British Columbia Securities Commission

P.O. Box 10142, Pacific Centre
701 West Georgia Street
Vancouver BC V7Y 1L2
Canada
Telephone: (604) 899-6500
Fax: (604) 899-6506
Toll Free: 1-800-373-6393

BC Notice 2018/01

Notice and Request for Comment

Consulting on the Securities Law Framework for Fintech Regulation

PART 1 – INTRODUCTION

Background

In the summer of 2017, the British Columbia Securities Commission (**BCSC** or **we**) engaged in focused consultations with stakeholders in British Columbia to better understand the nature and growth of the financial technology (fintech) industry, and how the current regulatory framework may impede innovation. We recognize that British Columbia's technology sector is the fastest-growing in Canada, and that Vancouver's start-up ecosystem has been ranked among the strongest in the world, so this consultation was an important first step to continue our efforts to support the growth of emerging companies in this thriving sector.

In this notice and request for comment (**notice**), we set out the results of the consultations and seek comment on potential regulatory action to clarify or modernize securities laws to benefit all stakeholders, including investors in fintech. Building on our outreach activities, we have identified specific subjects that form the basis of this notice. Towards the end, we have posed a series of questions to generate further discussion, ideas and strategies about fintech and fintech regulation.

We aim to have a competitive regulatory environment that fosters innovation and gives investors confidence to invest in our capital markets. Effective regulation will help companies grow, protect investors, and further B.C.'s reputation for innovation.

Structure of Notice

The remainder of this notice is structured as follows:

- Part 2 provides an overview of BCSC's fintech activities in 2017
- Part 3 addresses the crowdfunding and online lending business models
- Part 4 addresses the online adviser business model
- Part 5 addresses cryptocurrency funds

- Part 6 addresses initial coin offerings and cryptocurrencies

- Part 7 addresses the future of fintech regulation

- Part 8 explains how stakeholders can provide comments and discusses next steps

PART 2 – BCSC's 2017 FINTECH ACTIVITIES

In 2017, the BCSC was actively involved in a number of outreach activities in the fintech sector. Outreach to the fintech industry is an identified strategy in the BCSC's 2017/18 service plan and aligns with our general approach to regulation - to be innovative, flexible, adaptable, and responsive.

We consulted with BC businesses and stakeholders active in the fintech sector. These consultations have helped us to understand how businesses are targeting their technology to financial services and raising capital to fund development of new technologies and platforms.

Initial outreach

In the winter of 2016-17, we initiated our outreach by engaging with firms active in online lending and advising through a series of breakfast meetings. Senior staff from our Capital Markets Regulation and Corporate Finance groups attended to learn more about these emerging businesses and how their activities might trigger securities laws requirements.

Tech Survey

In January 2017, we followed up with a tech survey to engage fintech stakeholders and learn about the challenges and opportunities they face. We posed specific questions to crowdfunding portals, online advisers and online lenders to follow-up on the guidance we had previously provided to them.

The responses we received indicated the following challenges:

- Online advisers viewed regulatory requirements as a significant challenge. They identified compliance costs (for example, custodial costs) as a significant barrier to developing a successful business. Respondents also questioned whether the current regulatory requirements were suited to the new world of online advising.

- Crowdfunding portals identified regulatory harmony and clarity across Canada as significant challenges. They highlighted specific requirements related to profitability (investment limits, costs of compliance) as barriers to developing a successful business.

- While online lenders identified regulatory clarity as an impediment to business success in BC, they primarily cited non-regulatory factors (the pool of available capital and difficulties in attracting talent) as the most significant.

- The top two challenges that emerged from the survey were the ability to attract and raise capital. Respondents noted the limited risk appetite among BC investors and pool of available capital in BC as significant non-regulatory barriers to growth and development.

Tech Team

In January 2017, we also established the Tech Team, a team focused on and dedicated to supporting the fintech sector. The formation of this team formalizes the BCSC's commitment to being a leader in assisting Canadian companies to grow and meet their securities compliance needs in the capital markets.

The Tech Team is a point of contact for fintech companies and provides a forum for discussion on the regulatory perimeter and application of securities regulation. The Tech Team also considers eligibility for admission to the Canadian Securities Administrators' Regulatory Sandbox, a Canadian approach to facilitating emerging issues in the fintech sector (described further in the section entitled *CSA Regulatory Sandbox* below).

To date the Tech Team has responded to over 125 inquiries from fintech companies, industry advocates and securities lawyers and substantively addressed over 40 matters, including:

- responding to inquiries from over 25 potential initial coin offerings (ICOs) or token-based businesses regarding whether a token is a security to which securities regulation applies. In assessing the facts specific to an offering, we concluded that they were securities in some cases, but not all[1].

- assessing five regulatory technology (**regtech**) entities to determine whether they were conducting activities requiring registration[2].

- issuing guidance to existing or potential investment fund managers proposing cryptocurrency fund offerings[3].

[1] For example, the Tech Team provided guidance to a token-based business looking to offer a sale of tokens on a pre-existing gaming platform based on collectible, distinguishable tokens, that the BCSC did not view the token in question as a security.

[2] For example, the Tech Team provided guidance to an entity providing an online white-labelled back-office solution for issuers that its proposed activities did not require securities registration.

[3] The BCSC registered the first investment fund manager and exempt market dealer in Canada intending to operate a bitcoin investment fund.

- reviewing proposed business models, or business model changes, of several crowd-financing businesses.

- reviewing with corporate finance staff prospectus disclosure for certain blockchain and cryptocurrency businesses.

To support the compliance needs of companies proposing to launch ICOs, the Tech Team produced a video describing what ICOs are, providing guidance on the potential application of securities laws, and setting out factors to consider before launching or investing in an ICO. The Tech Team plans to look for more opportunities to provide this kind of guidance.

CSA Regulatory Sandbox

In February 2017, the Canadian Securities Administrators (CSA) launched a regulatory sandbox initiative. The purpose of the sandbox is to foster novel businesses and innovation by providing a harmonized regulatory approach across Canada. Through it, the CSA members (including the BCSC) consider applications for registration and/or exemptive relief on a coordinated and flexible basis.

To date, the sandbox has granted exemptive relief to three businesses – a crowdfunding platform oriented to sophisticated investors and two companies seeking funding through ICOs[4]. As well, the sandbox published CSA Notice 46-307 *Cryptocurrency Offerings*, to provide guidance to cryptocurrency businesses on potential securities law considerations[5].

Fintech Events

Throughout the year, the BCSC actively participated in a variety of fintech events. In March, we participated in the BC Tech Summit, which gave us an opportunity to meet and dialogue with various businesses and industry groups. We have also been a sponsor of the BC Technology Impact Awards since 2016. Our speaking engagements at industry events include the 2017 Canadian Crowdfinance Summit, Vancouver Startup Week 2017 and VanFUNDING 2017, where we sponsored a regtech hackathon.

Stakeholder Consultations

In the summer of 2017, we conducted in-person and telephone consultations with various fintech industry segments. We consulted with crowdfunding portals, crowdfunding

[4] The relevant exemptive relief decisions are:AngelList, LLC http://www.osc.gov.on.ca/en/SecuritiesLaw_ord_20161024_angellist.htm; Impak Finance Inc. http://www.osc.gov.on.ca/en/SecuritiesLaw_ord_20170824_212_impak.htm; and Token Funder Inc. http://www.osc.gov.on.ca/en/SecuritiesLaw_ord_20171023_token.htm.

[5] The CSA notice can be found at https://www.bcsc.bc.ca/Securities_Law/Policies/Policy4/PDF/46-307__CSA_Staff_Notice___August_24__2017/.

industry groups and online advisers to assess their current circumstances and the challenges they face. We also identified the following topics for future consultations: cryptocurrencies (including cryptocurrency exchanges and investment funds), ICOs and tailoring regulation for fintech businesses.

Stakeholders included BC fintech companies, incubators and academic groups. To broaden our knowledge, we have also been in contact with securities regulators in other countries to learn from and understand their approaches towards fintech regulation.

PART 3 – CROWDFUNDING AND ONLINE LENDING

In 2015, the securities regulatory authorities of British Columbia, Saskatchewan, Manitoba, Québec, New Brunswick and Nova Scotia adopted substantially harmonized registration and prospectus exemptions that allow start-up and early stage companies to raise capital in these jurisdictions. As of December 2017, businesses raised an aggregate of approximately $1.8 million under start-up crowdfunding campaigns.

In 2016, the securities regulators of Ontario, Saskatchewan, Manitoba, Québec, New Brunswick and Nova Scotia adopted Multilateral Instrument 45-108 *Crowdfunding* (45-108 exemption). Also in 2016, the Alberta Securities Commission adopted ASC Rule 45-517 *Prospectus Exemption for Start-up Businesses* (ASC Rule), which created a prospectus exemption similar to start-up crowdfunding but without a funding portal requirement.

The start-up crowdfunding exemptions and the ASC Rule were intended to provide an alternative source of capital to non-reporting issuers at an earlier stage of development. By contrast, the 45-108 exemption is available to both reporting and non-reporting issuers and provides a higher offering limit than under start-up crowdfunding.

Beyond these new prospectus exemptions, businesses in all Canadian jurisdictions have access to other prospectus exemptions that can be used to “crowdfund” if the offering is conducted through a registered dealer. For instance, the offering memorandum (OM) exemption is designed to facilitate capital-raising by allowing for investments from a wider range of investors than under other exemptions such as the accredited investor or the family, friends and business associates exemptions. Under the OM exemption in BC, issuers can raise an unlimited amount of money, provided that the issuer prepares an offering memorandum, including financial statements, and provides this document to potential investors.

Another type of crowdfunding portal, online lenders, primarily use internet-based platforms to assess the creditworthiness of potential borrowers and approve, advance and administer loans. Online lenders may also use prospectus exemptions, such as the OM and accredited investor exemptions, in order to raise the funds that they lend to borrowers. Depending on how an online lender structures this fund raising stream, that online lender may be in the business of trading, and may be required to register as a dealer or find an exemption from the dealer registration requirement that it can rely on.

During our stakeholder consultations, we received feedback on the regulatory regime for crowdfunding in Canada. The stakeholders, including fintech companies, crowdfunding associations, online lenders and legal representatives, shared the following views:

1. Start-up crowdfunding should be expanded

   Stakeholders indicated that start-up crowdfunding has had some success in Canada but could benefit from changes to enhance its effectiveness in helping small businesses and early-stage issuers raise capital. In particular, stakeholders suggested that we consider the following for start-up crowdfunding:

   - increasing investor limits and the aggregate amount that could be raised to make it a more efficient tool for capital raising

   - removing the requirement that only certain types of "eligible securities" (as defined in the start-up crowdfunding exemption) can be issued. This would permit the issuance of other securities, such as convertible preference shares, that small businesses and early stage issuers often use to achieve their capital raising objectives

   - permitting more than two distributions per calendar year so that issuers can raise the aggregate permitted amount in a larger number of small raises

2. Crowdfunding regulations in Canada are not harmonized provincially

   The crowdfunding regime in Canada is difficult to navigate due to differences in the provincial rules. This creates problems for issuers, especially small businesses with limited resources that wish to raise capital in multiple provinces. Respondents indicated that the costs of understanding and complying with the different regimes are not commensurate with the relatively small amounts of capital they raise.

3. Suitability requirements are not structured efficiently

   We heard that KYC requirements for funding portals could be streamlined and better adapted for an online environment. Respondents noted that the distinctions between the suitability processes of online portals and brick-and-mortar dealers lead to an application of the suitability requirement that has unequal results. We heard that the lack of real-time interaction for crowdfunding portals requires a client to access the platform multiple times before making a single investment. This friction arises from regulatory requirements and makes the investment process significantly longer than a meeting with a brick-and-mortar dealer.

4. <u>The 45-108 exemption is under-utilized</u>

   We heard that respondents do not use the 45-108 exemption because they think that restrictions on the advertising activities of portals and financial statement requirements are disproportionate to the amount they can raise.

5. <u>There are opportunities for regulators to expand outreach and support for securities crowdfunding</u>

   Entrepreneurs are not well educated on the legality of securities crowdfunding in Canada. Respondents observed that crowdfunding regulations outside of Canada have benefited from regulators becoming more actively involved with entrepreneurs, by participating in technology committees and local meet-and-greet events.

The BCSC has already taken steps to address some of this feedback:

- In 2017, the BCSC and the Saskatchewan Financial and Consumer Authority (FCAA) announced amendments to start-up crowdfunding rules that increase access to capital. Specifically, BC and SK permit an interface between issuers and investors located in BC, SK and AB using start-up crowdfunding and the ASC Rule. BC also currently permits BC-based issuers to access investors outside of BC by using BCI 72-505 *Distributions outside Province using Crowdfunding*.

- Also in 2017, the BCSC and the FCAA increased the investor limit under start-up crowdfunding from $1,500 to $5,000 if the investor has obtained advice from a registered dealer that the investment is suitable for them. We made this change to harmonize with the ASC Rule.

Questions:

1. If we were to consider changes to the start-up crowdfunding exemption:

   (a) We could consider moving from an offering limit to a lifetime aggregate raise of $1,000,000, as was originally proposed under the ASC Rule. Would adopting a lifetime cap improve the effectiveness of the exemption?

   (b) The rationale for the "eligible securities" requirement was to limit start-up crowdfunding capital raises to relatively simple types of securities and therefore keep costs down for start-ups and early stage issuers. Should we consider removing the requirement for "eligible securities"?

   (c) Are there any other changes to the start-up crowdfunding exemptions that we should consider in the medium or long term?

2. We acknowledge the feedback that amendments to the crowdfunding rules may make it a more efficient capital-raising tool for BC stakeholders. However, any changes we make to the crowdfunding rules may cause further disharmony if other jurisdictions do not identify those changes as a priority. Are there any particular amendments to our rules that we should prioritize, even if these will only result in local changes?

3. We have observed increased interest by businesses in initial coin offerings as an alternative method of raising capital[6]. What is the likely impact that ICOs will have on existing crowdfunding opportunities?

4. The BCSC currently provides web resources, including printed guides and video, to funding portals, issuers and investors to assist with understanding the crowdfunding exemptions. BCSC staff also present at various professional and industry events in order to provide additional information on existing crowdfunding rules. We will consider other novel and innovative ways of engaging our capital markets participants where the method will generate a productive discussion. What kind of additional outreach opportunities or communication mechanisms should we consider in order to better educate entrepreneurs?

PART 4 – ONLINE ADVISERS

Over the past few years some portfolio managers (PMs) and other registrants have incorporated computer algorithms into their business. Such PMs, known as online advisers, automate the following key parts of an adviser's business model:

- collecting KYC information through online questionnaires
- generating investment recommendations

The registration and conduct requirements set out in NI 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) for PMs are technology neutral in that they are the same for online advisers and traditional PMs. Currently, registered advising representatives (ARs) remain directly involved in decision making. For instance, an AR must obtain sufficient know-your-client (KYC) information to support suitability determinations for a client. An AR must also review the suitability of a client's investments.

In some cases, online advisers can complete KYC and suitability without any direct contact between the AR and client (no-call advisors). In these circumstances, the managed accounts for the client are limited to relatively simple investments such as certain unleveraged exchange traded funds (ETFs) and mutual funds.

[6] For additional discussion on cryptocurrency offerings, see the discussion in Part 6 below.

In our stakeholder consultations, online advisers indicated the following views about the securities regulatory regime as it pertains to their business:

1. Online advice is growing in Canada

We heard that online advisers expect to grow as the public becomes accustomed to their business model. Initially, the public seemed wary about the risks of using computer algorithms for advice, but online advisers are optimistic that public comfort will increase with this new way of receiving investment advice as online advisers establish longer track records.

2. Regulation should anticipate new technologies

Online advisers observed that current regulation is facilitative and that they do not see regulation as burdensome. They did note however, that as online advice technology develops, many of the registrant duties performed today by an AR may be automated. In order to facilitate business efficiencies like this, regulators need to be forward looking and ready to consider accommodating automation of various parts of a PM's business.

In particular, respondents identified KYC, suitability and generating investment recommendations as areas for regulators' consideration. For example, some online advisers envisaged a central repository of data that could provide client information for registrants to conduct KYC.

3. Modernize regulatory requirements to facilitate new business

Respondents suggested that we reconsider certain regulatory requirements in light of how the online advice industry is developing. In particular:

- Online advisers think collaborating with independent PMs will be a significant part of their future. However, they do not think there is clear guidance on how an online adviser can advise the clients of a PM.

- If certain physical requirements (e.g. wet signatures for directions to transfer assets) impede efficient movements of capital, they may encumber online advisers.

Based on our stakeholder consultations, we have identified the following operational issues that potentially merit further regulatory attention.

Use of third parties to facilitate or perform KYC

Section 13.2 of NI 31-103 requires a registrant to perform the KYC obligation. CSA Staff Notice 31-342 further states that like any other PM, an online adviser must gather its own KYC information and make its own suitability determination, and cannot rely on

information provided under a referral arrangement or otherwise delegate these obligations to another party.

Developments in regtech that allow access to current client information from a centralized source may result in efficiencies in gathering information. Third parties may offer data analysis capabilities that improve the KYC and suitability process. Regulators should consider these developments in technology as they consider the applicable regulatory framework.

Questions:

5. What future centralized or other third party information sources do you envision occurring that would help registrants comply with KYC and suitability obligations?

6. If registrants were permitted to rely on a third party to either provide KYC information or conduct certain KYC responsibilities, what kinds of functions would a third party most likely provide, and how?

7. How would registrants use information from a third party and ensure its ongoing accuracy, and how would it affect their KYC and suitability procedures?

8. What new risks would such reliance create for online advisers or their clients, and how could online advisers and regulators manage those risks?

Automation of PM duties

No-call advisors conduct onboarding KYC and suitability through online questionnaires without direct follow-up with the client. They are required to invest the accounts of these clients in relatively simple investments such as unleveraged ETFs. To invest in more complex securities, an AR must contact the client to confirm the KYC information is accurate, undermining the potential efficiencies from "no-call". Additionally, CSA Staff Notice 31-342 notes that an AR is required to determine the suitability of a recommendation generated by an algorithm.

These requirements reflect a view that onboarding and making investment decisions are enhanced when an AR (a human) is involved and that regulators can understand the decision-making path of an AR, but not an algorithm's. However, we are aware that the quality of information obtained through artificial intelligence (AI) applications such as chatbots is improving. As well, developments in machine learning are improving the quality of decision-making by AI, and algorithms are being refined to help humans better comprehend the decision-making path AI takes.

At some point, advisors may be capable of completely automating the KYC and suitability, and investment decision processes. At this point, the AR's manual review may provide little added value and only add to inefficiencies. Regulators may want to consider

these technological developments with a forward-looking view to regulatory requirements.

Questions:

9. What measures could be taken to ensure that where an AR has not directly followed up with a client, that no-call advisor has responsibly determined that the client is capable of making more complex investments?

10. Please propose how a mature AI might sufficiently conduct KYC and suitability without AR oversight, and what oversight compliance processes could be used to confirm that these duties were properly conducted.

11. What alternative safeguards could mitigate risks associated with using a fully automated recommendation and suitability process (other than restricting investment actions to relatively simple investments, such as ETFs)?

Outsourcing

Online advisers identified partnering with traditional PMs as an important source of future business. They identified three methods for doing this:

- referral arrangements (where a traditional PM refers a client to an online adviser, usually with some commission to be paid):

- purchasing the online adviser's software to bring it in-house, and

- outsourcing arrangements (which would involve a PM using an online adviser to complete some of its client duties, and the online adviser not taking on the client as its own).

Section 4.1 of NI 31-103 states that an individual cannot act as an AR for two firms that are not affiliated. The policy objective is that an AR should not have a conflict of interest between the firms they act for. In our consultations, we heard from an online adviser who thought that any outsourcing arrangement could breach this requirement.

Online advisers also suggested that regulators consider whether outsourcing that breaches section 4.1 of NI 31-103 could still meet the policy objective of that section.

Questions:

12. What kinds of outsourcing arrangements exist, or are being contemplated, by online advisers and independent PMs?

13. If an outsourcing arrangement identified above does not comply with the requirement in section 4.1 of NI 31-103, what alternative requirement could facilitate these outsourcing arrangements and meet the policy objective of that section?

Flow of Capital

We heard from stakeholders that the flow of capital could be made more efficient. For instance, transfers out from one managed account to another have physical requirements that do not make sense for online business models (e.g. requiring wet signatures from a client on a transfer instruction).

Stakeholders also noted that online advisers could allow smaller investors to access a financial service (investment advice) that traditionally was available only to clients with significant account sizes. However, we also heard that regulatory requirements contribute to fixed client acquisition costs, which makes managing small accounts less economical for online advisers.

Questions:

14. What regulatory or administrative requirements can result in an inefficient flow of capital when investors switch accounts or transfer assets between firms (e.g. the requirement for a wet signature for a client instruction to transfer out funds)?

    (a) If these requirements arise from securities laws, please identify them and propose alternatives, if any.

    (b) If these requirements do not arise from securities laws, are there ways securities regulators can encourage a more efficient flow of capital?

15. What securities law requirements impose significant costs on online advisers when taking on smaller client accounts (e.g. $2,000 or lower), that do not provide equally proportionate investor protection?

16. If the requirements identified in question 15 were eliminated, what alternative investor protection measures would be appropriate?

PART 5 – CRYPTOCURRENCY FUNDS

As cryptocurrency use develops, we can expect continued registration applications from fund managers looking to operate cryptocurrency investment funds. These may range from investments in established cryptocurrencies such as bitcoin and ethereum, to investing in speculative cryptocurrencies that may have other functionalities. These funds may also look to invest in ICOs and initial token offerings (ITOs).

In our consultations, we identified the following areas that could merit further regulatory consideration:

Risk management for cryptocurrency investment funds

We are considering how to manage the risks of investing in cryptocurrencies, including those identified in CSA Staff Notice 46-307. These risks range from operational (e.g. the risks associated with using specific cryptocurrency exchanges, cryptocurrency wallets and custodians; difficulties in determining a fair price for a cryptocurrency transaction) to systemic (e.g. the lack of regulation of cryptocurrencies overall; the lack of transparency in cryptocurrency trading).

Questions:

The following questions reflect regulatory concerns related to granting a firm registration as an investment fund manager (IFM) for managing cryptocurrency investment funds.

17. Many cryptocurrency exchanges currently operate without government oversight or regulation, which raises concerns about arbitrage (as prices can vary between exchanges), security of funds and tokens transacted, and anti-money laundering. How are cryptocurrency exchanges, or other industry stakeholders, working to address these issues?

18. Many cryptocurrency wallets/custodians currently operate without government oversight or regulation, which raises cyber security and anti-money laundering concerns. Please identify any standards or best practices followed by certain cryptocurrency wallets/custodians that may address these concerns.

19. Trading cryptocurrencies can give rise to concerns around price volatility, fair valuation (as prices between different exchanges can vary), transparency (as many transactions do not occur on exchanges that make transaction details available to the public), liquidity (as cryptocurrencies can be thinly traded) and anti-money laundering. What best practices can IFMs use to address these concerns?

20. For each of the above questions, are there best practices adopted by other stakeholders (industry groups, regulators, governments, etc.) that may be useful for us to consider in this context?

Incoming changes to custody requirements in NI 31-103

On June 4, 2018, proposed amendments for NI 31-103 are expected to come into effect that will impose requirements on registrants regarding custody of client cash, securities or other assets. The amendments will set out additional requirements for external custodians used by registered firms to hold cash or securities. There will also be specified restrictions on self-custody of cash and securities for registrants. The requirements for custody of client assets that are not cash or securities will remain essentially unchanged.

Questions:

21. If a specific cryptocurrency is considered cash or a security, what challenges arise for registrants looking to meet custodial requirements in the cryptocurrency space?

22. How can challenges identified in question 21 be addressed?

Investment and operational concerns for cryptocurrency investment funds

We are considering whether funds investing in ICOs give rise to additional concerns over those identified in CSA Staff Notice 46-307. For example:

- if the fund's assets include securities (which could include coins or tokens), the fund would need a registered PM to oversee its investment activities.

- coins or tokens that are securities may be subject to resale restrictions, adding liquidity risks to the fund.

- as market participants must evaluate each cryptocurrency offering on a case-by-case basis, a fund could incur significant risks if it invests in an ICO before there is clarity on whether the ICO is a distribution of securities. For instance, if an investment manager for a fund is not a registered PM and causes the fund to invest in an ICO that is later determined to be a distribution of securities, that investment manager would have advised the fund on securities without being properly registered. This may result in sanctions against the investment manager or the fund, such as a cease trade order of the securities.

Questions:

23. What other concerns may arise if an investment fund intends to invest in ICOs?

24. What measures could be put in place to address concerns identified in question 23?

Operational requirements for cryptocurrency investment funds

We are considering whether operational requirements for cryptocurrency investment funds should differ from requirements for other types of funds. We have received comments that proficiency and operational requirements for advisers and IFMs may not be pertinent to cryptocurrencies. For example, an AR's required knowledge of securities and standard investment management may not be as relevant as knowledge relating to cryptoeconomics.

Questions:

25. What different, or reduced, proficiency and operational requirements (if any) should apply to registrants advising or managing cryptocurrency funds, as compared to registrants advising or managing other funds?

PART 6 – ICOs and Cryptocurrencies

In CSA Staff Notice 46-307, the CSA noted the increase in ICOs and ITOs. For the purposes of this notice, the term ICO includes a distribution of coins or tokens also referred to as an initial token offering, token generation event, or token distribution event.

Exemptive Relief Decisions for ICOs

Since August 2017, the CSA has granted exemptive relief to two businesses proposing to conduct ICOs[7]. The relief granted consisted of:

- in both cases, dealer registration relief that provided for the ICO coins or tokens to be distributed using prospectus exemptions.

- in one case, prospectus relief, to facilitate the tokens' circulation in a defined ecosystem as a form of currency.

The relief allowed these novel businesses to raise capital with tailored restrictions. The prospectus relief demonstrates the regulators' willingness to consider a flexible approach to tokens with unique characteristics, if investor protection concerns are adequately addressed.

Question:

26. Is the exemptive relief discussed above an effective tool to enable efficient capital raising while providing sufficient investor protection and flexibility to allow the coin or token to function as it was intended to? If not, please explain why.

ICO as a distribution of securities

In CSA Staff Notice 46-307, the CSA noted that in many cases, the determination of whether a coin or token is a security will be based on whether it is an investment contract[8]. However, stakeholders have requested additional guidance on the factors we consider in determining whether an ICO is an offering of securities. Stakeholders have

[7] The relevant exemptive relief decisions are: Impak Finance Inc. (Impak) http://www.osc.gov.on.ca/en/SecuritiesLaw_ord_20170824_212_impak.htm ; and Token Funder Inc. (Token Funder) http://www.osc.gov.on.ca/en/SecuritiesLaw_ord_20171023_token.htm.

[8] The relevant case law, including *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 S.C.R. 112 as well as subsequent judicial and administrative decisions, refers to a four-pronged test for finding an investment contract if there is: a) an investment of money, b) the investment is made into a common enterprise, c) an expectation of profit, and d) such profit to come significantly from the efforts of others.

identified the following variables as potential factors to consider whether an investment contract exists with a given ICO:

- **Whether a secondary market exists and is available for a coin or token.** For example, tokens compliant with the Ethereum standard ERC-20 are structured in a way that makes them readily tradable on many cryptocurrency exchanges. This may increase the potential for speculation in a token.

- **Whether a buyer is intending to use a coin or token for a utility function or speculation.** Sellers of tokens often purport that there is a "utility" function to the token that constitutes the reason for its purchase, that is separate from its potential function as an investment. However, tokens are often traded from the time they are sold, indicating that buyers may be treating the token as a speculative instrument without an intention to participate in its future utility. We also note instances of futures trading for some tokens prior to their distribution under an ICO.

- **Functional differences to forms of non-securities crowdfunding.** Stakeholders argue that many businesses proposing ICOs use a coin or token in a manner similar to a prepayment of a good or service. However, we have observed that some ICOs issue coins or tokens that are readily tradable with an available secondary market, unlike the standard lack of transferability observed with prepaid promises to deliver under non-securities crowdfunding platforms such as Kickstarter.

- **Whether the utility function is available at the time the tokens are sold.** Most businesses that conduct ICOs are prospective and looking to raise capital to build out the utility function for the token. However, it has been argued that where some businesses have already built out the product for which the tokens are needed, the token may be less of a speculative instrument compared to a token whose utility function is not available at the time the token is sold.

- **Whether the business conducting the ICO has created an impression that the token is an investment or profit opportunity.** ICOs are conducted through the internet and can attract a wide range of potential buyers. Where a business is offering tokens and indicates that such token may generate positive returns for a buyer outside its use, the business may be creating the impression that such coin or token is actually an investment instead of a token with a specific use. This promotional aspect may be observed even where the business is separately asserting that the token is intended to be used for a utility function.

This is non-exhaustive list of variables that does not encompass all factors we may consider.

Questions:

27. Do you think that each of these variables is relevant and applicable? If not, please explain why.

28. There are developments in cryptocurrencies that may trigger new factors for regulatory consideration (for example, non-fungible tokens may give rise to different considerations than tokens that follow the ERC-20 protocol). What do you think are the most probable coin/token technology developments over the next 24 months that may have regulatory implications (e.g. tokenization of real property)?

29. What considerations should securities regulators keep in mind in relation to any developments identified in question 28?

Proposed ICO models

The most common ICO model is where a business raises capital by selling non-functional tokens and uses those proceeds to develop the functionalities it advertised for that token. The business issues the non-functional tokens immediately to purchasers following the ICO. The following are some other ICO models that have been proposed or used by businesses:

(a) an ICO structured so that one token is a security used for capital raising prior to the development of the platform, and a second, functional token is used for deployment once the platform is operational;

(b) an ICO where the developer delays release of the token to a later time, such as once the platform is functional; and

(c) an ICO in which the first step involves the purchasers and developer entering into an agreement for the right to a functional token, and then a second step involves fulfilment of the agreement by releasing the token when the platform/ecosystem is functional.

We consider the substance of a transaction, and not simply its form. However, the choice of ICO model that a business uses may affect the legal analysis of whether there is a distribution of securities.

Questions:

30. If you have considered the implementation of one of these ICO models, what factors led you to adopt or abandon that model?

31. Please describe any other ICO models that you think securities regulators in Canada should consider.

Securities Regulatory Approach to Virtual Currencies

Financial regulators are monitoring and taking varying approaches to respond to the challenges posed by virtual currencies. In this notice, “virtual currency” means

cryptocurrencies purported to function solely as a medium of exchange, without any added utility or purpose (for example, bitcoin).

We have heard arguments that virtual currencies fail the investment contract test when they are highly decentralized. For these virtual currencies it is argued there is no common enterprise, and no expectation of profit that relies on the significant efforts of others. Stakeholders have identified the following additional factors securities regulators should consider in determining when a virtual currency is not an investment contract, and therefore not a security:

- **No central governance for the coin.** For example, bitcoin has no entity or entities with authority to set rules applicable to the coin on an ongoing basis.

- **Creation or distribution of coins not dependent on a central issuer.** For example, new coins could be created or distributed through mining, staking or other decentralized forms of coin creation/distribution.

- **Transfer and trading of coins not dependent on a central party.** There are no restrictions on who may record new transactions on the blockchain ledger for the coin, and there is no central entity that can influence which transactions occur.

Questions:

32. What is your view with respect to the relevance and applicability of each of the above-noted factors?

33. Are there additional conceptual distinctions between virtual currencies, and other coins or tokens, that securities regulators should consider in assessing whether a security exists?

PART 7 – FINTECH REGULATION IN THE FUTURE

We understand that different regulatory models may help facilitate innovative and novel businesses in different ways. Currently, to provide regulatory certainty and ensure we manage risks to investors we expect to review novel fintech business models before they can operate. While we recognize that a regime that permits exploration without review or prior approval could facilitate innovation on a timelier basis, a lack of appropriate controls could also compromise investor protection. We are interested in exploring other options for approving or licensing new innovations.

ASIC 12-month licensing exemption

The Australian Securities and Investments Commission (ASIC) has a 12-month fintech licensing exemption that allows various fintech firms to operate freely for a limited time within strict parameters. These parameters are intended to decrease the market risk posed by a firm, and include investment limits and limiting a firm's exposure to retail investors.

Questions:

34. Would a BCSC exemption similar to the ASIC licensing exemption be useful for fintech businesses in BC or Canada?

35. For an exemption described in question 34, what would be appropriate safeguards to limit risks to the capital markets and retail investors?

Facilitating Innovation

As innovation progresses, regulation needs to keep pace in order to facilitate business operations. We consider this general objective in the specific context of our mandate, which is to promote the public interest by fostering fair and efficient capital markets in British Columbia that warrant investor confidence.

Questions:

36. If there are specific securities regulatory requirements that you think stifle innovation without an adequate rationale, please identify them and propose how they can be revised to facilitate innovation while meeting the policy concerns those regulatory requirements address.

37. Identify any technologies that you think we should specifically consider (such as developments in regtech or blockchain technology) to be relevant from a securities standpoint.

38. Identify the technological developments that you expect to see in the next few years that you think they will affect financial institutions and market participants. Identify how you think these developments will affect these parties.

39. Are there specific considerations that securities regulators should keep in mind when considering whether, or how, to regulate technologies identified in questions 37 and 38?

40. If there are technological developments that you expect could pose significant harm to investors, or risk to the capital markets in the next few years, please identify them and what harms or risks they will cause.

41. How should securities regulators address technological developments contemplated in questions 37, 38 and 40 in order to distinguish companies that build value in our capital markets from the “bad actors” and fraudsters?

42. What other suggestions do you have for modernizing the regulatory framework for fintech?

PART 8 – COMMENT PROCESS AND NEXT STEPS

The issues addressed in this notice are important ones that affect the future of the capital markets structure, and fintech industry, in British Columbia. We invite everyone to make written submissions. Once we have considered the feedback received, we will determine the appropriate regulatory action.

Please submit your comments in writing on or before **Tuesday, April 3, 2018**. You may provide written comments in hard copy or electronic form. It is important that you state on whose behalf you are making the comments.

If you are providing your comments electronically, please send your comments to techteam@bcsc.bc.ca. Alternatively, you have the option of providing comments via the following internet link: "https://bcsc.news/fintechcomments".

If you are providing your comments in hard copy, please deliver your comments to the following address:

Zach Masum
Manager, Capital Markets Regulation
British Columbia Securities Commission
P.O. Box 10142, Pacific Centre
701 West Georgia Street
Vancouver, BC V7Y 1L2

If you have any questions, please contact any of the BCSC Tech Team staff listed below.

Elliott Mak
Senior Legal Counsel, Corporate Finance
British Columbia Securities Commission
604-899-6501
emak@bcsc.bc.ca

James Leong
Senior Legal Counsel, Capital Markets Regulation
British Columbia Securities Commission
604-899-6681
jleong@bcsc.bc.ca