

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 7 | Issue 5

2024

© 2024 *International Journal of Law Management & Humanities*

Follow this and additional works at: <https://www.ijlmh.com/>

Under the aegis of VidhiAagaz – Inking Your Brain (<https://www.vidhiaagaz.com/>)

This article is brought to you for “free” and “open access” by the International Journal of Law Management & Humanities at VidhiAagaz. It has been accepted for inclusion in the International Journal of Law Management & Humanities after due review.

In case of **any suggestions or complaints**, kindly contact Gyan@vidhiaagaz.com.

To submit your Manuscript for Publication in the **International Journal of Law Management & Humanities**, kindly email your Manuscript to submission@ijlmh.com.

Regulation of Virtual Digital Assets: The Journey, Challenges, and Way Forward

AVADHESH PRATAP SINGH¹

ABSTRACT

This article explores the regulation of Virtual Digital Assets (VDAs) in India, focusing on their growth, risks, and the government's response. VDAs, which include cryptocurrencies and Non-Fungible Tokens (NFTs), have gained popularity but also raise concerns about misuse for illegal activities like money laundering and tax evasion. The Indian government issued a notification under the Prevention of Money Laundering Act (PMLA) to bring VDAs under regulatory oversight, requiring Virtual Asset Service Providers (VASPs) to follow strict rules such as Know Your Customer (KYC) norms and transaction monitoring.

Despite these efforts, the regulation of VDAs still faces challenges, including issues related to anonymity, cross-border transactions, and inconsistent compliance practices. The article suggests several solutions to improve the regulation of VDA regulation, such as creating a separate law for VDAs, establishing a regulatory sandbox for testing new ideas, and enhancing international cooperation.

A dedicated regulatory authority could better enforce rules and protect users' rights. Overall, the article highlights the need for a balanced approach that encourages innovation while ensuring security and accountability in the digital asset space.

Keywords: *Virtual Digital Assets, VDA regulation, money laundering, cryptocurrencies, compliance.*

I. INTRODUCTION

Virtual Digital Assets have gained popularity in recent years, it is mostly understood through the names of Cryptocurrencies like Bitcoin and Ethereum. However, Virtual Digital Assets have a wide definition it includes Non-Fungible Tokens and other forms of digital assets. Section 2(47A) of Income Tax Act 1961(as amended by the finance act, 2022) provides the definition of VDAs, it includes:

- a) Any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise, by whatever name called, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a

¹ Author is a student at GLA University, Mathura, UP, India.

unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and can be transferred, stored or traded electronically;

- b) A non-fungible token or any other token of similar nature, by whatever name called;
- c) Any other digital asset, as the Central Government may, by notification in the Official Gazette specify:

Provided that the Central Government may, by notification in the Official Gazette, exclude any digital asset from the definition of virtual digital asset subject to such conditions as may be specified therein.

However, in this definition, Indian currency and foreign currency are excluded. The taxation of VDAs involves specific provisions, including a flat 30% tax on any income derived from the transfer of VDAs, without the benefit of deductions (other than the cost of acquisition) or setting off losses.

Along with gaining popularity, VDAs also raise many concerns regarding their potential misuse, especially for illegal activities like money laundering, tax evasion and terror financing. Additionally, unregulated VDAs are vulnerable to scams, hacks, and fraudulent schemes. To address these concerns, the central government through the Ministry of Finance issued a notification in March, 2023 under PMLA, 2002, which included VDAs and Virtual Asset Service Providers such as VDA Exchanges, custodians and wallet providers, as reporting entities. This means that businesses dealing with VDAs must now comply with anti-money laundering regulations to prevent money laundering and terror financing.

The notification mainly focuses on three points:

1. **KYC and Compliance:** Virtual asset service providers now have to follow strict Know Your Customer (KYC) norms. This means they must verify the identity of their customers through government documents.
2. **Monitoring and Reporting:** The service providers now have to monitor transactions on their platforms and report any suspicious activity to the Financial Intelligence Unit - India (FIU-IND). Additionally, VDA service providers are required to ensure transparency in international transactions to prevent their use for illegal activities.
3. **Record Keeping:** The service providers are required to maintain records of all transactions, customer information, and compliance processes for a minimum of 5 years. This assists the authorities in tracing suspicious transactions if needed.

Regulation of VDAs is necessary to address evolving technology and financial crimes. While

this notification is a significant step, there are still many challenges and risks associated with its Regulation because of the unique nature of VDAs.

II. HISTORY OF VDA REGULATION IN INDIA

India's stand on VDAs has been developed over the years, the government's approach has always been inconsistent. The following are the key developments:

1. *2013-2017 (Initial Caution)*: during these years, cryptocurrencies gained more popularity worldwide, and people began showing interest in investing in VDAs. However, during this period, the Reserve Bank of India (RBI) issued multiple warnings, cautioning people about the risks of VDAs, such as scams, fraud and security threats.
2. *2018 (RBI's Banking Ban)*: In April 2018, the RBI issued a circular that prohibited banks and financial institutions from providing services related to virtual currencies and businesses related to cryptocurrencies. This made it difficult for VDA platforms to operate, but people continued to trade cryptocurrencies through peer-to-peer platforms.
3. *2020 (Supreme Court struck down the circular)*: In the case of *Internet and Mobile Association of India Vs. Reserve Bank of India, 2020*, the Supreme Court of India lifted the RBI's ban, based on 2 grounds, excessive delegated power of RBI and disproportionately. This decision revived the crypto industry in India, bringing the regulation of VDAs back into the spotlight.
4. *2021-2022 (Proposed Legislation)*: The Central government expressed its intention to introduce an act to regulate VDAs. A draft bill, the Cryptocurrency and Regulation of Official Digital Currency Bill, was prepared but was never introduced in Parliament, further leaving the regulation of VDAs in a grey area.
5. *2023 (The PMLA Notification)*: Finally, in 2023, the Ministry of Finance issued the notification that brought VDAs under the PMLA. This step aimed to address some of the risks associated with VDAs, particularly in the areas of money laundering, tax evasion and terror financing.

III. RISKS AND CHALLENGES OF REGULATING VDAS UNDER THE PMLA

While the notification is a significant move, it doesn't completely address the unique risks associated with VDAs:

1. *Anonymity and Pseudonymity*: the main feature of cryptocurrencies is the ability to remain anonymous or pseudonymous. Which in turn, makes it difficult for authorities to trace illegal transactions and identify people involved in illegal activities.

2. **Cross-Border Transactions:** The global nature of VDAs allows for easy cross-border transfers. People can transfer VDAs across the world very easily. This enhances the chances to exploit VDAs for money laundering, which in turn, makes it harder for Indian authorities to monitor or control these transactions.
3. **Technological Complexity:** VDA Service Providers are new start-ups and businesses which does not have the adequate infrastructure to comply with the AML regulations. Additionally, Monitoring VDA transactions requires advanced technology like blockchain analytics. Not all VDA businesses in India may have access to these tools, which could lead to difficulty for Service Providers in compliance.
4. **Regulatory Arbitrage:** Due to stringent compliance mechanisms in India and lenient regulations in other countries, businesses might move their operations from India to other countries, which in turn, can reduce India's competitive advantage in the growing digital asset market, reducing the foreign investment in India.
5. **Privacy concerns:** The enhanced KYC and reporting Compliances could potentially infringe upon the privacy rights of VDA users. This is very sensitive due to the absence of a comprehensive data protection regime in India.
6. **KYC compliance:** PMLA does not yet specify how VDA-specific KYC requirements should be framed, leading to inconsistent compliance practices across service providers.
7. **Peer-to-peer transactions:** PMLA does not explicitly cover the implications of VDAs such as custodianship, decentralized finance, or the peer-to-peer nature of transactions.

IV. ALTERNATIVE MEASURES TO REGULATE VDAS

As there are many challenges associated with the regulation of VDAs through the current legal framework, there are alternative solutions the government can consider:

1. **Comprehensive Law for VDAs:** Instead of regulating VDAs through an executive notification under PMLA, the government could introduce separate comprehensive legislation that clearly defines VDAs and provides specific regulations for VDAs by considering their unique nature. This would avoid confusion, provide clarity and ensure a tailored approach to VDA regulation.
2. **Regulatory Sandbox:** The government could create a regulatory sandbox, which could have in-built AML/KYC compliance protocols, where VDA Service Providers can test their models under the supervision of regulators. This would enable the development of efficient

regulatory strategies and technological innovations to reduce risks. This would reduce the full burden of regulation upon Service Providers for a specific period.

3. Sector-specific AML guidelines: there is a need for sector-specific AML guidelines for VDA Service Providers such as the use of blockchain analytics, artificial intelligence and machine learning for real-time transaction monitoring and identifying suspicious activities in VDAs. This would reduce manual work and increase regulatory efficiency. This would ensure early detection of illicit activities and enable regulators to track the chain of custody and potentially freeze assets more effectively.
4. International Cooperation: Since the nature of VDAs is global, they can easily be transferred across borders, the Indian government should strengthen its cooperation with international bodies to track and control cross-border transactions that involve illegal activities.
5. Data protection and privacy: The government should make provisions related to data retention, usage, and sharing specifically for the collection of sensitive personal data and financial data during KYC processes in terms of VDAs. This could reduce concerns over data misuse by service providers.
6. Separate VDA Regulatory Authority: there is a need to set up a new regulatory body for VDAs which could be responsible for providing license to service providers, enforcing KYC/AML regulations, and resolving disputes. This body could also collaborate with other financial and law enforcement agencies to strengthen regulatory oversight of VDAs.
7. Specific Reporting Obligations: The government is required to make the amendments under PMLA for laying down specific guidelines for VDA service providers, providing their responsibilities for KYC, transaction monitoring, and reporting.

V. CONCLUSION

The regulation of Virtual Digital Assets in India has come a long way, with the inclusion of VDAs under the PMLA being an important milestone. However, the unique risks associated with these digital assets require more comprehensive laws and better enforcement mechanisms. By introducing targeted amendments, working with the industry, and strengthening international cooperation, India can create a regulatory framework that not only protects against illegal activities but also encourages innovation and growth in the VDA space.

Effective regulation will be key to balancing the benefits of VDAs with the need for transparency, security, and accountability in the financial system.

VI. REFERENCES

1. Income Tax Act, No. 43 of 1961, § 2(47A) (as amended by Finance Act, 2022) (India).
2. Ministry of Finance, Notification No. S.O. 1072(E), Gazette of India, March 7, 2023 (India).
3. Prevention of Money Laundering Act, No. 15 of 2003, INDIA CODE (2003), available at <https://indiacode.nic.in/handle/123456789/1988>.
4. Reserve Bank of India, Prohibition on Dealing in Virtual Currencies (VCs), RBI Circular No. DCBR.BPD.(PCB/RCB).Cir.No.19/16.74.000/2017-18, April 6, 2018.
5. Internet & Mobile Association of India v. Reserve Bank of India, (2020) 10 SCC 274 (India).
6. Government of India, Draft Cryptocurrency and Regulation of Official Digital Currency Bill, 2021.
7. Financial Action Task Force, Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers, FATF Report (2019), available at <https://www.fatf-gafi.org/media/fatf/documents/recommendations/RBA-VA-VASPs.pdf>.
8. Varun Sinha, India Brings Cryptocurrencies Under Anti-Money Laundering Law, REUTERS, March 8, 2023, available at <https://www.reuters.com>.
9. Financial Intelligence Unit-India (FIU-IND), Reporting Entity Compliance, available at <https://fiuindia.gov.in>.
10. Siddhartha Shukla, India's Approach to Regulating Cryptocurrencies, BLOOMBERG, March 10, 2023, available at <https://www.bloomberg.com>.
11. The Financial Action Task Force (FATF), FATF Report on Virtual Assets and Virtual Asset Service Providers, June 2021, available at <https://www.fatf-gafi.org>.
