Investor Advisory: Bitcoin & Other Virtual Currencies

Virtual currencies, which include digital and crypto-currencies, are gaining in both popularity and controversy. Virtual currencies can offer lower transaction fees and greater anonymity. However, virtual currencies can carry substantial risk. Virtual currencies have fluctuated wildly in value, investors have had their investments in virtual currencies stolen by hackers, and MtGox, previously the largest virtual currency exchange, recently shut down after losing more than $350 million of Bitcoin.

What is Virtual Currency?

Virtual currency is an electronic medium of exchange that, unlike real money, is not controlled or backed by a central government or central bank. Virtual currencies include crypto-currencies such as Bitcoin, Ripple, Litecoin, Peercoin, and Dogecoin. Such currencies can be bought or sold through virtual currency exchanges and used to purchase goods or services where accepted. Even though some companies and individuals may accept a virtual currency as a monetary equivalent, the Internal Revenue Service has announced that it would treat virtual currency as “property” and not “currency” for tax purposes.

Risks Associated with Virtual Currency

As with all investments, those tied to virtual currency have risk. However, buying and trading in virtual currencies carries unique risks that are not found in other investments. Some common concerns and issues you should consider before investing in any virtual currency include:

- Virtual currencies are not legal tender, so stores, websites or people do not have to accept them as a form a payment. For example, if no one accepts Bitcoins, Bitcoins can become worthless.
- Virtual currency holdings are vulnerable to hacking attacks. There may be no way to recover stolen virtual currency.
- Unlike stocks, bonds, treasury bills, or other traditional investments, virtual currencies are not backed by any assets, legal rights or guarantees.
- Virtual currency accounts are not insured by the Federal Deposit Insurance Corporation (FDIC). (When a regular bank collapses depositors can recover up to $250,000, but when a virtual currency exchange collapses, account holders may be left with nothing).
- Virtual currencies are extremely volatile, and are therefore unsuitable for most investors.
- Investors in virtual currencies are highly reliant upon unregulated companies that may lack appropriate internal controls and may be more susceptible to fraud and theft than regulated financial institutions.
- Investors must rely upon the strength of their own computer security systems, as well as security systems provided by third parties, to protect their investments from theft.
- The IRS has found that virtual currencies are “property” for tax purposes. This means that, while fluctuations in the value of American dollars do not produce capital gains, profits realized on virtual currencies may be taxable as capital gains.
- Unlike regular currencies, virtual currencies may be restricted or banned by national governments. Governments are incentivized to restrict use of virtual currency because virtual currencies’ anonymity has historically facilitated illicit transactions, as seen with the Silk Road, a largely criminal website recently shut down by the FBI. Silk Road users accepted virtual currency as a medium of exchange for drugs, human trafficking, and murder for hire.

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Virtual Currency as an Investment

In addition to being used as a method of payment and exchange, virtual currencies are emerging as a popular underlying asset for a variety of investments. The use of virtual currency may exacerbate the existing risks inherent in such products and strategies. These investments include:

- Commodities. Virtual currency can be used as an investment in essentially the same way as gold or other commodities. Investors may purchase virtual currency with the expectation that they will be able to sell the currency for a higher price in the future. This can be highly speculative because virtual currency values can fluctuate dramatically throughout the day and each exchange can value the currency differently. *(For details: NASAA Commodity Alert.)*

- Exchange Traded Funds. A traditional Exchange Traded Fund (ETF) tracks a basket of stocks or a commodity and is traded on a stock market. An ETF may be made up of only virtual currencies, each with a value that fluctuates differently. *(For details: NASAA ETF Advisory.)*

- Derivatives. A derivative is a financial product with value that stems from an underlying asset (e.g., stocks, bonds, or Bitcoin) that contains an agreement between parties. The most common types of derivatives are futures, warrants, convertible bonds and swaps. In this case, an investor bets on the price swing of the virtual currency. *(For details: NASAA Derivatives Advisory.)*

Schemes Involving Virtual Currency

The Securities and Exchange Commission took enforcement action against a man in Texas who convinced others to give him their Bitcoin holdings in exchange for the promise of receiving even more Bitcoins in the future, plus seven percent interest a week. The scam was exposed when the promoter was not able to pay the promised returns. *(For details: SEC v. Shavers, et al.)*

The Bottom Line

It pays to do your homework before participating in any investment opportunity, including virtual currency. If you have any questions about virtual currency, contact the Attorney General's Investor Protection Unit at investor.protection@state.de.us or by visiting http://www.attorneygeneral.delaware.gov/fraud/ipu/.
You can call the Delaware Investor Protection Hotline at **(302) 577-8801**.

To learn more about virtual currency, additional resources include:
Bitcoin: More than a Bit Risky, Financial Industry Regulatory Authority
Ponzi Schemes Using Virtual Currency, U.S. Securities and Exchange Commission