OSLER

Cryptocurrency as collateral in Canada: Issues for lenders to consider

FEBRUARY 6, 2023 5 MIN READ

Related Expertise

- Capital Markets
- Digital Assets and Blockchain
- Financial Services
- Fintech
- Technology

Authors: Joyce M. Bernasek, Matthew T. Burgoyne, Yasir Samad

Cryptocurrency is a digital alternative to traditional currency. It exists entirely online, meaning there is no need for physical cryptocurrency bank notes or coins. Cryptocurrency is not issued or produced by a government or central bank. Rather new cryptocurrencies are created via technology that is used by thousands of international volunteers who "mine" or generate new cryptocurrencies through the use of their computers. With the prevalence of cryptocurrency, borrowers are increasingly seeking to use this digital alternative as collateral in lending transactions. This Update addresses several issues for lenders when considering whether to accept cryptocurrency as collateral in secured financing transactions.

Due diligence

In addition to the typical due diligence that is performed by a lender against a borrower and its proposed collateral, when considering crypto as collateral, lenders should be particularly interested in the following additional due diligence:

1. **Verify the location of the cryptocurrency**. Does the borrower have custody of its cryptocurrency, or is the cryptocurrency located in a digital wallet that is under the possession and control of a third party? The cryptocurrency should be held in the borrower's own digital wallet where the borrower has sole control over the private cryptographic key required to access the crypto in the digital wallet. Or, if the borrower is storing the crypto in a custodial account, the custodian should be well-known and reputable. One way to determine if the custodian is reputable is to confirm whether it is registered pursuant to the laws of any jurisdiction in the U.S. or Canada (for example, the custodian Gemini Trust Company, LLC is a New York trust company regulated by the New York State Department of Financial Services (NYDFS).
2. **Assess the nature and quality of the cryptocurrency**. Is it bitcoin or ether or some other well-known high volume traded cryptocurrency? Some cryptocurrency trades at an extremely low volume and was created for use by a project that doesn't exist anymore, or was involved in a fraud or where the underlying blockchain was hacked/compromised. Lenders will want to avoid taking this cryptocurrency as collateral. Ideally, the crypto being proposed as collateral is included in the top 10 highest volume traded list of crypto as published by CoinCap (https://coincap.io/).

3. **Assess any potential securities law-related risks**. Bitcoin and ether (in addition to a few others) are generally considered by Canadian securities regulators to be commodities, and not securities or derivatives. Some cryptocurrencies, by virtue of the facts surrounding their creation, promotion and sale, are more akin to securities or derivatives. Lenders should avoid taking cryptocurrencies which are themselves securities or derivatives as collateral (unless that is the specific intent of the lender) to avoid the unexpected application of securities laws to their activities, such as (for example) resale restrictions, registration requirements, or derivative trade reporting requirements.

4. **Assess any potential money-laundering and terrorist financing risks**. Since some cryptocurrency is pseudonymous or (in the case of privacy coins) almost completely anonymous, like cash, it is sometimes used to facilitate the sale of illegal drugs and/or has otherwise been used to launder money and finance terrorist activities. Unlike cash, crypto is not minted or disbursed via the traditional banking system. Arguably this heightens the risk of illegal activity. A lender should inquire as to the origins of the borrower's crypto and, if it did not originate from a federally regulated cryptocurrency exchange trading platform that is registered with FINTRAC in Canada or FinCEN in the U.S., the lender should consider engaging the services of a blockchain analytics company (such as ciphertrace (https://ciphertrace.com/) to perform an analysis and confirm that the crypto was not previously distributed through blacklisted or sanctioned crypto wallet addresses, or wallet addresses associated with dark internet marketplaces.

5. **Consider global and U.S. stock market conditions**. The increased correlation since 2020 between the price of crypto, such as bitcoin, and the price of tech-focused stocks on major U.S. stock indices, should be considered by a lender when considering whether to take crypto as collateral. A lender who desires a stable asset as collateral should re-think the use of crypto during times of global stock market turbulence. However, there are several products available in the crypto market that are designed to hedge volatility.

Security interests and control of crypto assets

Personal property legislation doesn't currently expressly include reference to cryptocurrency, and it most likely falls under the definition of "intangible property". Lenders should ensure that, when taking security over cryptocurrency, they consider personal property security legislation accordingly, and take the steps necessary to perfect by registration.

In addition, a lender can obtain control over crypto assets by entering into a control agreement, taking possession of the cryptographic private key necessary to unlock the assets from a digital wallet, or appoint a properly licensed trustee or custodian mutually agreeable to all parties to hold the crypto assets. Similar to disclosure relating to other types of assets, lenders should ensure that crypto assets are described in accurate detail and that cryptocurrency wallets are sufficiently identified and disclosed.

Enforcement

Enforcement of a security interest over digital asset collateral poses additional risks that a lender should consider, given that crypto transactions are quick and nearly impossible to track. Accordingly, the best protection for lenders is to include contractual mechanics and remedies in the loan agreement and reflected in the smart contract.