

1.1.2 CSA Staff Notice 51-363 – Observations on Disclosure by Crypto Assets Reporting Issuers



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Observations on Disclosure by Crypto Assets Reporting Issuers

March 11, 2021

Introduction

The public company crypto asset industry is relatively nascent. This includes reporting issuers¹ dealing in digital assets, such as cryptocurrencies, tokens, stablecoins, and similar digital assets relying on blockchain technology (**crypto assets**²). In Canada, most reporting issuers in the crypto asset industry entered the public markets in 2017 or 2018 via a restructuring transaction with, or a change of business by, an existing reporting issuer³. Given this timing, most of these reporting issuers completed their first annual filings in 2019 for their annual reporting period ending in 2018.

Staff of the securities regulatory authorities in each of Ontario, British Columbia, Alberta, Saskatchewan, Manitoba, Québec, New Brunswick, and Nova Scotia (collectively, **staff** or **we**) have prepared this notice to outline several disclosure observations based on the first annual filings by reporting issuers (other than investment funds) that engage materially with crypto assets via mining and/or the holding/trading of those assets (**crypto assets reporting issuers** or **issuers**). This notice also provides a snapshot of Canadian crypto assets reporting issuers (refer to **Figures 1-4** of this notice) and staff guidance to assist these issuers in meeting their ongoing continuous disclosure obligations.

Observations and Guidance**Safeguarding of Crypto Assets**

Securities legislation in Canada requires reporting issuers to disclose the material risks affecting their business and, where practicable, the financial impacts of such risks⁴. For crypto assets reporting issuers, the controls adopted to guard against the risk of loss and/or theft associated with holding such crypto assets is a material risk important for investors.

In light of this, the disclosure of such controls will be a focus of our review of these issuers' filings. In addition, the failure to adopt adequate protections may give rise to public interest concerns about the issuer.

¹ In this notice, references to reporting issuers refer to reporting issuers other than investment funds.

² For purposes of this notice, we considered the definition of a "crypto asset" to be consistent with CSA Staff Notice 21-327 *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets*.

³ To date, only two (2) crypto issuers have become reporting issuers in Canada through the issuance of a receipt for a final prospectus by a securities regulatory authority.

⁴ See section 5.2 of Form 51-102F2 *Annual Information Form* (the **AIF** or **Form 51-102F2**) and section 1.4(g) of Form 51-102F1 *Management's Discussion and Analysis* (the **MD&A** or **Form 51-102F1**).

Figure 1: Crypto Assets Reporting Issuers by Principal Regulator – as at December 31, 2020

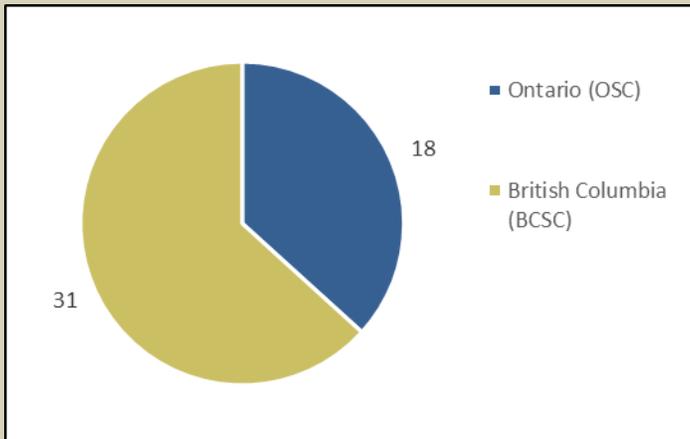


Figure 2: Crypto Assets Reporting Issuers by Primary Exchange – as at December 31, 2020

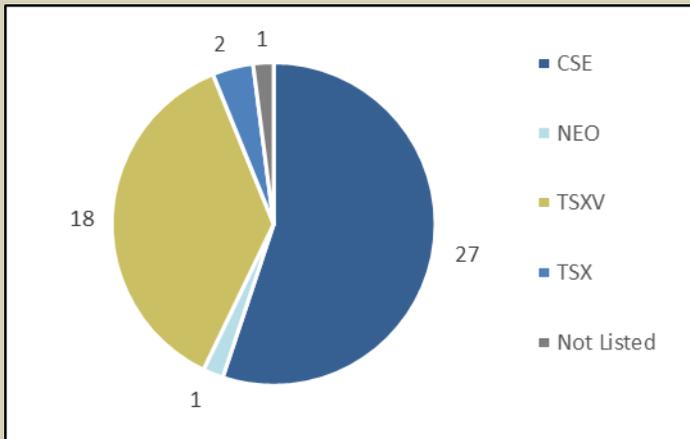


Figure 3: Crypto Assets Reporting Issuers by Activity – as at December 31, 2020

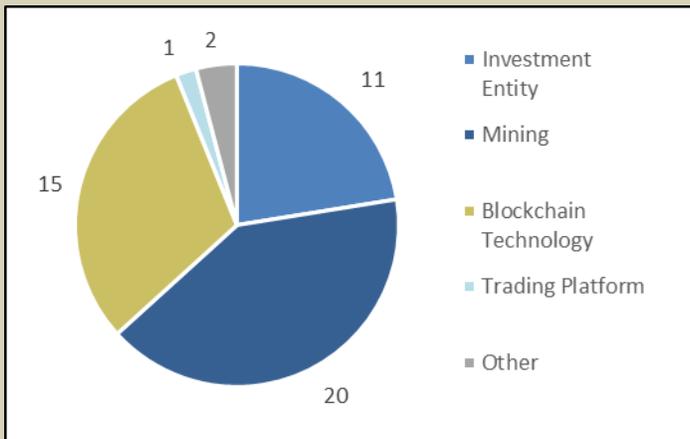
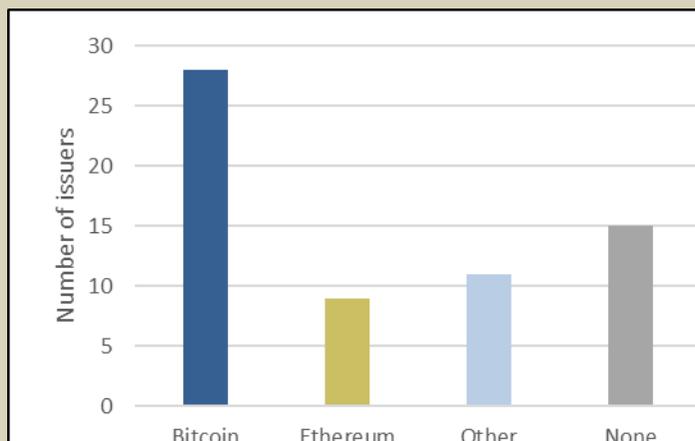


Figure 4: Crypto assets holdings of Crypto Assets Reporting Issuers – as at December 31, 2020

For those issuers that self custody their crypto assets, these may include, among other things, multi-signature wallets, safeguarding of private keys, the use of “cold wallets” and frequent monetization of crypto assets into fiat currency. The controls that are appropriate for a given issuer may vary depending on its size and the type and quantity of crypto assets held, as well as the frequency for which they move to and from “hot wallets” or liquidate the crypto assets.

Some issuers retain a third-party custodian to safeguard all or a substantial portion of their crypto assets. We would expect that for issuers that have retained a third-party custodian, the following information would be material to investors:

- the identity and location of the third-party custodian,
- if the third-party custodian has appointed a sub-custodian to hold certain crypto assets, the identity and location of the sub-custodian(s),
- a general discussion of the services provided to the issuer by the third-party custodian (e.g., is the custodian a payment processor or just responsible for holding/ safeguarding the crypto assets),
- whether the custodian is a Canadian financial institution (as defined in NI 45-106⁵) or a foreign equivalent, and if so by whom the custodian is regulated,
- whether the issuer is aware of anything with regards to the custodian’s operations that would adversely affect the issuer’s ability to obtain an unqualified audit opinion on its audited financial statements,
- whether the custodian is a related party of the issuer,
- the quantity or percentage of the issuer’s crypto assets held by the custodian as at each reporting period end date,
- whether the crypto assets held by the custodian are insured and any limitations on the custodian’s liability in the event of the loss or theft of the issuer’s crypto assets,
- any known security breaches or other similar incidents involving the custodian as a result of which crypto assets have been lost or stolen,
- the treatment of the assets in the event of an insolvency or bankruptcy of the custodian, and

⁵ National Instrument 45-106 *Prospectus Exemptions (NI 45-106)* defines a “Canadian financial institution” as: (a) an association governed by the Cooperative Credit Associations Act (Canada) or a central cooperative credit society for which an order has been made under section 473(1) of that Act, or (b) a bank, loan corporation, trust company, trust corporation, insurance company, treasury branch, credit union, caisse populaire, financial services cooperative, or league that, in each case, is authorized by an enactment of Canada or a jurisdiction of Canada to carry on business in Canada or a jurisdiction of Canada.

- if the custodian operates in a foreign jurisdiction, what due diligence the issuer has performed on the custodian (including the issuer's ability to: effectively monitor the custodian and execute contingency plans and exit strategies with minimal impact on the issuer's operation).

Such issuers should also consider whether a custodial agreement constitutes a material contract and whether the execution of such an agreement or the change of a custodian constitutes a material change for the issuer.

While we do not expect that all issuers will retain a third-party custodian, we expect that the reasons for not doing so would be material information for investors. We also expect that for issuers that self custody their crypto assets, the following information would be material to investors:

- a description of the controls implemented to protect the crypto assets against the risk of loss and/or theft associated with holding crypto assets,
- whether the issuer employs multi-signature wallets,
- the manner in which private keys are safeguarded, including the nature and extent of the use of "cold wallets",
- whether the issuer's crypto assets are insured, and any exclusions contained in the insurance policy that would prevent the issuer from making a successful claim in the event that the crypto assets are lost or stolen,
- measures taken to mitigate cyber security risks, and
- the frequency of monetization of crypto assets into fiat currency.

The controls that are appropriate for a given issuer may vary depending on its size and the type and quantity of crypto assets held, as well as the frequency for which they move to and from "hot wallets" or liquidate the crypto assets.

Use of Crypto Asset Trading Platforms

The use of, and reliance on, crypto asset trading platforms also raises issues that extend beyond an issuer's own controls. Issuers that hold crypto assets through a crypto asset trading platform generally do not hold the private key and do not have control over the assets. Their account with the crypto asset trading platform generally represents a contractual claim against the trading platform and subjects the reporting issuer to the risks related to the solvency, integrity and proficiency of the operators of the trading platform⁶. To the extent that an issuer relies on a crypto asset trading platform to hold its crypto assets, we expect the issuer to disclose, at a minimum, all the items referenced in the "Safeguarding of Crypto Assets" section of this notice when third-party custodians are used.^{7 8}

Description of Business

The description of an issuer's business in its continuous disclosure filings (e.g., such as in its Annual Information Form and/or Management's Discussion & Analysis), as well as any prospectus, should be sufficiently detailed to enable investors to make an informed decision about whether to buy, sell or hold the issuer's securities. Given the relative novelty of the crypto industry, disclosure regarding the nature of the issuer's operations, how the business intends to generate revenue, the specialized skill and knowledge possessed by the issuer, the competitive conditions faced by the issuer and the sources, pricing and availability of equipment used by the issuer, and any reliance on third-party service providers (e.g., trading platforms, mining pool operators, liquidity providers, etc.), would likely be material information for investors.

Risk Factor Disclosure

Risk factor disclosure should be specific and sufficiently tailored to the risks that relate to the issuer and its business. Depending on the issuer, these may include, among many others, risks pertaining to: (i) the availability and/or cost of electricity, (ii) potential declines in the price of crypto assets, (iii) decreased rewards for mining a particular crypto asset, and (iv) risks related to access to crypto assets held at third-party custodians and crypto asset trading platforms. Risks related to different forms of crypto assets differ. For example, the risks of holding more established cryptocurrencies, such as Bitcoin or Ether, may be significantly different from investments in other digital assets, such as digital tokens.

⁶ Joint CSA/IIROC Consultation Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms* outlines specific risks related to crypto asset trading platforms.

⁷ Note the report on the QuadrigaCX investigation released on June 11, 2020 by staff of the Ontario Securities Commission is an example of practices that can result in losses for parties relying on a crypto asset trading platform. The report can be found at <https://www.osc.gov.on.ca/quadrigacxreport>.

⁸ Reporting issuers using crypto asset trading platforms operating from outside Canada who have Canadian users should also consider the requirements under Canadian securities legislation, including the guidance in CSA Staff Notice 21-327 *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets*.

Promotional Activities

Issuers should not engage in promotional activities that provide unbalanced or unsubstantiated material claims about the issuer's business and the corresponding opportunity for profit by investing in the issuer. For example, a statement that an issuer is the largest of its type should be supported by objective data that provides the issuer with a reasonable basis on which to conclude that the statement is accurate. We refer issuers to CSA Staff Notice 51-356 *Problematic promotional activities by issuers* for staff's views on promotional activities generally.

Material Changes

All reporting issuers have an obligation to consider whether an event constitutes a material change (i.e., a change in its business, operations or capital that would reasonably be expected to have a significant effect on the market price or value of any of its securities). If so, issuers are required to immediately issue and file a news release authorized by an executive officer disclosing the nature and substance of the change and, as soon as practicable and in any event within 10 days of the date on which the change occurs, file a material change report with respect to the material change. We have noted several examples of issuers failing to file material change reports or failing to do so within the required 10-day period. Examples of changes that would require reporting, if material, may include: (i) entering into a custodial agreement with a third-party, (ii) changing custodians, (iii) the loss or theft of crypto assets, (iv) an acquisition or sale of crypto asset mining equipment, or (v) entering into a mining pool arrangement or an electricity supply agreement by a crypto asset mining issuer if the arrangement is significant in relation to the issuer's existing operations.

Issuers Whose Business is Investing in Crypto Assets

Investment Fund Requirements May Apply

If a material aspect of an issuer's business is investing in crypto assets and the issuer does not have other substantial operations, despite the fact that the issuer may not meet the definition of an investment fund⁹, many of the investor protection considerations applicable to investment funds may be relevant. If the issuer were to file a prospectus, staff may take the view that it would not be in the public interest to recommend issuing a receipt for the prospectus in the absence of the issuer taking relevant mitigation efforts comparable to those that apply under the investment fund regime. Such concerns are assessed on a case-by-case basis.

Some examples of investor protection considerations that have been required before the issuance of a prospectus receipt include:

- investment concentration restrictions,
- an undertaking to provide continuous disclosure for underlying investee companies if they represent a substantial amount of the issuer's business, and
- requirements to use a custodian qualified in accordance with Part 6 of National Instrument 81-102 *Investment Funds*.

Investment Portfolio Disclosure

In order to provide a meaningful discussion of an issuer's performance that meets the requirements of Form 51-102F1 *Management's Discussion & Analysis*, specific information about the issuer's crypto assets and other portfolio holdings is required.

For further staff guidance on the kind of disclosure staff may expect, crypto issuers that invest in crypto assets or other types of investments should refer to CSA Multilateral Staff Notice 51-349 *Report on the Review of Investment Entities and Guide for Disclosure Improvements (SN 51-349)*¹⁰.

Financial Statements

There are unique aspects of the crypto asset industry that raise novel accounting issues. As the discussion around many of these issues may continue to evolve, issuers should monitor and carefully consider any guidance published by accounting standard setters and regulatory bodies. The following section of the notice outlines considerations that staff believe are relevant to crypto issuers who face certain complex accounting and disclosure issues. This section of the notice applies specifically to holdings of cryptocurrencies, a subset of crypto assets, and does not apply to tokens or initial coin offerings.

⁹ National Instrument 81-106 *Investment Fund Continuous Disclosure* defines an "investment fund" as a mutual fund or a non-redeemable investment fund, and, for greater certainty in British Columbia, includes an EVCC and a VCC.

¹⁰ This Staff Notice was published in certain jurisdictions as CSA Multilateral Staff Notice 51-349 *A Guide for Disclosure Improvements by Investment Entities and Non-Investment Entities that Record Investments at Fair Value*.

Accounting Policies and Disclosure Expectations

The IFRS Interpretations Committee (the **Committee**) published its agenda decision on *Holdings of Cryptocurrencies* in June 2019. The Committee concluded that IAS 2 *Inventories* applies to cryptocurrencies when they are held for sale in the ordinary course of business, otherwise an entity should apply IAS 38 *Intangible Assets* to holdings of cryptocurrencies¹¹. The agenda decision directs entities to disclose the following information that is relevant to an understanding of its financial statements:

- (i) those specific disclosures noted by the Committee and required by IFRSs, including but not limited to:
 - accounting policies for classification and measurement [*IAS 1*],
 - significant judgments made in the application of accounting policies [*IAS 1*],
 - fair value disclosure requirements, if applicable [*IFRS 13*],
 - disclosure requirements for intangible assets or inventory, if applicable [*IAS 38* or *IAS 2*], and
 - consideration of subsequent events disclosure; and
- (ii) any additional information that is relevant to an understanding of its financial statements. Staff are of the view that such relevant information, for example, would generally include:
 - the nature of the different types of cryptocurrencies held, including disclosure concerning the entity's risk exposure to such assets,
 - the quantity and recorded value of each type of cryptocurrency that an issuer holds at the relevant financial reporting dates,
 - a continuity schedule for each type of cryptocurrency, differentiating between increases due to mining and due to acquisitions/dispositions in the market,
 - the source(s) of valuation information, including the name of the data aggregator, if applicable,
 - the entity's basis for determining whether cryptocurrencies are accounted for as inventory or an intangible asset, as well as the method of valuation used (cost, fair value, revaluation), and
 - a breakdown of mining equipment by cryptocurrency that the equipment is capable of mining, if applicable.

Cryptocurrencies Recorded at Fair Value

If cryptocurrencies have been measured at fair value, staff expect the notes to the financial statements to include appropriate disclosures (in accordance with IFRS 13 *Fair Value Measurement*) for a reader to understand:

- the valuation techniques used, particularly for holdings of decentralized cryptocurrencies where fair value may be more difficult to establish, and
- whether the fair value measurement has been categorized within level 1, 2 or 3 of the fair value hierarchy. IFRS 13 contains additional disclosure requirements depending on this categorization.

Where the fair value re-measurement of an issuer's cryptocurrencies has a significant impact on its financial results in a reporting period, staff are of the view that the realized and unrealized components of this gain or loss should be separately disclosed in the financial statements, including any reversal of previously unrealized fair value gains or losses.

Issuers should also consider the guidance provided in SN 51-349 as staff's disclosure expectations regarding investments recorded at fair value are generally also applicable to cryptocurrencies recorded at fair value.

Accounting for Mining of Cryptocurrency

Issuers that mine cryptocurrency must often deal with complexities in determining an appropriate accounting policy for their mining activity. The following are examples of where additional complexities may arise and considerations for issuers with these types of arrangements:

¹¹ Within its June 2019 agenda decisions, the IFRS Interpretations Committee referred to a "cryptocurrency" as being part of a subset of crypto assets and having all the following characteristics: (i) a digital or virtual currency recorded on a distributed ledger that uses cryptography for security, (ii) not issued by a jurisdiction authority or other party, and (iii) does not give rise to a contract between the holder and another party.

- miners that participate in mining pools should consider the structure and arrangements of the pool (for example, the payout formula and timing, any fees payable, and whether the pool differentiates between the cryptocurrency mined and the block reward) in determining their accounting policies,
- miners who receive a block reward and a transaction fee when completing mining activities should consider whether transaction fees should be separately recorded and disclosed, particularly if these fees are significant, and
- a separate accounting policy must be determined by issuers who sell or “rent” hash power to other entities. Revenue earned from this source should be separately disclosed from revenue earned from traditional mining activity.

Importantly, staff expect the financial statement notes to contain robust disclosure of a cryptocurrency miner’s accounting policies for its mining activity, including references to applicable IFRSs, and any significant judgments that have been made therein.

Cryptocurrency Mining Equipment

Many cryptocurrency miners own the specialized equipment used for their crypto mining activities including mining servers and the supporting infrastructure. Given this equipment typically represents a significant portion of the issuer’s total assets and different types of crypto assets are subject to different risks, staff expect the financial statements to disclose the disaggregation of this equipment by the type of crypto asset it is capable of mining.

Given the rate of technological obsolescence and other volatility (e.g., the price of cryptocurrencies) present in the industry, careful consideration should be given to whether an indicator of impairment exists in accordance with IAS 36 *Impairment of Assets* at each reporting date. If an indicator of impairment exists, the issuer should consider, among other things, the following when estimating the recoverable amount of the asset:

- the sustainability of current cryptocurrency prices, energy prices (particularly where the issuer currently receives unsecured preferential rates), and the level of block rewards received relative to hash power,
- the issuer’s hash rate relative to other miners in its mining pool, and
- the need for sustaining capital expenditures to maintain a consistent level of hash power relative to other miners.

Given the greater risk of technological obsolescence in this industry, issuers should also consider whether a reassessment of the useful life of the asset is necessary based on the results of the impairment test. If the impairment test results in the recognition of an impairment loss, issuers should ensure that the impairment loss is allocated in accordance with the principles in IAS 36.

Non-Monetary Transactions Settled in Cryptocurrencies

Non-monetary transactions where assets or services received are settled in cryptocurrencies present an increased risk of manipulation, particularly where such transactions involve related parties. Issuers should ensure they have robust controls in place regarding the initiation and approval of such transactions including appropriate segregation of duties and minimization of the time period between transaction inception and settlement. Issuers with significant non-monetary transactions should also ensure that their financial statements disclose their accounting policies for these transactions and incorporate such transactions into their continuity schedule for each type of crypto asset (as referenced in the “*Financial Statements – Accounting Policies and Disclosure Expectations*” section of this notice). Issuers should also ensure that their MD&A includes a robust discussion of such non-monetary transactions if they are material to the issuer’s business.

Auditing Issues

As the mining of cryptocurrencies and holding of crypto assets in Canada is an emerging industry with unique technological aspects, a number of novel auditing challenges have arisen. Audit firms, standard setters, and regulatory bodies continue to explore these challenges and potential solutions.

We encourage issuers, and their audit committees and advisors, to review guidance that has been published by the Chartered Professional Accountants of Canada and communications from the Canadian Public Accountability Board.

We continue to monitor developments in this area and may raise comments in the context of prospectus or continuous disclosure reviews where it appears that novel auditing issues may exist.

Conclusion

Reporting issuers in the crypto asset industry are subject to the same disclosure obligations as other reporting issuers. However, the emerging nature of the crypto asset class and the evolving risks involved can raise novel issues when complying with these

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obligations. It is important to avoid inaccurate or misleading disclosure and to provide the information necessary for investors to make informed investment decisions.

Crypto issuers considering filing a prospectus or entering into a restructuring transaction to enter the Canadian public markets should carefully consider what disclosure to provide about their business model in order to meet their regulatory requirements.

We will continue to evaluate the disclosure of reporting issuers that engage in crypto asset-related activities and will consider the need for further guidance or policy changes specific to these issuers.

Questions

Please refer your questions to any of the following:

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