

## Canadian Securities Administrators Staff Notice 81-336 *Guidance on Crypto Asset Investment Funds that are Reporting Issuers*

July 6, 2023

### 1. Purpose of this Notice

Staff of the Canadian Securities Administrators (**CSA staff** or **we**) are publishing this notice (the **Notice**) concerning investment funds that seek to invest in crypto assets, either directly or indirectly<sup>1</sup> under National Instrument 81-102 *Investment Funds* (**NI 81-102**) (**Public Crypto Asset Funds**). This Notice is intended to provide guidance to stakeholders and to outline CSA staff's views and expectations regarding the operations of Public Crypto Asset Funds within the framework of NI 81-102.

This Notice will

- provide an overview of the Public Crypto Asset Funds market in Canada and clarify the current securities regulatory requirements applicable to Public Crypto Asset Funds;
- discuss key findings from reviews of Public Crypto Asset Funds conducted by CSA staff, including fund liquidity, exchange-traded mutual fund (**ETF**) structural matters and custody; and
- outline CSA staff expectations for stakeholders with respect to matters that could impact existing and future Public Crypto Asset Funds, specifically concerning
  - liquidity, valuation and other considerations with respect to potentially investing in crypto assets other than bitcoin and ether, which are currently the only crypto assets accepted as investments for Public Crypto Asset Funds;
  - expectations for custodians of crypto assets (**Crypto Custodian**) to meet standard of care obligations under NI 81-102;
  - issues relating to staking of crypto assets or other similar yield-generating activities within Public Crypto Asset Funds; and
  - know-your-product (**KYP**), know-your-client (**KYC**) and suitability obligation issues with respect to Public Crypto Asset Funds.

Guidance provided in this Notice is based on existing securities regulatory requirements and does not create any new legal requirements or modify existing ones.

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<sup>1</sup> For example, through the use of derivatives or fund of fund investing.

## 2. Background

The first prospectus receipt for a Canadian Public Crypto Asset Fund was issued on April 1, 2020, following a panel decision of the Ontario Securities Commission (the **Bitcoin Decision**).<sup>2</sup> The Bitcoin Decision resulted in a prospectus receipt being issued with respect to the Bitcoin Fund, a non-redeemable investment fund that invests substantially all of its assets directly in bitcoin. The Bitcoin Decision also led to the launch of several other Public Crypto Asset Funds, including the first ETFs in the world that invest directly in bitcoin and ether.

As of April 30, 2023, there are 22 Public Crypto Asset Funds in Canada that collectively have approximately \$2.86 billion in net assets. The Public Crypto Asset Funds currently invest only in bitcoin and/or ether and achieve this primarily through direct holdings of those crypto assets (including through fund of fund structures). More detailed market data concerning Public Crypto Asset Funds is provided in the Appendix to this Notice.

## 3. Regulatory Framework for Public Crypto Asset Funds

Public Crypto Asset Funds are subject to the same regulatory framework as other publicly distributed investment funds in Canada.

This framework includes having a registered investment fund manager (**IFM**) and portfolio manager(s) under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**), distributing securities of the fund by way of a prospectus prepared in accordance with National Instrument 41-101 *General Prospectus Requirements* (**NI 41-101**) or National Instrument 81-101 *Mutual Fund Prospectus Requirements* (**NI 81-101**), as well as being subject to the operational framework of NI 81-102, among other rules and instruments. Public Crypto Asset Funds must also compute a net asset value (**NAV**) on a daily basis that must be calculated in accordance with National Instrument 81-106 *Investment Fund Continuous Disclosure* (**NI 81-106**).

The existing Public Crypto Asset Funds that are structured as ETFs or conventional mutual funds are classified as “alternative mutual funds” under NI 81-102 and accordingly have a greater ability to borrow cash or provide a security interest over their assets, engage in short selling or use specified derivatives applicable to alternative mutual funds, subject to the limits set out in that rule.<sup>3</sup> They are also subject to issuer concentration and control restrictions, restrictions on holding illiquid assets,<sup>4</sup> and other investment restrictions set out in Part 2 of NI 81-102.

The Public Crypto Asset Funds have appointed custodians and sub-custodians to hold their portfolio assets, each of which is required to meet the applicable qualification criteria set out in Part 6 of NI 81-102.

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<sup>2</sup> *3iQ Corp (Re)*, 2019 ONSEC 37, available at [https://www.osc.ca/sites/default/files/pdfs/proceedings/rad\\_20191029\\_3iq-2.pdf](https://www.osc.ca/sites/default/files/pdfs/proceedings/rad_20191029_3iq-2.pdf).

<sup>3</sup> See subsection 2.6(2) and sections 2.6.1, 2.6.2 and 2.9.1 of NI 81-102.

<sup>4</sup> See sections 2.1, 2.2 and 2.4 of NI 81-102 respectively. Public Crypto Asset Funds structured as non-redeemable investment funds are permitted to invest a higher proportion of their portfolio in illiquid assets but are otherwise subject to the same investment restrictions as alternative mutual funds under NI 81-102.

#### **4. Oversight by CSA Staff**

As part of the CSA's general oversight role, and in response to issues that have arisen in crypto asset markets, CSA staff have conducted reviews of Public Crypto Asset Funds that directly hold crypto assets,<sup>5</sup> focused on liquidity, ETF structure, and custody. Our findings are described below.

##### ***(a) Liquidity***

Liquidity reviews of the Public Crypto Asset Funds structured as ETFs were initiated in May 2021. CSA staff noted that the Public Crypto Asset Funds had not experienced any material difficulties in meeting redemption requests since their respective inceptions. IFMs reported using various approaches for liquidity risk management of Public Crypto Asset Funds, which included ongoing portfolio management and continuous liquidity assessments of the underlying crypto asset, in addition to ongoing monitoring of relationships with liquidity providers and ensuring that alternative sources of liquidity are available.

##### ***(b) ETF Structure***

In May 2021, CSA staff conducted a review of Public Crypto Asset Funds structured as ETFs to better understand how they managed their subscription and redemption activities, where they sourced their crypto assets, and how they continued to accurately calculate their Public Crypto Asset Funds' NAV. CSA staff found that most of the ETFs traded very closely to their NAV.

In June 2022, CSA staff made further inquiries to understand how certain Public Crypto Asset Funds structured as ETFs were able to meet large redemption requests including whether extraordinary measures were needed to meet the redemption requests. We found that in those cases, the ETFs were able to meet the redemption requests as part of their normal operating procedures, with all redeemed securities paid in cash at NAV based on their respective valuation index, with settlement the next business day. We also found that none of the ETFs needed to borrow cash to meet the redemption requests.<sup>6</sup>

##### ***(c) Custody***

In November 2022, CSA staff conducted a review of the custody arrangements for several Public Crypto Asset Funds that directly held crypto assets. We confirmed, among other things,

- the segregation of the Public Crypto Asset Fund's crypto assets from those of the Crypto Custodian and other clients of the Crypto Custodian;
- the use of offline or "cold wallet" storage of crypto assets held by the Crypto Custodian;
- the listing of Public Crypto Asset Fund as the beneficial owner of its crypto assets in the Crypto Custodian's books and records;

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<sup>5</sup> As is noted in the Appendix, the existing Public Crypto Asset Funds that directly hold crypto assets in their portfolios are primarily structured as ETFs.

<sup>6</sup> An investment fund can borrow cash as a temporary measure to accommodate redemption requests pursuant to subparagraph 2.6(1)(a)(i) of NI 81-102.

- the existence of controls and procedures that validate security, segregation and ownership of the crypto assets including verification on the blockchain; and
- the maintenance by the Crypto Custodian of insurance over custodied crypto assets.

## **5. Stakeholder Considerations Regarding Public Crypto Asset Funds**

The nature of crypto assets can create unique challenges for funds that hold these assets directly, which may require specific regulatory consideration. We have identified a number of areas for which we believe greater guidance regarding CSA staff expectations may be warranted, for both existing and possible future offerings of Public Crypto Asset Funds. One or more of the identified areas may also become the subject of future policy work by the CSA.

### ***(a) Crypto Asset and Crypto Asset Market Characteristics***

The unique features of each crypto asset and its market are key to determining whether the crypto asset is a suitable investment for a publicly distributed investment fund under NI 81-102. Among the most important considerations are (i) the ability to determine a fair value of the crypto asset, (ii) liquidity of the crypto asset and (iii) the classification of the crypto asset and the implications arising from its classification, each of which is discussed further below.

#### *(i) Valuation*

Markets for various crypto assets have been evolving rapidly over the course of the last several years and now fall on a wide spectrum in terms of maturity. CSA staff are of the view that the more efficient and transparent the facilities provided by a market, the more such a market can support the operations of Public Crypto Asset Funds. Less mature markets may offer less efficient facilities and institutional support for Public Crypto Asset Funds to operate without compromising investor protection.

The market for any crypto asset in which a Public Crypto Asset Fund seeks to invest should support the fund's ability to calculate its NAV in accordance with NI 81-106. CSA staff will take into consideration the particulars of a given crypto asset's market in their analysis of whether to recommend the issuance of a receipt for the prospectus for an investment fund that seeks to directly invest in the crypto asset. These particulars will include

- sufficient evidence of an active market for the crypto asset comprising actual and regularly occurring market transactions on an arm's length basis;
- the presence of a regulated futures market for that crypto asset; and
- publicly available indices administered by a regulated index provider for the crypto asset.

#### Active markets

Under NI 81-106, an investment fund's NAV must be calculated using the "fair value" of its assets and liabilities. "Fair value" in this context means either the market value based on reported prices and quotations in an active market or, if the market is not an "active market", a value that is fair

and reasonable in all the relevant circumstances.<sup>7</sup> A market is generally considered an active market when the quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices reflect actual and regularly occurring market transactions on an arm's length basis.<sup>8</sup>

There is data that suggests evidence of market manipulation in some unregulated segments of existing crypto asset markets<sup>9</sup> such that the markets for certain crypto assets may not be considered "active markets". CSA staff think that this would impair or limit an IFM's ability to determine a fair value for the crypto asset in question for the purpose of calculating a NAV. Crypto asset markets that are active markets provide more accurate and legitimate information and, therefore, a fair and reasonable market value.

To accurately value a crypto asset, an IFM should consider whether the market for that crypto asset has real and substantial trading volume, in large size, both in absolute terms and when compared to other markets for commodities and equities.<sup>10</sup> These types of markets will generally provide enough liquidity to promote accurate price discovery.<sup>11</sup> Additionally, markets that have a significant volume of transactions on regulated exchanges as opposed to unregulated exchanges will promote more reliable price discovery due to the lower risk of market manipulation.

### Regulated Futures

CSA staff are also of the view that the presence of a regulated futures market for a crypto asset provides support for the proper valuation of a Public Crypto Asset Fund that invests in that crypto asset, along with other operational benefits. First CSA staff consider that the presence of a regulated futures market for a particular crypto asset promotes greater price discovery, a view that is supported by recent research.<sup>12</sup> We note that there is some evidence of market manipulation in crypto asset futures markets, which highlights the importance of relying on a regulated futures market rather than an unregulated futures market.<sup>13</sup> Accordingly, in their analysis of whether to recommend the issuance of a receipt for the prospectus of an investment fund that seeks to directly invest in a crypto asset, CSA staff would consider a crypto asset for which there is a regulated futures market where anti-manipulation rules allow for a fair and transparent value of that crypto asset to be more accurately determined, to raise fewer investor protection concerns.<sup>14</sup>

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<sup>7</sup> See subsection 14.2(1.2) of NI 81-106.

<sup>8</sup> See subsection 9.4(1) of Companion Policy 81-106CP *Investment Fund Continuous Disclosure*.

<sup>9</sup> See for example Cong, L. W., Li, X., Tang, K., and Yang, Y. "Crypto Wash Trading" (July 1, 2021), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3530220](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530220) and Paz, J., "More Than Half Of All Bitcoin Trades Are Fake" (August 26, 2022), available at <https://www.forbes.com/sites/javierpaz/2022/08/26/more-than-half-of-all-bitcoin-trades-are-fake/?sh=17f7f7666681>.

<sup>10</sup> See the Bitcoin Decision, par. 47 and 49 to 51.

<sup>11</sup> See the Bitcoin Decision, par. 50.

<sup>12</sup> See for example Sharma et al., "Investigating the Efficiency of Bitcoin Futures in Price Discovery" (2022), available at International Journal of Economics and Financial Issues: <https://www.econjournals.com/index.php/ijefi/article/view/12783>.

<sup>13</sup> Cong, L. W., Li, X., Tang, K., and Yang, Y. "Crypto Wash Trading" (2021), p. 5, available at SSRN: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3530220](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530220).

<sup>14</sup> CSA staff note that the Australian Securities and Investments Commission has expressed a similar view. See *Report 705 Response to Submissions on CP 343 Crypto-assets as Underlying Assets for ETPs and Other Investment*

Additionally, market makers for ETFs use different tools, including derivatives, to hedge against market price fluctuations in the ETFs' underlying assets. The presence of a regulated futures market can support the ability of authorized dealers and market makers to properly carry out their market making duties with respect to Public Crypto Asset Funds that are ETFs. Regulatory expectations relating to the proper functioning of these ETFs include the ability for market makers of an ETF to be able to carry out their duties under their agreements with the ETF, including being able to make liquid markets for the ETF's units.<sup>15</sup> We further note that the presence of a regulated futures market for a given crypto asset generally correlates with institutional support for that particular crypto asset.

### Use of Pricing Indices

CSA staff note that several existing Public Crypto Asset Funds base their valuations on spot pricing from available crypto asset indices.<sup>16</sup> Selecting publicly available indices that aggregate pricing from a variety of sources to determine a spot price, and that are administered by regulated index providers using transparent, auditable and replicable calculation methodologies that comply with industry best practices as well as International Organization of Securities Commissions standards, will help mitigate the risks of inaccurate pricing of a particular crypto asset.<sup>17</sup> In addition, an IFM may be better able to confirm the ongoing accuracy and reliability of the index by referring to other widely used and reputable pricing sources for the crypto asset.<sup>18</sup>

### Crypto Assets that Best Support Fair Valuation

Considering the above criteria, CSA staff are of the view that the markets for bitcoin and ether best support the operations of Public Crypto Asset Funds at this time without compromising investor protection. In the future, greater institutional support and mainstream adoption of other crypto assets may result in those crypto assets becoming suitable investments for publicly distributed investment funds.

#### *(ii) Liquidity of Underlying Assets and Factors to Consider in Assessing Liquidity*

Under NI 81-102, investment funds are subject to restrictions on the proportion of "illiquid assets" that can be held in their portfolios.<sup>19</sup> When contemplating an investment in a particular crypto asset, a fund must conduct the necessary due diligence to determine if that crypto asset is of sufficient liquidity to comply with the requirements in NI 81-102. A crypto asset may be an "illiquid asset" within the meaning of NI 81-102 if, among other things, it is a portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use

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products, 29 October 2021, p. 8, available at <https://download.asic.gov.au/media/p3tnevt/rep705-published-29-october-2021.pdf>.

<sup>15</sup> See *Exchange Traded Funds – Good Practices for Consideration Consultation Report* by the International Organization of Securities Commissions, p. 24, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD701.pdf>.

<sup>16</sup> This is the primary approach taken by existing Public Crypto Asset Funds that directly hold bitcoin or ether.

<sup>17</sup> See also the Bitcoin Decision, par. 65.

<sup>18</sup> See also the Bitcoin Decision, par. 141.

<sup>19</sup> See section 2.4 of NI 81-102.

are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the NAV of the investment fund.<sup>20</sup>

The markets for many crypto assets are generally volatile and price movements can be accompanied by significant inflows or outflows of capital due to changes in investor sentiment. Recent events<sup>21</sup> have also highlighted that crypto asset businesses may not always have sufficient liquidity to facilitate significant redemption and withdrawal requests, resulting in their collapse and increased market volatility. In some cases, the market for a crypto asset may become significantly one-sided to the point that it is not possible to liquidate existing holdings of that crypto asset in a timely fashion, or at a fair and reasonable price.

Public Crypto Asset Funds that hold crypto assets directly often acquire their underlying crypto assets from a variety of liquidity providers, including crypto asset trading platforms (CTP). Previous CSA staff guidance noted concerns may arise where there is a potential mismatch between the liquidity of an investment fund's underlying portfolio assets and the redemption terms offered to investors, and that IFMs are expected to regularly measure, monitor and manage the liquidity of the investment fund's underlying portfolio assets, considering the time to liquidate each underlying portfolio asset, the price the asset may be sold at and the pattern of redemption requests.<sup>22</sup> Given the observed volatility in crypto asset markets and the failure of some large firms that engaged in crypto asset trading, CSA staff emphasize the need for Public Crypto Asset Funds to have effective liquidity risk management programs that include the use of stress testing and ongoing monitoring of underlying crypto asset market liquidity and encourage regular review of such programs.

(iii) *Classification of Crypto Asset*

The CSA has stated in previous CSA guidance<sup>23</sup> and announcements,<sup>24</sup> that certain crypto assets may be considered to be securities or derivatives. CSA staff expect Public Crypto Asset Funds to conduct appropriate due diligence to determine whether or not the crypto assets they propose to invest in are securities or derivatives. Depending on how a given crypto asset is characterized, various provisions of NI 81-102, including concentration<sup>25</sup> and issuer control restrictions,<sup>26</sup> may

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<sup>20</sup> Under NI 81-102, an "illiquid asset" may also be a restricted security held by an investment fund. See the section of this Notice titled "Classification of Crypto Asset" for further guidance about when a crypto asset may be a security.

<sup>21</sup> See the examples of the bankruptcies of crypto asset exchange platform FTX, the crypto asset lender Genesis and the collapse of the algorithmic value-referenced crypto asset (commonly referred to as a stablecoin) and crypto asset UST/LUNA pair.

<sup>22</sup> See CSA Staff Notice 81-333 *Guidance on Effective Liquidity Risk Management for Investment Funds*.

<sup>23</sup> See CSA Staff Notice 46-307 *Cryptocurrency Offerings*, CSA Staff Notice 46-308 *Securities Law Implications for Offerings of Tokens*, CSA Staff Notice 21-327 *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto assets*, Joint CSA-IIROC Staff Notice 21-329 *Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements* and CSA Staff Notice 21-332 *Crypto Asset Trading Platforms: Pre-Registration Undertakings, Changes to Enhance Canadian Investor Protection (CSA Staff Notice 21-332)*.

<sup>24</sup> Per CSA Staff Notice 21-332, CSA staff are of the view that value-referenced crypto assets may constitute securities and/or derivatives.

<sup>25</sup> See section 2.1 of NI 81-102.

<sup>26</sup> See section 2.2 of NI 81-102.

limit an investment fund's ability to buy and hold a single crypto asset, as is currently done by existing Public Crypto Asset Funds holding bitcoin or ether.

Public Crypto Asset Funds that invest in crypto assets that are characterized as securities also need to consider the restrictions in NI 81-102 related to securities lending.<sup>27</sup> CSA staff are aware of various investors engaging in "crypto lending". Under these arrangements, investors typically deposit crypto assets onto crypto lending platforms. The crypto assets are then lent out to borrowers in return for regular interest payments. We expect that a Public Crypto Asset Fund that proposes to engage in such activity conduct appropriate due diligence to ensure compliance with applicable securities laws. We also note that Public Crypto Asset Funds are generally prohibited from lending portfolio assets that are not securities.<sup>28</sup>

CSA staff also note that in addition to the requirements applicable to investment funds subject to NI 81-102, there are general securities law requirements that would apply to crypto assets that are securities or derivatives. These include the prospectus requirement for securities, as well as restrictions on secondary trades.<sup>29</sup>

Recognizing that the properties of a crypto asset may materially change over time, such as through updates to the prevailing network protocols, CSA staff also expect that Public Crypto Asset Funds will regularly update their due diligence on crypto assets they invest in to ensure that their investments remain in compliance with applicable securities laws.

#### ***(b) Custody Requirements***

Public Crypto Asset Funds are subject to the custody requirements set out in Part 6 of NI 81-102. Their portfolio assets (including crypto assets) must be held by custodians or sub-custodians that qualify under sections 6.2 and 6.3 of NI 81-102 as applicable. In addition to the usual consideration of trust law principles that apply to all types of assets held on behalf of clients, crypto assets present unique custodial considerations, including expertise and infrastructure specifically tailored to the safekeeping of this type of asset. This is reflected in the additional practices that have developed concerning the custody of crypto assets held by a Crypto Custodian on behalf of a Public Crypto Asset Fund. These include the following practices, which we would consider to be the minimum expectations for practices pertaining to the custody of crypto assets of a Public Crypto Asset Fund by a Crypto Custodian and consistent with existing legal obligations under Part 6 of NI 81-102, including the standard of care for custodians and sub-custodians:

- *Crypto Custodian Expertise.* The IFM, consistent with its fiduciary obligations to the Public Crypto Asset Fund, should satisfy itself that a proposed Crypto Custodian has the necessary expertise and experience to safely custody the crypto assets to be held on behalf of the Public Crypto Asset Fund;
- *Primary storage of crypto assets in "cold wallets".* Crypto assets held on behalf of a Public Crypto Asset Fund should be held in online storage or "hot wallets" only as is necessary to

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<sup>27</sup> Among these restrictions include those in section 2.12 of NI 81-102.

<sup>28</sup> See paragraph 2.6(1)(f) of NI 81-102.

<sup>29</sup> In particular, where the crypto asset is a security, the requirement that the issuer is a reporting issuer or that the secondary trade is conducted in accordance with National Instrument 45-102 *Resale of Securities*.



facilitate purchases and redemptions by the fund. Otherwise, crypto assets are to be held in offline storage or “cold wallets” in secured facilities maintained by the Crypto Custodian;

- *Segregation of assets, visible on the blockchain.* Assets of an investment fund held by a custodian or sub-custodian are required to be segregated under Part 6 of NI 81-102. In the context of a Public Crypto Asset Fund, this will generally include the use of segregated wallets that confirm the fund’s ownership of the applicable crypto assets or in an omnibus wallet visible on the blockchain so long as in each case the Crypto Custodian’s books and records clearly reflect the fund’s ownership of the crypto assets held by it;
- *Website security measures.* Crypto Custodians should be using website protection measures such as two-factor authentication, strong password requirements that are cryptographically hashed, and encryption of user information among other measures to secure client information and protect the Crypto Custodian’s website from hacking attempts;
- *Maintenance of insurance for corporate crime/theft relating to the storage of crypto assets.* The Crypto Custodians for the existing Public Crypto Asset Funds should each maintain appropriate insurance for the crypto assets in their custody; and
- *SOC-2 Type-2 Reports of the crypto custodian provided to the Fund’s auditors.* The Crypto Custodians will generally provide or make available for review, on an annual basis, by the Public Crypto Asset Fund’s auditor in connection with its audit of the Public Crypto Asset Fund, System and Organization Control (SOC) reports prepared on the Crypto Custodian’s behalf by a public accountant, which assess a service organization’s security, availability, processing integrity, confidentiality and privacy controls. Where a SOC report is not available, we expect the Crypto Custodian to permit the Public Crypto Asset Fund’s auditor to directly examine its controls for similar purposes.

CSA staff note that these practices and expectations are substantially similar to the proposed terms and conditions for entities that seek to act as custodians for CTPs in Canada as is set out in CSA Staff Notice 21-332.

### ***(c) Staking Crypto Assets***

In this Notice, “staking” refers to the act of committing or locking crypto assets in smart contracts to permit the owner or the owner’s agent to act as a validator for a particular proof-of-stake consensus algorithm blockchain. A validator, in connection with a particular proof-of-stake consensus algorithm blockchain, is an entity that operates one or more nodes that meet protocol requirements for a crypto asset and participates in consensus by broadcasting votes and committing new blocks to the blockchain. Validators are incentivized to add legitimate transactions to a proof-of-stake blockchain through rewards and can be penalized for breaching protocol requirements, including through having staked crypto assets “slashed” (i.e., removed from the offending validator).

CSA staff continue to monitor and assess the presence and role of staking in the crypto asset industry. As a result of this ongoing work, CSA staff are of the view that, depending on how it is conducted, staking may involve the issuance of a security or derivative. CSA staff would therefore expect Public Crypto Asset Funds interested in staking crypto assets held in their portfolios to have established policies and procedures to assess whether any staking or similar activity involves the issuance of a security and/or derivative. Our view is that such policies and procedures should include a process for independent analysis of the staking activities and consideration of statements made by any regulator or securities regulatory authority about whether staking conducted in the contemplated manner involves the issuance of a security and/or a derivative.

We note that there are circumstances in which a Public Crypto Asset Fund's participation in staking may result in a portfolio crypto asset that may otherwise be liquid, becoming an "illiquid asset" within the meaning of NI 81-102. This could occur for example, if a staked crypto asset is subject to any lock-up, unbonding, unstaking, or similar periods imposed by the crypto asset protocol, custodian or validator, where such crypto asset would not be accessible to the Public Crypto Asset Fund or would be accessible only after payment of additional fees, penalties or forfeiture of any rewards. CSA staff expect a Public Crypto Asset Fund to conduct appropriate due diligence with respect to the effect on the crypto asset's liquidity within the fund's portfolio as a result of the fund's participation in staking and in turn how this impacts the Public Crypto Asset Fund's compliance with the illiquid asset restrictions in section 2.4 of NI 81-102.

Public Crypto Asset Funds interested in staking should also consider the prohibitions in section 2.6 of NI 81-102 related to lending and other investment practices by an investment fund. Specifically, investment funds are prohibited from lending portfolio assets and guaranteeing securities or obligations of a person or company. Depending on how it is proposed to be conducted, staking could be viewed as akin to lending portfolio assets to or even guaranteeing obligations of a person or company engaged to act as validator.<sup>30</sup> If the underlying staked crypto assets are themselves securities, staking such assets could also be viewed as akin to securities lending. Public Crypto Asset Funds should therefore also be mindful of the restrictions on securities lending transactions detailed in section 2.12 of NI 81-102.

Consistent with the definition of "non-redeemable investment fund" in NI 81-102 and the CSA's discussion in section 1.2 of Companion Policy 81-106CP *Investment Funds Continuous Disclosure*, CSA staff regard an investment fund as an issuer that does not seek to exercise control over, or become involved in the management of, investee companies. Since staking requires a validator to actively participate in consensus of a proof of stake network protocol by broadcasting votes and committing new blocks to the blockchain, this could be viewed as exerting control over or being involved in the management of the proof of stake protocol (which can be viewed as being akin to an investee company). To mitigate this concern CSA staff would expect that neither a fund nor its IFM would act as its own validator. Rather, a Public Crypto Asset Fund would be expected to engage a third party to act as validator (i.e., "staking as a service").

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<sup>30</sup> See paragraphs 2.6(1)(f) and 2.6(1)(g) of NI 81-102.

The expectation that a Public Crypto Asset Fund would not act as its own validator is also consistent with requirements imposed on registered CTPs that engage in certain staking activity.<sup>31</sup> CSA staff would expect that any staking activity permitted to be engaged in by a Public Crypto Asset Fund would be done within a framework similar to the terms and conditions imposed on registered CTPs, where applicable. CSA staff would expect that the practices relating to staking by Public Crypto Asset Funds include that

- the fund will engage in staking only for (i) crypto assets of blockchains that use a proof of stake consensus mechanism and (ii) the staked crypto assets that are used to guarantee the legitimacy of new transactions the validator adds to the blockchain;
- the IFM must be proficient and knowledgeable about staking crypto assets;
- the IFM must enter into written agreements with one or more third parties to stake the fund's crypto assets and each such third party is proficient and experienced in staking crypto assets. The IFM must also consider the application of securityholder approval requirements under Part 5 of NI 81-102 concerning any fees that may be payable by the fund under those agreements;
- the fund's Crypto Custodian will remain in possession, custody and control of the staked crypto assets at all times;
- the fund's staked crypto assets be held in offline storage or "cold wallets" in secured facilities maintained by the Crypto Custodian, where applicable;
- the IFM will monitor validators retained on behalf of the fund for downtime, jailing and slashing events and take any appropriate action to protect crypto assets staked by the fund; and
- the IFM will appropriately manage any liquidity risk and other risks to the fund's financial viability that may arise because of the fund's staking activities.

IFMs of Public Crypto Asset Funds are expected to engage in their own due diligence to determine whether proposed staking activity by a Public Crypto Asset Fund will comply with applicable securities legislation.

We also encourage Public Crypto Asset Funds interested in staking portfolio assets to contact their principal regulator to discuss the applicability of securities legislation and possible approaches to compliance.

***(d) Know-Your-product, Know-Your-Client and Suitability Obligations***

Registrants have to comply with obligations under securities legislation related to KYC, KYP, and suitability determinations in connection with purchases or sales of securities of Public Crypto Asset Funds for, or recommendations of Public Crypto Asset Funds to, their clients.

To comply with their KYC obligations, registrants must collect certain information from clients, take reasonable steps to have clients confirm the accuracy of the information and keep the

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<sup>31</sup> Consult National Registration Search <https://info.securities-administrators.ca/nrsmobile/nrssearch.aspx> for terms and conditions imposed on the registrations of CTPs that engage in certain staking activity.

information current.<sup>32</sup> For KYP compliance, registered firms are required to take reasonable steps to assess and understand any securities that are made available to clients and in particular, are required to assess and monitor on an ongoing basis all relevant aspects of the securities, including the securities' structure, features, risks, initial and ongoing costs and the impact of those costs.<sup>33</sup>

Once a registrant has complied with its KYC and KYP obligations, it is expected to have sufficient information to make a reasonable determination of whether an investment action<sup>34</sup> is suitable for a client and registrants must put their clients' interests first when taking any investment action.<sup>35</sup>

When conducting KYC, KYP and suitability determinations in connection with recommending Public Crypto Asset Funds to clients, registrants should be cognizant that holding crypto assets, including Public Crypto Asset Fund securities, comes with elevated levels of risk that may not be suitable for many investors.

## 6. Questions

Please refer your questions to any of the following CSA staff:

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<sup>32</sup> See section 13.2 of NI 31-103. Registrants that are members of the Canadian Investment Regulatory Organization (**CIRO**) must also comply with all applicable CIRO rules relating to KYC, including Rule 3200 of the Corporation Investment Dealer and Partially Consolidated Rules (the **ID Rules**) and/or Rule 2.2.1 of the Mutual Fund Dealers Association of Canada Rules (the **MFD Rules**).

<sup>33</sup> See section 13.2.1. of NI 31-103. Registrants that are members of the CIRO must also comply with all applicable CIRO rules relating to KYP, including Rule 3300 of the ID Rules and/or Rule 2.2.5 of the MFD Rules.

<sup>34</sup> An investment action includes opening an account for a client, purchasing, selling, depositing, exchanging or transferring securities for a client's account, taking any other investment action for a client, making a recommendation or exercising discretion to take any such action.

<sup>35</sup> See sections 13.3 and 13.3.1 of NI 31-103.

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### Appendix Select Public Crypto Asset Fund Market Data

The following charts provide key market data<sup>36</sup> about Public Crypto Asset Funds in Canada. The information provided is current to April 30, 2023.

#### By Fund Structure

Public Crypto Asset Funds are structured as non-redeemable investment funds, ETFs and open-ended mutual funds, with the ETF structure being the most common, as is illustrated below:

Fund Structure	No. of Funds	Net Assets (\$millions)
Non-redeemable investment fund	2	\$576
ETFs	12	\$2,289
Open-ended mutual fund <sup>37</sup>	8	
<b>Total</b>	<b>22</b>	<b>\$2,865</b>

#### By Crypto Asset Type

The existing Public Crypto Asset Funds seek exposure only to bitcoin and/or ether, with funds focused on bitcoin representing the majority of net assets in this space as is illustrated below:

Crypto Asset	No of Funds	Net Assets (\$millions)
Bitcoin	11	\$1,860
Ether	8	\$1,005
Bitcoin and Ether	3	n/a
<b>Total</b>	<b>22</b>	<b>\$2,865</b>

<sup>36</sup> The information was collected internally by CSA staff through publicly available sources, including SEDAR, fund company websites and other third-party data providers.

<sup>37</sup> The open-ended mutual funds invest their assets in securities of one or more of Public Crypto Asset Investment funds that are ETFs. As such, their net assets are part of the total assets under management for the ETFs listed above.

By Fund Strategy

The existing Public Crypto Asset Funds employ 3 main strategies for achieving the desired exposure to bitcoin or ether, namely:

- directly holding bitcoin or ether in a “buy and hold” strategy;
- indirectly holding bitcoin or ether through a fund of fund structure; or
- indirect exposure through investment in bitcoin or ether futures that trade on regulated derivatives exchanges.

Direct investment remains the most common strategy as is illustrated below:

<b>Strategy</b>	<b>No of Funds</b>	<b>Net Assets (\$millions)</b>
Direct investment	12	\$2,838
Fund of fund	8 <sup>38</sup>	
Investment in listed futures	2	\$27
<b>Total</b>	<b>22</b>	<b>\$2,865</b>

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<sup>38</sup> The Public Crypto Asset Funds that employ a fund of fund strategy invest their assets in one or more of the “direct investment” Public Crypto Asset Funds structured as ETFs. The net assets of the “fund of fund” strategies are therefore included as part of the net asset of the “direct investment” funds.