Stikeman Elliott

The Virtual Currency Regulation Review

By Alix d'Anglejan-Chatillon, Ramandeep K. Grewal, Éric Lévesque and Christian Vieira

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THE VIRTUAL CURRENCY REGULATION REVIEW

Second Edition

Editors
Michael S Sackheim and Nathan A Howell

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Chapter 7

CANADA

Alix d'Anglejan-Chatillon, Ramandeep K Grewal, Éric Lévesque and Christian Vieira[1]

I SECURITIES AND INVESTMENT LAWS

Securities regulation in Canada is primarily a matter of provincial jurisdiction. While each province and territory has its own rules and securities regulators, the securities regulatory framework is largely streamlined and harmonised across Canada, with certain provincial or regional variances.[2] However, legislative jurisdiction in the area of derivatives is divided between the federal and provincial governments, and the harmonisation of rule-making in this area has been more elusive.

Generally, the two basic purposes of the securities laws are to provide protection from unfair, improper or fraudulent practices, and to foster fair and efficient capital markets, and confidence in those capital markets.[3] Securities regulation in Canada generally governs the distribution and trading of both securities and derivatives. The distribution and trading of securities and derivatives is primarily regulated through the imposition of prospectus requirements, dealer, adviser and investment fund manager registration requirements, and certain requirements imposed upon those operating exchanges, alternative trading facilities or other marketplaces that facilitate their trading.

The Canadian Securities Administrators (CSA) is an umbrella organisation of Canada's provincial and territorial securities regulators whose objective is to improve, coordinate and harmonise regulation of the Canadian capital markets. While Canadian securities regulators have not yet formulated any definitive regulations, the CSA has published two staff notices with respect to virtual currencies with a view to being responsive to the evolving activity related to virtual currencies: Staff Notice 46-307 – Cryptocurrency Offerings[4] and Staff Notice 46-308 – Securities Law Implications for Offerings of Tokens.[5] More recently, the CSA and Investment Industry Regulatory Organization of Canada (IIROC) also published a more comprehensive joint consultation paper[6] (the Consultation Paper) seeking input on various

1 Alix d'Anglejan-Chatillon, Ramandeep K Grewal and Éric Lévesque are partners and Christian Vieira is an associate at Stikeman Elliott LLP.

2 While the province of Quebec has a separate Derivatives Act that regulates over-the-counter and exchange-traded derivatives, derivatives regulation in the remaining provinces is governed by the securities and, in certain provinces, commodities futures legislation.

3 Securities Act, R.S.O. 1990, c. S.5, s. 1.1.

4 Canadian Securities Administrators, Staff Notice 46-307 – Cryptocurrency Offerings (2017), 40 OSCB 7231. (Canadian Securities Administrators, 2017).

5 Canadian Securities Administrators, Staff Notice 46-308 – Securities Law Implications for Offerings of Tokens (Canadian Securities Administrators, 2018).

6 Canadian Securities Administrators and Investment Industry Regulatory Organization of Canada, Consultation Paper 21-402 – Proposed Framework for Crypto-Asset Trading Platforms (Canadian

considerations relating to the potential regulation of virtual currencies. The Staff Notices are intended to provide guidance to industry participants on the applicability of securities laws to virtual currencies and, together with the Consultation Paper, are the primary basis for the discussion that follows.

i Applicability of Canadian securities laws to virtual currencies

Virtual currencies may be subject to Canadian provincial securities laws to the extent that a virtual currency is considered a security or a derivative for the purposes of such laws, such as the Securities Act (Ontario). The Securities Act defines a security to include, among other things, an investment contract. The seminal case in Canada for determining whether an investment contract exists is *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*,[7] where the Supreme Court of Canada identified the four central attributes of an investment contract, namely:

a an investment of money;
b in a common enterprise;
c with the expectation of profit; and
d which profit is to be derived in significant measure from the efforts of others.

If an instrument satisfies the *Pacific Coin* test, it will be considered an investment contract and, therefore, a security under Canadian securities laws.

The application of the *Pacific Coin* test to virtual currencies is not always straightforward, however. Industry participants have taken the position that utility tokens, which have a specific function or utility beyond the mere expectation of profit (such as providing their holders with the ability to acquire products or services) should not be considered securities.[8] This position appears to have been accepted by the CSA and IIROC in the Consultation Paper, in which it was acknowledged that proper utility tokens may not be securities. However, the CSA has also noted that most of the offerings of virtual currencies purporting to be utility tokens that its staff had reviewed involved the distribution of a security, usually in the form of an investment contract.[9]

The CSA and IIROC have also acknowledged that it is widely accepted that some of the well-established virtual currency assets that function as a form of payment or means of exchange on a decentralised network, such as Bitcoin, are not currently in and of themselves, securities or derivatives and have features that are analogous to commodities such as currencies and precious metals.[10] The regulators have cautioned, however, that securities law requirements may still apply to platforms that offer trading of virtual currencies that are neither securities nor derivatives where the arrangement, when viewed as a whole, including the investor's contractual rights and how they relate to the manner in which the virtual currency is transacted, among other things, is sufficient to constitute an investment contract.[11]

Securities Administrators and Investment Industry Regulatory Organization of Canada, 2019) (the Consultation Paper).

7 *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 SCR 112.

8 ibid., footnote 5.

9 ibid., footnote 6.

10 ibid., footnote 6.

11 ibid., footnote 6.

In assessing whether a particular virtual currency will be considered a security subject to Canadian securities laws, the CSA will consider the substance of the virtual currency over its form.[12] The CSA has outlined a number of considerations in determining whether an investment contract exists. While no single factor is determinative, the CSA has stated that the existence of some or all of the following circumstances may cause a virtual currency to be considered an investment contract:[13]

a the underlying blockchain technology or platform has not been fully developed;
b the token is immediately delivered to each purchaser;
c the stated purpose of the offering is to raise capital, which will be used to perform key actions that will support the value of the token or the issuer's business;
d the issuer is offering benefits to persons who promote the offering;
e the issuer's management retains a significant number of unsold tokens;
f the token is sold in a quantity far greater than any purchaser is likely to be able to use;
g the issuer suggests that the tokens will be used as a currency or have utility beyond its own platform, but neither of these things is the case at the time the statement is made;
h management represents or makes other statements suggesting that the tokens will increase in value;
i the token does not have a fixed value on the platform;
j the number of tokens issuable is finite or there is a reasonable expectation that access to new tokens will be limited in the future;
k the token is fungible;
l the tokens are distributed for a monetary price; and
m the token may be reasonably expected to trade on a trading platform or otherwise be tradeable in the secondary market.

A particular virtual currency that meets the criteria of the *Pacific Coin* test or has certain of the characteristics described in the CSA guidance discussed above may be properly considered an investment contract and therefore a security, subject to Canadian securities laws.

ii Virtual currency offerings in Canada

Canadian securities laws generally require the filing of a prospectus to qualify any distribution of securities. No person or company may trade in a security where the trade constitutes a distribution unless a prospectus has been filed or the trade is made in reliance upon a prospectus exemption. Securities originally distributed under a prospectus exemption are generally subject to resale restrictions that require the issuer to have been a reporting issuer (i.e., a public company) for a specified period of time and, in some cases, that the securities be held for a specified period of time. To the extent that a virtual currency is considered a security or a derivative, the issuance or distribution to the public is subject to prospectus, qualification or similar requirements, or must be effected pursuant to applicable exemptions from prospectus or derivatives qualification requirements.

There are a number of options available for distributing securities in Canada on a prospectus-exempt basis, generally referred to as exempt distributions or private placements. Most of these are harmonised under National Instrument 45-106 – Prospectus Exemptions.[14]

12 ibid., footnote 5.
13 ibid., footnote 5.
14 Ontario Securities Commission, National Instrument 45-106 – Prospectus Exemptions (2018).

The CSA has indicated that persons wishing to distribute virtual currencies may do so pursuant to these exemptions.[15] Specifically, distributions may be completed pursuant to the accredited investor exemption, which provides a prospectus exemption for trades of securities to entities and individuals that are qualified accredited investors.[16]

Distributions may also be made to investors who do not qualify as accredited investors in reliance on the offering memorandum prospectus exemption.[17] To rely on this exemption, investors must be provided with a written document that contains certain prescribed disclosure, but this exemption does not require the same level of disclosure as a prospectus. Importantly, an investor has certain rights in connection with this type of investment, including a two-business-day withdrawal right and a right of action for rescission or damages if the offering memorandum contains a misrepresentation.[18] Non-reporting issuers (generally, unlisted companies) that rely on the offering memorandum exemption will generally be required to provide to the applicable securities regulatory authority audited annual financial statements and a notice describing how the money raised has been used. The financial statements and notice must be made available to investors within 120 days of each financial year end.

A number of companies have successfully completed virtual currency offerings in compliance with applicable securities law requirements and bespoke exemptions from such requirements. Montreal-based Impak Finance Inc (Impak) was the first Canadian company to complete a virtual currency offering with the approval of Canadian securities regulators. Impak issued Impak Coin (MPK), a new virtual currency based on the Waves blockchain platform, for gross proceeds of over C$1 million by way of private placement, in reliance on the offering memorandum exemption.[19]

A few months later, Token Funder Inc (Token Funder) completed the first virtual currency offering under the oversight of the Ontario Securities Commission (OSC). Token Funder was established for the purpose of creating a smart token asset management platform that is intended to, inter alia, facilitate capital raising by third-party issuers through the offering of blockchain-based securities, including tokens and coins.[20] Token Funder issued its virtual currency, FNDR, in reliance on the offering memorandum exemption. In this case, the OSC granted an exemption from the dealer registration requirement for a period of 12 months from the date of the decision, subject to a number of conditions similar to those imposed on Impak.[21]

More recently, ZED Network Inc (ZED) became the first company to obtain exemptive relief from the prospectus and dealer registration requirements (discussed below) under Canadian securities laws for the distribution and trading of the ZED digital remittance and foreign exchange blockchain tokens to (1) money transfer operators (MTOs) registered as money services businesses in Canada with the Financial Transactions and Reports Analysis

15 ibid., footnote 4.

16 ibid., footnote 4.

17 ibid., footnote 4.

18 ibid., footnote 14 at s. 2.9.

19 Ontario Securities Commission, AMF Impak Finance Decision, 16 August 2017.

20 Ontario Securities Commission, OSC Token Funder Decision, 17 October 2017.

21 ibid.

Centre of Canada (FINTRAC Registered MTOs), and (2) MTOs appropriately registered or authorised to operate as money services businesses, or its equivalent, in accordance with the laws of foreign jurisdictions (Foreign Registered MTOs), as applicable.[22]

Notwithstanding the success stories of Impak, Token Funder and ZED, the prospectus and registration requirements imposed by Canadian securities laws may be an obstacle to the issuance of virtual currencies in Canada on a retail basis, even with negotiated bespoke exemptions.[23]

iii Regulatory considerations for intermediaries

Any person or company engaging in, or holding themselves out as engaging in, the business of trading or advising in securities, and, in certain Canadian jurisdictions, in derivatives, must register as a dealer or as an adviser or, where available, conduct these activities pursuant to an exemption from the dealer or, as the case may be, adviser registration requirement under the applicable securities laws. A person or entity that directs the business, operations and affairs of an 'investment fund' must comply with the investment fund manager registration requirements or obtain an exemption from such requirements. Registration requirements are generally harmonised under National Instrument 31-103 – Registration Requirements, Exemptions and Ongoing Registrant Obligations,[24] which sets out requirements for dealers and advisers dealing with capital, proficiency, insurance, financial reporting, know your client, investor suitability, client disclosure, safekeeping of assets, record-keeping, account activity reporting, complaint handling and other compliance matters.

In Canada, the requirement to register as a dealer or adviser is triggered where a person or company conducts a trading or advising activity with respect to securities or derivatives for a business purpose.[25] The mere holding out, directly or indirectly, as being willing to engage in the business of trading in securities may trigger the requirement to register as a dealer; however, a number of factors must be considered when determining whether registration is required, including whether a business:

a engages in activities similar to a registrant;
b intermediates trades or acts as a market maker;
c carries on an activity with repetition, regularity or continuity;
d expects to be remunerated or compensated; and
e directly or indirectly solicits.[26]

In the context of virtual currency distributions, the CSA has noted the following additional factors in determining whether a company may be considered to be trading in securities for a business purpose:[27]

a soliciting of a broad range of investors, including retail investors;

22 Ontario Securities Commission, OSC ZED Network Decision, 21 May 2019.

23 Kik Interactive opted to exclude Canadian investors from the initial offering of its virtual currency following discussions with the OSC. See Claire Brownell, 'Kik bans Canadians from investing in new crypto-token, cites 'weak guidance' from regulators', *Financial Post* (8 September 2017).

24 Ontario Securities Commission, National Instrument 31-103 – Registration Requirements, Exemptions and Ongoing Registrant Obligations.

25 Ontario Securities Commission, Companion Policy 31-103 CP – Registration Requirements, Exemptions and Ongoing Registrant Obligations.

26 ibid.

27 ibid., footnote 4.

b using the internet to reach a large number of potential investors;
c attending public events to actively advertise the sale of a virtual currency; and
d raising a significant amount of capital from a large number of investors.

The CSA has stated that persons facilitating offerings of virtual currencies that meet the business trigger must collect know your client information and perform suitability assessments to ensure that purchases of virtual currencies are suitable, including with respect to investment needs and objectives, financial circumstances and risk tolerance.[28]

The creation and marketing of products related to virtual currencies are also subject to derivatives-related regulatory requirements, including in relation to qualification, registration and trade data reporting in a number of Canadian jurisdictions, including specifically Quebec, where the rules in relation to over-the-counter (OTC) and exchange-traded derivatives are more fully developed.[29]

The CSA has also issued recent proposals to establish a harmonised framework of registration and business conduct requirements for OTC derivatives market participants.[30] The proposals expressly define a commodity to include a cryptocurrency.

iv Exchanges and other platforms

As marketplaces, exchanges are regulated pursuant to their applicable provincial securities statutes, as well as National Instrument 21-101 – Marketplace Operation (NI 21-101),[31] National Instrument 23-101 – Trading Rules (NI 23-101)[32] and their related companion policies.

NI 21-101 defines a marketplace as a facility that brings together buyers and sellers of securities, brings together the orders for securities of multiple buyers and sellers, and uses established non-discretionary methods under which the orders interact with each other.[33]

An exchange is a marketplace that may:

a list the securities of issuers;
b provide a guarantee of a two-sided market for a security on a continuous or reasonably continuous basis;
c set requirements governing the conduct of marketplace participants; or
d discipline marketplace participants.[34]

28 ibid., footnote 4.
29 Autorité des marchés financiers, Notice relating to the public offering of derivatives on cryptocurrencies and other innovative assets (22 May 2018).
30 Canadian Securities Administrators, Notice and Request for Comment – Proposed National Instrument 93-102 Derivatives: Registration and Proposed Companion Policy 93-102 Derivatives: Registration (published 19 April 2018 for comment until 17 September 2018), and Notice and Second Request for Comment – Proposed National Instrument 93-101 Derivatives: Business Conduct and Proposed Companion Policy 93-101CP Derivatives: Business Conduct (published 14 June 2018 for comment until 17 September 2018).
31 Ontario Securities Commission, National Instrument 21-101 – Marketplace Operation (2018).
32 Ontario Securities Commission, National Instrument 23-101 – Trading Rules.
33 ibid., footnote 31.
34 ibid.

To operate as an exchange in Canada, a person or company must first apply for recognition as an exchange or for an exemption from the recognition requirement.[35] As another type of marketplace, alternative trading systems, which provide automated trading systems that match buyer and seller orders, are also regulated under NI 21-101 and NI 23-101.

It follows that exchanges or other platforms that facilitate the purchase, transfer or exchange of virtual currencies that are considered securities or derivatives may be subject to recognition requirements as securities or derivatives exchanges or marketplaces.[36] In the institutional market, prescribed or negotiated exemptions may be available in respect of platform-related recognition requirements under securities or derivatives laws, subject to the satisfaction of certain conditions and acceptance by the applicable regulators.

On 14 March 2019, the CSA and IIROC published the Consultation Paper, seeking input from the fintech community, market participants, investors and other stakeholders on how securities regulatory requirements may be tailored for platforms that facilitate the buying and selling or transferring of virtual currencies operating in Canada. The feedback is intended to be used to establish a framework to provide regulatory clarity to virtual currency exchange platforms and address risks to investors while fostering market integrity. The content and tone of the Consultation Paper suggest that the CSA and IIROC are looking to develop a regulatory framework for virtual currency exchange platforms that would largely rely on or be inspired by the existing regulatory framework applicable to marketplaces, while addressing more appropriately the specific factors and nuances relevant to the trading of virtual currencies in a largely digital environment. The Consultation Paper proposed a number of factors that may be considered in determining whether the trading of a security or derivative is involved, including:

a whether the platform is structured so that there is intended to be and is delivery of crypto assets to investors;

b if there is delivery, when that occurs, and whether it is to an investor's wallet over which the platform does not have control or custody;

c whether investors' crypto assets are pooled together with those of other investors and with the assets of the platform;

d whether the platform or a related party holds or controls the investors' assets;

e if the platform holds or stores assets for its participants, how the platform makes use of those assets;

f whether the investor can trade or roll over positions held by the platform; and

g having regard to the legal arrangements between the platform and its participants, the actual functions of the platform and the manner in which transactions occur on it:

- who has control or custody of crypto assets;
- who the legal owner of such crypto assets is; and
- what rights investors will have in the event of the platform's insolvency.

In formulating applicable requirements for a future regulatory framework, the CSA and IIROC have suggested that such a framework take into account risks associated with:

a custody;

b price determination;

35 ibid., footnote 4.

36 Canadian Securities Administrators, CSA Investor Alert: Caution Urged for Canadians Investing with Crypto-Asset Trading Platforms, 6 June 2018.

c surveillance of trading activities;
d systems and business continuity;
e conflicts of interest;
f insurance; and
g clearing and settlement.

To date, no virtual currency trading platform has been recognised as an exchange, or otherwise authorised to operate as a marketplace or dealer in Canada.[37] As such, the CSA has urged Canadians to be cautious when buying virtual currencies. The CSA has issued a steady stream of market advisories alerting market participants to risks related to products linked to virtual currencies, including futures contracts, on both regulated and unregulated platforms.[38,39]

v Asset management and investment funds

The demand for economic exposure to virtual currencies is high and investment funds have been a popular vehicle for obtaining this exposure. However, persons operating or administering collective investment structures that hold or invest in virtual currencies may also be subject to investment fund manager registration requirements in addition to dealer, adviser and prospectus or private placements requirements. The structures themselves may also be subject to reporting and conduct requirements that apply to investment funds.

In September 2017, First Block Capital Inc became the first registered investment fund manager (IFM) in Canada for a fund dedicated solely to investments in virtual currencies.[40] The British Columbia Securities Commission (BCSC) granted First Block Capital registration as an IFM and exempt market dealer in order to operate a Bitcoin investment fund, subject to certain bespoke exemptions from the applicable regime.[41] In its decision, the BCSC imposed a number of conditions on First Block Capital, including the requirement to seek the prior approval of the BCSC:

a to establish or manage any virtual currency investment fund;
b to change the investment objective of the virtual currency investment fund;
c to change the entity that maintains custody of the specified virtual currencies held by any investment fund;
d to change the entity responsible for the execution of trades in specified virtual currencies; and
e to change the firm's policies and procedures used to value any virtual currency held by any investment fund managed by the firm.[42]

37 ibid., footnote 6.
38 For example, the CSA reminds investors of the inherent risks associated with virtual currency futures contracts (18 December 2017). OSC Study: Lack of understanding of crypto assets puts Ontarians at risk (28 June 2018).
39 CSA Investor Alert: Caution Urged for Canadians Investing with Crypto-Asset Trading Platforms (6 June 2018).
40 British Columbia Securities Commission, B.C. Securities Commission grants landmark bitcoin investment fund manager registration (6 September 2017).
41 ibid.
42 ibid.

The BCSC also imposed a number of other obligations on First Block Capital with respect to oversight of the third-party custodians and brokers.[43]

Additional investment fund managers have also been approved by the CSA since the *First Block Capital* decision.[44]

The CSA has encouraged fintech businesses interested in establishing a virtual currency investment fund to consider:

a the prospectus requirements when distributing securities to retail investors;
b the legal and operational suitability of virtual currency exchanges;
c the registrations required with respect to the investment fund;
d the valuation methodology for the virtual currencies; and
e the virtual currency expertise of the custodian for the virtual currencies.[45]

Although certain virtual currency investment fund applications have been successful, it has proven difficult for these funds to become accessible to the general public. In October 2018, 3iQ Corp (3iQ) filed a non-offering preliminary prospectus on behalf of the Bitcoin Fund (3iQ Fund), a non-redeemable investment fund established as a trust under the laws of the province of Ontario, in its capacity as investment fund manager of the Fund.[46] As stated in the prospectus, the 3iQ Fund intended to invest in long-term holdings of Bitcoin purchased from various sources, including Bitcoin exchanges, to provide its investors with (1) exposure to Bitcoin and the daily price movements of the US dollar price of Bitcoin; and (2) the opportunity for long-term capital appreciation.[47] Cidel Trust Company (the Custodian), which was expected to be appointed as the custodian of the assets of the 3iQ Fund, had advised 3IQ that it did not have the capacity to hold bitcoin and that it intended to appoint a sub-custodian to hold bitcoin on behalf of the 3iQ Fund.[48]

On 15 February 2019, the Director, Investment Funds and Structured Products (the Director) of the OSC decided that it would be contrary to the public interest to issue a receipt for the 3iQ Fund's preliminary prospectus for multiple reasons, including:

a the difficulty of asset valuation as a result of the fragmented and unregulated environment in which Bitcoin generally trades;
b the difficulty of the sub-custodian to provide customary reports on the design of the 3iQ Fund's controls and their ability to operate as intended over a defined period of time; and
c the lack of clarity as to how the 3iQ Fund's auditor would be able to provide an unqualified opinion on its annual financial statements in accordance with Canadian securities laws.[49]

43 ibid.
44 See, for example, Canadian Securities Administrators, Majestic Asset Management; Canadian Securities Administrators, Rivemont Investments Inc; and Canadian Securities Administrators, 3iQ Corp.
45 ibid., footnote 4.
46 Ontario Securities Commission, OSC 3iQ Corp. Decision, 15 February 2019.
47 ibid.
48 ibid.
49 ibid.

On 15 March 2019, 3IQ and the 3iQ Fund made an application to the OSC seeking an order to et aside the decision of the Director to refuse to issue a receipt for the final non-offering prospectus of the 3iQ Fund and an order directing the Director to issue the receipt.[50] The appeal process is ongoing.

II ANTI-MONEY LAUNDERING

The Financial Transactions and Reports Analysis Centre (FINTRAC) is Canada's financial intelligence unit. FINTRAC administers the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA)[51] and its associated regulations, and assists in the detection, prevention and deterrence of money laundering and terrorist financing activities.[52] The PCMLTFA applies to a wide range of regulated entities, including money services businesses (MSBs). It requires that reporting entities develop a risk-based compliance programme to identify clients, monitor business relationships, keep records and report certain types of financial transactions.[53]

In 2017, the PCMLTFA was amended through the Budget Implementation Act, 2017[54] to, among other things, expand the application of the MSB rules to foreign persons and entities that have a place of business outside Canada but that are engaged in providing services to their customers in Canada as a foreign MSB. The application of the PCMLTFA was also extended to regulate businesses dealing in virtual currencies. These amendments are scheduled to come into force on 1 June 2020.

On 9 June 2018, the amendments to the regulations to the PCMLTFA were published for industry comments.[55] Final amendments to the regulations were issued on 22 June 2019 and are currently scheduled to come into force on 1 June 2020 concurrently with the MSB amendments to the PCMLTFA.[56] To mitigate the money laundering and terrorist activity financing vulnerabilities of virtual currencies, while at the same time not excessively obstructing innovation, the final amendments do not target virtual currencies themselves, but the persons or entities engaged in the business of dealing in virtual currencies. These dealing in activities include virtual currency exchange services and value transfer services. Persons and entities that are dealing in virtual currency would be financial entities, or domestic or foreign MSBs. As required of all MSBs, persons and entities dealing in virtual currencies would need to implement a full compliance programme and register with FINTRAC. Foreign MSBs would be subject to the same obligations (e.g., to register with FINTRAC, exercise customer due diligence, report transactions and keep records) for these activities. Furthermore, a

50 3iQ Corp. Press Release: 3iQ Appeals Decision of OSC Director on The Bitcoin Fund. 19 March 2019.

51 Proceeds of Crime (Money Laundering) and Terrorist Financing Act, S.C. 2000, c.17.

52 Financial Transactions and Report Analysis Centre of Canada, FINTRAC Annual Report Maximizing Results Through Collaboration, 2017.

53 ibid., footnote 51.

54 Budget Implementation Act, 2017 No. 1 (S.C. 2017, c. 20). Note: the amendment was originally proposed and made in 2014 although not brought into force.

55 Canada Gazette, Part I, Volume 152, Number 2: Regulations Amending Certain Regulations Made Under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act 2019.

56 Canada Gazette, Part II, Volume 153, Number 14: Regulations Amending Certain Regulations Made Under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act 2019 (expected to be officially published on 10 July 2019).

foreign MSB found to be non-compliant with the PCMLTFA and its regulations could face an administrative monetary penalty, and in the case of a failure to pay, revocation of its MSB registration, making it ineligible to do business in Canada.

The final amendments define the term 'virtual currency' as:

a a digital representation of value that can be used for payment or investment purposes that is not a fiat currency and that can be readily exchanged for funds or for another virtual currency that can be readily exchanged for funds; or

b a private key of a cryptographic system that enables a person or entity to have access to a digital representation of value referred to in point (a).

The final amendments do not specifically outline what constitutes dealing in virtual currency, although guidance published in connection with the 9 June 2018 proposed amendments states that dealing in activities would include virtual currency exchange services and value transfer services.[57] A virtual currency exchange transaction is defined to mean an 'exchange, at the request of another person or entity, of virtual currency for funds, funds for virtual currency or one virtual currency for another'.[58]

Quebec has enacted separate MSB legislation, which is administered by the AMF. The Money-Services Businesses Act[59] requires that any person or entity who operates a money-services business for remuneration be registered as an MSB. MSB registration issues in Quebec should be considered in connection with any virtual currency businesses with a Quebec nexus.

Canadian federal legislation also provides for economic and political sanctions, including additional monitoring and reporting obligations and prohibitions. These rules include offences such as knowingly collecting or providing funds to terrorist organisations or associated individuals, or dealing with sanctioned governments, entities or individuals.

III REGULATION OF MINERS

The process of virtual currency mining, which utilises specialised, high-speed computers, is energy-intensive. While virtual currency mining is not specifically regulated in Canada at this time, the use of virtual currency mining hardware may be subject to provincial or municipal requirements, or both, relating to the use of energy.

Canada's cold temperatures and low electricity costs make it particularly attractive for virtual currency miners.[60] This increased demand for electricity has caused some provincial and municipal governments to re-evaluate how to process requests from virtual currency miners going forward.

On 25 April 2019, Quebec's Régie de l'énergie issued a decision[61] regarding the rates and conditions for electricity use by blockchain (including virtual currency) clients. In its decision, the Régie de l'énergie, among other things, approved the creation of a new 'blockchain' consumer category and approved the creation of a reserved block of 300 megawatts (MW)

57 ibid.

58 ibid.

59 Money-Services Businesses Act, CQLR, c. E-12.000001.

60 Hooman B, 'Crypto-miners flood into Canada, boosting the hopes of small towns looking for a break', *Financial Post*, 9 April 2018.

61 *Régie de l'énergie* decision D-2019-052 (29 April 2019).

for this category, of which 50 MW must be allocated to blockchain projects of 5 MW or less. On 5 June 2019, Hydro-Quebec launched a request for proposals with respect to the allocation of the 300 MW block reserved for the blockchain consumer category. Projects will be evaluated based on economic and environmental criteria, including number of direct jobs in Quebec, total payroll of direct jobs in Quebec, capital investment in Quebec and total electricity use.

IV CRIMINAL AND CIVIL FRAUD AND ENFORCEMENT

Given the relatively nascent stage of the market, the policing of virtual currencies and virtual currency offerings in Canada presents unique enforcement challenges for both criminal prosecutors and securities regulatory authorities. While most of the litigation in the virtual currency market to date has occurred outside Canadian borders, a few Canadian cases warrant discussion.

In 2017, PlexCorps undertook an initial offering of its own virtual currency, PlexCoin. PlexCorps distributed to prospective investors a white paper stating that investors could expect a 1,354 per cent return on investment in less than 29 days.[62] On 20 July 2017, at the request of the AMF, Quebec's Financial Markets Administrative Tribunal issued various *ex parte* orders against PlexCorps, PlexCoin and related businesses, prohibiting them from engaging in activities for the purpose of directly or indirectly trading in any form of investment described in Section 1 of the Securities Act (Quebec),[63] including the solicitation of investors in Quebec and the solicitation, from Quebec, of investors outside the province.[64] The orders effectively required PlexCorps to abandon the planned token offering. PlexCorps disregarded the order and pursued the offering, and, despite AMF warnings to potential investors that PlexCorps had disregarded its orders, Plexcorps still raised approximately US$15 million from over 1,000 investors.[65]

In December 2018, the sole officer and director of Quadriga Fintech Solutions Corp (Quadriga), the operator of a platform that facilitated the purchase and sale of virtual currencies, died suddenly. It was alleged that this individual was the only Quadriga employee with knowledge of the encrypted passcodes required to gain access to Quadriga's virtual currency cold wallets and, as a result, upon the passing of the individual, the majority of Quadriga's virtual currency assets could not be located. In an email statement, a spokesperson for the BCSC stated that the regulatory body did not have any indication that Quadriga was trading in securities or derivatives or operating as a marketplace or exchange under British Columbia securities laws and, as such, that the BCSC did not regulate it.[66]

62 Jonathan Montpetit, 'Alleged Cryptocurrency fraud by Quebec company highlights need for more regulations, experts say', CBC News, 6 December 2017.

63 Quebec Securities Act, 1982, c.48; 2001, c.38. s.1.

64 Autorité des marchés financiers, Virtual Currency – Orders issued against PlexCorps, PlexCoin, DL Innov inc., Gestio inc. and Dominic Lacroix, 21 July 2017.

65 Autorité des marchés financiers, AMF urges utmost caution regarding solicitations relating to PlexCoin, 3 August 2017.

66 Debroop Roy and John Tilak, 'Canada Securities Watchdog Says Crypto Firm Quadriga Beyond its Purview', Reuters, 9 February 2019.

On 5 February 2019, the Supreme Court of Nova Scotia granted Quadriga protection under the Companies' Creditors Arrangement Act (Canada)[67] and Ernst & Young Inc was appointed as monitor in connection with the proceedings. As at 19 June 2019, approximately 76,000 unsecured creditors of Quadriga are owed approximately C$215 million.[68]

V TAX

i Taxation of virtual currencies

For Canadian tax purposes, the Canada Revenue Agency (CRA) has taken the position that virtual currencies constitute a commodity rather than a currency.[69] As such, gains or losses resulting from the trade of virtual currencies are taxable either as income or capital for the taxpayer.[70] Whether a transaction is on the account of income or capital is a question of fact. As with any transactions in securities, the CRA examines the following criteria to determine the nature of a transaction:

a the primary and secondary intentions of a taxpayer;
b the frequency of transactions;
c the period of ownership;
d the taxpayer's expertise and knowledge of virtual currencies markets;
e the relationship between the virtual currency's transaction and the taxpayer's business;
f the time spent engaged in virtual currencies activities;
g the type of financing required to support the taxpayer's cryptocurrency activities; and
h the taxpayer's advertising of the activities, if any.

Where a transaction is considered on capital account, the taxpayer will be required to include in computing its income for the taxation year of disposition one-half of the amount of any capital gain (a taxable capital gain) realised in such year. Subject to and in accordance with the provisions of the Income Tax Act,[71] the taxpayer will generally be required to deduct one-half of the amount of any capital loss (an allowable capital loss) realised in the taxation year of disposition against taxable capital gains realised in the same taxation year. Allowable capital losses in excess of taxable capital gains for the taxation year of disposition generally may be carried back and deducted in any of the three preceding taxation years or carried forward and deducted in any subsequent taxation year against net taxable capital gains realised in such taxation years, to the extent and under the circumstances specified in the Tax Act. Where a transaction is considered on income account, the resulting gains are taxed as ordinary income and the losses are generally deductible.

67 Companies' Creditors Arrangement Act, RSC 1985, c. C-36.
68 Fifth Report of the Monitor in the matter of Application by Quadriga Fintech Solutions Corp, Whiteside Capital Corporation and 0984750 B.C. Ltd. dba Quadriga CX and Quadriga Coin Exchange for relief under the Companies' Creditors Arrangement Act, 19 June 2019.
69 Canada Revenue Agency, Document No. 2013-051470II7, 23 December 2013.
70 Canada Revenue Agency, Fact Sheets & Taxpayer Alerts, What You Should Know About Digital Currency, 17 March 2015.
71 Income Tax Act, RSC 1985, c.1.

ii Virtual currency mining

The tax treatment of virtual currency mining will depend on whether the activity is undertaken for profit or as a personal endeavour.[72] A personal endeavour is an activity undertaken for pleasure and does not constitute a source of income for tax purposes, unless it is conducted in a sufficiently commercial and business-like way. However, the mining of virtual currencies is likely to be considered a business activity by the CRA considering the complexity of such activity. The mining of virtual currencies would therefore require the taxpayer to compute and report business income in compliance with the Income Tax Act, including the rules with respect to inventory.

iii Paying with virtual currencies

Where a virtual currency is used as payment for salaries or wages, the amount must generally be included in the employee's income computed in Canadian dollars.[73] As a result of the qualification of virtual currencies as a commodity, the use of virtual currencies to purchase goods or services is subject to the rules applicable to barter transactions.[74] Therefore, where virtual currencies are used to purchase goods or services, the value in Canadian dollars of the goods or services purchased must be included in the seller's income for tax purposes, rather than the value of the virtual currencies.[75] However, the CRA has stated that the fair market value of the virtual currency at the time the supply is made must be used to determine the goods and services tax and harmonised sales tax payable on the purchase of a taxable supply of a good or service.[76]

iv Specified foreign property

The CRA has finally stated that virtual currencies situated, deposited or held outside Canada fall within the definition of specified foreign property, as defined in the Tax Act.[77] As such, Canadian residents must report to the CRA when the total costs of virtual currencies situated, deposited or held outside Canada exceed C$100,000 at any time in the year by filing Form T1135 with their income tax return for the year.

v Collection of goods and services tax and harmonised sales tax with respect to virtual currency transactions

There is currently no legislation indicating how to address the collection of goods and services tax and harmonised sales tax (GST/HST) in virtual currency transactions. The CRA's position on the characterisation of virtual currencies for GST/HST purposes is equally unclear. On 17 May 2019, the Department of Finance sought to clarify this issue by releasing draft legislation[78] amending the Excise Tax Act (ETA)[79] to include explicit reference to virtual currencies. The proposed amendment adds 'virtual payment instruments' to the definition of 'financial instruments' in Section 123(1) of the ETA, thus rendering any sale of the virtual

72 Canada Revenue Agency, Document No. 2014-0525191E5, 28 March 2014.
73 ibid., footnote 72.
74 ibid., footnote 68.
75 ibid., footnote 70.
76 ibid., footnote 69.
77 Canada Revenue Agency, Document No. 2014-0561061E5, 16 April 2015.
78 Department of Finance Canada, Draft Legislation Relating to the Excise Tax Act, 17 May 2019.
79 Excise Tax Act, RSC 1985, c. E-15.

currency or transaction involving virtual currencies as a form of payment exempt from GST/HST collection. If the draft legislation is enacted and adopted as proposed, the changes would be effective as of 18 May 2019.

VI LOOKING AHEAD

To achieve a balance between investor protection and innovation, the CSA has introduced the CSA regulatory sandbox, an initiative to support financial technology businesses seeking to offer innovative products, services and applications in Canada.[80] The initiative, along with province-specific initiatives such as the OSC's Launchpad, allow firms to register or obtain exemptive relief from securities law requirements, or both, under a faster and more flexible process than through a standard application, to test products, services and applications in the Canadian market on a time-limited basis.[81] Regulated offerings of virtual currencies such as Impak Coin, FNDR and ZED and approvals of virtual currency investment funds, represent early success stories of the CSA regulatory sandbox.

Market events such as those described in this chapter have highlighted certain risks that the CSA is seeking to address through rule-making and exemptive relief. However, it is clear that while Canadian securities regulators will attempt to make and enforce rules that foster innovation, and fair and efficient capital markets, they will seek to prioritise investor protection, particularly in the retail space.

80 Canadian Securities Administrators, CSA Regulatory, Sandbox, 2018.

81 ibid.

Appendix 1

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