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Blockchain & Cryptocurrency Regulation: Canada

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Government attitude and definition

As in many countries, the regulation of cryptocurrencies in Canada is divided among various levels of government and administrative agencies, depending on the nature of the activity undertaken. Despite these jurisdictional constraints, Canadian regulators generally continue to take a receptive and innovative approach to regulation, including, for example, in approving crypto-based exchange-traded funds ("**ETFs**") and developing a pragmatic regulatory oversight and compliance framework under provincial securities regulation.

Cryptocurrency regulation

Provincial securities and derivatives regulation provides the main regulatory framework for the regulation of digital assets in Canada. As discussed below under "*Money transmission laws and anti-money laundering requirements*", jurisdiction is also exercised by the federal government through federal anti-money laundering legislation, which requires registration of certain virtual currency exchange or transfer services as money services businesses ("**MSBs**").

Securities regulation in Canada generally governs the distribution and trading of both securities and derivatives. These activities are primarily regulated through the imposition of prospectus requirements, dealer, adviser and investment fund manager registration requirements, and certain requirements imposed upon those operating exchanges, alternative trading facilities or other marketplaces that facilitate trading activities, as well as related reporting and disclosure requirements.

The Canadian Securities Administrators (the "**CSA**") is an umbrella organisation of Canada's provincial and territorial securities regulators. While there are no specific rules or regulations for digital assets, the CSA has published guidance in the form of a number of staff notices with respect to virtual currencies with a view to addressing rapidly evolving developments in retail crypto markets and adapting the existing regulatory framework to digital assets. The CSA and the investment industry self-regulatory organisation known as the Investment Industry Regulatory Organization of Canada ("**IIROC**") have most recently set out their framework and proposed approach to regulating this asset class in Staff Notice 21-329 – *Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements* ("**Staff Notice 21-329**").[1] Staff Notice 21-329 provides an actionable roadmap, building on earlier guidance, including the 2019 Consultation Paper 21-402 – *Proposed Framework for Crypto-Asset Trading Platforms* (the "**Consultation Paper**"),[2] Staff Notice 46-307 – *Cryptocurrency Offerings*,[3] Staff Notice 46-308 – *Securities Law Implications for Offerings of Tokens*,[4] Staff Notice 21-327 – *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets* ("**Staff Notice 21-327**"),[5] and Staff

Notice 51-363 – *Observations on Disclosure by Crypto Assets Reporting Issuers*.[6] Virtual currencies may be subject to Canadian provincial securities and derivatives laws to the extent that a virtual currency is considered a security or a derivative for the purposes of those laws, which define a security to include, among other things, an investment contract. The seminal case in Canada for determining whether an investment contract exists is *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*,[7] where the Supreme Court of Canada identified the four central attributes of an investment contract, namely: (a) an investment of money; (b) in a common enterprise; (c) with the expectation of profit; and (d) where this profit is to be derived in significant measure from the efforts of others.

The application of the Pacific Coin test to virtual currencies is not always straightforward, however. Industry participants have taken the position that proper utility tokens, which have a specific function or utility beyond the mere expectation of profit (such as providing their holders with the ability to acquire products or services), should not be considered securities. This position appears to have generally been accepted by the CSA and IIROC. The CSA and IIROC have also acknowledged in the Consultation Paper that it is widely accepted that some of the well-established virtual currency assets that function as a form of payment or a means of exchange on a decentralised network, such as BTC, are not currently, in and of themselves, securities or derivatives and have features that are analogous to commodities such as currencies and precious metals.

In assessing whether a particular virtual currency will be considered a security subject to Canadian securities laws, the CSA has generally applied a very broad and multi-factor approach to determining whether an investment contract exists and focusing on the substance of the virtual currency over its form.

A particular virtual currency that meets the criteria of the Pacific Coin test or has certain of the characteristics described in the CSA guidance may be properly considered an investment contract and therefore a security, subject to Canadian securities laws. A similarly broad approach is generally expected to apply when reviewing non-fungible tokens ("**NFTs**"), including whether there is a capital-raising and/or investment element, how the number of tokens issued correlates to the original purpose, and whether the tokens are expected to trade on secondary markets. More recently, the CSA has expanded its regulatory approach to cover arrangements that are securities or derivatives because they are "crypto contracts" and, as discussed below, the consequences of characterisation as a security or a derivative include distribution-related (prospectus) requirements, as well as requirements to be registered as a dealer and/or marketplace.

The guidance set out in Staff Notice 21-327 further outlines the circumstances in which the CSA will consider "any entity that facilitates transactions relating to cryptoassets" to be subject to securities legislation requirements relating to platform recognition and dealer registration. In particular, the CSA has cautioned that securities legislation may also apply to platforms that facilitate the buying and selling of cryptoassets, including cryptoassets that are commodities, because the user's contractual right to the cryptoasset may itself constitute a derivative. This will generally be the case where the platform is determined to be merely providing users with a contractual right or claim to an underlying cryptoasset, rather than immediately delivering the cryptoasset.

While regulators will consider all the terms of the relevant contract or instrument, the CSA has taken the view that if there is no immediate delivery of the cryptoasset, securities legislation will generally apply. For these purposes, immediate delivery will be considered to have occurred if: (a) there is immediate transfer of ownership, possession and control of

the cryptoasset and the user is free to use, or otherwise deal with, the cryptoasset without any further involvement with, or reliance on, the platform or its affiliates, and the platform or any affiliate retaining any security interest or any other legal right to the cryptoasset; and (b) following the immediate delivery, the user is not exposed to insolvency risk (credit risk), fraud risk, performance risk or proficiency risk on the part of the platform.

Other factors to be considered include: (a) the contractual arrangements between the platform and the user; (b) whether there is immediate settlement of the transaction; (c) whether there is margin and leverage trading; (d) typical commercial practice with regard to immediate delivery; (e) whether there is immediate transfer to a user's wallet; and (f) who has ownership, possession or control over the transferred cryptoasset.

Sales regulation

To the extent that a virtual currency is considered a security or a derivative, the issuance or distribution to the public is subject to prospectus, qualification or similar requirements, or must be effected pursuant to applicable exemptions from prospectus or derivatives qualification requirements.

There are a number of options available for distributing securities in Canada on a prospectus-exempt basis, generally referred to as "exempt distributions" or "private placements". Most of these exemptions are harmonised under National Instrument 45-106 *Prospectus Exemptions*. The CSA has indicated that persons wishing to distribute virtual currencies may do so pursuant to these exemptions.[8]

A number of investment funds have also completed prospectus offerings qualifying the distribution of units of retail pooled fund vehicles whose underlying investments are cryptoassets such as BTC and ETH. The first such offering was completed by 3iQ for its Bitcoin Fund in April 2020 and then in December 2020 for the Ether Fund. CI Galaxy Bitcoin Fund, managed by CI Asset Management, and Bitcoin Trust, managed by Ninepoint Partners LP, were also launched in December 2020 and led to a number of similar offerings of crypto-based ETFs.

Ownership and licensing requirements

Dealer registration

Any person or company engaging in, or holding themselves out as engaging in, the business of trading or advising in securities, and, in certain Canadian jurisdictions, in derivatives, must register as a dealer or as an adviser or, where available, conduct these activities pursuant to an exemption from the dealer or adviser registration requirement under the applicable securities or derivatives laws. A person or entity that directs the business, operations and affairs of an "investment fund" (as defined under applicable laws) must comply with the investment fund manager registration requirement or obtain an exemption from that requirement.

In Canada, the requirement to register as a dealer or an adviser is triggered where a person or company conducts a trading or advising activity with respect to securities or derivatives for a business purpose. The mere holding out, directly or indirectly, as being willing to engage in the business of trading in securities may trigger the requirement to register as a dealer. However, a number of factors must be considered when determining whether registration is required, including whether a business engages in activities similar to a registrant, intermediates or expects to be remunerated or compensated.

In the context of virtual currency distributions, the CSA has noted the following additional factors in determining whether a person or entity may be considered to be trading in securities for a business purpose, namely: (a) soliciting of a broad range of investors, including retail investors; (b) using the internet to reach a large number of potential investors; (c) attending public events to actively advertise the sale of a virtual currency; and (d) raising a significant amount of capital from a large number of investors.

Following the regulatory approach outlined in Staff Notice 21-329, a number of domestic platforms have been granted "restricted dealer" registration while other domestic and global platforms continue to engage with CSA members with a view to being appropriately regulated.[9]

Exchanges and other platforms

As marketplaces, exchanges are regulated pursuant to their applicable provincial securities statutes, as well as under National Instrument 21-101 *Marketplace Operation* ("**NI 21-101**"), National Instrument 23-101 *Trading Rules* ("**NI 23-101**") and their related companion policies.

NI 21-101 defines a marketplace as a facility that brings together buyers and sellers of securities, brings together the orders for securities of multiple buyers and sellers, and uses established non-discretionary methods under which the orders interact with each other. Additional factors apply to further distinguish marketplaces that are exchanges.

To operate as an exchange in Canada, a person or company must first apply for recognition as an exchange or for an exemption from the recognition requirement. As another type of marketplace, alternative trading systems, which provide automated trading systems that match buyer and seller orders, are also regulated under NI 21-101 and NI 23-101.

It follows that exchanges or other platforms that facilitate the purchase, transfer or exchange of virtual currencies that are considered securities or derivatives may be subject to recognition requirements as securities or derivatives exchanges or marketplaces. In the institutional market, prescribed or negotiated exemptions may be available in respect of platform-related recognition requirements under securities or derivatives laws, subject to the satisfaction of certain conditions and acceptance by the applicable regulators.

The appropriate category of dealer platform registration depends on the business model and the nature of the platform's activities. Relevant factors include whether the platform offers margin or leverage.

Dealer platforms that trade crypto contracts and trade or solicit trades for retail investors will generally be expected to be registered as investment dealers and become members of IIROC. However, they are able to access a transitional "interim period" process by seeking "restricted dealer registration" (under the stated guidance, provided they do not offer leverage or margin trading) while they ramp up to full investment dealer registration and compliance. The interim period is generally expected to be two years. During that period, applicant platforms may expect to undergo a detailed regulatory screening of trade flows, financial controls and auditing, custody, valuation, insurance, market integrity, professional proficiency and experience, ability to comply with prescribed business conduct requirements, cybersecurity and risk management, although some flexibility may be extended.

Asset management and investment funds

Persons and entities operating or administering collective investment structures that hold or invest in virtual currencies may also be subject to investment fund manager registration requirements, in addition to dealer, adviser and prospectus or private placements requirements. The structures themselves may also be subject to reporting and business conduct requirements that apply to investment funds.

Canada has been at the forefront of regulatory and market breakthroughs in the retail crypto fund space. In 2020, Canada's 3iQ launched North America's first major exchange-listed Bitcoin and Ether Funds. In 2021, Canada's Purpose Investments obtained approval from the CSA for the world's first actively managed crypto-based ETFs.

The CSA has since registered several managers of pooled investment vehicles and approved a number of retail closed-end funds and ETFs investing in cryptoassets.

Promotion and testing

The CSA and IIROC have addressed promotional activities in Joint Staff Notice 21-330 – *Guidance for Crypto-Trading Platforms; Requirements relating to Advertising, Marketing and Social Media Use* issued on September 23, 2021, including requirements, best practices and examples with respect to advertising, marketing, social media activities, fee disclosure and other compliance matters for crypto-trading platforms under Canadian securities legislation.

The CSA has also established a regulatory sandbox initiative to support fintech businesses seeking to offer innovative products, services and applications in Canada. It allows firms to register and/or obtain exemptive relief from securities laws requirements under what is stated to be "*a faster and more flexible process than through a standard application, in order to test their products, services and applications throughout the Canadian market on a time limited basis*". Certain provincial securities regulators have established their own specifically tailored programmes, such as Ontario Securities Commission's Launchpad, Autorité des marchés financiers's Fintech group and fintech lab, British Columbia Securities Commission's Fintech Advisory Forum and Advertising Standards Canada's InnoFinTeam.

Money transmission laws and anti-money laundering requirements

Under the federal *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (Canada) (the "**PCMLTFA**"), any entity that is engaged in the business of foreign exchange dealing, remitting or transmitting funds, issuing or redeeming money orders or similar instruments, dealing in virtual currency or providing crowdfunding platform services, must be registered in Canada as an MSB. Under guidance issued by the Financial Transactions and Reports Analysis Centre of Canada ("**FINTRAC**"),[10] any entity that holds a permit, licence or registration related to any of these services, advertises by any means that it is engaged in providing any of these services, or reports income from any of these services as income from a separate business, must also register as an MSB. Any entity that does not have a place of business in Canada (which includes having employees, agents or branches in Canada), and directs any of the above services at, and provides these services to, persons or entities in Canada, must also be registered as a foreign money services business ("**FMSB**"). Both domestic and foreign MSBs must implement a compliance programme to implement know-your-customer, reporting, record-keeping, travel rule and related compliance requirements under the PCMLTFA.

The activities that are considered "dealing in" virtual currency are not specifically defined in the legislation. However, FINTRAC has clarified that these activities include virtual currency exchange services and virtual currency transfer services, with a view to regulating entities such as virtual currency exchanges, and not individuals or businesses that use virtual currency for buying and selling goods and services. A "virtual currency exchange transaction" is defined in this guidance as an exchange, at the request of another person or entity, of virtual currency for funds, funds for virtual currency or one virtual currency for another. Virtual currency transfer services include transferring virtual currency at the

request of a client or receiving a transfer of virtual currency for remittance to a beneficiary. An entity registered as the equivalent of an MSB and/or performing any of the covered services may also be required to be registered as an FMSB in Canada.

Under FINTRAC guidance, a business is considered to be "directing services" at persons or entities in Canada if: (a) the business's marketing or advertising is directed at persons or entities located in Canada (e.g., in Canadian newspapers and on websites aimed at clients in Canada or through emails to persons in Canada promoting its virtual currency services); (b) the business operates a ".ca" domain name; or (c) the business is listed in a Canadian business directory.

However, FINTRAC guidance also provides that even if none of the above factual elements apply, a business may still be directing services at persons or entities in Canada, and a combination of additional criteria should also be considered in order to make this determination, including: (a) describing services as being offered in Canada; (b) offering products or services in Canadian dollars; (c) making customer service support available in Canada; (d) seeking feedback from clients in Canada; and (e) having another business in Canada promote its services to clients in Canada.

These criteria are not exhaustive and apply regardless of whether a Canadian client to whom the services are directed is an individual or an institutional client. FINTRAC guidance provides that a client is deemed to be "in Canada" if they have a connection or residential ties with Canada (such as having an address in Canada), the document or information used to verify the client's identity is issued by a Canadian province or territory or by the federal government, or their banking, credit card or payment processing service is based in Canada. Failure to comply with applicable requirements of the PCMLTFA may result in criminal charges for non-compliance offences or administrative monetary penalties.

Canadian federal law also includes other laws and regulations governing money laundering, terrorist financing and the use/handing of proceeds of crime, and various trade sanction and similar restrictions. These rules may provide additional monitoring and reporting obligations and prohibitions, including offences such as knowingly collecting or providing funds to terrorist organisations or associated individuals, or otherwise dealing with sanctioned governments, entities or individuals. The rules generally apply to persons in Canada and Canadians outside of Canada.

Québec is the only provincial jurisdiction to have enacted legislation, the *Money-Services Businesses Act* (Québec) (the "**QMSBA**"), requiring MSB registration. The QMSBA is administered by Revenu Québec, the taxation authority in that province. Unlike the PCMLTFA, the QMSBA does not distinguish between foreign and domestic MSBs.

Reporting requirements

MSBs and FMSBs are subject to prescribed suspicious transaction reporting, terrorist property reporting, large cash transaction reporting, large virtual currency transaction reporting and electronic funds transfer ("**EFT**") reporting requirements. MSBs and FMSBs must take reasonable measures to ensure that prescribed travel information is included in relation to virtual currency and EFT transfers.

Border restrictions and declaration

There are no border restrictions specific to cryptocurrencies, but persons entering or leaving Canada with C$10,000 or more in their possession must report it in person on *E677 – Cross-Border Currency or Monetary Instruments Report – Individual* in the case of persons

reporting their own currency or monetary instruments, or *E667 – Cross-Border Currency or Monetary Instruments Report – General* in the case of persons transporting them for a third party. Canadian tax reporting requirements may also apply.

Mining

The process of virtual currency mining, which employs specialised, high-speed computers, is energy intensive. However, Canada's cold temperatures and low electricity costs make it particularly attractive for virtual currency miners.[11] While virtual currency mining is not specifically regulated in Canada at this time, the use of virtual currency mining hardware may be subject to provincial and municipal requirements relating to the use of energy. On March 9, 2022, the Ontario Ministry of Energy tabled regulatory amendments to Ontario Regulation 429/04 that would prevent facilities that engage in cryptocurrency mining from participating in the Industrial Conservation Initiative ("**ICI**")[12] on the basis that currency mining is energy intensive and runs counter to ICI's goals.[13]

The increased demand for electricity in this sector has also led certain provincial and municipal governments to re-evaluate requests from virtual currency miners. On April 25, 2019, Québec's Régie de l'énergie issued a decision[14] regarding the rates and conditions for electricity use by blockchain (including virtual currency) clients. In its decision, Régie de l'énergie approved the creation of a new "blockchain" consumer category and the creation of a reserved block of 300 megawatts ("**MW**") for this category, including 50MW to be allocated to blockchain projects of 5MW or less. On June 5, 2019, Hydro-Québec launched a request for proposals with respect to the allocation of the 300MW block reserved for the blockchain consumer category. Projects are to be evaluated based on economic and environmental criteria, including the number of direct jobs in Québec, total payroll of direct jobs in Québec, capital investment in Québec and total electricity use.

Taxation

Taxation of virtual currencies

For Canadian tax purposes, the Canada Revenue Agency (the "**CRA**") has taken the position that virtual currencies constitute a commodity rather than a currency.[15] Gains or losses resulting from the trade of virtual currencies are therefore taxable either as income or capital.[16] The treatment of a transaction as being taxable as income or capital is a question of fact and is determined by the CRA through an examination of the nature of the relevant transaction. Where a transaction is considered on capital account, the taxpayer will be required to include, in computing its income for the taxation year of disposition, one-half of the amount of any capital gain (a taxable capital gain) realised in that year. Subject to and in accordance with the provisions of the *Income Tax Act* (the "**ITA**"),[17] the taxpayer will generally be required to deduct one-half of the amount of any capital loss (an allowable capital loss) realised in the taxation year of disposition against taxable capital gains realised in the same taxation year. Allowable capital losses in excess of taxable capital gains for the taxation year of disposition generally may be carried back and deducted in any of the three preceding taxation years or carried forward and deducted in any subsequent taxation year against net taxable capital gains realised in those taxation years, to the extent and under the circumstances specified in the ITA. Where a transaction is considered on income account, the resulting gains are taxed as ordinary income and the losses are generally deductible.

Virtual currency mining

The tax treatment of virtual currency mining turns on whether the activity is undertaken for profit or as a personal endeavour.[18] A personal endeavour is an activity undertaken for

pleasure and does not constitute a source of income for tax purposes, unless it is conducted in a sufficiently commercial and business-like way. However, the mining of virtual currencies is likely to be considered a business activity by the CRA given the complexity of the activity. The mining of virtual currencies would therefore require the taxpayer to compute and report business income in compliance with the ITA, including the rules with respect to inventory. The CRA has specifically stated that Bitcoin received by a miner to validate transactions is consideration for services rendered by the miner.[19] Where a taxpayer is in the business of Bitcoin mining, the Bitcoin received must be included in the taxpayer's income at the time it is earned. The CRA has confirmed that the miner must include as income the value of the services rendered or the value of the Bitcoin received, whichever is more readily valued. The CRA generally expects the value of the Bitcoin received to be more readily valued and, accordingly, this is the amount to be included as income.[20]

Paying with virtual currencies

Where a virtual currency is used as payment for salaries or wages, the amount must generally be included in the employee's income computed in Canadian dollars.[21] As a result of the qualification of virtual currencies as a commodity, the use of virtual currencies to purchase goods or services is subject to the rules applicable to barter transactions. Therefore, where virtual currencies are used to purchase goods or services, the value in Canadian dollars of the goods or services purchased must be included in the seller's income for tax purposes, rather than the value of the virtual currencies.[22] However, the CRA has stated that the fair market value of the virtual currency at the time the supply is made must be used to determine the goods and services tax ("**GST**") and harmonised sales tax ("**HST**") payable on the purchase of a taxable supply of a good or service.[23]

Specified foreign property

The CRA has stated that virtual currencies situated, deposited or held outside Canada fall within the definition of specified foreign property, as defined in the ITA.[24] As such, Canadian residents must report to the CRA when the total costs of virtual currencies situated, deposited or held outside Canada exceed C$100,000 at any time in the year by filing Form T1135 with their income tax return for the year. The CRA has not yet adopted a position on the situs of virtual currencies, which remains an open question, and the issue is currently under review.[25]

Collection of GST and HST on virtual currency transactions

The exchange of cryptocurrency is no longer considered a sale of an asset, but rather a sale of a financial instrument for purposes of GST/HST. The amendment of section 123(1) of the *Excise Tax Act* (Canada) (the "**ETA**"),[26] effective as of May 18, 2019, adds "virtual payment instruments" to the definition of "financial instruments", rendering any sale of or transaction involving virtual currencies as a form of payment exempt from GST/HST collection.

The Department of Finance sought to clarify the characterisation of cryptoasset activities by releasing, on February 4, 2022, draft legislation to amend the ETA[27] to include "cryptoasset mining". With this change, cryptoasset mining would not be considered a supply, so GST/HST would not apply to hash power services and input tax credit would not be available to the person providing the service. The draft amendment also included section 188.2 of the ETA, effective as of February 5, 2022, to expand who is involved in a mining activity to not give rise to an input tax credit. For instance, the allowance of computing resources from one person to another for the purpose of mining will be considered a "mining activity". However, in a situation where the recipient of the mining activity is known, subsection 188.2(5) of the ETA may provide an exception and supplies of such activities would be taxable supplies and expenses.

Other Canadian legislative requirements

Depending on the specificities of a particular business model and its nexus to the Canadian market, trading, lending and other activities involving crypto contracts may be subject to a range of other Canadian legal requirements that are not specifically described in this chapter but should be considered, including the potential application of federal banking legislation, provincial loan and trust regulation, consumer protection legislation, privacy legislation, proposed new retail payments legislation, Canadian trade and economic sanctions, extra-provincial business registration, advertising and marketing laws, Canadian anti-spam laws and Québec language laws.

* * *

Endnotes

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6. Canadian Securities Administrators, Staff Notice 51-363 – *Observations on Disclosure by Crypto Assets Reporting Issuers* (Canadian Securities Administrators, 2021) (Staff Notice 51-363).
7. *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 SCR 112, which is itself based on the better known "Howey Test" set out by the Supreme Court of the United States in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).
8. Staff Notice 46-307.
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