LUXEMBOURG FINANCIAL SERVICES REGULATOR CSSF ISSUES FAQ ON INVESTMENTS IN VIRTUAL ASSETS BY UNDERTAKINGS IN COLLECTIVE INVESTMENTS AND CREDIT INSTITUTIONS

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Luxembourg Asset Management and Investment Funds Alert

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Like other financial centers, Luxembourg has recently seen a strongly growing interest in investments in new technologies, including virtual assets such as digital tokens. Complementary to that interest is a growing strong demand for guidance regarding the regulatory treatment of virtual assets.

Luxembourg law defines a "virtual asset" (VA) as a digital representation of value, including a virtual currency, that can be digitally traded, or transferred, and can be used for payment or investment purposes, except for digital (i) financial instruments and (ii) electronic money.[1]

On 4 January 2022, the Luxembourg financial sector supervisory authority, *Commission de surveillance du secteur financier* (CSSF), updated and complemented its frequently asked questions (FAQ) on investments in VA by (i) undertakings for collective investments and (ii) credit institutions (CI). The FAQ, which were first published at the end of 2021, are in furtherance of the CSSF's guidance published on 29 November 2021 and its previous communications on virtual asset service providers (VASP).[2] They will be updated from time to time going forward. On the European level, the forthcoming European Regulation on Markets in Crypto Assets[3] is expected to influence the regulatory framework in the foreseeable future.

1. KEY TAKEAWAYS OF THE CSSF'S NOVEMBER 2021 GUIDANCE

The CSSF embraces the challenges raised by financial innovation such as VA. As part of its mission, the CSSF is committed to promote an open, technology neutral and prudent risk-based regulatory approach. Any entity under the prudential supervision of the CSSF intending to pursue an activity involving VA is required to carry out a thorough due diligence, weigh the risks and benefits of such activity and proactively engage with the CSSF when planning such activity.

2. UNDERTAKINGS FOR COLLECTIVE INVESTMENTS

2.1 Investment in VA Reserved to Professional Investors

Only regulated or unregulated alternative investment funds that are marketed to professional investors (AIFs), may invest in VA. In contrast, undertakings for collective investments that are marketed to non-professional investors and pension funds generally may not invest in VA.

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An AIF may invest in VA directly or indirectly (such as through using derivative instruments), provided that such investment does not compromise the existing regulatory requirements applicable to that AIF. AIFs interested in the investment in VA must bear in mind that VA are specific in terms of volatility, liquidity, and technological risk, all of which may affect the AIF's risk profile. Furthermore, it is important for the AIF to keep investors informed in a timely and transparent manner and to update the fund documentation.

2.2 Requirements for Luxembourg Investment Managers

Specific requirements apply to Luxembourg authorized investment managers (IFMs) managing an AIF investing in VA.

An IFM managing an AIF that invests or intends to invest in VA must obtain prior authorization by requesting an extension of its license for the strategy referred to as “Other-Other Fund-Virtual Assets”. In the context of the license extension, particular emphasis is put on the risk management, the valuation determination, the Anti-Money-Laundering/Counter-Terrorism Financing analysis and mitigation, and the control of the VA (that is, access to, and control over, the cryptographic keys).

Depending on the activities performed by the IFM (or another participant in the management of the AIF), it may be necessary to apply to the CSSF for registration as a VASP.

2.3 Requirements for Luxembourg Fund Depositaries

A Luxembourg authorized fund depositary must notify the CSSF before acting as depositary for an AIF investing directly in VA, and it must implement both organizational arrangements and an operating model that appropriately reflect the specific risks related to the safekeeping of VA.

In respect of VA that are ineligible to be held in custody as financial instruments under article 19(8)(a) of the Luxembourg law of 12 July 2013 on alternative investment fund managers, as amended, the depositary's role is limited to ownership verification and record keeping (as opposed to the safekeeping of financial instruments).

A Luxembourg fund depositary that provides services related to the safekeeping or the administration of VA (including the custodian wallet service) must file an application with the CSSF for registration as a VASP. In addition, a depositary envisaging to directly safeguard VA has to inform the CSSF of that intention.

3. CREDIT INSTITUTIONS

Banking regulation does not prevent a CI from investing in VA directly (subject to certain accounting and capital-related requirements),[4] or from opening accounts that permit its customers to deposit their VA. However, CI cannot take deposits, or execute payments, in virtual currencies.

The CSSF requires that a CI intending to offer VA-related services or to directly safeguard VA consult with the CSSF before starting that activity (with a particular focus on the governance and risk management frameworks, the effective handling of counterparty and concentration risks and the implementation of investor protection rules).

Where a CI is acting as a fund depositary, the rules outlined under point 2.3 above apply.

Depending on the circumstances, it may be necessary for a CI to file an application with the CSSF for registration as a VASP before it can offer VA-related services.

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FOOTNOTES

[1] See article 1 (20b) of the Luxembourg law of 12 November 2004 on the fight against money laundering and terrorist financing, as amended (the 2004 Law). Financial instruments are defined in article 1 (19) of the Luxembourg law of 5 April 1993 on the financial sector, as amended. Electronic money is defined in article 1 (29) of the Luxembourg law of 10 November 2009 on payment services, as amended.
This legal alert only considers VA. Where other digital assets meet the requirements of financial instruments or electronic money, the established regulatory framework in that respect continues to apply.

[2] VASP is defined in article 1 (20c) of the 2004 Law. See, in particular, the application form for registration as VASP published on 9 April 2020 and the study on the vertical risk assessment of VASP published on 27 January 2021.

[3] See the proposal of the European Commission for a regulation of the European Parliament and of the Council on markets in Crypto-assets, and amending Directive (EU) 2019/1937, dated 24 September 2020, COM(2020) 593 final.

[4] See in this context the consultative document on the prudential treatment of crypto-asset exposures of the Basel Committee on Banking Supervision of the Bank for International Settlements, dated June 2021, and the related client alert available at https://www.klgates.com/Digital-Tokens-and-the-Banking-System-Basel-Committee-Proposes-Risk-Weighted-Assets-Framework-for-Cryptoassets-7-12-2021.

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