Further Canadian Crypto Regulatory Guidance to Come via OSFI and FSB

Insights from the recently proposed OSFI guidance and FSB recommendations for crypto-assets

Tetra Trust Company

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Introduction

Throughout 2023, Canadian regulatory bodies have been providing updated guidance, and there is evidence that there will be more to come. The Office of the Superintendent of Financial Institutions (OSFI), released proposed guidance in July of 2023 which outlined the financial implications of holding crypto assets on a balance sheet. A timeline of the relevant events regarding the guidance can be found in the diagram below. Much of the guidance originates from the international Basel Committee on Banking Supervision, highlighting a continuing trend of Canadian regulators taking cues from international bodies, that is further contributing to efforts to harmonize regulation more broadly.

Current OSFI Guidance Timeline

August 2022	July 2023	September 2023	Q1, 2025
OSFI Published Interim Guidance	OSFI Proposed Enhanced Guidance	Consultation on Proposed Guidance closes	New Enhanced Guidance goes into effect

Additionally in July, the Financial Stability Board (FSB) - another international organization which works to create global financial stability - also released its report containing recommendations for the regulation of crypto assets. This report was commissioned by the G20, and is a significant step towards globally harmonized standards. The FSB is working with a wide array of international bodies for further cross-border cooperation, and as a member of the FSB, OSFI will likely incorporate a version of these proposals into its future regulations. The FSB is also publishing a joint paper with the IMF in September 2023, providing even further crypto-asset guidance in the near future.

Key Takeaways

1 **OSFI's proposed guidance significantly broadens the interim guidance. Notably, it expands on the groups of crypto assets, specifically including stablecoins in the first classification group.**

2 **The FSB recommends that full and accurate disclosures should be made to clients by those providing custody services, including "the risks that could be faced by the client if the custodian were to enter bankruptcy."**

3 **There is a clear focus within the FSB report on crypto asset service providers that engage in multiple activities, and whether or not they should be forced to restructure their operations.**

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OSFI identified a lack of clarity for financial institutions regarding crypto assets and how to best handle the resulting liquidity needs. To help solve this, OSFI published interim guidance in August of 2022 which served the purpose of bridging the gap before new regulation is published. Moving forward into July of 2023, OSFI has proposed two *OSFI guidelines on the regulatory capital and liquidity treatment of crypto-asset exposures (one for banking and one for insurers)*, which expand on the interim guidance.

"Deposit-taking institutions and insurers need clarity on how to treat crypto-asset exposures when it comes to capital and liquidity. We look forward to giving them this clarity through these new guidelines that reflect industry input and international standards."

— Peter Routledge, Superintendent of Financial Institutions, July 26, 2023

This draft guidance greatly expands on the interim, especially on the classification of the crypto assets and the specific capital requirements to maintain acceptable liquidity. While the initial interim guidance defined two crypto-asset classes, the new notice creates two subcategories in each group with with the subcategories having their own unique formulas to calculate the appropriate amount of capital. The below table summarizes the new classes of assets. These guidelines are open to public consultation until September 20, 2023, meaning there may be revisions when the final guidance is published in Q1, 2025.

Group 1 Assets: Less capital and liquidity required to hold these assets comparatively	
1a: Tokenized Crypto-assets	The asset is a tokenized traditional asset by both being a digital representation of a traditional asset and posing the same level of risk as the non-tokenized version of the asset.
1b: Stablecoins	The asset is a crypto-asset with a stabilization mechanism that satisfies the five given expectations, notably relating to redemption, ownership rights, risk management, and proper functioning of the stabilization method.
Group 2 Assets: More capital and liquidity required to hold these assets comparatively	
2a: Hedged Crypto-assets	Most simply, three conditions are met: 1. the crypto asset has a derivative, or exposure to the asset is derivative-based and all have sufficient regulatory oversight; 2. the crypto asset is highly liquid; and 3. there is sufficient data for the crypto asset available.
2b: Other Crypto-assets	All other crypto-assets.

OSFI guideline on the regulatory capital and liquidity treatment of crypto-asset exposures: https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/crypto-bnk.aspx

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Recommendation 7: Disclosures

Authorities should require that crypto-asset issuers and service providers disclose to users and relevant stakeholders ***comprehensive, clear and transparent information regarding their governance framework, operations, risk profiles and financial conditions,*** *as well as the products they provide and activities they conduct.*

Within the *High-level Recommendations for the Regulation, Supervision and Oversight of Crypto-asset Activities and Markets* report conducted by the FSB, an overarching theme through all nine recommendations is transparency. Recommendation 7 specifically focuses on the disclosures to be made to users, with clear guidance for custody services and in particular with regards to bankruptcy.

Tetra notes that in the case of a custodian bankruptcy, there is clear extra-jurisdictional legal risk when keys are held in another jurisdiction, especially one with unclear crypto-asset regulations. This opens the door for the potential to lose access to the crypto-assets under custody. Risks like this should be disclosed to the clients of custodians so they can understand the potential impacts to their business.

Additional Disclosures

The FSB mentions the following disclosures should also be included:

- the ownership rights retained by the client;
- the safeguards implemented by the service provider for client assets;
- the existence of any outsourcing arrangements; and
- any circumstances where a crypto-asset issuer or service provider might not provide timely redemption or withdrawal of assets.

FSB High-level Recommendations for the Regulation, Supervision and Oversight of Crypto-asset Activities and Markets: Final report
https://www.fsb.org/2023/07/high-level-recommendations-for-the-regulation-supervision-and-oversight-of-crypto-asset-activities-and-markets-final-report/

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There is a clear focus within the FSB report on crypto asset service providers that engage in multiple activities, and whether or not they should be forced to restructure their operations.

Recommendation 9: Comprehensive regulation of crypto-asset service providers with multiple functions

*Authorities should ensure that **crypto-asset service providers and their affiliates that combine multiple functions and activities, where permissible, are subject to appropriate regulation, supervision and oversight that comprehensively address the risks associated with individual functions and the risks arising from the combination of functions**, including but not limited to requirements regarding conflicts of interest and separation of certain functions, activities, or incorporation, as appropriate.*

In jurisdictions where crypto-asset service providers are allowed to perform multiple functions, the industry has seen an expansion of service offerings from crypto companies, often into new ventures like custody or lending. To account for the compounded risks of this centralization of services, the FSB recommends strict oversight and comprehensive regulation. Once again, transparency is key for the FSB, this time specifically for the organization's structure to better understand how the different functions of the business overlap.

In cases where adequately minimizing the resulting risks is not possible, the FSB recommends regulators evaluate *legal disaggregation and separation*. The FSB is specifically interested in cases where service providers combine functions such as 'custody, trading, settlement, lending, and borrowing or proprietary trading'. Other regulators, including OSFI, will likely begin to look at the combination of these activities with increasing awareness and sensitivity as a result of this recommendation.

*"Authorities should **pay particular attention to service providers combining multiple functions** that engage in facilitating custody, trading, settlement, lending, and borrowing or proprietary trading, and should apply regulatory measures that are designed for the adequate segregation of risks. For example, **this may include legal disaggregation and separation of certain functions.***

— Excerpt from the FSB Report

FSB High-level Recommendations for the Regulation, Supervision and Oversight of Crypto-asset Activities and Markets: Final report https://www.fsb.org/2023/07/high-level-recommendations-for-the-regulation-supervision-and-oversight-of-crypto-asset-activities-and-markets-final-report/

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Tetra invites you to contact us to understand how we set the standard for regulated Canadian digital asset custody.

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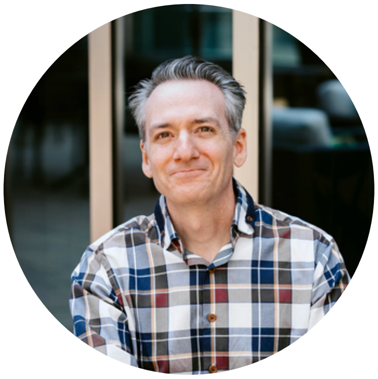

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