

THE IMPACT OF CRYPTOCURRENCIES ON FINANCIAL REGULATIONS: A LEGAL PERSPECTIVE

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ABSTRACT

Cryptocurrencies have emerged as a disruptive force in the global financial landscape, challenging traditional regulatory frameworks. The decentralized nature and technological advancements underlying cryptocurrencies, such as Bitcoin and Ethereum, have raised significant legal concerns for governments and regulatory authorities worldwide. Cryptocurrency is currently at the frontier of financial development. It provides both opportunities and risks in financial markets and has attracted significant attention recently. Cryptocurrencies didn't come out of the blue, the origin and how it was developed over a period of time will be presented in this article. Cryptocurrencies pose new challenges to the legal system, in this article, the challenges and what are the current laws that are dealing with Cryptocurrencies will be discussed.

Keywords: Cryptocurrency, Blockchain, Financial Regulations, Financial Development, Financial Openness.

INTRODUCTION

Cryptocurrency is currently at the frontier of financial development. It provides opportunities and risks in financial markets and has attracted significant attention recently. A cryptocurrency is a digital medium of exchange that relies on a decentralized network that facilitates peer-to-peer exchange of transactions secured by public-key cryptography. In early 2009, an anonymous programmer or a group of programmers created Bitcoin. It is a 'peer-to-peer electronic cash system.' It is completely decentralized, meaning there are no servers involved and no central controlling authority.¹ Cryptocurrencies like bitcoins can be and are being used in a number of ways like buying goods, as an investment, mining, business transactions, etc. With the level of growth that has occurred in the industry, greater attention is now being paid by Governments and other stakeholders around the world.

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¹Right Legal Issues with Cryptocurrencies & NFTS, 2.4 JCLJ (2022) 397.

Cryptocurrencies are becoming more and more mainstream.² Law enforcement authorities, tax bodies, and legal regulators worldwide are trying to understand the very concept of cryptocurrencies and where exactly they fit in existing regulations and legal frameworks. The decentralized and anonymous nature of cryptocurrencies has also attracted various illegal activities. Authorities all over the world are worried about the use of cryptocurrencies in money laundering, terrorist funding, and tax evasion schemes. Cryptocurrency is also used in controversial settings in the form of online black markets, such as the Silk Road. Cryptocurrencies such as Bitcoin are completely banned in countries such as Bangladesh, Bolivia, Ecuador, Kyrgyzstan, and Vietnam, with China and Russia being on the verge of banning them as well. Whereas, countries like Japan and Sweden have taken steps to regulate cryptocurrency by declaring Bitcoin as a legal tender. As the USA has the highest number of Bitcoin ATMs and also the highest Bitcoin trading volumes globally, the usage of cryptocurrencies is not illegal as of yet, but the laws and regulations can vary drastically depending on the state or the country.³

A lot of challenges are going to come up with the emerging trends in the field of digital currencies at an extensive rate. The legal fraternity should be well prepared for the possible issues and try to foresee most of them coming and also build capabilities to resolve most of them. It is vital that the legal issues are addressed by the legislators before the judiciary is bombarded with numerous lawsuits involving cryptocurrencies.

ORIGIN AND DEVELOPMENT OF CRYPTOCURRENCIES

The origin of cryptocurrencies can be traced back to a groundbreaking whitepaper published in 2008 by an anonymous person or group of people using the pseudonym "Satoshi Nakamoto." The whitepaper, titled "Bitcoin: A Peer-to-Peer Electronic Cash System," introduced the concept of a decentralized digital currency that would operate on a technology called blockchain. Satoshi Nakamoto's whitepaper proposed a system where transactions could be recorded on a public ledger, known as the blockchain, maintained by a network of computers, or nodes, without the need for a central authority. This decentralized approach aimed to address the limitations and inefficiencies of traditional financial systems.⁴

²Holden, R., & Malani, A. 2022. The Law and Economics of Blockchain. Annual Review of Law and Social Science, 18, 297-313.

³Cryptocurrency in India, 1.4 JCLJ (2021) 226.

⁴Rosenberg, E. (2022). History of cryptocurrency. Retrieved from <https://www.thebalancemoney.com/history-of-cryptocurrency-5119511>

In January 2009, Nakamoto launched the first cryptocurrency, Bitcoin, by mining the genesis block, also known as Block 0. Mining involves solving complex mathematical problems to validate and record transactions on the blockchain. Bitcoin gained attention and started to gain popularity among early adopters, tech enthusiasts, and cryptography communities. Bitcoin's success as the first cryptocurrency led to the emergence of numerous alternative cryptocurrencies, often referred to as altcoins. These altcoins sought to improve upon the limitations of Bitcoin or introduce new features and functionalities.

One of the notable altcoins that emerged in 2011 was Litecoin, created by Charlie Lee, a former Google engineer. Litecoin aimed to offer faster transaction confirmation times and a different hashing algorithm than Bitcoin. This marked the beginning of a trend where individuals and teams started to create their own cryptocurrencies, each with its unique features and objectives.⁵

In 2015, Ethereum, a significant milestone in cryptocurrency development, was introduced by Vitalik Buterin and a team of developers. Ethereum introduced the concept of smart contracts, which allowed for the execution of programmable agreements on the blockchain. This innovation opened up a wide range of possibilities beyond simple peer-to-peer transactions, enabling the development of decentralized applications (DApps) and the creation of new cryptocurrencies through Initial Coin Offerings (ICOs). Since the launch of Bitcoin and the subsequent proliferation of cryptocurrencies, the cryptocurrency market has experienced significant growth and volatility. Cryptocurrencies have attracted attention from investors, entrepreneurs, financial institutions, and governments worldwide.

The origin of cryptocurrencies can be attributed to the publication of the Bitcoin whitepaper, the true identity of Satoshi Nakamoto remains unknown, adding an air of mystery to the beginnings of this transformative technology. Nonetheless, the impact of cryptocurrencies on the financial landscape is undeniable, and they continue to shape the way we perceive and interact with money and financial systems.⁶

CURRENT FINANCIAL REGULATIONS

A person who invests in cryptocurrencies does so at their own risk because they are not considered legal tender and using cryptocurrencies is not prohibited, there is no legal avenue

⁵Cryptocurrencies and Allied Services: Another Challenge for Competition Watchdog, (2018) PL March 89.

⁶Cryptocurrency in India : Empowered in 2020?, 7.2 NLUJ LR (2021) 245

for doing so in India. Therefore, it shows that cryptocurrencies are not reliable means of payment or settlement in India. However, there are certain laws that govern the usage of Cryptocurrencies.

Payment & Settlement Systems Act, 2007: In accordance with this law, RBI is authorized to certify any type of pre-paid payment instrument. Pre-paid payment instruments are those that allow purchases of goods and services using the value that has been pre-loaded on them, according to the RBI. The value kept on these instruments is the amount that the owners have paid for them with cash, a debit from a bank account, or a credit card. Now, with regard to cryptocurrencies, it has been noted that they are not stable very often. Additionally, they could or might not be recognized as a way to make purchases of goods and services because they don't meet the criteria for "Prepaid Payment Instruments" Consequently, they cannot be characterized under the purview of the Payment and Settlement Systems Act, 2007.⁷

Negotiable Instruments Act, 1881: According to section 13 of this act, a "promissory note, bill of exchange, or check payable either to order or to bearer" is a negotiable instrument. As a result, it is evident that a cryptocurrency lacks the qualities necessary to be included in a promissory note, bill of exchange, or check. Therefore, its specifications are insufficient for it to fall within the ambit of this Act.⁸

The Coinage Act, 2011: The term "securities" is defined under Section 2 (h) of the Securities Contracts (Regulation) Act of 1956. When this sentence is examined critically, it becomes clear that cryptocurrencies like Bitcoin are beyond the purview of the sub-clauses contained in this section. A cryptocurrency may only be classified as a "securities" within the terms of subclause (ii)(a), which gives the Central Government the power to designate certain instruments as securities. But at the moment, the central government does not recognize cryptocurrencies as legitimate money and does not consider them to be legal currency. As a result, it is not covered by the aforementioned Act.⁹

Foreign Exchange Management Act, 1999 (FEMA): None of the laws of India define or interpret cryptocurrency. Therefore, the definition of currency under section 2(h) of the Foreign Exchange Management Act, 1999, should be examined in order to assess the status

⁷<https://ifsc.gov.in/Document/Legal/67-the-payment-and-settlement-systems-act-200712092020034236.pdf>

⁸ <https://www.weforum.org/agenda/2021/07/new-rules-tools-cryptocurrencies/>

⁹ Kolhatkar, S. (2021) *The challenges of regulating cryptocurrency*. Available at: <https://www.newyorker.com/business/currency/the-challenges-of-regulating-cryptocurrency> (Accessed: 17 June 2023).

of cryptocurrencies. Cryptocurrencies do not fit into any of the instruments in the, but this does not rule out the potential that the Reserve Bank would designate them as money. However, until then, the issue must be assessed in light of the fact that Japan has recognized Bitcoin to be legal cash in their nation. As a result, any currency other than the Indian rupee will need to be classified as foreign currency under the FEMA and would need to be disclosed to comply with the guidelines in it.¹⁰

Information Technology Act, 2000: Within the purview of the Information Technology Act of 2000, the phrase "asymmetric cryptosystem" is used. Each owner and holder of a cryptocurrency receives a private key, which is how cryptocurrencies work. Therefore, it makes sense that cryptocurrencies can be evaluated and utilized as a component of the IT Act, 2000 within the definition of the word "Asymmetric Crypto System". However, there is no limpid framework on how it will affect the usage of cryptocurrencies in business.¹¹

The above-mentioned laws have no clear clarification related to Cryptocurrencies in Financial aspects, but these laws help the Central bank to make laws on it and how the new technology can shape the Indian economy.

THE SUPREME COURT VIEW

The Reserve Bank of India (RBI) published a circular in April 2018 that forbade all regulated financial institutions from forming partnerships with people or businesses that trade in cryptocurrency. The RBI is being unfair, according to members of the Indian Bitcoin community, who also say that their freedom to perform a profession or occupation is being infringed upon. This resulted in a legal dispute between the RBI and the cryptocurrency community, which is a matter before the Indian Supreme Court. The RBI released its first official statement on cryptocurrencies back in December 2013 in a Press Release titled 'RBI cautions users of Virtual Currencies against Risks', where they said that holding and trading cryptocurrencies such as Bitcoin can pose a "potential financial, operational, legal, customer protection and security related risk".¹²

Following multiple warnings on trading safely and making their stance on cryptocurrencies clear, the Reserve Bank of India, in a Notification on 6th of April, 2018 titled 'Prohibition on

¹⁰https://live.icai.org/bos/vcc/pdf/FEMA_Theory_Notes.pdf

¹¹(2023). <https://www.geeksforgeeks.org/information-technology-act-2000-india/>

¹²Recent Amendment to Schedule III of the Companies Act, 2013 - Whether a step towards recognition and regulation of virtual currencies/cryptocurrencies in India?, 2021 SCC OnLine Blog OpEd 99

dealing in Virtual Currencies (VCs)'. The Reserve Bank provided a three-month period after which all regulated financial institutions will stop providing services to those people or firms involved in cryptocurrency-related transactions. This deadline ended on the 6th of July, 2018. Indian bitcoin exchanges and dealers expressed indignation in response to this news. A number of internet petitions were established, with one receiving more than 125,000 signatures. The parent company of the CoinRecoil cryptocurrency exchange, Kali Digital Ecosystems, based in Ahmedabad, claimed in a writ petition filed with the Delhi High Court that this notification violates Article 19(1)(g) of the Indian constitution, which guarantees the right to choose any occupation, trade, or business, as well as Article 14, which forbids discrimination between equals.

The Supreme Court refused to hear any party pertaining to the pending cryptocurrency case and directed the Union of India to come up with a cryptocurrency regulatory policy. Depending on the definition, the weight of making a regulatory framework will fall either upon the RBI, or the Securities & Exchange Board of India (SEBI). The latter has already organized cryptocurrency study tours to Switzerland, the UK, and Japan for its officials, hinting the security regulator might take on the burden of creating a new Bitcoin law. The supreme court expressed that in order to deal with cryptocurrencies, there should be proper laws on it and withhold the cases until laws are made on it.¹³

IMPACT OF CRYPTOCURRENCIES ON FINANCIAL REGULATIONS

REGULATORY CHALLENGES

The cryptocurrency industry's rapid development, which is the most popular trend in financial technologies, also presents challenges for certain regulators. It is challenging to create laws in this sector given that we still do not completely understand the nature and risks of the system.

Classification- Many analysts think cryptocurrencies represent an entirely new asset class. This classification may be correct for tokens that function like securities. Generally, crypto assets are defined as an investment as have other benefits apart from or in addition to their value.

¹³From Banning to Regulating: Unexpected Journey of Cryptocurrencies in India, 2022 SCC OnLine Blog Exp 11

Over-Regulation- Another concern is how innovation is being undermined by the excessive regulation of crypto assets. This is to stop a sector from expanding. The fundraising capabilities of novices have been dramatically democratized by the swift increase in the value of assets like Bitcoin. This highlights the necessity for a specific set of rules created to enable cash-strapped small businesses to raise money from a range of sources.¹⁴

Decentralized system- Cryptocurrencies operate on decentralized networks, such as blockchain, which do not rely on central authorities like banks or governments. This decentralized nature poses challenges for regulators as there is no single point of control or entity to regulate. Transactions occur directly between users, making it challenging to monitor and regulate financial activities effectively.

EVOLVING REGULATORY RESPONSES

Along with India, many countries are actively responding to emerging Cryptocurrencies. Regulatory bodies around the world have been actively responding to the challenges posed by cryptocurrencies by implementing various regulatory frameworks.

1) US

In the United States, regulatory bodies such as the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) play a significant role in regulating cryptocurrencies. The SEC has taken the approach of treating certain cryptocurrencies and initial coin offerings (ICOs) as securities, subjecting them to existing securities laws. This allows for investor protection and regulation of fundraising activities. The CFTC, on the other hand, treats cryptocurrencies as commodities and regulates cryptocurrency derivatives trading. While these regulations provide some clarity and consumer protection, they have also led to compliance burdens for businesses and stifled innovation due to regulatory uncertainty.¹⁵

2) EU

The EU has taken a more coordinated approach to cryptocurrency regulation. The Fifth Anti-Money Laundering Directive (AMLD5) brought cryptocurrencies and cryptocurrency

¹⁴Kolhatkar, S. (2021). Retrieved from <https://www.newyorker.com/business/currency/the-challenges-of-regulating-cryptocurrency>

¹⁵Green, J. M. (2022). What are the laws for cryptocurrency? Retrieved from <https://www.thebalancemoney.com/what-are-the-laws-for-cryptocurrency-5121102>

exchanges under anti-money laundering (AML) and Know Your Customer (KYC) regulations. Additionally, the Markets in Crypto-Assets Regulation (MiCA) is being developed to establish a comprehensive regulatory framework for cryptocurrencies and related services. The EU's approach aims to enhance consumer protection, promote market integrity, and foster innovation. However, the complex and lengthy process of developing and implementing EU-wide regulations can result in delayed responses to market developments and create regulatory fragmentation among member states.¹⁶

3) JAPAN

Japan has been a pioneer in cryptocurrency regulation, having introduced a regulatory framework early on. The country recognized Bitcoin as a legal tender and enacted the Payment Services Act, which requires cryptocurrency exchanges to obtain licenses and adhere to strict security and operational standards. Japan's regulatory approach has provided a clear legal framework, fostering investor confidence and attracting cryptocurrency businesses. However, the regulatory framework has also faced challenges, such as the high cost of compliance and the need to balance innovation with investor protection.¹⁷

4) INDIA

Cryptocurrency in India is neither a digital legal tender nor is considered legal as per the government announcement on Virtual Digital Assets on February 1, 2022. However, it was decided to tax cryptocurrencies and other digital assets and non-fungible tokens (NFT) - a 30 percent tax on any income generated from their transactions as well as a 1 percent tax deduction at source (TDS) on all transactions. Earlier in 2010, there was a complete ban on all crypto-related activities like mining, buying, or selling. The Reserve Bank of India has also time and again shown strong reluctance regarding legalizing cryptocurrencies implying that they pose a serious threat to the macroeconomic stability of the country.¹⁸

The status of cryptocurrencies in India has therefore changed in recent years, from a complete ban to taxation; taxing however has not made it necessarily legal either. "The Cryptocurrency and Regulation of Official Digital Currency Bill of 2021", is now underway, which would

¹⁶Legal and Regulatory Intervention in the Cryptocurrency Space, (2021) 33 SAclJ 50.

¹⁷Status of Cryptocurrencies under Investment Law: Not so Cryptic Anymore?, 7.2 IJAL (2019) 1

¹⁸Kolhatkar, S. (2021) *The challenges of regulating cryptocurrency*. Available at: <https://www.newyorker.com/business/currency/the-challenges-of-regulating-cryptocurrency> (Accessed: 17 June 2023).

clarify the actual status of cryptocurrency, once it becomes a law. As per the latest reports, the Indian government is in consultation with the International Monetary Fund (IMF), the World Bank, and some Indian stakeholders to discuss valuable inputs to be incorporated into the country's crypto policy. However, an important announcement made in the Union Budget was the creation of the Central Bank Digital Currency (CBDC) or the digital rupee by 2023, which would be a legal tender, backed by the RBI.¹⁹

People from different jurisdictions started working together to understand the nature of crypto assets and address issues fully. Various other countries have implemented their own regulatory frameworks for cryptocurrencies. Some countries, like Switzerland, have adopted a more crypto-friendly approach, providing a supportive regulatory environment through guidelines and creating regulatory sandboxes for businesses to innovate and test their cryptocurrency-related services. On the other hand, countries like China have taken a more stringent approach, banning certain cryptocurrency activities and imposing restrictions on cryptocurrency exchanges. These different approaches reflect the diversity in regulatory responses and their impact on the cryptocurrency market.

LEGAL IMPLICATION

Traditional financial regulations are designed to govern centralized financial systems and may not adequately address the unique risks associated with cryptocurrencies. Its emergence of it creates jurisdictional challenges as Cryptocurrencies are being used and operated widely across the globe. Fraud, Market Manipulation and other acts are very rampant in the Blockchain system, as there is no proper legislation regarding Cryptocurrencies, it had become difficult to address these issues.

Jurisdictional challenges- Cryptocurrencies operate on a global scale, and different countries have varying approaches to cryptocurrency regulation. This creates jurisdictional challenges and conflicts, as regulations in one country may not align with those in another. It becomes challenging to establish consistent regulations and enforce them across borders. This lack of harmonization can lead to regulatory arbitrage, where businesses and individuals exploit regulatory gaps by operating in jurisdictions with lenient or unclear regulations.

¹⁹Cryptocurrency in India : Empowered in 2020?, 7.2 NLUJ LR (2021) 245

Criminal consequences

i) Fraud- The decentralized nature of cryptocurrencies creates opportunities for fraudulent activities. Ponzi schemes, initial coin offering (ICO) scams, and pump-and-dump schemes are examples of fraudulent practices that have been associated with cryptocurrencies. Regulators struggle to identify and prosecute perpetrators due to the pseudonymous nature of cryptocurrency transactions, making it challenging to trace and hold individuals accountable.²⁰

ii) Market manipulation- Cryptocurrency markets are susceptible to market manipulation due to their relatively low liquidity and lack of oversight. Practices like wash trading, spoofing, and front-running can artificially inflate or deflate cryptocurrency prices, leading to market instability and investor losses. Regulators face challenges in detecting and preventing these manipulative practices, as they often occur across various cryptocurrency exchanges and jurisdictions.

iii) Cybersecurity Risks- The digital nature of cryptocurrencies exposes them to cybersecurity risks. Hacking incidents, thefts from exchanges, and vulnerabilities in smart contracts have resulted in substantial financial losses. Regulators struggle to develop frameworks that ensure the security of cryptocurrency platforms and protect users' assets. Additionally, the decentralized nature of cryptocurrencies makes it challenging to assign liability and provide adequate consumer protection in the event of a security breach.²¹

CONCLUSION AND WAY FORWARD

The impact of cryptocurrencies on financial regulations from a legal perspective has been profound and continues to shape the evolving regulatory landscape. The decentralized nature and global reach of cryptocurrencies have presented significant challenges for regulators worldwide. Difficulties in regulating decentralized systems, jurisdictional conflicts, and the need to address fraud, market manipulation, and cybersecurity risks have tested the effectiveness of existing regulatory frameworks.

Regulatory bodies have responded by implementing diverse approaches. Some countries have sought to strike a balance between innovation and investor protection by developing

²⁰Watters, C. 2023. When Criminals Abuse the Blockchain: Establishing Personal Jurisdiction in a Decentralised Environment. *Laws*, 12(2), 33.

²¹Murphy, H. (2021) *How do criminals exploit cryptocurrencies?*, *Financial Times*. Available at: <https://www.ft.com/content/85c8d520-b2d9-4a35-abdb-2f56cdd48792> (Accessed: 17 June 2023).

comprehensive regulatory frameworks, while others have adopted a more cautious or restrictive stance. These regulatory responses have had both strengths and weaknesses. They have provided consumer protection, enhanced market integrity, and brought legal clarity, but they have also faced challenges of regulatory uncertainty, jurisdictional conflicts, and potential impact on innovation.

Moving forward, it is crucial for regulators to adapt and evolve alongside the rapid advancements in the cryptocurrency space. Collaboration and international coordination among regulators are essential to address the global nature of cryptocurrencies effectively. Regulatory frameworks should be agile, providing clarity, promoting innovation, and protecting investors without stifling growth. Striking the right balance will require ongoing dialogue between regulators, industry participants, and other stakeholders to develop targeted and adaptable regulations that foster a healthy and sustainable cryptocurrency ecosystem. Cryptocurrencies have gained significant traction in the financial sector, although their inherent volatility presents challenges in considering them as legal tender by central banks. However, it is imperative for central banks to acknowledge the importance of cryptocurrencies within the context of a rapidly advancing technological landscape. The dynamic nature of cryptocurrencies necessitates careful consideration of their regulatory framework. Additionally, the absence of clear guidelines surrounding blockchain technology has created opportunities for criminal activities, as perpetrators exploit the lack of regulatory oversight. Consequently, establishing a comprehensive legal framework for cryptocurrencies is essential to address these concerns and ensure the integrity of financial systems.