A Shot in the Arm for Virtual Currencies*

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The Supreme Court has set aside a circular issued by the Reserve Bank of India in April 2018, which directed all entities regulated by it to "not deal in virtual currencies (VCs) or provide services for facilitating any person or entity in dealing with or settling VCs." By creating this Chinese Wall between the legal and formal financial system that comes under RBI surveillance and the world of virtual currencies and the virtual currency exchanges that facilitate transactions involving those currencies, the RBI did not shut the door on digital tokens in India. But by excluding entities dealing in VCs from the payments and settlements system meant for actual legal tender, it did circumscribe the world of virtual currencies in this country. If agents are not able to easily traverse between the worlds of actual and virtual currencies, VCs would not disappear from the economy, but the penetration of VCs would be limited. More importantly, virtual currency exchanges would be marginalized and their functioning rendered near impossible. Not surprisingly, the judgement setting aside the RBI circular has been welcomed by those directly or indirectly engaged with the world of digital currencies.

It is true that the degree to which cryptocurrencies are used in routine day-to-day transactions involving goods and services is small. But the ability of block chain technology to create communities of agents who can transact among themselves using a particular set of digital tokens with a reasonable degree of trust has resulted in a proliferation of such tokens. Besides Bitcoin, there were an estimated 1300-plus digital tokens in circulation by the end of 2017. There have also been innovations like Initial Currency Offerings, through which start-ups can crowd fund capital, by issuing digital tokens that represent share capital in the concern in return for legal tender, to finance their operations. Investors expect the value of the tokens to appreciate when they make their investments, but many would like to exit at some point by reconverting the tokens to legal tender. All this requires virtual currency exchanges with a functioning interface between the world of digital tokens and that of fiat money. Shutting down that interface constricts the realm in which digital currencies operate.

There are many grounds on which the use of cryptocurrencies have been viewed with suspicion in India, as elsewhere. The official view seems to be that, digital tokens can potentially serve as means for payments in illegal activities, and can be used for financing illicit operations or for money laundering. In addition, given their money-like characteristics, even though they are not legal tender, their proliferation it is feared can adversely affect the central bank's ability to manage money supply and inflation, and its and the government's ability to manage the balance of payments, leading to economic instability. These are among the grounds often used to prohibit or limit the use of cryptocurrencies in different countries and provide the background for the RBI's circular.

It needs to be noted that the Supreme Court has not disputed such fears, even when noting and discussing them. In the elaborate judgement that discusses the powers and functions of the central bank and traverses the difficult terrain of defining the features and role of cryptocurrencies, the three-judge bench (consisting of Justices Rohinton

Fali Nariman, Aniruddha Bose and V. Ramasubramanian) has dismissed many of the claims of the petitioners (fronted by the Internet and Mobile Association of India). One was that the RBI had breached its remit when banning any interaction of the regulated financial sector with virtual currencies or virtual currency exchanges (VCEs), because virtual currencies are not legal tender or money of any kind but just goods or commodities (though digital in form) that are not covered by the Acts defining the role and powers of the central bank.

In response, having noted the wide powers conferred on the central bank by the RBI Act 1934, the Banking Regulation Act 1949 and the Payments and Settlements Act 2007 to be exercised to reduce systemic risk and ensure the stability of the banking system, the Supreme court turns to the elusive definition of virtual currencies to examine whether they and the exchanges in which they are traded fall in the ambit of the RBI's regulatory jurisdiction. The bench notes that, while cryptocurrencies were at birth seen as an alternative to legal tender, they do not possess as yet many of the leading attributes of money. They currently serve poorly as stores of value, with their value in terms of legal tender being hugely volatile, and are not popular as units of account and media for exchange in real economy transactions.

However, there is unanimity of opinion among governments and regulators that, despite not having acquired the status of legal tender, they constitute digital representations of value, and are capable of functioning as media for exchange, units of account and stores of value. The Court too disagreed with the view "that the RBI's role and power can come into play only if something has acquired the status of a legal tender." In fact, many Acts of the government in India identify instruments other than legal tender as "money", which the RBI has powers to regulate. So despite the cross-jurisdictional confusion it finds in the law when categorizing money (as property, commodity, payment instrument or money), the Court concluded that "once it is accepted that some institutions accept virtual currencies as valid payments for the purchase of goods and services, there is no escape from the conclusion that the users and traders of virtual currencies carry on an activity that falls squarely within the purview of the Reserve Bank of India." On that ground it rejected the contention of the petitioners that the RBI's circular was ultra vires. It also rejected the contention that the "RBI is conferred only with the power to regulate, but not to prohibit." In any case, said the Court, the RBI's circular does not prohibit the VCEs from functioning, but only bans entities the former regulates from dealing with VCs and VCEs.

Moreover, it found as weak the view that the exercise of power by the RBI, over the entities regulated by it, has caused unwarranted collateral damage to entities it is not entitled to regulate. The position taken by the judges on this count is particularly strong. They concluded that: "There can be no quarrel with the proposition 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. To constitute colourable exercise of power, the act must have been done in bad faith and the power must have been exercised not with the object of protecting the regulated entities or the public in general, but with the object of hitting those who

form the target. To constitute malice in law, the act must have been done wrongfully and wilfully without reasonable or probable cause. The impugned Circular does not fall under the category of either of them."

In sum, the Supreme Court has not accepted the contention of the petitioners that the Reserve Bank of India, when issuing the impugned circular, did not act in keeping with its mandate and powers, or that it exceeded its jurisdiction. On those terms the Court saw the circular as justified. If yet the petitioners have "won" their case it is only in terms of the question of the proportionality of the RBI's decision relative to the problem or dangers it was seeking to address. Recognising that (i) access to banking provides a lifeline to any business, trade or profession; and (ii) under article 19(1)(g) of the Constitution, "the Right to practice any profession or to carry on any occupation, trade or business" is a fundamental right conferred on all citizens, the Court noted that "the burden of showing that larger public interest warranted" an action that severely damaged the functioning of the VC exchanges rests with the central bank.

The petitioners contended that though the entities posing a threat to the stability of the financial system in the RBI's perception are virtual currencies, they were not the actual target of the RBI's circular. VCs have not been banned in India, even though the volume of trade in digital tokens may have come down because of the RBIs action. The target has turned out to be the virtual currency exchanges which are unable to carry on their business, even while, the bench noted, "people who wish to buy and sell VCs can still do so merrily, without using the medium of a VC Exchange and without seeking to convert the virtual currencies into fiat currency."

Virtual currency exchanges facilitate the buying and selling of virtual currencies, the storing and securing of the virtual currencies in "wallets" and the conversion of virtual currencies into fiat currency and vice versa. According to the Court, while the users and traders of virtual currencies as part of their occupation or profession have not been shut out of their business, even if constrained, by the RBI's circular, "the VC exchanges do not appear to have found out any other means of survival (at least as of now) if they are disconnected from the banking channels." So even though the RBI could claim it has the right to close the interface between the formal and regulated financial system and a growing "parallel economy" of virtual currencies, its action must pass the "test of proportionality", "since the impugned Circular has almost wiped the VC exchanges out of the industrial map of the country, thereby infringing Article 19(1)(g)."

On deciding on that matter the Court took account of the facts that (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) the RBI has held a consistent stand of not prohibiting VCEs in the country; and (iii) the Inter-Ministerial Committee set up to "recommended a specific legal framework including the introduction of a new law" to regulate the virtual currency eco-system, was in it "Note-precursor to the Report" was "of the opinion that a ban might be an extreme tool and that the same objectives can be achieved through regulatory measures" and was "was fine with the idea of allowing the sale and purchase of digital crypto asset at recognized exchanges." However, the Committee subsequently dramatically changed its view and "the final report of the very same Inter-Ministerial Committee, submitted in February 2019 recommended the imposition of a total ban

on private crypto currencies through a legislation to be known as "Banning of Cryptocurrency and Regulation of Official Digital Currency Act, 2019"."

The Act has however not been passed as of now. VCs are not banned. There is no significant evidence that the operations of the VCEs have damaged the formal financial sector. Yet the RBI has issued a circular, the directions of which has severely adversely affected the trading in virtual currencies and the functioning of the VCEs. There is, therefore, the Court held, no proportionality in the RBI's action and set aside the circular on those grounds.

The Supreme Court's judgement has given the virtual currency exchanges a new lease of life and thereby recharged the virtual currency eco-system in India. The issue that remains is whether this new environment will sustain, since the right of the central bank to intervene in the matter has not been rejected. What has been questioned by the judgment is the form in which that right has been exercised, given circumstances, leading to the conclusion that the action does not pass the test of proportionality. But if the consequences of this judgement are to be reversed, in order to once again restrain the functioning of the VCEs, the onus of establishing that the virtual currency world has damaged the formal financial structure and challenged the latter's stability has been placed on the RBI. That would prove difficult in the near future.

The RBI can think of superceding this judgement by declaring virtual currencies illegal and ban transactions based on them in the country. But even that action may once again be questioned on grounds of proportionality, so long as the operation of the virtual currency world has not significantly damaged the formal financial sector regulated by the RBI. So, as of now, it appears the virtual currency eco-system in India is here to stay. The only question is whether it would gain the popularity needed to make it qualify as money, both in the legal sense (by achieving legal tender status) and in the social sense (by becoming widely accepted as a medium of exchange and store of value)

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