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CRYPTO IN THE LEGAL SHADOWS: ANALYSING GREY AREAS IN INDIAN CYBER LEGISLATION

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Abstract:

Cryptocurrency usage in India has grown exponentially and at the same time the regulatory scenario is quite disjointed and confusing in terms of legality. The Reserve Bank of India has been issuing warnings about the dangers of cryptocurrencies since 2013. The Supreme Court decision in IMAI v. RBI (2020) overturned the banking ban. Nonetheless, the nation has not yet come up with a comprehensive legal framework for virtual digital assets (VDAs). This article outlines major legal loopholes in the Information Technology Act, 2000 as well as other financial laws, such as absence of clear definitions, jurisdictional issues, security deficiencies, and lack of consumer protection measures. Besides briefly mentioning the Morris Coin scam and the WazirX hack, this article employs doctrinal and comparative methods to study the regulatory frameworks of USA, EU, and China. The paper proposes a regulate and innovate approach for India which includes a central regulatory authority, digital asset law, AML/KYC upgrades, unified tax and cybersecurity standards, i.e. the basics for new legislation and simultaneously investor protection and systemic resilience.

1. Introduction:

The creation of Bitcoin in 2009 marked the start of a kind of financial system that operates without a central authority. This system directly challenges the people in charge of overseeing the sector. In India people did not welcome this new technology with excitement. Instead they viewed it with a lot of doubt. In 2013 the Reserve Bank of India started warning people about the dangers of Bitcoin and other cryptocurrencies. The main concerns were the changes in prices and the potential risks to consumers. Other issues that were mentioned included the use of Bitcoin and other cryptocurrencies for activities like money laundering and funding terrorist groups. Far the government has not taken any strong action against these issues.¹

¹ *Internet and Mobile Association of India v. RBI*, 2020 SCC OnLine SC 275

Then in April 2018 the Reserve Bank of India took a step and stopped banks and other financial institutions from working with the Bitcoin and cryptocurrency industry. This move completely stopped the growth of the Bitcoin and cryptocurrency industry in India. The ban was challenged in court and the Supreme Court eventually canceled it in the *Internet and Mobile Association of India, versus Reserve Bank of India* case. The Court said that the ban was unfair and that the Reserve Bank of India had not shown any proof of the harm caused by Bitcoin and cryptocurrency operations. The Court also said that the Reserve Bank of India did not follow the rules of proportionality.

Despite this court relief there was still confusion in the laws. The 2019 Garg Committee Report suggested banning cryptocurrencies completely but it was never implemented. At the time the 2022 Union Budget imposed a 30% tax and 1% tax deduction on crypto transactions, which kind of acknowledged crypto but without proper rules. Later in 2023 the Ministry of Finance brought crypto exchanges under the Prevention of Money Laundering Act making them follow regulations.²

On the hand India still lacks a main law that defines or regulates cryptocurrencies. The Information Technology Act of 2000 does not cover blockchain, tokens or virtual assets. The RBI, SEBI, MeitY and ED have overlapping areas of control, which is causing confusion. With scandals like the Morris Coin fraud and WazirX hack the lack of regulation is a threat, to users and the economy. A sensible and comprehensive legal framework must be set up without delay.

2. Legal Commentary and Policy Analysis:

Scholars in India have been saying for a time that the laws in India are not good enough to deal with the issues related to crypto assets. Parul said in 2021 that the IT Act³ and financial laws do not have a definition of assets, which makes it hard for the people who enforce the law. Nakul Dewan and Rohan Naik wrote in 2020 that the decision of the Supreme Court in the case of *IAMAI versus RBI*⁴ was a relief for the people who use crypto assets because the court said that the rules for digital finance should be fair and reasonable.

² Garg Committee Report, Ministry of Finance (2019).

³ Parul (2021), *Legality and Scope of Cryptocurrency in India*.

⁴ *Internet and Mobile Association of India v. RBI*, 2020 SCC OnLine SC 275

The Garg Committee⁵ said in 2019 that crypto assets should be completely banned because they are worried about the fact that crypto assets can be used secretly and that people can use them to do things. However Gupta and Anuradha⁶ said in 2020 that these problems can be fixed by making rules for crypto assets. The Vidhi Centre for Legal Policy and the International Bar Association, which are groups that think about issues have been very critical of the way India is dealing with crypto assets. They say that the way the Reserve Bank of India the Securities and Exchange Board of India the Enforcement Directorate and the Income Tax authorities are all involved, in regulating crypto assets is very confusing and does not work well.

3. Loopholes in the Indian Cyber Law:

Though more people in India are using cryptocurrencies, the current cyber crime laws are not enough. They are old and not well organized. The laws do not clearly define which areas are under which authorities. There are no working methods for the authorities. This causes problems, for users, regulators and courts. They struggle with rules, Because of these gaps it is hard to implement policies, Regulatory arbitrage increases The rights of investors suffer.

I. Absence of Definition and Classification:

Indias laws do not say what cryptocurrency, virtual digital asset or blockchain token mean. This makes it hard to make rules because it is not clear if these things are money, investments, products or information. The government is not sure how to deal with them. The laws that are already in place like the IT Act from 2000 and the RBI Act from 1934 do not help explain what these terms mean. As a result different groups are trying to be in charge. They do not have a clear reason to do so. This situation is also affecting people who invest in cryptocurrency because Indian law does not clearly say what their rights and responsibilities are when it comes to crypto transactions. Indias laws need to be clearer, about cryptocurrency, virtual digital asset and blockchain token so that investors are protected.

II. Jurisdictional Ambiguity:

The blockchain is special because it is decentralised. This makes it really hard to apply

⁵ Garg Committee Report, Ministry of Finance (2019).

⁶ Gupta & Anuradha (2022), *Cryptocurrency in India: Legal and Economic Analysis*.

the law Section 75 of the IT Act, 2000 when it comes to things that happen outside of India. Most crypto transactions do not care about borders the people using them do not have to give their names and they are checked by computers all around the world. This makes it very difficult to figure out which part of the transaction is subject to law. For example when people trade with each other directly using exchanges the Indian regulators have no power to track or punish the people from other countries who are doing things that are against the law. What is more if the platform is based in another country or is owned by a company that's in a place that does not charge much tax then the Indian laws about cyber crimes are almost impossible to enforce. The blockchain and crypto transactions are a problem, for Indian regulators because they are decentralised and borderless.

III. Enforcement and Cybersecurity Gap:

Although the IT Act talks about hacking and data theft it does not mention cybersecurity rules for blockchain platforms or exchanges that hold crypto for users. This means crypto exchanges do not need to do checks have systems to detect hacking or report when they are breached. The big problem with WazirX in 2024, where losses were over \$230 million shows what happens when there are no standards. It leaves users very vulnerable. Crypto platforms are different from banks, which have to follow cybersecurity rules set by the RBI. Users of crypto platforms do not have the level of protection or way to resolve issues if something goes wrong which is a major concern. The IT Act does mention hacking under Section 66 and data theft under Section 43. For now crypto exchanges operate with a lot of freedom and little oversight. This freedom can put users at risk because there are no required audits or breach reporting protocols. The lack of rules to those, for banks, which follow RBIs risk assessment and incident response mechanisms leaves users without institutional help or protection. The example of WazirX highlights the need for regulations to protect users and their assets.

IV. Consumer Protection and Legal Remedies:

Indias rules to protect consumers are not good enough for people using crypto. The Consumer Protection Act 2019 does not clearly say that crypto exchanges are covered under it. This makes it unclear how people can solve problems they face. When people get cheated in crypto deals they have to use laws like Section 318 (cheating) and Section 316 (criminal breach of trust) of the BNS. The Morris Coin scam showed how

bad the system is. Over 1200 crore was lost. People are still trying to get their money but its taking a long time because there are no specific rules for crypto fraud. Investors have to go to court and spend a lot of time and money fighting for their rights. They are also confused about which court or tribunal can help them. The lack of rules for crypto is a big problem for people, in India. Investors want rules so they can trust crypto and feel safe.⁷

V. Tax Arbitrage and Evasion Risk:

The government has introduced a thirty percent tax on digital assets and a one percent tax deduction at source through the Finance Act, 2022. This has caused a lot of problems for the government to make sure people pay their taxes. Many traders are now using digital assets on exchanges in other countries and on over-the-counter platforms to avoid the government tracking their tax deduction at source. The problem is that the government has not clearly said how virtual digital assets should be treated under the Foreign Exchange Management Act. This makes it hard for the government to keep track of people sending digital assets across borders. Because of this users are finding ways to avoid paying taxes in India by using private networks peer to peer platforms or keeping their virtual digital assets in wallets in other countries. The fact that countries do not automatically share digital assets transaction data, with each other makes it easier for people to avoid paying taxes on their virtual digital assets.⁸

4. Case Studies:

i. IAMA v. RBI:

In April 2018 the Reserve Bank of India issued a circular that stopped banks and other financial institutions from working with cryptocurrencies. This really hurt cryptocurrency exchanges in India. Caused big problems for the digital asset market. The Internet and Mobile Association of India which represents people who work with things did not agree with this decision. They said it was not fair because it stopped people from doing business which's a basic right under the Constitution.

On March 4 2020 the Supreme Court made a decision in favor of the Internet and Mobile Association of India. The Court said that the Reserve Bank of India did not

⁷ *LiveMint*, WazirX Security Breach Reports (2024).

⁸ *Economic Times* (2023), Crypto Taxation and Market Shifts.

have a reason to stop cryptocurrency exchanges and that they did not have enough proof that virtual currencies were causing harm. The Court also said that the Reserve Bank of India has the power to make rules but they have to follow the Constitution. This important decision allowed crypto businesses to work with banks again. Showed that regulations should be fair and not stop new ideas from happening. However the decision did not make a plan, for virtual currencies so there are still some things that are not clear. The decision showed that India needs to make laws that explain how digital assets can be used.⁹

ii. Morris Coin Scam:

The Morris Coin scam that happened from 2020 to 2021 is one of the cryptocurrency scams in India. This scam was presented as an Initial Coin Offering. The people who invested in the Morris Coin scam were told they would get returns of 2 percent to 3 percent. Than 900 people invested around ₹1,200 crore in the Morris Coin scam because they thought they would get a lot of money back.. It was found out that the Morris Coin did not even exist. The money that was collected was used to buy properties in Kerala, Tamil Nadu and Karnataka.

The Enforcement Directorate took assets ₹14 crore because of the Prevention of Money Laundering Act. The main person accused, Nishad K and the people who helped him were arrested.. This case showed that there are big problems in Indias laws when it comes to digital asset fraud. Since there are no rules for cryptocurrency scams the authorities had to use general laws. This shows that India really needs laws that're just for digital assets to stop scams, like the Morris Coin scam. The Morris Coin scam is an example of why India needs these laws.¹⁰

iii. Wazir X Hack:

On July 18 2024 WazirX, one of Indias leading cryptocurrency exchanges had a problem. It got. People lost a lot of money around \$235 million. The people who did this were from North Koreas Lazarus Group. They found a way into WazirXs system because it was not secure enough. The hackers played with the contracts to get into the wallets that had money in them. They took money from both the cold wallets. This

⁹ *Internet and Mobile Association of India v. RBI*, 2020 SCC OnLine SC 275

¹⁰ *Business Today*, Morris Coin Scam Coverage (2022).

problem affected a lot of people around 15 million users. So the company had to stop trading for a while.

The big problem showed that India's cryptocurrency exchanges do not have to follow security rules. This made people want the government to make new rules to keep people's money safe. The problem also showed that cryptocurrency exchanges need to be more careful. They need to make their wallets more secure and watch what is happening all the time. They need to make sure they can tell people what happened if something goes wrong. Other cryptocurrency exchanges like WazirX need to do these things to keep people's money safe. The cryptocurrency exchanges like WazirX need to have a plan to deal with problems, like this.¹¹

5. Comparative Global Approach:

A. United States:

The rules for cryptocurrencies in the United States are made by different agencies each in charge of a different part. The SEC uses the Howey Test to decide if a digital asset is a security, which means it follows securities laws. The CFTC says Bitcoin and Ether are commodities and it regulates them when they are traded on derivatives markets. The IRS thinks of cryptocurrencies as property. You have to pay capital gains tax on profits from trading them. Also FinCEN makes sure that cryptocurrency exchanges follow -money laundering and know-your-customer rules. This system has different agencies involved which can be confusing and make it hard to follow the rules. Companies have to follow rules from agencies, which can be very expensive. However lawmakers are starting to work on rules and there are bills like the Digital Commodity Exchange Act and the Crypto Regulation Clarity Act that could make things simpler. Even though the system is not well organized it does make sure that there are no loopholes that people can use to avoid the rules. This approach is more about being careful and strict unlike in India, where the rules are still being developed. The United States cryptocurrency regulatory framework involves agencies. The SEC, CFTC, IRS and FinCEN all play a role in regulating cryptocurrencies. The SEC focuses on securities laws while the CFTC oversees commodities. The IRS looks at cryptocurrency as property, for tax purposes. FinCEN enforces -money laundering rules.

¹¹ *LiveMint*, WazirX Security Breach Reports (2024).

B. European Union:

The European Union made a rule called Markets in Crypto-Assets Regulation in 2023. This rule makes sure that all countries in the European Union follow the laws when it comes to Crypto-Assets. The rule says that tokens are put into groups like utility tokens, asset-referenced tokens and e-money tokens. It also says that companies that work with Crypto-Assets called Crypto-Asset Service Providers have to get a license and follow some rules. These rules include having some money saved up and being honest with their customers. They also have to tell their customers everything they need to know and follow some rules to stop money laundering.

The European Unions Markets in Crypto-Assets Regulation is special because it is clear and helps new ideas happen. It tries to protect people who invest in Crypto-Assets while also letting companies try things. This helps avoid problems that happen when different countries have rules like in the United States and India. For India the European Unions Markets in Crypto-Assets Regulation is an example of how to make rules, for digital assets. It can help make things more transparent and make it easier for companies to work with each other across borders. This can also help people trust the crypto economy more.¹²

C. China:

China has taken a stance against cryptocurrencies. In 2021 China stopped all cryptocurrency transactions, mining and exchanges from happening in the country. China said that only the digital yuan, which is Chinas digital currency is allowed. China did this to control the money leaving the country stop people from making investments and keep an eye on digital money.

This approach gets rid of confusion about the rules. Stops illegal cryptocurrency activities.. It also hurts the development of new blockchain ideas and limits what people can do with their money. Chinas strict rules are very different from what other countriesre doing. For example India cannot just ban everything because it would not be fair and would not work. India needs to find a balance between making rules and allowing new ideas to happen. This means India should look at what China's doing and what the European Union is doing and use the good parts to create a strong digital economy for India and the digital economy of India and the future of digital yuan and

¹² European Union, *MiCA Regulation* (2023).

cryptocurrencies, in India.

6. Recommendation for Legal Reforms:¹³

- **Pass a Dedicated Cryptocurrency and Digital Assets Regulation Act:**

India needs to make a law that explains what digital assets are and puts them into groups, like cryptocurrencies, utility tokens and bank digital currencies. This law should say that cryptocurrencies are okay to use. They are not real money and it should give us rules to follow when we use them. If India makes this law it will help people who invest in assets and businesses that work with them. They will know what to expect. It will be safer for them to do business. India can keep people safe. Help new ideas happen in the crypto space if it makes clear rules for everyone to follow.

- **Establish a Central Regulatory Authority:**

India needs to make it easier to keep an eye on things. To do this India should think about making a group that watches over digital assets like a Digital Asset Regulatory Authority or DARA. This group would have people from the RBI, SEBI, ED, MeitY and the Ministry of Finance working together. The Digital Asset Regulatory Authority would be in charge of giving licenses keeping an eye on things and making sure digital asset service providers follow the rules. Having one group in charge would help avoid confusion and make sure the rules are applied consistently. This would make things easier for people involved and make it simpler for India to deal with changes, in the asset sector. The Digital Asset Regulatory Authority would be the one place to go for help which would make things a lot easier.

- **Amend the IT Act:**

The Information Technology Act, 2000 should also be amended to take care of blockchain technology and smart contracts and crypto-related cybercrimes. This is because The Information Technology Act, 2000 has to take care of things such as blockchain technology and smart contracts. It should clearly define what a smart contract is. The Information Technology Act, 2000 should also make smart contracts legally binding so that digital contracts made using smart contracts are legally valid.

¹³ FATF (2021), *Guidance on Virtual Assets and VASPs*.

The Information Technology Act, 2000 should also make rules for investigating and prosecuting crimes related to assets such as hacking a cryptocurrency wallet or breaking into a blockchain network. The Information Technology Act, 2000 should also discuss blockchain technology and smart contracts. By amending The Information Technology Act, 2000, India's laws will also become better equipped to handle new technologies such as blockchain and crypto. This will also strengthen India's laws so that they become better equipped to handle challenges. The Information Technology Act, 2000 and blockchain technology and smart contracts are related. The Information Technology Act, 2000 should also define what contracts and blockchain technology are. The Information Technology Act, 2000 should also be amended to take care of crypto-related cybercrimes.

- **Cybersecurity Standards for Exchanges:**

The implementation of the mandatory cybersecurity standards by crypto exchanges is of critical importance to ensure the safety of users and instill confidence in the digital asset market. The cybersecurity standards should also include aspects such as the cold wallet reserves of assets, technical audits to assess risks, and the reporting of cybersecurity breaches.

The consequences of non-compliance and negligence should be clearly defined. By enforcing stringent cybersecurity standards, India can avoid the possible risks of hacks and breaches, thereby protecting the interests of investors.

7. Conclusion:

Thus, it can be stated that the present scenario is a critical juncture for the evolution and growth of the digital asset environment in the country. The cryptocurrencies have gained widespread popularity in the recent past. The popularity of cryptocurrencies is not just for investment purposes but also for their use as a tool for innovation. However, it is also important to understand that the environment in which cryptocurrencies are operating is fragmented and unregulated. This is also the reason why several challenges are being faced due to the lack of a comprehensive legal environment.

The scams like the Morris Coin scam and the WazirX hack are a reminder of the need for a legal environment for the growth and evolution of the cryptocurrency environment. The

government is taking several steps to deal with the situation, like taxing profits from cryptocurrencies and including it in the PMLA. This is, however, a piecemeal approach towards dealing with the problem. It is of critical importance for the government to take a proactive approach towards dealing with the problem. A 'regulate and innovate' approach would enable the government to take advantage of the benefits provided by blockchain and cryptocurrency technologies.

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