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Legality of Crypto-Assets in India

PRADYUMN AMIT SHARMA[1]

ABSTRACT

On 4th March, 2020, the Supreme Court of India in a significant judgement Struck down a Reserve Bank of India (RBI) circular that had effectively banned the trading of virtual currency and assets in India. This decision by the apex court gives India the potential to be a future hub for crypto-assets and cryptocurrency, an industry which boasted a market capitalization of U.S. $ 327.1 billion in 2019 in the United States alone. However, despite the aforementioned judgement, dealing in crypto-assets remains quite risky due to the absence of a regulatory body to monitor the transactions and the fact that the industry is not viewed favorably by the Indian government. Still the industry is growing at a high rate domestically, with the sum total of daily transactions ranging in millions of dollars. It has become an instrument which can no longer be ignored and it is important to study it as a revolutionary financial technology, especially by analyzing how other nations and international markets have proceeded to tackle it.

I. INTRODUCTION

Cryptocurrencies can be defined as a digital asset designed to work as a medium of exchange wherein the ownership records of individual coins are stored in a computerized database or digital ledger using strong cryptography in order to secure transaction record entries, control the creation of additional digital records and verify the transfer of coin ownership.[2] An interesting feature of cryptocurrency is that they are not issued by a central authority, like most currencies, and do not exist in physical form. Some cryptocurrencies are also known to use decentralized control as opposed to centralized control as opposed to digital currency and central banking systems.[3] Ever since bitcoin was released as an open-source software in 2009, the number of cryptocurrencies and crypto-assets are on a rise, with over 6000 altcoins (alternative variants of bitcoin) in existence.[4]

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[1] Author is a student of Symbiosis Law School, Noida, India.

[2] A. Greenberg, *Crypto currency*, forbes.com, (2011, Apr. 20), http://web.archive.org/web/20140831001109/http://www.forbes.com/forbes/2011/0509/technology-psilocybin-bitcoins-gavin-andersen-crypto-currency.html; and T. Polansek, *CME, ICE prepare pricing data that could boost bitcoin*, reuters.com, (2016, May. 20), http://www.reuters.com/article/us-cme-group-bitcoin-idUSCNOXT1G1.

[3] I. Allision, *If Banks Want Benefits of Blockchain, They Must Go Permissionless*, (2015), International Business Times.

[4] K. Sagona-Stophel, *Bitcon 101 white paper*, thomasreuters.com, (2016, Aug. 13),

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Cryptocurrency first came into existence in 1983, when the American Cryptographer, David Chaum, conceived an anonymous cryptographic electronic money called ecash.[5] Subsequently, in 1995 he implemented it through Digicash, a nascent form of cryptographic electronic payments which required user software in order to withdraw notes from a bank and designate specific encrypted keys before it could be sent to the recipient. This allowed the digital currency to be untraceable by the issuing bank, the government, or any third party. This and several subsequent developments culminated when Satoshi Nakamoto, presumably a pseudonymous developer, created Bitcoin in 2009.[6] Since then, the popularity and usage of bitcoin has increased tremendously, with the value of one bitcoin, as of 13th June, 2020, being equal to INR 7,15,002.23.[7] Such enormous figures are a clear testament to the economic value and wealth generation potential cryptocurrencies hold.

II. HISTORY OF CRYPTOCURRENCY IN INDIA

The advent of cryptocurrency in India began in 2013 when Bitcoin was first introduced in the Indian markets. A lot of people began investing and speculating on the new entry in the financial market which led to the emergence of several private cryptocurrency exchanges and startups like Zebpay, Wazirx, Cashaa, etc. During this time, several authorities posted about the risks involved in dealing with cryptocurrencies, but no official regulatory policy was enacted. Things began to take a turn in 2017, when rumors circulated that severe regulations might be enacted on the crypto market and that coupled with the poor performance of the market led to major fluctuations in the value of cryptocurrencies.

It was in November 2017 that a high level inter-ministerial committee was constituted by the Government of India. The objective of the committee was to look into the challenges and issues surrounding cryptocurrencies and assets and to propose specific actions and measures which may be taken regarding them. The committee on July, 2020 submitted its report, recommending that all private cryptocurrencies in India should be banned, with a fine of INR 25 Crore and imprisonment for as long as 10 years for anyone found dealing in it.[8] This was followed by the RBI and Ministry of Finance, in December 2017, issuing press releases comparing cryptocurrencies to Ponzi schemes and cautioning the general public regarding them by

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http://www.thomsonreuters.com/en.html.

[5] D. Chaum, *BLIND SIGNATURES FOR UNTRACEBALE PAYMENTS*, (1983), Santa Barbara, California: Department of Computer Science, University of California.

[6] J. Brito, & A. Castillo, *Bitcoin: A Primer for policymakers*, (2013), George Mason University.

[7] Morningstar for Currency and Coinbase for Cryptocurrency, (2020, June. 13).

[8] *Inter-ministrial group suggests banning of private cryptocurrencies in India*, economictimes.indiatimes.com, (2019, July. 23), http://economictimes.indiatimes.com/news/economy/policy/indian-panel-recommends-ban-on-cryptocurrency/asrticleshow/70331293.cm?from=mdr.

declaring that they are neither currencies or coins. Finally, on 6th April, 2018, RBI issued a circular whereby it prevented Commercial and co-operative banks, payment banks, small finance banks, non-banking financial companies and payment system providers from dealing in virtual currencies and directed them to stop providing services to all the entities which deal in virtual currency.

The circular crippled the business operations of cryptocurrency exchanges in India. Cryptocurrency exchanges relied on normal banking channels for sending and receiving money to and from their users but now they could not access any banking services within India. As converting cash to cryptocurrency and vice versa was an essential element of their operations, their business began to fail. Cryptocurrency exchanges, which did not deal in fiat currency, were also unable to carry on their operations as without the access to banking services, they were unable to pay their vendors, staff salaries, server space, etc.

Following this, a number of cryptocurrency exchanges which were part of the Internet and Mobile Association of India (**IMAI**), filed a writ petition in the Supreme Court on 15th May, 2018. The Supreme Court of India, in its judgement, struck down the above-mentioned circular.

III. Reasons for RBI's de-facto ban on crypto-assets

Bitcoin or other virtual currencies are way different than any other asset or currency which most of the population is accustomed with. As virtual currency trading and transactions are unregulated, they lack accountability and they can only be tracked if virtual currency holders convert their virtual currency into regular currency. Blockchain is akin to a decentralized, public ledger where digital information is stored.[9] Cryptocurrencies use blockchain technology as database to store information. However, if the blockchain is not secure, then the counterfeiting of cryptocurrencies is not a far-fetched idea. Apart from this, conversion of bitcoin into foreign exchange does not fall under the RBI's purview, making cryptocurrency transactions highly vulnerable to cyber-attacks. Apart from this, as no regulator can track, monitor or regulate cryptocurrency transfers, it has the potential to support criminal and anti-social activities such as money laundering, tax evasion, funding terrorism, etc.

As cryptocurrency lacks any intrinsic value and affords anonymity to its holder, the RBI's primary reason for banning cryptocurrency was to protect investors. Even imposing know-your-customers or **KYC** regulations does not assist in decreasing the possibility of fraudulent

[9] N. Reiff, *Blockchain Explained*, Investopedia.com, (2020, Feb. 1), http://www.investopedia.com/terms/b/blockchain.asp.

transactions since determining the identity of the original holder of the cryptocurrency is quite difficult. Lack of control of central authorities and regulatory agencies over cryptocurrencies is another common reason why cryptocurrencies are distrusted. For instance, if in the event a payment is hacked or there is an unfortunate failure of transfer of funds due to a technical glitch or bug, then regulators fear that investors may not have any recourse. All of these factors make it quite clear why the Indian government and RBI consider trading in cryptocurrencies a major risk for its potential investors.

IV. Advantages of legalizing cryptocurrencies

Despite the above-mentioned reasons, rejecting bitcoins or cryptocurrencies as a volatile and risky market would not be in the best interest of the economy. Cryptocurrency is one of the many innovations in the field of cyberspace that the world has witnessed over the last two decades of the 21st century. Just like other revolutionary ideas and technology like electronic wallets (**e-wallets**), they have a huge potential for wealth generation. To compare them with the previously mentioned e-wallets, they were first popularized as a source of online money transfer when PayPal launched its electronic payments system in 1999.[10] Since then, many estimates suggest that the global mobile wallet market value would reach a staggering $1 trillion in 2020.[11] And it's not just the global economy or the foreign multinational corporations which have benefitted from this. In India several companies, such as Paytm, Mobikwik, Jio money, Freecharge, etc. have successfully introduced e-wallet services to make it a billion-dollar industry domestically as well.

Cryptocurrency has a similar growth potential. As mentioned earlier, Bitcoin was the first cryptocurrency ever launched. However, since then a lot of new private cryptocurrencies emerged in the global market like Ethereum, Ripple, Litecoin, Tether, Libra, Monero and many more. All of these currencies have proved to be extremely successful and generating billions of dollars of wealth. Similarly, if the cryptocurrency and asset industry becomes legal and regulated in India, there is a high possibility that Indian entrepreneurs would emerge with domestically engineered cryptocurrencies which would take off, Just like Paytm did in India in case of e-wallet services. And that would result in the generation of tremendous amounts of wealth for the domestic markets.

The present government has robustly declared plenty of times that they aim for India to become

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[10] *History of PayPal*, gadegtdetail.com, (2015, July. 21), http://www.gadgetdetail.com/history-paypal/.
[11] A. Rolfe, *Global mobile wallet market value set to reach $1 trillion in 2020*, paymentscardsandmobiles.com, (2020, Feb. 26), http://www.paymentscardsandmoblies.com/global-mobile-wallet-market-value-set-to-reach-1-trillion-in-2020/.

a $5 trillion economy by 2024.[12] Assessing the current situation, amid the global pandemic due to COVID-19 and the subsequent economic slowdown and stagnation, this might be a pretty far fetched objective. Nevertheless, in order to achieve that $5 trillion economic mark, the India government would have to do its best to support innovations and provide economic ecosystem, where investors and entrepreneurs feel secure and encouraged to invest into startups and independent ventures, through a strong regulatory and oversight system. Not supporting the presence of cryptocurrencies in the market because there is no system in place to regulate them in a great example of how India is passing by great opportunities to grow economically. Straight up restricting the trade and banning cryptocurrencies is not the answer to the problem which investors and the Indian markets need.

V. Cryptocurrency regulations in international markets

United Kingdom and the United States of America are two markets which have significantly progressed when it comes to developing laws and regulations for crypto-assets. Despite the fact that the economies and markets of both the above-mentioned countries are different from that of India, it's important to analyze how other nations have/are challenging the issue of regulating crypto-assets.

Cryptocurrency regulations in the United Kingdom

In the UK, financial services and business are overseen by the Financial Conduct Authority ("**FCA**"), which aims to "protect consumers from harm and enhance the integrity of the UK's financial services sector, and promote effective competition in the interest of its consumers", through its regulations. At present, there is no absolute restriction or any regulatory agency in place, when it come to the subject of cryptocurrencies in UK. However, if a cryptocurrency falls within the general financial regulatory perimeter established under the Financial Services and Markets Act 2000 ("**FSMA**"), under the Payment Services Regulations 2017 ("**PSRS**", the Electronic Money Regulations 2011 ("**EMRs**") and some money transmission laws and anti-money laundering requirements, then it would be subject to financial regulation and oversight in the UK.[13] Determining whether existing financial regulations should apply to cryptocurrencies is based on the purpose such cryptocurrencies are being used for, and must be established on a case by case basis. Therefore, a crypto-asset taskforce was established in

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[12] M. Sharma, *Can India become a $5 trillion economy*, The Economic Times, (2019, June. 20), https://economictimes.indiatimes.com/news/economy/indicators/can-india-become-a-5-trillion-economy/articleshow/69869145.cms?from=mdr.

[13] S. Davis, S. Waxon, & A.C. Moyle (n.d.), *Blockchain & Cryptocurrency Regulations 2020 | UK.*, Blockchain & Cryptocurrency Regulation 2020, Global Legal Insight.

March 2018 to consider the policy and regulatory implications of distributed ledger technology and crypto-assets.[14] Several policy thinking was set out by the UK crypto-assets Taskforce in its final report ("**Taskforce**")[15] which classified crypto-assets into three sub-categories namely Exchange tokens, which includes cryptocurrencies such as Bitcoin, Litecoin, etc.; Security tokens, which amount to a 'specified investment' as set out in the FSMA; and finally Utility tokens, which can be redeemed for access to a specific product or service that is typically provided using a distributed ledger technology platform.[16] And like many countries and regions around the world, the UK also does not consider cryptocurrencies as fiat currency.[17]

The Taskforce determined that all those cryptocurrencies which are used as a means of exchange, may classify under the regulatory perimeter under the PSR. According to the Taskforce, if a cryptocurrency is being used to facilitate regulated payment services, such as an intermediary in a cross-border transaction or an indirect investment, that reference crypto-assets, from a financial institution, they would subject to money remittances under the PSR.[18] When it comes to investments, only those which are directly into crypto-assets are subject to the regulatory perimeter if the said asset is a security token or if the investment is made through regulated investment machinery. Incase crypto-currency is included as a capital-raising tool, then it would also fall within the perimeter, if the asset is a security token.[19]

When it comes to taxation, till date there are no exclusive tax rules which are applicable on cryptocurrencies. Therefore, despite uncertainty as to their application, existing tax principles and rules are applied on crypto-assets.[20] Despite their being no definitive tax policy on the subject, the UK tax authority, HM Revenue and Customs ("**HMRC**") published a paper which set out views on how individuals who hold crypto-assets are to be taxed and some potential schemes on how crypto-assets and the relating industry can be taxed.[21]

When it comes to the subject of anti-money laundering policies, on 10th January, 2020 the fifth Money laundering Directive (EU) 2018/843 ("**5MLD**") came into force. 5MLD expanded the scope of businesses to which the UK's antimony laundering regime applies, now including

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[14] HM Treasury, Financial Conduct Authority, Bank of England. (2018). *Cryptoaaets Taskforce: Final Report.*
[15] *Cryptoasset Taskforce published report on UK approach to Cryptoassets*, Financial Conduct Authority, (2018, Oct. 29), https://www.fca.org.uk/news/news-stories/cryptoasset-taskforce-publishes-report-uk-approach-cryptoassets.
[16] Ibid 16.
[17] Herbet, J., *2020: THE YEAR OF EU CRYPTO-ASSET REGULATION?* (2020, June 2), *Laywer Monthly*.
[18] Ibid 15.
[19] Ibid 16.
[20] Ibid 15.
[21] See HRMC, *Cryptoassets for individuals*.

crypto-asset exchanged, and amended a number of the substantive requirements.[22]

CRYPTOCURRENCY REGULATIONS IN THE UNITES STATES

In the United States of America, crypto-assets have garnered a lot of attention from the federal as well as the state governments. Most of the agencies of the federal government, such as the Securities and Exchange Commission ("**SEC**"), the commodities and Futures Trading Commission ("**CFTC**"), the Federal Trade Commission ("**FTC**") and the Department of Treasury, through both the Internal Revenue Service ("**IRS**") and the Financial Crimes Enforcement Network ("**FinCEN**") have mainly focused at the administrative and agency level. While there has been skepticism regarding this upcoming technology, most policy makers and federal agencies have appreciated this technology and referred to it as being an important part of the United States' future infrastructure and the need for USA to maintain a leading role in development.[23]

Governing laws for cryptocurrency exchanges vary depending upon the state and federal authorities differ in their definition of the term "cryptocurrency" and thus follow different approaches when it comes to them. The SEC has regulatory authority over the issuance of digital assets or tokens that constitute a security, at the federal level. Under the U.S. law a security would include "an investment contract" which the U.S. Supreme Court defined as an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.[24] Thus SEC has been clear that if a token, which has "utility", been issued through an Initial Coin Offering ("**ICO**"), and it meets the elements of the *Howey test*, then it would be governed by the Securities Act.[25] Regulations by the SEC has definitely created a layer of assurance when it comes to cryptocurrencies but owning to the different state laws and the various types and categories of cryptocurrencies that exist on the market, it's not possible for each and every crypto-asset to fall under the ambit of federal jurisdiction.

In the U.S., Under the Bank Secrecy Act ("**BSA**") FinCEN regulates money services business ("**MSB**"). The sale of cryptocurrency is only regulated in the U.S. if the sale constitutes the sale of a security under state or Federal law or, if the sale is considered to have constituted money transmission under the State law or, pursuant to FinCEN's regulations, the sale was

[22] See fifth Money laundering Directive (EU) 2018/843.
[23] Dewey, J., *Blockchain & Cryptocurrency Regulations | USA, (2020), Blockchain & Cryptocurrency Regulations 2020.* Global Legal Insights.
[24] SEC v. Howey Co., 328 U.S. 293, 301 (1946).
[25] Ibid 25.

done as part of MSB under the federal law. FinCEN, on March 18, 2013, issued guidelines which stated that a virtual currency exchange and an administrator of a centralized repository of virtual currency who has the authority to both issue and redeem the virtual currency would be considered MSB.[26] FinCEN regulations mandate MSBs to develop, maintain and implement a written program that is reasonably designed to prevent it from being used as a medium to facilitate money laundering and financing terrorist activities. Every MSB must develop an anti-money laundering ("**AML**") program based on a comprehensive risk assessment of their potential exposure to money laundering. Apart from this, there also exist other measures in place to prevent money laundering. For instance, U.S. citizens are prohibited from doing business with certain foreign nationals who are on the Specially Designated Nationals and Blocked Entities List of the U.S. Department of the Treasury's Office of Foreign Asset Control.

When it comes to taxation on crypto-assets in the U.S., the IRS in 2014 declared that virtual currency would be subject to taxation as property and not currency. Consequent to this announcement, every individual or business that deals in crypto-assets will be required to keep detailed records of cryptocurrency purchases and sales, furnish taxes on gains made by selling crypto-assets, pay taxes on gains made upon the purchase of goods or services via crypto-assets and pay taxes on the fair market value of any mined cryptocurrency.[27]

VI. FUTURE OF CRYPTO-ASSETS IN THE INDIAN MARKET

Despite the fact that the Draft Banning of Cryptocurrency and Regulation of Official Currency Bill, 2019 continues to remain pending in the Parliament of India, during the months of the lockdown, caused to the Covid-19 pandemic, trading volumes of cryptocurrencies have increased 400 times with the estimated trading volume pegged at $10-$30 million.[28] This level of market play seems to astonishing considering that Indian government is reportedly planning to introduce a law to ban cryptocurrencies altogether.[29]

In order to safely and securely introduce crypto-assets in the Indian market, the government would have to re-evaluate its proposed legislation to ban all cryptocurrencies. Laws governing crypto-assets would have to be designed in such a way that their utility as payment mechanism

[26] See FIN-2013-G001, Application of FinCEN's Regulations to Person's Administering, Exchanging or Using Virtual Currencies (March 18, 2013).
[27] See IRS Notice 2014-21, Guidance on Virtual Currency (March 25, 2014).
[28] A. Singh, *Despite growing interest, cryptocurrencies face uncertain future in India*, The Week, (2020, July. 31), https://www.theweek.in/news/biz-tech/2020/07/31/despite-growing-interest-cryptocurrencies-face-uncertain-future-in-india.html.
[29] D. Sikarwar, *With a law, India plans lasting ban on cryptos,* (2020, June. 12), economictimes.indiatimes.com, https://economictimes.indiatimes.com/news/economy/policy/with-a-law-india-plans-lasting-ban-on-cryptos/articleshow/76330403.cms.

is governed by the RBI and at the same time they can be traded as an asset or security on an exchange regulated by a body such as SEBI. In order to tackle issues such as money laundering via cryptocurrencies, India would have to develop as solid framework to regulate, supervise and monitor cryptocurrency transactions. Collaborating with international organizations such as the Financial Action Task Force and other countries which have successfully developed a regulatory mechanism for crypto-assets can be one way forward. At the nascent stage of the industry a stringent licensing, compliance and inspection norms for transaction concerning crypto-assets would be warranted but at the same time maintaining their financial advantage. The creation and implementation of an efficient system to tax crypto-assets can potentially increase revenue for the nation and create a successful industry which might amplify and support other sectors greatly.[30]

VII. Conclusion

Compared to several western nations like the United States, Germany, U.K. and even Asian countries such as Japan and China, India is way behind when it comes to the adoption of new and innovative technology; crypto-assets being a prime example to the fact. Adoption of such innovative technology is bound to be met with a lot of skepticism and distrust, especially since innovations keep on getting more and more complicated for an everyday person. Crypto-assets present a golden opportunity for financial gains and it’s in the best interests of every country to take proactive steps to integrate them in their respective economies. If India ever hopes to become a financial super power and achieve the kind of economic goals which the government as well the population are striving towards, it would have to become more receptive and open minded when it comes to adoption of new technology and financial instruments.

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[30] T. Jain, *Opinion | Designing cryptocurrency regulations in India post Supreme Court order*, livemint.com, (2020, July. 27) https://www.livemint.com/opinion/online-views/opinion-designing-cryptocurrency-regulations-in-india-post-supreme-court-order-11595844624893.html.

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