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Ignore at Your Own Risk: OSC Accuses Crypto Exchange Poloniex of Disregarding Securities Laws

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The Ontario Securities Commission (OSC) recently made good on its promise to hold crypto asset trading platforms (CTPs) operating in Ontario accountable for failing to comply with Ontario securities laws. In a hard-hitting [statement of allegations](#) issued on May 25, 2021, the OSC initiated proceedings against Polo Digital Assets, Ltd. (operating as Poloniex) “for disregarding Ontario securities law and to signal that crypto asset trading platforms flouting Ontario securities law will face regulatory action.”

Background

The OSC’s regulatory action comes on the heels of guidance from the Canadian Securities Administrators (CSA) and Investment Industry Regulatory Organization of Canada (IIROC), issued on March 29, 2021 (the [2021 Notice](#)). As discussed in our [April 15, 2021 bulletin](#), the 2021 Notice reaffirmed the regulators’ position that CTPs holding non-security crypto assets on behalf of their users (often referred to as “custodial” platforms) may be subject to the regulatory requirements that are applicable to traditional securities dealers, marketplaces or exchanges, because the user’s contractual right to the crypto asset may itself constitute a security or derivative.

The 2021 Notice contemplated a period of interim relief to allow CTPs time and flexibility to comply with securities laws. To this end, the OSC issued a statement advising CTPs that offer trading in crypto-based derivatives or securities to persons located in Ontario to contact the OSC by April 19, 2021 to discuss how to bring their operations into compliance or risk potential enforcement action. The interim relief period is expected to be two years, during which time CTPs may seek registration as exempt market dealers or restricted dealers, provided that they do not offer leverage or margin trading and are not considered to be a securities exchange.

What Is Poloniex?

According to the OSC’s statement of allegations, Poloniex is a CTP registered in the Republic of Seychelles that allows users, including Ontario residents, to open accounts and deposit, purchase and trade in crypto assets. Poloniex’s platform also facilitates both margin trading (where users can engage in user-to-user lending transactions to short sell crypto assets) and futures trading (where users can buy or sell contracts for future settlement of crypto assets at up to 100x leverage). Poloniex charges users a per-transaction fee based on trading volume.

Poloniex does not offer its services to persons who are citizens of, or incorporated or residing in, the United States, but it does not similarly exclude Canadian residents.

A Novel Approach

Poloniex operates as a custodial platform because its users do not possess or control the crypto assets they deposit, purchase, hold or trade on the Poloniex platform. Rather, the crypto assets are recorded as a balance in a user’s account, and users have a contractual right to take possession of the crypto assets by requesting delivery of such assets from Poloniex. As noted above, the 2021 Notice reaffirmed the regulators’ view that this type of contractual right to a crypto asset may itself constitute a security or derivative, notwithstanding that the underlying crypto asset may not. These custodial arrangements could expose the platform’s users to the risks of insolvency, fraud and a failure to perform on the part of the platform. The CSA has taken the position that this type of relationship would generally be subject to securities legislation.

Making an Example

The OSC statement of allegations claims that Poloniex is not complying with Ontario's registration and prospectus requirements, and has not obtained any exemptions therefrom. The OSC also indicated that Poloniex did not contact the OSC by the April 19, 2021 deadline to obtain interim relief. It appears Poloniex continued to allow Ontario residents to purchase and trade crypto assets and crypto asset-based derivatives on its platform.

While many other CTPs operate using a custodial model, Poloniex's margin trading and highly-leveraged futures contract offerings were likely contributing factors to the OSC taking action against Poloniex, given the heightened risk to investors involved with such products. In its response to commentators as part of the 2021 Notice, the CSA noted that CTPs would not be permitted to extend margin or futures contracts to their participants in the short term, while the regulators continue to assess the risks introduced by CTPs to the market.

Whether Poloniex was unconcerned or just oblivious, it might be rethinking its actions now. The regulator has shown its hand, and it appears intent on using Poloniex as an example to other CTPs that may choose to "flout" the new compliance process.

Full OSC Armoury Deployed

OSC staff (Staff) is seeking a full slate of corrective and punitive sanctions against Poloniex to send a warning to other CTPs that choose to "expose Ontario investors to unacceptable risks and create an uneven playing field within the crypto asset trading platform sector." Staff has requested sanctions, which include the following:

- a permanent cease-trade of any securities or derivatives by Poloniex;
- a permanent ban on Poloniex acquiring securities;
- a permanent order to prevent Poloniex from obtaining exemptions contained in Ontario securities laws;
- an OSC reprimand;
- a permanent prohibition on Poloniex acting as a registrant, investment fund manager or promoter under securities regulations;
- administrative monetary penalties of not more than \$1 million for each failure to comply with Ontario securities laws;
- a disgorgement to the OSC of any amounts obtained as a result of non-compliance with Ontario securities laws;
- payment of the OSC's costs for its investigation and hearing; and
- any other order the OSC considers appropriate.

Notably, the administrative monetary penalties sought by Staff could be significant. While details of how the OSC will determine "each failure to comply" are not provided in the statement of allegations, each purchase, sale or trade on the Poloniex platform by an Ontario resident could potentially constitute a failure to comply with Ontario securities laws.

The scope of the proposed sanctions suggests that the OSC is trying to preclude Poloniex from future operations in Ontario.

Looking Back and Looking Forward

In June 2019, Canadian securities regulators issued guidance that the contractual rights provided by platforms retaining custody of their users' crypto assets may constitute securities. In the two-year period since, crypto assets have increased in popularity with retail investors, but CTPs have largely continued to operate in a regulatory grey zone. The CSA made efforts to balance investor protection and foster innovation, including most recently by introducing a two-year transitional period to allow CTPs to continue operations while seeking registration. With the action against Poloniex, the OSC seems to be sending a strong message to the industry: If you want to play ball, you'll be playing by OSC rules.

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