

THE VIRTUAL
CURRENCY
REGULATION
REVIEW

THIRD EDITION

Editors

Michael S Sackheim and Nathan A Howell

THE LAWREVIEWS

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REGULATION
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PREFACE

We are pleased to introduce the third edition of *The Virtual Currency Regulation Review* (the *Review*). The increased acceptance and use of virtual currencies by businesses and the exponential growth of investment opportunities for speculators marked late 2019 and early 2020. In 2019, it was reported that several of the largest global banks were developing a digital cash equivalent of central bank-backed currencies that would be operated via blockchain technology, and that Facebook was developing its own virtual currency pegged to the US dollar – Libra – to be used to make payments by people without bank accounts and for currency conversions. In 2019, the US House of Representatives’ Committee on Financial Services held a hearing on the potential impact of Libra in which one witness testified that Libra posed a fundamental threat to the ability of sovereign nations to maintain distinct monetary policies and respond to currency crises.

The *Review* is a country-by-country analysis of developing regulatory initiatives aimed at fostering innovation, while at the same time protecting the public and mitigating systemic risk concerning trading and transacting in virtual currencies. In February 2020, the International Organizations of Securities Commissions (IOSCO) published a final report titled ‘Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms’. The final report describes issues and risks identified to date that are associated with the trading of cryptoassets on cryptoasset trading platforms (CTPs). In relation to the issues and risks identified, the report describes key considerations and provides related toolkits that are useful for each consideration. The key considerations relate to: (1) access to CTPs; (2) safeguarding participant assets; (3) conflicts of interest; (4) operations of CTPs; (5) market integrity; (6) price discovery; and (7) technology. IOSCO advised that these seven key considerations (and the related toolkits described in the report) represent specific areas that IOSCO believes jurisdictions could consider in the context of the regulation of CTPs.

Fortunes have been made and lost in the trading of virtual currencies since Satoshi Nakamoto published a white paper in 2008 describing what he referred to as a system for peer-to-peer payments, using a public decentralised ledger known as a blockchain and cryptography as a source of trust to verify transactions. That paper, released in the dark days of a growing global financial market crisis, laid the foundations for Bitcoin, which would become operational in early 2009. Satoshi has never been identified, but his white paper represented a watershed moment in the evolution of virtual currency. Bitcoin was an obscure asset in 2009, but it is far from obscure today, and there are now many other virtual currencies and related assets. In 2013, a new type of blockchain that came to be known as Ethereum was proposed. Ethereum’s native virtual currency, Ether, went live in 2015 and opened up a new phase in the evolution of virtual currency. Ethereum provided a broader platform, or protocol, for the development of all sorts of other virtual currencies and related assets.

In 2020, the global outbreak of the novel coronavirus (or covid-19) impacted virtually every person on the planet and had severe and sudden effects on every major economy. At the time of writing, the pandemic is ongoing and, while some locations are pushing past their respective ‘peaks’ of infection, cities that are central to the global financial markets, such as New York City, remain under strict lockdown orders, with many workers in the financial services sector working remotely. It is unclear when these cities will return to a version of ‘normal’. In the midst of all this chaos, there is a natural experiment under way in the cryptocurrency markets. We are perhaps learning what happens when our governments are strained and their competence is questioned. Since mid-March 2020, when the pandemic hit the United States in earnest (it had already been raging in China, Italy, Iran, etc.), the price of Bitcoin has gone up in essentially a straight line – from approximately US\$5,000 to almost US\$10,000 as at mid-May. Now, to be fair, this follows a significant price decline preceding March, but it is at least interesting to observe that the most widely held cryptocurrency is weathering a significant economic storm with apparent ease.

When we first launched the *Review* three years ago, we were optimistic but sceptical about whether virtual currencies would be widely and consistently in commercial use. However, the virtual currency revolution has come a long way and has endured a sufficient number of events that could or should have been fatal for the asset class. Our confidence in the long-term viability of virtual currency has only increased over the previous year. Virtual currencies and the blockchain and other distributed ledger technology on which they are based are groundbreaking, and are being deployed right now in many markets and for many purposes. As lawyers, we must now endeavour to understand what that means for our clients.

Virtual currencies are borderless: they exist on global and interconnected computer systems. They are generally decentralised, meaning that the records relating to a virtual currency and transactions therein may be maintained in a number of separate jurisdictions simultaneously. The borderless nature of this technology was the core inspiration for the *Review*. As practitioners, we cannot afford to focus solely on our own jurisdictional silos. For example, a US banking lawyer advising clients on matters related to virtual currency must not only have a working understanding of US securities and derivatives regulation; he or she must also have a broad view of the regulatory treatment of virtual currency in other major commercial jurisdictions.

Global regulators have taken a range of approaches to responding to virtual currencies. Some regulators have attempted to stamp out the use of virtual currencies out of a fear that virtual currencies such as Bitcoin allow capital to flow freely and without the usual checks that are designed to prevent money laundering and the illicit use of funds. Others have attempted to write specific laws and regulations tailored to virtual currencies. Still others – the United States included – have attempted to apply legacy regulatory structures to virtual currencies. Those regulatory structures attempt what is essentially ‘regulation by analogy’. In some countries, a virtual currency, which is not a fiat currency, may be regulated in the same manner as money; in other countries, virtual currency may be regulated similarly to securities or commodities. We make one general observation at the outset: there is no consistency across jurisdictions in their approach to regulating virtual currencies. Perhaps the efforts of IOSCO will help to change that going forward, but there is currently no widely accepted global regulatory standard. That is what makes a publication such as the *Review* both so interesting and so challenging.

The lack of global standards has led to a great deal of regulatory arbitrage, as virtual currency innovators shop for jurisdictions with optimally calibrated regulatory structures that provide an acceptable amount of legal certainty and virtual currency scofflaws shop for jurisdictions with regulatory structures that provide no meaningful regulation. While some market participants are interested in finding the jurisdiction with the lightest touch (or no touch), most legitimate actors are not attempting to flee from regulation entirely. They appreciate that regulation is necessary to allow virtual currencies to achieve their potential, but they do need regulatory systems with an appropriate balance and a high degree of clarity. The technology underlying virtual currencies is complex enough without adding layers of regulatory complexity into the mix.

It is perhaps ironic that the principal source of strength of virtual currencies – decentralisation – is the same characteristic that the regulators themselves seem to be displaying. There is no central authority over virtual currencies, either within or across jurisdictions, and each regulator takes an approach that seems appropriate to that regulator based on its own narrow view of the markets and legacy regulations. Again, we are hopeful that IOSCO's efforts will help to encourage the emergence of optimal regulatory structures over time. Ultimately, the borderless nature of these markets allows market participants to 'vote with their feet', and they will gravitate towards jurisdictions that achieve the right regulatory balance of encouraging innovation and protecting the public and the financial system. It is much easier to do this in a primarily electronic and computerised business than it would be in a brick-and-mortar business. Computer servers are relatively easy to relocate; factories and workers are less so.

The third edition of the *Review* provides a practical analysis of recent legal and regulatory changes and developments, and of their effects, and looks forward to expected trends in the area of virtual currencies on a country-by-country basis. It is not intended to be an exhaustive guide to the regulation of virtual currencies globally or in any of the included jurisdictions. Instead, for each jurisdiction, the authors have endeavoured to provide a sufficient overview for the reader to understand the current legal and regulatory environment at a high level.

Virtual currency is the broad term that is used in the *Review* to refer to Bitcoin, Ether, Tethers and other stablecoins, cryptocurrencies, altcoins, ERC20 tokens, digital, virtual and crypto assets, and other digital and virtual tokens and coins, including coins issued in initial coin offerings. We recognise that in many instances the term 'virtual currency' will not be appropriate, and other related terms are used throughout as needed. In the law, the words we use matter a great deal, so, where necessary, the authors of each chapter provide clarity around the terminology used in their jurisdiction and the legal meaning given to that terminology.

Based on feedback on the first and second editions of the *Review* from members of the legal community throughout the world, we are confident that attorneys will find the updated third edition to be an excellent resource in their own practices. We are still in the early days of the virtual currency revolution, but it does not appear to be a passing fad. The many lawyers involved in this treatise have endeavoured to provide as much useful information as practicable concerning the global regulation of virtual currencies.

The editors would like to extend special thanks to Ivet Bell (New York) and Dan Applebaum (Chicago), both Sidley Austin LLP associates, for their invaluable assistance in organising and editing the third edition of the *Review*, and particularly the United States chapter. The assembly of this third edition is made all the more remarkable by the fact that

many of the authors and contributors are working from home, with dogs barking in the background and children at their feet. Special thanks go out to all those dogs and children for being as tolerant as possible as we try to conduct the work of busy lawyers and also produce this *Review*.

Michael S Sackheim and Nathan A Howell

Sidley Austin LLP

New York and Chicago

August 2020

INDIA

*Vaibhav Parikh and Jaideep Reddy*¹

I INTRODUCTION TO THE LEGAL AND REGULATORY FRAMEWORK

The Indian population has shown significant interest in virtual currencies. According to the most recent statistics available, there were estimated to be around 5 million traders in India in 24 exchanges, with trading volumes in the range of 1,500 Bitcoins a day.²

As the law currently stands, there is no clear definition of virtual currencies, cryptoassets or cryptocurrencies in India. On 4 March 2020, the Supreme Court of India set aside, on constitutional grounds, a circular (the VC Circular) issued by India's central bank, the Reserve Bank of India (RBI), which restricted the use of regulated banking and payment channels for the sale and purchase of virtual currencies (the *IAMAI* case).³ This affirmed virtual currency exchanges' fundamental right to trade and do business, guaranteed under the Constitution of India.

In the past, the RBI and the Ministry of Finance had issued warning statements about the risks associated with virtual currencies, including money laundering, consumer protection, market integrity, cybersecurity and volatility. However, various government committee reports have also lauded certain advantages of virtual currencies, such as efficiency and cost-savings.

In July 2019, an Inter-Ministerial Committee established by the Ministry of Finance released a report on a proposed regulatory approach towards distributed ledger technology and virtual currencies (the IMC Report). The Committee recommended an outright prohibition, along with criminal penalties, on dealing with virtual currencies.⁴ It also recommended the promotion of distributed ledger technology without the use of virtual currencies, and the exploration of a sovereign digital currency. The Committee's recommendation is non-binding and appears to be under consideration by the government.

Currently, despite the *IAMAI* case, which throws some light on the legal characteristics of virtual currencies, there is no law that expressly classifies virtual currencies as goods or

1 Vaibhav Parikh and Jaideep Reddy are lawyers at Nishith Desai Associates. Meyyappan Nagappan and Ipsita Agarwalla, lawyers at Nishith Desai Associates, contributed to the tax portions of this chapter.

2 <https://dea.gov.in/sites/default/files/Approved%20and%20Signed%20Report%20and%20Bill%20of%20IMC%20on%20VCs%2028%20Feb%202019.pdf> (22 June 2020).

3 *Internet and Mobile Association of India v. Reserve Bank of India*, W.P.(C) 528/2018, Supreme Court of India, 4 March 2020. The authors advised the Internet and Mobile Association of India (the lead petitioner in the case and the industry body) in the proceedings against the RBI.

4 <https://dea.gov.in/sites/default/files/Approved%20and%20Signed%20Report%20and%20Bill%20of%20IMC%20on%20VCs%2028%20Feb%202019.pdf> (23 June 2020).

commodities, services, securities, derivatives or currencies. The categorisation of virtual currencies into one or more of these stated classes is important, as the existing law would apply differently based on the categorisation.

At the time of writing, there are over 5,000 virtual currencies in existence,⁵ all with differing properties, and their categorisation depends on their nature.⁶ For instance, some are intended to be electronic cash (e.g., Bitcoin) and some are intended to be ‘gas’ for computer processing operations (e.g., Ether).

As there is no specific legislation regulating virtual currency, the laws referred to in this chapter are all of general application and we have interpreted them in the context of virtual currency.

II SECURITIES AND INVESTMENT LAWS

i Virtual currencies as securities

As the law currently stands, virtual currencies in the nature of Bitcoin and Ether are unlikely to attract regulations relating to securities. The Securities Contracts (Regulation) Act 1956 (SCRA) provides a non-exhaustive definition of securities, and there is currently no regulatory guidance on its application in the virtual currency context. Virtual currencies do not fall within the enumerated items of the definition. Further, the items under the definition derive their value from an underlying asset. However, virtual currencies like Bitcoin and Ether do not have underlying assets. Rather, the value is determined purely based on demand and supply. Further, virtual currencies such as Bitcoin often do not have an identifiable issuer, unlike the items in the definition of security under Indian law.

Even when considering the ordinary meaning of the word ‘security’, the word is defined in *Black’s Law Dictionary*⁷ to include an instrument evidencing a holder’s ownership rights in a firm or a holder’s creditor relationship with a firm (or government). It also states that a security indicates an interest based on investment in a common enterprise. Virtual currencies, including Bitcoin and Ether, do not have such ownership rights, credit relationships or investment in a common enterprise. Therefore, such virtual currencies are unlikely to fall within the definition of securities.

However, some tokens (although not all) issued through initial coin offerings (ICOs) may fall within the ambit of the SCRA if they are issued by an Indian entity and meet the above tests. This is likely to be the case if they are issued by an identifiable issuer and are backed by the underlying assets of the issuer. Such tokens should be subject to regulation under the Companies Act 2013 (the Companies Act) (in respect of requirements surrounding the issuance and transfer of securities) and the SCRA (in respect of securities only being allowed to be listed on licensed stock exchanges).

5 <https://coinmarketcap.com/all/views/all/> (22 June 2020).

6 A useful definition provided by the Financial Action Task Force is as follows: ‘Virtual Currency means a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency.’

7 *Black’s Law Dictionary* (10th edition 2014).

Some issuances of virtual currency tokens may also amount to collective investment schemes, which are regulated under the Securities and Exchange Board of India Act 1992.⁸

ii Deposits

Since many token sales involve the acceptance of money or other tokens, it is relevant to analyse what regulations other than securities regulations (e.g., for tokens that do not qualify as securities) apply in such sales.

The regulations under the Companies Act and the Companies (Acceptance of Deposits) Rules 2014 (Deposits Rules) specify when the receipt of money, by way of deposit or loan or in any other form, by a company would be termed a deposit, and also provides certain exemptions from its applicability. For example, any amount received in the course of business as an advance for the supply of goods or services would not be a deposit if the advance is appropriated against the supply of such goods or services within 365 days. If a company is deemed to be accepting deposits, a variety of compliance steps under the Companies Act and its rules, along with RBI regulations, would be triggered. Only the receipt of money, and not virtual currency, would trigger these steps.

Further, after the issuance of the Banning of Unregulated Deposit Schemes Act 2019, virtual currency token issuers will need to ensure, to be outside the purview of the Act, that any money received should not be liable to be returned.⁹

iii Regulation as commodities

In the *IAMAI* case, the Supreme Court expressed some doubt over whether a virtual currency could be classified only as a good or commodity. Ultimately, it held that a virtual currency is an intangible property which acts under certain circumstances as money.

India is a country with capital controls, where the inflow of foreign exchange into and outside the country is regulated under the Foreign Exchange Management Act 1999 (FEMA). If virtual currencies are classified as commodities, the activity of operating an exchange for trading virtual currencies may be regulated as a commodities exchange, which can have implications under India's regulation on inward foreign direct investment (FDI), that is, the Foreign Exchange Management (Non-debt Instruments) Rules 2019 (the NDI Rules).

Within the commodity space, there are two relevant concepts: a commodities spot exchange, which deals with ready delivery, and a commodities derivative exchange, which deals with derivative contracts. The NDI Rules restrict the amount of foreign investment

8 This will be the case if: (1) the contributions, or payments made by the investors, by whatever name called, are pooled and utilised for the purposes of the scheme or arrangement; (2) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property, whether movable or immovable, from such scheme or arrangement; (3) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors; and (4) the investors do not have day-to-day control over the management and operation of the scheme or arrangement.

9 The term deposit includes 'an amount of money received by way of an advance or loan or in any other form, by any deposit taker with a promise to return whether after a specified period or otherwise, either in cash or in kind or in the form of a specified service, with or without any benefit in the form of interest, bonus, profit or in any other form, but does not include . . . [certain enumerated categories]'. The Act provides a schedule of regulated deposit schemes, and all unregulated deposit schemes are prohibited.

into commodity spot exchanges to up to 49 per cent of the share capital, without government approval. The SCRA requires that any exchange facilitating commodity derivatives needs to be a recognised stock exchange (i.e., a licensed entity).

As the law stands, virtual currencies may not be regulated as commodities within the meaning of the NDI Rules. According to a Securities and Exchange Board of India (SEBI) Circular¹⁰ read with a central government notification¹¹ under the SCRA, the central government has notified certain goods for the purpose of the term commodity derivative under the SCRA and does not include any virtual currency. While this notification is only applicable to commodity derivatives and not ready delivery contracts, it provides the closest guidance on the point of what may be considered a commodity exchange at the moment.

However, the central government may at any time choose to notify virtual currencies (in general, or any class of them) as commodities under the above notification. This would bring derivatives contracts in virtual currencies within the SCRA (and hence, SEBI's jurisdiction). For spot trading, FDI would then be restricted to 49 per cent of the capital. There is currently no separate licensing regime for commodities spot exchanges.

Other implications of a virtual currency amounting to a good or commodity (under foreign exchange control laws) are discussed in Section X.

iv FDI in Indian virtual currency-based businesses

The *IAMAI* case held that the RBI had jurisdiction over issues relating to virtual currencies, as virtual currencies act as money under certain circumstances. This poses the question of whether virtual currency businesses will be restricted because they are 'other financial services' (OFS) under the NDI Rules. FDI in OFS is permitted without government approval in up to 100 per cent of the Indian entity's equity except where: the financial services activity is not regulated by any financial sector regulator (RBI); only part of the financial services activity is regulated; or there is doubt regarding the regulatory oversight. It can be argued that since the *IAMAI* case clearly lays down that the RBI has jurisdiction over the virtual currency space, there is no doubt regarding the regulatory oversight and, hence, FDI is permitted without government approval.

Additionally, it can be argued that most business models facilitating the buying and selling of virtual currencies can be characterised as e-commerce marketplaces, in which foreign equity investment is permitted up to 100 per cent of the entity's capital, without government approval. The term e-commerce has been defined by the NDI Rules to mean 'buying and selling of goods and services including digital products over digital and electronic networks'. As discussed in Section X, virtual currencies such as Bitcoin and Ether can be characterised as goods or digital products.

10 SEBI/HO/CDMRD/DMP/CIR/P/2016/105.

11 S.O. 3068(E) (Ministry of Finance, Department of Economic Affairs).

III BANKING AND MONEY TRANSMISSION

i No prohibition on dealing in virtual currencies

The VC Circular prohibited regulated financial institutions (including banks and payment processors) from dealing with virtual currencies or providing services for facilitating any person or entity in dealing with or settling virtual currencies.¹² In the *IAMAI* case, this restriction was set aside by the Supreme Court and is therefore no longer valid in law. Further, the RBI responded to a citizen's Right to Information request stating that there was no prohibition on banks from dealing with virtual currency businesses.¹³

ii Payment and Settlement Systems Act 2007

As many virtual currencies are used as a means of value exchange, questions arise as to whether any authorisation or compliance is required under the Payment and Settlement Systems Act 2007 (the PSS Act). Under Section 2(1)(i) of the PSS Act, a payment system is defined as 'a system that enables payment to be effected between a payer and a beneficiary'. If virtual currency-based systems do form payment systems, any person commencing or operating them will require the authorisation of the RBI under Section 4(1) of the PSS Act.

There is nothing in the PSS Act to exclude virtual currency, since only the term payment is referred to, as opposed to currency, legal tender or money. Therefore, it needs to be judged whether a particular cryptocurrency-based system enables payment to be effected between a payer and a beneficiary, or a person to commence or operate such system.

Arguably, many virtual currencies are not part of a system that enables payment to be effected between a payer and a beneficiary. A user may, for example, merely buy virtual currency using fiat currency for investment purposes and never choose to make any payment with it, and then dispose of it in return for fiat currency. There would be no payment, payer or beneficiary in this connection, and it would resemble the sale and purchase of an asset such as gold. Further, the fact that the value underlying the virtual currency is not backed or guaranteed by the issuing entity or any other party (i.e., holders of virtual currencies cannot redeem them for value to the issuer (other than as a sale through ordinary market channels)) supports the view that a virtual currency is likely not to be considered a payment system.

Under this view, virtual currencies can be characterised as goods or digital products that people are trading just as they would any other digital products, such as music files or e-books.

Furthermore, owing to the decentralised nature of many virtual currencies, including Bitcoin, the issuers who do commence systems as a matter of practicality cannot be identified. This would mean even if decentralised virtual currencies amount to payment systems, regulators may be unable to pursue the issuers, as they are anonymous. In addition, as is the case with decentralised virtual currencies, entities without power, influence or control over a system are unlikely to be liable for operating it, as the ledger functions independently of any operator.

Even if there is a centralised issuer, that issuer may merely create and release tokens, which are then listed on virtual currency exchanges: the issuer may not play a payment, clearing or settlement role. In this case, a virtual currency can be seen as a licence to use the particular virtual currency ledger and the licence is freely tradable in the open market.

12 <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11243&Mode=0>.

13 RBIND/R/E/20/02104 (27 May 2020).

However, a counterargument to the above analysis can be made that a virtual currency blockchain does create a technology to enable the transfer of value from person to person, and hence enables payment to be effected between parties. According to this argument, many virtual currency blockchains may amount to payment systems, requiring the entities commencing or operating them to obtain authorisation under the PSS Act.

According to the RBI's submissions in the *IAMAI* case, virtual currencies do not amount to payment systems under the PSS Act.

IV ANTI-MONEY LAUNDERING

It is often difficult for regulators to track virtual currency transactions owing to their pseudonymous nature. While wallet identities can be tracked in the blockchain, these wallet identities cannot be easily traced to individual identities. This ability to transfer something of value over the internet that can evade the conventional financial monitoring framework has raised alarm in the eyes of regulators, as they are unable to track the flow of funds that could be used for money laundering purposes.

Currently, know your customer (KYC) and anti-money laundering (AML) norms are set out under a range of different legislation and RBI directions. However, these norms do not apply specifically to virtual currency-based businesses (unless they are otherwise-regulated financial institutions). KYC/AML norms under various laws (e.g., the Prevention of Money-Laundering Act 2002 and the RBI Master Direction – Know Your Customer (KYC) Direction 2016) only apply to businesses regulated by the RBI and other regulators such as SEBI. Therefore, businesses dealing with security-related virtual currencies, as discussed in Section II, or operating payment systems, as discussed in Section III, may be subject to KYC/AML requirements.

Although KYC norms do not appear to apply to most virtual currency-related businesses, it is advisable for these businesses to follow KYC measures on the lines followed by regulated entities, especially if they accept retail users. This would enable such businesses to effectively respond to law enforcement investigations and requests for information, to avoid allegations of being complicit in money laundering or other fraudulent activities.

V REGULATION OF EXCHANGES

There is no specific regulation of the activity of virtual currency exchanges and trading platforms, and the functioning of such businesses is regulated by generally applicable corporate, criminal, labour, local and tax laws. As a practical matter, at the time of writing, exchanges face a degree of resistance when accessing the facilities of regulated financial institutions, despite the Supreme Court setting aside the VC Circular.

VI REGULATION OF MINERS

There is no law that specifically regulates the activity of virtual currency mining. Mining can be considered a software development activity that generates value in the form of a newly generated virtual currency (sometimes known as the block reward). Fully domestic mining as an activity therefore should only be subject to laws of general application.

While there is no judicial precedent on this issue, FEMA and its regulations may be relevant where the block reward is sent to a virtual wallet address in India and subsequently

transferred abroad to a foreign wallet (see Section X). However, an arrangement where an Indian entity only provides the physical mining infrastructure and the newly generated virtual currency is availed directly by a wallet address that is held by a non-resident entity abroad should not attract the export and import-related legal obligations under FEMA. In such a situation, as the virtual currency was never held in India, there is no transfer of a virtual currency from India to a foreign country.

VII REGULATION OF ISSUERS AND SPONSORS

i Securities, deposits and collective investment schemes

If a virtual currency being issued amounts to a security, deposit or collective investment scheme, the applicable legal requirements for such issuance and related ongoing compliance will be triggered.

ii Import and export regulations

The purchase, whether through fiat currency or virtual currency, by Indian residents of virtual currencies issued by international entities is subject to the import and export regulations under FEMA. Cross-border crypto-to-crypto transactions may fall afoul of FEMA from an Indian resident's perspective (see Section X).

iii ICOs

Security tokens

Indian entities issuing tokens amounting to securities under Indian law must comply with the relevant obligations under the Companies Act and the SCRA, as discussed in Section II. For example, under Sections 23 and 24 of the Companies Act, if more than 200 people subscribe to a token sale, it may be deemed a public issue that would be regulated by SEBI.¹⁴

Utility tokens

Issuing tokens in exchange for money or other tokens that merely act as an advance against future services (often known as utility tokens) is workable subject to – for cross-border issuances – the FEMA issues discussed in Section X. However, if such advance is not appropriated against the actual services within 365 days, the amount may be considered a deposit under the Companies Act and the Deposits Rules, as discussed in Section II. Thus, utility token issuers wishing to avoid the restrictions on deposits can contractually ensure that the services are supplied within the required 365-day period.

Payment tokens

These tokens are intended to be used as a means of payment for trading goods or services, as a form of money or value. Unlike utility tokens, they do not give rise to claims for goods or services against their issuer.

From an Indian law perspective, if the blockchain relating to a token forms a payment system requiring authorisation under the PSS Act, then, as discussed in Section III.ii, the entity that commences or operates such a system may be required to be authorised by the RBI.

14 Rule 14(2) of the Companies (Prospectus and Allotment Securities) Rules 2014.

VIII CRIMINAL AND CIVIL FRAUD AND ENFORCEMENT

There are no laws specifically targeting fraud in the virtual currency sector.

However, although it may be a common misconception in India that virtual currency businesses are operating in a completely unregulated space, this is not the case. Various laws of general application, such as the Indian Penal Code 1860 (IPC), the Prize Chits and Money Circulation Schemes (Banning) Act 1978 (the Prize Chits Act), Consumer Protection Act 1986 (CPA) and the Banning of Unregulated Deposit Schemes Act 2019 (the UDS Act), will act against fraudulent business activity. Action has already been taken by authorities under the IPC and Prize Chits Act against fraudulent virtual currency-based businesses.¹⁵ The IPC, the Prize Chits Act and the UDS Act are criminal laws, while the CPA provides a civil remedy.

Sections 415 to 420 of the IPC criminalise cheating. If any person (thus including a virtual currency business) 'fraudulently induces [a deceived person] to deliver any property to any person', and that act causes or is likely to cause damage to the deceived person, he or she can be penalised under Sections 417 and 420. Similarly, the Prize Chits Act penalises schemes for the making of quick or easy money (money circulation schemes) and various types of prize distribution schemes (prize chits). The UDS Act prohibits the acceptance of any unregulated deposit (i.e., an amount of money by any deposit taker with a promise to return the same in cash or in kind).

The CPA protects consumers against unfair trade practices, deficiencies in services and defects in goods. Unfair trade practices include false or misleading advertising. As a result, if any virtual currency business makes misrepresentations to consumers or provides deficient services, consumers will have recourse under the CPA.

IX TAX

In India, taxes may be on income (direct taxes) or expenditure (indirect taxes). Taxation of virtual currency-related activity can therefore be discussed under two heads: income tax (direct tax) and goods and services tax (GST) (indirect tax).

i Direct tax

Taxation of income is governed by the provisions of the Income-tax Act 1961 (ITA). Under the ITA, Indian residents are subject to tax in India on their worldwide income, whereas non-residents are taxed on, inter alia, income deemed to accrue or arise in India. Recently, the ITA has widened the scope of 'deemed to accrue or arise in India' by introducing the significant economic presence (SEP) test. A non-resident is considered to have established a SEP in India if the non-resident, inter alia, enters into transactions in respect of goods, services or property with a person resident in India (above specified thresholds) or is engaged in systematic and continuous soliciting of business activities from customers in India. However, non-residents who are residents of a country with which India has signed a tax treaty have the option of being taxed as per the tax treaty or the ITA, whichever is more beneficial.

¹⁵ <https://timesofindia.indiatimes.com/city/navi-mumbai/one-coin-fraud-18-in-cop-custody/articleshow/58439996.cms>.

Under the ITA, the one of the key issues is whether income from virtual currencies is treated as capital gains or profits and gains of a business or profession.¹⁶ If income from virtual currencies is considered as business income, it will be taxable in India only if the non-resident has a permanent establishment in India (assuming they are from a treaty country). Further, in the case of characterisation as capital gains, as capital gains are typically taxed in India only if the asset is located in India, determining the location of the virtual currency to establish a nexus may be important. The position in relation to the location of a virtual currency is unclear. The Supreme Court in the *IAMAI* case noted that a virtual currency has no location. In our view, the location of the owner is the closest approximation of location for the virtual currency. Currently, the ITA and its associated rules do not specifically refer to the treatment of virtual currencies and there have been no judicial precedents in this regard.

Another important consideration will be determining the applicability of the recently introduced equalisation levy (EL) on virtual currency operators. The EL applies at a rate of 2 per cent on the gross value of the services rendered or goods supplied (defined as 'e-commerce supply or service') by 'e-commerce operators' to residents in India.

When interpreting the ITA, the facts and circumstances of each transaction should be kept in mind, because individuals and corporates may deal with virtual currencies in a variety of contexts, sometimes as capital assets and sometimes in the course of business. Similarly, the income-tax implications may also depend on the business model of the mining company, the virtual currency exchange platform, money transfer company or relevant party.

ii Indirect tax

The relevant laws concerning GST are the Central Goods and Services Tax Act 2017, the Integrated Goods and Services Tax Act 2017 (the IGST Act) and the respective State Goods and Services Tax Acts, which each have a different jurisdictional ambit.

GST is payable on:

- a* sales of goods where goods are sold within one state in India;
- b* sales of goods where goods are transported from one state to another state;
- c* the provision of services within one state in India; and
- d* the provision of services from one state to another state in India.

The applicability of GST on a virtual currency depends on whether the virtual currency may be considered as 'goods'. As mentioned in Section I, there is no law that expressly classifies virtual currencies as goods. Although the Supreme Court in the *IAMAI* case considered whether virtual currencies can be categorised as money or goods (or commodities) and noted that virtual currencies have attributes of both these categories, it did not make any definitive categorisation, leaving the question open. If virtual currencies are categorised as money, then no GST should be applicable as money is excluded from its scope. However, in this case, the Supreme Court acknowledged that virtual currencies are capable of being considered intangible property and goods as well. The characterisation of a virtual currency for the purpose of GST may, therefore, ultimately depend on the context of the transaction.

Further, the Tariff Schedule for Goods currently contains no specific category for virtual currencies but it does contain a residuary category of goods. Virtual currencies may therefore

¹⁶ For instance, if a seller is a trader by occupation, the income should be taxed as business income. If it is not business income, it would be taxed in the same way as capital gains. However, this is not yet clear under Indian law, which makes it difficult to conclude how virtual currencies may be taxed.

(assuming they are treated as goods for the reasons discussed in Section X) fall within the residuary category. Under the GST regime, GST is chargeable on transactions where goods are supplied in the course or furtherance of business. As there are a multitude of virtual currencies and each transaction varies in nature, determinations must be made on a case-by-case basis as to whether GST is to be paid. Persons selling goods in the course or furtherance of business and requiring GST registration (which registration depends on persons meeting an annual revenue threshold) are required to include GST in their sale invoices. In addition, if an exchange operator sells a virtual currency in exchange for another virtual currency, the transaction may be considered as barter and GST may be applicable on both transactions as dual supplies.

Under the IGST Act, tax is levied when goods are imported into the country. As virtual currencies are digital goods, unless they are stored in a wallet that is in a physical medium, such as a pen drive or a hard drive, they are unlikely to be subject to customs duties as such duties apply only to the import of tangible goods. Therefore, in practice, IGST would not be levied as the tax mechanism prescribes that IGST shall be applicable only at the point in time when customs is payable on the import of goods into India.

Additionally, GST should be payable with respect to services provided (e.g., services of a trading exchange) in connection with the sale and purchase of virtual currencies. Where a person sells virtual currencies as a hobby, there should be no GST consequences. Sales of virtual currencies where they were initially held as an investment should also attract no GST liability.

Double taxation issues may arise where consumers might be subject to GST while purchasing virtual currencies, and again on their use in exchange for other goods and services that are in turn subject to GST. These issues have yet to have been accounted for by the GST regime.

It should be noted that the above analysis is based on our analysis of GST provisions as they apply generally, and there is no specific government guidance on the application of GST to virtual currencies.

X OTHER ISSUES

i Foreign exchange control

Cross-border transfers of virtual currencies, or cross-border remittances for the purchase or sale of the same, raise questions under FEMA.

Nature of virtual currencies under FEMA

There is no express classification of virtual currencies under FEMA. The RBI has stated in response to Right to Information requests that it does not classify virtual currencies as currencies under FEMA, no guidelines have been framed on virtual currencies under FEMA and there is no prohibition under law (including FEMA) on banks facilitating the purchase and sale of virtual currencies and cryptocurrencies.¹⁷ Our view is broadly aligned with this, though the answer will depend on the nature of the particular virtual currency being analysed.

The definition of currency under FEMA is an enumerated list, and includes 'any instrument which can be used to create a financial liability'. Virtual currencies are not named

17 RBIND/R/E/20/02104 (May 27, 2020) and RBIND/R/2018/51897 (9 May 2018).

under any of the enumerated categories and, in the case of virtual currencies such as Bitcoin, there is no entity that is accepting financial liability in connection with the instrument. The *LAMAI* case also recognises that virtual currencies have not been classified as currency under FEMA by the RBI. This becomes relevant as FEMA requires that all sales and draws of foreign currency are made through an authorised dealer of a foreign exchange. If virtual currencies are not foreign currency, they can be bought and sold through regular business entities or peer-to-peer, as they are today. However, for virtual currencies that are the liability of a particular entity (e.g., certain types of stablecoins), the considerations may be different. Stablecoins are discussed in subsection ii.

Further, virtual currencies may also be considered as goods or software under FEMA. There is no express definition of goods under FEMA. However, according to the Foreign Exchange Management (Export of Goods and Services) Regulations 2015, goods and software are treated alike and software means ‘any computer program, database, drawing, design, audio/video signals, any information by whatever name called in or on any medium other than in or on any physical medium’. As virtual currencies are information stored on an electronic medium, it would appear that they fall within the aforesaid definition of software. The RBI’s master direction on imports also recognises imports of goods and services ‘in non-physical form, i.e., software or data through internet / datacom channels’.¹⁸

Further, in the case of *Tata Consultancy Services v. State of Andhra Pradesh*,¹⁹ in a decision of a constitution bench of the Supreme Court of India, the Court considered whether certain software would fall within the meaning of goods under a state sales tax law. The majority held that the term ‘goods’ as used in the Constitution of India and under the Sales Tax Act is ‘very wide and includes all types of movable properties, whether those properties be tangible or intangible’, ‘the moment copies are made and marketed, it becomes goods’, and ‘a transaction sale of computer software is clearly a sale of ‘goods’ within the meaning of the [relevant Sales Tax Act]’, and ‘the term “all materials, articles and commodities” includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed etc’. In the concurring opinion by Honourable Justice Sinha, a three-part test was laid down for when a software would become goods.²⁰

While the judgment was not in the context of a virtual currency or the definition of goods under FEMA, it provides useful interpretational guidance, since the term goods has not been defined under FEMA.

Virtual currencies are intangible and are made, marketed and stored on physical servers. They are capable of being bought and sold, as well as transmitted, transferred, delivered, stored and possessed. It may be argued that virtual currencies do not possess utility. However, virtual currencies such as Bitcoin and Ethereum are used for various purposes, including being a store of value, a means of exchange (including for micro-payments) and decentralised

18 Master Direction – Import of Goods and Services (RBI/FED/2016-17/12 FED; Master Direction No. 17/2016-17).

19 *Tata Consultancy Services v. State of Andhra Pradesh*, (2005) 1 SCC 308.

20 ‘Goods may be tangible property or intangible property. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) [whether it is] capable of being bought and sold; and (c) [whether it is] capable of being transmitted, transferred, delivered, stored and possessed. If software, whether customised or non-customised, satisfies these attributes, the same would be goods.’

applications. Demand for such virtual currencies further indicates their utility. Therefore, based on the text of the law as it stands, virtual currencies such as Bitcoin and Ether are closest in nature to intangible goods or software under FEMA.

As already mentioned, there is no express classification of virtual currencies under FEMA, and the above discussion is only intended to highlight some plausible interpretations as at the time of writing. The *LAMAI* case holds that virtual currencies are intangible property, which also act, under certain circumstances, as money. This casts a degree of doubt on the interpretation of the classification of virtual currencies under FEMA.

Cross-border transactions involving virtual currencies

Cross-border sales of virtual currency by an Indian resident

If a virtual currency is sent from India to somewhere outside India by Indian residents as payment for services rendered or goods (including other virtual currencies) sold by a non-resident entity, then the transaction may be characterised as an export of goods regulated under the Foreign Exchange Management (Export of Goods and Services) Regulations 2015 and the Master Directions on Export of Goods and Services (together, the Export Regulations). The Export Regulations require, inter alia, that the full value of any exports be received only via authorised banking channels (i.e., in fiat currency) and that any set-off of import payments against export receivables only happen through a process facilitated by the authorised bank. This means that cross-border barter would not be permitted. Thus, the cross-border transfer by Indian residents of virtual currencies without receiving fiat currencies through authorised banking channels may be viewed to violate the Export Regulations. However, there are counterarguments to this view, owing to the silence of FEMA on virtual currencies.

The export-related obligations are on the exporter: that is, usually the Indian resident and not the foreign recipient. As such, foreign recipients, unless they specifically target Indian residents, may be able to ring-fence themselves from the above provisions.

Cross-border purchases of virtual currency by an Indian resident

Outward remittances of fiat currency that are made by an Indian resident for the purchase of virtual currencies like Bitcoin can be argued to be permissible current account transactions under FEMA, as they can be characterised as imports of intangible assets. The provisions under the RBI's directions on import of goods and services allowing for non-physical imports of software lend further support to this view. However, owing to the lack of operational guidance from the RBI on this point, the outward remittance of fiat currency for the purchase of virtual currency is seeing some on-the-ground resistance by banks and other authorised dealers of foreign exchange. Additionally, where the purchase is sought to be made by individuals, it would be subject to conditions under the RBI's Liberalised Remittance Scheme, which restricts outward remittances to US\$250,000 per year.

ii Stablecoins

Stablecoins are units of value that are usually issued by an identifiable entity, and, as the name suggests, are intended to be relatively immune to price swings.²¹ This is achieved by the stablecoins being ‘backed’ (though this may not always be the case) by underlying fiat currencies or other traditional assets like gold. A stablecoin issuer may operate by maintaining a reserve of these assets at a given ratio to every unit of cryptocurrency issued. The issuer would generally allow holders of the stablecoin to redeem each stablecoin for its equivalent value in fiat currency. Some examples of such stablecoins currently in the market are TrueUSD and Tether, which are attempting to be pegged in price to the US dollar. Other stablecoins, such as DAI, do not appear to be backed by reserves maintained by any identifiable entity and may require a different analysis. Recent announcements of proposed new stablecoins by various large enterprises show that stablecoins are gathering mainstream corporate momentum.

There is no Indian law that is specifically applicable to stablecoins. The following issues should be analysed:

- a whether a given stablecoin would amount to currency under FEMA, since the term currency includes any ‘instrument by whatever name called that can be used to create a financial liability’;²² and
- b whether a given stablecoin system would amount to a payment system under the PSS Act (i.e., a system that enables payment between a payer and a beneficiary).

These are interesting questions in the context of Indian law and should be examined carefully on a case-by-case basis, as each stablecoin may have varying legal characteristics.

iii Proposed ban

As mentioned in Section I, the IMC Report made a non-binding recommendation in 2019 to the government to ban dealings in cryptocurrencies. The draft bill proposed by the IMC Report goes so far as to provide for a maximum of 10 years’ imprisonment for persons who mine, generate, hold, sell, deal in, issue, transfer, dispose of or use cryptocurrencies. The definition of the term ‘cryptocurrency’ in the draft bill is ambiguous and is likely to require further legal vetting. The effect of the draft bill is to prohibit all activities relating to cryptocurrencies in India, barring activities relating to a government-authorized cryptocurrency (or ‘digital rupee’).

XI LOOKING AHEAD

The law in India on virtual currencies is in flux. The Supreme Court’s decision in the *LAMAI* case is positive and affirms the legitimacy of the virtual currency industry, as well as the fundamental rights of stakeholders under the Constitution of India. It confirms that restrictions on virtual currency activity ought to be proportionate – namely, evidence-based, rational and calibrated in accordance with the desired outcome.

In our view, therefore, although the IMC Report has recommended an outright ban, its recommendation is susceptible to challenge on constitutional grounds as it is excessive,

21 e.g., https://www.gdf.io/wp-content/uploads/2019/05/GDF-Stablecoin-Key-Considerations_9-MAY-SUMMIT-DISCUSSION.pdf.

22 <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10267&Mode=0>.

and the risks associated with virtual currencies can be addressed with less invasive measures. International bodies such as the G20 and the Financial Action Task Force, and leading jurisdictions such as the European Union, Singapore, the United Kingdom and the United States, have all proposed regulatory approaches to address the risks, so that the benefits are not lost out on.

Experts have opined that blockchain as a system would be rendered either impotent or severely restricted (depending on the blockchain implementation) without any virtual currency or crypto token. These experts include Princeton computer scientist Arvind Narayanan, Ethereum co-founder Vitalik Buterin and author Andreas Antonopoulos. These tokens act as an incentive to blockchain participants to verify transactions and, hence, preserve decentralisation, which is the very breakthrough of blockchain technology. As a result, it may not be a wise policy to try to promote blockchain on the one hand, and then severely restrict tokens on the other.

While virtual currencies entail risks, they also bring with them several benefits, most notably disintermediation and cost savings. Outright restrictions on this technology are impractical and might be relatively straightforward to circumvent. Rather, as with all disruptive technologies, balanced regulation should be adopted to mitigate the risks and promote the benefits. It is our hope that any impending government decision recognises this fact, and adopts a nuanced framework towards this.

Some uncertainty may continue to prevail in India until industry and regulatory understanding matures both domestically and globally; however, our long-term view is positive. The implementation of successful regulatory models in other jurisdictions should also hasten progress towards a balanced regime.

Appendix 1

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