TO: Canadian Securities Administrators
Investment Industry Regulatory Organization of Canada

FROM: DV Chain, LLC

DATE: May 15, 2019

RE: Joint Canadian Securities Administrators/Investment Industry Regulatory Organization of Canada Consultation, Paper 21-402 *Proposed Framework for Crypto-Asset Trading Platforms* (March 14, 2019)

Dear Sir/Madam:

This letter is offered in response to the Joint Canadian Securities Administrators ("CSA") /Investment Industry Regulatory Organization of Canada ("IIROC") Consultation (Paper 21-402 Proposed Framework for Crypto-Asset Trading Platforms) (the "Proposal"). DV Chain, LLC, a CSA's request for comments on their Consultation Paper 21-402, the "Proposed Framework for Crypto-Asset Trading Platforms". The undersigned at DV Chain, LLC ("DV Chain"), a proprietary cryptocurrency trading desk and an affiliate of Independent Trading Group (ITG) Inc., a registered IIROC dealer ("ITG"), respectfully offer the following comments addressing the questions posed in the Proposal.

PART 2 – Nature of crypto assets and application of securities legislation

DV Chain agrees that the determination of a crypto asset's categorization as a security, derivative, commodity, or alternative investment asset, is essential to understand the appropriate regulatory framework which should be applied to the specific facts and circumstances. As such, in addition to the factors enumerated in the Proposal, DV Chain wishes to expound on the list with the following:

As early as 2013, the U.S. Commodity Futures Trading Commission (the "CFTC") has promulgated both formal guidance and agency rulings that bitcoin and other virtual currency is a commodity.[1] Various US federal rulings and statements by other US regulators, i.e. the Securities and Exchange Commission (the "SEC") and the Financial Crimes Enforcement Network ("FinCEN") have extrapolated from CFTC guidance to affirm this classification to encompasses any digital representation of value (a "digital asset") that functions as a medium of exchange, and any other digital unit of account that is used as a form of a currency (i.e., transferred from one party to another as a

[1] *In re Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29, 2015 WL 5535736, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33,538 (CFTC Sept. 17, 2015) (consent order); *In re TeraExchange LLC*, CFTC Docket No. 15-33, 2015 WL 5658082, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33,546 (CFTC Sept. 24, 2015) (consent order).

medium of exchange); may be manifested through units, tokens, or coins. Notably, this excludes certain utility tokens which may be deemed securities.

Per the US Commodity Exchange Act (the "CEA"), the CFTC has broad regulatory jurisdiction over "retain commodity transactions."[2] A retail commodity transaction may be excepted from CEA section 2(c)(2)(D) (and thus not subject to CEA sections 4(a), 4(b), and 4b) if actual delivery of the commodity occurs within 28 days of the transaction.[3]

The Canadian parallels to US regulation are quite clear. More specifically, the Ontario Securities Commission ("OSC") Rule 91-506, 2 (1) (d), which discusses a ***product's determination (if securities legislation applies),*** states that a contract or instrument is prescribed not to be a derivative if it is (quoting in pertinent part):

> *a contract or instrument for delivery of a commodity other than cash or currency that,*
>
> *(i) is intended by the counterparties, at the time of execution of the transaction, to be settled by delivery of the commodity, and*
> (ii) *does not allow for cash settlement in place of delivery…*

In Canada, like in the US, if a commodity is not intended to be delivered, at the time of execution, it is deemed to be a derivative and therefore applicable securities legislation applies. It is clear, in both the spirit of the rule and accepted practice, that for a commodity that is intended to be delivered (such as gold, silver, platinum, palladium, diamonds, etc.), securities legislation would not apply, and the commodity would be treated as a spot commodity product. Therefore, a crypto asset that is intended to be delivered, would not be a derivative and should not be subject to securities legislation (i.e. treated no different than gold, silver, platinum, palladium, diamonds, etc.).

The meaning of "delivery" for crypto assets is an area which needs further explanation. This is best illustrated by comparing a crypto asset (like bitcoin) to a traditional commodity (like gold). If a client buys gold from an online platform, and that gold is:

- delivered (within a reasonable time frame) to a client approved vault;
- the client has first rights (and legal title) to the specific quantity of gold he/she just purchased which is now being held in that vault;
- (and further evidence of legal title is demonstrated by segregation of the client's gold from the firm's own assets and routine third-party audits of the vault to ensure physical existence of such gold),

then the gold has met the delivery requirement such that it is clearly a commodity and securities legislation does not apply.

Similarly, if a client buys bitcoin from an online platform, and that bitcoin is:

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[2] CEA section 2(c)(2)(D)(i) captures any such retail transaction "entered into, or offered ... on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis."

[3] 7 U.S.C. 2(c)(2)(D)(ii)(III)(aa).

- delivered (within a reasonable time frame) to a client approved wallet, evidenced by an "on-chain transaction"[4], (preferably) in cold storage, and custodied by a third party;[5]
- the client has first rights (and legal title) to the specific quantity of bitcoin he/she purchased which is now being held in that wallet (or cold storage facility);
- (and further evidence of legal title is demonstrated by segregation of the client's bitcoin from the firm's own assets and routine third party audits of the wallet and cold storage to ensure "physical" existence of such bitcoin),

then the bitcoin, similar to gold, has met the delivery requirement such that it is clearly a commodity and securities legislation would not apply.

PART 3 – Risks related to Platforms

DV Chain agrees with the CSA's comprehensive list of risks related to crypto asset platforms and has several comments responding to the question of best practices to mitigate such risks:

- **Investors' crypto assets may not be adequately safeguarded**. DV Chain believes this risk has the potential to jeopardize the legitimacy of the entire crypto industry. One way to mitigate this risk is to require all online trading platforms to contract custodial services to a third party who can demonstrate adequate processes and procedures to safeguard their clients' assets and be subject to routine (annual) audits, unless the platform can demonstrate adequate processes and procedures itself. For example, if an on online trading platform is holding more than $10,000,000 in clients' assets, then it should be required to have a SOC2 Type1 report, demonstrating its minimum required competency. There are three crypto-custodians today that have obtained this minimum requirement, meaning that there are auditing firms performing this function. Furthermore, all third party custodians holding more than $10,000,000 in clients' assets should also be SOC2 Type1 certified.
- **Processes, policies and procedures may be inadequate**. With respect to the processes, policies and procedures for safeguarding clients' assets, it is essential to create best practices, as discussed above. DV Chain also believes online trading platforms with more than $10,000,000 of assets[6] should have an annual financial audit, testing the adequacy of the firm's accounting procedures and controls. With respect to more standard business processes, policies and procedures, DV Chain believes the industry will weed out those participants without adequate processes and procedures, leaving only institutional, professional firms in the space.
- **Investors' assets may be at risk in the event of a Platform's bankruptcy or insolvency.** All online platforms must record their clients' assets separate and totally segregated from the Firm's own assets. Furthermore, the Client Agreements must clearly state that all clients' have full title to their assets. If investors wish to risk trading with online trading platforms that are

[4] Where the crypto assets are held at a third party custodian and wallet service provider, and a transaction is done between two or more clients within the same custodian, then no "on-chain" transaction is required because its neither efficient nor practical (just like if gold was traded between two or more clients using the same vault, only an entry to the books and records of the vault provider is made).

[5] To be discussed in more detail later, although we believe the custody function for Bitcoin, which is analogous to the vault function for gold, should be performed by a trusted third party custodian and wallet service provider, we believe it is not 100% necessary.

[6] Clients' assets held by themselves or on behalf of their clients with a third party custodian.

operating in foreign jurisdictions, they can if they wish, but they are subject to the perils of doing so; notwithstanding, there must be legal reach to prohibit foreign online trading platforms from doing business in Canada that do not comply with our new standards.

- **Investors may not have important information about the crypto assets that are available for trading on the Platform.** DV Chain agrees that platforms should maintain standard evaluations for all crypto assets they provide access to. The evaluation should include a description of the crypto asset and references to its backing project. Platforms should also provide clear policy around the handling of forks, airdrops and other events of relevance to these assets.
- **Investors may not have important information about the Platform's operations.** DV Chain believes the safekeeping of all clients' assets is of upmost importance. Simple disclosure describing the custody and wallet process, which we've already explained above, should be mandatory. Trading fees along with other ancillary fees (such as deposit fees, withdrawal fees, etc.) are all relatively easy to ascertain and usually posted on existing online crypto trading platform websites. If fees are not disclosed and/or the fees are too high, investors already have sufficient choices in the marketplace and ultimately, like in the FX business, (with everything else equal) the platforms with the best prices and cheapest fees will prevail.
- **Investors may purchase products that are not suitable for them.** DV Chain's view, similar to that of any traditional commodity business, provided there is no misleading information, it is "buyer beware".
- **Conflicts of interest may not be appropriately managed**. In the crypto asset trading industry, just like any traditional commodity trading business, for example the buying and selling of cars, small boats, physical food products such as dairy, meat, or even agricultural products, trading as principal is both accepted and fair. It is very common for the "middleman" Commodity Trader to take on principal risk and buy the goods in advance (whether it's a car, a small boat, tons of cheese or meat) in anticipation of selling it shortly thereafter to their client at a profit. This isn't disclosed, it is simply expected. Similarly, in the crypto asset space that are not securities or derivatives, there are many OTC trading desks that exclusively trade as principal. It is common and well understood. The clients (or Investors or counterparties) to the OTC trading desk all understand this fact and can easily compare prices with other OTC desks to ensure they are receiving fair prices. It is our view that online crypto trading platforms, which are analogous to an electronic OTC crypto trading desk, should simply disclose that they may be acting as principal on some of their clients' transactions.
- **Manipulative and deceptive trading may occur**. The CSA and the CFTC have already reminded the crypto trading industry that the provisions of their legislation relating to fraud, market manipulation, and misleading statements apply to the underlying commodities (i.e. Bitcoin or any crypto asset that is deemed to be a commodity). Said another way, the rules are already set. A RSP (such as IIROC) can be delegated the responsibility of enforcing these rules to prohibit illegal activities such as spoofing, wash trading, layering, banging the close, etc., and it's our recommendation for that to be the case. To be more specific, it is our recommendation that the monitoring be self-administered, with routine (monthly) reporting of transactions to the RSP to ensure compliance with existing rules.
- **There may not be transparency of order and trade information**. In the trading of physical commodities, there is no requirement to provide order and trade transparency. So, in instances when it is determined that the online crypto trading platform is trading crypto assets that are

deemed to be a commodity (and not a security or a derivative), then we believe there should be no requirement for ensuring the client has "efficient price discovery". Just like trading gold, or silver, or cars, or small boats, or any physical commodity, it is up to the buyer (or seller) to ensure they are getting fair prices. We believe that online crypto trading platforms should make it easy for clients to understand the prices they are paying but not necessarily the prices that everyone else is paying; however, having said that, most online trading platforms already make visible the prices and volumes of all clients' trades. It has become an industry norm. If they fail to do so, customers will not trust the platform and ultimately the platforms that do not disclose all their clients' trade data will either struggle with perpetually low volumes or go out of business.

- **System resiliency, integrity, and security controls may be inadequate.** As described above, it is imperative to safeguard clients' crypto assets (and personal data) from theft. We believe the solutions already mentioned help sufficiently mitigate this risk.

PART 4 – Regulatory approaches in other jurisdictions

It is very important to take a global eye to securities and derivatives regulators when determining the right approach for Canada. The SEC and the CFTC together have taken a very pragmatic and eloquent approach. If the crypto asset is a commodity, then a delivery test must be met for the crypto asset not to be deemed a derivative (and therefore subject to CFTC, or in Canada, provincial security legislation). The discussions and examples published by the CFTC, on what it means to deliver a crypto asset, are very specific and easy to understand. For asset determination, DV Chain believes the Canadian regulators should mirror that of the SEC and the CFTC.

One area where DV Chain believes that Canada can set the global best-practice, is in the custody of crypto assets. DV Chain believes creating a standard for all online trading platforms, or any crypto related business that holds in excess of $10,000,000 of clients' assets, should have their processes for safeguarding such assets subject to passing a SOC2 Type1 audit, and eventually a recurring SOC2 Type2 audit. Furthermore, because DV Chain believes the safeguarding of clients' assets is the single most important issue that all crypto industry participants need to address, DV Chain recommends ***that all custodian service businesses for crypto, that is deemed to be a commodity, should be restricted to either an IIROC dealer, a trust company, or a bank.*** This is consistent with the current Canadian requirements to custody securities. This would mean that all IIROC dealers, trust companies, or banks that wished to offer crypto commodity custody services, would need to have their custody solution SOC2 Type 1 certified.

PART 5 – The Proposed Platform Framework

5.1 Overview of the Proposed Platform Framework

DV Chain agrees with everything the CSA has outlined, and offers clarification on the following points:

- As described above, if the online crypto trading platform is only trading crypto assets determined to be commodities (and not securities or derivatives), then the assets and the platform listing the assets would not be subject to securities regulation.
- However, even where the crypto asset is a commodity, when such commodities are held on behalf of clients and exceed $10,000,000, the firm acting as the custodian should have a SOC2, Type1 certification, **with the ultimate goal of within 12-18 months, that all such custodian services only be provided by either an IIROC dealer, a trust company, or a bank.**

With respect to Question 5, DV Chain believes a SOC2 Type1 certification is superior to ensure the safeguarding of clients' crypto assets for the following reasons:

1. BitGo and Gemini have already obtained such certification;
2. (At least) two other reputable crypto custodians are in the process of receiving the same certification;
3. Among the main industry participants, a SOC2 report is the gold standard; and
4. KPMG, Deloitte, and other major auditing firms have built specific businesses within their practice to perform such an audit, at fairly reasonable prices, offering any firm the ability to maintain compliance.

With respect to Question 6, while there are challenges to make actual delivery of crypto assets to a client's wallet, by implementing several simple processes, firms can overcome these challenges. For example, the costs and administration to book every single transaction "on the native chain" (i.e. for Bitcoin, Ethereum, etc) to verify delivery is extremely expensive and time consuming. However, by batching and delivering trades "on-chain" within a reasonable time frame, and creating an omnibus accounting system to record all the transactions, (containing a master account and client sub-accounts integrated with the custodian/wallet service provider), ensures all clients' assets are fully segregated and ultimately delivered and verifiable "on-chain".

The benefits to participants for platforms, or other third party custodians, storing participants' crypto assets on their behalf are highly analogous to the benefits of banks storing participants' fiat assets on their behalf. Properly designed, certified and accountable custodial solutions (as we've advocated for throughout this commentary) provide participants with audit trails, access recovery and convenient asset access and transfer ability while maintaining tight security standards. Participants who wish to store their crypto assets themselves, and in effect act as their own crypto asset bank, should be free to do so. However, DV Chain believes most participants do not want to, nor should be forced to, act as their own crypto asset bank. **The benefits to participants of Platforms holding crypto assets on their behalf versus a third party custodian are so minimal, and simply put, should not be allowed unless their systems and processes are SOC2 certified, and then eventually only permitted within an IIROC Dealer, a Trust Company, or a Bank.**

In response to Questions 7 and 8, DV Chain believes that existing, recognized ATSs and exchanges offering crypto securities and/or derivatives will need to publish trading data, and online trading platforms will need to ensure that their clients received a fair price. However, the lack of liquidity for most crypto securities, should they become popular, and their underlying assets, (e.g. real estate tokens), will make compliance with ensuring fair price execution for their clients increasingly difficult.

In response to Questions 9 and 10, for crypto assets determined to be commodities (not securities or derivatives), it is appropriate for platforms to monitor trading activities on their own platforms. Market abuse and manipulation rules, however, are already set forth by global regulators. The CSA in Canada and CFTC in the US retain jurisdiction over commodity transaction as they relate to ***fraud, market manipulation, and misleading statements.*** A regulation service provider ("RSP"), (such as IIROC) may be delegated authority for enforcing these rules, but ultimately, the monitoring be self-administered, with routine (monthly) reporting of transactions to the RSP to ensure compliance with existing rules. Specific rules and integrity requirements (for trading commodity crypto assets) should prohibit spoofing, wash trading, layering, and fraud. This not dissimilar to how market manipulation is monitored today in some physical commodity markets.

In response to Question 11, existing solutions for traditional assets classes such as equities or in-house custom solutions already using by experienced proprietary trading firms can be easily adapted to monitor illegal trading behavior for crypto assets.

In response to Question 12, No; one type of trading behavior to explicitly monitor is "round robin" wash trading. There is a large incentive for crypto exchanges to show volume, such that near-riskless trading among a small number of participants (i.e. "round robin" wash trading) is a means to fictitiously inflate volume.

In response to Question 13, for online trading platforms that only trade crypto assets (not securities or derivatives), DV Chain recommend that all custody (ensuring security against hacks and other cyber-attacks), should be only conducted by a SOC2 Type1 certified entity, ***with the 12-18 month goal of custody only permitted within a IIROC dealer, trust company or bank***.

In response to Questions 14 and 15, like in traditional commodity trading, principal trading is both accepted and fair. It is very common for the "middleman" commodity trader to take on principal risk and buy the goods in advance (whether it's a car, a small boat, tons of cheese or meat) in anticipation of selling it shortly thereafter to a third party at a profit. This isn't disclosed, it is simply expected. Similarly, in the crypto asset space, there are many OTC trading desks that exclusively trade as principal. Counterparties to the OTC trading desk understand this fact and can easily compare prices with other OTC desks to ensure they are receiving fair prices. DV Chain believes online crypto trading platforms are analogous to *electronic* OTC crypto trading desks, and should simply disclose that they may be acting as principal on some of their clients' transactions.

In response to Questions 16 and 17, custodians should acquire insurance, at least for the values typically kept in their hot/warm wallet. The need for insurance for assets held in cold storage is debatable, especially if the custodian is SOC2 certified.

In response to Question 18, an inherent safeguard that offers investor protection in the event of bankruptcy, but not theft, is segregation of clients' assets as discussed earlier. DV Chain recommends that all online trading platforms segregate all clients' funds from firm assets.

In response to Question 19, for crypto assets that are neither a security nor a derivative, the clearing and settlement requirement for marketplaces would not apply.

In response to Question 20, for crypto assets that are settled (i.e. delivered) on a decentralized model or simply not through a centralized clearing entity, the key risk is ensuring *delivery* versus

payment. For online trading platforms that settle and deliver the traded crypto assets to its clients, the *payment* is made when the client deposits fiat or cryptocurrency as the means to purchase a crypto asset. The *delivery* (and settlement) of the crypto asset purchase is confirmed via receipt of the crypto asset at the custodian, verifiable "on-chain" by anyone running a node, including the custodian, and should be delivered (and settled) within a reasonable time frame ***(e.g. CFTC mandates within 28 days).***

DV Chain thanks the CSA and IIROC for considering its views on the Proposed Framework for Crypto-Asset Trading Platforms. We welcome the opportunity to discuss our views with you in greater detail. Please do not hesitate to contact the undersigned at (647) 496-9450 with any questions the CSA or its staff might have regarding this letter.

Respectfully submitted,

/s/ Dino Verbrugge

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