POLICY CONSENSUS CENTRE

# Policy Brief

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# A Roadmap for VDA Regulations in India

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# List of Abbreviations

| | |
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| AML | Anti Money Laundering |
| CARF | Crypto Asset Reporting Framework |
| CASPs | Crypto Asset Service Providers |
| CBDCs | Central Bank Digital Currencies |
| CFT | Countering Financing Of Terrorism |
| DeFi | Decentralised Finance |
| DLT | Distributed Ledger Technology |
| EMDEs | Emerging Markets and Developing Economies |
| FATF | Financial Action Task Force |
| FIU | Financial Intelligence Unit |
| FIU-IND | Financial Intelligence Unit - India |
| FSB | Financial Stability Board |
| FSDC | Financial Stability and Development Council |
| FSS | Financial Supervisory Services |
| JVCEA | Japanese Virtual Currency Exchange Association |
| MiCA | Market in Crypto Asset |
| PMLA | Prevention of Money Laundering Act |
| SROs | Self-Regulatory Organisation |
| STOA | Japan Security Token Offering Association |
| UAPA | Unlawful Activities (Prevention) Act |
| USD | United States Dollar |
| VARA | Virtual Assets Regulatory Authority |
| VDAs | Virtual Digital Assets |
| WMDA | Weapons of Mass Destruction and Delivery Systems (Prohibition of Unlawful Activities) Act |

## 1. Introduction

Digital assets are commonly referred to as virtual digital assets (VDAs) or crypto assets. Crypto assets are financial digital blocks created on distributed ledger technology (DLT), which is a technological protocol allowing simultaneous access, validation, and record updating across a networked database. The legitimacy and validation of exchange of a crypto asset is full proofed by the shared and immutable ledger facilitating the process of recording and tracking transactions in the blockchain technology.

Innovations in VDAs have caused much debate in both domestic and international forum largely owing to the fact that many of these recent innovations in the financial sector fall outside the ambit of traditional regulatory frameworks. The risks associated with VDAs and decentralised finance (DeFi) are well documented. However, risk mitigation measures are still evolving as a greater degree of global consensus and coordination is required to monitor large cross border transactions through VDAs.

The crypto market is growing, and growing fast. Between 2020 and 2021 the market grew tenfold, but with volatilities that are characteristic of the crypto market, the market capitalisation of the crypto sector also fell from USD 2.9 trillion to USD 1.7 trillion in March 2022. This accounted for 0.4 per cent of total global assets. Of this, around 90 per cent of the assets are in unbacked VDAs. Since the share of VDAs to global assets is still a very small percentage, the common opinion is that the risks are also currently limited, but this could change very fast. The debates about VDAs and particularly around unbacked crypto assets and stable coins have intensified in the recent past.

Crypto markets by nature of their pseudo anonymity and their decentralised functioning pose risks for stability, primarily, because by virtue of their structure they are disintermediated, which means, their functioning falls outside of the purview of traditional monetary policy, fiscal policy, and capital flow management.

## 2. Definitions and Types of VDAs

Crypto assets or VDAs are yet to have globally consistent definitions and classifications or taxonomy. Multiple agencies, such as, World Bank, Financial Stability Board (FSB), Financial Action Task Force (FATF) have provided their own definitions; but they are broadly similar in that they define VDAs as a representation of value that can be digitally traded, transferred, and stored, and that it is based on distributed ledger technology.

In India, the definition of VDAs is provided in Section 2, Clause (47A) of the Indian Income Tax Act, 1961. The current definition although adequate for the purpose of taxation, lacks robustness, considering the gamut of VDAs available in the global market and the extent to which they vary in terms of operation, distribution, purpose and underlying technology. Inclusion of these functions are critical for creating relevant regulations and supervisory guidelines to enable smooth market operations and better uptake of these products. Hence, a nuanced definition of VDAs should be put in place which takes into account the subtleties of each VDA in the market.

## 3. The Risks Associated with VDAs

The rapid growth of financial technology combined with investments in VDAs in the last decade have prompted policymakers to reassess the quantum of risk and the extent of risk permeation that investments in VDAs can have on investors and on the financial and real economy. These concerns among policymakers largely stemmed from the lack of understanding of VDAs and their operational deviation from the traditional financial system. With the passage of time and further integration of VDAs into the global financial system, several inter-governmental institutions and major economic blocs have drafted detailed macro and micro classifications of risks associated with such trade and have made numerous recommendations to counter such risks. These are:

i. Market Risk - Risk of losses arising from movements in market prices due to events in crypto asset markets.
ii. Liquidity Risk - Risk of incurring losses resulting from the inability to meet payment obligations in a timely manner when they become due or without incurring unacceptable losses.
iii. Credit Risk - Potential that a counterparty in crypto asset markets or directly exposed to crypto assets will fail to meet its obligations in accordance with agreed terms.
iv. Operational Risk - Risk of loss resulting from inadequate or failed internal processes and systems, human errors, or from external events.
v. Bank Disintermediation Risk or Macroeconomic Risk - Risk that individuals and firms withdraw their deposit funds from traditional financial institutions and transfer them to other institutions.
vi. Capital Flow Risk - Potential for large and sudden changes in the flow of capital between countries due to the buying and selling of VDAs.
vii. Fiscal Risk - Lack of clarity on tax regimes and tax collection mechanism and enforcement.

viii. Financial Instability Risk - Risks arising from financial institutions having exposures to crypto assets.
ix. Money Laundering Risks - Misuse of crypto assets for money laundering and terrorist financing due to the anonymity they provide to the transacting parties.
x. Legal and Regulatory Risk - The legal classification of crypto assets and the application of existing rules to them pose significant challenges, leading to uncertainty and potential legal risks.
xi. Consumer Protection Risk - Consumer protection risks arise when consumers and investors are unaware or do not fully comprehend the risks associated with crypto assets.
xii. Risk of Global Stable Coins - Risk of capital flight if buying and holding foreign currency denominated stable coins is cheaper than holding them in bank accounts.
xiii. Technological Risk - Risks that rise due to high dependence on technology.
xiv. Emerging Markets and Developing Economies (EMDEs) Risks - Risks that are unique to EMDEs by virtue of the characteristics of their economies.

## 4. G20 and Crypto Regulations

In September 2024, the G20 countries convened to address the regulatory landscape surrounding cryptocurrency assets, culminating in a set of agreements aimed at fostering a secure and stable financial environment. The discussions centred on the need for a global regulatory framework to mitigate risks associated with digital currencies, which have proliferated in recent years.

Key provisions of the agreement included the establishment of standardised regulatory guidelines to combat money laundering, fraud, and other illicit activities facilitated by cryptocurrencies. The G20 emphasized the importance of consistency across jurisdictions to prevent regulatory arbitrage, where entities may exploit differing regulations to evade oversight.

Furthermore, the leaders acknowledged the necessity of protecting consumers and investors, advocating for measures that ensure transparency and accountability in crypto transactions. Member states were encouraged to share data and best practices to enhance regulatory cooperation and to develop a collaborative approach to monitor the impacts of crypto assets on global financial stability.

The agreement also highlighted the role of central bank digital currencies (CBDCs) and their potential to complement existing financial systems while addressing concerns about the volatility and speculative nature of decentralized cryptocurrencies.

The G20 called for further research into the implications of CBDCs for monetary policy, particularly in relation to cross-border transactions.

The G20's September 2024 agreement marked a significant step towards cohesive international regulations for cryptocurrency assets, fostering a balance between innovation and regulatory oversight to safeguard the integrity of the global financial system.

## 5. How the World Regulates VDAs?

Taking into account the rise in trading volume and investors in VDAs, international policymaking bodies and global financial institutions have either established a regulatory framework on VDAs or are in the process of formulating policies on regulating VDA. However, due to the novelty of the crypto ecosystem, regulatory responses from individual countries have been either ad-hoc or driven by enforcement. While most countries have opted for an ex-post regulatory regime, others have chosen to ban VDAs completely, mostly due to a lack of understanding of crypto assets. However, bans rarely work in real world situation and the same is true for the VDAs.

With inter-governmental agencies and standard setting bodies actively framing guidelines for the crypto industry, crypto regulations around the globe are becoming more uniform and standardised. Adoption of such regulations are also expected to reduce sudden financial shock in the economy, increase consumer protection and lay down good business practices for the industry.

The relevance of VDAs to global finance has led international financial bodies and inter-governmental organisations to develop model rules and best practices for better cooperation among different economies to minimise the possible macroeconomic risks and financial instability. Hence, major international financial bodies and inter-governmental organisations have held numerous consultations and released detailed documents suggesting ways to regulate VDAs and steps to mitigate risk arising from transactions in VDAs.

## 6. Lessons for India – The Case of EU, Japan, Dubai, and Australia

While quite a few countries have formulated and adopted a standard framework for regulating VDAs in their jurisdiction, in our opinion, Market in Crypto Asset (MiCA) Regulations in the European Union and the Crypto Asset Reporting Framework (CARF) in Japan are two of the most robust and forward- looking regulatory

frameworks introduced in their respective jurisdictions. MiCA is an exhaustive set of regulations which is being developed in phases in consultation with market experts and policymakers from different jurisdictions in the European Union. MiCA has been created by learnings from on-ground experiences of crypto transactions and functioning in different jurisdictions of Europe. MiCA has further subsumed many existing regulations of multiple regulatory bodies to form a comprehensive set of regulatory guidelines for all VDA markets in the European Union.

Japan too has been very progressive with regulation of VDAs. Over the last couple of years, Japan has emerged as a global leader in VDA regulation because of how its regulatory framework has managed to find a good balance between combating money laundering and terrorism financing risks, while maintaining financial and economic stability, and fostering innovation. Japan's licensing framework for VDA exchanges and other service providers has been praised for its stringent, yet fair, security measures criteria, customer protection, and governance structures, which are regularly audited by regulatory authorities. Another excellent initiative by the government was the setting up of a self-regulatory organisation (SROs). The creation of crypto self-regulatory organisations (SROs) such as the Japanese Virtual Currency Exchange Association (JVCEA) and the Japan Security Token Offering Association (STOA), have helped in ensuring market compliance among crypto asset service providers (CASPs) and building investors' confidence in the Japanese VDA market. It sets industry-wide standards and guidelines to promote ethical conduct, operational transparency, and consumer protection.

To tackle anti money laundering (AML) and countering financing of terrorism (CFT) transactions, the Financial Supervisory Services (FSS) of South Korea has undertaken steps to restrict unauthorised crypto transactions by restricting use of anonymous accounts in trading in VDAs and tightening the reporting norms for banks having accounts of VDA exchanges. The FSS of South Korea has instructed banks to deal with only VDA accounts with a "real name", i.e., a VDA account holder (or crypto wallet) has to create a bank account bearing the same name as the VDA account, to enable transactions, including deposits and withdrawal from the crypto wallet.

In March 2022, Dubai became the first country to set up an independent regulatory body, Virtual Assets Regulatory Authority (VARA), to regulate VDAs. VARA was set up with an aim to provide regulations, rules and develop standards necessary to regulate, supervise and control all concerns related to virtual assets, enhance investor understanding of the virtual assets sector, and attract investment and companies operating in virtual assets to establish themselves in Dubai.

In October 2023, the Federal Government of Australia proposed that VDA exchanges and CASPs must be subjected to existing Australian financial services regulations and platform operators acquire an Australian Financial Services Licence. This will increase operational fairness and transparency among CASPs, manage conflicts of interest, make disclosures, submit financial accounts, and meet solvency and cash reserve requirements.

## 7. India's PMLA Regulation and FIU Guidelines

In India, the crypto economy is nowhere as advanced or developed as those in advanced economies, and therefore, while it is important to be prudent and take calculated steps, it is possible for the Reserve Bank of India, the central government, and other relevant regulatory agencies to adopt risk mitigation measures that can ensure that the risks of the crypto economy permeating to the real economy are manageable.

In March 2023, India's Financial Intelligence Unit (FIU) put in place detailed guidelines for VDA transactions and service providers. These guidelines also brought all VDA transactions under the ambit of the Prevention of Money Laundering Act (PMLA), Unlawful Activities (Prevention) Act (UAPA), and the Weapons of Mass Destruction and Delivery Systems (Prohibition of Unlawful Activities) Act (WMDA). This was India's first step towards risk mitigation measures against crypto crimes.

Crypto transactions in India can occur either as peer to peer, through Indian exchanges, or through foreign exchanges. Tracking peer to peer transactions are still difficult and largely rely on self- declaration. The only effective way to track these transactions is when fiat money is converted to VDAs or VDAs are converted into fiat money. This is an important reason for ensuring that fiat to crypto transactions and vice versa are seamless. Limiting options through which fiat money can be converted into VDAs or vice versa will make traceability difficulty. The FIU guidelines bring all service providers under their purview and have placed reporting obligations, including reporting of high value transactions, and suspicious transactions.

## 8. Next Step for India

India's renewed stand taken at the G20 Presidency demonstrated that Indian policymakers understand the importance of the crypto ecosystem and are open to making necessary policy changes to cater to the evolving nature of the crypto landscape. Considering the nascent stage of the VDA sector in India, India can utilise the G20 declaration as a springboard for crafting its own comprehensive and effective

VDA regulatory framework. Further, developing market infrastructures, bringing ease of doing business in the VDA market, creating consumer awareness, and advancing technological solutions will be the bedrock for such a regulatory framework.

This said, policymakers must recognise that VDAs are a new innovation in the financial market and are similar to other classes of financial assets which were introduced in the past in the traditional financial market. Thus, VDAs are inclined to incur risks like any other new investment product. If the need arises, policymakers may consider developing differentiated regulations based on risks associated with different VDAs in India, similar to other financial assets, rather than presuming all VDAs carry equal risk weightage. Unless the VDA market is given the opportunity to develop, the next phase of financial market innovation will not take off.

## 9. Purpose and Outcome of the Discussion

The Policy Consensus Centre organised an online discussion on "Regulatory Roadmap for India's Virtual Digital Asset (VDA) Sector" on 13th February 2025 to understand the immediate challenges in the VDA sector, examine the impact of policy reforms undertaken in the past and ingeminate the need for further reforms in the VDA sector in India. The panel for this discussion consisted of Dr. Ashima Goyal, Professor, Indira Gandhi Institute of Development Research (IGIDR), Mr. Antonio Zaballos, Director of Digital Technology Solutions, Asian Development Bank, Mr. Dilip Chenoy, Chairperson, Bharat Web3 Association (BWA), Ms Pallavi Singh Rao, Partner, Cyril Amarchand Mangaldas, and Mr. Jaideep Reddy, Partner, Trilegal. The discussion also heard comments from Mr Ramakrishna Venkatesh, Senior Vice President & Head – Public Policy, CoinSwitch and Director, Bharat Web3 Association. The purpose of this webinar was to understand the types of risks associated with VDAs that are particularly pertinent to India and how VDAs can be regulated. This policy brief distils recommendations from the discussion into core policy actions to guide India's crypto regulatory journey.

## 10. Recommendations

*Adopt a Balanced, Innovation-Friendly Regulatory Framework*

India needs to move away from a ban-centric approach in the crypto ecosystem. Rather regulations should be developed to allow for market visibility, regulatory learning, and prevention of illicit use rather than pushing activity underground. Further, innovation should be encouraged by developing regulatory sandboxes for

blockchain/Web3 projects, ensuring young tech talent can develop solutions domestically.

*Establish a Dedicated or Coordinated Regulatory Structure*

For a holistic growth of the crypto ecosystem and VDA market in India, policy makers should consider immediate regulatory and supervisory reforms in the sector. To enable this, either of these two options may be considered.

- Option one is to set up an independent or apex VDA regulator with cross-representation from relevant policy makers such as the RBI, SEBI, IRDAI, Ministry of Finance, MEITY, Department of Science and Technology and technology experts.
- Option two is to maintain jurisdiction within existing regulators but establish a formal coordination mechanism under the Financial Stability and Development Council (FSDC).

It was further suggested that capacity building within regulators should be undertaken for real-time monitoring, enforcement, and adaptation to evolving VDA use cases. An immediate actionable step is to release the much-awaited Comprehensive Discussion Paper on VDA regulation by the Government of India outlining global learnings, potential models for India, and seeking stakeholder input within a fixed timeline.

An SRO-led code of conduct should be developed for token listing, trading practices, and cyber-security compliance. This will go a long way in setting an example for good business practices and building credibility for the industry. Saying that, SROs in India are essentially affiliated or recognised by a nodal regulator or a line ministry. In India, the VDA sector neither has a nodal policy maker, nor has defined regulations. Thus, setting up an SRO is not just challenging but also be ineffective. SROs are effective in laying down good business practices, creating compliance etc., despite the fact that they have limited enforcement ability. In absence of regulatory guidelines and any penalising capacity, an SRO will be ineffective.

*Strengthen Law Enforcement and Cross-Border Coordination*

The Financial Intelligence Unit - India (FIU-IND) must be empowered with penal powers beyond website blocking to act against non-compliant or offshore VDA entities serving Indian users. Enhancing cooperation and creating partnership with international regulators will further help in recovering stolen assets and help in

investigating cybercrime incidents. To prevent cases of illicit trade and financing criminal operation through VDAs, wallet-level KYC and registration for peer-to-peer and DeFi transactions should be encouraged, wherever feasible. Allowing registration of crypto wallets through banks (similar to South Korea) can be cross-verified with banks.

*Investor Protection and Prioritising Public Awareness*

Introducing licensing requirements for wallet providers and VASPs with minimum operational, cybersecurity, and governance standards would prevent malpractices and fly by night operators from undertaking business. Moreover, to increase investor protection and raise awareness, the government should mandate clear risk disclosures and investor education campaigns by exchanges and VASPs. Further, such entities must be encouraged to develop compensation mechanisms and/or mandatory insurance coverage for user assets held by platforms.

A pan India VDA awareness campaigns on risks, rights, and fraud prevention should be launched for public awareness on VDAs and the crypto sector. Further, cybersecurity and VDA literacy must be integrated into broader digital financial inclusion programmes.

*Reform the Taxation Regime to Curb Arbitrage and Capital Flight*

Reducing TDS on VDA transactions from 1% to a market-friendly rate (e.g., 0.01%) or replacing TDS with a securities transaction tax-style levy will help grow businesses as well as encourage more start-ups in the sector. This apart, permitting set-off and carry-forward of losses in line with treatment of other financial assets will benefit the industry.

The Government of India should focus on aligning VDA taxation with securities/commodities to minimise domestic and cross-border arbitrage to lessen tax burden on legitimate market players and prevent grey market trade. Linking tax rationalisation to mandatory reporting and AML/CFT compliance will also help in bringing transparency and prevent fly by night operators from entering the market.

*Integrate VDAs into India's Digital Public Infrastructure*

The Government of India must restore UPI and CKYC integration for compliant domestic exchanges and VASPs to improve user experience and bring down migration to foreign platforms. To popularise and encourage CBDC operations in

India, CBDC-based settlement should be enabled for VDA transactions. This will further facilitate regulatory oversight and help data tracking, particularly for cross-border remittances.

*Support Domestic Web3 Industry Growth*

The Government of India should consider offering startup-friendly corporate tax rates for VDA and Web3 enterprises similar to manufacturing incentives. Moreover, removing barriers to accessing and staking development tokens for Layer-1/Layer-2 blockchain participation and providing clarity on token-based compensation for developers, enabling legitimate earning and declaration of income will help in supporting start-ups and smaller players.

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## About Policy Consensus Centre (PCC)

The Policy Consensus Centre (PCC), founded by Ms. Nirupama Soundararajan and Mr. Arindam Goswami, emerges with a distinct mission: to conduct impactful policy research and drive policy transformations. Our focus encompasses pivotal sectors crucial for India's advancement, along with those that have been underexplored. In the intricate landscape of India, divergent opinions often hinder consensus-building for policymakers amidst diverse stakeholders.

PCC stands dedicated to comprehensive, evidence-driven research, promoting inclusivity and rigor. Our objective resides in cultivating accord among stakeholders through independent, data-centric analysis, a catalyst for meaningful policy shifts. In a climate where some research entities avoid unconventional subjects, PCC remains resolute in advocating thorough exploration across all sectors. Our belief underscores the necessity to scrutinize seemingly unconventional domains, an approach vital for identifying accurate risks and formulating sound policies.

PCC champions the synergy of economic rationale and empirical data, pivotal in fostering consensus and enabling effective policymaker engagement. In essence, PCC embodies a pioneering spirit committed to navigating uncharted territories, propelling well-informed policy decisions for India's holistic growth.

Ms. Nirupama Soundararajan
Co-founder & CEO
Mobile: +91 9971100996
Email: nirupama@policyconsensuscentre.org

Mr. Arindam Goswami
Co-founder & Partner
Mobile: +91 9811095423
Email: arindam@policyconsensuscentre.org