

PERSPECTIVES ON THE INTERSECTION OF THE FOREIGN EXCHANGE MANAGEMENT ACT, 1999 AND THE INDIAN CRYPTO-MARKET

May 2022 | Issue No. 019



ESYA
centre

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Internet And Mobile Association Of India



This is the third report in the Esya Centre - IAMAI knowledge series on crypto assets.

Attribution: Meghna Bal and Mohit Chawdhry. *Perspectives on the Intersection of the Foreign Exchange Management Act, 1999 and the Indian Crypto-Market*. May 2022, Esya Centre and IAMAI

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The Internet and Mobile Association of India (IAMAI) is a not-for-profit industry body whose mandate is to expand and enhance the online and mobile value added services sectors.

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A. INTRODUCTION

Public information suggests that the Enforcement Directorate, India's primary economic law enforcement and intelligence agency, has begun inquiring whether cross-border crypto-to-asset activity would violate the Foreign Exchange Management Act, 1999 (FEMA), India's capital controls legislation.

International financial and monetary organizations such as the International Monetary Fund too have called on nations to amend their capital control laws to meet the challenges raised by the sale and purchase of crypto-assets.¹ Empirical assessment of the matter, however, suggests that the link between

crypto-assets and capital control evasion is overstated.

THE CURRENT PAPER SEEKS TO ASSESS WHETHER CRYPTO-ASSETS CAN BE ACCOMMODATED WITHIN INDIA'S FOREIGN EXCHANGE FRAMEWORK

In this context, the current paper seeks to assess whether crypto-assets can be accommodated within India's foreign exchange framework. It also suggests ways to regulate the cross-border flow of crypto-assets without hampering the development of the Web3 economy in India.

B. BACKGROUND

FEMA was enacted in 1999 in the backdrop of economic liberalization with a view to facilitate external trade and payments in order to promote the development and maintenance of the foreign exchange market in India. Broadly, FEMA provides the framework for the Government to regulate forex flows through the country with the objective of maintaining financial stability. While inward restrictions on capital flows are meant to prevent significant volumes of 'fast-moving money' from 'overheating an economy and leaving it vulnerable' (Carlson 2021),² restrictions on outward capital flows are intended to prevent 'runs' on financial institutions or the domestic currency.³

FEMA OVERSEES TRANSACTIONS OF TWO KINDS: CAPITAL ACCOUNT AND CURRENT ACCOUNT TRANSACTIONS

FEMA oversees transactions of two kinds: capital account and current account transactions. It defines the former as any transaction that alters the foreign assets or liabilities, including contingent liabilities, of Indian residents, or the Indian assets and liabilities of foreign residents. Broadly, capital account transactions involve cross-border transfers of money that affect wealth, and the acquisition or sale of an asset in a foreign country by an Indian resident is a capital account transaction. Capital account transactions require sanction from the RBI – unless specifically

permitted (e.g., investment in foreign shares and immovable property are permitted subject to criteria), and are subject to various compliance requirements and monetary thresholds.

In FEMA current account transactions are more broadly defined – as any transaction other than a capital account transaction. e.g., transactions that essentially do not alter the assets or liabilities outside India of an Indian resident. Current account transactions are permitted unless specifically prohibited e.g., gambling transactions are prohibited,

and are subject to compliance requirements and monetary thresholds. Both current account and capital account transactions are processed through Authorised Dealers of foreign exchange, with due reporting and declarations.

The Liberalised Remittance Scheme (LRS) framed by the RBI allows resident individuals to carry out outward remittances for permitted capital account and current account transactions, subject to due reporting and a monetary threshold of USD 250,000 per financial year.⁴



Image 1: Depiction of Capital and Current Account Transactions (Source: Author's creation)

C. EMPIRICAL ASSESSMENTS FIND THAT THE LINKS BETWEEN CRYPTO-ASSETS AND CAPITAL CONTROL EVASION ARE OVERSTATED

Crypto-assets present a relatively frictionless way of moving money into and out of a country, leading to fears that they may be used to evade capital controls. Indeed, the IMF's Global Financial Stability Report (GFSR) for October 2021 notes that 'the advent of crypto assets may be accelerating dollarization and eroding the effectiveness of existing exchange restrictions and capital control management measures.' It adds that such effects are likely to be seen in countries with high inflation, corruption and low trust in the domestic currency.⁵ The most recent edition of the GFSR categorically recommends developing a comprehensive, coordinated and consistent approach to regulating crypto-assets, including the effective application of capital flow control measures.⁶

However, a study exploring the links between capital control liberalization and crypto-exchange trading volumes in Argentina, a nation characterized by hyperinflation and low trust in the domestic currency, paints a different picture. Carlson (2021) evaluated Argentina's experience with Bitcoin adoption, both when strict capital controls were in place and when they had been relatively liberalized after the election of Mauricio Macri in 2015. Carlson notes that after Macri liberalized the Argentine economy, exchanges expected a downturn in business – on the assumption that capital controls, or more specifically the desire to evade

them, were driving Bitcoin adoption. After the reforms were introduced, however, the country's largest exchanges reported 'stable or growing volumes', indicating that the presence of capital controls is not the primary driver of investment in cryptocurrency. Carlson concludes that it is likely that the association between Bitcoin and capital controls has been overestimated and 'overstated by the media and academia'.

THERE IS GROWING CONCERN AMONG REGULATORS ABOUT THE IMPLICATIONS OF CRYPTO-ASSETS ON CAPITAL CONTROLS

While the connection between crypto-assets and capital controls remains unclear, there is growing concern among regulators about the implications of crypto-assets on capital controls. In India, this makes it important to assess how crypto-assets can be accommodated within the framework of FEMA.

D. WHAT DOES FEMA HAVE TO DO WITH CRYPTO-ASSETS?

Broadly speaking, FEMA governs any cross-border transaction involving foreign exchange. Although India has a burgeoning crypto-asset market, the purchase of these assets is not limited to Indian exchanges alone. There are three ways in which cross-border transactions of crypto-assets may be performed:

International credit cards: Global exchanges and aggregators such as Binance and Kraken can be accessed by Indians with international credit cards and on a P2P basis.

Initial Exchange and Coin Offerings (IEOs and ICOs): Another way for crypto to cross borders is through blockchain start-ups. Many blockchain start-ups offer tokens on crypto-exchanges to raise capital for their projects. These are known as initial exchange offerings or initial coin offerings. A difference between the two is that IEOs involve exchanges vetting the issuer as well as the token project, but there is no such due diligence for ICOs since exchanges may simply list the token at a later stage but do not facilitate the offering itself.

Air Drops: To encourage uptake of their tokens, start-ups may also carry out air drops which involve gifting tokens to users for free.

EXISTING PROVISIONS AND ASSET CLASSIFICATIONS IN THE LAW MUST BE EXTRAPOLATED TO GAUGE WHETHER CRYPTO-ASSETS CAN BE ACCOMMODATED BY FEMA.

Neither FEMA nor any of the regulations drafted under it specify a clear position on cross-border transactions relating to crypto-assets. So the existing provisions and asset classifications in the law must be extrapolated to gauge whether crypto-assets can be accommodated by FEMA.

Do crypto-assets fit within the existing FEMA framework?

To understand the extent of FEMA's applicability to crypto-assets, we investigate:

1. the nature of the asset and whether it fits in any of the categories recognized by FEMA, and
2. the location of the asset under FEMA.

Nature of crypto-assets and classification under FEMA

The Finance Act 2022 has, for the purpose of the Income Tax Act, 1961,

introduced a new asset category known as virtual digital assets (VDAs).ⁱ VDAs have been classified as property both movable and immovable property. From the above provision as well as certain observations of the Supreme Court in the matter of the Internet and Mobile Association of India vs Reserve Bank of India (IAMAI v. RBI) we can glean that VDAs are a type of intangible, movable property.⁷

FEMA currently broadly deals with four kinds of intangible, movable assets:

- (i) securities/derivatives,
- (ii) foreign currency,
- (iii) intellectual property rights, and
- (iv) software.

The next section evaluates whether crypto-assets can be classified as any of these asset classes in FEMA.

I. Crypto-assets as foreign currency under FEMA

Some agencies, such as the Financial Crimes Enforcement Network (FINCEN) under the US

Treasury, classify crypto-assets as convertible virtual currencies. FINCEN defines a virtual currency as a ‘medium of exchange that can operate like a currency’, without having all the characteristics of a fiat currency as defined in US regulations. A convertible virtual currency is one that has an equivalent value as currency, or acts as a substitute for currency.⁸

Similarly, the Russian parliament is considering a law that would regulate crypto-assets as an ‘analogue to currency’ as opposed to a digital asset.⁹ Indeed, certain crypto-assets such as stablecoins (which are often pegged to the value of fiat currencies) display the characteristics of currencies and may be regulated similarly.

FEMA defines ‘currency’ as all currency notes, postal notes, promissory notes, etc. or any similar instrument notified by the RBI.ⁱⁱ So far, the RBI has not notified any kind of virtual currency as currency under FEMA. In fact, the Supreme Court in IMAI v. RBI recognized the RBI’s stated position that

i 2(47)(A) of the Income Tax Act “virtual digital asset” means—

- (a) any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise, by whatever name called, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and can be transferred, stored or traded electronically;
 - (b) a non-fungible token or any other token of similar nature, by whatever name called;
 - (c) any other digital asset, as the Central Government may, by notification in the Official Gazette specify:
- ii 2 (h) of the Foreign Exchange Management Act - “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

virtual currencies are not ‘foreign currency’ as defined under FEMA. Prior to that, the RBI had also clarified that it does not classify virtual currencies as currencies under FEMA in response to a Right to Information request.¹⁰ Further, the Finance Act, 2022, has excluded ‘currency’ as defined under FEMA from the definition of VDA. On this basis, it is reasonable to infer that crypto-assets are not ‘currency’ under FEMA.

2. Crypto-assets as foreign securities under FEMA

Some jurisdictions¹¹ classify certain crypto-assets as securities. The key reason is that while laws in other countries rely on conceptual levers to classify financial instruments, FEMA takes an instrument-led approach. Thus, it is unlikely that crypto-assets will qualify as securities under FEMA.

FEMA defines the term “security” narrowly in terms of traditional financial instruments such as shares, stocks, bonds, and debentures or any instrument notified by the RBI

FEMA defines “foreign securities” as any security in the form of shares, stocks, bonds, debentures or any other instrument denominated or expressed in foreign currency, including a security that is expressed in foreign currency but redeemable in Indian rupees. In turn, FEMA defines the term “security” narrowly in terms of traditional financial instruments such as shares, stocks, bonds, and

debentures or any instrument notified by the RBI.

Today, crypto-assets have not been notified by any regulator, including the RBI, as amounting to any of these instruments. Therefore, in the absence of any notification from the RBI, crypto-assets including crypto-assets that have been designated as securities in other jurisdictions- cannot be classified as foreign securities under FEMA.

3. Crypto-assets as goods/software under FEMA

Several crypto-assets contain some sort of software functionality. While they are primarily regarded as an investment class, entire ecosystems of developers work on creating crypto-assets that would provide access to a good or a service (utility tokens), or who rely on developing applications using crypto-assets native to their own blockchain, such as Bitcoin or Ether.

The Foreign Exchange Management (Export of Goods & Services) Regulations, 2015 deal with the import and export of software (among other goods and services). They define software as ‘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’. If crypto-assets are classed as software for the purpose of these regulations, their cross-border sales and purchases will not require specific sanction from the RBI as the export and import of software is considered a current account transaction

– although a declaration must be made to the regulator in most circumstances.¹² Further, all transactions involving Indian or foreign currency will have to be routed through the Authorised Dealers Category I (banks).

The Supreme Court, in the IMAI case, found it difficult to accept that crypto-assets are simply digital goods/software.¹³ As a result, there may be certain legal challenges in classifying crypto-assets as software or goods.

From the above discussion, it is clear that crypto-assets do not fit neatly into any of the existing classes of intangible movable property under FEMA. It is also apparent that crypto-assets serve different purposes and cannot be effectively regulated using a blanket statutory designation. Unlike conventional assets, crypto-assets can be programmed to fulfil many different purposes and utilities. Some crypto-assets are akin to utility instruments, while others, such as non-fungible tokens, are more like goods. This makes it difficult to place all crypto-assets into a single category.

Location of crypto-assets for FEMA purposes

The site or location of an asset is an important aspect of foreign exchange management laws, as it helps determine whether the asset has moved across borders. Determining the situs of crypto-assets is complicated as these assets are intangible and do not technically exist in any one location. In the *RBI v IMAI* case, the Supreme Court noted

that ‘virtual currencies cannot be stored anywhere, in the real sense of the term, as they do not exist in any physical shape or form.’¹⁴ There is currently no guidance, statutory or otherwise, on how the situs of intangible assets, such as virtual digital assets, should be determined under FEMA.

Indian courts have, however, deliberated on the location of intangible assets in tax-related matters. For instance, the Delhi High Court, in *CUB Pty Ltd v Union of India*, held that the situs of intangible assets is the same as the location of their owner. The Court had been called upon to decide whether income from the sale licensing rights granted by Foster’s in Australia to its Indian subsidiary would be taxable under the Income Tax Act. It stated that absent clear guidance under the Income Tax Act, the internationally accepted rule of *mobilia sequuntur personam* i.e. the situs of the owner of the intangible asset will also be the situs of the intangible asset should be followed, and hence, that the income was not taxable in India.¹⁵ It may, then, be advisable for the Government to consider espousing this principle for situs determination in the context of crypto-assets and FEMA, to enable consistency across frameworks.

E. A SUI-GENERIS LAW TO GOVERN CROSS-BORDER CRYPTO-ASSET FLOWS

The prevailing uncertainty regarding the application of FEMA to crypto-assets hampers the ability of exchanges, developers and other professionals to build Web3 projects that boost the domestic economy and attract investment. Simply put, crypto's intersection with FEMA is a regulatory quagmire, and can only be resolved by clarificatory intervention. Such intervention could take the form of a sui-generis law, which while introducing a broader regulatory framework for the sector, can also clarify any capital controls aspects for crypto-assets.

A NEW LAW TO GOVERN ANY FEMA-RELATED ASPECTS OF CRYPTO-ASSETS WOULD ENABLE INDIA TO FOLLOW AN APPROACH ACCOMMODATIVE OF THE NUANCES AND PECULIARITIES THAT COME WITH REGULATING COMPLEX FINANCIAL TECHNOLOGIES

A new law to govern any FEMA-related aspects of crypto-assets would enable India to follow an approach accommodative of the nuances and peculiarities that come with regulating complex financial technologies. We propose the following core principles for such a new law:

- a. **Adopt a utility-based approach to classifying crypto-assets for the purpose of foreign exchange management.** As illustrated in the previous section, crypto-assets serve a variety of purposes, and hence have different ramifications for capital controls. For instance, asset-backed tokens are of a different nature from NFTs and utility tokens, which in turn are often of a different nature from value transfer tokens like Bitcoin. A law that captures these nuances would facilitate the usage of crypto-assets while allaying concerns related to the RBI's control over capital flows.
- b. **Create regulatory pathways to ensure that crypto-based remittances have effective oversight.** Such a framework would clarify how crypto exchanges and trading platforms are to report international transactions to the RBI. It would also specify the relation between trading platforms and existing authorized dealers in foreign currency. A threshold value below which RBI authorization is not required for remittances dealing in crypto-assets may also be prescribed, in keeping with the existing LRS.
- c. **Clarify the position on crypto-to-crypto transfers that do not involve the transfer of Indian or foreign currency.** There is ambiguity regarding the treatment of Crypto-to-crypto transfers which do not create any direct implications for financial stability as there is no transfer of fiat currency. However, the ED's enforcement actions have shown that it may view even such transfers as falling within FEMA's ambit. As a result, the sui-generis law must resolve this confusion and specify

how crypto-only transfers will be dealt with.

d. Differentiate between enforcement actions aimed at capital controls as opposed to money laundering.

In our view, these are two distinct objectives and should not be conflated by a single law. The proposed sui-generis law would be limited to controlling crypto transfers from the viewpoint of capital controls, while money laundering concerns would continue to be dealt with under the Prevention of Money Laundering Act (the requirements of which may be separately clarified for the crypto sector)

e. Establish principles to determine the situs of crypto-asset transfers.

The location of an asset is important for the application of capital controls, particularly in the case of digital assets, where it is difficult to draw neat lines of location. A new law would adopt the settled position under tax law, i.e. that the location of the owner is the location of the intangible asset. This would harmonize the principle of situs determination across legal doctrines, i.e. tax and foreign exchange management, yielding greater regulatory clarity.

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