

# B.11

## SROs, Marketplaces, Clearing Agencies and Trade Repositories

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### B.11.2 Marketplaces

#### B.11.2.1 Coinsquare Capital Markets Ltd. – Notice of Completion of Staff Review of Initial Operation Report

##### COINSQUARE CAPITAL MARKETS LTD.

##### NOTICE OF COMPLETION OF STAFF REVIEW OF INITIAL OPERATION REPORT

On May 16, 2022, Coinsquare Capital Markets Ltd.'s (**Coinsquare**) Notice of Initial Operations (**NIO**) was published for comment in accordance with OSC Staff Notice 21-706 – *Marketplaces' Initial Operations and Material System Changes*. The public comment period ended on June 15, 2022. Two comments were received and a summary of comments and responses is contained in this notice.

OSC staff have completed the review of Coinsquare's Form 21-101F2 *Information Statement Alternative Trading System – Initial Operation Report* and have no further comments.

#### Summary of Comments and Responses

Several commenters stated that the NIO was short on details concerning how Coinsquare would operate. This was because, unlike other crypto-asset platforms that have been registered as restricted dealers with terms and conditions, Coinsquare is registered as an investment dealer, is a Dealer and Marketplace Member of the Investment Industry Regulatory Organization of Canada (IIROC) and is approved to operate an alternative trading system (**ATS**). As an ATS, it will be subject to the same body of rules governing other ATSs, including National Instrument 21-101 *Marketplace Operation*, National Instrument 23-101 *Trading Rules*, and National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces*. As an IIROC member, it will also be subject to applicable IIROC Rules. It is anticipated that Coinsquare will also be subject to a Commission order requiring it to comply with the same *Process for Review and Approval of the Information Contained in Form 21-101F2 and the Exhibits Thereto (ATS Protocol)* as all other ATSs. The ATS Protocol will provide for advance notice to the Commission of significant changes to the information in Form 21-101F2 and the process for approval of changes, which may require publication for comment in advance of approval.

In connection with its application for approval as an investment dealer and ATS, Coinsquare has been granted exemptions from the prospectus and trade reporting requirements and certain marketplace rules. A copy of the decision granting relief is in Chapter 2 of this Bulletin.

The following are Coinsquare's responses to specific issues raised in the comment letters.

#### Counterparty Risk

1. "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."

**Coinsquare response:** The operational model that has been presented for the Coinsquare ATS<sup>1</sup> reflects current regulatory expectations and is appropriate at the outset of the Coinsquare ATS's operations, when there will only be one Subscriber (i.e., the Coinsquare dealer) or a limited number of Subscribers on the marketplace ("Phase 1"). In that context, there is no practical need for ATS-specific pre-trade financial or credit checks. The Coinsquare dealer, as a Subscriber, applies pre-trade risk controls, as required by IIROC Rules, and any other Subscribers would similarly be required to apply their own controls in respect of their order flow. The Coinsquare ATS has also implemented various marketplace risk-management controls using a third-party system that is also used by other Canadian marketplaces.

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<sup>1</sup> Capitalized terms not defined herein are as defined in the *Coinsquare Capital Markets Ltd. – Notice of Initial Operations and Request for Comment* dated May 16, 2022 (available at: <https://www.osc.ca/en/industry/market-regulation/marketplaces/alternative-trading-systems-atss/atss-operating-ontario/pending-applications/coinsquare-capital-markets-ltd>) (the "Notice").

Moreover, with respect to trading by clients of the Coinsquare dealer (on an OEO account basis):

- All such trading must be pre-funded by the client through deposits of fiat and/or Digital Assets into the client's account(s) held at the Coinsquare dealer.
- The Coinsquare dealer has automated pre-trade risk controls that strictly limit what the client can trade in terms of fiat and Digital Assets at any one time, based on the client's account balances.
- As a further control, the Coinsquare dealer will not offer margin or any other forms of leverage to its clients.

That being said, we acknowledge that the comment raises valid considerations regarding counterparty risk that arise in the context of a multi-Subscriber environment which will become relevant as the crypto market in Canada continues to evolve. Accordingly, the second phase of the Coinsquare ATS contemplates multiple Subscribers admitted to trade on the Coinsquare ATS ("Phase 2") as further described below.<sup>2</sup> At present, the Coinsquare ATS has adopted policies and procedures that address the majority of the material risks arising in both phases, including requiring every Subscriber to contract with qualified custodians (the "Custodians") and to deposit Digital Assets into cold wallets held in the Subscriber's name at the Custodians. Further, Coinsquare has dedicated "CS Admin" personnel who will be able to facilitate settlement between Subscribers on a net basis at the end of each day, as reflected in the Notice. These elements mitigate the relevant counterparty risk to a large degree.

In addition, Coinsquare is currently working on a more targeted solution and risk-management system for Phase 2 of the Coinsquare ATS that will further address the risk posited in this comment. We anticipate that the Phase 2 architecture will be reviewed as a "Significant Change" to Coinsquare's Form 21-101F2 at the appropriate time. However, we believe that the existing processes are sufficient and appropriate to address any risks that may arise throughout the duration of Phase 1, and the early part of Phase 2.

2. "...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."

**Coinsquare response:** At the commencement of operations, all trading on the Coinsquare ATS will be done by the Coinsquare dealer. As soon as the ATS has two (or more) Subscribers, all trading on the Coinsquare ATS will be done on a fully disclosed basis, reflecting the name of each Subscriber that is a party to each trade. For greater certainty, we would note that, in the context of Phase 2, the Coinsquare ATS will be a single CLOB model; Subscribers will not have the ability to "approve" or "deny" trading with any other specific Subscriber(s), similar to any other Canadian marketplace.

3. "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 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."

**Coinsquare response:** In Phase 1, with a single Subscriber, there is no risk of default. For Phase 2, we would refer the commenter to our response to comment #1 above.

### **Market Risk**

4. "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."

**Coinsquare response:** In Phase 1, with a single Subscriber, there is no risk of default or cascading losses. For Phase 2, we would refer the commenter to our response to comment #1 above.

5. "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." (p.4)

**Coinsquare response:** We acknowledge that, in theory, this comment raises a valid point regarding the risks that flow from reliance on traditional fiat wire transfers, were the Phase 1 system to apply to multiple Subscribers indefinitely. However, as noted above in our response to comment #1, we are currently working on a targeted Phase 2 solution, and in the meantime, we believe that the settlement system that has been proposed in the Notice is sufficient and appropriate for Phase 1 and for the early part of Phase 2. In any event, it is certain that the risk highlighted in this comment will have no practical relevance at launch, as the Coinsquare dealer will never be wiring fiat to itself (let alone, over the weekend)..

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<sup>2</sup> There may be some limited counterparty or other risks that arise from the moment when there are two Subscribers, depending on the nature of the second Subscriber, the volume of its trading on the Coinsquare ATS, the value of the assets it deposits with the Custodians (as defined herein), etc. However, we anticipate that any such risks will be mitigated and managed by the systems that have been adopted for Phase 1.

**Operational Risk**

6. *“the proposal identifies that fiat settlement will occur prior to Digital Asset settlement, in each and every instance. Because fiat settlements are affected via a wire with delayed settlement, this could take T+1 on a weekday, or T+3 on a holiday or weekend.”*

**Coinsquare response:** We acknowledge the comment; however, in Phase 1, there is no practical risk arising from wire transfers, as the Coinsquare dealer will never wire fiat to itself. For additional details, please see our response to comment #5 above.

7. *“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.”*

**Coinsquare response:** We acknowledge the comment; however, in Phase 1, there is no practical risk arising from wire transfers, as the Coinsquare dealer will never wire fiat to itself. For additional details, please see our response to comment #5 above.

8. *“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?”*

**Coinsquare response:** If the Coinsquare ATS were to discontinue trading of any particular Digital Asset — a decision that must be made by senior management in accordance with Coinsquare’s written policies and procedures, including those covering suspension or removal of Digital Assets — any trades that were still in process would be canceled, and any previously transferred fiat would be required to be returned to the purchaser, all in accordance with Coinsquare’s written policies and procedures, as they exist today.

9. *“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.”*

**Coinsquare response:** We disagree with this comment for the following reasons:

- Valid addresses are always whitelisted by the Custodians.
- Operational deposit and withdrawal processes (including regular testing of such processes) are in place at the Custodians to reduce any risk of sending a Subscriber’s Digital Assets to the wrong address.

Coinsquare expects that the solution it is developing for Phase 2 will have additional safeguards to mitigate the risk described in this comment, and it will be subject to regulatory review in the normal course, at the appropriate time.

**Conflict of Interest**

10. *“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.”*

**Coinsquare response:** “Best execution” is not addressed in the Notice as it is not relevant to the operation of an ATS *per se*. We would note, however, that the Coinsquare dealer is subject to a “best execution” obligation under IIROC Rules and that it has adopted extensive written policies and procedures to fulfill its obligation. Coinsquare has also adopted policies and procedures to ensure fair pricing on the Coinsquare ATS in its capacity as a provider of principal liquidity on the Coinsquare ATS. Moreover, all written policies and procedures of both the Coinsquare ATS and the Coinsquare dealer have been reviewed as part of Coinsquare’s regulatory approval process.

11. *“...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.”*

**Coinsquare response:** Coinsquare has adopted a written policy, entitled the *ATS Conflict of Interest Policies and Procedures*, which sets out how conflicts inherent in the Coinsquare business model will be managed. In accordance with subsection 10.1(e) of National Instrument 21-101 *Marketplace Operation*, that policy will be published on the Coinsquare ATS page on the Coinsquare website at (or prior to) launch of the marketplace. (Like all other written policies of the Coinsquare ATS, the *ATS Conflict of Interest Policies and Procedures* has been reviewed by the regulators.) Briefly, we would note that the policy:

- imposes strict information- and physical barriers to separate Coinsquare dealer (trading) personnel from Coinsquare ATS personnel;
- prohibits Coinsquare dealer (trading) personnel from having any advance notice of orders on the Coinsquare ATS; and

- ensures that Coinsquare dealer principal orders are handled in the same manner as Coinsquare dealer client (agency) orders through the Coinsquare ATS's matching engine, with no preference or advantage given to any of the principal orders.

12. *"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."*

**Coinsquare response:** All decisions around forks, airdrops, and other similar events will be made in accordance with Coinsquare's *Digital Asset Fork Policy*. In the event of a planned fork, unplanned fork, or airdrop, Coinsquare will submit the details of the action to its Fork Review Committee which will determine whether Coinsquare will support the fork, as required by the policy. This committee is composed of senior officers of Coinsquare from both business and information technology divisions of the firm. The Fork Review Committee, in determining how these events will be handled on the Coinsquare ATS, will consider the following factors: blockchain stability, market capitalization, liquidity, cost and timing. The goal of the Fork Review Committee is to ensure that the Coinsquare ATS offers products which are considered safe and acceptable for all Subscribers to trade.

13. *"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."*

**Coinsquare response:** We disagree with the premise of this comment. The marketplace model adopted by Coinsquare is common for crypto asset trading platforms at this stage of the development of the crypto market in Canada. For additional details, please see our response to comment #11 above. Further, there is precedent for ATS operators to also conduct a traditional "dealer" business alongside the ATS.

### **Settlement**

14. *"However, as written the Proposal does not suggest that dealer members wishing to access Coinsquare ATS, rather than the Coinsquare dealer, will be required to also maintain client accounts at the Coinsquare dealer."*

**Coinsquare response:** We believe the comment intends to state that the Notice "does suggest" that dealer members wishing to access the Coinsquare ATS as Subscribers will be required to maintain accounts for their clients at the Coinsquare dealer. In fact, the comment as written is true: the Notice does *not* suggest that a Subscriber must maintain its client accounts at the Coinsquare dealer; that is because there is no such requirement. Subscribers to the Coinsquare ATS, to the extent that they are approved as IIROC dealers in their own right, must maintain their own client accounts within their own business operations.

15. *"Since any Subscriber can trade with any other Subscriber on the ATS, all Subscribers will potentially need to be able to settle with all other Subscribers. This requires business relationships to exist between dealers. Any new dealers seeking to become Subscribers must be full members of the collection of Subscribers, introducing a significant barrier to entry. Further, this de-facto requirement gives each Subscriber a veto over the entry of another dealer into the network. This is because any Subscriber could simply refuse to open credit with another – meaning that if a trade were to happen between them (in a multilateral market), that trade would not be settled bilaterally."*

**Coinsquare response:** This comment, which appears to raise an issue relating to counterparty risk similar to comments made by the other commenter, is addressed in our response to comment #1 above.

16. *"As settlement is bilateral, and requires credit relationships to exist, dealers must be free to negotiate policies for how they face each other as Coinsquare ATS Subscribers."*

**Coinsquare response:** This comment, which appears to raise an issue relating to counterparty risk similar to comments made by the other commenter, is addressed in our response to comment #1 above.

17. *"There is no clarity on the manner of settlement (i.e. use of wire transfers, escrow agents, etc.), timing requirements, or what recourse there may be for bilateral settlement fails."*

**Coinsquare response:** For Phase 1, Coinsquare will have in place a bilateral settlement and custody process, which is documented in various written policies and procedures that have been vetted by the regulators. (As noted in response to comment #1 above, a new system is being developed for Phase 2, and it will be subject to regulatory review, in the normal course, at a future time.)

18. *"It is also unclear what safeguards exist to manage the risk that Digital Asset transfers are erroneously sent to the wrong wallet."*

**Coinsquare response:** For details on the safeguards that the Coinsquare ATS will have in place for Phase 1, please see our response to comment #9 above.

19. *“Further, the bilateral nature of settlement as described introduces the potential for cascading credit risk between counterparties. If settlement is bilateral, as described in the Proposal, Subscribers must be in a position to control credit limits with each other – on a trade-by-trade basis.”*

**Coinsquare response:** This comment, which appears to raise an issue relating to counterparty risk similar to comments made by the other commenter, is addressed in our response to comment #1 above.

#### **Fair Access**

20. *“First, the settlement issues above introduce either a requirement that all Subscribers establish credit relationships with each other (which is difficult), or potentially become trading clients of Coinsquare Capital Markets Ltd.”*

**Coinsquare response:** For Phase 1, Coinsquare will have in place a bilateral settlement and custody process, which is documented in various written policies and procedures that have been vetted by the regulators. A new system is being developed for Phase 2 that will address settlement operations in a multi-subscriber environment and, as noted in response to comment #1 above, it will be subject to regulatory review, in the normal course, at a future time.

21. *“Second, while the requirement that all Coinsquare ATS members must be IIROC members is reasonable, it bears noting that IIROC would have to approve each dealer’s activities in digital assets. There are currently no written or proposed rules on this topic from IIROC. It is impossible to judge whether this standard is an unreasonable condition of access for most dealers.”*

**Coinsquare response:** Requiring ATS subscribers to be IIROC members is a long-standing ATS requirement in Canada. The need for IIROC to approve trading of Digital Assets by prospective Subscribers to the Coinsquare ATS is not an access requirement or restriction imposed by Coinsquare or by the operational model of the Coinsquare ATS, but rather, it is the logical consequence of an IIROC Rule requiring pre-approval of any material business change by an IIROC Dealer Member. We expect all of our IIROC dealer Subscribers to comply with their obligations under IIROC Rules. We also submit that this comment is more appropriately raised with the regulators than with Coinsquare.

22. *“Third, all dealers must have the ability to hold digital assets. While this is ordinarily a reasonable requirement, as of this writing only one dealer in Canada has any capability to hold digital assets.”*

**Coinsquare response:** This is a regulatory issue endemic to, and unavoidable in, the current stage of the evolution of the market and regulatory framework for Digital Assets in Canada. It is not an issue that results from the manner in which the Coinsquare ATS conducts its operations. As the market and regulatory framework evolve over time, the Coinsquare ATS will evolve as well. For now, we believe that the Coinsquare ATS processes described in the Notice are appropriate and sufficient.

#### **Other Matters**

23. *“We do not believe it is sufficient for the broader marketplace to rely on the representation that “Coinsquare has policies and procedures in place to appropriately manage any conflicts between its OEO dealer activities, the Coinsquare ATS, and other Coinsquare businesses.”*

**Coinsquare response:** All ATSs with affiliated dealers have had to confront this issue since formal market regulation was introduced approximately 25 years ago. All Canadian ATSs, including the Coinsquare ATS, address potential conflicts by disclosing the existence of each conflict and creating an information barrier between the ATS and dealer operations.

24. *“We believe that at this time UMIR does not sufficiently address trading of digital assets, and therefore Coinsquare ATS would need to establish (including through publication for comment) market integrity rules under which surveillance will be conducted. Alternatively, UMIR must be amended prior to the operation of Coinsquare ATS to incorporate specific provisions unique to the crypto ecosystem and which may represent risks unique to crypto assets.”*

**Coinsquare response:** Responsibility for rulemaking does not reside with the Coinsquare ATS, but rather, with the appropriate regulatory body. Coinsquare has worked diligently and collaboratively with the regulators over a lengthy period of time to operationalize a digital asset marketplace that complies with the current regulatory framework for crypto-asset trading platforms set out by the CSA and IIROC. We expect the regulatory framework to evolve over time and, until then, Coinsquare continues to work with IIROC to ensure that the Coinsquare ATS complies with all applicable requirements, including the current provisions of UMIR, but with flexibility, taking into account the unique practical realities presented by Digital Asset trading, balanced with the need to address the legitimate underlying policy considerations of the relevant provisions.

25. *“Further, the Proposal indicates that Coinsquare ATS will self-police until IIROC is able to provide surveillance services. We are concerned that this is a window of unknown length, and potentially very long.”*

**Coinsquare response:** In consultation with the regulators, Coinsquare has developed a set of market-surveillance protocols to monitor activity on the Coinsquare ATS, supervised by IIROC, to reasonably ensure market integrity. This is an interim measure, in compliance with the regulatory framework that currently exists. In accordance with these interim protocols, the Coinsquare ATS

will generate alerts, reports, and other information, which it will provide to IIROC on a daily basis pursuant to a Regulation Services Agreement between Coinsquare and IIROC as the Coinsquare ATS regulation services provider, in accordance with applicable regulations. These interim protocols will remain in place until a more permanent (consolidated) market surveillance solution is introduced by the regulators, at which time, the interim protocols will be discontinued by the Coinsquare ATS.

26. *"The Proposal also does not address how potential conflicts of interests between the surveillance function (interim or otherwise) and the broader for-profit business will be managed."*

**Coinsquare response:** As set forth in the applicable written policies and procedures, the Coinsquare ATS personnel responsible for the Coinsquare ATS's marketplace surveillance will be highly trained, highly specialized individuals; they will not have any interaction with, nor any access to, the operations of the Coinsquare dealer. These (and other) safeguards have been discussed in detail with the regulators, and they are all thoroughly documented in the relevant written policies and procedures of the Coinsquare ATS.

27. *"The Proposal indicates that policies & procedures exist to manage conflicts between OEO dealer & ATS activities, but no details are provided, including whether these policies specifically address potential conflicts between trading and surveillance."*

**Coinsquare response:** The potential conflict between trading and surveillance raised in this comment is addressed through extensive training and the strict segregation of Coinsquare ATS personnel responsible for market surveillance from all other firm (including Coinsquare dealer) personnel. For additional details, please our response to comment #26 above.

28. *"Finally, Coinsquare ATS fees are not yet disclosed at [www.coinsquare.com](http://www.coinsquare.com), as indicated in the Proposal."*

**Coinsquare response:** Coinsquare ATS fees and other required regulatory disclosures in respect of Coinsquare ATS will be available on the Coinsquare ATS page on the Coinsquare website once the ATS has been approved by the regulators and the business has been launched.