

CSSF Warnings on Initial Coin Offerings (“ICOs”) and Virtual Currencies

Executive Summary

- > On 14 March 2018, the CSSF issued two warnings to the public related to ICOs and virtual currencies.
- > The CSSF draws attention to the absence of specific protective regulation and guarantees at the national and European level.
- > The CSSF outlines certain risks related to ICOs and virtual currencies.
- > Undertakings for Collective Investment in Transferable Securities (UCITS), Undertakings for Collective Investment (UCIs) as well as pension funds are not permitted to invest directly or indirectly to ICOs and virtual currencies.
- > Certain legal provisions in Luxembourg and certain supervision requirements may apply to ICOs and virtual currencies, depending on their characteristics. ICO initiators should put in place procedures to prevent money laundering or terrorist financing operations.

1. Issuance of the Warnings

On 14 March 2018, the Luxembourg Financial Sector Supervisory Commission (“CSSF”) issued two warnings to the public related to Initial Coin Offerings (“ICOs”) and virtual currencies. The warnings are consistent with the statements on ICOs issued by ESMA on 13 November 2017 and the warnings on investments in virtual currencies issued by the EBA on 12 December 2013 and, jointly, by the European Supervisory Authorities on 12 February 2018. Similar statements were issued in the last months by financial supervisory authorities in the US and in EU Member States such as Germany,

France and the UK, showing that ICOs and virtual currencies are high in the agenda of financial regulators.

2. Virtual Currencies

Different terms are used to describe virtual currencies, such as “alternative currency” or “cryptocurrency”. In general, virtual currencies are means of exchange or digital representations of value, represented in the form of encrypted coins, which are neither issued by a central bank or a public authority, nor necessarily attached to a fiat currency, but are accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically. Hence, its value is derived solely from the trust that holders and users place in the acceptance of virtual currencies and thus there is no guarantee as to the underlying. From a legal point of view, there is currently no uniform definition of virtual currencies, either on a national or European level.

3. ICOs and Tokens

An ICO refers to a new means of fundraising by issuance of new coins or tokens without regulatory safeguards appropriate to the risks that investors are subject to.

An ICO is generally announced through the publication of a “White Paper” and, depending on the case, through an “executive summary”. The “White Paper” is a pivotal component of an ICO as it is a marketing document which contains a detailed description of the terms and conditions of the offer, its duration, the funding targets, the mechanism for subscription and issuance of the tokens, as well as any rights attached to the issued tokens. Contrary to prospectuses for the issuance of transferable securities, the content of a “White Paper” is typical-

ly neither legally regulated nor reviewed by a supervisory authority to ensure it is complete.

Upon expiration of the duration of the offer, the tokens are created and distributed to the investors. Once distributed, some of the tokens may confer holders with diverging rights as for example participation rights to the capital of the company or discount rights on certain services with regards to the use of a platform. In addition, these tokens can generally be stored in electronic wallets and can be structured in a way permitting their trading on specialized platforms.

4. The Risks Associated with ICOs and Virtual Currencies

The CSSF points out that ICOs and cryptocurrencies may involve significant and often unpredictable risks for both professional investors and consumers. In particular, the CSSF draws the attention to the following:

a. Absence of protection

For the time being there is no specific regulation applicable to ICOs and virtual currencies neither on national nor on a European level. Investments on ICOs and virtual currencies do not offer any guarantee or other form of specific protection and are highly speculative.

b. Success of the project funded

Projects funded through ICOs are generally in the development phase and are based on business plans that have not been subject to independent evaluation. Hence, there is no guarantee that the projects will be successfully developed and that they will generate any value in the future.

c. Loss of capital

Capital invested in tokens through secondary markets is not guaranteed. As a result, the capital invested may be partially or completely lost depending on market developments. Similarly, there is no guarantee that the project initiator will be able to fulfil its contractual obligations after publicly collecting the necessary funds. In this context, the rights assigned to the tokens may be rendered ultimately worthless.

d. History of rapid value increase

The important recent upward fluctuations of a certain number of virtual currencies over a short period of time have initiated a wave of euphoria in favour of ICO and virtual currencies investments. Many participants hope for the past developments to be repeated and thus for exponential growth of their portfolios. However, investors shall bear in mind that past rapid value on tokens and coins is not a precedent for continuing value increase of these markets.

e. Risk of tokens and coins to be stolen

Specialized platforms and storage systems may have security flaws and thus investors may not be able to access or control their coins or tokens, or the coins or tokens may be stolen in case of a hack.

f. Lack of liquidity

The tradability of tokens and virtual currencies on specialized platforms, if provided, is subject to sufficient liquidity, i.e. a sufficient number of tokens and virtual currencies in circulation and the existence of a request from third parties. As a result, holders of tokens and coins may not be able to resell them or only under unfavourable conditions.

g. Volatility

Tokens and virtual currencies may be subject to extreme price volatility and set a price bubble risk. As a result, any capital invested is not guaranteed and may, depending on price developments, be partially or totally lost.

h. Fraud and money laundering

The lack of regulation and supervision is likely to attract criminals who use ICOs and virtual currencies in order to create fraudulent schemes or engage into illicit activities such as money laundering or terrorist financing operations.

i. Flaws in the technology

Despite the fast evolution of technology allowing the creation, the transfer and the conservation of the tokens and virtual currencies, there may be still flaws in the relevant programs used for the above purposes, which may expose the investors to risks of temporary or permanent disruptions of the systems, piracy attempts or problems relating to peaks of activity.

j. *Misleading information, lack of transparency and risk of price manipulation*

In the case of ICOs, “White Papers” are not documents subject to specific regulations and may contain incomplete or even misleading information as to the description of the financed project and its economic potential, the general conditions applicable or the rights attached to the tokens issued and the charges levied. In the absence of surveillance by a public authority, the information disclosed by the initiator in the “White Paper” is not subject to any control or verification and may, in some cases, be incorrect. Subsequently, the absence of regulated information on the amount of tokens issued, the amount of money collected, the evolution of the rights attached to the tokens and the financial position of the initiator, won’t allow an investor or potential buyer to have an accurate picture of the value or possible liquidity of the token. This absence also constitutes a fertile ground for value manipulations in the event of trading on specialized platforms. In addition, in the case of virtual currencies, the available information to investors is either very often incomplete or difficult to understand or does not reflect all the risks associated with virtual currencies.

k. *An investment which does not suit all investors and objectives*

Under no circumstances investing on ICOs and virtual currencies shall be considered as appropriate for long-term projects such as retirement plans, due to fact that such businesses have an inherently risk of failure.

5. *The CSSF advises investors to be careful in their ICOs and virtual currencies investments*

The CSSF advises potential investors to be extremely cautious and to ensure the suitability and the soundness of the methods used by the ICO initiator by carrying out research on the latter, as for example in relation to the registered office of the relevant company, its legal form, the act of incorporation, the capital and the persons involved in the project, including the person and the country of origin of the account on which the amounts in currency or in virtual currency are to be paid.

In addition, the CSSF advises potential investors to ensure that they have fully understood the risks

related to the project and the returns on their investment before proceeding with any investment. The CSSF further recommends to the people wishing to buy tokens or virtual currencies to learn about the storage procedure, as well as to ensure that their electronic devices have adequate security measures in order to prevent unauthorized access. Finally, the CSSF in its statement outlines the fact that it is essential not to risk the money that we cannot afford to lose.

6. *Information to Entities Supervised by the CSSF*

The entities under prudential supervision of the CSSF must take into account the fact that investments in tokens or virtual currencies are not suitable for all types of investors and investment objectives. Hence, the CSSF specifically refers to the fact that Undertakings for Collective Investment in Transferable Securities (UCITS), Undertakings for Collective Investment (UCIs), which are addressed to non-professional investors as well as pension funds are not permitted to invest directly or indirectly to ICOs and virtual currencies.

7. *Information to Service Providers using ICOs and virtual currencies and to ICO Initiators*

Despite the absence of specific regulation applicable to ICOs and virtual currencies, the activities related to or implied by the creation and trade of tokens and virtual currencies, the collection or raising of funds may, depending on their characteristics, be subject to certain legal provisions in Luxembourg and therefore to certain supervision requirements, in particular the provisions of the Law of 10 July 2005 on prospectuses for securities and the Law of 5 April 1993 relating to the financial sector.

Initiators of ICOs should anyway put in place procedures to prevent money laundering or terrorist financing operations.

The CSSF warnings were issued in French. An English translation is available for information purposes via the following links:

[CSSF Warning on Initial Coin Offerings and Tokens](#)

[CSSF Warning on Virtual Currencies](#)

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