

**NAVIGATING THE CROSSROADS: CRYPTO ASSETS IN INDIA- SECURITY,
CURRENCY OR AN UNCHARTED TERRITORY**



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by

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under the guidance of

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DECLARATION

I, PREETI RATNOO, do hereby declare that this dissertation titled 'NAVIGATING THE CROSSROADS: CRYPTO ASSETS IN INDIA- SECURITY, CURRENCY OR AN UNCHARTED TERRITORY' is the outcome of bona fide research undertaken by me in partial fulfilment of the Degree of Master of Laws (LL.M.) for the academic year 2023-24, at the National Law School of India University (NLSIU), Bangalore, under the guidance and supervision of PROFESSOR ASHRITA PRASAD KOTHA.

I declare that this dissertation is my own original work and all sources used have been properly acknowledged and cited. I further declare that I have not used any generative artificial intelligence (AI) and AI-assisted technologies in the writing process.

I also declare that this work has not been submitted either in part or in whole for any Degree or Diploma at any other university.

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CERTIFICATE

This is to certify that this dissertation titled '**NAVIGATING THE CROSSROADS: CRYPTO ASSETS IN INDIA- SECURITY, CURRENCY OR AN UNCHARTED TERRITORY**', submitted by **PREETI RATNOO (ID No: M23061)** at the National Law School of India University, Bangalore, in partial fulfilment of the Degree of Master of Laws (LL.M.) for the academic year 2023-24, was undertaken under my supervision.

Date: 2nd May 2024

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NAVIGATING THE CROSSROADS: CRYPTO ASSETS IN INDIA- SECURITY, CURRENCY OR AN UNCHARTED TERRITORY

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1. Introduction

A “virtual currency” can be defined as “digital representation of value that can be traded online and can function as a medium of exchange, and/ or a unit of account, and/ or as a store of value, but lacks the status of a legal tender”¹. Virtual currencies are therefore different from fiat currency of a country that is designated as its legal tender. Cryptocurrencies/ crypto assets are a subset of virtual currencies that are characterised by their decentralised nature and cryptographic protection².

Some of the characteristics of crypto assets that make their regulation necessary includes the pseudonymity that they offer to the transactions, decentralised nature, underlying blockchain technology based on distributed ledger, lack of adequate regulation and the highly volatile valuation³. Despite these challenges, cryptocurrencies have received unprecedented demand not only in India but across the globe. According to a NASSCOM report published in September 2021⁴, the investment of Indian retail investors in crypto assets is estimated to increase to USD 15.6 billion by 2030. Additionally, more than 230 start-ups operating in the crypto space in India are projected to have the potential to generate more than 800,000 jobs by 2030⁵. While reports like these clearly highlight the economic benefits of crypto assets, the clarity on the future regulatory treatment of these assets in India remain blurred⁶.

Some scholars have analysed the option of outright ban on crypto assets from a constitutional angle and have found it to be arbitrary and excessive⁷. Instead, it has been suggested by them that in the interests of liberty, innovation, and consumer protection, a risk-based analysis and

¹ FATF, Virtual Currencies: Key Definitions and Potential AML/ CFT Risks (June 2014) <http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-keydefinitions-and-potential-aml-cft-risks.pdf> accessed 15 Apr. 24

² Ibid

³ Gregory M. Karch, ‘Bitcoin, the Law and Emerging Public Policy: Towards a 21st Century Regulatory Scheme’, *Florida A & M University Law Review* 10, no. 1 (Fall 2014): 193-244

⁴ NASSCOM, ‘Cryptotech Industry in India- Decentralized Systems at the Center Stage Of Digital Evolution’ (2021) <https://nasscom.in/>: <https://nasscom.in/knowledge-center/publications/cryptotech-industryindia-decentralized-systems-center-stage-digital> accessed 15 Apr. 24

⁵ Ibid

⁶ Akanksha Singh & Sharan Chawla, ‘Cryptocurrency Regulation: Legal Issues and Challenges’, *International Journal of Reviews and Research in Social Sciences* Volume 7 Issue 2 (2019) 365-375 ISSN Online: 2454-2687

⁷ Jaideep Reddy, ‘The Case for Regulating Crypto-Assets’, *Indian Journal of Law and Technology* (2019) Volume 15: Issue 2, Article 5, 380-423 < <https://repository.nls.ac.in/cgi/viewcontent.cgi?article=1018&context=ijlt>> accessed 15 April 2024

mitigation would be a better option⁸. On the other hand, some other scholars have tried to understand the aspects relating to tax treatment⁹, insider trading regulations¹⁰, anti- money laundering and terrorist financing¹¹ etc.

Currently, the primary challenge with regulating cryptocurrencies lies in the uncertainty regarding their legal classification. This uncertainty presents a dilemma in determining which regulatory body should be responsible for overseeing them. Courts in various jurisdictions have interpreted cryptocurrencies differently based on the specific legal texts or statutes being considered.¹² Given the diverse nature of crypto assets, it is difficult to categorise them into any specific type either as commodities, securities, derivatives or currencies¹³. Therefore, it is crucial to develop a comprehensive approach that can effectively prescribe appropriate regulations or treatment for various types of crypto assets.

In view of the above background, author aims to examine the regulatory dilemma in India as to whether cryptocurrency should be classified as security, a currency, a commodity or fall into an entirely new category. The research will then delve into the implications of such classifications on regulatory framework and the broader financial markets. Lastly it shall include an analysis of global best practices and literature to suggest some solutions so as to ensure a balance between innovation and consumer protection.

The research for the purpose of this paper is primarily doctrinal in nature. It involves a comprehensive review of existing literature on cryptocurrencies, blockchain technology and regulatory frameworks in India and the world. The aim of the author is to analyse the relevant

⁸ Ibid

⁹ Prof. Dr. Robby Houben and Alexander Snyers, 'Cryptocurrencies and Blockchain; Legal Context and Implications for Financial Crime, Money Laundering and Tax Evasion', (Study for European Parliament's Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, June 2018); K. Baer and others, 'Taxing Cryptocurrencies', IMF Working Paper No. 2023/144, International Monetary Fund (July 2023) ISBN/ISSN: 9798400246586/1018-5941 <<https://www.imf.org/-/media/Files/Publications/WP/2023/English/wpica2023144-print-pdf.ashx>> accessed 10/04/2024

¹⁰ Aravind Giri & Adarsh Vijayakuran, 'Error 5XX: A Critique on Application of Insider Trading Regulations to Cryptocurrencies in India', RGNUL Financial and Mercantile Law Review (RFMLR), 2021, 8(1): 228-259

¹¹ Vibhore Batwara, Purushotham Kittane, Alipak Banerjee & Vaibhav Parikh, 'Making Crypto Industry Compliant in India: a Welcome Move under the Anti-Money Laundering Laws', (Nishith Desai Associates- News Articles, 13 march 2023) <https://www.nishithdesai.com/newsdetails/9522>; Emily Fletcher, Charles Larkin and Shaen Corbet, 'Cryptocurrency Regulation: Countering Money Laundering and Terrorist Financing', Research in International Business and Finance Volume 56, April 2021; A. Bala, 'Cryptocurrency and its scope in India'. International Journal of Innovative Research in Technology (IJIRT), 2022 Volume 8, Issue 8, ISSN: 2349- 6002

¹² Casey Watters, 'Digital Gold or Digital Security? Unravelling the Legal Fabric of Decentralised Digital Assets, *Commodities*' 2023, 2(4), 355 -366

¹³ Utkarsh Mehrotra, 'Crypto currency: A Regulatory Conundrum', SCC Online Blog (November 3, 2021) <<https://www.sconline.com/blog/post/2021/11/03/cryptocurrency-a-regulatory-conundrum/>> accessed 15 April 2024

regulatory documents, policy statements and legal frameworks to extract key themes, contradictions and areas of ambiguity within the existing regulations. However, in order to get a better understanding of potential solutions, a comparative analysis with other jurisdictions as well as the recommendations of global institutions like IMF, FATF, G20 etc. will be looked into.

By way of this dissertation, the author seeks to find an answer to following research questions:

Q.1. How is the cryptocurrency currently classified in India, and what regulatory bodies are involved in its oversight?

Q.2. How do regulatory classifications impact the legal standing and obligations of cryptocurrency issuers and users in India?

Q.3. How can regulators strike a balance between fostering innovation in the Virtual Digital Asset ecosystem and ensuring the protection of consumers and investors in India?

To find an answer to the above – mentioned research questions and explain them in a structured manner, the dissertation has been divided into following chapters: -

This chapter, that is the introductory chapter provides a brief overview of the regulatory ecosystem surrounding cryptocurrencies in India. It further sets the background with respect to the review of available literature, aims and objectives of this paper, the research questions sought to be answered under it, the research methodology to be adopted as well as the structure of this paper.

The next chapter then delves into the intricate landscape of cryptocurrency regulation within the Indian context. It sheds light on its current classification and the multitude of regulatory bodies that are tasked with overseeing its operations. Through a comprehensive analysis, it explores the evolving nature of cryptocurrency regulation in India, tracing its historical trajectory and examining the interplay between governmental policies, legal frameworks, and technological advancements. Additionally, this chapter scrutinizes the evolving regulatory landscape, including recent policy developments, legal challenges, and the implications of technological innovations on regulatory approaches.

As we move to the next chapter, the focus is on understanding how the classification of crypto assets by regulatory bodies influence the legal status and obligations of both issuers and users

within the Indian context. Through a detailed analysis, this chapter explores the implications of regulatory classifications on aspects such as taxation, compliance requirements, consumer protection, and the overall legality of cryptocurrency activities. By unravelling these dynamics, the chapter aims to offer insights into how regulatory frameworks shape the rights and responsibilities of stakeholders in India's cryptocurrency ecosystem and the impact it has or might have upon the Indian economy.

After having understood the impact of regulatory classification and consequent legal measures on the ecosystem, the next chapter explores the delicate task facing regulators across the world in fostering innovation within the Virtual Digital Asset (VDA) ecosystem while safeguarding the interests of consumers and investors. It investigates various regulatory approaches and strategies aimed at striking a harmonious balance between promoting innovation and ensuring robust investor protection. Through a comprehensive analysis of regulatory frameworks, case studies, and best practices, the chapter identifies key challenges and opportunities for regulators. It also delves into potential solutions and policy recommendations to navigate this complex landscape effectively.

Lastly, based on the analysis done in previous chapters, the final chapter seeks to suggest certain measures for policymakers, stakeholders, and researchers that might foster innovation while addressing risks. Emphasizing collaboration, it outlines pathways for enhancing regulatory clarity and promoting responsible cryptocurrency adoption in India. This chapter aims to inspire constructive dialogue for navigating the dynamic landscape of cryptocurrencies in India's economy and society.

2. Current Status of Crypto Asset Classification and Regulatory Oversight in India

The term 'crypto currency' as defined in Merriam Webster dictionary refers to those digital currencies that do not have any central issuing or regulating authority and instead rely upon blockchain based distributed ledger to record transactions and manage the issuance of new units¹⁴. As per Guidelines of the Financial Action Task Force (FATF), 'cryptocurrencies or crypto assets' do not encompass the digital representation of fiat currencies, securities and other

¹⁴ Merriam Webster Dictionary, 'Cryptocurrency: Definition and Meaning', <https://www.merriam-webster.com/dictionary/cryptocurrency> accessed 15 April 2024

assets that are addressed elsewhere in the FATF standards.¹⁵ Some of the popular examples of crypto assets in India and the world are Bitcoin, Ethereum, Ripple etc. The progress of the fintech sector coupled with the potential of crypto currencies to facilitate easier, faster, cheaper, borderless and secure payments, have made them an appealing investment and payment option¹⁶. Nevertheless, there are significant concerns relating to the regulatory gap, high volatility, speculations and the susceptibility to cyber-attacks and scams as far as the ecosystem of crypto assets is concerned¹⁷.

India's regulatory stance on crypto assets exemplifies a state of uncertainty. Rather than legalising or explicitly prohibiting crypto assets, India has adopted what can be called a 'wait-and-see' approach to their regulation.¹⁸ This uncertainty has created an environment of continual change, characterised by ongoing debates and frequent shifts in regulatory measures. In view of this background, let us thus first try to understand the nature of crypto currency which has contributed significantly to this flux over their regulatory treatment.

2.1 Nature of Crypto Currencies¹⁹

The key issue regarding the regulation of cryptocurrencies revolves around their classification. A common question that arises is how cryptocurrencies should be categorized — as a currency, a security, a commodity, or perhaps as an entirely new asset class. This classification is important because it determines which regulatory framework should apply to cryptocurrencies and how they are treated under the law.

As the name suggests, the crypto currency was initially envisioned as a medium of exchange for the purpose of settling payments. However, they lack in certain fundamental aspects of being a currency, such as the lack of a trusted issuing authority like sovereign or an intrinsic value as an asset or an instrument of debt. Any currency derives its value from the trust vested

¹⁵ FATF, 'Virtual Assets' <<https://www.fatf-gafi.org/en/topics/virtual-assets.html>> accessed on 10 April 2024

¹⁶ Nishi Agrawal & Mihir Modi, 'India and the Blockchain Technology: The Dawdling Desi Approach' (2022) Indian Journal of Law & Legal Research Volume 4 Issue 5 ISSN: 2582-8878, pp.1-15

¹⁷ Ibid.

¹⁸ Utkarsh Mehrotra, 'Crypto currency: A Regulatory Conundrum', SCC Online Blog (November 3, 2021) <<https://www.sconline.com/blog/post/2021/11/03/cryptocurrency-a-regulatory-conundrum/>> accessed 15 April 2024

¹⁹ World Economic Forum, *Regulatory and Policy Gaps and Inconsistencies of Digital Currencies*, (2/8 Digital Currency Governance Consortium White Paper Series, November 2021) https://www3.weforum.org/docs/WEF_Regulatory_and_Policy_Gaps_2021.pdf accessed 15 April 2024; Shehnaz Ahmed & Swarna Sengupta, *Blueprint of a Law for Regulating the Crypto Assets*, Working Paper (January 2022), Vidhi Centre for Legal Policy. < https://vidhilegalpolicy.in/wp-content/uploads/2022/01/220127_Blueprint-of-a-Law-for-Regulating-Cryptoassets-1.pdf> accessed 15 April 2024

upon it by its users. The lack of any intrinsic value along with the absence of sovereign or institutional backing has given rise to suspicion amongst the policy makers and regulators over the use of crypto currency as currency.

Some other countries have adopted a different approach. They treat crypto currencies as a financial asset. Supporters of this approach justifies the said categorisation by highlighting the ‘store of value’ characteristic of the crypto assets, where the value is dependent upon the market forces of demand and supply. However, the opponents of this approach are of the view that cryptocurrencies are neither any person’s liability nor do they have any underlying cash flows and thus do not fit into the category of financial asset.

The classification of cryptocurrencies as commodities faces challenges due to their intangible nature and limited practical utility beyond serving as a medium of exchange or store of value. Some have tried to liken crypto assets to gold by restricting their supply through design (like Bitcoin's mining process), but this comparison is flawed due to the absence of sovereign backing and the high volatility inherent in cryptocurrencies. Unlike gold, which has physical properties and historical acceptance as a store of value, cryptocurrencies lack these attributes, making their classification as commodities more complex and contentious.

In addition to the above-mentioned challenges, the dynamic nature of crypto assets suggests that they often exhibit characteristics that align with multiple functional types of tokens²⁰. This fluidity stems from the diverse uses and evolving features of different cryptocurrencies within the digital asset landscape. In addition to the fluidity of crypto assets, there is also a lack of consensus on the nomenclature and categorization of tokens within the cryptocurrency space²¹. For example, some tokens like Bitcoin and Zcash are primarily used for payment transactions, which might lead to categorizing them as payment tokens. On the other hand, tokens such as Golem and Filecoin enable access to specific services like computing power and data storage, suggesting they could be categorized as utility tokens due to their utility within decentralized networks. However, despite these apparent distinctions, determining the precise classification of tokens can be challenging due to their evolving functionalities and the interconnected nature of blockchain ecosystems²².

²⁰ ‘Token’ here means an asset that represents ownership or value in a decentralised system.

²¹ Roee Sarel, ‘Property Rights in Cryptocurrencies: A Law and Economics Perspective’, (2021) 22 N.C. J.L. & Tech., 389, 406

²² Ibid.

Additional difficulties emerge once we shift our focus away from the tokens with clear pre-defined purposes. Certain crypto assets, often referred to as 'hybrid tokens,' can display characteristics that align with multiple categories. This can introduce regulatory complexities, particularly when laws seek strict delineations between different token types²³. Such tokens challenge traditional classification frameworks, making it challenging for regulators to apply precise rules and definitions²⁴.

Crypterium is an example of a hybrid token that serves multiple functions within its ecosystem. It facilitates various activities, including payment of transaction fees for the issuer's services (banking solutions), offering of discounts on future services, and granting of revenue rights to token holders. This multifunctional nature presents a complex regulatory challenge²⁵. The challenge is to identify the regulations that should apply over such tokens- those pertaining to payments or the ones relating to regulation of securities or both or none and how. This complexity underscores why traditional laws governing financial products and services in India and the world may not adequately regulate hybrid tokens.

The ever-expanding scope of activities enabled by crypto assets has made the determination of the right regulatory approach more challenging. This complexity has led to varied classifications of crypto assets across jurisdictions, primarily based on their specific functions and use cases. Generally, crypto assets are categorized into the categories of payment tokens, security/investment tokens, and utility tokens, reflecting their roles in transactions, investments, or accessing services within blockchain ecosystems. For instance, in the United Kingdom, the Financial Conduct Authority (FCA) categorizes crypto assets into three broad categories- e-money tokens (regulated by Electronic Money Regulations, 2011²⁶), security tokens (considered securities), and unregulated tokens (payment/exchange tokens and utility tokens)²⁷. On the other hand, in the European Union, the Markets in Crypto-assets Regulation (MiCA) identifies three categories of crypto assets: utility tokens, asset-referenced crypto assets, and e-money crypto assets, which are pegged to a single fiat currency to maintain a

²³ Prof. Dr. Houben, R., Snyers, A., Crypto-assets – Key developments, regulatory concerns and responses, Study for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2020, accessed 13 January 2024

²⁴ Ibid

²⁵ Thijs Maas, 'Initial Coin Offerings: When Are Tokens Securities in the EU and US?' (2019), SSRN Electronic Journal DOI: 10.2139/ssrn.3337514, accessed on 14 January 2024

²⁶ Section 2, Electronic Money Regulations, 2011

²⁷ FCA, Guidance on Cryptoassets, (*Consultation Paper CP 19/3*, <January 2019>, <fca.org.uk/publication/consultation/cp19-03.pdf> accessed 13 April 2024

stable value. Meanwhile, Switzerland's FINMA categorizes tokens into payment tokens, utility tokens, and asset tokens in its guidelines for initial coin offerings (ICOs)²⁸.

It is often argued that the above-mentioned classifications aid in applying appropriate regulatory frameworks to different types of crypto assets based on their functions and characteristics and thus ensures consistency and clarity in the regulatory treatment of crypto assets²⁹. However, one cannot overlook the fact that, due to the dynamic and evolving nature of the crypto industry, there can be overlap and ambiguity in the classification of certain tokens, especially those with hybrid characteristics or multiple functionalities³⁰. As a result, regulatory frameworks must be adaptable and responsive to accommodate the diverse range of crypto asset use cases and functions while ensuring investor protection and market integrity.

In view of the above discussion, it is clear that because of their very nature it is very difficult to pigeon hole crypto assets either as a currency or as a financial asset or commodity. Thus, what started as a medium of exchange is now seen as an electronic code with high speculative value/ worth. This confusion relating to classification of crypto assets and thus over their regulatory oversight has raised alarms world over and especially in countries like India due to the popularity that crypto currencies are enjoying amongst the young populace, the stage of economic and institutional development of the country, young demography and relative lack of financial literacy.

2.2 The status of regulation over Crypto Assets in India

In India, regulators have been cautious about regulating cryptocurrencies. For example, the Reserve Bank of India (RBI) warned investors as early as 2013 against trading in crypto assets, reflecting a conservative stance towards the risks associated with cryptocurrencies³¹. In 2017, Reserve Bank of India (RBI) made it clear that it had not licensed or authorized any company or entity to deal with virtual currencies³². This statement cautioned traders that engaging in transactions involving virtual currencies was done at their own risk, underscoring the lack of official regulatory oversight and protection in India for activities related to cryptocurrencies. Later in 2018, the Reserve Bank of India (RBI) prohibited its regulated entities from processing

²⁸ FINMA, 'Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICO)', (16 February 2018) <<https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/>> accessed 14 April 2024

²⁹ Roe Sarel, 'Property Rights in Cryptocurrencies: A Law and Economics Perspective', (2021) 22 N.C. J.L. & Tech., 389, 406

³⁰ Ibid

³¹ RBI Press Release No. 2013-2014/1261 dated December 24, 2013

³² RBI Press Release No. 2016-17/2054 dated Feb 01, 2017

transactions involving virtual assets due to concerns about high volatility, lack of transparency, and security risks associated with cryptocurrencies³³.

However, the ban imposed by the Reserve Bank of India (RBI) was overturned by the Supreme Court in 2020. The honourable court ruled that the RBI Circular was unconstitutional, citing violations of Article 19(1)(g) of the Constitution and the Doctrine of Proportionality³⁴. The Supreme Court ruled that any restrictions on virtual currency activities must be proportionate, meaning they should be based on evidence, rational, and calibrated to achieve specific outcomes. This principle requires regulatory measures to be carefully designed to achieve their goals without overly restricting innovation or infringing on individual rights. However, the court acknowledged the Reserve Bank of India's (RBI) authority to regulate virtual currencies under the Payment and Settlement Systems Act, 2007, indicating that regulation is permissible as long as it is justified and not excessively burdensome³⁵.

The Securities Exchange Board of India (SEBI), in its response to the Parliamentary Standing Committee on Finance in June 2022, expressed its agreement with the RBI's concerns regarding cryptocurrencies³⁶. While not advocating for an outright ban, SEBI proposed that given the nature and prevalence of cryptocurrencies, their oversight should be assigned to a government-appointed investigating authority³⁷. SEBI also emphasized the importance of categorizing tokenized assets based on their features, which could lead to supervision by different sectoral regulators³⁸. Additionally, SEBI recommended bringing crypto assets under the scope of the Consumer Protection Act, 2019, to enhance consumer protection in the crypto space³⁹. This stance reflects SEBI's cautious approach towards regulating cryptocurrencies in India, focusing on appropriate oversight and consumer safeguards without imposing a blanket ban.

Following the judgment of the apex court, the Government of India introduced the *Cryptocurrency and Regulation of Official Digital Currency Bill, 2021*, which is still pending. Meanwhile, the Union Budget for 2022-23 introduced new provisions to tax and monitor Virtual Digital Assets (VDAs)⁴⁰. This marked the first time that the Indian parliament legally

33 RBI Press Release No. RBI/2017-18/154 dated April 6, 2018

34 Internet and Mobile Association of India v. Reserve Bank of India 2020 SCC online SC 275

³⁵ Ibid

³⁶ Business Today Desk, 'SEBI echoes RBI woes on crypto, calls for regulation', June 17, 2022 <<https://www.businesstoday.in/crypto/story/sebi-echoes-rbi-woes-on-crypto-calls-for-regulation-336877-2022-06-09>> last accessed on 14/1/2024

³⁷ Inter-ministerial Committee, *Report of the Committee to propose specific actions to be taken in relation to Virtual Currencies* (2019), Ministry of Finance, Government of India.

³⁸ Ibid

³⁹ Ibid

⁴⁰ Section 115BBH and Section 194S, Income Tax Act, 1961

defined virtual digital assets, signalling a step towards regulating and taxing cryptocurrencies in India.

The virtual digital assets as defined under section 2(47A) of the Income Tax Act, 1961 means “any information, code, number or token generated through cryptographic means or otherwise which can be transferred, stored or traded electronically”⁴¹. The section specifically brings “Non-Fungible Tokens and other tokens of similar nature”⁴² within the ambit of the said definition. Additionally, the Central Government has been empowered by virtue of this section empowers to include or exclude any digital assets from the definition by way of a notification in this regard⁴³.

In addition to the measures discussed above, the Ministry of Finance expanded the scope of the Prevention of Money Laundering Act, 2002 (PMLA) to include service providers and businesses dealing with virtual digital assets (VDAs) by way of a notification dated 7 March 2023. This notification required Virtual Digital Asset Service Providers (VASPs) to register as reporting entities with the Financial Intelligence Unit-India (FIU-Ind). Consequently, VASPs are now obligated to comply with know-your-customer (KYC) norms, anti-money laundering regulations, and customer due diligence standards similar to those required of other regulated entities such as banks, NBFCs (Non-Banking Financial Companies), and stock exchanges.

As discussed above, recent legislative actions in India regarding virtual digital assets (VDAs) reflect an active effort on the part of the government to regulate and tax cryptocurrencies. The aim of the government through these measures is to provide clarity and oversight to this evolving sector. The definition of virtual digital assets under section 2(47A) of the Income Tax Act, 1961, is broad and covers various digital information and tokens, including Non-Fungible Tokens (NFTs) and similar assets. While this inclusive definition acknowledges the diverse nature of digital assets, it may pose challenges in accurately defining and categorizing tokens for taxation purposes.

Moreover, the introduction of a 30% tax rate on gains along with additional cess and surcharges on virtual digital assets in the Union Budget for 2022-23 presents a substantial tax burden that could affect the appeal of cryptocurrency investments and transactions. The combination of a high tax rate and a broad definition raises concerns about the discretion of tax authorities, potentially leading to increased scrutiny and compliance challenges for stakeholders in the

⁴¹ Section 2(47A), Income Tax Act, 1961

⁴² Ibid

⁴³ ibid

crypto market. This could result in uncertainties and apprehensions among investors and businesses operating in the cryptocurrency space, impacting the overall development and adoption of digital assets in India.

The expansion of the Prevention of Money Laundering Act (PMLA) to include Virtual Digital Asset Service Providers (VASPs) reflects a concerted effort to combat financial crime in the crypto space. However, ensuring effective compliance with stringent KYC and anti-money laundering regulations poses implementation related challenges.

In view of the above analysis, one can safely argue that achieving a delicate balance in crypto asset regulation is essential for fostering the growth of the industry while effectively managing risks related to financial crime and ensuring investor protection. As the crypto market continues to evolve rapidly, a successful regulatory framework will require continuous adaptation and refinement. Collaboration among regulators, industry participants, and policymakers is crucial to develop regulations that are proportionate, transparent, and conducive to the growth of legitimate crypto activities⁴⁴. It thus becomes important to analyse in detail as to how the regulatory dilemma surrounding crypto assets impact different stakeholders in India.

3. An analysis of the impact of regulatory dilemma surrounding classification of crypto assets on stakeholders in India

The exclusive authority held by states to issue currency and thereby control monetary and fiscal policies is a fundamental aspect of modern governance. This control empowers governments to regulate key economic elements such as trade, banking, taxation, and expenditure. Dollarization gives rise to various concerns about importing of U.S. monetary and fiscal policies. In a similar manner, the widespread adoption of cryptocurrencies within an economy could potentially outsource monetary and fiscal policy decisions to private entities. The unpredictable nature of cryptocurrencies and the uncertainties surrounding their potential impact on macroeconomic stability have triggered concerns amongst policymakers and regulators in India and the world.

Despite the said concerns, the Indian cryptocurrency market has seen significant growth because of the interest shown by individual investors and businesses seeking to benefit from the potential of this sector. According to a report by cryptocurrency exchange platform Coin

⁴⁴ K. Baer et. al., Taxing Cryptocurrencies, IMF Working Paper No. 2023/144, International Monetary Fund (July 2023) ISBN/ISSN: 9798400246586/1018-5941 <<https://www.imf.org/-/media/Files/Publications/WP/2023/English/wpia2023144-print-pdf.ashx>> accessed 10/04/2024

Switch, India as in December 2023 has around 19 million cryptocurrency investors, 75% of which fall within the young demography of age ranging between 18-35 years⁴⁵. Further according to a study by data analytics platform Statista⁴⁶, Cryptocurrencies market is expected to generate revenue of USD 343.5 million in 2024. Further the user penetration is projected to be 18.78% in 2024 and is expected to hit 22.20% by 2028⁴⁷.

The expanding market potential in India has given rise to new participants like crypto asset exchanges, miners, custodians, and issuers, resulting in the development of a dynamic ecosystem. However, the increasing interest in cryptocurrencies also brings attention to associated risks such as volatility, speculative trading, money laundering and terrorist financing, underscoring the necessity for a robust regulatory framework. Such a framework will aid not only in addressing the risks but will also foster trust among users while facilitating efficiency in payments, investments, and capital raising.

What makes the classification/ categorisation of financial instruments and transactions significant for the purpose of regulation is the fact that it helps in determining the applicable laws as well as the supervisory powers that will apply to such instrument or transaction. This categorisation becomes crucial especially in countries like India with multiple regulators with varied and sometimes mutually exclusive jurisdiction. This gives rise to a potential threat of regulatory arbitrage. The factors like rapid advancement in associated technologies, use cases and business models often act as an impediment to the classification of crypto assets. This process becomes even more complex in cases of hybrid crypto assets.⁴⁸

Additionally, the money laundering and terrorist financing risks associated with convertible crypto assets can be attributed to variety of reasons including greater anonymity and the global reach that they facilitate⁴⁹. These fears are further strengthened in cases of crypto assets popularly known as privacy coins. Different use cases and design elements imply that each

⁴⁵ Coin Switch, India's portfolio 2023- How India invests in Crypto? (2023) <<https://coinswitch.co/switch/crypto/india-crypto-adoption-2023/>> accessed 15 April 2024

⁴⁶ Cryptocurrencies - India Statista, <<https://www.statista.com/outlook/fmo/digital-assets/cryptocurrencies/india>> accessed 14 April 2024

⁴⁷ Ibid

⁴⁸ Rodrigo Coelho and others, 'Supervising Cryptoassets for Anti-Money Laundering' (April 2021) FSI Insights on policy implementation No 31, Financial Stability Institute, Bank of International Settlement <<https://www.bis.org/fsi/publ/insights31.pdf>> accessed 13 January 2024.

⁴⁹ FATF, 'Virtual Currencies: Key Definitions and Potential AML/CFT Risks' <<http://www.fatfgafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>> (June 2014) accessed 13 January 2024.

crypto asset may have a unique structure, each of which can pose legal and regulatory challenges⁵⁰.

This leads us to the question the significance of an effective and efficient regulatory framework governing the crypto asset ecosystem. The first reason in this regard is the fact that the emergence of crypto assets has sparked discussions about Web 3.0 as the next evolution of the internet⁵¹. Web 3.0 envisages a decentralized internet where there's no central authority controlling content or monetization. Users have the ability to trace their data and directly derive value from it. Crypto assets are fundamental to Web 3.0, as they will function as transactional currency for applications built on their respective blockchains or serve as exchange mediums within these applications⁵².

Another key consideration to be kept in mind is that an active crypto market within the country will strengthen India's position in international discussions regarding regulation of crypto assets⁵³. Just as a country gains influence in global conversations by having a thriving private market for various products or technologies, India has the opportunity to establish itself as a significant player in the crypto space. China's decision to shut down its private crypto sector was seen as a missed opportunity, and India should heed this lesson. By preserving and nurturing its private crypto ecosystem, India can solidify its position as a leader in this emerging technological frontier on the global stage.

Opposing the tendencies amongst policy makers to ban rather than regulate the industry it has been highlighted by scholars that given the decentralized nature of the technology and the ease of transferring crypto assets using public keys, attempting to block the inflow of crypto assets from overseas is going to be technologically challenging⁵⁴. It is to be noted that every crypto asset user possesses a public key, enabling them to receive crypto assets from any online source. Moreover, the blockchain underlying a crypto asset is replicated across countless computers globally, with mining and nodes spread across different locations. Thus, any effort to prohibit

⁵⁰ Ibid

⁵¹ Silver, Charles. "What Is Web 3.0?" (Forbes, 6 January 2020) <https://www.forbes.com/sites/forbestechcouncil/2020/01/06/what-is-web-3-0/?sh=46857f7858df> accessed 15 April 2024

⁵² Ibid

⁵³ Meghna Bal, Shweta Venkatesan and Varun Ramdas, 'Regulating Crypto Assets in India' (2021) ORF Online < <https://www.orfonline.org/public/uploads/posts/pdf/20221228120908.pdf>> accessed 15 April 2024.

⁵⁴ Blockchain and Crypto Assets Council, 'The Case for Regulating the Use of Cryptocurrency in India' (March 2021) Internet and Mobile Association of India <https://www.koanadvisory.com/storage/2021/04/The-case-for-regulating-Crypto-in-India.pdf> accessed 15 April 2024

crypto asset usage would likely impede the growth of the domestic industry and drive investors and traders toward illicit markets or global safe havens.

As per a Report of a think tank⁵⁵, in July 2022, India implemented a 30% tax on crypto profits and a 1% tax deducted at source (TDS) on all transactions, leading to a significant decline in trading activity and putting Indian crypto exchanges in survival mode. The introduction of these taxes prompted a large number of Indian crypto traders, estimated at around 5 million, to shift their transactions to offshore exchanges. As a result, the government potentially lost approximately \$420 million in revenue. Additionally, the study revealed that Indian traders transferred over \$3.8 billion in trading volume from local to international crypto exchanges following the announcement of the controversial crypto regulations⁵⁶. This demonstrates the adverse impact of stringent taxation policies on the domestic crypto industry and the propensity for traders to seek alternative platforms in response to excessively stringent regulatory measures.

Regulation is also crucial for instilling trust in crypto markets and protecting the interests of the 15 million or more Indians who have invested in crypto. Without clear laws and measures for investor protection, any financial investment carries inherent risks. Given the decentralized nature of crypto assets, regulators need to focus on centralized points within crypto markets for effective regulation. According to a study from the National Bureau of Economic Research (NBER)⁵⁷, crypto exchanges account for 75% of activity in these markets, making them the most feasible entities for regulation enforcement. The controversies surrounding crypto assets largely stem from the absence of appropriate regulations and safeguards. However, regulators worldwide are actively addressing these regulatory concerns to ensure the stability and security of crypto markets.

In light of the said analysis, it becomes important to discuss the regulatory discussions and developments that are taking place across the world. In addition to giving a glimpse of global

⁵⁵ Dr. Vikash Gautam, 'Impact Assessment of Tax Deducted at Source on the Indian Virtual Digital Asset Market' (November 2023) Policy Brief and Special Issue No. 210, Esya Centre <<https://www.esyacentre.org/documents/2023/11/9/impact-assessment-of-tax-deducted-at-source-on-the-indian-virtual-digital-asset-market>> accessed 15 April 2024

⁵⁶ *ibid*

⁵⁷ Makarov Igor, and Antoinette Schoar, *Blockchain Analysis of the Bitcoin Market* (October 2021) National Bureau of Economic Research https://www.nber.org/system/files/working_papers/w29396/w29396.pdf accessed 15 April 2024

best practices in this regard, such discussion will help in arriving at solutions that might help promoting innovation while protecting the investors.

4. How the world is trying to Balance Innovation and Investor Protection in the Virtual Digital Asset Ecosystem

The regulatory focus across the world on crypto assets has seen a remarkable surge in recent years and this trend is expected to continue in years to come. In recent years, the retail as well as the institutional investors are showing an unprecedented interest in investing in these assets. This has led to an exponential increase in the capitalisation of this market. This however, has not been without a simultaneous rise in the volatility of these assets. Along with the volatility because of the very nature of the asset, the growth in the market has also been marred by incidents of frauds, scams and mismanagement of funds by some crypto firms, eroding consumer trust prompting immediate attention from regulators⁵⁸. The risks posed to market integrity underscore the urgent need for a swift and comprehensive global regulatory approach and supervisory framework to bolster consumer protection. The rapid emergence of digital assets as a global asset class has intertwined them more deeply with the traditional financial system, posing potential threats to financial stability, particularly due to rapid pace of innovation and inadequate risk management focus. Therefore, it becomes important to understand how the policy makers at the national, regional and global level are responding to these challenges.

4.1 Responses at National and Regional levels

Global regulators are increasingly focusing on enhancing international collaboration in setting standards for regulation. Simultaneously, numerous local jurisdictions are aiming to establish themselves as prominent global centres for digital assets, technology, and innovation. For example, the European Union has introduced the Markets in Crypto-Assets Regulation in 2023, and authorities in Dubai have launched the Virtual Assets Regulatory Authority (VARA), the world's first authority dedicated exclusively to virtual assets. Switzerland has developed a comprehensive regulatory framework for digital assets, providing market participants with clear guidelines on the legal and regulatory aspects of their projects and operations.

⁵⁸ Arriana Trozze and others, 'Cryptocurrencies and future financial crime', *Crime science* vol. 11,1 (2022): 1. doi:10.1186/s40163-021-00163-8 <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC8730302/> accessed on 15 April 2024

Across various countries, there is a concerted effort to integrate crypto assets into their financial systems by way of comprehensive research, defining these assets, consulting stakeholders, negotiating regulatory frameworks, and enacting specific legislation. Despite this global push, significant fragmentation persists in regulatory practices. The pace at which regulations are implemented varies greatly, with some jurisdictions acting swiftly while others proceed cautiously. As far as the approaches to regulation are concerned, they range from stringent oversight to more permissive environments. The coverage of digital asset services and products differs widely among countries and there is inconsistency in defining and describing digital assets. This has led to ambiguity and challenges for market participants navigating this evolving regulatory landscape. This fragmentation highlights the need for greater international cooperation and standardization to promote clarity, transparency and consistency in regulating digital assets across borders.

Countries are currently facing challenges in determining the most suitable regulatory measures for crypto assets, leading to a lack of uniformity in approaches worldwide. At one end of the spectrum, nations like China and Egypt have opted to outright ban crypto assets⁵⁹, while at the opposite end, countries like El Salvador have embraced Bitcoin as legal tender⁶⁰. However, the prevailing trend among major jurisdictions appears to be a more balanced one, that is, to effectively regulate the crypto assets⁶¹. This balanced approach seeks to address the complexities and risks associated with crypto assets while also fostering innovation and technological advancement⁶².

One of the policy approaches that has been observed towards regulation of crypto assets, relies on following the prevailing/ existing laws within the jurisdiction. One can elucidate this approach by looking at how regulators in jurisdictions like the USA⁶³ and Australia⁶⁴ are

⁵⁹ Global Future Council on Cryptocurrencies, ‘Navigating Cryptocurrency Regulation: An Industry Perspective on the Insights and Tools Needed to Shape Balanced Crypto Regulation’ (September 2021), World Economic Forum <https://www3.weforum.org/docs/WEF_Navigating_Cryptocurrency_Regulation_2021.pdf> accessed 14 April 2024

⁶⁰ Tim Fries, ‘El Salvador has adopted Bitcoin as official legal tender - but will other countries follow?’ (*World Economic Forum*, 30 September 2021), <https://www.weforum.org/agenda/2021/09/el-salvador-officially-adopts-bitcoin-as-legal-tender-but-will-other-countries-follow/> accessed 14 April 2024

⁶¹ Shehnaz Ahmed & Swarna Sengupta, Blueprint of a Law for Regulating the Crypto Assets, Working Paper (January 2022), Vidhi Centre for Legal Policy. <https://vidhilegalpolicy.in/wp-content/uploads/2022/01/220127_Blueprint-of-a-Law-for-Regulating-Cryptoassets-1.pdf> accessed 14 April 2024

⁶² Ibid

⁶³ SEC, ‘Framework for “Investment Contract” -Analysis of Digital Assets’, US Securities and Exchange Commission <https://www.sec.gov/corpfin/framework-investment-contractanalysis-digital-assets#_ednref5> accessed 14 April 2024.

⁶⁴ ASIC, ‘Crypto-assets’, Information Sheet 225, Australian Securities and Investments Commission <<https://asic.gov.au/regulatory-resources/digital-transformation/crypto-assets/#part-a>> accessed 14 April 2024.

utilizing their legal frameworks to determine whether crypto assets fall under existing securities laws and provide guidance to businesses accordingly. This approach enables regulators to address crypto asset-related activities without the need for new legislation. They tend to regulate the concerned entities by utilizing their powers to interpret and enforce the existing laws.

The Vidhi Centre for Legal Analysis conducted an in-depth analysis of the laws governing crypto assets in different jurisdictions⁶⁵. As per the said analysis, the prime approach across major financially mature jurisdictions has been to assess whether specific types of crypto assets bear similarities to securities as defined under their laws. This is done with an aiming to subject them to securities regulations. This approach has been prevalent especially in countries like Canada and the USA. In the USA, crypto assets resembling securities fall under securities regulations, which cover investment contracts, stocks and shares⁶⁶. The authorities in USA utilise the *Howey test*, laid down in *SEC v. W.J. Howey Co.*⁶⁷, to ascertain what constitutes an investment contract. According to the Howey test, an investment contract exists when funds are invested in a joint endeavour with an expectation of profits derived from the efforts of others. Any crypto asset offering to meet this criterion is subjected to the federal securities laws of the USA.

Similarly, in Canada, the primary regulatory method involves subjection of crypto assets to securities laws⁶⁸. Here, the investment contracts test, as outlined by the Canadian Supreme Court in *Pacific Coast Coin Exchange v. Ontario Securities Commission*⁶⁹, is employed to determine which crypto assets resemble securities. Likewise, in Singapore, crypto assets resembling capital market products, such as collective investment schemes, fall under the ambit of the Securities and Futures Act, 2001. In many of these countries, regulating certain crypto assets within existing securities laws has often served as the initial regulatory step. As far as India is concerned regulators like RBI and SEBI have time and again used their powers under

⁶⁵ Shehnaz Ahmed & Swarna Sengupta, *Blueprint of a Law for Regulating the Crypto Assets*, Working Paper (January 2022), Vidhi Centre for Legal Policy. < https://vidhilegalpolicy.in/wp-content/uploads/2022/01/220127_Blueprint-of-a-Law-for-Regulating-Cryptoassets-1.pdf> accessed 14 April 2024

⁶⁶SEC, ‘Framework for “Investment Contract”-Analysis of Digital Assets’, < https://www.sec.gov/corpfin/framework-investment-contractanalysis-digital-assets#_ednref5> accessed 14 April 2024.

⁶⁷ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

⁶⁸ Canadian Securities Administrators, ‘Canadian securities regulators outline regulatory framework for compliance for crypto asset trading platforms’ (29 March 2021) <<https://www.securities-administrators.ca/news/canadian-securities-regulators-outline-regulatoryframework-for-compliance-for-crypto-asset-trading-platforms/>> accessed 14 April 2024.

⁶⁹ *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 SCR 112.

the legislations like the Banking Regulation Act, 1949; Payment and Settlement Act, 2007 and the Securities Contract (Regulation) Act, 1956 etc. to regulate crypto asset ecosystem either directly or indirectly⁷⁰.

Another approach adopted by countries towards regulation of these assets has been to amend the existing laws to better regulate them. For instance, the South Korean Financial Transaction Reports Act 2001 was amended with an aim to strengthen Anti Money Laundering and terrorist financing controls of the Korean finance Intelligence Unit over the virtual asset service providers and financial institutions handling transactions involving virtual assets.⁷¹ This also resulted in their subjection to conditions like customer due diligence, suspicious transaction reporting etc.⁷² From an Indian perspective, the amendments to the Income Tax Act, 1961 brought in by the Union Budget 2022-23⁷³ as well as the Ministry of Finance Circular dated 7 March 2023 incorporating Virtual Asset Service Providers within the ambit of regulated entities under the Prevention of Money Laundering Act, 2002 can be cited as an example of this approach.

Yet another frequently adopted approach that may also be referred to as the bespoke regulatory approach aims at the enactment of a new standalone law or regulation by the policy makers. The proposed regulatory framework MiCA⁷⁴ (Markets in Crypto-Assets) in the EU is also an instance of a bespoke regulatory framework through which a comprehensive framework for regulating different types of crypto assets (as identified in the framework) is sought to be implemented. Similarly, Dubai's Virtual Asset Regulatory Authority (VARA) and VARA Regulations, 2023 laying down licensing requirements for seven virtual asset related activities is also an example of this approach.

Apart from the governing law, determination of the regulatory body that will oversee the crypto assets ecosystem in the country hinges on several factors, primarily influenced by a country's financial regulatory setup. In nations like Singapore, where a single financial sector regulator, like Monetary Authority of Singapore (MAS) exists, identifying the responsible authority is straightforward. Even in jurisdictions with multiple regulators, efforts have been made to foster collaboration in crafting effective policy responses to crypto asset regulation. For example, the UK established the UK Crypto asset Taskforce, comprising three key regulators: the FCA, the

⁷⁰ See discussion in Section 2.2 of this paper

⁷¹ Financial Services Commission, 'Revision Act on Crypto Assets Passes at Cabinet Meeting' (17 March 2020) <<https://www.fsc.go.kr/eng/pr010101/22325>> accessed 14 April 2024

⁷² Ibid

⁷³ Insertion of Section 2(47A) and Amendment of Sections 115 BBH and Section 194 S of the Income Tax Act 1961

⁷⁴ European Union's Markets in Crypto- Assets Regulations, 2023

Bank of England, and HM Treasury. This collaborative approach ensures a coordinated and comprehensive regulatory framework for crypto assets, despite the complexity posed by multiple regulatory bodies⁷⁵. While the regulators are trying to coordinate, cooperate and collaborate on national and regional levels, how are the International financial institutions responding to the challenges posed by the Virtual Digital Asset ecosystem.

4.2 Responses of the International Financial Institutions

Apart from the individual countries, the recent surge in interest and activity surrounding crypto assets has prompted many of the world's leading international organizations to issue policy notes and papers addressing the regulatory challenges and implications associated with them. Organizations such as the UNCTAD⁷⁶, World Bank⁷⁷, IMF⁷⁸, and World Economic Forum⁷⁹ have all contributed their perspectives on this complex issue, highlighting a significant correlation between crypto assets and broader monetary and financial stability concerns.

About five years ago, the Financial Action Task Force (FATF) took a significant step by extending its global standards on anti-money laundering (AML) and counter-terrorist financing (CFT) to encompass Virtual Digital Assets (VDAs) and Virtual Asset Service Providers (VASPs). While acknowledging progress in some jurisdictions, the FATF's 2023 Targeted Update⁸⁰ raised serious concerns about the lack of compliance with these standards, with 75% of assessed jurisdictions falling short. This shortfall underscores the urgent need for enhanced regulatory measures to address financial crimes associated with VDAs effectively.

As can be deciphered from the above discussion that, despite shared concerns, countries have adopted diverse approaches to regulating and adopting Virtual Digital Assets. While these varied approaches offer alternatives to blanket bans and punitive taxes, the borderless nature

⁷⁵UK Cryptoassets Taskforce Final Report (2018), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/crypto_assets_taskforce_final_report_final_web.pdf accessed 15 April 2024

⁷⁶ UNCTAD, *All that Glitters is not Gold: The high cost of leaving Cryptocurrencies Unregulated* (June 2022) UNCTAD Policy Brief No. 100, United Nations Conference on Trade and Development https://unctad.org/system/files/official-document/presspb2022d8_en.pdf last accessed on 15 April 2024

⁷⁷Erik Feyen, Yusaku Kawashima and Raunak Mittal, *Crypto-Assets Activity around the World: Evolution and Macro-Financial Drivers*, Policy Research working paper no. WPS 9962/ 2022, World Bank Group: Washington D.C. <http://documents.worldbank.org/curated/en/738261646750320554/Crypto-Assets-Activity-around-the-World-Evolution-and-Macro-Financial-Drivers> accessed 15 April 2024

⁷⁸ IMF, *Elements of effective policies for Crypto Assets* (2023) IMF Policy Paper Number 2023/004, International Monetary Fund < <https://www.imf.org/-/media/Files/Publications/PP/2023/English/PPEA2023004.ashx>> accessed 15 April 2024

⁷⁹ World Economic Forum, *Pathways to Regulation of Crypto Assets: A Global Approach* (2023) <https://www3.weforum.org/docs/WEF_Pathways_to_the_Regulation_of_Crypto_Assets_2023.pdf> , last accessed on 15 April 2024

⁸⁰ FATF, Targeted Update on Implementation of the FATF Standards on Virtual Assets/ VASPs (2023) FATF, Paris France <https://www.fatf-gafi.org/content/fatf-gafi/en/publications/Fatfrecommendations/targeted-update-virtual-assets-vasps-2023.html>, last accessed on 15 April 2024

of the Virtual Digital Asset ecosystem necessitates a common regulatory roadmap to establish best practices globally.

However, achieving global coordination faces numerous barriers, including the lack of harmonized taxonomies, regulatory arbitrage between jurisdictions, fragmented monitoring and enforcement, and inadequate coordination among law enforcement agencies. These challenges undermine the effectiveness of regulatory oversight and developments in the Virtual Digital Asset ecosystem, highlighting the imperative for a common global roadmap for minimum policy standards.

4.3 Potential Solutions and Policy Recommendations from an Indian perspective

In view of the detailed discussion done above in this paper, it becomes important to delve into the potential solutions and policy recommendations to deal with the issues in the ecosystem of crypto assets in India. The regulation of crypto assets in India presents a complex landscape with various challenges, including regulatory arbitrage, punitive tax measures, and ambiguity surrounding the classification and tax treatment of crypto assets. To address these issues effectively, policymakers must consider comprehensive solutions that balance innovation with investor protection and regulatory integrity.

One of the significant concerns in regulating crypto assets is the potential for regulatory arbitrage, where market participants exploit regulatory discrepancies across jurisdictions to gain competitive advantages. While international collaboration and unified regulatory oversight are touted as solutions, implementing them faces practical challenges. International cooperation requires alignment with diverse regulatory philosophies and legal systems, potentially slowing down progress. Furthermore, establishing a unified regulatory framework in a country as diverse as India, with its federal structure and multiple regulatory bodies, is a formidable task. Policymakers must navigate these complexities to ensure that regulatory efforts are robust, coherent, and adaptive to the evolving crypto asset landscape.

Bespoke regulatory approach as done via the establishment of International Financial Services Authority (IFSCA) in India can serve as a role model in this regard. It has been granted significant autonomy and flexibility to regulate financial services and institutions operating within International Financial Services Centres (IFSCs) in India. Here all the financial regulators, like RBI, SEBI, PFRDA and IRDAI cooperate and coordinate to develop tailored regulations for specific financial sectors, fostering innovation, while ensuring robust investor protection and market integrity in the evolving crypto asset landscape. The establishment Virtual Assets Regulatory Authority (VARA) in Dubai is an example of a unified tailor-made

regulatory approach designed to regulate crypto assets. The same can be analysed and emulated to Indian needs.

Another challenge in the context of India relates to the classification of crypto assets and their corresponding tax treatment. Defining crypto asset categories based on their characteristics and functions is complex, given the diverse range of tokens and coins in circulation. While the broad definition of virtual digital assets under Section 2(47A) of the Income Tax Act, 1961 is a welcome move to avoid regulatory arbitrage, the lack of clear guidelines on tax classification can lead to uncertainty and inconsistency in tax enforcement, creating challenges for taxpayers and regulators alike. Moreover, a tailored regulatory approach for different categories of crypto assets must be developed with caution to avoid stifling innovation or inadvertently facilitating regulatory arbitrage.

The imposition of exorbitant tax rates on crypto assets raises concerns about fairness and effectiveness. While clarity on taxation frameworks is crucial for promoting compliance, excessively punitive tax rates can stifle innovation and drive activities underground. Implementing fair and transparent taxation policies requires striking a delicate balance between generating revenue for the state and fostering a conducive environment for crypto asset development. Strong anti-tax evasion measures are necessary but must be accompanied by educational initiatives to ensure that taxpayers understand their obligations and rights in the crypto asset space.

Penalties can be a tool to enforce compliance with tax laws in emerging areas like crypto assets, but their effectiveness and extent must be carefully considered. In cases of non-compliance with tax laws related to crypto assets, penalties can serve as a deterrent and encourage taxpayers to fulfil their obligations. However, the imposition of penalties should be proportional and reasonable, taking into account the complexity and evolving nature of crypto asset transactions. Excessive penalties could discourage innovation and investment in the crypto space, leading to unintended consequences such as driving activities underground or deterring legitimate market participants. Therefore, while penalties can play a role in ensuring tax compliance, they should be balanced and applied judiciously, with a focus on education, transparency, and fair enforcement to foster a compliant and responsible crypto asset ecosystem.

Apart from the above discussed measures at the national level, considering the border-less nature of crypto assets, it is important coordinate and cooperate at global and regional levels to regulate crypto assets effectively and efficiently.

5. Conclusion and the Way Forward

The emergence of the Fourth Industrial Revolution and the advent of Web 5.0 have brought about transformative changes in the global economy. The crypto assets ecosystem has played playing an increasingly prominent role in this transformation. However, alongside the opportunities presented by this digital revolution, there has been a growing recognition among governments and institutions worldwide of the need to regulate the Crypto Asset industry.

Instances of financial frauds, money laundering, and terrorist financing through Virtual Digital Assets (VDAs) of which crypto assets are a type have raised significant concerns, prompting governments to take action. The level and scope of these regulations surrounding Crypto Assets vary significantly from one jurisdiction to another and are influenced by factors such as the maturity of the ecosystem, perceived threats to financial stability, regulatory capacity, and the desire to foster innovation. This variability has resulted in a complex regulatory landscape, with some countries, like China, imposing outright bans on crypto-assets, while others, such as El Salvador and the Central African Republic embracing them by designating Bitcoin as legal tender. In the case of India, the government has responded to these concerns by amending various laws and issuing directives and regulations aimed at regulating the industry.

These regulatory measures are essential for several reasons. Firstly, because they tend to address the immediate threats posed by illicit activities conducted through crypto assets, such as financial frauds and money laundering. By implementing regulations, authorities can establish mechanisms for monitoring and preventing such activities, thereby enhancing the integrity of the financial system.

Secondly, regulation provides clarity and legal certainty to participants in the virtual asset industry. By defining the 'crypto assets' within the legal framework and establishing specific guidelines for their operation, the government can mitigate uncertainty and ambiguity surrounding the legality, viability, and trustworthiness of the industry. This clarity is crucial for fostering investor confidence and encouraging responsible participation in the crypto asset market.

Moreover, regulatory measures can facilitate the long-term growth and sustainability of the Crypto Asset industry. While initial compliance with regulations may pose challenges for traders and Virtual Asset Service Providers (VASPs), such as adapting to new reporting requirements or implementing enhanced security measures, these measures ultimately contribute to a more transparent and robust ecosystem. By addressing regulatory loopholes and vulnerabilities, the industry can build a foundation for sustainable growth and innovation.

However, despite the recent regulatory efforts, various loopholes and challenges remain. Achieving effective regulation requires ongoing collaboration between governments, regulatory authorities, industry stakeholders, and international bodies. Additionally, regulatory frameworks must evolve in response to emerging threats and technological developments to ensure their effectiveness in addressing the evolving landscape of virtual assets.

Given the nature and global reach of Crypto Assets, it is imperative for agencies at various levels—international, regional, and national—to adopt a multi-dimensional and multi-stakeholder approach to effectively regulate this sector. Addressing the technological, legal, regulatory, and supervisory challenges associated with these assets require careful consideration of suggestions from experts, institutions, and agencies.

In view of the above discussion and research conducted for the said purpose, author has following suggestions with regard to the way forward for the policy makers and other stakeholders of the Virtual Digital Asset ecosystem: -

Firstly, as far as the countries like India are concerned, the specialised regulatory principles and approaches governing International Financial Services Centres Authority (IFSCA) of India and Dubai's Virtual Asset Regulatory Authority (VARA) can serve as a guiding light to overcome the regulatory dilemma surrounding crypto assets. Establishing such specialised regulatory framework, implementing regulatory sandbox, fostering cooperation amongst regulators, enhancing investor protection efforts while maintaining flexibility in regulations is the need of the hour. This will help achieve regulatory clarity, foster a conducive business environment for the industry while ensuring protection of consumers and investors in India.

Secondly, considering the border less nature of crypto assets, it is essential to promote a unified understanding of the taxonomy and classification for Crypto Assets as well as the activities of Virtual Asset Service Providers (VASPs) and virtual asset investors. This entails clearly distinguishing the features and risks associated with different types of Crypto Assets. By doing so, it will be possible to establish technology-neutral principles and achieve jurisdictional convergence on the legal characterization of these assets and related activities. The Harmonised System (HS) administered by the World Customs Organisation serves as a good example of such harmonization at global level.

Thirdly, learning from organizations like the International Organization of Securities Commissions (IOSCO), there's a need to set out best practices and baseline regulatory standards to achieve desired regulatory outcomes. These standards should serve as a framework for framing and executing effective regulations at national, regional and global levels.

Further, the stakeholders in the ecosystem shall strive to achieve standardization and interoperability among entities to promote data sharing, which is crucial for effective regulation and oversight. Moving forward, collaboration between the public and private sectors is essential to leverage emerging technologies and ensure effective legal compliance. Technological solutions such as blockchain analytics and transaction monitoring tools can play a crucial role in this regard.

Additionally, heavy investment in capacity building for individuals and agencies involved in detection of crypto asset related malpractices is the need of the hour. This goes beyond training existing staff and requires changes in hiring practices to attract individuals with relevant skills and expertise.

A multidisciplinary approach involving specialized law enforcement units cooperating with expert financial investigators, IT/forensics experts, and cybercrime specialists is essential to tackle cases of virtual asset-based money laundering and related crimes. This involves increasing intra-agency cooperation between different units and establishing specialist teams where feasible.

Last but not the least, ensuring financial education, including awareness of potential risks associated with various assets, as part of the school curriculum is crucial. This will help individuals make informed financial decisions and mitigate the risks associated with Crypto Assets.

While potential solutions such as international collaboration, fair taxation policies, and clear asset classification are essential, their implementation must be carefully managed to avoid unintended consequences. Policymakers must engage with industry stakeholders, legal experts, and international counterparts to develop robust regulatory frameworks that foster innovation, protect investors, and ensure financial integrity in the rapidly evolving crypto asset ecosystem. By critically analysing potential solutions and policy recommendations, India can position itself as a leader in responsible crypto asset regulation while navigating the complexities of this emerging digital economy.

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