

CRYPTO IN INDIA: TIME FOR SEBI TO TAKE THE LEAD

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Abstract

This article delves into India's cautious approach to regulating crypto-assets and explores the pivotal role that the Securities and Exchange Board of India (SEBI) could play in shaping a comprehensive regulatory framework. SEBI's hesitancy arises from the inherent challenges posed by the decentralised nature of crypto-assets and the divergence between Indian legislation and global benchmarks. The article emphasises the operational intricacies of crypto-assets, including their anonymity and cross-border complexities, which complicate traditional regulatory approaches. Highlighting the potential legal vulnerabilities and global repercussions of inaction, the article argues for SEBI's proactive intervention. Drawing on international examples, it discusses the evolving regulatory landscape in the European Union, the United States, and the United Kingdom, emphasising the need for SEBI to assume a leadership role in India's crypto market regulation.

Keywords: *Crypto assets; Distributed Ledger Technology; Decentralisation; Securities; Howey Test*

I. INTRODUCTION

In the dynamic landscape of global financial markets, the emergence of crypto-assets has triggered regulatory responses from advanced economies. Notably, the Securities and Exchange Board of India (“SEBI”) has adopted a circumspect approach, refraining from active oversight of this burgeoning sector. This cautious stance stems from pivotal factors that delineate the complex relationship between SEBI and the decentralised realm of crypto-assets. Primarily, SEBI's regulatory mandate, inherently tailored for centralised securities, encounters challenges when applied to the decentralised nature of crypto-assets. The divergence in definitions between Indian legislation and global benchmarks, such as the Howey Test in the United States (“US”), further accentuates the limited scope of SEBI's authority over these assets. Additionally, SEBI's scepticism, shared with the Indian government, revolves around the perceived association of cryptocurrencies with Ponzi schemes, exacerbating the regulatory dilemma.

The operational intricacies of crypto-assets on decentralised blockchain networks pose formidable challenges to SEBI's traditional regulatory approaches. The anonymity inherent in distributed ledger technology, coupled with cross-border complexities, amplifies the difficulties in effective oversight and tracing of illicit activities. As the crypto-asset market matures into a trillion-dollar behemoth, SEBI's reluctance to intervene carries potential legal vulnerabilities and undermines global efforts to mitigate financial risks. In this article, the authors examine

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the implications of India's hesitancy towards regulating crypto-assets, considering the imperative for regulatory frameworks, the potential risks of inaction, and the pivotal role SEBI could play in shaping a comprehensive and consistent regulatory framework for the evolving crypto market.

II. SEBI'S CAUTION: THE SCEPTICISM SURROUNDING CRYPTO-ASSET REGULATION

As advanced economies across the globe embark on regulating the crypto-asset market,¹ the SEBI has refrained from actively engaging in oversight of this burgeoning sector. This stance is primarily driven by these key factors.

First, SEBI's regulatory mandate primarily encompasses securities, and it has consistently maintained that crypto-assets do not fall under the ambit of "securities" as defined under section 2(h) of the Securities Contracts (Regulation) Act of 1956.² Further, in India, the provisions limit its scope to incorporated companies or bodies corporate, unlike the broader definition adopted in the *Howey Test*³ of the United States, which focuses on "common enterprises". This limited scope of SEBI's regulatory authority over crypto-assets is a significant factor in its decision not to regulate them.

Second, SEBI and the Indian government have viewed cryptocurrencies sceptically, often associating them with the potential for Ponzi schemes.⁴ While India's legal system lacks a specific definition of a Ponzi scheme, the Securities Exchange Commission ("SEC") defines⁵ it as an investment fraud where returns to existing investors are generated from funds contributed by new investors rather than from legitimate business activities.

Moreover, Crypto-assets operate on a decentralised blockchain network, also known as distributed ledger technology ("DLT"). This decentralised structure poses significant challenges for traditional regulatory approaches, primarily designed for centralised markets like banks or exchanges. SEBI's regulatory authority primarily lies in overseeing centralised securities markets, and the decentralisation of DLT transactions presents a significant hurdle. Furthermore, SEBI has highlighted the anonymity inherent in DLT transactions, where records are stored on dispersed computer nodes across various jurisdictions.⁶ This cross-border aspect of DLT transactions further complicates regulatory oversight and the tracing of illegal activities.

¹ Coryanne Hicks, 'Cryptocurrency Regulations around the World' (*Forbes*, 3 April 2023) <<https://www.forbes.com/advisor/investing/cryptocurrency/cryptocurrency-regulations-around-the-world/>> accessed 22 November 2023.

² The Securities Contracts (Regulation) Act of 1956, sec 2(h).

³ *SEC v WJ Howey Co* [1946] 328 US 293.

⁴ 'Crypto Currency Is "Ponzi Scheme", Should Be Banned in India: Govt Official' (*Business Standard*, 26 April 2019) <https://www.business-standard.com/article/pti-stories/crypto-currency-is-ponzi-scheme-should-be-banned-in-india-govt-official-119042600794_1.html> accessed 25 November 2023.

⁵ 'Investor Alert Ponzi Schemes Using Virtual Currencies' (*Security Exchange Commission*) <https://www.sec.gov/files/ia_virtualcurrencies.pdf> accessed 03 December 2023.

⁶ Sriram Srinivasan, 'Explained: What Are SEBI's Concerns Around Crypto Assets?' (*The Hindu*, 13 June 2022) <<https://www.thehindu.com/business/Economy/explained-what-are-sebis-concerns-around-crypto->

III. THE IMPLICATIONS OF KEEPING IT UNREGULATED

Amid the transformative impact of crypto-assets on the financial landscape, regulatory bodies face the exigent task of crafting effective frameworks. India's continued silence towards crypto-assets, however, presents potential legal vulnerabilities, as discussed below, and hinders the global effort to mitigate financial risks.

First, the crypto-asset market's explosive growth, from the unregulated periphery to a trillion-dollar behemoth, necessitates SEBI intervention. While early regulatory forays, like the SEC's 2000 action against SG Ltd.'s⁷ “virtual exchange,” encountered minimal resistance due to the market's nascent stage, the current landscape's complexity and size demand a comprehensive regulatory framework. Inaction risks investor detriment, market instability, and potential legal challenges, potentially outweighing concerns about resistance.

Second, a blanket ban on crypto-assets, often cited as a solution to concerns about money laundering and criminal activity, is demonstrably ineffective due to the technology's inherent decentralisation and global reach. The ease of transferring crypto assets through public keys and the distributed nature of blockchain technology, replicated across millions of computers, renders control measures technically infeasible. Consequently, SEBI regulation, rather than prohibition, emerges as the only viable option to mitigate these risks and safeguard investor interests within the burgeoning crypto market.

Third, India's crypto boom saw BitConnect,⁸ a Bitcoin Ponzi scheme, soar before crashing, leaving investors with worthless tokens and promoters enriched by a staggering INR 220 billion. This debacle exposes the dire need for SEBI regulation. Clear disclosure rules, investor awareness campaigns, and robust education initiatives are crucial to protect Indian investors from such predatory schemes in the booming, yet unregulated, crypto market.

Moreover, the IMF-FSB paper⁹ highlights the near impossibility of unilateral crypto bans, emphasising the global imperative for minimum regulatory standards. Consequently, India's inaction in crypto regulation carries potential legal ramifications and undermines the collective effort to address financial risks.

IV. SEBI: THE CORRECT REGULATOR FOR CRYPTO-ASSET

The booming crypto-asset market has reached a critical juncture, demanding immediate regulatory intervention. With this imperative established, the crucial question arises: which

assets/article65517621.ece#:~:text=SEBI%20has%20essen-
tially%20flagged%20the,%2C%20Ether)%20as%20also%20non%2D> accessed 17 November 2023.

⁷ *SEC v SG Ltd* [2001] 265 F 3d 42.

⁸ Parth Shastri, ‘Bitcoin Fraud: How Investors Lost Rs 22,000 Crore’ (*The Times of India*, 14 August 2018) <<https://timesofindia.indiatimes.com/business/india-business/bitcoin-fraud-how-investors-lost-rs-22000-crore/articleshow/65393687.cms>> accessed 15 December 2023.

⁹ International Monetary Fund and Financial Stability Board, IMF-FSB Synthesis Paper: Policies for Crypto-Assets (IMF and FSB, 2023) <<https://www.fsb.org/2023/09/imf-fsb-synthesis-paper-policies-for-crypto-assets/>>.

regulatory body is best equipped to assume this responsibility? This section will delve into the compelling arguments for SEBI's leadership in this domain.

First, the government's anti-crypto stance often cites money laundering and criminal activity as justifications, yet evidence suggests this concern is overstated. In 2020, only 0.34% of global crypto transactions were criminal,¹⁰ representing USD 10.0 billion. Moreover, India's current KYC/AML regulations solely bind entities regulated by the Reserve Bank of India (“RBI”) or SEBI. Should SEBI assume regulatory authority over crypto, these businesses would fall under the purview of these essential safeguards, potentially mitigating unlawful activities to a significant degree.

Second, SEBI has demonstrably shown a willingness to understand cryptocurrencies. Notably, in 2018, it dispatched officials on 'study tours'¹¹ to the financial regulatory hubs of Japan, the UK, and Switzerland. This initiative facilitated engagement with global financial agencies and fostered a deeper comprehension of regulatory approaches to cryptocurrencies and Initial Coin Offerings (“ICOs”).

Third, SEBI's core mandate is to regulate and develop the Indian securities market. Crypto-assets, particularly those with characteristics similar to securities such as security tokens and tokenized securities, fall within SEBI's existing expertise and regulatory framework. This expertise can be readily applied to crypto-assets, ensuring effective oversight and investor protection.

Fourth, while SEBI and RBI have historically engaged in a regulatory tug-of-war regarding crypto-assets, assigning this responsibility to RBI risks fragmented and inconsistent regulation. Such an approach could create confusion, hinder market development, and ultimately prove detrimental to the nascent crypto ecosystem. Conversely, SEBI's centralised approach, leveraging its established expertise in securities regulation and investor protection, can ensure a streamlined and consistent framework, fostering responsible innovation and safeguarding investor interests.

Additionally, Crypto exchanges have urged¹² the government to designate SEBI as the primary regulator for crypto-assets, citing their closer resemblance to securities like Bitcoin and Ethereum than traditional currencies, which fall under RBI's purview. This aligns with SEBI's existing expertise in securities regulation and investor protection, ensuring a more comprehensive and consistent regulatory framework for the burgeoning crypto market.

¹⁰ ‘The Chainalysis 2023 Crypto Crime Report’ (*Chainalysis*, 2021) <<https://go.chainalysis.com/2023-crypto-crime-report.html>> accessed 10 November 2023.

¹¹ ‘SEBI Sends Officials Overseas to Study Cryptocurrencies, Initial Coin Offering’ (*The Economic Times*, 6 September 2018) <<https://economictimes.indiatimes.com/markets/stocks/news/sebi-sends-officials-overseas-to-study-cryptocurrencies-initial-coin-offering/articleshow/65708126.cms>> accessed 12 December 2023.

¹² Dave, ‘Crypto Exchanges Want SEBI or a New Entity as Regulator, Not RBI’ (*The Economic Times*) <<https://economictimes.indiatimes.com/markets/cryptocurrency/crypto-exchanges-want-sebi-or-a-new-entity-as-regulator-not-rbi/articleshow/82718907.cms>> accessed 01 December 2023.

V. APPROACH OF DIFFERENT JURISDICTIONS TOWARDS CRYPTO-ASSETS

The once-nascent crypto market, initially met with regulatory scepticism, has matured into a behemoth demanding global attention. As concerns over investor protection, financial stability, and illicit activity rise, jurisdictions worldwide are stepping in to tame the digital frontier. This section delves into the evolving regulatory landscape, focusing on prominent advanced economies wielding their securities exchange boards as the primary instruments of control.

The European Union's historic Market in Crypto Assets Regulation (“**MiCA**”),¹³ adopted in June 2023, marks a pivotal step in crypto-asset market regulation. It defines crypto-assets as digital representations of value or rights, transferable electronically via DLT. This regulation is designed to oversee various aspects of crypto-assets, with a particular emphasis on stablecoins, which are crypto-assets that pledge a stable value against official currencies or benchmarks. Here, the European Securities and Markets Authority (“**ESMA**”) will assume a key role, issuing guidelines within eighteen months to establish criteria for classifying digital assets within or outside MiCA's scope, addressing potential regulatory ambiguity in this evolving domain.

In the US, the SEC has established itself as the primary crypto-asset regulator. Its 2019 framework,¹⁴ leveraging the 'investment contract' analysis, provides clarity on classifying digital assets as securities. This approach hinges on the 1946 Howey Test,¹⁵ established by the Supreme Court, which determines whether a scheme falls under the Securities Act based on (a) investment of money, (b) in a common enterprise, (c) expectation of profits, and (d) solely from the efforts of others. This framework serves as a valuable precedent for other jurisdictions contemplating crypto-asset regulation.

The United Kingdom (“**UK**”), in 2016, established a pioneering FinTech regulatory sandbox¹⁶ under the Financial Conduct Authority (“**FCA**”), fostering innovation within a controlled environment. In June 2023, the landmark Financial Services and Markets Act (“**FSMA**”)¹⁷ was enacted, comprehensively revising the 2000 FSMA. This legislation replaces and modernises European Union law, empowering regulators and introducing dedicated chapters on crypto-assets. Notably, the FSMA aims to ensure compliance with anti-money laundering and counterterrorism legislation by crypto-asset firms operating within the UK's financial system.

VI. CONCLUSION

¹³ The Market in Crypto Assets Regulation (EU) 2023/1114.

¹⁴ Security Exchange Commission, ‘Framework for “Investment Contract” Analysis of Digital Assets’ (*SEC Emblem*, 3 April 2019) <<https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>> accessed 13 December 2023.

¹⁵ Seward, ‘Sec. Framework for “Investment Contract” Analysis of Digital Assets (2019)’ (*Harvard Law Review*, 24 March 2023) <<https://harvardlawreview.org/print/vol-132/sec-framework-for-investment-contract-analysis-of-digital-assets-2019/>> accessed 01 December 2023.

¹⁶ ‘Regulatory Sandbox’ (*FCA*, 1 August 2023) <<https://www.fca.org.uk/firms/innovation/regulatory-sandbox>> accessed 18 November 2023.

¹⁷ The Financial Services and Markets Act 2023 87.

In conclusion, the SEBI has maintained a cautious stance on regulating the crypto-asset market, primarily due to its limited statutory authority over decentralised transactions. SEBI's regulatory mandate is confined to centralised securities markets, and the decentralised nature of blockchain technology poses significant challenges for traditional oversight methods. The Indian government's scepticism and association of cryptocurrencies with potential Ponzi schemes further contribute to SEBI's reluctance. However, the exponential growth of the crypto-asset market, the imperative for a comprehensive regulatory framework, and the need to protect investors necessitate SEBI's intervention. A blanket ban is deemed ineffective, and SEBI's expertise in securities regulation aligns with the characteristics of certain crypto-assets. Considering the global trend of regulatory frameworks led by securities exchange boards, SEBI's proactive engagement becomes imperative to address legal vulnerabilities, financial risks, and align India with international efforts in regulating the evolving crypto landscape.