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Re: Coinsquare Capital Markets Ltd. (“Coinsquare”) Notice of Initial Operations and Request for Comment

Ladies and Gentlemen:

DV Chain, LLC. and its affiliate, Independent Trading Group (ITG) Inc. (collectively the “DV Companies”)¹ appreciate the opportunity to respond to the Ontario Securities Commission’s (the “OSC” or “Commission”) request for comment on the Coinsquare Capital Markets Ltd. (“Coinsquare”) Notice of Initial Operations and Request for Comment (the “Notice”). As avid cryptocurrency traders with plans to grow their cryptocurrency businesses, the DV Companies have supported innovation in the space. And as a leading liquidity provider in many Digital Assets, DV Chain is intimately familiar with the still-evolving marketplace. Founded by traditional asset traders, the DV Companies have applied the risk mitigation systems from traditional over the counter (“OTC”) markets to implement processes designed to address (1) counterparty risk; (2) market risk; and (3) operational risk. In this comment letter, the DV Companies will share these insights as they apply to the proposal set forth in the Notice.

As a general note, we found that the Coinsquare Notice did not provide a number of key details required to fully understand the risks (and, potentially, any safeguards). These mostly relate to procedures in the event there are settlement failures, as more fully discussed below.

Counterparty Risk.

At present, there is no clearing model that exists for spot cryptocurrencies. In traditional markets, the concept of clearing mitigates many risk factors including (1) creating a central counterparty for all trades, eliminating counterparty risk; (2) netting risk of long and short positions; (3) collecting and custodial margin deposits, covering a portion of the risk; and (4) maintaining a guarantee fund. In the Coinsquare model set out in the Notice, the system described appears to be a rudimentary bilaterally settled model with no counterparty risk parameters or detailed settlement procedures.

¹ DV Chain is an active liquidity provider in the United States and Canada to institutional counterparties. DV Chain’s affiliate, ITG, is a registered IIROC dealer member firm.



The Notice states that Subscribers² will enter orders, and the ATS will “*treat all orders as fully committed and binding.*” There is no indication of a maximum order size (in dollars), maximum open position (in dollars), pre-trade risk check, or any of the typical and necessary limit parameters found on a traditional ATS. Hypothetically speaking, a Subscriber could “fat-finger” an additional zero in an order, and such order would be fully committed and binding despite whether or not the Subscriber could financially settle such an order. While the ATS may check for potentially erroneous *prices*, there are no apparent pre-trade financial, or credit checks related to size or overall notional of the trade.

Without an initial margin requirement or requirement for Subscribers to pre-fund the trade, the Subscriber is being trusted to settle each and every order and manage its own leverage. If a Subscriber were to have a failed trade, will Coinsquare step in and provide settlement? If so, this should be an obligation, and not in Coinsquare’s discretion. If not, a sufficiently large Subscriber default could have a ripple effect across the ATS and multiple Subscribers with retail order flow behind them may be left unable to settle.

Absent a clearing entity or Coinsquare guaranteeing settlement with insurance, one might argue that Subscribers, as sophisticated, regulated institutions, should assess the risk of their counterparties on a case-by-case basis. However, the Notice does not indicate whether trading is done on a disclosed name basis. Hypothetically, if Subscribers could “approve” or “deny” trading with other Subscribers, the model is no longer a single CLOB model, but a multi-CLOB model where each Subscriber only views other Subscribers’ orders that it has approved for trading and vice versa. This may pose an additional issue related to best execution if Subscribers have retail orders behind them, but only want to face specific Subscribers and not necessarily those Subscribers with the most competitive prices.

Moreover, even if the model were a disclosed-name model where a Subscriber (Subscriber A) did know its counterparty, Subscriber B; Subscriber A would not know Subscriber B’s outstanding exposure at that moment in time, and vice versa. Hypothetically, Subscriber A may have approved Subscriber B with a maximum open position limit of \$100,000,000, but Subscriber B already has \$110,000,000 of exposure versus other Subscribers on open, unsettled trades. The Subscribers are not best positioned to know each other’s risk profiles. Only Coinsquare will have visibility into *all* Subscribers’ open positions on the ATS, and thus should be responsible for setting the necessary risk parameters and guaranteeing all trades on the ATS. This issue will be discussed further below in Conflicts of Interest.

The Notice also indicates that Subscribers settle trades bilaterally:

*Each business day, the Coinsquare ATS will generate a file that notifies each Subscriber, on a **Subscriber-to-Subscriber basis**, of their respective net settlement obligations. **Subscribers will be responsible for initiating settlement** based on those instructions via fiat and Digital Asset transfer, in that order of priority, and then confirming final settlement with the ATS’s settlement personnel*

This begs the same questions as posed above. If, for example, Subscriber A fails to settle a trade versus Subscriber B for any reason, will the ATS make Subscriber B whole? What recourse does a Subscriber have in the case of a default or even delayed settlement? The risk a Subscriber takes when placing an order

² All capitalized terms used but not defined herein shall have the meanings ascribed to them in the Notice.



in the CLOB is that it will be matched with another Subscriber who has over-levered its position or failed to properly hedge and ultimately fails to deliver and settle the transaction.

Bilateral settlement on a delayed, post trade basis poses an even greater risk in volatile markets. In fact, the greatest risk in this system is an outsized price *appreciation* of a Digital Asset between trade date and settlement date. For example, if a Subscriber (Subscriber A) sells \$5,000,000 of CoinX at \$0.10 to another Subscriber (Subscriber B). Subscriber A then hedges that exposure away from the ATS with a third-party liquidity provider (an “LP”) in an OTC trade. Following the trade with the LP, Subscriber A expects to receive 50 million CoinX. However, after the trade with Subscriber B and the hedge with the LP, CoinX increases to a price of \$2.00 and the LP fails to deliver the 50 million CoinX to Subscriber A. At this point, in order for Subscriber A to settle this trade on the ATS with Subscriber B, Subscriber A must either (1) buy CoinX in the open market at the new price of \$2.00 (which now costs Subscriber A \$100,000,000) or (2) simply fail to settle the transaction. Subscriber A will likely be insolvent in this event and therefore fail to settle with Subscriber B. This, in turn socializes the \$100,000,000 loss across the various counterparties to Subscriber A, which could result in a cascade of bankruptcies across the ATS.

Another benefit of a central clearing model is the ability to net down risk with a single, central counterparty (a “CCP”). In the model proposed by Coinsquare, where settlement occurs bilaterally, Subscribers suffer from netting inefficiency when they have multiple, potentially offsetting positions open with multiple Subscribers. For example, if Subscriber A (1) buys 100 BTC from Subscriber B and (2) sells 100 BTC to Subscriber C, Subscriber A would have counterparty risk exposure from both Subscriber B and Subscriber C and would have to settle separately with both. Subscriber A may show a zero exposure on its balance sheet (100 BTC receivable and 100 BTC deliverable), but if either Subscriber B or Subscriber C defaults, Subscriber A will be left with a loss that may impact its ability to deliver to the non-defaulting Subscriber. This could cause a chain reaction default on the ATS. By having bilateral settlement, a Subscriber cannot net its risk exposure and would have to treat each and every trade as adding to its gross risk exposure.

Without a clearing model, the risks discussed above could be addressed in one of three ways: (1) Subscribers can pre-fund each Digital Asset purchase and pre-deliver each Digital Asset sale conducted on the ATS; (2) Subscribers can manage pre-funding themselves by committing capital or Digital Assets for each trade, subject to trade reporting and audit by the applicable regulator to ensure each trade was properly pre-funded; or (3) Coinsquare can provide a guarantee fund or insurance to backstop any potential defaults or failures to deliver. Without a mechanism to manage failures, the possibility of default that cascades across the ecosystem is too great a risk.

Market Risk

Digital Assets are volatile instruments. As discussed above, the Notice does not describe a robust pre-trade risk, credit check, or pre-funding requirements. But in addition to counterparty risk, the volatility of Digital Assets makes the Coinsquare model even more vulnerable to market risk. One of the examples discussed above examined an instance of rapid price appreciation. However, when a Digital Asset rapidly *depreciates* intra-day like LUNA or UST (Terra USD Stable Coin) did between Saturday May 7th, 2022 and Monday, May 9th, 2022, Subscribers could have lost nearly 100% of the value of their positions over a weekend. In



the absence of pre-funding or proper credit checks, several Subscribers could have experienced material losses, possibly large enough to default and not settle their trades, which in turn results in losses for other Subscribers.

In a traditional market, there would be variation margin to address the price movements, and an inability to post margin would result in forced liquidation. Furthermore, in instances when the forced liquidation still results in an unrecoverable loss from the Subscriber, there is a guarantee fund and other clearinghouse mechanisms to shield other Subscribers from such a loss. The Notice does not address any liquidation procedures.

The Notice also specifies that “*Trading will not be offered on the Coinsquare ATS in Digital Asset pairs.*” This means total reliance on the fiat wire system to settle each and every trade. Fiat wires often take hours, extend into the next day or even worse, are not available over the weekend. In the Terra/LUNA event referenced above, UST de-pegged from the dollar over a weekend. With an inability to settle trades in other Digital Assets, Subscribers would have been left with unsettled positions in a plummeting asset for three days prior to receiving settlement on Tuesday morning for a then nearly worthless Digital Asset. Because Subscribers face each other bilaterally, what recourse would a Subscriber have if the contra-party to its trade failed to settle? In a 24-hour market, “*The Coinsquare ATS will be open for trading 24 hours a day, 7 days a week, 365 days a year,*” Coinsquare must consider the limited, 5-day week fiat settlement availability.

Operational Risk

The next issues to address are those posed by the proposed settlement procedures. The Notice indicates that, *Subscribers will be responsible for initiating settlement based on those instructions via fiat and Digital Asset transfer, in that order of priority.* Specifically, the proposal identifies that fiat settlement will occur prior to Digital Asset settlement, in each and every instance. Because fiat settlements are effected via a wire with delayed settlement, this could take T+1 on a week day, or T+3 on a holiday or weekend. The Notice does not, however, indicate whether the subsequent Digital Asset transfer must occur upon *initiation* of a wire or *after* the wire lands.

Specifically, if the fiat wire is initiated before settling (and receiving) the Digital Asset, what form of confirmation will Subscribers provide to the ATS that the wire has been initiated? The Notice states the Subscriber settling the fiat transaction will be “*confirming final settlement with the ATS’s settlement personnel*”. There is no additional color as to the nature of the confirmation. The Subscriber transmitting the Digital Assets will likely want to confirm *receipt* of the fiat prior to initiating the Digital Asset transfer. If the Digital Asset settlement occurs *after* the fiat transfer is received, it could be outstanding for more than three days, all the while counterparty and market risk left unchecked by the bilateral settlement process.

To revisit the Terra/LUNA example, following the cascading price, the UST blockchain became vulnerable to possible governance attacks making the blockchain unstable to send/receive transfers. With such a delayed settlement process, the Digital Asset could experience a network event, fork, airdrop, or similar event.



In fact, the Notice does mention:

The operator of the Coinsquare ATS will, in its sole discretion, make any decisions in respect of forks, airdrops, or other similar events, including whether or not to continue supporting trading on the Coinsquare ATS of a Digital Asset subject to such an event.

It seems the Coinsquare ATS is unwilling to provide settlement insurance or to actually facilitate settlement of the trading, but is, in its sole discretion, making decisions related to forks, airdrops or similar events. How would the ATS handle a situation where the fiat settlement for the UST had occurred, but the ATS decided to stop offering support for the Digital Asset? This issue will also be addressed in the Conflicts of Interest section.

Another concern is the validation of Digital Asset addresses. Instrumental in Digital Asset settlement is a procedure around whitelisting or validating new addresses. The Notice does not appreciate the risk of sending Digital Assets to the wrong address and how such an error would be rectified. Sending Digital Assets to the wrong address might occur due to incorrect settlement instructions provided by “ATS settlement personnel”. When inserting a third party (the ATS settlement personnel) into an already sensitive process, the possibility of human error is more likely than not. Even if the ATS were not directly responsible for the error, the ATS must have a mechanism to handle funds being sent to the wrong address (first, for the sender who may have received incorrect settlement instructions and second, for the recipient who never received the funds). Once funds are sent to the wrong address, they are irretrievable by the sender. This risk can only be mitigated by ATS insurance coverage for such an event or separately allocated funds to address errors or settlement failures.

An additional operational issue is the cumbersome settlement process where a Subscriber has multiple outstanding trades with different Subscribers. For example, where a Subscriber (Subscriber A) must settle a large fiat transaction with one Subscriber (Subscriber B), which is offset with a large Digital Asset settlement to a different Subscriber (Subscriber C). Separate from the outstanding counterparty risk with two Subscribers rather than one CCP, Subscriber A would have to initiate a wire for the fiat settlement with Subscriber B *before* the fiat is received for the Digital Asset settlement with Subscriber C. This incongruent settlement combined with the inability to net transactions with different Subscribers on the ATS would require a significant capital commitment to manage deliveries.

Conflict of Interest

As prefaced above, the Coinsquare proposal has several glaring conflicts of interest. First, the Notice states:

At launch, the dealer operated by Coinsquare will be the sole Subscriber to the Coinsquare ATS, and all orders displayed in the book will be either agency orders (whereby the Coinsquare dealer will be representing client order flow) or Coinsquare principal orders (which will be entered by the Coinsquare dealer, using an automated system, to provide liquidity on the Coinsquare ATS).

But the proposal fails to address the significant conflict of interest having the Coinsquare matching engine (the ATS) with all order flow managed by Coinsquare, matching Coinsquare retail order flow with the



Coinsquare principal dealer. There is no disclosed procedure around best execution or how the ATS will ensure the retail clients behind the Coinsquare dealer will be guaranteed fair pricing when such pricing is offered and controlled by Coinsquare.

Separately, when additional Subscribers join the ATS, the Coinsquare ATS will still have visibility into the positions of all Subscribers, not just the original Subscriber—the Coinsquare dealer. Moreover, with the competitive advantage of knowing all other Subscribers' positions and credit exposure, the Coinsquare dealer has not offered a commitment to withdraw from the ATS when other Subscribers begin participating.

The Coinsquare ATS will also make unilateral decisions around "*forks, airdrops, or other similar events*" and how they are handled on the ATS. It would be naïve to believe the ATS's decisions will not be impacted by the decision most advantageous for the Coinsquare dealer.

The conflict of interest where a single entity (or two entities with common ownership and personnel) can see the activities of all other market participants, while the other Subscribers are trading blind, is insurmountable. Such a conflict must be rectified. While there is vague mention of a conflicts policy, this issue should not be minimized, and the public should be allowed the opportunity to assess the conflicts policy and its adequacy to address these serious concerns.

The DV Companies have a considerable vested interest in the success of Digital Asset markets. As the sector evolves, we believe it is essential that we look to the traditional markets not to replicate their procedures verbatim, but to learn important lessons around risk, volatility, settlement, and conflicts. We urge the Commission to evaluate the risks identified above and look forward to continuing to contribute and drive the Digital Asset market forward in a thoughtful and innovative way.

Respectfully,

A handwritten signature in blue ink, appearing to read "Dino Verbrugge", is written over a thin horizontal line.

Dino Verbrugge
DV Chain & Independent Trading Group (ITG)