

Bhavnish Kaur Chhabda and Vasanthi Hariharan, 'Cryptocurrency in India: Empowered in 2020?' (2021) 7(2) NLUJ L Rev 246

**CRYPTOCURRENCY IN INDIA: EMPOWERED IN 2020?**

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**ABSTRACT**

*Cryptocurrencies are distinguished from traditional currencies by way of their operation as a medium of exchange through the use of blockchain technology and their freedom from a central authority, regulatory or otherwise. While cryptocurrencies enamoured the world and the number of interested parties grew, governments of different nations became apprehensive of their potential dangers. India was no different, however since there was no explicit ban, cryptocurrency business slowly started becoming prominent locally. In April 2018, the Reserve Bank of India issued a circular which barred banks and other financial institutions from facilitating transactions involving cryptocurrencies. Subsequent to a challenge, the Supreme Court of India set aside the said circular which resulted in a temporary respite for cryptocurrencies. This paper adopts a comparative understanding of how other countries have responded to the growth of cryptocurrency business so as to determine their future in India. With this approach, it becomes apparent that only a permissive framework will benefit Indian regulators in addressing the risks associated with cryptocurrencies. If undertaken properly, such an approach has the potential to*

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*boost India's economic growth and make it an epicentre of industrial development. It is concluded that at the heart of cryptocurrency regulation lies the challenge of correctly classifying crypto-assets and identifying appropriate regulators. It is only a carefully calibrated legal framework that will protect the interests of stakeholders and enable blockchain-based growth in India.*

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## **I. INTRODUCTION**

From tweets on Twitter that dramatically affect the stock prices of a company<sup>1</sup> to negative effects on market strength due to sudden developments in the ongoing global pandemic,<sup>2</sup> the volatility of the financial market has become apparent to regular investors as well as laymen. The cryptocurrency market is one such example of a market that is known for fluctuations. Even though some view cryptocurrencies as a safe haven asset<sup>3</sup> or a hedge against the effects of global politics on the market, there are several risks associated with it. The speculative nature of cryptocurrencies brings volatility and instability in their value. The risk of cyber hacking is high and the anonymity in transactions results in various money laundering and terrorism financing activities through the cryptocurrency market. Therefore, countries around the world are considering the regulation of cryptocurrencies, or in a broader sense, of virtual currencies (“VCs”). Such regulation will help in ensuring that shocks caused by this market can be remedied through the existing infrastructure, and its investors can be protected. This has led to an important and widespread debate on nature, function, and ultimately, legality of

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<sup>1</sup> David Canellis, ‘Tesla stock crashes after Elon Musk tweets: Tesla stock too high imo’ *The Next Web* (1 May 2020) <<https://thenextweb.com/hardfork/2020/05/01/tesla-stock-crashes-after-elon-musk-tweets-tesla-stock-too-high-imo/>> accessed 19 October 2020.

<sup>2</sup> FE Bureau, ‘Covid fears: Markets plummet tracking global peers’ *Financial Express* (16 June 2020) <<https://www.financialexpress.com/market/covid-fears-markets-plummet-tracking-global-peers/1992804/>> accessed 19 October 2020.

<sup>3</sup> Zack Guzman, ‘Coronavirus helps make the case for crypto: Tom Lee’ *Yahoo! Finance* (5 February 2020) <<https://finance.yahoo.com/news/bitcoin-could-top-18000-if-history-of-this-technical-buy-signal-repeats-itself-tom-lee-213148645.html>> accessed 19 October 2020.

cryptocurrencies. The central focus of this paper is the prevailing debate regarding cryptocurrencies in India.

Cryptocurrency is an innovation in the financial technology space and, therefore, its unique nature is an important factor to be considered in its regulation. The key characteristics of cryptocurrency include its existence as a digital asset, the lack of any central regulatory authority, decentralization of the public account using distributed ledger technology (“DLT”), and the use of cryptography to secure the transaction records.<sup>4</sup> Despite not being a legal tender, it serves as a medium of both, exchange and investment. The advent of blockchain technology has enabled the development of a global cryptocurrency market which is influenced by market forces alone and is distinguished by freedom from any single government’s control.<sup>5</sup>

With increasing developments in this area, countries have started recognising and clarifying the status of cryptocurrency in their jurisdiction. In India, the Reserve Bank of India (RBI) took note of the risk posed by VCs in its Financial Stability Reports of 2013, 2015, and 2016.<sup>6</sup> They

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<sup>4</sup> Giancarlo Giudici, Alistair Milne and Dmitri Vinogradov, ‘Cryptocurrencies: market analysis and perspectives’ (2020) 48(1) *Journal of Industrial and Business Economics* 1, 3.

<sup>5</sup> Lawrence Wintermeyer, ‘The Role of Cryptocurrencies in Future Society’ *Forbes* (16 October 2018) <[www.forbes.com/sites/lawrencewintermeyer/2018/10/26/the-role-of-cryptocurrencies-in-future-society/#7e094711787d](http://www.forbes.com/sites/lawrencewintermeyer/2018/10/26/the-role-of-cryptocurrencies-in-future-society/#7e094711787d)> accessed 19 October 2020.

<sup>6</sup> *Internet and Mobile Association of India v Reserve Bank of India* [2020] SCC OnLine SC 275 [2.2], [2.10], [2.11]; Reserve Bank of India, ‘Financial stability Report June 2013’ *Reserve Bank of India*, (2013) ch 3, para 3.60 <<https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FSPI260613FL.pdf>> accessed 19 October 2020; Reserve Bank of India, ‘Financial Stability Report December 2015’ *Reserve Bank of India*(2015) ch 3, box 3.1 <<https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/0FSR6F7E7BC6C14F42E99568A80D9FF7BBA6.PDF>> accessed 19 October 2020; Reserve Bank of India, ‘Financial Stability Report December 2016’ *Reserve Bank of India*(2016), ch 3, para

highlighted the concerns over the volatility in value and anonymous nature of virtual currencies. These concerns translated into a Statement and Circular issued by the RBI in 2018, which prohibited all entities regulated by it from providing its services to any individual or entity dealing in VCs.<sup>7</sup> Before this Circular, the entities that dealt with VC exchanges operated in a regulatory vacuum. Upon challenge, the Supreme Court of India (SC) in the case of *Internet and Mobile Association of India v. Reserve Bank of India* (“*Cryptocurrency judgment*”) struck down the said Statement and Circular for being unconstitutional.<sup>8</sup> The judgment was welcomed and celebrated by the industry and the professionals working in the cryptocurrency market.

Parallel to the RBI Circular, an Inter-Ministerial Committee (“Committee”) was constituted by the Ministry of Finance in 2018 to look into the regulatory framework for cryptocurrencies. The Committee published its report in February 2019 along with the Draft Banning of Cryptocurrency and Regulation of Official Digital Currency Bill, 2019 (“Draft Bill”) which, as the name suggests, introduced a complete ban on cryptocurrencies.<sup>9</sup> The future of VCs in India, however, is still uncertain.

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3.22<[https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/0FSR\\_166BABD6ABE04B48AFB534749A1BF38882.PDF](https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/0FSR_166BABD6ABE04B48AFB534749A1BF38882.PDF)> accessed 19 October 2020.

<sup>7</sup> Jose J Kattoor, ‘Statement on Developmental and Regulatory Policies’ *Reserve Bank of India* (5 April 2018) <[https://www.rbi.org.in/scripts/bs\\_pressreleasedisplay.aspx?prid=43574](https://www.rbi.org.in/scripts/bs_pressreleasedisplay.aspx?prid=43574)> accessed 19 October 2020; Saurav Sinha, ‘Prohibition on dealing in Virtual Currencies (VCs)’ *Reserve Bank of India* (6 April 2018) <<https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11243>> accessed 19 October 2020.

<sup>8</sup> *Cryptocurrency judgment* (n 6).

<sup>9</sup> Department of Economic Affairs, ‘Report of the Committee to propose specific actions to be taken in relation to Virtual Currencies’ *Ministry of Finance* (29 February 2019) 34 <<https://dea.gov.in/sites/default/files/Approved%20and%20Signed%20Report%20and%20Bill%20of%20IMC%20on%20VCs%2028%20Feb%202019.pdf>> accessed 19 October 2020.

While some experts<sup>10</sup> argue that this judgment will change the approach of the government towards cryptocurrencies, others<sup>11</sup> believe that there is still scope for the legislature and the RBI to come up with a ban.

In this paper, the authors focus on the aftermath of the *Cryptocurrency judgment* and explore a feasible regulatory framework to deal with cryptocurrency trade in India. It analyses whether the Draft Bill is the best way forward for India, keeping in mind the growth trajectory of the Indian cryptocurrency industry that is set to gain a considerable global market share despite the negative effects on the economy due to the COVID-19 outbreak.<sup>12</sup> This paper intends to fill the gap in the existing literature by providing a comprehensive analysis of the proposed regulatory framework against the backdrop of approaches adopted by different countries. It identifies a need for regulation and explores the factors that legislators will need to keep in mind while formulating a law on VCs.

## **II. UNDERSTANDING CRYPTOCURRENCY**

Predating the cryptocurrencies of the present, several attempts were made to create a digital currency that would be secured with cryptography

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<sup>10</sup> Suprita Anupam, 'Cryptocurrency vs RBI: The Supreme Court Judgement and The Aftermath' *Inc 42* (5 March 2020) <<https://inc42.com/features/cryptocurrency-vs-rbi-the-sc-judgement-and-the-aftermath-in-india/>> accessed 19 October 2020.

<sup>11</sup> Vishal Chawla, 'SC Verdict on Lifting Cryptocurrency Ban in India may be misinterpreted, and we may see the ban reinstated' *Analytics India Magazine* (7 April 2020) <<https://analyticsindiamag.com/cryptocurrency-ban-india-verdict/>> accessed 19 October 2020.

<sup>12</sup> Amit Raja Naik, 'Cryptocurrency This Week: Indian Crypto Exchanges Witness Surge in New Users, Bitcoin Sees \$1000 Spike & More' *Inc 42* (2 June 2020) <<https://inc42.com/buzz/indian-cryptocurrency-market-to-witness-increase-in-new-users-more/>> accessed 19 October 2020.

and a ledger that would be easy to use and be decentralized.<sup>13</sup> The first serious attempt at developing cryptocurrency was Wei Dai's 'B-money', which was conceptually "a scheme for a group of untraceable digital pseudonyms to pay each other with money and to enforce contracts amongst themselves without outside help".<sup>14</sup> In 2008, this concept became a reality with the publication of Satoshi Nakamoto's paper titled "Bitcoin – A Peer to Peer Electronic Cash System".<sup>15</sup> Bitcoin has a limited supply to ensure steady appreciation of value and is secured cryptographic protocols which provide anonymity to its users. It was designed to function as a medium of exchange on the internet, without facing the problem of double-spending, which refers to a risk where a digital currency can be potentially spent twice and is susceptible to fraud.

From thereon, the growth of Bitcoin and other cryptocurrencies provoked countries to find ways to regulate the market. Thailand declared trading in bitcoin as illegal.<sup>16</sup> Germany's Ministry of Finance rejected it as an legal currency but paved the way for taxing transactions involving bitcoin by recognizing it as a "unit of account".<sup>17</sup> The People's Bank of China prohibited financial institutions from using bitcoins.<sup>18</sup> While some

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<sup>13</sup> Mark Atwood, *Bitcoin Explained: Become a Bitcoin Millionaire in 2018* (Create Space Independent Publishing Platform 2018).

<sup>14</sup> Wei Dai, 'B-money' (1998) <<http://www.weidai.com/bmoney.txt>> accessed 20 October 2020.

<sup>15</sup> Satoshi Nakamoto, 'Bitcoin: A Peer-to-Peer Electronic Cash System' (2008) <<https://bitcoin.org/bitcoin.pdf>> accessed 20 October 2020.

<sup>16</sup> AP, 'Virtual currency Bitcoin banned' *Bangkok Post* (30 July 2013) <<https://www.bangkokpost.com/business/362222/bitcoin-declared-illegal-in-thailand>> accessed 20 October 2020.

<sup>17</sup> GDN, 'Bitcoin approved by Germany as a 'unit of account' for transactions' *South China Post* (12 August 2013) <<https://www.scmp.com/news/world/article/1298155/bitcoin-approved-germany-unit-account-transactions>> accessed 20 October 2020.

<sup>18</sup> Laney Zhang, 'Regulation of Cryptocurrency: China' *Library of Congress* (June 2018) <<https://www.loc.gov/law/help/cryptocurrency/china.php>> accessed 20 October 2020.

countries, such as Japan<sup>19</sup> and Norway,<sup>20</sup> are still open to the acceptance of bitcoin as a currency, central regulatory authorities around the world recognize the need to understand the technology and create an appropriate financial framework.

### **A. CONCEPT**

A virtual currency has been defined as a digital representation of value that can be traded electronically, functioning as “(1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but not having a legal tender status”.<sup>21</sup> Cryptocurrency is a subset of virtual currency which is decentralised and protected by cryptography.<sup>22</sup> Bitcoin is an example of cryptocurrency.

To obtain a cryptocurrency, for example, bitcoin, the users must either “mine” them through their computer by solving complex mathematical algorithms or purchase them using the fiat currency. There are two ways in which cryptocurrency is used in the market - *first*, as a payment system or a means of exchange, and *second*, in the form of tokens issued through Initial Coin Offerings (“ICO”).<sup>23</sup>

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<sup>19</sup> Luke Graham, ‘As China cracks down, Japan is fast becoming the powerhouse of the bitcoin market’ *CNBC* (29 September 2017) <<https://www.cnn.com/2017/09/29/bitcoin-exchanges-officially-recognized-by-japan.html>> accessed 20 October 2020.

<sup>20</sup> Jamie Redman, ‘Norway’s Largest Online Bank Integrates Bitcoin Accounts’ *Bitcoin.com* (15 May 2017) <<https://news.bitcoin.com/norways-online-bank-bitcoin-accounts/>> accessed 20 October 2020.

<sup>21</sup> Financial Action Task Force, ‘Virtual Currencies – Key Definitions and Potential AML/CFT Risks’ *FATF* (June 2014), 8 <<https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>> accessed 25 October 2020.

<sup>22</sup> *ibid* 5.

<sup>23</sup> Department of Economic Affairs (n 9) 22.

As a ‘payment system’, cryptocurrency lets users make secure payments and store money anonymously.<sup>24</sup> It is a peer-to-peer system which means that users can send or receive money from anyone without any external interference.<sup>25</sup> This allows users to process transactions through digital units of exchange. All records of the transactions are maintained in a public ledger which uses blockchain technology. The blockchain cannot be altered, and so the funds and goods can be transferred trustfully.<sup>26</sup> This ensures transparency and also decreases fraudulent activities.

As an ‘asset’, cryptocurrency can be issued as tokens through ICO. A company can raise funds through ICO, and this process is crypto-industry’s equivalent to an Initial Public Offering in a stock market. This has emerged as an alternative to traditional forms of financing. People interested in making an investment can buy the token and invest in a company, where the token is a utility or asset issued by the company. They can be transferred or traded by the holders. Such tokens can serve two functions of (i) a utility and (ii) a security. A utility token gives the holder access to the company’s products whereas, security tokens are similar to shares wherein its holders get dividend whenever the company earns a profit.<sup>27</sup>

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<sup>24</sup> Ilker Koksak, ‘The Rise of Crypto as Payment Currency’ *Forbes* (23 August 2019) <<https://www.forbes.com/sites/ilkerkoksak/2019/08/23/the-rise-of-crypto-as-payment-currency/?sh=6428941026e9>> accessed 30 January 2021.

<sup>25</sup> *ibid.*

<sup>26</sup> *ibid.*

<sup>27</sup> Luis Oliveira and others, ‘To Token or not to Token: Tools for Understanding Blockchain Tokens’ (International Conference of Information Systems, San Francisco, USA, 12 - 16 December 2018) 6.

## **B. NATURE AND RISKS**

Since cryptocurrency is a decentralized medium of exchange, its value is immune from government control. The emergence of VCs is believed by some to be a threat to the banking sector since it eliminates the need for an intermediary and has risen to be a viable alternative to traditional payment methods.<sup>28</sup> This results in a lower cost of transaction and increased efficiency. The ease of using cryptocurrencies has been predicted to revolutionise the banking sector.<sup>29</sup> Financial institutions will have to incorporate blockchain technology into their operations to compete in the market.

However, there are some drawbacks. Despite the secure nature of blockchain transactions, cryptocurrency exchanges and its users remain vulnerable to cyber hacking. In 2014, a major security flaw was exposed when Mt. Gox, a Bitcoin exchange in Japan, went offline and announced that approximately 850,000 BTC went missing.<sup>30</sup> Unlike fiat money, cryptocurrencies are not backed by a central authority. An incident like Mt. Gox can devalue the VCs overnight.<sup>31</sup> Further, acceptance of VCs does not

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<sup>28</sup> Antonio Fatás and Beatrice Weder di Mauro, 'As Cryptocurrencies Rise, Who Needs Banks?' (2018) *Harvard Business Review* 7 May 2018 <<https://hbr.org/2018/05/as-cryptocurrencies-rise-who-needs-banks>> accessed 20 October 2020.

<sup>29</sup> Abhay Padda, 'How Will Blockchain Revolutionize the Global Financial System?' *WNS* (2018) <<https://www.wns.com/insights/articles/articledetail/534/how-will-blockchain-revolutionize-the-global-financial-system>> accessed 20 October 2020.

<sup>30</sup> Robert Mcmillan, 'The Inside Story of Mt. Gox, Bitcoin's \$460 Million Disaster' *Wired* (3 March 2014) <<https://www.wired.com/2014/03/bitcoin-exchange/>> accessed 20 October 2020.

<sup>31</sup> A Greenberg, 'Bitcoin's price plummets as Mt. Gox goes dark, with massive hack rumored' *Forbes* (25 February 2014) <<http://www.forbes.com/sites/andygreenberg/2014/02/25/bitcoins-price-plummets-as-mt-gox-goes-dark-with-massive-hack-rumored/>> accessed 30 January 2021.

depend upon any government or country and therefore, in absence of any regulations or oversight, there is no consumer protection.<sup>32</sup> This means that consumers are not insured against incidents like the shutdown of a VC exchange company. There are also concerns around the lack of traceability of VCs which were highlighted when money laundering activities and drug transactions on Silk Road, a digital black market, were carried out using bitcoin.<sup>33</sup> Increasing risks to consumers and economy due to cryptocurrency transactions have led various governments to explore regulatory options and, in some cases, even ban their use.

### **III. GLOBAL REGULATORY APPROACHES**

With advanced technological developments and increasing popularity of cryptocurrency, countries around the world have had to clarify its legal status. No country has accepted cryptocurrency as a legal tender.<sup>34</sup> Most of the countries, including India,<sup>35</sup> have released warnings to their citizens about how a virtual currency is different from the legal tenders issued by the government. Jurisdictions like the United States of America

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<sup>32</sup> Kim-Kwang Raymond Choo, 'Cryptocurrency and Virtual Currency: Corruption and Money Laundering/Terrorism Financing Risks?' in David Lee Kuo Chen (eds) *Handbook of Digital Currency: Bitcoin, Innovation, Financial Instruments and Big Data* (Academic Press 2015) 301.

<sup>33</sup> David Adler, 'Silk Road: The Dark Side of Cryptocurrency' *Fordham Journal of Corporate and Financial Law*, 21 February 2018) <<https://news.law.fordham.edu/jcfl/2018/02/21/silk-road-the-dark-side-of-cryptocurrency/>> accessed 20 October 2020.

<sup>34</sup> 'Regulation of Cryptocurrency Around the World' *Law Library of Congress* (June 2018) 2 <<https://www.loc.gov/law/help/cryptocurrency/cryptocurrency-world-survey.pdf>> accessed 25 October 2020.

<sup>35</sup> Ajit Prasad, 'RBI cautions users of Virtual Currencies against Risks' *Reserve Bank of India* (24 December 2013) <[https://www.rbi.org.in/Scripts/BS\\_PressReleaseDisplay.aspx?prid=30247](https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=30247)> accessed 25 October 2020.

(USA or US), Singapore and Germany have capitalized on the crypto market and have not restricted their use. However, some jurisdictions have decided to impose a ban instead. Nepal, Pakistan, and Vietnam have banned cryptocurrency directly while China has done so indirectly.<sup>36</sup> Venezuela has, in fact, developed its own cryptocurrency. In most countries, including India, Austria, Belgium, Greece and Lithuania there are no clear regulations and the crypto-industry functions in a legal vacuum.<sup>37</sup> This section analyses the different approaches taken by the major economies to regulate cryptocurrency.

#### **A. PERMISSIVE**

The most common trend that can be observed is the adoption of a permissive approach by developing a cryptocurrency-friendly regime. Various countries, while being permissive, have also recognized the risks that come along with it. They have either developed a new regulatory framework or accounted for these challenges within their existing laws. The former spectrum includes countries like France and Malta,<sup>38</sup> while the latter system includes jurisdictions like the USA, Australia, Canada and Japan. This section looks at the permissive regulatory frameworks in the USA and Japan.

##### **i. USA**

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<sup>36</sup> Library of Congress Report (n 34) 2.

<sup>37</sup> 'Cryptocurrencies by country' *Thomson Reuters* (25 October 2017) <<https://blogs.thomsonreuters.com/answeron/world-cryptocurrencies-country/>> accessed 30 January 2021.

<sup>38</sup> Radhika Pandey, D Priyadarshini and Raghunath Seshadri, 'Approaches to regulation of cryptocurrencies' *Ideas for India* (31 October 2019) <<https://bit.ly/2HA8M7T>> accessed 25 October 2020.

The laws governing crypto exchanges in the USA differ state-wise and are enacted largely based on three major approaches.<sup>39</sup> *First*, in order to boost the local economy, few states have brought in favourable regulations which aim at increasing investment. For instance, the state of Wyoming is considered as the friendliest state for cryptocurrency and has exempted crypto transactions from property taxation.<sup>40</sup> Some states, such as Ohio,<sup>41</sup> have even allowed the payment of taxes through cryptocurrency. *Second*, states like California and New Mexico have issued warnings against the potential risks associated with cryptocurrency investment.<sup>42</sup> *Third*, restrictive use legislations have been passed, for instance, in the state of New York.<sup>43</sup> Therefore, it is difficult to identify a consistent approach in the USA with respect to cryptocurrency legislation. At the federal level, however, the USA regulators have taken a proactive approach in dealing with cryptocurrencies.

### **Securities and derivative market**

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<sup>39</sup> Joe Dewey, 'Blockchain and Cryptocurrency Regulation, USA' *Global Legal Insights* (2020) <<https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/usa>> accessed 25 October 2020.

<sup>40</sup> Kevin C. Desouza, Chen Ye, and Kiran Kabtta Somvanshi, 'Blockchain and U.S. state governments: An initial assessment', *Brookings* (17 April 2020) <<https://www.brookings.edu/blog/techtank/2018/04/17/blockchain-and-u-s-state-governments-an-initial-assessment/>> accessed 25 October 2020.

<sup>41</sup> Kelly Philips Erb, 'Ohio Becomes the First State to Allow Taxpayers to Pay Tax Bills Using Cryptocurrency' *Forbes* (26 November 2018) <<https://bit.ly/3e9yonD>> accessed 25 October 2020.

<sup>42</sup> Desouza (n 40).

<sup>43</sup> Matthew Kohen and Justin Wales, 'State Regulations on Virtual Currency and Blockchain Technologies' (Updated July 2020) *Carlton Wales* (14 July 2020) <[https://www.carltonfields.com/insights/publications/2020/state-regulations-on-virtual-currency-and-blockchain-technologies-\(updated-july-2020\)](https://www.carltonfields.com/insights/publications/2020/state-regulations-on-virtual-currency-and-blockchain-technologies-(updated-july-2020))> accessed 25 October 2020.

USA's securities market regulator, Securities and Exchange Commission (SEC), has classified cryptocurrencies as securities<sup>44</sup> decided by the 'Howey Test'. Developed by the Supreme Court of the United States (SCOTUS) in 1946, the Howey Test lays down four criteria for an instrument to be classified as a security: It must be an (i) investment of money, (ii) with an expectation of profit, (iii) in a common enterprise, and (iv) with the profit to be generated by a third party.<sup>45</sup> The Howey Test is used in order to identify whether the tokens issued in an ICO are utility based or a security.<sup>46</sup> If classified as a security, then the regulatory framework of SEC, including the licensing and disclosure requirements, will become applicable. The Commodities Futures Trading Commission,<sup>47</sup> which regulates the USA derivative markets, has adopted a liberal approach. It considers cryptocurrencies, like Bitcoin, as commodities which can be traded in public. Both the regulators agree that when the Howey Test is not met, the crypto-asset will be classified as a commodity.<sup>48</sup>

### **Financial crimes**

The Financial Crimes Enforcement Network, a US agency for tackling financial crimes, has accepted cryptocurrency exchanges as money

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<sup>44</sup> Chairman Jay Clayton, 'Statement on Cryptocurrencies and Initial Coin Offerings' *U.S. Securities and Exchange Commission* (17 December 2018) <<https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>> accessed 25 October 2020.

<sup>45</sup> *SEC v WJ Howey Co* [1946] 328 US [293], [298], [299].

<sup>46</sup> M Todd Henderson and Max Raskin, 'A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets' (2019) 2019 Colum Bus L Rev 443, 454.

<sup>47</sup> 'Bitcoin' *Commodities Futures Trading Commission* <<https://www.cftc.gov/Bitcoin/index.htm>> accessed 25 October 2020.

<sup>48</sup> Pandey, Priyadarshini and Seshadri (n 38).

transmitters.<sup>49</sup> Therefore, these exchanges have to abide by the Bank Secrecy Act of 1970.<sup>50</sup> The money services businesses, including cryptocurrency businesses, have to implement the anti-money laundering program, and need to conduct a risk assessment about their exposure to money laundering. Cryptocurrencies are considered as property and not currency by the Internal Revenue Service, and therefore, are taxed accordingly.<sup>51</sup>

## ii. Japan

Japan has created a very conducive environment for cryptocurrency and witnessed a market boost in 2018. After allowing cryptocurrency transactions in 2017, the market saw the retail investors shift from leveraged foreign-exchange trading to leveraged cryptocurrency trading.<sup>52</sup> Japan's Financial Services Agency ("FSA")<sup>53</sup> regulates trading and exchanges. In order to provide exchange services in the country, the entity has to register as a Virtual Currency Exchange Service Provider with the FSA.<sup>54</sup> Thus, the

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<sup>49</sup> 'Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies' *Financial Crimes Enforcement Network* (13 March 2018) <<https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulationsperson-s-administering>> accessed 25 October 2020.

<sup>50</sup> 'What is FinCEN? How Does It Regulate Virtual Currencies?' *Sygnia* (2020) <<https://www.sygnia.io/blog/what-is-fincen/>> accessed 25 October 2020.

<sup>51</sup> Mordecai Lerer, 'The Taxation of Cryptocurrency' *The CPA Journal* (January 2019) <<https://www.cpajournal.com/2019/01/24/the-taxation-of-cryptocurrency/>> accessed 25 October 2020.

<sup>52</sup> C. Edward Kelso, 'Japan's GDP Grows Due to Bitcoin Wealth Effect' *Bitcoin.com* (12 January 2018) <<https://news.bitcoin.com/japans-gdp-grows-due-to-bitcoin-wealth-effect/>> accessed 30 January 2021.

<sup>53</sup> Financial Services Agency, 'About FSA' <<https://www.fsa.go.jp/en/about/index.html/>> accessed 25 October 2020.

<sup>54</sup> Taro Awataguchi and Takeshi Nagase, 'Blockchain & Cryptocurrency Regulation 2021, Japan' *Global Legal Insights* (2020) <<https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/japan>> accessed 25 October 2020.

registration requirements subject the businesses to the money laundering and terrorism financing laws of the country. Japan had to make its laws stricter after the incident of Mt. Gox in 2014<sup>55</sup> and of 2018 where Japan's cryptocurrency exchange, Coincheck, lost around \$530 million to hacking.<sup>56</sup> As a result, both the Payment Services Act ("PS Act") and the Financial Instruments and Exchange Act ("FIEA") were amended.

The PS Act, which regulates cryptocurrency exchange businesses, requires them to establish security systems to protect their information.<sup>57</sup> In addition, it makes it necessary for businesses to manage the user's money separately than their own. The FIEA amendment brought within its purview the ICO and Security Token Offerings ("STO").<sup>58</sup> It also regulates any unfair activities involving crypto-asset derivatives. From the tax perspective, cryptocurrencies are classified as 'miscellaneous income' by the National Tax Agency and the investors are taxed at the rates of 15% - 55%.<sup>59</sup>

Japan is also the first country in the world to establish a self-regulatory body for cryptocurrency exchanges. The Japanese Virtual

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<sup>55</sup> McMillan (n 30).

<sup>56</sup> Reuters Staff, "Tokyo-based cryptocurrency exchange hacked, losing \$530 million: NHK" *Reuters* (26 January 2018) <<https://www.reuters.com/article/japan-cryptocurrency/tokyo-based-cryptocurrency-exchange-hacked-losing-530-million-nhk-idUSL4N1PL4K9>> accessed 30 January 2021.

<sup>57</sup> Awataguchi and Nagase (n 54).

<sup>58</sup> *ibid.*

<sup>59</sup> *ibid.*

Currency Exchange Association<sup>60</sup> was put in place to improve compliance with the regulations and give advice to unlicensed exchanges.

## **B. RESTRICTIVE**

An overly cautious approach has been taken by countries like Bolivia and Vietnam which have banned cryptocurrencies outrightly.<sup>61</sup> Indirect restrictions have been placed in countries like China and Bangladesh whereby the government, by barring financial institutions within their borders from facilitating transactions involving cryptocurrencies, have effectively crippled its usage in the country.

### **i. China**

The approach of the People's Republic of China towards cryptocurrency regulation, while being cautious, has been structured to achieve technological benefits without compromising on stability. Like many other jurisdictions, China has recognized the potential of blockchain technology<sup>62</sup> and aims to integrate blockchain-based solutions in areas ranging from credit reporting and supply chain management to e-commerce and the finance industry. However, cryptocurrencies do not receive the same treatment.

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<sup>60</sup> William Suberg, 'Japan Finally Gets Self-Regulatory Body for Cryptocurrency Exchanges', *CoinTelegraph* (24 April 2018) <<https://cointelegraph.com/news/japan-finally-gets-self-regulatory-body-for-cryptocurrency-exchanges>> accessed 25 October 2020.

<sup>61</sup> Library of Congress Report (n 34) 2.

<sup>62</sup> Arjun Kharpal, 'Chinese giants Huawei and Tencent join national group on blockchain after Xi's backing for the tech' *CNBC* (15 April 2020) <<https://www.cnbc.com/2020/04/15/huawei-tencent-on-china-blockchain-national-committee.html>> accessed 25 October 2020.

In 2013, several Chinese regulatory bodies issued a joint ‘Notice of Preventing the Risk of Bitcoin’, confirming that there is only one official currency recognized in the country and other cryptocurrencies like Bitcoin shall not be treated as “currency”, but instead as a “virtual commodity”. China also released a notice ordering commercial banks and payment institutions to stop providing services to the Bitcoin industry<sup>63</sup>.

Therefore, while the act of holding or transferring cryptocurrencies has not been directly banned, its growth has been restricted by enforcing a separation between cryptocurrencies and the financial market. In 2017, seven central government regulators issued a joint announcement which banned ICOs in China.<sup>64</sup> According to the announcement, ICO financing that raises “so-called ‘virtual currencies’ such as Bitcoin and Ethereum” through the irregular sale and circulation of tokens is essentially public financing without approval, and hence illegal.

China implements strict capital controls which are supervised by the State Administration of Foreign Exchange and designed to limit the amount of capital outflow via foreign exchange and remittances abroad, by both corporations and individuals.<sup>65</sup> By their nature, cryptocurrencies do

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<sup>63</sup> Gerry Mullany, ‘Notice on Further Strengthening the Bitcoin Risk Prevention Work’ *The New York Times* (5 December 2013) <<https://www.nytimes.com/2013/12/06/business/international/china-bars-banks-from-using-bitcoin.html>> accessed 25 October 2020.

<sup>64</sup> Saheli Roy Choudhury, ‘China bans companies from raising money through ICOs, asks local regulators to inspect 60 major platforms’ *CNBC* (4 September 2017) <<https://www.cnbc.com/2017/09/04/chinese-icos-china-bans-fundraising-through-initial-coin-offerings-report-says.html>> accessed 25 October 2020.

<sup>65</sup> ‘Major Functions’ *State Administration of Foreign Exchange* <<https://www.safe.gov.cn/en/MajorFunctions/index.html>> accessed 25 October 2020.

not fall within state control, and therefore, risk destabilising the system of capital controls. As per existing regulations, any corporate entity utilising cryptocurrency to transfer significant sums of money abroad would be deemed to violate these controls.<sup>66</sup>

China's strategy of increasing the use and importance of its sovereign currency has dominated the regulation of cryptocurrency in the nation.<sup>67</sup> While it cracks down on decentralized cryptocurrencies like Bitcoin, Ripple, etc., the government has been working on an official digital currency known as the Digital Currency Electronic Payment ("DCEP"), available via a mobile wallet and pegged 1:1 with fiat currency.<sup>68</sup> Preserving the authority of the Central Bank unlike existing cryptocurrencies, the DCEP is aimed at reducing handling charges, promoting financial inclusion in difficult circumstances like the coronavirus pandemic and making cross border payments seamless.

#### **IV. THE INDIAN APPROACH**

The Inter-Ministerial Committee, in its 2019 report, identified several issues with the usage of non-official digital currencies and arrived at the conclusion that VCs need to be banned in India. The main issues identified were, viz. the need to protect consumers from fraud and risks

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<sup>66</sup> Rosie Peper, 'China is moving to eliminate all cryptocurrency trading with a ban on foreign exchanges' *Business Insider* (6 February 2018) <<https://bit.ly/2TyY3gn>> accessed 25 October 2020.

<sup>67</sup> Hirooyuki Nishimura, 'China takes battle for cryptocurrency hegemony to new stage' *Nikkei Asia* (14 June 2020) <<https://asia.nikkei.com/Spotlight/Comment/China-takes-battle-for-cryptocurrency-hegemony-to-new-stage>> accessed 25 October 2020.

<sup>68</sup> Partha Ray and Shantanu Paul, 'Notes on a digital currency plan, made in China' *The Hindu* (23 May 2020) <<https://www.thehindu.com/opinion/op-ed/notes-on-a-digital-currency-plan-made-in-china/article31653605.ece>> accessed 25 October 2020.

due to price manipulation, the need to protect the financial system and economy from instability caused by a decentralized system and massive energy consumption, and the need to prevent criminal activity.<sup>69</sup> Keeping these issues in mind, the Committee submitted the Draft Bill which is indicative of India's regulatory approach at present.<sup>70</sup>

### **A. DRAFT BILL**

The Draft Bill provides a broad definition for cryptocurrency –

*“any information or code or number or token not being part of any Official Digital Currency, generated through cryptographic means or otherwise, providing a digital representation of value which is exchanged with or without consideration, with the promise or representation of having inherent value in any business activity which may involve risk of loss or an expectation of profits or income, or functions as a store of value or a unit of account and includes its use in any financial transaction or investment, but not limited to, investment schemes.”<sup>71</sup>*

The definition not only covers recognized cryptocurrencies, but also any virtual currency that may not even use cryptography or employ a decentralized system or DLT. It may cover ‘Supercoins’ on Flipkart, ‘Frequent Flyer rewards’ on IndiGo or any digital representation of value that is capable of exchange. This is problematic as the major issues identified in the Committee’s report with respect to the protection of consumers and the economy mainly pertain to cryptocurrencies and thus, a

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<sup>69</sup> Department of Economic Affairs (n 11) 17.

<sup>70</sup> *ibid* 59.

<sup>71</sup> Banning of Cryptocurrency & Regulation of Official Digital Currency Bill 2019, s 2(1)(a).

widespread ban on all types of virtual currencies is a disproportionate measure. As a result of employing a broad definition, the Draft Bill prohibits the mining, generation, holding, sale, dealing in, issue, transfer, disposal or use of all VCs other than the official digital currency in the territory of India.<sup>72</sup>

It further provides that the Central Government may, in consultation with the Central Board of the RBI, approve digital rupee to be legal tender. Central Bank Digital Currency (“CBDC”), if introduced, has both advantages and disadvantages in its impact on the monetary policy and financial stability. A CBDC can result in lower transaction costs and increase technology efficiency by removing the need for intermediaries like banks. It will create an attractive ecosystem that will encourage economic growth and digital innovation.<sup>73</sup> On the other hand, CBDC being a virtual currency is also subject to price volatility and speculations. This can result in competition for commercial banks and may lead to banks increasing their deposit rates.<sup>74</sup> The CBDC has geographical limitation wherein it is only accepted in the issuing country<sup>75</sup> and poses other infrastructural challenges.<sup>76</sup> Therefore, the Committee recommended the constitution of a “Group” by the Department of Economic Affairs with the participation of the representatives of the RBI, Ministry of Electronics and Information

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<sup>72</sup> *ibid* ss 6 and 7.

<sup>73</sup> A Koumbarakis and G. Dobrauz-Saldapenna, ‘Central bank digital currency: Benefits and drawbacks’ (2019) SSRN Electronic Journal1, 8 <<http://dx.doi.org/10.2139/ssrn.3429037>> accessed 31 January 2021.

<sup>74</sup> O Olson, ‘Central bank digital currencies’ (2018) 1 Norges Bank Papers 15.

<sup>75</sup> A Wadsworth, ‘The pros and cons of issuing a central bank digital currency’ (2018) 81(7) Reserve Bank of New Zealand Bulletin 1, 9.

<sup>76</sup> *ibid*.

Technology and Department of Financial Services for the examination and development of an appropriate model for digital currency in India.<sup>77</sup> This “Group” has not been formed yet.

## **B. NEED FOR A PERMISSIVE FRAMEWORK**

Reviewing the recommendations of the Committee and the approach adopted in the Draft Bill leads to the conclusion that there are some aspects that are still unresolved when it comes to regulation. Although a complete ban has been recommended, it would be prudent for the government to reconsider the economic and legal factors.

*First*, a report written by Coinpaprika and OKEx observed that the Indian cryptocurrency market is set to gain a considerable global market share starting from 2020.<sup>78</sup> The report attributes this growth projection to three factors, viz. cross border remittances, concerns over stability of the Indian rupee and current regulatory environment post the *Cryptocurrency judgment*. Several crypto exchanges have reported huge growth in trading volumes and new users during the pandemic and nationwide lockdown.<sup>79</sup> There is an overall growth in this market with new cryptocurrency

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<sup>77</sup> Department of Economic Affairs (n 11) 45.

<sup>78</sup> ‘Mapping out India’s Blockchain Ecosystem – Coinpaprika & OKEX report’ *OKEX* (26 May 2020) <<https://www.okex.com/academy/en/mapping-out-indias-blockchain-ecosystem-coinpaprika-okex-report>> accessed 25 October 2020.

<sup>79</sup> Kevin Helms, ‘India to Significantly Increase Crypto Market Share This Year: Report’ *Bitcoin* (1 June 2020) <<https://news.bitcoin.com/india-significantly-increase-crypto-market-share/>> accessed 25 October 2020.

exchanges being launched,<sup>80</sup> global exchanges expanding into the country, and increasing investment in Indian cryptocurrency start-ups.

*Second*, a complete ban does not ensure consumer protection. It would instead push the agencies dealing with such transactions under the radar and equate genuine transactions to illegal payments in unregulated markets. It is a reaction akin to blaming the tool for the crimes committed by a human using the tool. Since the potential effect of new technology is scalable for benefit as well as harm, only strong governance, regulation, and education can help reduce the dangers.<sup>81</sup>

*Third*, even China, which has completely banned cryptocurrencies, has acknowledged its existence as a virtual asset and even allowed for the inheritance of virtual assets such as bitcoin in its new Civil Code.<sup>82</sup> Therefore, even if it is declared unfeasible to allow the trade and use of cryptocurrency as a medium of exchange without being legal tender, there is still scope for the use of cryptocurrency as assets or commodities.

*Fourth*, by regulating cryptocurrencies and clearly identifying the categories of use, the transactions that could previously slip out of the purview of a regulatory authority will be monitored and as a result, the RBI will be in a better position to protect the investors and consumers.

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<sup>80</sup> Kevin Helms, 'New Cryptocurrency Exchanges Launch in India as Businesses Seek Answers From RBI' *Bitcoin* (8 May 2020) <<https://news.bitcoin.com/new-cryptocurrency-exchanges-india/>> accessed 25 October 2020.

<sup>81</sup> Don Tapscott and Alex Tapscott, *Blockchain Revolution* (Portfolio Penguin 2018) 276.

<sup>82</sup> Kevin Helms, 'China Passes Law Protecting Cryptocurrency Inheritance' *Bitcoin* (28 May 2020) <<https://news.bitcoin.com/china-law-cryptocurrency-inheritance/>> accessed 25 October 2020.

*Fifth*, a working permissive model has been implemented in Japan and the USA, as explained earlier. Accordingly, these countries have been able to harness the technology in a better fashion while addressing security threats like hacking and fraud.

A comprehensive legislation for the regulation of cryptocurrencies in cohesion with an enacted data protection law would bring a largely unregulated self-sustaining economy within the fold of the RBI and would ensure security.

## **V. ENVISIONING THE INDIAN MODEL**

While looking at the regulatory approaches adopted by countries around the world, various trends emerge. Essentially, the Indian government will have to tackle two main aspects while framing a national strategy: *first*, the classification of cryptocurrency, and *second*, the potential regulatory challenges.

### **A. CLASSIFICATION OF CRYPTOCURRENCY ACTIVITIES**

The regulatory framework for cryptocurrencies depends on the nature of the activity and its classification. It is important that cryptocurrency is classified because it helps the regulators to fit it in the existing framework or create a new one. Regulators around the world are largely attempting to classify cryptocurrency as a “currency, commodity, or security”.<sup>83</sup> Cryptocurrencies are complex, and people use them in different

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<sup>83</sup> J Riley Key, Lee Gilley and Erin Jane Illman, ‘Cryptocurrencies: Currency, Commodity, Security or Something Else?’ *Financial Services Perspectives* (5 February 2019) <<https://www.financialservicesperspectives.com/2019/02/cryptocurrencies-currency-commodity-security-or-something-else/>> accessed 25 October 2020.

ways. Depending on the nature of its activity, it can even be classified as all three. The original cryptocurrencies were conceived as an alternative to money but over the past decade, they have assumed different shapes and utility values.<sup>84</sup>

### **i. Currency**

Cryptocurrency can easily be classified as a currency because it acts as a medium of exchange, it is a unit of account, and it is capable of storing value.<sup>85</sup> However, in practicality, it does not behave like currency. Due to the fluctuations in its value, traders choose the time of sale of goods and services based on when the specific cryptocurrency peaks. Such vast fluctuations do not happen for normal currencies and thus, the price instability makes it unsafe as a medium of exchange.

### **ii. Commodity**

VCs are increasingly being classified as a commodity and are sometimes referred to as digital gold.<sup>86</sup> Commodities can be traded in exchanges and their value is determined by the supply and demand. They are regarded as interchangeable units which have the same core properties and are objects with utility.<sup>87</sup> Some cryptocurrencies seem to fit these

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<sup>84</sup> *Cryptocurrency judgment* (n 6) para 6.54.

<sup>85</sup> CMC Germany, 'Cryptocurrency as a means of payment' *Lexology* (18 January 2018) <<https://www.lexology.com/library/detail.aspx?g=83d9e851-5263-411d-ab00-b5bee8707fbd>> accessed 25 October 2020.

<sup>86</sup> Jeffrey Gogo, 'Bitcoin to Be Digital Gold in 2020, Says Bloomberg Report' *Bitcoin.com* (23 April 2020) <<https://www.luno.com/learn/en/article/bitcoin-as-digital-gold>> accessed 25 October 2020.

<sup>87</sup> Team Luno, 'Cryptocurrency, Is It A Security, Currency or Asset?' *Medium* (8 November 2018) <<https://medium.com/luno/cryptocurrency-is-it-a-security-currency-or-asset-1785acb1e60f>> accessed 25 October 2020.

characteristics as they can be bartered, and the value is determined by market expectations. It, therefore, has an exchange value. There is a certain overlap between these two categories. If regular currency, like the Indian Rupee, is used to buy something then it acts as a mode of payment. However, when traders sell it in the exchange market depending upon the rate fluctuations, it acts as a commodity. The same is the case with cryptocurrencies.

### **iii. Securities**

Cryptocurrencies can be classified as securities because just like stocks, the owner makes money if it rises in value and loses out if it drops.<sup>88</sup> The distinction lies in the fact that cryptocurrencies are decentralised. However, in the case where ICOs are used to raise funds by issuing digital tokens, they are released by a company and can therefore be regulated as stocks.

Different regulators around the world have adopted different definitions for cryptocurrency leading to opposite views from the courts across jurisdictions.<sup>89</sup> They have classified cryptocurrency into different categories ranging from property to commodity to non-traditional currency to payment instruments to money to funds. They have adopted this classification depending upon the context and the statute involved in the case.

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<sup>88</sup> *ibid.*

<sup>89</sup> *Cryptocurrency judgment* (n 6) para 6.71.

In the Indian context, the SC has ruled that cryptocurrencies can be regulated by the RBI. It held that virtual currencies can be classified as “currency”.<sup>90</sup> Section 2(h) of the Foreign Exchange Management Act, 1999 defines currency as “*all currency notes, postal notes.... bills of exchange and promissory notes, credit cards or other such similar instruments as may be notified by the Reserve Bank.*”<sup>91</sup> The SC observed that bills of exchange, cheques are also not currencies but still operate as a valid mode of discharge of debt. Therefore, even virtual currencies can be classified as currency falling under the category of “other similar instruments” since it acts as money under certain circumstances.<sup>92</sup>

The SC has, however, acknowledged that the nature of virtual currencies is ever-changing. While it seems that the cryptocurrency exchanges will be regulated by the RBI, it will be open to other regulators to bringing crypto transactions under their purview depending upon the nature of the activity. The Securities and Exchange Board of India (SEBI) might recommend the amendment of the definition of “security” to bring within its scope the cryptocurrency tokens issued through the ICOs.<sup>93</sup> In such a case, the regulation and compliances are likely to be similar as initial public offerings.

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<sup>90</sup> *ibid* para 6.86 and 6.111.

<sup>91</sup> The Foreign Exchange Management Act 1999, s 2(h).

<sup>92</sup> *Cryptocurrency judgment* (n 6) para 6.86.

<sup>93</sup> Securities Contracts (Regulation) Act 1956, s 2(h).

## **B. POTENTIAL REGULATORY CHALLENGES**

The Committee's report clearly highlights the risks associated with cryptocurrencies.<sup>94</sup> There is potential for money laundering and terrorism funding due to the anonymous or pseudonymous nature of owning/trading in cryptocurrencies. There are other security issues as well due to the irreversible nature of transactions and the irretrievable nature of a lost private key or wallet. Additionally, ignoring the impact of cryptocurrencies on the income of individuals and companies or inefficiently addressing the same by haphazardly applying general taxation laws could lead to adverse effects like double taxation. Considering these issues, the stark challenges before the government are taxation, prevention of crimes and technological barriers.

### **i. Taxation**

The tax regime on cryptocurrencies has been in an ambiguous space since the *Cryptocurrency judgment*. There is a lack of clarity on the status of cryptocurrency exchanges for the purposes of availing banking services and the status of cryptocurrency itself in the nation. As highlighted earlier, the classification of cryptocurrency will impact how it is regulated. The nature of the transaction (income or expenditure) will determine whether it will be taxed under the Income Tax Act 1961 ("ITA") or the Central Goods and Services Tax Act 2017 ("CGST Act") respectively. Countries around the world have put the cryptocurrencies in the bracket of either goods/property or currency for tax purposes. Under the ITA, as a

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<sup>94</sup> Department of Economic Affairs (n 11) 27.

good/property, it will fall within the head of ‘Profit and Gains from Business and Profession’<sup>95</sup> (in case of goods) or ‘Income from Capital Gains’<sup>96</sup> (in case of property), depending upon the purpose of the transaction. As a currency, it will not be subject to tax. This is because ‘money’ or ‘currency’ does not fall within the definition of ‘income’ under the ITA nor as ‘goods’ or ‘services’ under the CGST Act.

## ii. Prevention of Crime

Due to the anonymity offered to those who hold and trade in cryptocurrency and decentralization, there is scope for terrorism funding and money laundering. Legitimate transactions follow regulatory requirements for identity verification and sourcing of funds, and exchanges that facilitate transactions are required to comply with anti-money laundering laws. However, cryptocurrency allows criminals to hide the origin of funds. To counter this, countries like Canada and Japan have brought their users and intermediaries within the purview of their anti-money laundering and prevention of terror laws.<sup>97</sup> The Draft Bill addresses this problem by bringing any act of mining, generating, issuing, holding, using, selling, transfer and/or disposal of cryptocurrency as defined in the legislation, within the ambit of the Prevention of Money Laundering Act 2002 (“PMLA”) as a “scheduled offence”. This approach treats the simple act of holding cryptocurrency as a major economic offence akin to money laundering, and any value so derived through such acts, as the “proceeds of

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<sup>95</sup> The Income Tax Act 1961, s 28.

<sup>96</sup> *ibid* s 45.

<sup>97</sup> Department of Economic Affairs (n 11) 33.

crime” under section 2(u) of PMLA. Instead, India can adopt a permissive approach by imposing obligations under Section 12 of PMLA as per which an obligation is imposed on banking companies, financial institutions, and intermediaries to maintain records regarding such transactions.<sup>98</sup> At the international level, the Financial Action Task Force (“FATF”) has urged countries to “*identify, assess, and understand the money laundering and terrorist financing risks emerging from virtual asset activities*” and adopt a risk-based approach.<sup>99</sup>

### iii. Technological Barriers

As highlighted by the Committee’s report, there are technological challenges to the acceptance of cryptocurrencies as well.<sup>100</sup> For example, blockchain transactions are much slower than existing digital financial services to ensure security and prevention of tampering. The transaction processing capacity for an average sized block is 3.3 to 7 transactions per second (TPS).<sup>101</sup> Financial services provider, Visa Inc. conducts 1700 TPS over a total claim of 150 million transactions per day.<sup>102</sup> Therefore, this is a

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<sup>98</sup> Anukriti Priya, ‘Why the government should regulate and not ban cryptocurrency’ *Inventiva* (2 July 2020) <<https://www.inventiva.co.in/trends/anukriti/why-the-government-should-regulate-and-not-ban-cryptocurrency/>> accessed 25 October 2020.

<sup>99</sup> Financial Action Task Force (n 21).

<sup>100</sup> Department of Economic Affairs (n 9) 27.

<sup>101</sup> Kyle Croman and others, ‘On Scaling Decentralized Blockchains’ in: Jeremy Clark and others (eds) *Financial Cryptography and Data Security: FC 2016* (Lecture Notes in Computer Science, vol 9604 Springer, 2016) 3 <[https://doi.org/10.1007/978-3-662-53357-4\\_8](https://doi.org/10.1007/978-3-662-53357-4_8)> accessed 25 October 2020.

<sup>102</sup> L Kenny, ‘The Blockchain Scalability Problem & the Race for Visa-Like Transaction Speed’ *Towards Data Science* (30 January 2019) <<https://towardsdatascience.com/the-blockchain-scalability-problem-the-race-for-visa-like-transaction-speed-5cce48f9d44>> accessed 25 October 2020.

very pertinent issue regarding scalability of cryptocurrencies, should they be accepted as legal tender.

However, this issue is slowly being addressed with innovative solutions only due to use and regulation. The Lightning Network which operates as a payment protocol over blockchain transactions, allows users to create payment channels between any two parties to ensure that transactions between them are instant and cost effective.<sup>103</sup> This serves as a solution to speed up transactions and ensure the same level of security. A complete ban on cryptocurrencies would not promote such solutions to a developing technology and would be contradictory to the country's vision to promote innovators and pioneers in digital manufacturing and development.

## **VI. CONCLUSION: THE WAY FORWARD**

A complete ban on cryptocurrency use is neither feasible nor efficient, keeping in mind the ambitions of the nation. The significance of crypto-assets in relation to the growth of blockchain technology has been observed by National Association of Software and Service Companies, which proposed a regulatory sandbox to address the risks,<sup>104</sup> and by the report of the Steering Committee on Fintech related issues, which has commented on the inevitable role of cryptocurrencies and ICOs in

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<sup>103</sup> Joseph Poon and Thaddeus Dryja, 'The Bitcoin Lightning Network: Scalable Off-Chain Instant Payments' (2016) <<https://lightning.network/lightning-network-paper.pdf>> accessed 25 October 2020.

<sup>104</sup> Chawm Ganguly, 'Banning Cryptocurrencies is not the solution, a regulatory framework must be developed: NASSCOM' *Core Sector Communique* (30 July 2019) <<https://www.corecommunique.com/banning-crypto-currencies-is-not-the-solution-a-regulatory-framework-must-be-developed-nasscom/>> accessed 25 October 2020.

transforming the global fintech landscape.<sup>105</sup> NITI Aayog, the policy think tank of the Government of India, published a discussion paper which recognized and analysed the areas that can be greatly benefitted by the use of blockchain technology.<sup>106</sup> Part 2 of the discussion paper is set to explore specific recommendations that would enable the growth of the blockchain ecosystem in the country. That said, at present, the legal framework around blockchain and cryptocurrency is still uncertain and needs to be resolved at the earliest, to ensure appropriate actions are taken.

Different regulators should work together and classify cryptocurrency activities in order to bring them under regulatory purview. A security under the Securities Contracts (Regulation) Act 1956, includes “*shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate.*”<sup>107</sup> There is an ambiguity as to whether crypto tokens and other crypto assets fit within this definition. These tokens may come under the control of SEBI if they are issued as ICOs or in collective investment schemes. Even with such uncertainty around cryptocurrency-related instruments, the Income Tax Department, in some cases, has issued notice and initiated proceedings against businesses dealing with cryptocurrencies. The chairman of the

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<sup>105</sup> Subhash Chandra Garg and others, ‘Report of the Steering Committee on Fintech Related Issues’ *Department of Economic Affairs, Ministry of Finance, Government of India* (2019) <[https://dea.gov.in/sites/default/files/Report%20of%20the%20Steering%20Committee%20on%20Fintech\\_1.pdf](https://dea.gov.in/sites/default/files/Report%20of%20the%20Steering%20Committee%20on%20Fintech_1.pdf)> accessed 25 October 2020.

<sup>106</sup> Arnab Kumar and others, ‘Blockchain: The India Strategy - Towards Enabling Ease of Business, Ease of Living and Ease of Governance’ *NITI Aayog* (January 2020) <[https://niti.gov.in/sites/default/files/2020-01/Blockchain\\_The\\_India\\_Strategy\\_Part\\_I.pdf](https://niti.gov.in/sites/default/files/2020-01/Blockchain_The_India_Strategy_Part_I.pdf)> accessed 25 October 2020.

<sup>107</sup> SCRA (n 93) s 2(h).

Central Board for Direct Taxes has stated that Bitcoin-related income will be taxed.<sup>108</sup> If the existing laws are applied without considering the challenges highlighted earlier, those who deal with crypto-assets may be taxed twice under the CGST Act, as there is a tax liability on the purchase of the asset and subsequently, at the time of exchange for other goods and services subject to GST.<sup>109</sup>

The Inter-Ministerial Committee recommended the ban due to the regulatory concerns surrounding VCs. These risks have been addressed by the international community at the G20 leaders' summit at Osaka, Japan in 2019, where world leaders of the group and India affirmed their commitment to the FATF standards.<sup>110</sup> One major recommendation has been “*to manage and mitigate the risks emerging from virtual assets*” by ensuring virtual asset service providers like cryptocurrency exchanges are regulated through licensing and registration requirements, alongside effective monitoring systems for preventing money laundering and combatting financing of terrorism.<sup>111</sup> All G20 nations, while recognising the risks associated with VCs have chosen not to put an outright ban on crypto-

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<sup>108</sup> 'Bitcoin earnings to be taxed, investors to face action for hiding income, says CBDT chairman' *Business Today* (11 February 2018) <<https://www.businesstoday.in/current/policy/bitcoin-investment-trade-earning-under-tax-income-virtaul-currency-tax-on-bitcoin/story/269981.html>> accessed 25 October 2020.

<sup>109</sup> Nishith Desai and others, 'Building a successful blockchain ecosystem in India: Regulatory approaches to cryptoassets' *Nishith Desai & Associates*, (December 2018) <[https://www.nishithdesai.com/fileadmin/user\\_upload/pdfs/Research\\_Papers/Building-a-Successful-Blockchain-Ecosystem-for-India.pdf](https://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/Building-a-Successful-Blockchain-Ecosystem-for-India.pdf)> accessed 25 October 2020.

<sup>110</sup> 'G20 Osaka Leaders' Declaration' *European Council* (29 June 2019) <[https://www.consilium.europa.eu/media/40124/final\\_g20\\_osaka\\_leaders\\_declaration.pdf](https://www.consilium.europa.eu/media/40124/final_g20_osaka_leaders_declaration.pdf)> accessed 25 October 2020.

<sup>111</sup> Financial Action Task Force (n 21).

trading.<sup>112</sup> Countries like the USA and Japan have chosen to deal with these by extending their existing laws to cryptocurrency related activities. Even China, which has taken a strict approach, issued severe restrictions on the use of VCs but none of these amount to an outright prohibition like the one recommended in the Draft Bill. Considering the economic and legal factors, a permissive approach seems like the most prudent model for India. It will not only facilitate economic growth but will ensure that illegal activities associated with the use of cryptocurrencies are brought under regulatory purview.

In light of the *Cryptocurrency judgment* and amidst reports of the RBI considering a review,<sup>113</sup> it is open to the government to either ban or regulate cryptocurrencies in India. Reports<sup>114</sup> point to the fact that the government is in discussion with the RBI to bring out a regulatory framework.<sup>115</sup> The comparative study and analysis carried out in the previous sections indicate that it would be pragmatic for the Indian government to regulate cryptocurrencies in a permissive manner, in order

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<sup>112</sup> Jaideep Reddy, 'The Case for regulating crypto-assets: a constitutional perspective' (2019) 15(2) IJLT 417.

<sup>113</sup> Saloni Shukla and Sachin Dave, 'RBI to seek review of Supreme Court order on cryptocurrency' *ET Prime* (6 March 2020) <<https://economictimes.indiatimes.com/news/economy/policy/rbi-to-seek-review-of-supreme-court-order-oncryptocurrency/articleshow/74503345.cms>> accessed 25 October 2020.

<sup>114</sup> Paddy Baker, 'India's Rumored Crypto Ban May Be Overblown, Say Industry Pros' *Coindesk* (15 June 2020) <<https://www.coindesk.com/india-lawmakers-figuring-crypto-regulation>> accessed 25 October 2020.

<sup>115</sup> Kevin Helms, 'Indian Government Engages RBI to Discuss Cryptocurrency Regulation' *Bitcoin.com* (21 March 2020) <<https://news.bitcoin.com/indian-cryptocurrency-regulation/#:~:text=The%20Indian%20government%20has%20been,providing%20recommendations%20for%20the%20country>> accessed 25 October 2020.

to realize the potential benefits of DLT in the financial sector while mitigating the acknowledged risks.