



DIGITAL ASSET MANAGEMENT

April 17, 2024

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumers Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities Service Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor, Box 55
Toronto, Ontario M5H 3S8

Via email: comments@osc.gov.on.ca

Re: Proposed amendments (the Proposed Amendments) to National Instrument 81-102 Investment Funds (NI 81-102) and proposed changes (the CP Changes) to Companion Policy 81-102CP Investment Funds (81-102CP) (collectively referred to as the Proposed Amendments and CP Changes)

Dear Sirs/Mesdames:

3iQ Corp. (**we** or **3iQ**) are writing to submit comments to the Proposed Amendments and CP Changes pertaining to reporting issuer investment funds that seek to invest directly or indirectly in crypto assets. Thank you for the opportunity to comment on these proposals.

Restrictions on Investing in Crypto Assets

The Proposed Amendments contemplate amending the investment restrictions in section 2.3 of NI 81-

102 to permit only alternative mutual funds and non-redeemable investment funds to buy, sell, hold or use crypto assets directly. This restriction would also apply to investing indirectly in crypto assets through specified derivatives. Mutual funds, other than alternative mutual funds, would only be permitted to invest in crypto assets by investing in underlying alternative mutual funds or non-redeemable funds that invest in crypto assets, subject to the fund of fund restrictions in subsection 2.5(2) of NI 81-102. We are of the view that these restrictions are not reasonable and run counter to the Canadian Securities Administrator's (CSA) explicit goals of facilitating new product development in this space with the appropriate risk mitigation measures.

We believe that providing a regulated and efficient product is essential for investor protection. Investors who seek exposure to this asset class will find a way, whether through unregulated markets and/or service providers, or investing in less efficient investment products. Historically, Canada has been at the forefront of developing new, regulated products for retail investors, well ahead of the United States. For example:

- the first exchange-traded fund (ETF) was launched in Canada in 1990 which paved the way for the United States;
- in 2020, 3iQ launched the first Bitcoin and Ether exchange-traded products (ETPs) in North America well before the United States by several years thereby attracting more innovation and investment to the Canadian markets; and
- 3iQ and the Ontario Securities Commission (OSC) continued that effort recently when, in 2023, 3iQ launched the 3iQ Ether Staking ETF, the world's first Ether ETF vehicle to enable staking.

Accordingly, we strongly encourage the CSA (and the OSC) to reconsider the Proposed Amendments to protect a budding innovation hub for the crypto asset class. This would allow Canada to remain at the forefront of developing new, regulated products for retail investors. There are currently billions of dollars of assets under management in Canadian crypto ETPs that have been managed without issue for the last four years. These proposed restrictions would be akin to the mindset of the Securities Exchange Commission (the SEC) which ultimately led to undue harm for investors.

For example, we saw this exact situation play out in the United States when investors were forced to use products like GBTC and ETHE to obtain exposure. This ultimately led to harm for investors who purchased the vehicle at substantial dislocations to the underlying value and had no way to redeem from such vehicles. ETFs are much more efficient vehicles that provide investors with a regulated way to invest in such assets. ETFs trade very tightly to the price of the underlying assets with daily creations/redemptions, and they provide a regulated wrapper that ensures that investment fund managers are following best practices around trade execution, pricing, custody, etc. We are aware that offering an ETF is challenging without regulated futures markets for digital assets since it poses challenges for authorized participants to effectively hedge their positions. However, a closed-end fund vehicle, similar to 3iQ's The Bitcoin Fund, serves as a more efficient product for investors than closed-end trusts, similar to those offered by Grayscale Investments, LLC (Grayscale) and Osprey Funds, because of the annual redemption mechanism, without the need for the futures markets for the authorized participants. The below example of Grayscale's ETHE illustrates the harm investors incur when they purchase products that deviate substantially from NAV. On December 22, 2020 the market price of Grayscale's ETHE product was trading at a 369% premium to NAV and by January 25, 2021, that was reduced to a ~2.5% premium. This is just one example of this product where it highlights the extremes of the premiums these products have, which can impact investors' assets. This example also coincides around the time that 3iQ launched alternative Ether products and we saw a shift of Grayscale's ETHE product go from a premium to a discount. 3iQ's closed-end funds can trade at premiums and discounts but the investment manager has mechanisms within our control to help limit the dislocation such as using ATM and NCIB programs which is in addition to our built-in annual redemption feature found within the prospectus.

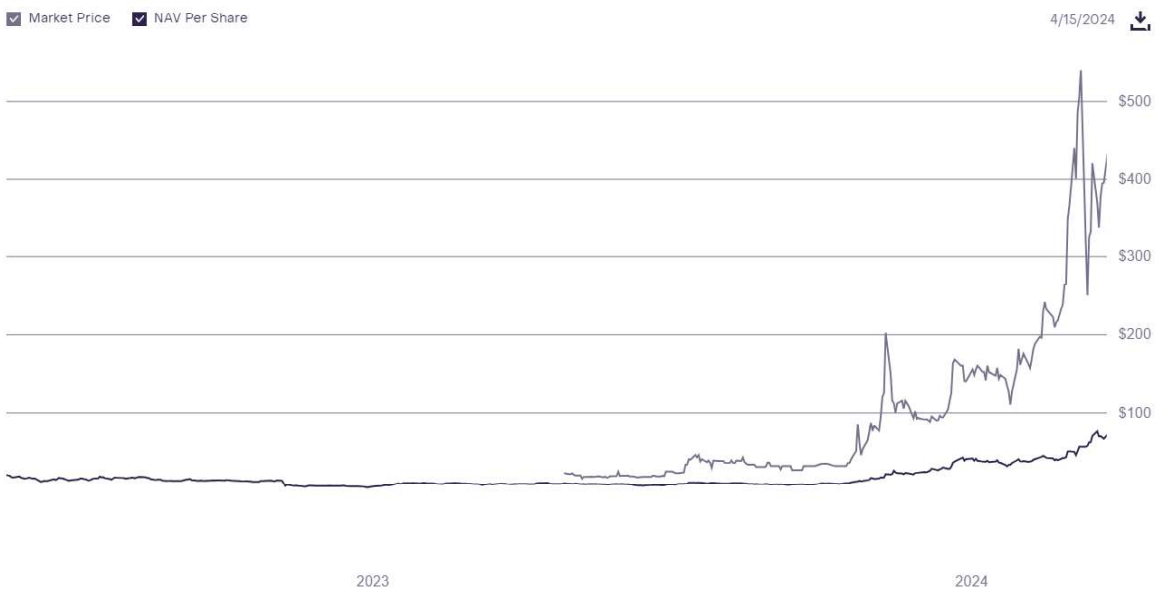
Performance Chart



Source <https://www.grayscale.com/crypto-products/grayscale-ethereum-trust#section3877>

The below chart of the Grayscale GSOL product highlights the huge premiums, 650%+ as of April 16, 2024^h, investors are currently paying compared to the NAV. By potentially limiting innovation and blocking additional products to come to market it puts investors at a disadvantage. It is our goal to continue to innovate and be a leader in the space so that we can help minimize future investors from purchasing products with such high volatility tied to premiums and discounts which are in addition to the underlying asset performance.

Performance Chart



Source: <https://www.grayscale.com/crypto-products/grayscale-solana-trust>

3iQ's closed-end funds in Canada have achieved a favorable balance between closed-ended investment

trusts and an ETF product by offering investors an annual redemption feature at NAV, thereby minimizing the differential to the underlying value throughout the year. We believe this product development lifecycle reflects a healthy iteration of capital markets infrastructure. When a crypto asset is sufficiently liquid and mature, it can evolve from a private fund or a Grayscale-style trust to a closed-ended investment vehicle that is exchange traded. This provides a more regulated and liquid vehicle to access the asset class. Then, when regulated futures are available, open-ended ETFs become a viable solution to bring to market.

Additionally, the CSA has built a framework for Crypto Trading Platforms that allows them to maintain oversight over crypto spot markets. An ecosystem with regulated market participants bodes well for investment fund managers who wish to incorporate these same assets into investment vehicles that make it safe and easy for investors to obtain access.

The Proposed Amendments also contemplate restricting publicly distributed investment funds to holding crypto assets that trade on, or are reference assets for specified derivatives that trade on, a “recognized exchange” in Canada. This proposed requirement reflects concerns about determining the suitability of a crypto asset as a portfolio holding of a public crypto asset fund, such as market integrity and price discovery. We are of the view that this is not a reasonable qualifying criterion. The TMX recently launched Bitcoin Futures (BT), indexed to Coindesk (XBX). The launch was largely unsuccessful, generating zero total trades and volume. How can the CSA justify this as a source of truth for price discovery? There are more appropriate means for determining when a crypto asset should be deemed an appropriate investment for an investment fund directed at retail investors. For example, there exists a variety of crypto assets such as Solana that trade hundreds of millions of dollars of volume on top tier crypto exchanges that are subject to regulatory oversight by the OSC and various other regulators around the world. Coinbase and Kraken alone, both licensed crypto platforms in the United States, average more than 200M of trading volume on Solana since the start of 2024, with several days exceeding 500M.

An asset should not be restricted from inclusion in a portfolio because of the lack of a derivative. These crypto assets trade on crypto exchanges that are regulated in Canada under the rules applicable to regulated crypto asset trading platforms (CTPs). In Canada, the CSA permits crypto assets to be offered by regulated CTPs for trading, subject to the registration orders or pre-registration undertakings for CTPs. A crypto asset could have a substantial trading volume on licensed exchanges but not have a derivative market. While this may be well intentioned, we are of the view that the unintended consequences of these actions mean that crypto asset managers will be forced to utilize less efficient vehicles (such as alternative mutual funds or non-redeemable funds) which have a higher likelihood to cause undue harm to investors.

The CSA has allowed a pathway for CTPs to register as Investment Dealers and members of the Canadian Investment Regulatory Organization (CIRO), thereby allowing “spot” trading for crypto assets and, as such, we submit that the CTPs should be recognized exchange in Canada for “spot” trading for crypto assets and that crypto assets that are listed on these platforms should also be allowed under NI 81-102, given that these are regulated “spot” trading activities. Accordingly, we recommend that the addition of subsection 2.3(1)(b)(ii) in the Proposed Amendments be amended as follows: **“The crypto asset trades on a licensed and or regulated platform, an exchange recognized by a securities regulatory authority in a jurisdiction of Canada or in a comparable foreign jurisdiction.”**

The existence of a derivative is not required to determine a fair value of a crypto asset. There exist a variety of index methodologies from established entities that have provided fair value pricing of crypto assets beyond Bitcoin and Ether for years. For example, the CME Group (issuer of Bitcoin and Ether

Futures) partnered with CF Benchmarks and maintains indices for a variety of crypto assets such as Solana, Chainlink, Matic (see [CME CF Cryptocurrency Benchmarks - CME Group](#)). These follow a similar methodology to their Bitcoin and Ether indices which have variables that protect the indices from being manipulated.

Furthermore, the concerns of “market manipulation” in crypto markets are unsubstantiated. We note that the risk of market manipulation exists in all commodity markets. The crypto industry is not more susceptible to manipulation than other commodity products. The Commission panel previously ruled in 3iQ’s favor when arguing ‘market manipulation’ concerns.ⁱ Similarly, the SEC recently lost their case to Grayscale when attempting the same argument.ⁱⁱ There is no evidence of such manipulation, and established indices and pricing mechanics have existed through highly reputable and regulated entities.

The Proposed Amendments also make reference to “*an exchange that has been recognized by a securities regulatory authority in Canada*”. Currently, only Bitcoin futures are listed for trading on an “*exchange recognized by a securities regulatory authority in a jurisdiction in Canada,*” The Proposed Amendments would essentially make all existing Ethereum ETFs technically non-compliant, and this outcome would have unintended consequences. We ask the CSA to clarify whether this is the intended outcome. If so, we believe that the CSA must grant an exemption to allow existing ETFs to continue.

We believe this approach is a mistake given that the ETPs in Canada have seen such success in regulated, secure and safe manner. What is the justification for such a ban of crypto assets in NI 81-102 vehicles? There are plenty of equities and commodities that have similar volatility profiles but are not subject to such restrictions. Rather than an outright restriction, we believe liquidity and valuation risks can be addressed through the fund structure (i.e. non-redeemable investment fund) using appropriate pricing indices based on auditable parameters, or by applying fund concentration limits to fund holdings where appropriate for the fund type.

Securities Lending

Finally, the Proposed Amendments contemplate prohibiting the use of crypto assets in securities lending, repurchase transactions or reverse transactions, as the loaned securities, transferred securities or collateral posted in connection with these transactions, as applicable. We question why the CSA would consider restricting crypto assets from lending activity like any other asset if following the appropriate rules and guidelines. The outright prohibition of lending activities is a brute force approach that removes the ability for asset managers to innovate in Canada. Other foreign jurisdictions will be able to provide products that add more value to end investors as a result, and assets will flow to other vehicles such as crypto ETPs in the US and Europe.

While we agree that they are inherent risks lending any asset (including crypto assets), 3iQ is an institutional manager with years of experience managing crypto assets. We have deep relationships with traditional institutions (such as regulated banks and brokers) that are involved in borrowing/lending crypto assets. We believe if structured properly, the lending of crypto assets can add additional value for unitholders of funds through reduced fees and additional returns while minimizing risk by following the NI 81-102 securities lending guidelines. For example, counterparty risk can be minimized by working with extremely high creditworthy counterparties. Additionally, the posting of 102%+ USD collateral eliminates the downside risk of a crypto specific crash materially impacting the borrower. The collateral value would appreciate relative to the lent asset in such an instance, meaning the asset manager is protected and can repurchase the underlying asset using the collateral. It is therefore difficult to conclude that CSA’s

proposal will have a positive impact on the industry.

Conclusion

We understand that crypto space has had some very high-profile fraudulent activity such as with FTX in the last few years. A natural reaction to such an event may be to blanket restrict access to this ecosystem to protect consumers. Although it is counterintuitive, we believe that leaning into providing regulated products will actually better protect consumers.

For example, if we go back in time to the Quadriga collapse in 2019, many Canadians lost a significant amount of assets in that fraud. 3iQ subsequently brought regulated investment funds for Bitcoin and Ether to market in Canada to provide a safer way to access these assets. If those products had been blocked from creation, we believe it is likely that more Canadians would have utilized offshore exchanges like FTX. The existence of crypto regulated products likely reduced the harm for Canadian investors by making it easier to access the asset class in a safe way. That is why we believe now in light of the recent FTX collapse, the CSA (and the OSC) should continue to take the approach to continue to foster innovation to protect investors.

To conclude, we believe these restrictions are unduly burdensome on innovation in the crypto space. The Proposed Amendments will negatively impact Canadian domiciled businesses and will ultimately lead to negative impacts for Canadian investors. Canada is well positioned to be a global leader in the crypto economy with the appropriate regulatory framework.

Thank you for the opportunity to comment on the Proposed Amendments. Should you wish to discuss any of the comments with us in more detail, we would be pleased to respond. 3iQ wants to continue to innovate and bring to market regulated crypto ETPs to make it easier to invest in the asset class. That said, 3iQ closely evaluates each asset that we bring forward to ensure there is retail and institutional demand from traditional market participants to support and grow a product and sufficient track record, infrastructure, liquidity, custody, etc. to support a regulated product. As such, 3iQ is aligned with the OSC to only bring forward protocols that are mature enough for a regulated product. We would be happy to engage with the CSA (and/or the OSC) to help come up with a comprehensive regulatory framework for funds investing in crypto assets.

Sincerely,



Pascal St. Jean, President, 3iQ Corp.





cc. Diana Escobar Bold, Chief Compliance Officer

ⁱ www.osc.ca/sites/default/files/pdfs/proceedings/rad_20191029_3iq-2.pdf

ⁱⁱ <https://www.govinfo.gov/app/details/USCOURTS-caDC-22-01142/summary>

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