
TO : Cyprus Investment Firms

FROM : Cyprus Securities and Exchange Commission

DATE : 15 May 2018

CIRCULAR NO.: C268

SUBJECT : Introduction of new rules governing derivatives on virtual currencies

A. INTRODUCTION

Further to the European Securities and Markets Authority's ("ESMA") [decision](#) on 27 March 2018 to include Contracts For Differences ("CFDs") on virtual currencies¹ into the scope of its product intervention measures, CFDs on virtual currencies are considered as financial instruments under the Investment Services and Activities and Regulated Markets Law of 2017² (the "Law").

In line with the Cyprus Securities and Exchange Commission's ("CySEC") [announcement](#) dated 28 March 2018 notifying Cyprus Investment Firms (CIFs) of ESMA's product intervention measures, CySEC wishes to update CIFs with a new circular to incorporate this development. This Circular (C268) replaces [Circular C244](#) (as issued on 13 October 2017) regarding the trading in virtual currencies and/or trading in CFDs relating to virtual currencies.

In effect, virtual currencies may constitute an underlying variable in other derivative contracts including CFDs, options and futures (the "Derivative on Virtual Currencies"). To this end, CySEC hereby clarifies the following:

1. Any activity relating to virtual currencies is not currently regulated by CySEC, unless a virtual currency meets the criteria and falls under the existing regulatory framework as per CySEC's [announcement](#) dated 15 November 2017.

¹ The term 'virtual currencies' includes cryptocurrencies, tokens and digital coins.

² Transposing Directive 2014/65/EE of the European Parliament and of the Council of 15 May 2014 ("MiFID II") on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

2. However, Derivatives on Virtual Currencies are now capable of qualifying as financial instruments under the Law. A “*financial instrument*” means those instruments specified in Part III of the First Appendix of the Law. Among the financial instruments listed in Part III of the First Appendix of the Law, Derivatives on Virtual Currencies may fall under the following:
- i. (4): “[...] *any other derivative contracts relating to securities [...] which may be settled physically or in cash*”;³
 - ii. (9): “*financial contracts for differences*”;⁴
 - iii. (10): “[...] *any other derivative contracts relating to assets [...] not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments*”.⁵
3. Therefore, depending on their specific characteristics and use, providing investment services in relation to derivatives on virtual currencies will require specific authorisation by CySEC.

B. OBLIGATIONS OF CIFs WHEN PROVIDING INVESTMENT SERVICES IN DERIVATIVES ON VIRTUAL CURRENCIES

CIFs conducting regulated activities in Derivatives on Virtual Currencies, including in CFDs on Virtual Currencies (hereinafter collectively referred to as “Derivatives on Virtual Currencies”) must be authorised and must comply with the applicable national legislation, directly applicable European Union regulations, the Guidelines or Recommendations issued by the European Supervisory Authorities (ESMA and the European Banking Authority), which are adopted by CySEC and with the Q&As, Opinions and other Convergence Tools published by ESMA.

It is the view of CySEC and its peers that the risks associated with the underlying instrument in derivatives on virtual currencies are high. CIFs should consequently approach the provision of such services with caution, in the knowledge that close attention will be paid to all of their legal obligations. To this end, CySEC would like to particularly remind CIFs of their obligations to:

- i. act honestly, fairly and professionally, in accordance with the best interests of their clients;
- ii. provide fair clear and not misleading information to their clients;
- iii. provide appropriate guidance on and warnings of the risks associated with investments in those instruments;
- iv. have adequate product governance arrangements;

³ Corresponding to Section C(4) of Annex I of MiFID II.

⁴ Corresponding to Section C(9) of Annex I of MiFID II.

⁵ Corresponding to Section C(10) of Annex I of MiFID II.

- v. execute orders on terms most favorable to the client;
- vi. maintain adequate capital.

To that end:

- i. CIFs should thoroughly consider their obligations under the Law when designing/ manufacturing and/or distributing Derivatives on Virtual Currencies.
- ii. CIFs should inform their clients before investing into Derivatives on Virtual Currencies:
 - a) of the risks associated with these products. These risks should be stipulated in a specific risk warning;
 - b) that such products are complex, extremely risky, and usually highly speculative;
 - c) that they entail a high risk of losing all the invested capital;
 - d) that the values of virtual currencies values are subject to extreme price volatility and hence may result in significant loss over a short period of time;
 - e) they are not appropriate for all investors. As such, customers should not engage in trading in relation to such products if they a) do not have the necessary knowledge in this specific product; or b) if they cannot bear the loss of the entire invested amount. Customers must be fully aware of, and understand, the specific characteristics and risks in relation to these products.
 - f) of the fees and costs entailed. In particular, CIFs must disclose and explain any roll over fees.⁶
- iii. In the event of a CIF providing investment services in relation to OTC Derivatives on Virtual Currencies, the CIF should ensure that the reference prices used in relation to the underlying asset are gathered from publicly available sources of good repute. CIFs should perform a thorough evaluation before selecting its pricing sources. Moreover, CIFs must undertake an ongoing evaluation and review of its pricing sources, in order to ensure that it complies with the best execution requirements.
- iv. CIFs must also include the risks associated with their activities relating to Derivatives on Virtual Currencies when calculating their capital adequacy ratios. Where relevant, they should adjust their risk mitigation strategies. CIFs should consider the potential impact of their activity in Derivatives on Virtual Currencies on their wider operations, and adequately address the risks associated with these activities in the context of their Internal Capital Adequacy Assessment Process (ICAAP).

⁶ Overnight charge/swap rate.

Taking into account the extremely volatile nature of virtual currencies, CIFs that engage in investment activities in relation to OTC derivatives on virtual currencies will be expected to maintain an adequate additional capital buffer of the highest quality of their capital (common equity tier 1 capital) in the context of their ICAAP, in order to enhance their resilience.

- v. In addition to the above, when providing services to clients in CFDs on virtual currencies, [ESMA's product intervention measures relating to Contracts for Differences and binary options](#) also apply. CIFs must therefore ensure that they also abide to the leverage limits (1:2), the margin close out rule, negative balance protection, the restriction on incentives and providing a firm-specific risk warning. It is also stressed that CIFs providing services to clients in CFDs on virtual currencies should also abide by the [ESMA Questions and Answers Relating to the provision of CFDs and other speculative products to retail investors under MiFID](#).

C. NEXT STEPS

CIFs that have submitted an application for the provision of services in relation to Derivatives on Virtual Currencies, as "*other service*" pursuant to Article 5(5) of the Investment Services and Activities and Regulated Markets Law of 2017 and have not yet had a decision communicated to them, may claim back the application fees they have paid by contacting the Accounting Department of CySEC at accounts@cysec.gov.cy.

No reimbursement will be provided to the cases where the application was fully examined and a decision was reached and communicated to the respective CIF.

CIFs should seek for the appropriate permission for the provision of services in relation to the category of financial instruments that the respective Derivative on Virtual Currency falls. If a CIF is not sure as to which category the specific Derivative on Virtual Currency may fall, we encourage you to seek advice before submitting an application to CySEC.

CIFs offering such products without the appropriate permission will encounter enforcement actions.

Yours sincerely

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