

# Nicolas Roth: «This is the Dark Side of Crypto Coins»

Friday, 9 February 2018 15:58



Nicolas Roth

**The cryptocurrency world is full of potential landmines for prospective buyers. Nicolas Roth explains how investors can avoid pitfalls, in an exclusive essay for *finews.first*.**

**The first hurdle** for anyone who decides to gain exposure to cryptocurrency comes with the choice of instrument. As with gold, investors can access synthetic or physical exposure. Synthetic exposure is achieved by buying an exchange-traded fund or a one that affords exposure to cryptocurrency prices. Given that some of the key underlying principles of cryptocurrencies are privacy, protection and decentralization, there is something contradictory in buying an ETF and leaving it in the hands of a custodian.

It is the same reasoning that has always pushed perma-bears into buying gold bullions and storing it in specific facilities rather than buying into the gold and silver index XAU.

However, in early 2018, finding the right financial instrument to gain exposure to the space is not as straightforward as with other more mainstream asset classes – only a handful of products are available.

Most funds are managed by first time teams with little experience in money management, while being registered in offshore places such as the British Virgin Islands or Caymans. In the era of UCIT funds and alternative investment funds, or AIFs, investing in a BVI to gain exposure to cryptocurrency seems like a serious U-turn on risk and good governance principles!

«Account opening can be a tedious process»

The alternative to an ETF is an account with a platform that offers crypto trading. Platforms and exchanges haven't had the best press of late, developing a reputation of being vulnerable to hacking and heists. Most recently, Japanese platform Coincheck was lightened of a hefty

\$400 million in bitcoin and other cryptocurrencies. However, for most cryptocurrency investors, the fear of missing out outweighs the risk of losing it all. This has pushed many market participants onto platforms without fully vetting their security.

Nevertheless, platforms offer easy money transfers from a credit card or a bank account to an exchange to buy a choice of the top four cryptocurrencies: bitcoin, ethereum, litecoin, or bitcoin cash. Anyone looking to trade in alternative coins such as iota, ripple, augur or factom must first open an account on platforms that can only be funded in cryptocurrencies, adding some complexity in the process. Some exchanges of alternative coins are often questionable, and account opening can be a tedious process.

«The coins are held outside of the exchange, but can still be at risk of an attack»

How to store cryptocurrency is another real-life problem that large investors face. Because exchanges are notorious for being not very reliable, anyone who has accumulated a large amount of coins must consider a safer solution, akin to a bank vault. Storage can be roughly classified by three levels of risk, the riskiest of which consists of leaving coins on the exchange. In this scenario, the coins are technically the property of the exchange and can only be accessed through the exchange; this becomes impossible when a platform is down.

The second storage system is in a wallet - an application designed to store private keys. This means the coins are held outside of the exchange, but remain on the network and are still at risk of attack.

The third and most secure storage system involves taking the coins off the network and putting them in «cold storage». The simplest form of this is a piece of paper with the private key. More complex systems might include hard drives disconnected from the internet held in physical vaults. Although cold storage ranks as the most secure storage protocol, it removes most of the liquidity for the investor, because the private key to the coins is off the network. Cold storage would therefore be ill-suited to investors who require swift access to their cryptocurrency.

«This list of potential potholes for investing in cryptocurrencies is non-exhaustive»

The fiscal treatment of cryptocurrencies is also a point of contention. Consider a scenario in which a miner has mined a large amount of coins. In order to be monetized, the cryptos must be exchanged against fiat such as euros or dollars, and subsequently deposited into a bank account. The fiscal problem comes to declaring this bank account's existence. Is the amount in the account the result of work, in which case it should be treated as income and taxed as such? Or should it be considered existing wealth and taxed at the appropriate rate? This remains an open question, but it's likely that fiscal authorities will tackle this issue very soon. This list of potential potholes for investing in cryptocurrencies is not exhaustive, and one can add the low quality of execution on some exchanges, potential delays in transactions being confirmed on the blockchain during congestion, as well as high transaction fees on the bitcoin blockchain. However, cryptocurrencies are the most visible part of a technological innovation that is likely to radically change the way business is conducted. Take, for example, the ability that initial coin offerings and tokenisation have to disrupt the access to venture capital for new companies in need of financing.

There is much around cryptocurrencies that is not yet clear, but what's certain is that blockchain will shake up many industries, including financial services. Despite the risks and volatility, cryptocurrencies are a reflection of the tectonic shift in how business is conducted, and so a few little earthquakes are to be expected...