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# The Cryptocurrency Judgement: Changing Contours of Virtual Currency Regulation in India

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## ABSTRACT

*The Hon'ble Supreme Court of India in the case of Internet Mobile Association v. Reserve Bank of India (hereinafter, "Cryptocurrency Judgement") set aside a Circular issued by the Reserve Bank of India (hereinafter, "RBI") which prescribed the financial entities regulated by the RBI to cut their association and discontinue to provide their services to entities and individuals which trade in virtual currencies. The rationale of the court for striking down the said circular was the non-satisfaction of the test of proportionality which was further backed by the omission by the RBI to show any actual harm or loss occurred due to the interaction between regulated financial entities and the entities dealing in virtual currencies. This paper argues that while the decision of the apex court to strike down the RBI circular is plausible, there are some incongruities in the application of the test of least intrusive measures as applied by the court. The paper also highlights the necessity of defining virtual currency and creating an effective regulatory framework for crypto assets in India. It suggests certain essential parameters on which the omphalos of virtual currency regulation in India can be nurtured.*

*Key Words: Virtual Currency, Blockchain Law, Test of Proportionality, AMLD5.*

## I. INTRODUCTION

The central aim behind the introduction of virtual currencies as has been discussed in a white paper written in the year 2008 by Satoshi Nakamoto (possibly a pseudonym), was to develop an alternative to fiat currency, to counter the problems of the debasement of the currency by regulators.[3] Accordingly, there is no central authority in most cryptocurrency setups around the world and the value of such currencies cannot usually be unilaterally reduced. The operation of virtual currency started for the first time when a transaction was made using Bitcoin for buying two pizzas back in the year 2010 and a valuation was attached to it. Following 2010, newer cryptocurrencies started to emerge in the year 2011 and soon virtual

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[3] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN ORG. (2008), https://bitcoin.org/bitcoin.pdf.

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currencies began to gain traction amongst the commonality because of the absence of a central system and shooting up of the valuation of most virtual currencies following 2011.[4] The trend of the popularity of virtual currency similarly also started in India, with the coming of various cryptocurrency exchanges such as Unocoin, Bitxoxo, etc.

The popularity of the virtual currency in the market coupled with its systematic aim to provide for an alternative to traditional fiat currencies, having a pseudo-anonymous or anonymous peer to peer transactions which were not capable of being tracked by different regulatory bodies, raised some legitimate concerns relating to the usage of virtual currencies for illegal activities, evasion of taxes, and erosion of monetary stability of traditional currencies and the credit system. Accordingly, there was an increasing clamour amongst regulatory bodies for the regulation of cryptocurrencies. The RBI released a Press Release in the year 2013, thereby cautioning Indian citizens from the possible usage of cryptocurrencies including Bitcoin.[5] Subsequently, another Press Release was issued by the RBI in the year 2017, owing to the growing acceptance of virtual currency in India, whereby it reiterated the previous concerns which were raised in its 2013 Press Release.[6] Similarly, the Ministry of Finance also issued a Press Release on the risks associated with the usage of cryptocurrencies in 2017. The Government of India constituted a high-level Inter-ministerial Committee in the year 2017 to analyse various subjects surrounding the operation of virtual currency in India which set forth its report in 2019 and suggested a total ban on private cryptocurrencies in India.[7] Nevertheless, it must be noted that the nature of the Press Releases issued by the RBI and the Ministry of Finance lacked any legal basis i.e. they were only recommendatory in scope and as such could not stop the operations of virtual currency in India.

Given the nature of the Press Releases and recommendations given, the RBI came up with a Statement[8] and a Circular[9] (*hereinafter*, "**RBI Circular**") dated 5th and 6th April 2018, respectively. The kernel of the said Statement and Circular was that (1) the financial entities regulated by the RBI were prevented from dealing with entities or individuals dealing in

[4] Sawant Singh, et al., *SC Judgement on Cryptocurrency*, MONDAQ (May 8, 2020), https://www.mondaq.com/india/fin-tech/930894/sc-judgement-on-cryptocurrency.
[5] Reserve Bank of India, *Press Release: RBI Cautions users of Virtual Currencies against Risks* (2013), https://www.rbi.org.in/Scripts/BSPressReleaseDisplay.aspx?prid.
[6] Reserve Bank of India, *Press Release: RBI Cautions users of Virtual Currencies* (2017), https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid.
[7] Ministry of Finance, *Report of the Committee to propose specific actions to be taken in relation to Virtual Currencies* (February 29, 2019), https://dea.gov.in/sites/default/files/Approved-and-Signed-Report-and-Bill-of-IMC-on-VCs-28Feb-2019.pdf.
[8] Reserve Bank of India, *Statement on Developmental and Regulatory Policies*, (April 5, 2018), https://www.rbi.org.in/scripts/bs_pressreleasedisplay.aspx?prid.
[9] Reserve Bank of India, *Prohibition on dealing in Virtual Currencies (VCs)*, (April 6, 2018), https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id.

virtual currencies and (2) the entities which were hitherto dealing with entities dealing in virtual currencies were directed to terminate such operations.

## II. INTERNET MOBILE ASSOCIATION CASE

In the backdrop of the April 2018 Statement and Circular of the RBI, the Internet and Mobile Association filed a Writ Petition before the Hon'ble Supreme Court of India.[10] The Internet Mobile Association (*hereinafter*, "**IMA/Petitioner**") argued to seek directions for the RBI not to restrict the entities regulated by it from providing services to virtual currency exchanges and other entities dealing in virtual currencies. It argued that the effect of the RBI Circular is that it prohibits the entities regulated by it from providing their services to entities dealing in virtual currencies, thereby practically imposing a ban on the usage of cryptocurrency in India.

The major arguments of the IMA, *inter alia*, were that; 1) the RBI in absence of a law made by the Parliament cannot regulate virtual currency as the same is outside the scope of its powers; 2) the restriction imposed by the RBI Circular and Statement is violative of Articles 14 and 19(1)(g) of the Constitution of India for being unreasonable and arbitrary; 3) the restriction imposed by the RBI does not pass the test of proportionality as there is the presence of less intrusive measures for the regulation of virtual currency.

The RBI strongly rebutted the contentions of the IMA on all the grounds which were taken by it. It argued that; 1) the RBI being the regulator of payment systems and fiat currency has wide powers to regulate virtual currency in light of provisions of the Banking Regulation Act, 1949[11] (*hereinafter*, "**Banking Act**"), the Reserve Bank of India Act, 1934[12] (*hereinafter*, "**RBI Act**") and the Payment and Settlement Systems Act, 2007[13] (*hereinafter*, "**PSSA**"); 2) the provision of complete anonymity and pseudo-anonymity makes virtual currency handy for illegal activities such as cross-border terror funding, tax evasion, and Benami transactions; 3) the RBI Circular was not violative Articles 14, 19 and 21 as they were proportionate and fell within the ambit of reasonable restriction under Article 19(6) of the Constitution.

The Hon'ble Supreme Court after going into the nitty-gritty of the nature of different virtual currencies and the wide powers conferred upon the RBI by various statutes concluded that the RBI had the powers to regulate the usage of cryptocurrencies even to the extent of severing

[10] Internet Mobile Association v. Reserve Bank of India, SC W.P. (Civil) No. 528 of 2018 (India) (*hereinafter*, "**Cryptocurrency Judgement**").
[11] The Banking Regulation Act, No. 10 of 1949, INDIA CODE (*hereinafter*, "**Banking Act**").
[12] The Reserve Bank of India Act, No. 2 of 1934, INDIA CODE (*hereinafter*, "**RBI Act**").
[13] The Payment and Settlement Systems Act, No. 51 of 2007, INDIA CODE (*hereinafter*, "**PSSA**")

the umbilical cord that virtual currency has with fiat currency. However, the said wide powers of the RBI must be exercised in light of the constitutional principle of reasonability and pass the test of proportionality.

## III. POWERS OF THE RBI FOR VIRTUAL CURRENCY REGULATION

The RBI had issued the RBI Circular based on the powers conferred upon it by section 35A read with sections 36(1)(a) and 56 of the Banking Act, sections 45JA and 45L of the RBI Act, and section 10(2) read with section 18 of the PSSA.[14] Accordingly, to understand the scope of powers of the RBI to issue impugned circular, the Hon'ble Supreme Court referred to the history of the constitution of the RBI and the subsequent legislation passed to enable the RBI to regulate the traditional financial system in India.

The Apex Court referred to the three-fold objectives of the RBI Act; (1) to regulate the issue of currency notes; (2) to operate and secure monetary policy framework and price stability within the country; and, (3) to regulate the credit/financial stability system of the country to its advantage. Besides, sections 45L and 45JA of Chapter III of the RBI Act which empowers the RBI to determine policy and give directions to all Non-Banking Financial Companies (*hereinafter*, "**NBFC(s)**") and other financial institutions, to enable public interests, operating financial/credit system of the country, protecting depositors' interests, and interests of NBFC(s).[15] Cautious scrutiny of the RBI Act, *in toto*, manifests that the operation/regulation of credit/financial system of the country to its advantage is a chain that links all the provisions which empower RBI to regulate/identify the policies as well as to provide directions.[16]

Similarly, the Banking Act also enables the RBI to issue directions to the Banking Companies in the public interest. Such directions may concern public interests, banking policy, interests of depositors, and proper management of banking companies.[17] Additionally, section 36(1)(a) enables the RBI to either caution or to prohibit banking companies from undertaking any specific transaction or class of transactions. A reference must also be made to the PSSA which was enacted to regulate and supervise the payment system within the Indian legal framework for which RBI is deputed as the sole governing authority. Section 10 of PSSA confers powers upon RBI to stipulate particular directives and guidelines efficient management of payment systems. Moreover, section 18 of PSSA facilitates the RBI to issue

[14] Cryptocurrency Judgement, *supra* note 8, ¶ 6.50, 6.173.
[15] RBI Act, *supra* note 10, § 45L, 45 JA.
[16] *See:* D.K.V. Prasada Rao v. Govt. of A.P. AIR 1984 AP 75; ICICI Bank Ltd. v. Official Liquidator of APS Star Industries Ltd. (2010) 10 SCC 1 (India).
[17] Banking Act, *supra* note 9, § 35A.

directions to system providers, system participants or any other person in respect of matters concerning public interest, regulation, and management or operation of payment systems.

The IMA had argued that Section 45JA of the RBI Act confers only regulatory powers and the RBI cannot completely prohibit activities by relying on it. Additionally, it was argued that *res extra commercium* activities can only be a law made by the legislature.[18] However, the apex court did not concur with the arguments of the IMA and accordingly held that the RBI has powers to issue the impugned circular because, *first*, the power to regulate entails the power to check and even includes the power to prohibit under certain circumstances,[19] and *second*, the pivotal role of the RBI within the economic realm which is not similar to any delegate. Accordingly, it is now a settled law that RBI is conferred with the statutory powers to enact policy and to issue directions for its execution, such guidelines or directions are supporting legislation[20] and thus, are a supplement to the Act itself.[21]

On the issue of effective total prohibition in virtual currency trade by the RBI Circular, the Court opined that it did not *per se* impose a total prohibition on the use or trading of the virtual currencies. Rather it only prevented the banking entities regulated by the RBI from providing banking services to those involved in trading or facilitating the trading in virtual currencies and thus, only prohibited a class of transactions as given under the Banking Regulation Act, 1949, which authorizes RBI to caution or bar banking companies from entering into particular kinds of transactions or class of transactions.[22] Additionally, the court acknowledged that not only is the power of RBI curative but also preventive and thus, facilitates RBI to take pre-emptive measures while taking into consideration the entirety of situations.[23]

## IV. THE SATISFACTION OF THE TEST OF PROPORTIONALITY

The rationality of a restriction imposed upon the exercise of fundamental rights guaranteed under article 19 of Part III of the Constitution of India can be tested on the touchstone of proportionality. The IMA had argued that the RBI Circular had infringed their right to carry on trade under Article 19(1)(g) and imposed disproportionate restrictions. Accordingly, to determine the reasonability of the RBI Circular reliance was placed upon the fourfold test of proportionality as elucidated in the case of *Modern Dental College and Research Centre v.*

[18] Godawat Pan Masala Products IP Ltd. & Anr. v. Union of India, (2004) 7 SCC 68 (India).
[19] Star India Pvt. Ltd. v. Dept. of Industrial Policy and Promotions and Ors., (2019) 2 SCC 104 (India).
[20] Udai Singh Dagar v. Union of India (2007) 10 SCC 1 (India).
[21] St. Johns Teachers Training Institute v. Regional Director, NCTE (2003) 3 SCC 321 (India); *See also:* Peerless General Finance and Investment Co. Ltd. v. Reserve Bank of India (1992) 2 SCC 343 (India).
[22] Banking Act, *supra* note 9, § 36(1)(a).
[23] Ganesh Bank of Kurunwad Ltd. & Ors. v. Union of India & Ors. (2006) 10 SCC 645 (India).

*State of Madhya Pradesh*,[24] which includes (i) that the measure is designated for a proper purpose; (ii) that the measures are rationally connected to the fulfilment of the purpose; (iii) that there is a proper relation between the importance of achieving the aim and the importance of limiting the right; and (iv) that there are no alternative less invasive measures.

According to the court, the first three tests of proportionality were satisfied by the RBI Circular; however, the test of least intrusive measures was a moot issue. Accordingly, while deliberating upon the test of less intrusive measures, the court emphasized the following aspects, *first*, RBI has not found the activities of virtual currency exchanges to have impacted the functioning of the regulated entities; *second*, the unswerving stance of RBI that it has not banned virtual currencies; and *third*, the suggestion of the Inter-Ministerial Committee for the introduction of Crypt–token Regulation Bill and taking regulatory measures.[25] Pertinently, the Inter-Ministerial Committee did not suggest to impose a blanket ban on the usage of virtual currency in India. Moreover, on the availability of alternatives, the European Union Report of 2018[26] was also referred. The prime recommendation of the said report was to ban the illicit use of cryptocurrency rather than administering a total ban on the interaction between the trading of virtual currencies and the financial sector as a whole.

The court came out with a stand-in favour of the IMA on two grounds. Firstly, that the RBI had not banned virtual currencies and the absence of a law made by the legislature to regulate virtual currency. Despite the position maintained by RBI that its circular had not banned the virtual currencies, the trading in virtual currencies and functioning of virtual currency exchanges were paralysed by it as the said circular cut-off their interface with the regulated banking entities. Secondly, despite the power of RBI to take pre-emptive measures on being satisfied,[27] the RBI had failed to show any actual harm or loss directly or indirectly suffered by the entities regulated by it on account of their interaction with the virtual currency exchanges.[28]

[24] Modern Dental College and Research Center v. State of Madhya Pradesh, (2016) 7 SCC 353 (India).
[25] Ministry of Finance, *Report of the Committee to propose specific actions to be taken in relation to Virtual Currencies* (February 29, 2019), https://dea.gov.in/sites/default/files/Approved-and-Signed-Report-and-Bill-of-IMC-on-VCs-28Feb-2019.pdf, ¶ 7 of 'Note-precursor to report' opined that, "*A ban would make dealing in VCs illegal but simultaneously it might decrease the ability of the law enforcement agencies and regulators to track and stop illegal activities."*
[26] Robby Houben, *Cryptocurrencies and Blockchain: Legal context and implications for financial crime, money laundering and tax evasion*, EUROPEAN PARLIAMENT (July, 2019), https://www.europarl.europa.eu/cmsdata-TAX-Study-on-cryptocurrencies-and-blockchain.pdf (hereinafter, "**EUP: Cryptocurrency and Blockchain**").
[27] Banking Act, *supra* note 9, § 36(1)(a).
[28] State of Maharashtra v. Indian Hotel and Restaurants Association, (2013) 8 SCC 519 (India).

## V. DUAL INTONATION OF THE COURT'S REASONING

Having explained the reasoning of the Hon'ble Supreme Court for striking down the RBI Circular, the author shall now delve into the congruity of the court's decision. While dealing with the question of the competency of the RBI to issue the impugned circular, the court had opined that the RBI has wide powers vested in it by various statutes such as the RBI Act, Banking Act, and the PSSA and therefore it could prohibit the usage of virtual currencies. However, to bring the crypto-assets into the regulatory framework of the RBI, it was essential to define virtual currencies. The Supreme Court in its judgment delved into the question of the definition of crypto-assets and surveyed various jurisdictions for a suitable definition but there is no determinative definition of the virtual currency which has been accepted by the court. Accordingly, determining the scope of the powers of the RBI in absence of a definition for virtual currency is rather fallacious. In the humble opinion of the authors, the top court missed an opportunity to settle the myriad of problems associated with the regulation of virtual currency in India as the same is not appropriately defined by any statute. Moreover, the definition so proposed by the top court would have been an epoch-making overture for the regulation of virtual currencies in India.

Further, it must be noted that the major reason behind nullifying the effect of the RBI Circular by the Hon'ble Supreme Court was the inability of the RBI to show any actual harm or loss suffered by the entities which were regulated by it. Accordingly, following the reasoning of *State of Maharashtra v. Indian Hotel and Restaurants Association*,[29] that there must be some empirical data for the actual loss suffered, the court struck down the RBI Circular. The same was done even in the presence of the powers of the RBI to take pre-emptive measures in the exercise of its wide powers which were also recognised by the top court in the same judgment. Therefore, the scheme of the judgment on the element of pre-emptive powers of the RBI is somewhat incongruous. The RBI's wide powers to take pre-emption action on qualified satisfaction is not a moot question here but it is the necessity on its part to show actual harm or loss for taking a pre-emptive measure.

Another very important aspect of the judgment is the interpretation and satisfaction of the least intrusive measure test of the four-pronged test of proportionality. According to the least intrusive measure test, the state action has to be judged on the point of factual alternatives to a given proposition and the least evasive measure amongst the alternatives must be shown to

[29] *Id.*

be chosen by the state authority for the satisfaction of the necessity stage.[30] In the IMA case, the standard of the least intrusive measures applied by the Hon'ble Supreme Court is only to the extent of presence and mere routine consideration of less intrusive measures. An all-inclusive analysis reveals that the IMA case is in parenthesis to the existing standard of the application of the test of proportionality.[31]

## VI. EPILOGUE: BEST PRACTICES FOR VIRTUAL CURRENCY REGULATION

The IMA case can be correctly deemed as a mere transitory relief to the stakeholders and the users of crypto assets in India as the operations of the virtual currency will eventually be regulated by a law passed by the legislature. While the judgment of the Hon'ble Supreme Court is apt to be celebrated for creating a balance between fundamental rights of citizens and issues of national security and law enforcement, there is an immediate need for developing a framework of virtual currency regulation in India. The same can be effectively done by taking inspiration from the European model and the Japanese model for the regulation of crypto-assets.[32]

### 1. Defining Virtual Currency

The immediate need before the setting up of a framework for virtual currency regulation is the definition of virtual currency. Heretofore, in absence of legislation, there is no definition of virtual currency that has been accepted by any regulator in India. The definition which is proposed by the European Parliament in its study of cryptocurrency and blockchain after considering the lacunae in the existing EU Cryptocurrency framework can be fair guidance for defining the scope of virtual currency in India and incorporating it into legislation. Hence, a suitable inclusive definition of virtual currency must include, (1) digital representation of value; (2) decentralised set-up, (3) not legal tender; (4) digitally transferable, storable, and tradeable; (5) means of exchange.[33]

### 2. Addressing anonymity surrounding Virtual Currencies

The anonymity surrounding the transactions made using cryptocurrency, *inter alia*, is one of the major factors which needs to be considered for addressing money laundering, terror financing, and tax compliance concerns. Accordingly, there is a need to bring about a balance

[30] Justice K.S. Puttaswamy & Ors. v. Union of India & Ors., (2019) 1 SCC 1 (India).
[31] Suhrith Partsarathy, *Analysis of Supreme Court's Cryptocurrency Judgement*, LIVE LAW (March 14, 2020), https://www.livelaw.in/columns/the-supreme-courts-cryptocurrency-judgment-153826.
[32] The Japanese model of cryptocurrency regulation is by far considered as the most developed framework in the world. Nevertheless, the European model is also promising and the series of developments that have taken place after the singing of an agreement between the European Parliament and the Council of Anti-Money Laundering Directive 5, further establishes the relative superiority of the European model of virtual currency regulation.
[33] *See:* EUP: Cryptocurrency and Blockchain, *supra* note 24, at 73-64.

between the merits and demerits of the usage of blockchain technology. The need is to ensure that the transfer of payments that are made through virtual currencies must be made possible to be tracked by different regulators. However, in absence of a central authority, the same cannot be achieved without attaching the regulation to one of the stakeholders in the crypto market.[34] The best practices followed by developed cryptocurrency jurisdictions is to attach the regulation on the virtual currency exchanges and custodian wallet providers. The licensing or the registration of the aforesaid entities is therefore a possible way to achieve the objective of regulating crypto assets.[35]

### 3. Money Laundering and Terror Financing

The next tenable step after the formulation of a working definition of virtual currency is the addition of the licensed/registered entities into the ambit of the Prevention of Money Laundering Act, 2002 (*hereinafter*, "**PMLA**").[36] This step will essentially be in-line with the practices of the European Union in which the emphasis is on bringing the virtual currency exchanges and custodian wallet providers into the ambit of obliged entities[37] under the Anti-Money Laundering Directive5.[38] The bringing of virtual currency exchanges and the custodian wallet providers under the purview of reporting entities under section 12 of the will effectively address the issue of anonymity and pseudo-anonymity in the virtual currencies.[39]

### 4. Taxation Compliance

The major issue that comes in way of optimum tax compliance in respect of virtual currencies is information paralysis due to the anonymous nature of most cryptocurrencies. However, bringing the virtual currency exchanges under the purview of PMLA would resolve this issue.[40] The information which is made available by the reporting entities to the authorities under the PMLA can also be shared with tax authorities which can accordingly ensure tax compliance on a case to case basis. Moreover, the tax liability on the sale proceeds of cryptocurrencies can either be brought under the ambit of income from capital gains[41] or other sources[42] under the Income Tax Act, 1961, thereby filling the lacunae surrounding tax

[34] Jacinta B. Shirakawa & Upalat Karwatanasaukul, Cryptocurrency Regulation: Institutions and Financial Openness, A.D.B. (July, 2019), https://www.adb.org/sites/default/files/publication/513726/adbi-wp978.pdf.
[35] Dennis Chu, *Broker-dealers for Virtual Currency Regulating Cryptocurrency Wallets and Exchanges*, 118 COLUMBIA L.R. 2323, 2328-2330 (2018).
[36] The Prevention of Money Laundering Act, No. 15 of 2003, INDIA CODE (*hereinafter*, "**PMLA**").
[37] Entities which are under an obligation to report transactions to the Council of Anti-Money Laundering Directive 5. *See:* AMLD5 (2018), https://eur-lex.europa.eu/eli/dir/2018/843/oj.
[38] EUP: Cryptocurrency and Blockchain, *supra* note 24, at 76-78.
[39] PMLA, *supra* note 33, § 12.
[40] EUP: Cryptocurrency and Blockchain, *supra* note 24, at 70.
[41] The Income Tax Act, No.43 of 19, INDIA CODE, § 45.
[42] The Income Tax Act, No. 43 of 19, INDIA CODE, § 56.

compliance uses regarding income generated through virtual currencies.

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