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# Dawn of Crypto Derivatives: Impact of Internet and Mobile Association of India v. Reserve Bank of India

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## ABSTRACT

*Crypto-currencies are an exciting phenomenon of virtual world. Since their advent they have been seen as volatile and deceiving instruments by regulators around the world. However their adoption among the masses and backing of big names in tech has enabled them to weather the storms.*

*Indian regulators have been highly apprehensive of crypto-currencies and for good reason. However as the understanding of these assets has developed, we are in a better position to regulate them and benefit from their value. The current article discusses the impact of 2018 RBI circular banning bank from providing banking services to crypto-currency participants and the recent Supreme Court's decision in Internet and Mobile Association of India v. RBI which removed that blanket ban.*

*The analysis of the above mentioned judgment has been done in the backdrop of crypto-derivatives market which is witnessing a global boom. The article places reliance on existing regulatory framework along with reports of public and private institutions to analyze the need of a robust and efficient framework.*

The Derivatives are a category of risk management tools which have the primary function of transferring risk by providing mechanism for liquidity and price discovery. They derive their value from an underlying asset and can take many forms such as forwards, futures, options, swaps etc. These instruments are highly attractive and appealing because of their liquidity, leveraged positions and ascertained risk. While traditionally, derivatives have derived their value from commodities, currencies, interest rates etc, in recent times, with major stock exchanges embracing crypto-currency, their portfolio has expanded.<sup>1</sup>

The explosion of crypto-currencies has taken the world by storm.<sup>2</sup> India has not been immune

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<sup>1</sup>CoinDesk. 2019. Nasdaq Lists An AI-Powered Index Of Crypto Market's Top 100 Performers - Coindesk. [online] Available at: <<https://www.coindesk.com/nasdaq-lists-ai-powered-crypto-index>> [Accessed 15 May 2020].

<sup>2</sup>Fortune Business Insights, n.d.Cryptocurrency Market Size, Share And COVID-19 Impact Industry Analysis, And Regional Forecast (2020-2027). [online] Available at: <<https://www.fortunebusinessinsights.com/industry->

to the phenomenon of crypto currency and the recent Supreme Court Judgment opens doors for development of crypto market in India. The effect of this judgment is that it allows banks to provide banking services to participants in crypto market which was earlier banned by RBI in 2018.<sup>3</sup> Against this backdrop, the crypto exchanges are mulling to enter into the derivative segment<sup>4</sup>.

The derivative market in India is regulated by SEBI and RBI with jurisdictions over different types of products.<sup>5</sup> As a result both Securities Contracts Regulation Act and RBI act define the term derivative. Under the Securities Contracts Regulation Act, derivative has been defined to include:<sup>6</sup>

- (a) A security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;
- (b) A contract which derives its value from the prices, or index of prices, of underlying securities.

The RBI Act defines derivative to mean “*an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities, or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the bank from time to time.*”<sup>7</sup>

The above given definitions are not exhaustive but illustrative. On the face of it both the definition can be interpreted to include crypto-currencies within its ambit. In the crypto-currencies case, Internet and Mobile Association of India had put forth the argument that virtual currencies are not real money. The contention was that, virtual currencies should be seen as commodity and hence they should be outside the purview of RBI, whose primary function is to deal with payment systems. Supreme Court had looked into definitions of crypto-currencies in various jurisdictions and said that because of the characteristic of virtual currencies whereby they can be used as a medium of exchange, they fall under the ambit of

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reports/cryptocurrency-market-100149> [Accessed 29 May 2020].

<sup>3</sup>Rbi.org.in. 2018. Reserve Bank Of India - Notifications. [online] Available at: <<https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11243>> [Accessed 15 May 2020].

<sup>4</sup>Cointelegraph. 2020. Large-Scale Crypto Derivatives Trading May Be In India’S Future. [online] Available at: <<https://cointelegraph.com/news/large-scale-crypto-derivatives-trading-may-be-in-indias-future>> [Accessed 16 May 2020].

<sup>5</sup>Arthapedia.in. n.d.OrganisationOf Derivatives Market In India - Arthapedia. [online] Available at: <[http://www.arthapedia.in/index.php?title=Organisation\\_of\\_Derivatives\\_Market\\_in\\_India](http://www.arthapedia.in/index.php?title=Organisation_of_Derivatives_Market_in_India)> [Accessed 9 May 2020].

<sup>6</sup>Securities Contracts (Regulation) Act, 1956. 2(ac).

<sup>7</sup> Reserve Bank of India Act, 1934. 45(U).

‘other currency’ in Section 2(h) of FEMA. While the judgment does give some clarity with respect to identity crisis of virtual currencies the debate is far from over. However this should not pose any issue as the essence of definitions is that there must be an underlying security. Further if they are interpreted as other currency then crypto-instruments are valid for currency derivative segment. While the exact legal position cannot be pointed out with utmost accuracy, there is no doubt that the scope and potential of crypto-currencies has received a favorable impetus.

The judgment has also opened up gates for market makers to enter into the market for derivative trading. They are essential for a vibrant derivative segment and ensure that risk can be transferred to one who is better suited to take it. A market maker needs to apply to RBI for approval on fulfilling the eligibility criteria.<sup>8</sup> Prior to this, market makers in India could not provide services because of the blanket ban on banks from providing banking services. The SCRA further provides that for derivative trading to be legal and valid, the contracts are needed to be<sup>9</sup>:

- (a) Traded on a recognized stock exchange;
- (b) Settled on the clearing house of the recognized stock exchange;

The idea is to create a layer of regulation to ensure investor protection. However when derivatives are traded on OTC then this section does not apply. OTC derivatives are regulated by RBI and are legal as long as one of the parties is under RBI’s jurisdiction.<sup>10</sup> OTC contracts are those that are traded directly between two eligible parties, with or without the use of an intermediary and without going through an exchange.<sup>11</sup> The OTCs have a trust deficit compared to recognized stock exchanges and when seen in the context of widely held adverse public opinions for crypto-currencies, the need to have recognized exchange is felt. As such crypto-exchanges are not banned in India<sup>12</sup>. In fact the current regulatory framework allows for their functioning in exchanging one crypto-asset for another without the liberty to change them into currencies<sup>13</sup>. If these assets are to be exchanged for legal tender then investor has to go to foreign markets and take a detour for receiving payment in INR. Seeing the inefficiency

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<sup>8</sup>Reserve Bank of India, n.d. Draft Comprehensive Guidelines On Derivatives. p.3.

<sup>9</sup>Securities Contracts (Regulation) Act, 1956. 18(A).

<sup>10</sup> [Rbidocs.rbi.org.in](https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/DGBDFS280710.pdf). 2010. [online] Available at: <<https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/DGBDFS280710.pdf>> [Accessed 20 May 2020].

<sup>11</sup>Reserve Bank of India, n.d. Draft Comprehensive Guidelines On Derivatives. p.2.

<sup>12</sup>Bitcoin News. 2020. RBI Confirms No Ban On Cryptocurrency Exchanges, Businesses Or Traders In India | Regulation Bitcoin News. [online] Available at: <<https://news.bitcoin.com/rbi-confirms-no-ban-cryptocurrency-exchanges-businesses-traders-india/>> [Accessed 5 June 2020].

<sup>13</sup>Express Computer. 2020. Now To Regulate Cryptocurrencies In India ... - Express Computer. [online] Available at: <<https://www.expresscomputer.in/news/now-to-regulate-cryptocurrencies-in-india/53021/>> [Accessed 15 May 2020].

of this, steps have been initiated to bring them under the ambit of SEBI.

Crypto-currencies are a new asset class and highly exciting. The primary reason for suffocating regulations up till was the volatility and limited understanding of crypto-markets. As the world moves towards this new niche of financial products, India cannot fall behind. The primary reasons for ban are now the very rationale for developing a strong and robust regulatory framework. A recognized exchange is need of the hour which lowers the risks in derivative trading such as credit risk, market risk, liquidity risk, operational risk and legal risk. There was a time when derivatives were banned in India however we have come a long way since.

The rise of crypto asset funds around the globe<sup>14</sup> holds evidence of the fact that with proper understanding these new financial products can create value through their global nature. Initial Coin Offerings are increasing around the world and are driven by the factors such as lower costs, democratized holding and global base. Now the world is in a better position to understand crypto-currencies. The inception of regulatory sandboxes<sup>15</sup> by RBI and SEBI can be a boon to further enhance the understanding of this new tech enabled innovation and allow them ample space to showcase potential. Like any asset, crypto-currencies too hold value; the question is only how much do regulations allow harnessing them.

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<sup>14</sup>PWC, 2020. 2020 Crypto Hedge Fund Report. [online] Available at: <<https://www.pwc.com/gx/en/financial-services/pdf/pwc-elwood-annual-crypto-hedge-fund-report-may-2020.pdf>> [Accessed 29 May 2020].

<sup>15</sup>Mondaq.com. 2019. Differences Between Regulatory Sandbox Provision Of IRDAI, SEBI And RBI - Finance And Banking - India. [online] Available at: <<https://www.mondaq.com/india/financial-services/838320/differences-between-regulatory-sandbox-provision-of-irdai-sebi-and-rbi>> [Accessed 4 June 2020].