on any platform that will hold custody of your crypto assets or facilitate the trade of crypto assets that are securities or derivatives, check to ensure it is registered with your local securities regulator. Unregistered crypto asset trading platforms may not provide any of the typical investor protections that may exist when using a registered dealer.

Avoid social media and online groups that promote experts who can help you invest in crypto assets

You may find groups on apps, such as WhatsApp, Discord and websites that falsely promote themselves as analysts or advisers, that say they can help you invest in crypto assets or maximize your returns with your existing crypto assets for a fee. These scam artists will urge you to buy or move your existing crypto assets from your wallet or trading platform to them to "invest." You may see early returns, but this is just to establish a false sense of credibility. They will request more money, claiming you need to recoup losses, increase your supposed gains, or pay taxes and fees on your investment.

Ignore investment opportunities offered through social media and dating apps

Scam artists often use social media and dating apps to take advantage of those looking for meaningful friendships and relationships. Be mindful that investment offers proposed by new friends or love interests online are red flags of investment fraud.

Look out for guarantees of high returns with little to no risk of loss

Investing in crypto assets is high risk and carries the *potential* for high returns. Anyone who promises high returns with little to no risk to investors should not be trusted. This is one of the oldest and most prominent signs of fraud.

Be wary of crypto asset recovery offers

If you lost money in false crypto investments previously, fraudsters may contact you in an attempt to defraud you again by acting like they are part of an organization or law enforcement agency helping to recover your crypto assets or funds for a fee. Neither the fee nor the contact person is legitimate and should be reported to your local securities regulator.

Refuse remote access to your computer

When calling and pitching crypto asset investment offers, scam artists may try to convince you to give them remote access to your computer to guide you to a fake crypto asset trading platform to invest. The scam artist may even try to help you with depositing money into the fake trading platform while stealing personal information, including bank account numbers.

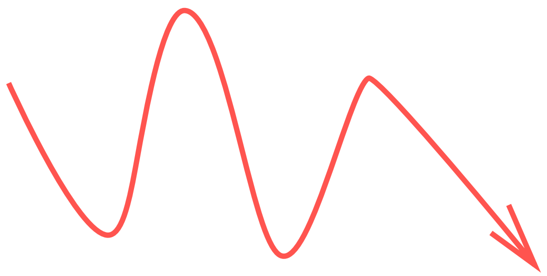
Avoid unusual forms of payment or transfers

Scam artists may ask you to wire money or transfer crypto assets to their desired platform to assist you in a crypto investment opportunity. These transfers are instant, hard to recover and it's nearly impossible to trace the recipient.

Don't invest in anything you can't understand

Scam artists like to use high pressure sales tactics, confusing jargon and complex documents and explanations to try to override your suspicions and keep you focused on the reward aspect of their scheme. Always research the investment outside of the information provided to you and verify that the individual offering it is registered before handing over your money or crypto assets.

Considerations before investing in crypto assets



Crypto assets carry a high level of risk that investors should consider before pursuing. Some of these risks include:

Lack of regulation or regulatory compliance: Regulations are evolving. Currently, not all crypto assets are considered securities. Non-securities are not subject to regulation by securities regulators. Additionally, many crypto asset trading platforms are not yet registered with Canadian securities regulators. Combined, these factors limit the protections afforded to investors. Despite this, the list of regulated dealers and marketplaces is growing and they are subject to various requirements designed to protect investors.

Leverage (on-margin) trading risks: Leverage trading is a complex and high-risk trading strategy in which investors borrow funds from a trading platform to multiply their potential profits and inversely, their potential losses from an investment based on a chosen leverage position. Some crypto asset trading platforms may allow for high levels of leverage that expose investors to extremely high levels of risk. For example, suppose a trading platform offers 100 times leverage. In that case, gains are amplified significantly, but even a very small drop in the crypto asset of just one per cent would wipe out the entire investment. Many crypto assets move more than one per cent in a given hour. Even if you think you understand the general, long-term direction of a crypto asset, the day-to-day volatility may still result in the complete loss of capital from high levels of leverage.

Volatility: The value of a crypto asset is often determined solely by the public's interest in it and the current supply and demand levels. As such, the price of a crypto asset may be driven primarily or solely by speculative demand that may be unsustainable and cause dramatic fluctuations in the value of the investment. A collapse in demand for a crypto asset may result in the loss of all or most of your investment.

Liquidity: Trading crypto assets for another or for money that is legal tender may not be easy or cost-effective. There is limited liquidity in some crypto assets with prices and bid-ask spreads (that is, the spread between the price sought by a seller and the price offered by a buyer) varying widely across crypto asset trading platforms. Crypto asset trading platforms may limit or suspend trading, or there may be limitations or suspensions imposed on funding and withdrawals from accounts. These risks may limit your ability to liquidate your investment on a timely basis or without significant expense.

Loss through fraud, theft, hacking or human error: Crypto assets are represented digitally and as such, are susceptible to loss through theft, hacking and the compromising or loss of digital wallets and keys. Further, there is a risk that the software code behind the crypto asset may not function as it is represented or change over time. Since crypto assets are typically sold online, their creation and sale may be conducted in other countries making it difficult for law enforcement agencies to monitor or take action. Additionally, because trading in crypto assets is largely anonymous, it can attract parties engaged in illegal businesses and unscrupulous practices. These characteristics make crypto assets attractive to those intending to perpetrate scams and fraud. These risks could result in the loss of your investment.

The bottom line

Crypto assets are high-risk investments that are not suitable for all investors. The nature, longevity and future application of crypto assets are largely unknown and evolving, and may not be appropriate for your financial plans and goals.

Knowledge is power

You are taking the right first steps by learning the fundamentals of crypto assets before considering to invest. In addition to this guide, you can visit the [Canadian Securities Administrators website] for a wealth of investor tools, information and resources.

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This guide is brought to you by the Canadian Securities Administrators in partnership with the Alberta Securities Commission (ASC). The Canadian Securities Administrators (CSA) is the umbrella organization of Canada's provincial and territorial securities regulators whose objective is to improve, coordinate and harmonize regulation of the Canadian capital markets.

Alberta Securities Commission

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