

CRYPTOCURRENCIES IN INDIA GET A SECOND WIND

BRIEF HISTORY AND BACKGROUND

On the 4th of March, 2020 the Supreme Court of India, in a landmark judgment, struck down the Reserve Bank of India Circular imposing a ban on banks servicing any person dealing in cryptocurrencies. This judgment paves the way for a reboot of the domestic cryptocurrency industry and will bring much joy and cheer amongst cryptocurrency enthusiasts and entrepreneurs in India. The saga of cryptocurrencies started in 2008 when a paper titled “Bitcoin: A Peer to Peer Electronic Cash System” was published by a single or group of pseudonymous developer(s) by the name of Satoshi Nakamoto. The actual network took some time to start with the first transactions taking place only in January, 2009. The first actual sale of an item using Bitcoin took place a year later with a user swapping 10,000 Bitcoin for two pizzas in 2010, which attached a cash value to the cryptocurrency for the first time. By 2011 other cryptocurrencies began to emerge, with Litecoin, Namecoin and Swiftcoin all making their debut. Meanwhile Bitcoin, the cryptocurrency that started it all, faced criticism after claims emerged that it was being used on the so-called “dark web”, particularly on sites such as Silk Road which was a means of payment for illegal transactions. Over the next five years cryptocurrencies steadily gained traction with increased number of transactions and the price of Bitcoin, the most popular cryptocurrency, shot up from around 5 Dollars in the beginning of 2012 to almost 1000 Dollars at the end of 2017.

Over the last few years the volume of transactions undertaken and the market capitalisation of some of the most popular cryptocurrencies world over has seen a steady increase, except for a major spike in the last months of 2017 and first few months of 2018.¹ The main reasons why cryptocurrencies became so popular are their inherent advantages such as privacy, lower transaction fees, speed of transfers, secure transfers, no involvement of a third party, etc.² It was the rapid rise in the number of users dabbling in cryptocurrencies in India that forced the Reserve Bank of India (RBI) to intervene in this regard and issue several press releases³ cautioning users, holders and traders of cryptocurrencies, about the various risks associated with such assets. Eventually on April 6, 2018 the RBI issued a Circular preventing Commercial and Co-operative Banks, Payments Banks, Small Finance Banks, NBFCs, and Payment System Providers not only

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<https://www.cryptocurrencychart.com/chart/BTC,EOS,ETH,LTC,XRP/price/USD/linear/2015-08-06/2020-01-22>

² Krishna Kumar Thakur and Dr. G.G. Banik, “Cryptocurrency: Its Risks And Gains And The Way Ahead”, IOSR Journal of Economics and Finance, Volume 9, Issue 2 Ver.1 (Mar-Apr .2018), PP 38-42, available at <http://www.iosrjournals.org/iosr-jef/papers/Vol9-Issue2/Version-1/F0902013842.pdf>.

³ The RBI issued separate press releases dated December 24, 2013, February 01, 2017 and December 05, 2017.

from dealing in cryptocurrencies themselves but also directing them to stop providing services to all entities which deal with cryptocurrencies.

Although this Circular did not *per se* ban the use of cryptocurrencies in India, the effect of the Circular was that cryptocurrency exchanges, which relied on normal banking channels for sending and receiving money to and from their users, could not access any banking services within India. This essentially crippled their business operations since converting cash to cryptocurrencies and *vice versa* was an essential part of their service. Faced with such an existential threat, a number of exchanges who were members of the Internet and Mobile Association of India (IMAI), filed a writ petition in the Supreme Court on May 15, 2018 which was finally decided on March 4, 2020 with the Court quashing the RBI Circular and thereby once again opening the doors for cryptocurrency exchanges in India to flourish.

In this article we try to analyse and discuss the various arguments raised before the Court and how they were dealt with as well as the policy implications for cryptocurrencies in India in the backdrop of this decision.

ARGUMENTS BEFORE THE COURT

RBI has no power to issue the Circular

The first ground of challenge to the Circular was that since cryptocurrencies are not money or other legal tender, but only goods/commodities, they fall outside the purview of the Reserve Bank of India Act, 1934 (**RBI Act**), Banking Regulation Act, 1949 (**BRA**) and the Payment and Settlement Systems Act, 2007 (**PSS Act**). Since the Circular was issued in exercise of powers under all three of these legislations therefore the Reserve Bank of India (**RBI**) had no power to issue the Circular in the first place.

To address this argument, the Court discussed the scope of various sections of these legislations cumulatively and held that they confer very wide powers upon the RBI.⁴ The Court then entered into an analysis of the legal nature of cryptocurrencies in order to determine whether the RBI had the power to issue the Circular. It noted that although different people have referred to them

⁴ These include the power “(i) to operate the currency and credit system of the country to its advantage (ii) to take over the management of the currency from central government (iii) to have the sole right to make and issue bank notes that would constitute legal tender at any place in India (iv) regulate the financial system of the country to its advantage (v) to have a say in the determination of inflation target in terms of the consumer price index (vi) to have complete control over banking companies (vii) to regulate and supervise the payment systems (viii) to prescribe standards and guidelines for the proper and efficient management of the payment systems (ix) to issue directions to a payment system or a system participant which in RBI’s opinion is engaging in any act that is likely to result in systemic risk being inadequately controlled or is likely to affect the payment system, the monetary policy or the credit policy of the country and (x) to issue directions to system providers or the system participants or any other person generally, to regulate the payment systems or in the interest of management or operation of any of the payment systems or in public interest.”

interchangeably as an exchange of value, stock or commodity, it becomes a problem in law if it is represented as a currency to a stock market regulator and a commodity to a money market regulator and so on, in order to escape regulation. While cryptocurrencies were conceived at their birth as an alternative to money, the Court noted that they have assumed other shapes and utilities over the years and then recounted (in a very neat and informative table) how they have been defined by various agencies and courts in different countries. On analysis of this information it was concluded that there is unanimity of opinion that though cryptocurrencies have not acquired the status of legal tender, they nevertheless constitute digital representations of value and are capable of functioning as (i) a medium of exchange and/or (ii) a unit of account and/or (iii) a store of value. It was however pointed out that what an article may be able to function as may be different from how it may be recognized in law. The Court then went on to discuss the definition of terms such as “currency”, “Indian currency”, “currency notes”, “money”, etc.

It is not clear why the Court entered into the definition of currencies or the legal treatment of cryptocurrencies all over the world. The challenge on the ground of RBI lacking the power to issue the Circular was already answered in the negative; holding that it is not necessary for a particular item to actually acquire the status of legal tender for RBI’s role and power to come into play. This conclusion could reasonably have been arrived at just by discussing the provisions of the RBI Act, the BRA and the PSS Act, but it seems that the Court did not want to leave anything to chance and was trying to ensure that the judgment does not leave room for criticism at least on this count.

Analysis of Functions and Legal nature of Cryptocurrencies

In fact it seemed that the Court was not yet done with trying to understand the nature and legal treatment of cryptocurrencies, because it then moved on to discuss judicial pronouncements on the nature of cryptocurrencies from various jurisdictions and after analyzing a large number of them, concluded that:

“(i) depending upon the text of the statute involved in the case, and (ii) depending upon the context, various courts in different jurisdictions have identified virtual currencies to belong to different categories ranging from property to commodity to non-traditional currency to payment instrument to money to funds. While each of these descriptions is true, none of these constitute the whole truth. Every court which attempted to fix the identity of virtual currencies, merely acted as the 4 blind men in the Anekantavada philosophy of Jainism, (theory of non-absolutism that encourages acceptance of relativism and pluralism) who attempt to describe an elephant, but end up describing only one physical feature of the elephant.”

Based on this analysis of the nature and legal treatment of cryptocurrencies the Court stated that the RBI could very easily include cryptocurrencies in the definition of currency by declaring them to be a currency under section 2(h) of the Foreign Exchange Management Act, 1999.⁵ This scenario was also discussed in a previous post by this author,⁶ and opens another avenue for potential regulation of cryptocurrencies by the RBI in the future.

RBI only has power to regulate and not prohibit

The next contention of the petitioners was that as per section 45JA of the RBI Act, the RBI is conferred only with the power to regulate, but not to prohibit. The Court noted that Section 36(1)(a) of the BRA very clearly empowers RBI to caution or prohibit banking companies against entering into certain types of transactions or class of transactions. Therefore this contention was rejected holding that the prohibition contained in the Circular is not *per se* against the trading in cryptocurrencies but against banking companies, with respect to a class of transactions.

Cryptocurrencies not a Payment System

Another argument raised by the Cryptocurrency Exchanges (“VCEs”) was that VCEs do not operate any payment system and that since the power to issue directions under Section 18 of the PSS Act is only to regulate payment systems, the invocation of this power to do something that does not fall within the purview of a “payment system”, is arbitrary. The Court however disagreed with this argument saying that in the overall scheme of the Act, the RBI has the power to frame policies and issue directions to banks who are system participants, with respect to transactions that will fall under the category of payment obligation or payment instruction, even if not a payment system.

Satisfaction of the RBI

The next argument was that assuming the RBI had the power to issue the circular, the necessary *sine qua non* is the “satisfaction” of the RBI. Section 35A(1) of the BRA as well as Section 45JA and 45L of the RBI Act empower RBI to issue directions “if it is **satisfied**” about the existence of certain parameters. Judicial precedents were cited to contend that satisfaction can be arrived at only by (i) gathering facts, (ii) sifting relevant material from those which are irrelevant and (iii)

⁵ Section 2(h) of the FEMA Act, states as under:

“(h) “currency” includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank.”

⁶ Vipul Kharbanda, “Can Bitcoin be Banned by the Indian Government”, <https://cis-india.org/internet-governance/bitcoin-legal-regulation-india>

forming an opinion about the cause and connection between relevant material and the decision proposed to be taken.

However Court felt that the entire sequence of events from June 2013 up to the issuance of the Circular in April 2018 showed that the RBI had been brooding over the issue for almost five years and therefore, the RBI could hardly be held guilty of non-application of mind. The Court held that if an issue had come up again and again before a statutory authority and such an authority had also issued warnings to those who are likely to be impacted, it can hardly be said that there was no application of mind. The Court further held that the RBI could not be accused of not taking note of relevant considerations or taking into account irrelevant considerations since the RBI had taken into account only those considerations which multinational bodies and regulators of various countries such as FATF, BIS, etc., had taken into account.

Although the Court held that taking into account reports and considerations that were considered by other multinational agencies satisfies the criterion of taking note of relevant considerations. However it could be argued that the absence of any actual damage caused to any banking entity in India or even outside India should have been considered a relevant issue which was not at all addressed in the RBI's deliberations. This lack of actual data to show any harm or damage to RBI regulated entities came up again in the arguments on the violation of the fundamental right to trade and business but the Court reached a very different conclusion in that context, as discussed in greater detail later.

Malice in law/ colourable exercise of power

It was also argued that since the RBI has itself accepted that cryptocurrencies are outside its regulatory purview, the impugned Circular is a colourable exercise of power and tainted by malice in law, in as much as it seeks to achieve an object completely different from the one for which the power is entrusted (since it effectively amounts to a prohibition on cryptocurrency trading). However, the Court negated this argument on the ground that RBI has sufficient power to issue directions to its regulated entities in the interest of depositors, in the interest of banking policy or in the interest of the banking company or in public interest. If the exercise of power by RBI with a view to achieve one of these objectives incidentally causes a collateral damage to one of the several activities of an entity which does not come within the purview of the statutory authority, the same cannot be assailed as a colourable exercise of power or being vitiated by malice in law.

Petitioners hit the Jackpot - Unreasonable restriction on right to trade under Article 19(1)(g)

The last throw of the dice by the petitioners was the argument that the Circular actually violated the freedom to carry on any occupation, trade or business (of the owners of the VCEs)

guaranteed under Article 19(1)(g) of the Constitution of India. It was argued that any restriction on the right to trade needs to pass the test of reasonableness contained in Article 19(6), i.e. the State can only put “reasonable restrictions” on the right to trade or business. The petitioners argued that since access to banking facilities is like oxygen for any business, the denial of such access is not a reasonable restriction. It was further contended that the right to access the banking system is actually integral to the right to carry on any trade or profession and that therefore a law whose effect or impact severely impairs this would be violative of Article 19(1)(g).

Referring to the case of [Md. Faruk v. State of Madhya Pradesh and others](#),⁷ the Court held that while testing the validity of a law restricting trade or profession, it must evaluate “(i) its direct and immediate impact upon of the fundamental rights of the citizens affected thereby, (ii) the larger public interest sought to be ensured in the light of the object sought to be achieved, (iii) the necessity to restrict the citizens’ freedom (iv) the inherent pernicious nature of the act prohibited or its capacity or tendency to be harmful to the general public and (v) the possibility of achieving the same object by imposing a less drastic restraint.”

The Court agreed with the proposition that as soon as a person is deprived of the facility of operating a bank account, the lifeline of his trade or business is severed, which would then result in the business automatically shutting down. Therefore there was a heavy burden upon the RBI of showing that larger public interest warranted such a serious restriction bordering on prohibition.

To counter the argument that the Circular was applicable only to entities regulated by the RBI and not to VCEs, the petitioners argued, by reference to previous case laws,⁸ that it is impact and not the object of a particular measure which determines whether a fundamental right is violated or not. The RBI argued that the Circular did not prohibit the trade of cryptocurrencies itself but only ring fenced regulated entities from dealing with them. However the petitioners showed the falsity of this claim by referring to the various committee reports and communications of the RBI which showed that, contrary to the stand taken by the RBI, the actual target of the Circular was the trade in cryptocurrencies.

The Court drew a distinction between the mere buying and selling of cryptocurrencies and the business of online exchanges providing certain facilities such as buying and selling cryptocurrencies, storing them in wallets, converting them into fiat currency, etc. It clarified that persons who engaged in buying and selling of cryptocurrencies as a hobby (i.e. without a profit motive) cannot take the benefit of Article 19(1)(g) but only those who have made trading in

⁷ (1969) 1 SCC 853.

⁸ [Md. Yasin v. Town Area Committee](#), (1952) SCR 572; [Bennett Coleman & Co. v. Union of India](#), (1972) 2 SCC 788.

cryptocurrencies or providing online platforms for cryptocurrency activities as a trade or business can do so.

It was also noted that various types of crypto wallets provide a very high degree of mobility and these wallets can be used to buy items and even withdraw local currencies in crypto ATMs (in countries such as the USA, Canada, Switzerland, etc.). Therefore despite preventing cryptocurrency traders from accessing banking facilities, the Court found that the Circular does not actually stop the many other ways in which cryptocurrencies can still find their way into the market.

Upholding the RBI's power to theoretically impose a ban on cryptocurrencies in the future, the Court noted that the top three companies who were members of the IMAI had a combined total of 17 lakh users, Rs. 1350 crores in user funds, and a total of Rs. 5000 crores in monthly transaction volumes. In light of these figures and the potential of their growth the Court held that in such circumstances an action of the RBI to cut the banking supply of such a parallel economy cannot be lightly set aside as offending Article 19(1)(g), even though such an action would still have to satisfy the test of proportionality since the action has virtually wiped off cryptocurrency exchanges from the industrial map of the country.

Proportionality Test

The Court then examined the Circular upon the four pronged test of proportionality laid down in the case of [*Modern Dental College and Research Center v. State of Madhya Pradesh*](#),⁹ viz. (i) the measure is designated for a proper purpose (ii) the measures are rationally connected to the fulfillment of the purpose (iii) there are no alternative less invasive measures and (iv) there is a proper relation between the importance of achieving the aim and the importance of limiting the right. Discussing whether less intrusive measures to achieve the objective of the Circular were available and whether these were considered by the RBI, the Court referred to the July, 2018 report of the European Union Parliament (titled 'Cryptocurrencies and Blockchain') which recommended not to go for a total ban on the interaction between cryptocurrency business and the formal financial sector as a whole. Relying upon this report of the EU Parliament, the Court concluded that the RBI had obviously not considered the availability of alternatives before issuing the Circular. It further pointed out "(i) that RBI has not so far found, in the past 5 years or more, the activities of VC exchanges to have actually impacted adversely, the way the entities regulated by RBI function (ii) that the consistent stand taken by RBI up to and including in their reply dated 04-09-2019 is that RBI has not prohibited VCs in the country and (iii) that even the Inter-Ministerial Committee constituted on 02-11-2017, which initially recommended a specific legal framework including the introduction of a new law namely, Crypto-token Regulation Bill

⁹ (2016) 7 SCC 353.

2018, was of the opinion that a ban might be an extreme tool and that the same objectives can be achieved through regulatory measures.”

It was also pointed out that till date, RBI has not come out with a stand that any of the entities regulated by it has suffered any loss or adverse effect on account of the interface that the VCEs had with any of them. Relying on the decision in [State of Maharashtra v. Indian Hotel and Restaurants Association](#),¹⁰ the Court stated that there must have been at least some empirical data about the degree of harm suffered by the regulated entities. It held that although the RBI had the power to issue such a Circular, it could do so only if the circumstances so demand and for that the RBI had to show some semblance of damage suffered by the regulated entities, which in this case it had been unable to do. With this background the Court found that the action taken by the RBI through the Circular could not be considered to be proportionate and therefore struck down the Circular in its entirety.

THE ROAD AHEAD

While the main impact of the judgment is obviously the fact that it would allow cryptocurrency traders, entrepreneurs and enthusiasts the ability to trade in cryptocurrencies more easily, there are other implications of the judgment for the future as well. The most important one being that the Court has recognized the power of the RBI to regulate cryptocurrency even though it does not form part of the credit system or payment system of the country, to quote; “*Therefore, anything that may pose a threat to or have an impact on the financial system of the country, can be regulated or prohibited by RBI, despite the said activity not forming part of the credit system or payment system.*” This means that although this Circular has been held *ultra vires*, the power of the RBI to regulate cryptocurrency in the future has been explicitly recognised.

Although such a finding means that there is nothing that prevents the RBI from issuing another similar circular restricting banking activities for cryptocurrency entities or even one which outright bans cryptocurrencies in India, such a circular would have to satisfy the proportionality test wherein the RBI would have to show empirical data and evidence to prove that cryptocurrencies have caused actual harm or damage which justifies such a future ban. It is therefore more likely that in the aftermath of this judgment the RBI may formulate guidelines to regulate rather than prohibit cryptocurrencies in India. It is also possible that the RBI could bring cryptocurrencies under the category of “other similar instruments” in section 2(h) of the Foreign Exchange Management Act, 1999, which defines the term “currency”. This scenario was not only mentioned in the judgment of the Supreme Court but also discussed in a previous post by

¹⁰ (2013) 8 SCC 519.

this author,¹¹ and opens another avenue for potential regulation of cryptocurrencies by the RBI in the future. However, the tone and tenor of such possible regulations remains to be seen.

CRYPTOCURRENCIES POST COVID-19

The COVID-19 pandemic has not only shaken the entire world, but also given a fillip to a number of IT enabled services as solutions for problems arising out of it, such as the requirements to maintain social distancing, travelling restrictions, etc. It has also given a push to non cash based payments as users shun cash transactions due to fears over transmission.¹² This may seem like an excellent opportunity for cryptocurrencies to occupy some of the space vacated by the reduction in cash transactions, but things are not as simple as they might seem. This is primarily because over the past two to three years cryptocurrencies have mostly been used for the purposes of investment, as a store of value and therefore the opportunity in the payments market may not be easily exploitable by cryptocurrencies since their primary use is no longer as a payments mechanism.

Further, in the uncertain economic times brought about by the COVID-19 pandemic investors are moving towards assets which are stable and can be easily liquidated if need be. Currently cryptocurrencies in India do not satisfy either of these requirements. Although the Supreme Court judgment will help the industry get back on its feet, the damage done by the RBI Circular over the last two years has reduced the depth of the Indian cryptocurrency market significantly, thereby making cryptocurrencies fairly illiquid when compared to other investment options.¹³

Cryptocurrencies are also an asset class which may seem immune from external factors since they are not linked to any underlying assets,¹⁴ however that does not mean they are free from volatility. Since the cryptocurrency markets are small in size, therefore even small events may lead to large surges or fall in their prices, infact price volatility was one of the reasons cited by the Report of Inter-Ministerial Committee on Virtual Currencies for recommending a ban on private cryptocurrencies in India.¹⁵ Further a lack of clarity on regulatory issues in most

¹¹ Vipul Kharbanda, “Can Bitcoin be Banned by the Indian Government”,
<https://cis-india.org/internet-governance/bitcoin-legal-regulation-india>

¹²

https://www.business-standard.com/article/companies/covid-19-opens-new-doors-for-fintechs-as-users-shun-cash-deals-for-digital-120052600970_1.html

¹³

<https://bfsi.economicstimes.indiatimes.com/news/blockchain/coronavirus-impact-on-bitcoin-and-its-future/74967071>

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<https://economicstimes.indiatimes.com/markets/stocks/news/bitcoin-beats-coronavirus-blues/articleshow/75049718.cms?from=mdr>

¹⁵ Report of Inter-Ministerial Committee on Virtual Currencies, Department of Economic Affairs, Ministry of Finance, India, Dated February 28, 2019, Para 2.4, at pg. 27.

jurisdictions is still considered as a major obstacle for widespread adoption of cryptocurrencies which would lead to greater price stability. However despite the above factors, it seems that people's appetite for cryptocurrencies has increased during the crises with demand increasing in various jurisdictions and also worldwide.¹⁶ Even though there does not seem to be enough information regarding the reasons for this increase, it is nonetheless a good opportunity for the industry to tap into this renewed demand and make cryptocurrencies more easily accessible to non technically inclined users as well.

¹⁶ <https://cointelegraph.com/news/interest-in-bitcoin-spikes-worldwide-during-covid-19-crisis>