

Backgrounder: Regulation of Crypto Currency

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Introduction

The use of cryptocurrencies and blockchain technology has seen explosive growth over the past decade, with over \$865B USD of global cryptocurrency market cap as of the beginning of December 2022 (Coin Market Cap, 2022). Worldwide, regulators have been grappling with how to deal with this new technology, and different jurisdictions have taken a variety of approaches. Given the significant decline in the value of crypto assets, with approximately 70% of a decrease in total value since its peak (Coin Market Cap, 2022), and the accompanying collapse of major platforms such as FTX, there has been increased discussion as to whether current regulations are appropriate, and what the next steps should be.

Crypto assets and decentralized finance have certainly gained a significant amount of traction in Canada. Approximately 13% of Canadians currently own crypto either directly or indirectly, with an additional 8% having held crypto within the past 12 months (Ontario Securities Commission Investor Office, 2022). A further 30% are considering investing in the next 12 months (Vingoe, 2022), all in spite of a wide lack of understanding with approximately half of Canadians being unaware of what cryptocurrencies even are (Ontario Securities Commission Investor Office, 2022).

Canada is also no stranger to attempts to regulate the decentralized finance space. Following the lock-up of QuadrigaCX in 2018, Canadian securities regulators, namely the Ontario Securities Commission (“OSC”), began to pursue more stringent regulation. Despite the opinion that the majority of cryptocurrencies are commodities, the OSC views any crypto assets being held by the trading platforms to actually constitute a security, in part due to the high degree of dependence users have on the delivery of assets from these platforms (Vingoe, 2022). This in turn grants the OSC jurisdiction on the grounds of securities regulation to regulate these platforms as well as address issues as they arise. Though the approach has been described as “piecemeal” with its focus on custody in reaction to QuadrigaCX’s own custody issues (Ossowski & Clement, 2022), it would require crypto trading platforms to register with Investment Industry Regulatory Organization of Canada (“IIROC”), presenting substantial costs.

This has seen some success, with ten platforms having undergone registration (Ontario Securities Commission, 2022), though other issues have persisted. There are a wide variety of platforms that have no qualms simply ignoring these regulations (Brownell, 2021), and such platforms seem to have a free hand to advertise to and accept users from Canadian jurisdictions where they are unregistered (Subramaniam, 2022).

Some other problems have come to light given the rapid decrease in the value of crypto assets worldwide. Caisse de dépôt et placement du Québec, a large pension plan manager, has had to write-off their \$150M USD investment after investing in Celsius, a crypto lending network which went bankrupt after the collapse in crypto prices (The Canadian Press, 2021), with further accusations that Celsius was actually a Ponzi-scheme all along (Miller, 2022).

Most recently, FTX, the once second largest trading platform has collapsed following the decline in asset prices and a run of users attempting to withdraw their funds following reports of missing assets (Lord, 2022). It is currently unclear if this was a hacking event due to system resilience deficiencies, or if there was again internal mismanagement and misuse of client funds, but it is estimated that \$477M USD went missing from the exchange (Lord, 2022). This has again severely impacted Canadians, with many users losing funds, and the Ontario Teachers Pension Plan losing their \$95M USD investment in FTX (Declonet, 2022).

These recent scandals have fueled increased interest by regulators, who see the decentralized finance space as being too risky in its current state. In the United States, more discussions have been had on how to implement the united national framework on crypto regulation, which was called for earlier this year in an executive order by President (The White House Briefing Room, 2022). More substantially, some in the European Union are calling for a speedier accepting of the proposed Market in Crypto-Assets Regulation (“MiCA”) regime, which supporters claim could have prevented the collapse of FTX and its associated effects (Schickler, 2022).

Regulatory Direction of the United States

Though it is somewhat vague, the recent executive order does specifically call for increases in regulation for the purposes of risk reduction and consumer protection, as well as the reduction of money laundering and trade of illegally acquired funds, while still preserving the importance of developing blockchain technology, even exploring a central bank backed cryptocurrency (The White House Briefing Room, 2022)

Progress since the signing of the executive order has remained slow, but progress has been seen, including the US Senate and Treasury agreeing to cooperate to create specific regulations and legislation targeted towards crypto (Shashikumar, 2022). Additionally, the Financial Stability Oversight Council, a branch within the US Treasury, recently released a detailed report on current US regulation and identified gaps in current regulations which should be kept in mind when crafting future regulations (Financial Stability Oversight Council, 2022).

One area which is identified as a challenge is the lack of standards in technology and system resilience. The report indicated that improved operational transparency, possibly through the implementation of required Software Bill of Materials standards may alleviate this issue (Financial Stability Oversight Council, 2022). This would be a regulatory defined inventory of software components, including open source, dependencies, as well as license and version information, for the purposes of increasing visibility and risk identification for users and regulators (Kerner, 2022)

The report also identifies liquidity issues and the risk of funds being mismatched as a particular risk for unregistered platforms (Financial Stability Oversight Council, 2022). In this regard, the report actually identified increased registration and legislation to help facilitate this as a possible solution. If the platforms are registered, not only would there be increased general transparency, reducing the risk of liquidity issues by nefarious means, but the platforms would be eligible to be considered broker or dealer platforms, and thus could qualify for federal deposit insurance, which would provide users further protection and lessen the effects of a run on deposits.

Though many other factors were discussed, the last that will currently be discussed is that the report encourages legislation to be passed to give explicit authority to regulators over crypto assets which are not themselves securities. Since there is currently gaps in how to classify many of the assets and services, there remains many businesses and crypto services which do not fit neatly into any box which would allow for any real regulation. Further, the report encourages cooperation between intranational and international regulators to reduce the risk of regulatory arbitrage, a process in which crypto businesses can shop for jurisdictions which will provide the most advantageous treatment to them.

Regulatory Direction of the European Union and MiCA

The proposed MiCA legislation hoped to create a harmonized framework for all crypto assets and services throughout the EU member states, in order to reduce discrepancies and shortcomings which currently exist under individual national regulations (Ng, 2022). MiCA thus hopes to be a unified and comprehensive international regime that can classify and regulate current and future tokens, assets, and services in the crypto universe.

The proposed MiCA regulations are expansive, with different regulations affecting different services depending on the nature thereof. Still, there are multiple portions which are worth highlighting. For example, MiCA would mandate creators of new crypto tokens or other assets to submit whitepapers to their relevant member state, outlining the details of their offering in order to obtain admission to trading (General Secretariat of the Council of the European Union, 2022). MiCA would also require registration within an EU member

state to grant a passport to operate throughout the union, though foreign, non-European services are able to submit whitepapers to be able to advertise and legally operate within the EU (General Secretariat of the Council of the European Union, 2022). This process is aimed at allowing for transparency and oversight, while not becoming a regulatory burden for international players to enter the European market. It is worth highlighting, however, that though some authorities claim MiCA would have protected many European users against the collapse of FTX, critics emphasize that FTX had been registered in Cyprus, and this could very well have benefited from the proposed passport system had MiCA already been implemented.

MiCA also mandates various capital and liquidity requirements for crypto trading platforms and decentralized finance protocols, and further encourages deposit insurance for companies engaging in this business, while mandating disclosures as to the insurance they have (General Secretariat of the Council of the European Union, 2022). This is aimed at preventing the run scenario that was seen in FTX, for example, as well as mitigating the risk of bankrupt crypto service companies being unable to reimburse customers. As a further protection, companies which hold custody of users crypto assets can be held liable for civil damages by users (General Secretariat of the Council of the European Union, 2022), which could be an additional safeguard, if in practice it would be unlikely for users to recover as unsecured creditors post bankruptcy.

While expansive and detailed, MiCA creates exceptions for new tokens and other crypto services which are not considered “significant”, using a variety of methods to make this determination, such as market cap, number of users, and the volume of transactions and their total value which occur through these services (General Secretariat of the

Council of the European Union, 2022). Ideally, this would allow small and innovative processes to be able to test the waters for their product, without being held accountable to the same standards as major trading platforms and major protocols. Similarly, crypto trading platforms and other crypto service providers are expected to employ resources in proportion to the scale of their services and activities in order to mitigate risks, such as ensuring business continuity and reducing custody concerns, to ensure systems resilience and prevent hacking attacks, and to combat the flow of illegal funds and money laundering. This would seem to further show a balance of allowing innovation and still maintaining regulatory oversight.

The Future of Canadian Regulation

Currently, each province has taken their own approach to crypto regulation in line with the federalized securities regulation that exists in the country. Ontario in particular has taken a particularly idiosyncratic approach internationally, by choosing to use the custody issue to allow securities regulators to gain regulatory oversight powers (Clements, 2022). While the OSC has highlighted their adoption of multi-jurisdictional disclosure between Ontario and the United States when evaluating current crypto regulation as an example of OSC innovation (Vingoe, 2022), some who are critical of the OSC approach in crypto regulation have indicated that Ontario refusing to adopt the intranational passport system between provincial regulators as aggravating the current issues seen in crypto regulation (Ossowski & Clement, 2022). Such critics encourage at a minimum, that the OSC consider adopting a reciprocity system for crypto service companies and trading platforms that have been granted licenses from other provincial securities regulators, something which is currently not the OSC policy.

The approach Canadian regulators, specifically the OSC, has taken has helped address some of the issues, but others remain a concern. While the OSC has cautioned that a “buyer beware” approach is insufficient (Vingoe, 2022), a two-tiered market of a small number of regulated platforms and a large number of unregulated platforms compete for Canadian users. Given the poor consumer understanding, and the freedom of unregulated platforms to advertise directly to the Canadian public, with the only prohibitions being placed on false advertisements and the encouraging of gambling like promotions (Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada, 2021), there would seemingly be advantages for companies to simply ignore the current Ontario regulations, and to gain the benefit of Canadian users without needing comply with any unique Canadian regulations (Subramaniam, 2022).

Overall, it may be worth considering for Canadian regulators to create a more harmonized regulatory framework for all crypto assets and services, as has been seen in the EU with proposed MiCA. Alternatively, creating a more specific regulatory power or body to address issues in the decentralized finance space where the assets are not themselves considered securities may be beneficial, as has been advised by the US Treasury’s Financial Stability Oversight Council.

Regardless, a balance must be struck on effective regulation, and promoting technological innovation, such that Canada is not subject to particular risk, nor is it cut-off from future innovation and technological advances, and interjurisdictional cooperation can help facilitate this and reduce the risk of regulatory arbitrage.

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