
TO : Cyprus Investment Firms

FROM : Cyprus Securities and Exchange Commission

DATE : 25 November 2020

CIRCULAR NO : C417

SUBJECT : Prudential treatment of crypto assets and enhancement of risk management procedures associated with crypto assets

The Cyprus Securities and Exchange Commission (the 'CySEC') wishes herein to provide guidance to the Cyprus Investment Firms ('CIFs') on issues relating to crypto assets¹. This circular deals with the prudential treatment of crypto assets and financial instruments relating to crypto assets, as well as, how the risk management procedures of CIFs should be enhanced².

In particular:

A. Calculation of own funds and capital adequacy ratio (Pillar I)

As noted in the [EBA's report on crypto assets](#) there is no reference in the current prudential framework for crypto assets. Thus, until a common application of the current rules is developed, the following treatment should be used by the CIFs when calculating their own funds and capital adequacy ratio, accordingly:

1. Direct investment in crypto assets on a non-speculative basis (banking book exposure)

When a CIF invests directly in crypto assets on a non- speculative basis, it should treat these investments according to Article 36(1)(b) of the Regulation (EU) No. 575/2013 (the 'CRR'), ie. direct capital deduction from own funds.

The above should be presented in Form 144-14-06.1, Sheet 'CA1', Row 350.

¹ For the purposes of this circular and until further notice with regards to the definition/classification of these, the term 'crypto assets' is the one included in [the EBA's report](#).

² It is provided that CIFs can only transact in crypto assets if they have obtained a permission to provide such services pursuant to article 6(9)(b) of Law 144(I)/2007 or article 5(5) of Law 87(I)/2007.

2. Direct investment in crypto assets on a speculative basis (trading book exposure)

When a CIF invests directly in crypto assets for speculative basis, it should treat these as investments in a derivative product subject to both of the following risks:

- i. Counterparty Credit Risk ("CCR") calculated according to Article 274 of the CRR, ie. a CIF should use the market-to-market method and apply a 10% potential future exposure percentage (PFCE).

The above should be presented in Form 144-14-06.1, Sheet 'CR-SA', Row 110.

- ii. Market Commodity Risk calculated according to Articles 355 to 361 of the CRR.

The above should be presented in Form 144-14-06.1, Sheet 'MKR SA COM', Row 050.

3. Direct investment of CIFs' clients in crypto assets and/or in financial instruments relating to crypto assets with the CIF acting as the counterparty to these transactions

When a CIF acts as the counterparty to its clients' trades by taking the opposite position to each client's transaction in crypto assets, and/or in financial instruments on crypto assets, the CIF is subject to Counterparty Credit risk and Market Commodity Risk, in accordance with the methodologies set out in point A. 2 above, as the CIF is acting as a market maker for its clients.

CIFs are expected to reflect the above treatment in the submission of the Form 144-14-06.1 (calculation of own funds and capital adequacy ratio) for the period ended 31 December 2020 which needs to be submitted to CySEC by 11 February 2021.

B. Internal Capital Adequacy Assessment Process ('ICAAP') (Pillar II)

4. CIFs should assess the risks emanated from trading in crypto assets, and/or in financial instruments relating to crypto assets, for their own account or for their clients within the Internal Capital Adequacy Assessment Process (ICAAP). The assessment and discussion of the risks associated with the activity in crypto assets should be included together with a sensitivity analysis that shows how the risks identified affect the CIFs' projections. In addition, any mitigations should also be discussed, stating any additional capital that should be held in relation to the identified risks.

C. Pillar III disclosures

5. CIFs should disclose within their Pillar III disclosures any material crypto-asset holdings and include information on:

- the exposure amounts of different crypto-asset exposures,
- the capital requirement for such exposures and
- the accounting treatment of such exposures.

D. Enhancement of risks management procedures associated with crypto assets

6. CIFs, which trade in crypto assets, and/or in financial instruments relating to crypto assets, should revisit their risk management procedures and strategies and ensure that all risks associated with this product are duly taken into consideration.
7. The below relevant regulatory provisions are reminded:
 - i. Section 68 of the [Law 144\(I\)/2007](#) (the “old CIF Law”), which is still in force as per the provisions of section 104(2) of [Law 87\(I\)/2017](#) (the “new CIF Law”), states that *“CIFs must have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. These strategies and processes are subject to regular internal review to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the CIF”*.
 - ii. Paragraph 6 of DI144-2014-14 of 2014 (‘the Directive’) states that *“CIFs must ensure that the board of directors approves and periodically reviews the strategies and policies for taking up, managing, monitoring and mitigating the risks the CIF is or might exposed to, including those posed by the macroeconomic environment in which it operates in relation to the statues of the business cycle”*.
 - iii. Paragraph 20(2) of the Directive states that *“the remuneration policy should be consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the CIF”*.
8. Considering the nature of crypto assets, CIFs should also examine taking mitigating measures against operational, cybersecurity and reputational risks.

Yours sincerely

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