

CSA publishes guidance on Public Crypto Funds – What fund managers need to know

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The number and size of public investment funds in Canada that hold crypto assets (Public Crypto Asset Funds) has grown rapidly since the first Public Crypto Asset Fund was launched in Canada in 2020. On July 6, 2023, the Canadian Securities Administrators (CSA) published CSA Staff Notice 81-336 Guidance on Crypto Asset Investment Funds that are Reporting Issuers (the Staff Notice) to provide guidance to fund managers regarding the operation of Public Crypto Asset Funds. The Staff Notice addresses a number of securities law issues and outlines a number of the CSA's expectations. In particular, the Staff Notice addresses:

- Market and other characteristics of crypto assets that could impact their viability as investments for Public Crypto Asset Funds;
- Custody of crypto assets held on behalf of Public Crypto Asset Funds; and
- Yield-generating activities, like staking, by Public Crypto Asset Funds.

Each of these areas of regulatory guidance is discussed below.

Crypto assets and crypto market characteristics

In the Staff Notice, the CSA indicate that the unique features of each crypto asset and its market are key to determining whether the crypto asset is a suitable investment for a publicly distributed investment fund under NI 81-102 Investment Funds (NI 81-102). These features include (i) the ability to determine a fair value of the crypto asset, (ii) the liquidity of the crypto asset, and (iii) the classification of the crypto asset for securities law purposes.

Valuation - Markets for crypto assets have evolved rapidly over the course of the last several years and now fall on a wide spectrum in terms of maturity. In the Staff Notice, the CSA note that the market for any crypto asset in which a Public Crypto Asset Fund seeks to invest should support the fund's ability to calculate its net asset value (NAV). In assessing a crypto asset market, the CSA look for (i) sufficient evidence of an active market for the crypto asset comprising actual and regularly occurring market transactions on an arm's length basis, (ii) the presence of a regulated futures market for the crypto asset, and (iii) publicly available indices administered by regulated index providers for the crypto asset. Currently, the only crypto assets that the CSA have

identified as being suitable for Public Crypto Asset Funds, based on the maturity of their **respective markets, are bitcoin and ether**. However, the CSA acknowledge that in the future greater institutional support and mainstream adoption of other crypto assets may result in those crypto assets becoming suitable investments for Public Crypto Asset Funds.

Liquidity - Under NI 81-102, investment funds are subject to restrictions on the proportion of “illiquid assets” that can be held in their portfolios. A crypto asset may be an “illiquid asset” if it cannot be readily disposed of by a fund through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount used to value the crypto asset for the purpose of the fund’s NAV calculations. Because markets for many crypto assets are volatile, and price movements can be accompanied by significant inflows or outflows of capital due to changes in investor sentiment, the CSA emphasize the need to have effective liquidity risk management programs that include the use of stress testing and ongoing monitoring of underlying crypto asset market liquidity.

Classification of crypto assets - Public Crypto Asset Funds are expected to conduct appropriate due diligence to determine whether the specific crypto assets they propose to invest in are securities or derivatives. The characterization of crypto assets as securities or derivatives impacts the application of certain provisions of NI 81-102, including concentration and issuer control restrictions and restrictions on securities lending. In addition, if a crypto asset is a security or a derivative, then general securities law requirements would apply, including the prospectus requirement and restrictions on secondary trades. Given that the characteristics of crypto assets may materially change over time, the CSA expects that Public Crypto Asset Funds conduct ongoing due diligence on crypto assets they invest in to ensure that they remain in compliance with applicable securities laws.

Custody of crypto assets

By their nature, crypto assets present unique custodial considerations. The CSA’s minimum expectations for practices pertaining to the custody of crypto assets of a Public Crypto Asset Fund include:

- The fund manager satisfying itself that the custodian has the necessary expertise and experience to safely custody crypto assets;
- The custodian holding the fund’s crypto assets in offline storage or “cold wallets” except as may be required to facilitate purchases and redemptions by the fund;
- The custodian segregating the fund’s crypto assets from the custodian’s own assets, and maintaining books and records that clearly reflect the fund’s ownership of its crypto assets;
- The custodian using appropriate website security measures to secure client information and protect the custodian’s website from hacking attempts;
- The custodian maintaining appropriate insurance for the crypto assets in its custody; and
- The custodian delivering system and organization control reports annually to the fund’s auditor.

The expectations noted above are substantially similar to the terms and conditions imposed on entities that seek to act as custodians of crypto trading platforms in Canada,

as set out in CSA Staff Notice 21-332 Crypto Asset Trading Platforms: Pre-Registration Undertakings, Changes to Enhance Canadian Investor Protection.

Staking crypto assets

The Staff Notice outlines the CSA's views on several issues that may arise when Public Crypto Asset Funds engage in staking. The CSA define the term "staking" as the act of committing or locking crypto assets in smart contracts to permit the owner or the owner's agent to act as a validator for a particular proof-of-stake consensus algorithm blockchain. A "validator", in connection with a particular proof-of-stake consensus algorithm blockchain, is an entity that operates one or more nodes that meet protocol requirements for a crypto asset and participates in consensus by broadcasting votes and committing new blocks to the blockchain. Validators are incentivized to add legitimate transactions to a proof-of-stake blockchain through rewards and can be penalized for breaching protocol requirements, including through having staked crypto assets "slashed" (i.e., removed from the offending validator).

The issues raised by the CSA include the following:

Potential issuance of a security or derivative - The CSA are of the view that, depending on how it is conducted, staking may involve the issuance of a security or derivative, and the CSA expect that Public Crypto Asset Funds interested in staking crypto assets held in their portfolios to have established policies and procedures to assess whether the staking activity involves the issuance of a security or derivative.

Limitations on illiquid assets - A Public Crypto Asset Fund's participation in staking may result in an otherwise liquid crypto asset becoming an "illiquid asset" within the meaning of NI 81-102. The CSA expect a Public Crypto Asset Fund to conduct appropriate due diligence with respect to the effect on the staked crypto asset's liquidity within the fund's portfolio, and how this impacts the fund's compliance with the illiquid asset restrictions contained in NI 81-102.

Restrictions on lending - Depending on how it is conducted, staking could be viewed as akin to lending portfolio assets to, or guaranteeing obligations of, a person or company engaged to act as validator. If the underlying staked crypto assets are themselves securities, staking such assets could also be viewed as akin to securities lending. Given this, Public Crypto Asset Funds interested in staking should consider the prohibitions in NI 81-102 related to lending portfolio assets and guaranteeing securities or obligations, as well as the restrictions in NI 81-102 relating to securities lending.

Control or management of the proof of stake protocol - The CSA regard an investment fund as an issuer that does not seek to exercise control over, or become involved in the management of, investee companies. Since staking requires a validator to actively participate in consensus of a proof of stake network protocol by broadcasting votes and committing new blocks to the blockchain, this could be viewed as exerting control over or being involved in the management of the proof of stake protocol (which could be viewed as being similar to an investee company). To mitigate this concern, the CSA expect that neither a fund nor its fund manager act as its own validator. Rather, a Public Crypto Asset Fund is expected to engage a third party to act as validator (i.e., "staking as a service").

While fund managers of Public Crypto Asset Funds are expected to engage in their own due diligence to determine whether proposed staking activities by a Public Crypto Asset Fund comply with applicable securities legislation, due to the issues that may arise in relation to staking activities the CSA have encouraged Public Crypto Asset Funds interested in staking portfolio assets to contact their principal regulator to discuss the applicability of securities legislation and possible approaches to compliance.

Know-your-product, know-your-client and suitability obligations

The Staff Notice also reminds registrants of the need to comply with all of their know-your-client (KYC), know-your-product (KYP) and suitability obligations in connection with purchases or sales of securities of Public Crypto Asset Funds for, or recommendations of Public Crypto Asset Funds to, their clients. While no substantive new guidance is provided in this regard, the CSA does note that when discharging their KYC, KYP and suitability obligations in connection with recommending Public Crypto Asset Funds to clients, registrants should be cognizant that holding crypto assets, including Public Crypto Asset Fund securities, comes with elevated levels of risk that may not be suitable for many investors.

Conclusion

For the most part, the guidance in the Staff Notice is not new, and fund managers that have launched Public Crypto Asset Funds have engaged in discussions concerning, and have addressed, all the issues raised in the Staff Notice. For the asset management industry, having this guidance made public is welcome. The challenge will be working with CSA staff to permit Public Crypto Asset Funds to invest in a broader range of crypto assets.

Although not referenced in the Staff Notice, it is worth noting that the CSA has imposed, and will likely impose in the future, terms and conditions on firms that engage in investment strategies related to crypto assets and related yield-generating activities, like staking, through private investment funds.

Our [digital asset focus group](#) has already started this discussion and looks forward to working with fund managers to both expand their fund line-up to include Public Crypto Asset Funds and to expand the crypto assets that are permitted to form part of this asset class.

By

[Robert D. Wallis, Carol Derk, Julie Mansi, Iñaki Gomez](#)

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BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

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