

# Changing Regulatory Landscape on Virtual Digital Assets in India



Developments under the PMLA to bring Virtual Digital Assets under its ambit

# I. INTRODUCTION

Pursuant to the notification issued by the Central Government on 07<sup>th</sup> March, 2023 the entities involved in or carrying out business of trading, holding, dealing, management, or handling of cryptocurrencies and other Virtual Digital Assets (“VDA”) would be brought under the scope of the Prevention of Money Laundering Act, 2005 (“PMLA”). Any legal or natural persons carrying such businesses were notified to be ‘reporting entities’ under the PMLA.

This new development is likely to spell lasting changes on how VDAs are rendered and traded in India and the impact it will have for the entities engaged in the business of virtual assets (“**Virtual Asset Service Providers**” or “**VASPs**”).

In this document we have discussed the current status of VDAs and the VASPs in India, and how by bringing them under the ambit of the PMLA, Prevention of Money-laundering (Maintenance of Records) Rules, 2005 (“**PML Rules**”) and the Indian Computer Emergency Response Team’s Directions dated 28<sup>th</sup> April, 2022 (“**CERT-In Directions**”) helps in identifying the current gaps and lacunas in the Indian legal system in regards to the fate of VDAs in the Country.



## II. What are Virtual Digital Assets

In simple terms, 'virtual digital assets' are the cryptocurrency, non-fungible tokens ("NFT"), and other decentralized finance (DeFi). A VDA basically is a digital representation of an item which has a certain value attached to it under specific circumstances. VDAs are governed by the Financial Action Task Force ("FATF") which is an inter-governmental entity which sets international criteria aimed at preventing money laundering and/or other terror financing.

VDAs are defined under section 2(47A) of the Income Tax Act, 1961 ("Act") wherein it is stated that "virtual digital assets" means-

- a. *"any information, code, number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise and can be called by whatever name and providing a digital representation of the value that is 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. *non-fungible token or any other token of similar nature, by whatever name called".*



### Who are Virtual Asset Service Providers?

VASPs are entities or persons that are engaged in the business relating to the exchange, transfer, and/or administration of the VDAs. The FATF defines the VASPs as an entity which conducts as a business by engaging one or more of the following activities:



- i. Transactions involving VDAs and paper currency (fiat money);
- ii. Trade involving one or more types of digital assets in virtual form;
- iii. Transfer of the VDAs;
- iv. Storage and safekeeping or management of VDAs or tools providing control over VDAs; and
- v. Engagement in the delivery of financial services associated with an issuer's offer and selling of any VDAs.

## III. Recognition of VDAs in India

At present, cryptocurrencies per se are not recognized as a legal tender in India, in fact while various efforts have been made by the government as well as the Reserve Bank of India (“**RBI**”) to put a blanket ban on cryptocurrencies by introducing the Cryptocurrency and Regulation of Official Digital Currency Bill, 2021 (“**Bill**”), however since the Bill is in the nascent stages of development at present there is no express recognition or restriction on cryptocurrencies in India.

In fact, in the Finance Bill for 2022 the government has proposed to implement a 30% capital gains tax on the transfer (via sale, gift or exchange) of the VDAs. In addition to this, the government has proposed a levy of 01% of tax deducted at source (“TDS”) on the payments made in relation to the transfer of VDAs effective from the 01<sup>st</sup> August, 2023.

It was also laid down that a cryptocurrency, by whatever name called, would be considered a VDA, taxable under the Act if it meets the following criteria:

- i. If it is in the form of information, code, numbers, or tokens;
- ii. If it is generated through cryptographic means or otherwise;
- iii. If it acts as a digital representation of value;
- iv. If it has some inherent value; and
- v. If it allows for the storage and transfer of its units or tokens.



## IV. Measures to ensure anti-money laundering activities

### 1. Customer Due Diligence

Under Rule 9(1) of the PML Rules, all the VASPs must put in place know-your-customer (“KYC”) measures (a) at the time of the commencement of an account-based relationship:

- i. Researching and discovering who its clients are, confirm their identities, and find out what the aim of the said business relationship is; and
- ii. Analyze whether a customer is representing a beneficial owner, locate the beneficial owner, and take all necessary measures to confirm the beneficial owner's identity.

And (b) in all other cases, verify identity while carrying out:

- i. Transaction of an amount equal to or exceeding rupees fifty thousand, whether conducted as a single transaction or several transactions that appear to be connected, or
- ii. Any international money transfer operations.

It is to be noted that while under annexure III of the CERT-In Directions only one valid document is required for the KYC, whereas under the Rule 6(4) of the PML Rules it is compulsory to issue to following documents:

- i. PAN or equivalent e-document thereof, or Form no. 60; and
- ii. Any of the following documents:
  - a. Aadhar Card;
  - b. Passport;
  - c. Driving License;
  - d. Voter Card (issued by the Election Commission of India);
  - e. Job Card issued by NREGA (duly signed by an officer of State Government);
  - or
  - f. A letter which is issued by the National Population Register.

As per para 3(a) of the Central KYC Registry Operating Guidelines, 2016 it is necessary for the VASPs to register themselves with the Central KYC Registry being the Central Registry of Securitization Asset Reconstruction and Security Interest of India (“CKYCR”). Further as per Rule 9(1A) of the PML Rules, the VASPs must file an e-copy of the clients KYC records within 10 days of an account-based relationship with the said client.

## **2. Ongoing Customer Due Diligence as per the PML Rules**

VASPs as per Rule 9(12)(i) have to continue due diligence and closely examine the transactions that their customers enter into in order to ensure that they are consistent with their understanding of the client, their business, risk profile, and, if necessary, the funding source.

As per Rule 9(12)(iii) VASPs must also repeat the KYC process for existing clients at appropriate time on the basis of

- i. Materiality and risk;
- ii. Time period which has elapsed since the last time KYC process was done; and
- iii. The inadequacy of the data that is obtained.

VASPs as per Rule 9(13)(i) must also have a documented process and plan in place for risk assessment to tackle any potential dangers of terror financing and/or money laundering. Further as per Rule 9(13)(ii) the risk assessment must be up to date with the latest laws and regulations, should be available to the competent authorities, and examine all pertinent risk factors before deciding the overall risk level and decide upon the best way to mitigate such risk.

### 3. Maintenance of Records

Section 12 of the PMLA dictates that reporting entities are to maintain records of all the transactions of its customers, hence a VASP must maintain a record of all the transactions for a minimum of five years. In respect of the Rule 4 of the PML Rules and the CERT-In Directions, the information to be maintained by the VASP must include:

- i. Nature of the transactions
- ii. Amount of the transaction and the currency in which it was denominated
- iii. Addresses or accounts involved (or equivalent identifiers)
- iv. Parties to the transactions
- v. Date of the transactions
- vi. IP addresses along with timestamps and time zones
- vii. The public keys (or equivalent identifiers); and
- viii. Transaction ID.

Apart from the above, the VASP as per section 12(1)(e) read with section 12(4) of the PMLA must also maintain records evidencing the identity of the client and the beneficial owner, and account files and business correspondence relating to its clients, for a period of five

years after the business relationship with the client has ended or the account is closed, whichever is later.

#### **4. Reporting to the Financial Intelligence Unit - India ("FIU-IND")**

Now with the issuance of the aforementioned notification dated 07<sup>th</sup> March 2023, VASPs would fall within the ambit of the PMLA hence they must also appoint a principal officer and a director to ensure that the PMLA and the PML Rules are adhered and complied with. Other than that, as per Rule 7(1) of the PML Rules, the VASPs must also provide the name, address, designation and other details of the said appointed principal officer and/or director with the **FIU-IND**.

Roles and responsibility of the principal officer for a VASP would include:

- i. As per Rules 7(2) and 8(1) of the PML Rules, furnishing information to the FIU-IND such as information on all the cross-border wire transfers where the amount of money is INR 5,00,000/- (Indian Rupees Five Lakhs Only) or more or its equivalent in foreign currency; and
- ii. Furnishing of information to the FIU-IND about any suspicious transactions that may be suspected within a period of 7 working days of being satisfied that the transactions was in fact suspicious, whether or not made in cash and by way of:
  - a. Any credits or deposits, or withdrawals from or in any of the accounts in whatsoever manner or name they are referred to and in any type of currency that is maintained;
  - b. Money transfers in favor of own clients or non-clients from India or abroad and to third-party beneficiaries in India or abroad;
  - c. Any kind of debit or credit from or into a non-monetary account;
  - d. Collection services of or in any currency; and
  - e. Loans and advances issued including any credit or loan substitutes, investments and contingent liability.
  - f. Presently, reporting entities must register on the FIU-IND portal and provide the aforementioned data in the manner specified by FIU-IND. The same may



change going forward to accommodate for a new format which provides for a space where transactions of cryptocurrency can also be reported.

## V. W&S Legal's Takeaway

Currently there is a lot of uncertainty with regards to the acceptability of VDAs, cryptocurrencies, and the VASPs in India. The central government and the RBI have consistently taken a stringent view with regards to the acceptability and use of cryptocurrency and other blockchain transactions in India and have placed reliance only on the fiat currency. The central government's stance has been ambiguous, there are still no clear laws or rules in place in India for the governance or recognition of the VDAs, however the government aims at levying tax on the VDAs from 01<sup>st</sup> April 2023, thereby giving the VDAs and the transactions effected by using VDAs an implied recognition.

Similarly, the notification dated 07<sup>th</sup> March 2023 which brings the VDAs within the ambit of the anti-money laundering laws, could also be seen as a step towards formally recognizing VDAs and cryptocurrencies as a valid source of currency or assets in India. It appears that the central government has recognized an increased acceptability of the VDAs across the globe as an important tool in trading of goods and assets. Even though currently there are no regulator's directly involved in the functioning of the VASPs and VDA in India, the decision to notify VASPs as reporting entities under the PMLA may indicate the government's intention of recognizing VDAs and the VASPs as an alternate and a legal form of currency and assets which may be applicable in India and also to regulate the industry and not just implement a blanket ban on the use and transactions of VDAs and cryptocurrencies. Going forward it will also be intriguing to observe how the scope of services provided by the VASPs would be affected by the PMLA and the PML Rules.

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