

BLUEPRINT OF A LAW FOR REGULATING CRYPTOASSETS | KEY TAKEAWAYS FROM STAKEHOLDER CONSULTATIONS

Background

Cryptoasset regulation has been a subject of intense policy debate, both in India and worldwide. While India has legislated on the taxation aspects of cryptoassets, it is yet to clarify the regulatory status of cryptoassets. As the cryptoasset sector continues to operate in a regulatory vacuum, it has heightened the risks for investors and intensified business uncertainty. In this context, the Vidhi Centre for Legal Policy (“Vidhi”) released an independent working paper “Blueprint of a Law for Regulating Cryptoassets” (“Working Paper”) in January 2022, which argues for the need to regulate cryptoassets in India through a standalone law. In doing so, the Working Paper presents the contours of a possible bespoke legal framework for cryptoassets. To take this conversation further and to assess the viability of the recommendations in the Working Paper, Vidhi conducted extensive consultations with numerous experts and stakeholders (“Vidhi Consultations”).

This document encapsulates the key findings from the specific issues discussed in the Vidhi Consultations. These key findings are not only important for informing research in this area but become relevant in the context of the recent developments in the crypto market. For instance, the Directorate of Enforcement (“ED”) had conducted investigations into the affairs of few cryptoassets exchanges alleging that they aided fraudulent loan applications in money laundering.¹ As per the ED investigation, these exchanges did not implement or follow Know-Your-Customer (“KYC”) norms and had not exercised adequate oversight over their users.² The ED investigation findings have intensified regulatory concerns regarding the safety of cryptoasset transactions and increased the uncertainty for investors and crypto businesses. Further, the recent market crash of popular cryptoassets and stablecoins has hampered the market capitalisation of cryptoassets and led to large-scale losses for investors.³ This crash has also heightened policymakers' concerns regarding the volatility of such cryptoassets and their susceptibility to systemic failures.

These developments call for a comprehensive regulatory framework to mitigate risks emanating from cryptoassets. Given the challenges in regulating this industry due to the decentralised and pseudonymous nature of many cryptoassets, any such framework must be based on inputs from relevant stakeholders and experts.

Vidhi Working Paper

The Working Paper argues for India to regulate the cryptoasset market since an unregulated market is likely to have wide ramifications on consumers and the financial system. In doing so, the Working Paper recommends that India must enact a standalone law “Regulation of Cryptoasset Markets Act” (“Proposed Law”) as existing laws are not well-equipped to accommodate different types of cryptoassets. Key features of the Proposed Law as outlined in the Working Paper are set out below. The blueprint of the Proposed Law draws on best practices adopted globally by different countries and international standard-setting bodies.

KEY FEATURES OF THE PROPOSED LAW

- **Scope:** *The Proposed Law will regulate: (a) issuers of cryptoassets; and (b) cryptoasset service providers (“CASPs”) who provide “crypto asset services” as*

¹ The Business Standard Wed Team, ‘Ten Crypto Exchanges under ED Lens for Allegedly Laundering Rs. 10 Billion’ *The Business-Standard* (New Delhi, 11 August 2022) <https://www.business-standard.com/article/current-affairs/ten-crypto-exchanges-under-ed-lens-for-allegedly-laundering-rs-10-billion-122081100185_1.html#:~:> accessed 14 November 2022.

² For instance as mentioned in the following press releases of the ED- ED ‘Press Release 05.08.2021’ <https://enforcementdirectorate.gov.in/sites/default/files/latestnews/PR%20HYZO_Freezing%20of%20assets%20of%20WazirX%20Crypto%20Exchange.pdf> accessed 14 November 2022 ;ED , ‘Press Release 12.08.2022’ <<https://enforcementdirectorate.gov.in/sites/default/files/latestnews/PR%20HYZO%20-%20Search%20%26%20freezing%20of%20Yellowtune%20%26%20Flipvolt%20CryptoExchange.pdf>> accessed 14 November 2022.

³ Pawan Nahar, ‘Bitcoin, Ethereum Crash over 70% from Peaks; Crypto Investors Lose over \$2 Trillion in 8 Months’ *The Economic Times* (India 14 June 2022) <<https://economictimes.indiatimes.com/markets/cryptocurrency/crypto-carnage-continues-investors-lose-over-2-trillion-in-eight-months/articleshow/92179178.cms>> accessed 14 November 2022 ; Reuters, ‘Crypto Meltdown Deepens as Stablecoin Tether Drops Below Dollar Peg’ *The Economic Times* (12 May 2022) accessed 14 November 2022.

defined under the law. CASPs refer to entities that serve as entry and exit points to the cryptoasset ecosystem. It includes entities providing exchange services (such as exchange from cryptoasset to fiat currency and vice versa), custodian and wallet services, investment advisory services and such other services notified by the Central Government.

- **Identifying the Regulator:** As the cryptoasset market is evolving, it may be useful to rely on the expertise of existing regulators like the Securities and Exchange Board of India (“SEBI”) and the Reserve Bank of India (“RBI”).
 - SEBI may regulate CASPs.
 - For regulating issuers, cryptoassets may be broadly classified as fiat/asset backed cryptoassets (such as stablecoins) and other cryptoassets. The former may be regulated by the RBI and the latter may be regulated by SEBI.
- **Regulating Use-cases:** The Proposed Law will empower the Central Government (in consultation with RBI and SEBI) to prohibit or restrict specific use-cases of cryptoassets on grounds such as public interest, including interests of consumers and safety and soundness of financial markets. This may be used to prohibit use cases like payments or using cryptoassets as underlying assets for derivatives.
- **Prohibited Cryptoassets:** The Central Government (in consultation with RBI and SEBI) may be empowered to notify certain cryptoassets as “Prohibited Cryptoassets”. Upon such notification, CASPs and other users will be prohibited from dealing in such cryptoassets.
- **Regulating Issuers:** Issuer of an asset backed / fiat backed cryptoassets will be subject to an authorisation requirement coupled with the requirement to file prospectus / whitepaper for issuing cryptoassets in India and for admission to trading on a trading platform. Issuers of other cryptoassets may only be required to file a prospectus / white paper with SEBI.
- **Regulating CASPs:** CASPs will require an authorisation from SEBI. They will also be subject to requirements relating to communications with investors, customer due diligence, investor protection, prevention of market abuse, etc.
- **Inter-Regulatory Council:** The Proposed Law envisages the creation of an Inter-Regulatory Council consisting of representatives from the Ministry of Finance, RBI and SEBI. The council may inter-alia - (a) decide on restrictions and prohibitions discussed above; and (b) operate a regulatory sandbox to test innovative crypto based solutions. The council may also invite stakeholders from other government agencies and the private sector for their inputs and suggestions on specific issues
- **Regulating Stablecoin Arrangements:** For regulating stablecoin arrangements, RBI may consider – eligibility conditions of issuers, exposure of existing financial institutions to such stablecoins, stabilisation mechanism, provisions on redeemability and governance arrangements.

Vidhi Consultations

The Vidhi Consultations were organized from April to June 2022 to inform the findings of the Vidhi Working Paper, discuss the challenges facing the cryptoasset industry in India and discuss the feasibility of the key features of the Proposed Law with important stakeholders. The consultations saw participation by 22 stakeholders and experts (collectively “**Consultees**”). The Consultees included 8 stakeholders from cryptoasset exchanges operating in India, 4 policy experts with expertise in digital assets, 5 lawyers with fintech expertise, 1 academician with expertise in cryptology, 1 stakeholder from a company that provides digital payment services, 1 stakeholder from an industry body, 1 stakeholder from a company developing blockchain applications and 1 stakeholder from the gaming industry. These consultations were closed-door and followed the Chatham House Rules.

Key Takeaways from the Vidhi Consultations

Classification of Cryptoassets

Working Paper Recommendations: The Working Paper found that rapidly evolving use cases and business models of cryptoassets make it difficult to pigeonhole cryptoassets under a particular recognised category of assets (such as securities, and commodities). Accordingly, the Working Paper studies the possible classification/taxonomy of cryptoassets and identifies key parameters for designing such classification. These parameters include the nature of the issuer, the origination of the token, functional use cases, and its relationship with fiat currency. Based on an analysis of existing laws on different types of assets, the Working Paper recommends a bespoke asset class for cryptoassets since existing laws cannot accommodate every use case or type of cryptoassets. Such a classification of cryptoassets should be dynamic with ongoing assessments of properties, use cases, and rights that cryptoassets embody.

Observations of the Consultees:

- Since cryptoassets are still evolving, Consultees acknowledged the need to classify cryptoassets and avoid a restrictive definition of cryptoassets. The classification of cryptoassets is necessary to identify the regulator for such assets and determine the nature of regulation. Any regulatory response must account for such classifications and ever-changing use cases of cryptoassets.
- Some Consultees also urged that asset classification of cryptoassets should be based on use-cases prevalent / dominant in the concerned country. It was pointed out that cryptoassets are not used as a medium of exchange or payment in India and since India already has a robust digital payments ecosystem, the industry is not keen to advance payments use case of cryptoassets. Most Consultees from the industry agreed that the primary use case for India is to use cryptoassets as a form of investment asset that yields capital gain.
- Some Consultees also referred to other categories of cryptoassets recognised globally such as exchange-based cryptoasset and utility-based cryptoasset and the need to recognise these in the classification framework. It was discussed that there could be specific regulations for each of these sub-categories as has been seen in the context of RBI guidelines on prepaid payment instruments over and above the legal requirements under the Payment and Settlement Systems Act, 2007.
- The Consultees also discussed if there is a need identified to introduce a bespoke asset class for cryptoassets in India to reflect the nature and use cases of cryptoassets in India and frame regulations basis this distinctive asset class.

Final Position

The consultation findings are in line with Working Paper’s argument that all cryptoassets cannot be pigeonholed under one asset class under existing laws. The findings support the recommendations of the Working Paper on the need to

identify cryptoassets as a bespoke asset class, with different sub-categories. Any such classification of sub-categories needs to consider the developing and dynamic use cases of cryptoassets which will ultimately determine the apposite regulatory treatment.

Further, defining sub-categories of cryptoassets should be based on the predominant use case of cryptoassets prevailing in the country.

Need and Nature of Regulation

Working Paper Recommendations: The Working Paper analysed three approaches to regulating cryptoassets – complete ban on cryptoassets, regulating cryptoassets under existing laws and regulating cryptoassets through a standalone law. The Working Paper concluded that given the pervasive and decentralised use of cryptoassets, a ban would be counterproductive since it would just push the market underground which would further perpetuate illegal activities without any scope for supervision. Pursuant to an analysis of existing laws, the Working Paper found that existing laws were inadequate to accommodate the different types and use-cases of cryptoassets. Therefore, the Working Paper recommended a bespoke regulatory framework for cryptoassets. The key features of the Proposed Law are already discussed above. In designing such a legal framework, the Working Paper stressed on the need for risk-based regulation where regulatory burden is proportionate to the risks posed by an activity. The Working Paper also emphasised the need for public-private coordination for enabling effective regulation, through the creation of a self-regulatory organization (“**SRO**”) to develop market conduct standards and facilitate enforcement of the Proposed Law.

Observations of the Consultees:

- Consultees agreed that there is a need for legal and regulatory certainty regarding cryptoassets. For instance, some Consultees raised concerns regarding notices under Foreign Exchange Management Act, 1999 being received by the industry and accordingly suggested legal clarity under the same is required.
- Some Consultees from the industry highlighted that there is a perception challenge that the industry is facing. The Government appears to view cryptoassets as a risky venture and trading in cryptoassets is viewed as akin to gambling and therefore, is hesitant to facilitate its usage amongst investors. The Consultees emphasised that there is a need to inform and change the perception of the Government and to reorient their view to treat cryptoassets as a legitimate form of investment that yields capital gain.
- Many Consultees agreed that a ban on cryptoassets is neither desirable nor feasible and it would severely hinder India’s ability to compete globally from a technological innovation standpoint. Instead, a new law for cryptoassets should be introduced. This is also necessary since most existing laws cannot accommodate all aspects of cryptoassets regulation. Cryptoasset regulation should focus on consumer protection safeguards, mechanisms to prevent illicit financing, and implement frameworks to protect market integrity and promote financial stability.
- The Consultees also discussed that cryptoassets regulations require public and private collaboration. It cannot solely be a top-down regulatory approach. For instance, some Consultees highlighted the role of industry bodies (or SROs) in laying down standards and codes of conduct for the market players which can be monitored and enforced by the industry. Larger policy issues such as data protection norms, consumer protection norms, or corporate governance/blockchain governance norms, can be left to be legislated upon by the Government.
- It was also pointed out that any regulation of cryptoassets needs to be at par with international standards so that there can be seamless integration globally. It needs to be futuristic and should not inhibit global competitiveness.

Final Position

The consultation findings support the recommendation of the Working Paper that a ban on cryptoassets is not feasible, and neither is sole reliance on existing laws to regulate cryptoassets.

The consultations further confirm the Working Paper's recommendation for a bespoke regulatory framework to account for the unique and dynamic nature of cryptoassets. This will enable supervision over cryptoassets use and intermediaries to address risks relating to customer/investor protection, money laundering, market manipulation, circumvention of exchange controls, cyber security, and overall economic stability.

The findings also supplemented the recommendations of the Working Paper by suggesting that the industry (through an SRO), and the Government need to come together to frame apposite regulations.

Identifying the Regulator

Working Paper Recommendations: The Working Paper recommended that the Proposed Law should rely on the expertise of existing regulators like RBI and SEBI, instead of creating a new regulator at this stage. For instance, SEBI may regulate on market conduct aspects by regulating CASPs and issuers of cryptoassets (other than stablecoin). On the other hand, RBI may regulate stablecoins as they are closely connected to the financial system. The Working Paper also identified that coordination amongst regulators is instrumental to ensure effective regulation and enforcement. Accordingly, the Working Paper recommended the setting up of an Inter-Regulatory Council consisting of representatives from the Ministry of Finance, RBI and SEBI to determine specific aspects of the implementation of the Proposed Law and operate a regulatory sandbox to test innovative use cases of cryptoassets.

Consultee Observations:

- Consultees discussed that typically the present use case of cryptoassets in a country will determine the regulator. For instance, in case of a payments use case, the central bank may be the appropriate regulator. However, for a securities or investment use case, the securities regulator may be the appropriate regulator.
- However, some Consultees also pointed out that since cryptoassets are shape-shifting, with evolving use-cases and possibility of overlap between different use-cases, a clear demarcation of regulatory jurisdiction may not be straightforward and therefore, some scope for inter-regulatory coordination may have to be built.
- On the issue of identifying a specific regulator for the cryptoasset sector in India, there was no consensus. Some Consultees considered SEBI as an appropriate regulator and some also suggested International Financial Services Centre Authority (“IFSCA”) as the appropriate regulator.
- It was also discussed if there is a need for a new and separate regulator for the sector. However, this did not find much support from Consultees as it was argued that establishing a new regulator will take a long time for such a new regulator to comprehensively develop itself. Therefore, most Consultees agreed that reliance on some existing regulator may be a more feasible option.

Final Position

There was no consensus on the relevant regulator for the cryptoasset market. However, most Consultees agreed with Vidhi's recommendation that India should rely on its existing regulators instead of creating a new regulator for the sector.

While some Consultees suggested that SEBI should be the primary regulator, some agreed with Vidhi's recommendation that both RBI and SEBI will have to play an important role in regulating the sector and some others also suggested IFSCA as the preferred regulator. Irrespective of the determination of the primary regulator, most Consultees seem to agree that the regulation of cryptoassets will require some element of coordination between different regulators and agencies. However, it was also pointed out that sometimes inter-regulatory coordination may cause inefficiencies in regulation if there is no consensus on the broad policy objective guiding the regulatory framework.

Based on the aforesaid inputs, it is clear that creating a new regulator is not warranted at this stage. It may be useful to rely on the market conduct regulation expertise of SEBI to regulate CASPs and the prudential regulation expertise of RBI to regulate asset/fiat-based cryptoasset issuers. While the issue of considering IFSCA as a possible regulator may require further consideration, one limitation in this regard is that the territorial jurisdiction of IFSCA is currently limited to regulate financial institutions in the International Services Centres.

Entities to be Regulated

Working Paper Recommendations: The identification and regulation of all players involved in a cryptoasset transaction may not be possible, especially, cryptoassets based on public permissionless decentralised technologies. Therefore, the Working Paper suggested that initially the regulatory oversight should be focused on actors who act as gatekeepers i.e., actors who facilitate entry and exit from the cryptoasset ecosystem. Therefore, the Proposed Law suggested that market participants who provide services relating to (a) exchange between cryptoasset and fiat currency or between two or more forms of cryptoassets; (b) transfer of cryptoassets; (c) custody and administration of cryptoassets or instruments enabling control over such assets; (d) facilitating buying and selling of cryptoassets; (e) providing investment advice on cryptoassets, can be brought within the regulatory ambit. Additionally, the Working Paper suggested that issuers of cryptoassets that intend to offer cryptoassets to the public in India or list their cryptoasset for trading in an exchange should also be subject to regulation.

Consultee Observations:

- In line with the Working Paper's recommendations, many Consultees suggested that market participants that facilitate cryptoasset transactions and which can be identified by policymakers easily may be the first point of regulation. These could include exchanges, and custodians. The regulatory framework must be flexible to allow regulation of newer players as and when the market expands.
- All Consultees agreed that centralised cryptoassets exchanges need to be regulated immediately. They are the main points of entry and exit into the crypto ecosystem and hence, need to and can be regulated. Many Consultees, including some Consultees from the industry argued that there is a need for regulatory requirements relating to anti-money laundering ("AML") and KYC norms that must be followed by such exchanges. Some Consultees also suggested for licensing or registration requirements.
- On the point of regulating decentralised exchanges, some Consultees agreed that there are challenges in regulating such exchanges. However, it was pointed out that such exchanges are not predominant in the

Indian market. They are expensive to operate and are not user-friendly since most consumers prefer to interact with the market through a centralised exchange. Consultees argued that regulation should focus on centralised exchanges which are operating in the country and the industry should not be penalised (through a ban or regulatory uncertainty) due to the concerns associated with decentralised exchanges.

- Regarding the regulation of issuers, some Consultees pointed out that it may be difficult to start regulating all issuers of cryptoassets considering many issuers may not be identifiable. Accordingly, it was suggested that for the time being, the regulatory focus should be on the service providers and not issuers. It was further discussed if there is a need for the Proposed Law to impose a physical presence requirement for issuers to enable Indian authorities to exercise jurisdiction over such issuers. There was no agreement on this issue.

Final Position

The Consultation findings support the recommendations of the Working Paper that market intermediaries (such as exchanges, and custodians) who act as entry and exit points should be the first point of regulation.

AML and KYC norms are essential to such regulation and must be applied diligently.

There was a difference of opinion regarding the regulation of issuers. While some Consultees agreed that issuers should also be brought within the ambit of regulation with a physical presence requirement, many Consultees argued that it may be difficult to enforce such a requirement for issuers of all cryptoassets especially those where issuers may not be traceable.

Regarding decentralized exchanges, Consultees agreed that taking action against such exchanges may not be easy. However, regulations should not be deterred fearing enforcement challenges relating to decentralized exchanges.

Enforcement Challenges and Solutions

The Working Paper observed that given the specific characteristics of cryptoassets such as the possibility of carrying out anonymous or pseudo-anonymous transactions and its ability to conduct transactions digitally and globally, enforcement can be a challenge. However, it concluded that formulating and implementing a regulatory framework and imposing AML and KYC norms would be instrumental in mitigating such challenges. It also recommended that enforcement authorities should be upskilled and equipped with technical skills which would enable them to enforce the provisions of the law. Further, the Working Paper proposed the establishment of a dedicated enforcement taskforce comprising representatives of various regulators and statutory authorities that would be responsible for regulating various aspects of cryptoasset activities. It also identified the important role that SROs can play in ensuring enforcement amongst the market participants.

Consultee Observations

- Most Consultees highlighted that the industry could play a proactive role in mitigating such enforcement challenges either by providing technological support or through an SRO. Some Consultees from the industry highlighted that the industry has the technological capacity to monitor accounts and transactions to track suspicious account activity. They are also willing to undertake KYC and AML obligations. Thus accordingly, it was discussed that regulatory clarity on the AML and KYC norms for the industry, is critical. This will enable the industry to share relevant data with the Government regarding suspicious account activity and furnish the details of such accounts to facilitate enforcement. Currently, there is no such legal mechanism for the industry to share such data which is critical for the open exchange of information. It was discussed that a legal framework will create a mechanism for the industry to cooperate with the Government on relevant data sharing and developing standards for such information exchange.

- Many Consultees pointed out that enforcement challenges should not be a cause to ban cryptoassets in India or let them remain unregulated. Instead, the Government may consider leveraging the expertise and technology of the private sector (industry, research centres) to build the Government's forensic capabilities. Further, Consultees also discussed that there is a need to focus on upskilling investigating authorities so that they can deal with the technical nuances of cryptoassets and detect any misuse.

Final Position

The Consultation findings echo the Working Paper's concerns regarding the enforcement challenges associated with cryptoasset regulation.

The Consultation findings also present specific areas where public-private collaboration may be required to mitigate enforcement challenges. For instance, the legal framework can create a mechanism for the industry to share information about suspicious activities and other regulatory information with regulators and law enforcement authorities. The Government must also leverage the forensic and technological capacities of the private sector to enable them to monitor cryptoasset transactions under applicable laws.

The Consultation findings also support the Working Paper's recommendations to establish an SRO, which will provide a means for the industry to work with the Government in ensuring better implementation and enforcement of cryptoasset regulations.
