

Tracing India's Regulatory Footsteps Towards Blockchain & Cryptocurrencies

Introduction

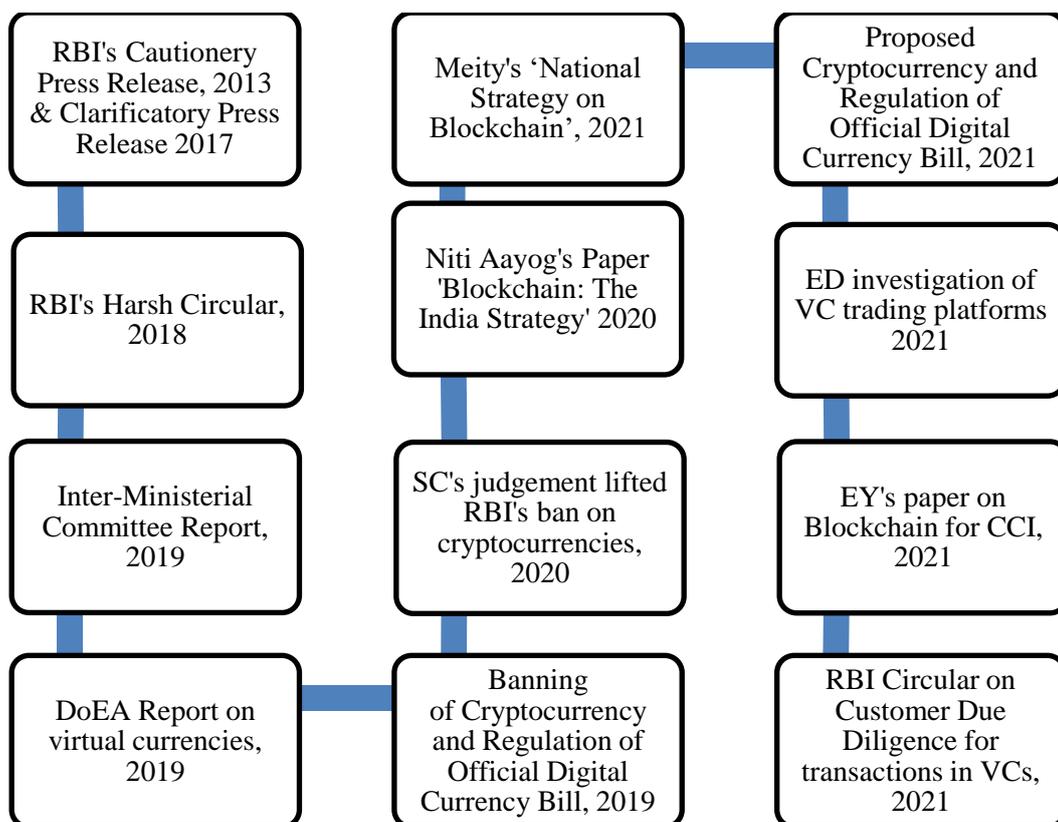
Blockchain¹ has been an area of interest across the globe. It may be best described as a database containing a list of records/transactions, like a ledger, which keeps growing as more entries are added to it. The database is distributed with copies of the entire database being stored on multiple computers synced on a network. One of the key features of the technology is immutability, i.e., it is impossible to change/delete any data once recorded and accepted. Details about blockchain, are available in our previous briefing paper 'Introduction to Blockchain Technology'.²

A popular use case of the emerging technology is a cryptocurrency³ (also known as virtual currency), which also enables smart contracts, facilitates cross-country payments, among other use cases. Popular cryptocurrencies include Bitcoin and Ethereum, which are traded in India through exchanges such as Coin DCX, WazirX, etc. As per estimates, there are ~10mn cryptocurrency users in India.

Regulatory Developments Surrounding Blockchain and Cryptocurrencies

India has so far adopted a multi-pronged approach to regulate blockchain and cryptocurrency technology, with the government, regulators and departments coming out with press releases, circulars, bills and papers on it.

However, indecision and unpredictability can also be seen in India's approach, changing its sentiments towards such technologies. A summary of notable developments has been given in the infographic below.



RBI's Approach

The Reserve Bank of India (RBI) took exemplary steps in 2013.⁴ It issued a press release to clarify that the creation, trading, or usage of virtual currencies (VCs), have not been authorised as a medium for payment by any central bank or monetary authority. It also listed various risks of using VCs, such as:

- No established framework for consumers grievance redressal;
- Susceptibility to losses arising due to hacking and cyber-attacks, loss of password, leading to denial to service;
- High price volatility of cryptocurrencies;
- Risks for illegal activities, for instance: money laundering and terror financing; and
- Questionable legal status of VC exchange platforms exposes traders of VCs to legal as well as financial risks.

Subsequent clarificatory press releases in 2017 reiterated that RBI had not approved any entity to operate or deal with cryptocurrencies. Any users, holders, investors, or traders dealing in cryptocurrency were doing so at their own risk.⁵ A harsher approach was adopted by it in 2018 when its circular directed all entities to cease dealing with cryptocurrencies immediately.⁶ All entities were asked to cease providing services regarding VCs within three months of the circular.

Inter-Ministerial Committee on VCs

The government set up an Inter-Ministerial Committee (IMC) in 2017 to study the issues related to VCs and propose a way forward for them. A report was submitted in 2019,⁷ which recommended that VCs cannot replace traditional forms of currencies.

Apart from the RBI's concerns, it also highlighted issues regarding regulation of cryptocurrencies given their decentralised nature and lack of digital infrastructure in the country to support them. The committee also echoed RBI's stance of banning all private cryptocurrencies and recommended activities connected with cryptocurrencies to be criminalised by law.

It further suggested the government establish a Standing Committee to look into global and local technological developments regarding cryptocurrencies.

However, it also recognised the utility and potential of blockchain technology identifying duplicate transactions, fraud-detection, processing Know Your Customer (KYC) requirements, claim management for insurance, removing errors and frauds inland markets. Accordingly, it suggested the Department of Economic Affairs (DoEA) identify use cases of blockchain and facilitate its usage.

The committee recommended a working group set up by the Ministry of Finance (MoF), with representatives from RBI and the Ministry of Electronics and Information Technology (Meity), to develop an appropriate digital currency model in India that may regulate.

Judicial Stance on Cryptocurrencies

In 2020, India started to adopt a more positive approach towards cryptocurrencies. The Supreme Court of India (SC), through its judgement lifted RBI's ban on cryptocurrencies.⁸

This enabled crypto-exchanges to begin operations in the country, while also decriminalising investments in cryptocurrencies. The SC judgement appeared to underline that regulators may not have the power to shut down something which does not violate any existing law, and is not fraud.

Post the judgement, the RBI recently advised banks not to caution its customers against using cryptocurrencies, given that its previous circulars on the subject had been nullified. It, however, asked banks to continue customer due diligence about Combating of Financing of Terrorism (CFT), as well as obligations under the Prevention of Money Laundering Act, 2002 (PMLA), and the Foreign Exchange Management Act, 1999 (FEMA).⁹

Government's Assessment of Blockchain

In 2019, the **DoEA** formed committee submitted its report to propose specific actions to be taken about Virtual Currencies.¹⁰ The committee reviewed legal frameworks governing VCs across several jurisdictions to understand the concerns surrounding VCs and recommend appropriate measures to address them.

It highlighted various concerns and challenges related to cryptocurrencies, which resound those raised by RBI et al. and recommended a ban on private cryptocurrencies. However, it suggests having an open mind to discuss the possibility of having an official digital currency in India and concludes with discussing the various possible use cases of cryptocurrency in financial services.

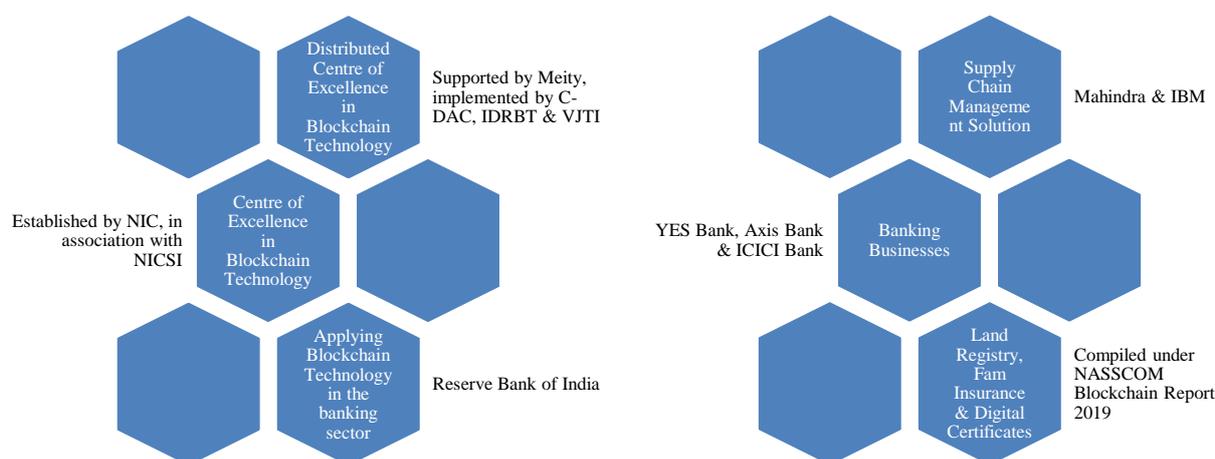
The report's notable point pertains to data localisation, as recommended under the Personal Data Protection Bill 2019 (PDPB). This has been seen as a barrier in implementing/adopting Distributed Ledger Technology (DLT).

Niti Aayog released its Discussion Paper 'Blockchain: The India Strategy',¹¹ in 2020, which recognised the potential of blockchain in revolutionising interactions between governments, businesses and citizens. It highlighted its possible contribution in revamping current processes to increase efficiency, thereby contributing towards Ease of Business, Ease of Governance, and Ease of Living.

Apart from enlisting various opportunities and challenges associated with blockchain, it also discussed results from pilot blockchain projects for various applications – land records management, pharmaceutical drugs supply chain, verification of educational certificates, among others.¹²

Also, the Ministry of Electronics and Information Technology (**MeitY**), released the 'National Strategy on Blockchain'¹³ earlier this year. It proposes to create a 'National Level Blockchain Framework', or infrastructure, capable of hosting sector specific blockchains, such as for insurance, healthcare, education, e-governance (integration of national-level services to blockchain), among many others.

Furthermore, various ongoing initiatives (by the government and the private sector) with respect to blockchain were also flagged by it, some of which have been given in the infographics below.



In addition to such opportunities, MeitY also highlighted the various challenges associated with blockchain technology, especially in the Indian context. These pertain to performance and scalability, skillset and awareness, security and privacy, standardisation and interoperability, legal and regulatory issues.

Legislative Approach

The government had prepared the Banning of Cryptocurrency and Regulation of Official Digital Currency Bill, 2019, which banned cryptocurrencies as a legal tender. It also prohibited mining or buying, selling or disposing of, using, or dealing in cryptocurrency and required persons to declare

and dispose of cryptocurrencies within 90 days of the commencement of the act. Violation attracted heavy penalties (including criminal liability).

It, however, provided for exemptions of using cryptocurrency technology for research and academic purposes. The bill also proposed to have a central government-backed official digital rupee. However, the bill did not see the light of the day.¹⁴

Subsequently, the government has proposed introducing the 'Cryptocurrency and Regulation of Official Digital Currency Bill, 2021'. This bill enables RBI to create an official digital currency while prohibiting all private cryptocurrencies in India.

Ongoing ED Investigation

India's cryptocurrency landscape is lurking in regulatory uncertainty and ambiguity. Various loopholes remain to be lugged. Against this backdrop, the Enforcement Directorate (ED) has begun investigations against WazirX (owned by Binance), under FEMA. The cryptocurrency exchange platform has been alleged to have been used for money laundering by Chinese-owned illegal online betting Applications.¹⁵

The Competition Angle of Blockchain

The Competition Commission of India (CCI) recently commissioned a discussion paper on blockchain technology¹⁶, reflecting its pro-activeness to deepen its market intelligence and create an opportunity to guide stakeholders on competition law compliance as a preventive measure at the technology development stage itself.

The paper poses several questions guiding future research on the technology and competition concerns pertaining to it, including the possibility of collusion among stakeholders due to the inherent transparency and access to real-time information.

In view of this, it warns against competition-sensitive data sharing among the participants, such as data on prices, cost, or output information of competitors, to avoid competition law infringement.

It also lists the types of vertical agreements possible in a blockchain application and related adverse effects and efficiencies, suggesting a case-by-case competition assessment.

The paper also explores the likelihood of abuse of dominance. It discusses several exclusionary and exploitative conduct possible through this technology, such as fixing unfair or discriminatory prices or conditions or provision of services, limiting or restricting production/development of goods or services or denying market access of goods or services.

One has to be cautious as the guidelines suggest compliance with the country's laws, given the challenge of cross-jurisdictional compliance. Timely and accurate information sharing, communication and coordination between competition and other regulatory authorities around the globe would be necessary for an effective enforcement mechanism. Harmonisation with allied domestic and foreign laws would also be useful in this regard.

Below are some of the highlights and lowlights/challenges in competition law enforcement in the blockchain ecosystem discussed in the paper.

Highlights	Lowlights/Challenges
<ul style="list-style-type: none"> The paper suggests competition enforcement through smart contracts by recognising such an approach to likely save high cost and effort that would have otherwise been incurred in monitoring compliance to fair competition commitments. 	<ul style="list-style-type: none"> Lack of credible data is a common problem in antitrust investigations, which may be overcome by blockchain technology, given its transparent and immutable transaction records, except in the case of encrypted or pseudonymous data in public blockchains. Blockchain applications span across geographies and it may not be possible to comply with different laws for the same application, thereby highlighting the jurisdictional issues arising in regulating blockchains. Compliance with other laws, such as data protection, in different countries for the same application may be challenging.

Conclusion

Basis the developments discussed above, the following broad pros and cons/challenges of using blockchain and cryptocurrency technology have been identified.

Pros	Cons/Challenges
<ul style="list-style-type: none"> Safe sharing of transactional data across a large network of untrusted entities Eliminate the need for a central entity or a third party to validate transactions over a peer-to-peer network Contribute to the growth of the fintech industry Provide transparency and efficiency in business operations Potential to build socio-economic value through use cases, such as tracking/tracing drugs in the pharmaceutical supply chain, verified direct benefit transfers, and managing land ownership records. 	<ul style="list-style-type: none"> No established framework for consumer grievance redressal Susceptibility to losses arising due to hacking and cyber-attacks, loss of password, leading to a denial of service High fluctuations in the value of cryptocurrencies Risks for illegal activities – money laundering and terror financing The absence of blockchain developers in India and inadequate infrastructure

India's regulatory landscape of blockchain-based cryptocurrencies remains in a state of flux, despite gaining global momentum. The abovementioned regulatory measures exhibit a lack of consideration to consumer/investor interests with respect to cryptocurrencies.

Uncertainty and risks of an outright ban on private cryptocurrencies are likely to create panic among Indian investors. This may do more harm than good for investors and also beat the regulatory objective of providing a safe technological environment for dealing with cryptocurrencies. It may also

give rise to an underground cryptocurrency trading market, luring genuine investors to trade in an insecure environment.

Furthermore, having a central monopoly of RBI over the proposed Indian cryptocurrency may go against the bedrock of blockchain technology, i.e. decentralisation. This may also hinder investments in blockchain technology in India, i.e., denting foreign investors' confidence in Indian cryptocurrencies.

From the lens of competition law and policy, CCI's preemptive endeavor is appreciable, given that once a blockchain is built, competition enforcement becomes challenging, though not impossible. Moreover, it can save resources on enforcement actions as well as consumer harm.

Recommendations

The aim of any law/regulation governing blockchain and cryptocurrencies should be to **help India become a blockchain hub**, i.e., encouraging more stakeholders to participate and contribute to crypto innovation and exploring the use of blockchain to improve existing systems. This would require a focus on Research and Development (R&D) on standardisation and interoperability, scalability and performance, privacy and security, and detecting vulnerabilities.

There is also a need to **build trust investor trust in the technology**, build an adequate skilled workforce, incorporate blockchain technology in appropriate education systems, utilising existing infrastructure, and create national-level infrastructure for the deployment of blockchain solutions (i.e., implementation of the Draft National Strategy on Blockchain in spirit).

Most importantly, a holistic regulatory approach is required to create a nuanced and forward-looking framework, which strives to plug risks associated with cryptocurrencies rather than moving towards an outright ban on private cryptocurrencies.

Examining successful models devised by other countries is also useful in this regard. Notably, countries like Japan, Switzerland and Thailand have now allowed the usage of cryptocurrencies as a mode of payment. Some, such as Russia, have been using as a mode of exchange (barter exchange), but not for payments.

It is recommended that learnings from such jurisdictions are suitably adapted in the Indian context. This becomes especially important given the country's federal structure, and states such as Andhra Pradesh¹⁷ and Kerala¹⁸, among many others, have already begun designing plans for blockchain adoption and innovation.

It, therefore, becomes important for the government to refer the 'Cryptocurrency and Regulation of Official Digital Currency Bill, 2021' to the **Parliamentary committee** before its passage, which may give recommendations after undertaking inclusive stakeholder consultations. Alternatively, going as per media reports, the government's intention to form a fresh panel of experts to study the possibility of regulating cryptocurrency in India is also a welcome step in this regard.¹⁹

- 1 A blockchain is essentially a digital ledger of transactions that is duplicated and distributed across the entire network of computer systems on the blockchain. Each block in the chain contains a number of transactions, and every time a new transaction occurs on the blockchain, a record of that transaction is added to every participant's ledger.
<https://www.euromoney.com/learning/blockchain-explained/what-is-blockchain>
- 2 CUTS Briefing Paper 'Introduction to Blockchain Technology', available at: https://cuts-ccier.org/pdf/Briefing_Paper-Introduction_to_Blockchain_Technology.pdf.
- 3 Cryptocurrency is a type of digital currency that generally only exists electronically. There is no physical coin or bill unless you use a service that allows you to cash in cryptocurrency for a physical token.
<https://www.consumer.ftc.gov/articles/what-know-about-cryptocurrency-and-scams#:~:text=Cryptocurrency%20is%20a%20type%20of.cryptocurrency%20for%20a%20physical%20token.>
- 4 RBI cautions users of Virtual Currencies against Risks, available at:
https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=30247
- 5 RBI Press Release: 2016-17/2054, available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=39435; and Press Release: 2017-2018/1530, available at: https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=42462
- 6 RBI's Circular 2017-18/154, available at: <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11243>
- 7 Committee Report Summary: Virtual Currencies in India, available at:
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- 8 What does the SC verdict mean for cryptocurrency, fintech innovations? Available at:
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- 13 Available at: https://www.meity.gov.in/writereaddata/files/NationalStrategyBCT_%20Jan2021_final.pdf
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- 16 Available at: https://www.cci.gov.in/sites/default/files/whats_newdocument/Blockchain.pdf
- 17 Andhra government to adopt blockchain tech to end land record tampering, available at:
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