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Cryptocurrency Regulation: Whither from here?

Breakthrough technology does better with fresh legislation -- legislation which protects consumers but does not choke innovation and drive it abroad. India waits for such a framework for blockchain and cryptocurrencies.

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There has been no shortage of calls in the recent past for the cryptocurrency industry in India to be regulated. Both industry and the trading public seem to have come to a consensus on this.

However, the government's position has been ambiguous: many have been waiting to see whether it would continue to follow its wait-and-watch approach or bite the bullet and regulate the industry. An outright ban was also a possibility.

Thus far, the Finance Ministry and the Reserve Bank of India (RBI) had issued stern cautionary notices, with the Finance Ministry's December 2017 press release noting that "[t]he investors and other participants therefore deal with these [virtual currencies] entirely at their risk and should best avoid participating therein."

However, besides statements to the effect that the government was not going to recognize cryptocurrencies as 'currencies' or 'coins', it was not clear how the government intended to approach the regulation of the industry from a legal perspective.

The recent Budget Speech and post-Budget comments by the Economic Affairs Secretary finally give some insight into what lies ahead for the industry. In his speech, the Finance Minister stated that "[t]he Government … will take all measures to eliminate use of these crypto-assets in financing illegitimate activities or as part of the payment system."

While this statement is open to interpretation, the likely consequences of it are that, first, the government – like many leading economies – will impose Know Your Customer (KYC) / Anti-Money-Laundering (AML) requirements on cryptocurrency businesses. (Currently, while several responsible businesses in India follow these norms, they are not mandated by law to do so).

Second, it is likely that cryptocurrencies will not be allowed to be used in authorized payment systems like card networks and prepaid payment instruments.
In a post-Budget TV interview, Economic Affairs Secretary Subhash Garg then provided an indication of the concrete next steps: he mentioned that all legitimate activity in the industry would be regulated by a regulator, and that a committee looking into the matter is due to submit its recommendations by the end of this financial year.

The steps to impose KYC/AML requirements and to regulate legitimate activities are positive, since this would mean that consumers are protected while the benefits of the industry are preserved.

An outright ban on the industry would be overreaching, difficult to enforce, and regressive. It would probably only result in the industry moving underground, and also take away some of the benefits of blockchain technology that the government wants to promote.

A regulatory regime would likely end the current on-ground difficulties faced by the industry. Reportedly based on a recent advisory by the RBI, several banks have decided to “stay away” from the industry and close accounts of existing players.

Similarly, the Registrar of Companies (RoC) is reportedly not registering companies seeking to deal with cryptocurrencies, and in some cases, is reportedly asking for an undertaking that the company will not deal with cryptocurrencies.

The constitutionality of some of these actions appears questionable, since all businesses have a fundamental right to carry on legitimate activity subject to reasonable restrictions. If a regulatory regime is introduced, restrictions can be made legal and transparent rather than through opaque, behind-the-scenes measures.

However, the move to eliminate cryptocurrencies (or ‘crypto-assets’, as the government has coined them) from the “payment system” appears to be overly restrictive and may deprive consumers of some of the benefits of cryptocurrency and blockchain technology.

For instance, platforms like OmiseGO would seem to promote financial inclusion and present a better alternative to cash. As opposed to cash, KYC-compliant cryptocurrency transactions are more traceable and the technology allows for easier transfer across locations.

Regulating cryptocurrency-based payment systems under the same consumer protection principles as traditional payment systems (such as prudential measures and disclosure requirements) would avoid an unnecessary restriction on legitimate business activity. This would also prevent against consumer losses and systemic risk, which are probably the bases of the government's concern.

When the government is considering regulatory approaches, it should look to models that have been already been arrived at after multi-stakeholder consultation, such as the US Uniform Law Commission's Model Law on Virtual Currency Businesses and the Australian Digital Currency Industry Code of Conduct.

The goal of a new regulatory framework should be consumer protection. This can be achieved through KYC/AML norms, financial adequacy norms (and possibly insurance), and disclosure requirements. At the same time, the framework should avoid choking innovation and driving it abroad; suitable exemptions for low-risk activity will prevent against this.

A standalone regulatory framework like this may be introduced ideally as a new legislation, or possibly through administrative regulation, though the latter will be a weaker approach. Breakthrough technologies, from motor vehicles to the Internet, have always merited separate legislation.

In parallel with the development of a new framework, regulators should provide clarity on the treatment of cryptocurrency transactions under existing laws, including foreign exchange laws (since cross-border transactions are almost integral to cryptocurrencies) and taxation laws (since cryptocurrency transactions are most often economic activity). Both of these are currently subject to varying interpretations.

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