

## BANK OF ITALY DRAWS ATTENTION OF MARKET PARTICIPANTS TO DLT AND CRYPTO ASSETS IN THE FINANCIAL SECTOR

With communication dated June 16, 2020 ("**Communication**"), the Bank of Italy draws attention of market participants to the increasing of the spread of distributed ledger technologies ("**DLT**") within the financial sector, and to the uses attributable to the holding and transfer, by those technologies, of the so called crypto-assets, and the risks arising from the lack of controls over their use.

At the international and European level, several supranational authorities, governments, central banks and supervisory authorities are trying to outline regimes and controls for these products and their related "ecosystems", in an effective way both in relation to their economic function and to the different risk profiles, taking into account in particular the variety of existing case histories, but their entry into force will still take time.

Meanwhile, the Bank of Italy, with the Communication, intends to pursue two objectives: from one side to draw attention of supervised intermediaries, supervised entities and those operating in various capacities in decentralized ecosystems, including where acting as users, to both opportunities and risks associated with the use of these technologies in finance and with crypto-related activities and services (issuance, custody, exchange, lending, payment services, see below); from the other side to highlight some profiles relevant to the definition, by those entities, of safeguards aimed at mitigating the risks associated with the use of decentralized technologies and/or crypto-asset operations.

The Communication is divided into five paragraphs concerning respectively:

### 1) **main features of the application of DLT to financial services**

The development of DLT in the field of financial services is based on the central role of cryptography and DLT.

If properly developed, DLT can bring benefits to users, connected with improvements in efficiency and speed in the delivery of financial services. However, within DLT solutions, the parties involved do not act in ways that can be attributed to the traditional financial system and, therefore, are difficult to frame in existing regulation.

DLT systems for cryptocurrency exchange can take different forms depending on whether:

- (i) DLTs are "*permissioned*" or "*permissionless*" i.e. whether or not it is possible to identify a "*central party or entity, which de facto assumes governance responsibilities.*"
- (ii) crypto-assets can be traded directly from "*user*" to "*user*" (so called pure DeFi) or through operators performing specific "*exchange*" and crypto-asset trading activities,

- (iii) crypto-assets lack a stabilization mechanism without a link between their value and a reference activity ("*unbacked crypto-assets*") or vice versa are secured by underlying assets ("*asset linked stablecoins*"). The use of the former, as underlined by the Communication, should not be incentivized, as they are devoid of intrinsic value and not assisted by any right on the part of the user to receive anything.

## 2) **state of international cooperation and the relevant regulatory environment**

From a financial perspective: at the European level, the Digital Financial Package (including Regulation (EU) 2022/858, on a pilot scheme for market infrastructure based on DLT technology (so-called DLT pilot regime, see our [Client Alert 4/2022](#) ), as well as two legislative proposals: the Markets in Crypto Assets Regulation (MiCAR) and the Digital Operational Resilience Act (DORA)) was approved in September 2020. The first one introduces a harmonized framework for the issuance and public offering of crypto assets (other than financial instruments under the MiFID Directive), and the second one aims at strengthening the digital resilience of the entire financial sector. Certain entities involved in decentralized finance systems such as programmers (of smart contracts) and holders of governance tokens of so-called "Decentralized Autonomous Organization" (Dao) as well as so-called unhosted wallets, software that enables peer-to-peer exchange between addresses on DLT, turn out to be excluded from the MiCAR regulation. Unique and non-fungible crypto-assets, so-called *Non-fungible tokens* or NFTs, such as digital art works, also remain excluded from the regulations.

The Bank of Italy, jointly with Consob and the UIF, has over time issued various warnings for supervised intermediaries and users, highlighting the risks associated with buying and holding crypto assets.

However, pending the finalization of MiCAR, there is currently no specific regulatory framework for crypto assets in Italy.

From an AML perspective: the Commission, in July 2021, presented a proposal to reform the regulatory and institutional framework for AML/CFT.

Pending the approval of the European regulatory proposals, Italy's AML legislation, set forth in Legislative Decree n.231/2007 as amended by Legislative Decree n.125/2019, embraces a very broad notion of both virtual currency (which includes crypto-assets with both payment and investment purposes) and a Virtual Asset Service Provider (VASP), comprising any natural or legal person offering services related to virtual currencies on a professional basis that are to be registered in a special section (established ex novo and active as of May 16, 2022) of the register of money changers kept by the OAM.

## 3) **references for supervised intermediaries and entities attracted under the supervision of the payments system**

This Communication is intended to call out certain profiles of attention for banks, financial intermediaries and players attracted within the scope of payment system oversight, as well as technology providers. Operations related to crypto-assets must be carefully supervised from a sound and prudent management perspective. In the absence of full supervision of the above-mentioned risks, the Bank of Italy requires banks and financial intermediaries to refrain from conducting this type of activity or to discontinue it.

Pending the definition of regulations, which are currently being developed at the international and European level, regardless of the specific type of operation in the crypto-asset sector, the current prudential regimes contain principles to which banks and other supervised intermediaries can immediately refer to assess and

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guard against the risks associated with the possible initiation of operations in crypto-assets.

The Communication defines certain safeguards that intermediaries are required to provide (e.g. appropriate definition of customer groups, fairness of the relationship with customers, adoption of the necessary safeguards for the containment of operational risks and the protection of cybersecurity, accurate assessment of the prudential treatment applicable to any exposure in crypto-assets, etc.).

#### 4) **possible risks to crypto-asset users**

The use of crypto-assets may involve risks of various kinds. Indeed, crypto-assets are not currently subject to the regulations on transparency of banking products, payment services and investment services and lack specific protections.

Clients should be aware of the risk of even total loss of invested capital, fraud and error, and the lack of safeguards.

In this regard, the Bank of Italy draws attention to the warnings already published, including jointly with Consob, the reports adopted by the ESAs as well as the guidelines issued by international bodies (FSB, FATF).

In the meantime, the Bank of Italy invites supervised intermediaries to take the most scrupulous care possible, even in the absence of regulatory prescriptions, of the information to be given to customers who intend to purchase and hold crypto-assets using any channels made available by the intermediaries and operators themselves.

#### 5) **next steps of Bank of Italy to the orderly and secure development of new digital solutions**

The Bank of Italy will continue to collaborate in the various international and European fora, jointly with the ECB and other national supervisory authorities, to set high quality standards and to strengthen dialogue with market participants with the aim of:

- (iv) foster the development of operational models;
- (v) ensuring an adequate level of interoperability (and "conversational standards") between different technological solutions supporting decentralized finance and cryptocurrency operations;
- (vi) ensure compliance with existing regulations, particularly AML regulations;
- (vii) foster competitive parity with other jurisdictions in light of technological development.

#### **DISCLAIMER**

The sole purpose of this Client Alert is to provide general information. Consequently, it does not represent a legal opinion nor can it in any way be considered as a substitute for specific legal advice.

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