Commission de Surveillance du Secteur Financier

WARNING

WARNING ON VIRTUAL CURRENCIES

Virtual currencies are not currencies, they are not regulated and not guaranteed by a central bank or a deposit guarantee scheme. They are highly volatile and speculative investments, bearing a number of risks including total loss of investment.

Introduction

The Commission de Surveillance du Secteur Financier (CSSF) warns the public of the significant risks linked to “virtual currencies”, also called “VCs”, “cryptocurrencies” or “virtual money”.

In this context, the CSSF recognises and stresses that the underlying technology of virtual currencies, the “blockchain technology”, can bring about certain benefits through its use in financial sector activities and in diverse innovative projects. Thus, the CSSF specifies that this warning only concerns virtual currencies that use this technology, without questioning the technology itself.

In practice, different terms designate virtual currencies, such as “alternative currencies” or “cryptocurrencies”. In general, virtual currencies are a means of exchange or digital representations of non-guaranteed values, which are not issued or controlled by central banks and whose offer and/or demand may be limited. Unlike a fiat currency, virtual currencies are not legal tender and do not represent a means of exchange whose value is guaranteed by a central bank. Thus, the value is solely based on the trust that holders and users have in the acceptance of virtual currencies by other natural or legal persons as a means of exchange. Virtual currencies are not subject to specific regulations either at national or European level and do not offer any legal protection to investors.

From a legal point of view, there is currently no uniform definition of virtual currencies, either at national or European level.

According to the European Central Bank, a virtual currency is “a digital representation of value, not issued by a central bank, credit institution or e-money institution, which in some circumstances can be used as an alternative to money”.

The draft of the 5th Anti-Money Laundering Directive defines virtual currencies as a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency, and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically.

Risks associated with virtual currencies

Investments in virtual currencies can be extremely risky and are highly speculative. Investors are thus exposed to several risks when buying virtual currencies or associated financial products, namely:

- Volatility and price bubble risk

Most of the virtual currencies are subject to extreme price volatility, which can sometimes occur in the course of one day, and have shown clear signs of a price bubble. In an environment that lacks transparency and supervision, temporary or permanent shifts towards price extremes may happen repeatedly. In the wake of such phenomena, the invested capital is likely to be partially or totally lost within a very short period of time.

- Lack of protection and risk of theft

Virtual currencies are unregulated products without any particular protection. Likewise, specialised exchange platforms and virtual currency storage systems may present vulnerabilities as regards their security, which may lead to risks of hacking and theft. Moreover, there is no investment guarantee should the service provider fail. Such risks recently occurred, and led to the total loss of investments.

- Liquidity shortage

Trading of virtual currencies on specialised exchange platforms implies sufficient demand from third parties. As a consequence, holders of virtual currencies may be unable to sell them, or only in adverse conditions. Also, the use of the gains, if any, resulting from the investments, may be limited.

- Historical rapid growth in value

The rapid growth in value of a limited number of virtual currencies may, under no circumstance, be considered as a guarantee for a future evolution. Recent substantial upward fluctuations of a certain number of virtual currencies in a short lapse of time triggered a wave of euphoria that drove investments in virtual currencies. Many participants hope that past evolutions will repeat and that the value of their portfolio will grow exponentially. The impression of missing out may obscure the serious underlying risks. Participants should consider that past evolutions are not a guarantee for the future, and fluctuations may also take the opposite direction, and that they could thereby lose everything.

- Operational disruption

The technologies underlying virtual currencies and the services relating to the creation, storage and transfer of virtual currencies are particularly innovative so that they may be vulnerable. As a consequence, they may expose users to lasting or temporary disruptions of systems, hacking attempts, problems relating to activity peaks, etc. In periods of disruption, holders of virtual currencies are not able to carry out transactions at the desired moment and may thus suffer considerable losses due to the fluctuations in value during that period.

- Misleading information

The information provided to investors is very often incomplete, difficult to understand or not reflecting all the risks underlying virtual currencies.

- Lack of transparency of costs and price formation process; risk of price manipulation

Due to the lack of regulation regarding transparency of costs and the price formation process and the key information to provide to investors in virtual currencies, there is a risk of VC price manipulation. As a consequence, in the absence of such rules and failing oversight of the price formation process, a fair and equitable treatment of information provided to the different participants may not be guaranteed and investors risk not being able to exchange virtual currencies at a fair price. For certain currencies and certain exchange platforms, the purchase and sale costs are very high and opaque.

- An investment which does not suit all types of investors and objectives

The high volatility of VCs entails for most consumers that investing a significant proportion of their portfolio in VCs is not appropriate, and, under no circumstances for long-term projects such as retirement projects.

- Fraud and money laundering

The lack of regulation and supervision is likely to attract criminals that wish to use VCs in fraudulent schemes, in the context of ransomware, to launder funds from illegal origins or for the financing of terrorism.

The CSSF recommends investors to be prudent in their acquisitions

Assessing the risks associated with a virtual currency can prove difficult. This is due to the fact that a technical understanding of their functioning as well as a thorough analysis of the market that accepts the virtual currency as means of exchange, is crucial.

The CSSF advises the persons wishing to buy virtual currencies or relating financial products, to gain exhaustive knowledge on the risks linked to such an acquisition beforehand. To this end, the CSSF strongly recommends verifying the following key elements and to be extremely prudent before investing in virtual currencies:

- Understanding how virtual currencies in which investment is sought work, and notably understand the technology of the underlying distributed ledger;
- Analysing the risks associated with the envisaged investment and assess the possible consequences of the total loss of investment on one's financial situation;
- Inquire about how virtual currencies are kept and how the support is secured;
- Ensuring that one's electronic devices are adequately protected to prevent any unauthorised access;
- Verifying that the exchange service provider, if it pretends to be authorised, really is authorised in its home country and if so, the extent of this authorisation, i.e. which services are supervised.

The CSSF reminds that it is essential not to risk money one cannot afford to lose.

Information for entities under the prudential supervision of the CSSF

As stated in the risk section above, the entities under the prudential supervision of the CSSF must take into account that investing in virtual currencies is not suitable for all kinds of investors and investment objectives. UCITS, UCIs addressing non-professional customers and pension funds are thus not allowed to invest directly or indirectly in virtual currencies.

Information for service providers that use virtual currencies or provide services in relation to virtual currencies

As explained above, there is currently no legal framework in Luxembourg or at European level that specifically applies to virtual currencies. However, it should be borne in mind that any provision of financial sector services by a natural or legal person requires an authorisation by the Minister of Finance. In this context, the importance of money laundering and terrorist financing which must undergo reliable procedures.

Legal qualification of virtual currencies and services provided relating to these virtual currencies is complex, notably given the technical specificities inherent in the different types of virtual currencies. That is why the CSSF invites the persons that envisage exercising an activity associated with virtual currencies (such as the issuing of means of payment in the form of virtual or other currencies, the offer of payment services using virtual currencies or other, or the provision of virtual currency exchange services) to submit their draft documentation to the CSSF beforehand. The CSSF will determine whether or not the activity is a regulated activity.

Given the cross-border character of VC transactions, establishing a national regulation would only have limited effects. The CSSF encourages an approach at European level, or even international level, notably as regards the legal qualification of VCs, possible impacts on the financial stability and market integrity, protection of non-professional investors and the prevention of the use of VC for money-laundering and terrorist-financing purposes.

Warnings issued by European Supervisory Authorities

The following warnings have already been released by the European Supervisory Authorities:

- https://www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf;
- http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf ;
- https://www.eba.europa.eu/documents/10180/1547217/EBA+Opinion+on+the+Commission's+proposal+to+bring+virtual+currency+entities+into+the+scope+of+4AMLD ;
- ESMA published a report on the possibilities of use, benefits and risks associated with distributed ledger technology in February 2017

  https://www.esma.europa.eu/sites/default/files/library/dlt_report_-_esma50-1121423017-285.pdf

Luxembourg, 14 March 2018