

## **A CRITICAL LEGAL STUDY RELATING TO THE PLAUSIBILITY OF A REGULATORY FRAMEWORK ON CRYPTOCURRENCY IN SRI LANKA**

Samaradiwakara S.<sup>1</sup>

### **Abstract**

Incredible innovations come with huge opportunities for the then existing practices and also with potential risks associated with them. Cryptocurrency is not an exception to this. Crypto is a constantly evolving topic and has gained momentum in both national and international forums. Having introduced ten years ago, the lack of unanimity in regulating and defining the crypto and associated mining process and the dilemma in associated jargon has created the lawmakers to have only three options available and they are to completely ban, regulate the mechanism, or completely ignore it and let the cryptocurrency to float on the hands of the owners. This paper intends to analyze the current legal positions in India and the European Union in regulating Virtual Currencies. It is an undisputable fact how the opportunity is exploited by the abusers to engage in illicit purposes in the absence of an effective legislative mechanism. The paper engages in justifying the necessity of a regulatory mechanism, which will be conducive to the thriving of the economy of the country amidst an economic crisis. The paper employs a black letter approach and an international and comparative one where the decided case laws and legislations are used as primary sources, and the scholarly articles and journal articles constitute secondary sources. The paper suggests that a complete ban will not be a panacea but a regulation to a certain extent is mandatory rather than ignoring the topic from the eyes of the legislature.

*Keywords:* Cryptocurrency, Economy, Illicit Purposes, Money, Regulations

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<sup>1</sup> Lecturer (Probationary), Department of Law, University of Jaffna. Email: sujathaasamaradiwakara@gmail.com

## **1. Introduction**

*“What we view as money has changed over time. Cowrie shells once were such a medium but they no longer are. Our currency originally included gold, coins and bullion, but after 1934, gold could not be used as a medium of exchange. Perhaps one day employees will be paid in Bitcoin or some other type of currency-Breyer Judge (Wiscoin Central Ltd v United States, Jan 12, 2018)*

Cryptocurrency regime has posed concerns to the orthodox definition of money and has become a threat to state backed monetary operations. On the one hand, virtual currencies have the potential to improve the efficiency and inclusiveness of the financial system, and pro-contra it does raise issues concerning consumer protection, money laundering (ML), terrorist financing (TF), pyramid and ponzi schemes, threats to the ecosystem as a whole, tax evasion, market integrity etc. due to its pseudonymous nature. With Cryptocurrency handling transactions, payments, banking, insurance, trade, etc. domestically and internationally has changed to a level that was unexpected by anyone. It must be noted that when consideration is given to the global level, regulatory responses to cryptocurrency have ranged from a complete clamp down in some jurisdictions to a comparatively light touch regulatory approach. The lack of an exact definition as to what is meant by cryptocurrency, and the technical issues that underpin its creation have led to varying regulations and the main obstacle is on arriving at a common consensus. Cryptocurrency is currently at the frontier of development and has gained overwhelming and significant attention over the years. The underlying aim of the creation of digital or virtual currency was to liberate the monetary system from being backed and authorized by the central authority and from being operated in a manner prejudicial to private interests. As per the International Monetary Fund’s definition, cryptocurrency means a digital representation of value, issued by private developers and denominated in their own unit of account (Lagarde, 2016). Currently, there is no exact legal definition provided by the Central Bank of Sri Lanka as to what cryptocurrency means. Generally, fiat money is backed and controlled by the government due to its centralized nature pro-contra virtual currency unregulated digital currency which is developed and backed by the controllers and usually accepted by the specific virtual communities. There are four basic characteristics of a cryptocurrency; digital in nature, private, global, run on autonomous, and decentralized algorithms (Frank, 2018). Since Cryptocurrencies are not regulated and backed by a central and trusted authority, the theme has posed several legal implications.

### **Research problem**

The research problem entails that Virtual Currencies, despite the advantages offered by blockchain technology, are important, and a number of disadvantages are also a field of discussion to which lawyers have not yet found a solution. The lack of an overall definite definition that defines the crypto assets and the absence of a regulatory mechanism that demarcates the frontiers of the assets shall lead to a breach and lack of confidence in these innovative assets which will impact the development of a market in this type of assets and would lead to the missed opportunities in the gamut of innovative digital services, alternative payment instruments and new funding and new income and revenue sources. Cryptocurrencies provide a conducive

environment to a considerable number of crimes including internationally sensitive issues such as money laundering, terrorist financing, tax evasion, and many other undefined and unrecognized illegal activities. The anonymity of the transaction and the absence of any regulator and mediator expose financial markets that accept transactions through cryptocurrencies create the avenue to a number of illegal activities. Lack of a dedicated harmonized legislative framework is vital in building confidence among the consumers and traders who use the assets, and the law should be innovative friendly and should ensure that it doesn't pose any threat to innovative applications. It is an undisputable fact that legal certainty promotes innovation, financial stability, and consumer investor protection while balancing the interest of both parties to the transaction.

## **2. Literature Review**

Bitcoin was conceived by the pseudonymous Satoshi Nakamoto in his seminal white paper first published on 1 November 2008. Bitcoin was envisaged as “an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.” As a result of the central role played by cryptography in the system, bitcoin and its derivatives are known as cryptocurrencies. Once properly validated, bitcoin transactions are irreversible, or in the parlance of the Bitcoin community, immutable (Kelvin F. K. and TEO, 2017).

Bitcoin may be the media darling of the moment, but it is not the only virtual currency in existence. Other cryptocurrencies such as Lite coin, Geist Geld, Solid Coin, BBQ coin, and PP Coin are similar in nature to Bitcoin but claim to offer technological improvements that will make them faster, safer, or more convenient than Bitcoin (Hughes S. T., 2014).

Unlike most prior forms of “electronic money,” the system is neither derived from nor backed by any fiat currency. Instead, individual bitcoins are first created in the system through a process called mining. This process is intimately connected to the verification process by which transfers are tracked within the system. Instead of a centralized ledger (or register), the Bitcoin system employs a decentralized system of ledgers known as the blockchain. The blockchain is essentially a register containing information tracking the creation and transfer of bitcoins much like a bank ledger that tracks payments between bank accounts. (Kelvin F. K. and TEO, 2017). Technology is creating a trustless environment, i.e., a financial system without the need for trusted intermediaries. In the brave new world of cryptocurrencies, there is no need for commercial banks to facilitate fund transfers, nor for central banks to issue currency and control interest and exchange rates. There also are no authorities with clearly defined supervisory powers currently, no guarantees by institutions or insurers, and not even rules of the road enacted by legislators or courts (EMMERT, 2022).

Unlike most businesses that can be invested in, decentralized cryptocurrencies do not have a specific legal entity that is responsible for consumer protection. The virtual and decentralized nature of this technology makes the application of traditional legal frameworks untenable. Furthermore, the absence of a specific legal entity makes enforcement of any new legal framework tenuous. For

these two reasons, the current regulatory status of decentralized cryptocurrencies, or digital currencies, is enigmatic (Hughes, 2017). Several key challenges exist for regulators. First, most cryptocurrencies have a decentralized structure that is not confined to one legal jurisdiction. <sup>3</sup> While legislators can make consumers and businesses within a specific geographic location subject to regulation, a decentralized blockchain is difficult to regulate. Therefore, legislation should specifically state who is bound by the policy. Secondly, legislation should aim to be technology neutral. For example, the New York Bit license legislation is atypical because the Bit license doesn't regulate a particular business model but instead regulates the use of a specific technology. Legislation that targets a particular cryptocurrency may lead to the success or the demise of a particular cryptocurrency, irrespective of that cryptocurrency's particular merits on the market. Thirdly, the goals of the legislation should be clearly formulated and transparent for market participants. In order to reduce compliance costs, governments can provide suggested guidelines for consumers and businesses that are subject to the new legislation (Hughes, 2017). Uncertainty over security, the legality of its transactions, and the extent of consumer and investor protection has kept policymakers wary about its operations. Because of this, many central banks around the world try to inform the public about the difference between legal tender, which is backed by their central bank, and cryptocurrency, which is neither backed by the domestic nor other foreign monetary authorities. Furthermore, the combination of the speculative nature of cryptocurrency and its lack of supervision poses a threat to both investors and consumers. Although the cryptocurrency market itself is not large enough to pose a global risk at this time (Jacinta Bernadette, 2019).

Impact of regulation as discussed by Jason Weinstein, while it is often said that cryptocurrencies and blockchain technology are unregulated, nothing could be far from the truth. Numerous federal and state agencies in the United States, as well as agencies in other countries, regulate applications for this technology in some fashion but the disparate approaches taken by different countries, or even by different agencies within the U.S., have led to confusion on the part of block chain companies about the jurisdictions and regulatory regimes to which their products and services will be subject to (Jason Weinstein, 2018).

For countries where cryptocurrency transactions take place, policy makers also need to consider other policies or legal issues. In particular, the anonymous nature of cryptocurrency leads to concerns about using it to finance illegal activities such as trade in illegal substances, tax evasion, and financing of terrorism. Thus, particular regulations are put in place on top of existing laws on commercial activities (Jacinta Bernadette, 2019).

The advantages offered by block chain technology are important, but a number of disadvantages are also a field of discussion to which lawyers have not yet found a solution. Crypto currencies for example provide an environment conducive to a considerable number of crimes including internationally sensitive issues such as money laundering, terrorist financing, tax evasion and many illegal activities (Arvind Narayanan, 2016). The anonymity of the transaction and the absence of any regulator and mediator exposes financial markets that accept transactions through

cryptocurrencies to a number of illegal activities. Are cryptocurrencies full-fledged currencies? Goods? Or a piece of equipment for the international financial system? The above literature has focused mainly on interpreting the idea behind Virtual Currencies (VCs) their evolution and their impact on trade, the economy, banking activities, and tax system. In the Sri Lankan context, the literature that addresses the issue pertaining to the plausibility of the introduction of a regulatory mechanism on VCs are rare, and the topic is untouched by scholars. The author aims to fill the gap by articulating the definition of VCs from other literature on the topic and thereby to find the avenues in order to justify in bringing legislation before an act becomes a *fait accompli*.

### **Objectives**

The main objective of the paper is to explore the plausibility of a regulatory mechanism that deals with cryptocurrencies. Also, the paper intends to define cryptocurrencies through existing literature. Also, the paper strives to understand the evolution of cryptocurrencies and aims to give an idea of the current regulatory mechanism dealing with crypto currencies in India and European Union and finally to recommend some suggestions to the government in introducing the regulations to back the crypto currencies.

### **Research questions**

- How VCs could be defined?
- How the concept evolved?
- How money and currency could be distinguished?
- Does VCs could be defined under the gamut of “money”?
- Does the VCs could be classified under the definition of “property”?
- What are the impacts of VCs on banking, trade, tax fields etc.?
- What are the current regulatory mechanisms existing in India and the European Union?
- What recommendations could be suggested to the domestic legal system in advancing a regulatory mechanism dealing with virtual currency in Sri Lanka?

### **3. Methodology**

The research was carried out using two fundamental methodologies. The black-letter approach of research is used to have a deep and objective analysis of the law in the text, including legal provisions and judicial decisions that define cryptocurrencies. Also, international and comparative research methodology is used to assess the similarities and differences in regulating practices of cryptocurrency in different jurisdictions.

### **4. Results and Discussion**

George Freidman in one of his speeches *“Bitcoin is neither fish nor fowl. But both pricing it as a commodity when no commodity exists and trying to make it behave as a currency, seem problematic. The problem is not that it is not issued by the*

*Government nor that it is unregulated. The problem is that it is hard to see what it is”.*

Bitcoin was introduced in 2008 by its creator Satoshi Nakamoto, whose name is known to be a pseudonym. Nakamoto first published his groundbreaking paper Bitcoin A Peer-to-Peer Electronic Cash System in 2008, and shortly after, in the beginning of 2009, launched the Bitcoin network by mining the so-called genesis block (Internet and Mobile Association of India v Reserve Bank of India , 2018)Crypto is built on blockchain technology. Blockchain is a system of transferring information in a way that makes it impossible to change the system. Blockchain can be explained as a rectangular building of bricks, the building has no limit on its height, but it is balanced on completely well-laid bricks.

According to Satoshi, Bitcoin white paper enumerates that each user of the system could have one or more public Bitcoin addresses sort of like bank account numbers, and a private key for each address. The coins attached to a given address could be spent only by a person with the private key corresponding to the address. The private key was slightly different from a traditional password, which has to be kept by some central authority to check that the user is entering the correct password. As per the white paper, Bitcoin was introduced as a financial network that could create and move money without a central authority where no bank, no credit card company, and no regulators were involved. The system was designed so that no one other than the holder of a private key could spend or take the money associated with a particular Bitcoin address. What’s more, each user of the system could be confident that, at every moment in time, there would be only one public, unalterable record of what everyone in the system owned. The paper eloquently established that the underlying aim of the experiments in introducing Bitcoin was to bring an alternative to conventional currency, to counter the problems of debasement of currency by central agencies the root problem with conventional currency is all the trust that’s required to make it work. The Central Bank must be trusted not to debase the currency but the history of fiat currencies is full of breaches of that trust. What we want is fully anonymous, ultra-low transaction cost, transferable units of exchange. If we get that going the banks will become the obsolete dinosaurs they deserve to become. Be safe from the unfair monetary policies of the monopolistic Central Banks and the other risks of centralized power over a money supply. The limited inflation of the Bitcoin system’s money supply is distributed evenly (by CPU power) throughout the network, not monopolized by a banking elite.

### **Money v currency**

*“Much of the debate on what constitutes money in law is rather sterile and has few implications for the rights of parties to commercial transactions, where payment by bank transfer is the almost universal method of settlement. In most developed countries, where bank failures were until recently infrequent, a bank’s unconditional commitment to pay is treated as the equivalent of cash. The crucial question, then, is not what constitutes money but what constitutes payment” (McKendrick, 2010)*

Traditionally the term “money” has always been defined in terms of the 3 functions or services that it provides namely (1) a medium of exchange (2) a unit of account and (3) a store of value. But in the course of time, a fourth function namely

that of being a final discharge of debt or standard of deferred payment was also added. This fourth function is acquired by money through the conferment of the legal tender status by a Government or central authority (Internet and Mobile Association of India v Reserve Bank of India , 2018).

Section 18 of the Payment and Settlement System Act No 28 of 2005 of Sri Lanka defines “money” as a monetary unit or a medium of exchange that is issued, established, authorized, or adopted by Sri Lanka or a foreign government. The term includes a monetary unit or a medium of exchange issued, established, authorized, or adopted by an inter-governmental organization or by agreement between two or more governments. Monetary Law Act No 58 of 1949 Sri Lanka which was enacted for the purpose of establishing a monetary system and Central Bank, section 48 “currency” means “all currency notes and coins issued or circulating in accordance with the provisions of this Act”. Section 49 of the Act states “the Central Bank shall have the sole right and authority to issue currency in Sri Lanka”. All currency notes and coins issued by the Central Bank shall be legal tender in Sri Lanka for the payment of any amount. Section 2 of the Monetary Law reads as follows, “the standard unit of monetary value in Sri Lanka shall be the Sri Lanka rupees which shall be represented by the signs Re. and Rs.”. The Sales of Goods Ordinance neither defines terms of money nor currency but excludes money from the scope of goods.

*Moss v Hancock* upheld that money passes freely from hand to hand throughout the community in the final discharge of debts and full payment for commodities, being accepted equally without reference to the character or credit of the person who offers it and without the intention of the person who receives it to consume it or apply it to any other use than in turn to tender it to others in discharge of debts or payment of commodities (*Moss v Hancock*, 1899). *Wiscoin Central* case held that so long as Virtual Currencies do not qualify as money either in the legal sense (not having a legal tender status) or in the social sense (not being widely accepted by a huge population as a medium of exchange), they cannot be treated as currencies within the meaning of any of the statutory enactments (*Wiscoin Central Ltd v United States*, Jan 12, 2018). In *Travelex Ltd v Federal Commissioner of Taxation* concluded money is any generally accepted medium of exchange for goods and services and for the payment of debts (*Travelex Ltd v Federal Commissioner of Taxation* , 2010). In *Railway Express Agency, Inc. v. Virginia* the court defined money as a medium of exchange (*Railway Express Agency, Inc. v. Virginia*, 1954)

The very concept of money and currency has drastically changed over the past few years and when a close examination is done of different jurisdictions and the statutes, it can be concluded that the definition varies depending on the factual issue confronted. Pro contra the concept of VCs have also undergone a sea of change, with different regulators , and statutory authorities adopting different definitions, leading to diametrically opposite views emerging from courts across the spectrum.

### **Does cryptocurrency fall under the gamut of money?**

*State of Florida v. Michell Abner Espinoza* Bitcoin may have some attributes in common with what we commonly refer to as money, but differ in many important aspects. While Bitcoins can be exchanged for items of value, they are not a commonly used means of exchange. They are accepted by some but not by all merchants or

service providers. With such volatility, they have a limited ability to act as a store of value, another important attribute of money. This court is not an expert in economics, however, it is very clear, even to someone with limited knowledge in the area, that Bitcoin has a long way to go before it is equivalent to money (he State of Florida v. Michell Espinoza, 2019).

A different view was reflected in *SEC v. Trendon Shavers* and it is clear that Bitcoin can be used as money. It can be used to purchase goods or services, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies such as the US dollar, euro, yen, and Yuan. Therefore, bitcoin is a currency or form of money (Securities and Exchange Commission v. Trendon T. Shavers and Bitcoin Savings and Trust, , 2014). *United States v Ulbricht* Bitcoins carry value-that is their purpose and function acts as a medium of exchange. Bitcoins may be exchanged for legal tender, be it US dollars, euros, or some other currency (United States of America v. Ross Willioam Ulbricht, 2014). The decision in Ulbricht was followed in *United States v. Faiella* the contention of the defendant was that Bitcoin does not qualify as money, that operating a Bitcoin exchange does not constitute transmitting of money, and that he is not a money transmitter. Finally, the court held Bitcoin clearly qualifies as money or funds under the plain meaning definitions. Bitcoin can be easily purchased in exchange for ordinary currency, acts as a denominator of value, and is used to conduct financial transactions (United States of America v. Robert M.Faiella, 2014).

There are 4 factors that lie behind the Virtual Currencies they are the development of blockchain technology, concerns about conventional money and banking, privacy concerns, and political views about the role of the Government. (Frank, Crypto currencies and Monetary Policies , 2019) Cryptocurrencies today do not do a good job of fulfilling the main functions of money. They may be favored by some for ideological, technological, or monetary policy reasons. The blockchain technology they use does have some important advantages in controlling fraud and maintaining privacy. But they also open up avenues for tax evasion and criminal activity (Frank, Crypto currencies and Monetary Policy, 2018).

### **Can Cryptocurrency be classified under “Property”?**

In *B2C2 Ltd. v. Quoine Pte Ltd* held that virtual currency can be considered as property that is capable of being held on trust (B2C2 Ltd v Quoine Pte , 2019). The case arose out of a dispute between a person who traded in virtual currencies and the VC Exchange platform on which he traded. The dispute revolved more around the breach of contract, and breach of trust than around the identity of virtual currencies. It was in that context that the court opined that cryptocurrencies satisfied the definition of ‘property’ as provided by the House of Lords in *National Provincial Bank v. Ainsworth* to the effect that it must be “definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability” (National Provincial Bank v Ainsworth, 1965). The court further noted that “crypto currencies are not legal tender in the sense of being a regulated currency issued by a government but they do have the fundamental characteristic of intangible property as being an identifiable thing of value”. The

decision of the Commercial Court was appealed to the Court of Appeal. While dismissing Quoine's appeal on the breach of contract claim, but allowing it on the breach of trust claim, the Court of Appeal held in *Quoine Pte Ltd v. B2C2 Ltd* that though cryptocurrencies are capable of assimilation into the general concepts of property, there are difficult questions as to the type of property that is involved. Therefore, the Court of Appeal did not take a final position on the question, since it felt that the precise nature of the property right involved, was not clear (*B2C2 Ltd. v. Quoine Pte, 2020*).

*AA v. Persons Unknown & others Re Bitcoin*, the English High Court ruled that Bitcoin is property but this decision was on the basis of the definition adopted by the UK Jurisdictional Taskforce of the Law Tech Delivery Panel, in its "Legal Statement on the Status of Crypto assets and Smart Contracts," that crypto assets constitute property under English law. The facts out of which this decision arose, were peculiar (*AA v Persons Unknown & Ors, Re Bitcoin* ). The IT system of a Canadian insurance company was hacked through malware called Bitpaymer, which encrypted all the data of the company. A ransom equivalent of US \$ 950,000 in Bitcoin was demanded by the hackers for decryption. After negotiations through a specialist intermediary by the name Incident Response Company, the insurance company paid the ransom into a wallet and retrieved the data with the decryption tools provided by the hackers. Thereafter the insurance company engaged the services of a blockchain investigation outfit known as Chainalysis Inc., which found that of the total of 109.25 Bitcoins transferred as ransom, 13.25 Bitcoins (worth approximately US \$ 120,000 at the time) had been converted into an untraceable fiat currency. The remaining 96 Bitcoins had been transferred to a "wallet" linked to a Virtual Currency exchange known as Bitfinex (registered in the British Virgin Islands). The insurance company then sued the VC Exchange before the High Court and sought ancillary disclosure orders to know the identity of persons who held the Bitcoins in the wallet of the exchange. The company also sought a proprietary injunction. Interestingly, the Court agreed to hear the application in private and protect the identity of the insurer who got hacked, for they feared retaliatory copycat attacks.

The core issue before the court was whether cryptocurrencies constituted a form of property capable of being the subject matter of a proprietary injunction. After referring to Fry L.J's statement in *Colonial Bank v. Whinney*, that all things personal are either in possession or in action and that the law knows no third category between the two and also after referring to the four classic criteria for property, [namely they are (i) definable; (ii) identifiable by third parties; (iii) capable in their nature of assumption by third parties; and (iv) capable of some degree of permanence] set out by Lord Wilberforce in *National Provincial Bank v. Ainsworth*, Bryan, J held in *AA v. Persons Unknown* that virtual currencies are neither chooses in action (not embodying a right capable of being enforced in action) nor chooses in possession (being virtual and incapable of being possessed) (*AA v Persons Unknown & Ors, Re Bitcoin* ). However, the court ruled that VCs can still be treated as property, by applying the four criteria laid down in the *National Provincial Bank and Law Tech Delivery Panel's Legal Statement*, though it did not constitute a statement of the law. Bryan J. was convinced that the statement's detailed legal analysis of the proprietary

status of cryptocurrencies was “compelling” and should be adopted by the court. Thus, what prevailed with the court was the definition provided by Law Tech Delivery Panel’s UK Jurisdiction Task Force, which, unlike RBI, did not enjoy a statutory status, but was only an industry-led government backed initiative. The ruling of the European Court of Justice in *Skatteverket v. David Hedqvist*, was with particular reference to the identity of virtual currencies. ECJ was in this case asked to decide a reference from the Supreme Administrative Court, Sweden on whether transactions to exchange a traditional currency for the Bitcoin virtual currency or vice versa, which Mr. Hedqvist wished to perform through a company, were subject to value-added tax.

The opinion of the court was to the effect that: (i) Bitcoin with bidirectional flow which will be exchanged for traditional currencies in the context of exchange transactions cannot be categorized as tangible property since virtual currency has no purpose other than to be a means of payment. (ii) VC transactions do not fall within the concept of the supply of goods as they consist of the exchange of different means of payment and hence, they constitute the supply of services. (iii) Bitcoin virtual currency being a contractual means of payment could not be regarded as a current account or a deposit account, a payment or a transfer, and unlike debt, cheques and other negotiable instruments (referred to in Article 135(1)(d) of the EU VAT Directive), Bitcoin is a direct means of payment between the operators that accept. (iv) Bitcoin virtual currency is neither a security conferring a property right nor a security of a comparable nature. (v) The transactions in issue were entitled to exemption from payment of VAT as they fell under the category of transactions involving ‘currency [and] bank notes and coins used as legal tender.’ (vi) Article 135(1)(e) EU Council VAT Directive 2006/112/EC is applicable to non-traditional currencies i.e., to currencies other than those that are legal tender in one or more countries in so far as those currencies have been accepted by the parties to a transaction as an alternative to legal tender and have no purpose other than to be a means of payment. The court accordingly concluded that virtual currencies would fall under this definition of non-traditional currencies. Various courts in different jurisdictions have identified virtual currencies to belong to different categories ranging from property to 107 commodities to non-traditional currency to payment instrument to money to funds. While each of these descriptions is true, none of these constitute the whole truth.

### **Legal Position of Sri Lanka in relation to virtual currency**

As per the definition given by the Central Bank of Sri Lanka Virtual Currencies are largely unregulated digital representations of value that are issued by private entities and can be electronically traded. CBSL has not given any license or authorization to any entity or company to operate schemes involving VCs, including cryptocurrencies, and has not authorized any Initial Coin Offerings (ICO), mining operations or Virtual Currency Exchanges (Lanka, 2018). Directions No. 03 of 2021 under Foreign Exchange Act, No. 12 of 2017 issued by the Department of Foreign Exchange of CBSL, Electronic Fund Transfer Cards (EFTCs) such as debit cards and credit cards are not permitted to be used for payments related to virtual currency transactions. Therefore, VCs are considered as unregulated financial instruments and have no

regulatory oversight or safeguards relating to their usage in Sri Lanka (Lanka, 2018). As per the Central Bank of Sri Lanka investing or using VCs has several risks such as (Lanka, 2018).

- Users/investors will have no regulatory or specific legal recourse in the event of any user or transaction-related issues or disputes.
- High volatility of the value of the VCs, as it is dependent on speculation, exposing the investment of VCs to a risk of making large losses.
- High Likelihood of VCs being associated with financing terrorist activities and used by criminals to launder criminal proceeds.
- Violation of Foreign Exchange Regulations. As VCs are traded as assets in Exchanges, purchasing VCs from abroad would lead to a violation of Foreign Exchange Regulations, as VCs are not identified as a permitted investment category in terms of the Foreign Exchange Act No. 12 of 2017 (FEA). Electronic Fund Transfer Cards (EFTCs) such as debit cards and credit cards are also not permitted to be used for payments in foreign currency related to virtual currency transactions, in terms of the Foreign Exchange Regulations in Sri Lanka.

### **Risks associated with crypto**

However, in the future, large cryptocurrencies holdings could complicate monetary policy management” Eventually the conclusions reached in the report are as follows.

- Cryptocurrencies today do not do a good job of fulfilling the main functions of money.
- They may be favored by some for ideological, technological, or monetary policy reasons.
- The blockchain technology they use does have some important advantages in controlling fraud and maintaining privacy.
- However, they also open up avenues for tax evasion and criminal activity.

#### **(1) Consumer vulnerabilities**

As enumerated in the case *Internet and Mobile Association of India v Reserve Bank of India* by quoting the reports of the Reserve Bank of India, “VCs being in digital form are stored in digital or electronic media that are called electronic wallets. Therefore, they are prone to losses arising out of hacking, loss of password, compromise of access credentials, malware attack etc. Since they are not created by or traded through any authorized central registry or agency, the loss of the wallet could result in the permanent loss of the VCs held in them. Payments by VCs, such as Bitcoins, take place on a peer-to-peer basis without an authorized central agency that regulates such payments. As such, there is no established framework for recourse to customer problems/disputes/chargebacks etc. Virtual currencies are traded on exchange platforms set up in various jurisdictions whose legal status is also unclear. Hence, the traders of VCs on such platforms are exposed to legal as well as financial risks” (*Internet and Mobile Association of India v Reserve Bank of India* , 2018).

(2) Money Laundering and Terrorist Financing (ML and TF)

Section 3 of the Prevention of Money Laundering Act No of Sri Lanka stipulates “Any person, who (a) engages directly or indirectly in any transaction in relation to any property which is derived or realized, directly or indirectly, from any unlawful activity or from the proceeds of any unlawful activity; (b) receives, possesses, conceals, disposes of, or brings into Sri Lanka, transfers out of Sri Lanka, or invests in Sri Lanka, any property which is derived or realized, directly or indirectly, from any unlawful activity or from the proceeds of any unlawful activity, knowing or having reason to believe that such property is derived or realized, directly or indirectly from any unlawful activity or from the proceeds of any unlawful activity, shall be guilty of the offense of money laundering”.

The Financial Action Task Force (FATF) has also observed that crypto assets are being used for money laundering and terrorist financing. A globally coordinated approach is necessary to prevent abuses and to strictly limit interconnections with regulated financial institutions (Force, 2021). The relative anonymity of digital currencies may make them especially susceptible to money laundering and other criminal activities. Virtual currencies have emerged and attracted investment in payment infrastructure built on their software protocols. These payment mechanisms seek to provide a new method for transmitting value over the internet. At the same time, virtual currency payment products and services (VCPSS) present ML/TF risks. The use of websites affiliated with terrorist organizations to promote the collection of Bitcoin donations is one of the existing ML and TF risks affiliated with virtual currency. Virtual currencies such as bitcoin, while representing a great opportunity for financial innovation, have attracted the attention of various criminal groups, and may pose a risk for terrorist financing. This technology allows for the anonymous transfer of funds internationally. While the original purchase of the currency may be visible all following transfers of the virtual currency are difficult to detect.

Law enforcement agencies are also concerned about the use of virtual currencies (VC) by terrorist organizations. They have seen the use of websites affiliated with terrorist organizations to promote the collection of Bitcoin donations. In addition, law enforcement has identified internet discussions among extremists regarding the use of VC to purchase arms and education of less technical extremists on the use of VC. For example, a posting on a blog linked to ISIL proposed using Bitcoin to fund global extremist efforts. The report made by the Financial Action Task Force headed “Emerging fiancé terrorist Risks” indicated a case study, which concerned the arrest of one Ali Shukri Ameen, who admitted having had a Twitter account with 4000 followers. He claimed to have used his Twitter handle to provide instructions on how to use a virtual currency to mask the provision of funds to ISIL. In an article, the link to which he tweeted to his followers, it was elaborated on how jihadists could utilize virtual currency to fund their efforts (Force, Emerging finance terrorist risks , 2015). (It must be noted that the report also took note of how prepaid cards and other internet-based payment services could also be used for terror financing) (Internet and Mobile Association of India v Reserve Bank of India , 2018)

*United States v. Ulbricht* the allegation against the defendant was that Ulbricht engaged in these offenses by designing, launching, and administering a website called Silk Road, as an online marketplace for illicit goods and services.

According to the prosecution, Bitcoin was used to launder the proceeds. The website was available only to those using Tor (abbreviation for 'The Onion Router'), free and open-source software and a network that allows anonymous, untraceable internet browsing. Payments were allowed only through Bitcoin (United States of America v. Ross Willioam Ulbricht, 2014).

The case was initiated based on four allegations namely participation in a narcotics trafficking conspiracy, a continuing criminal enterprise, a computer hacking conspiracy, and a money laundering conspiracy and the defendant committed the offenses by designing, launching, and administering a website called Silk Road, as an online marketplace for illicit goods and services and bitcoin was used to launder the proceeds and the it was the only payment method. *United States v. Faiella* defendant was alleged for the operation of an underground market in the virtual currency bitcoin via the website Silk Road (United States of America v. Robert M.Faiella, 2014).

Still, there are no case law authorities pertaining to ML or TF in relation to cryptocurrency in Sri Lanka since the concept is in its nascent stage. The lack of an exhaustive definition and lack of understanding about the technicalities underpinning the creation of cryptocurrency has led to the absence of a properly defined surveillance mechanism.

### (3) Pyramids and Ponzi schemes

The pyramids and the Ponzi schemes related with crypto are another worst economic crisis ever following a default on debt repayment. The Bank for International Settlements (BIS) has recently warned that the emergence of cryptocurrencies has become a combination of a bubble, a Ponzi scheme, and an environmental disaster, and calls for policy responses (Settlements, 2018) It is said that Ponzi scammers are compounding the economic misery of Sri Lankans by swindling them out of their savings with forged crypto schemes. Recently Ponzi scheme linked to cryptocurrency was carried out by a Chinese couple together with a Sri Lankan from 2020. The Banking Act No. 30 of 1988 was amended by incorporating the following provision to prevent the operation of Pyramid Schemes. "No person shall directly or indirectly initiate, offer, promote, advertise, conduct, finance, manage or direct a scheme where benefits earned by the participants to such a scheme are largely dependent on (a) increase in the number of participants (b) increase in the contributions made by the participants in the Scheme."

### (4) Tax evasion

Tax evasion is a punishable offence that harms the national economies, society, and it indirectly affects all the residents of the State. Pseudo anonymity and reduced traceability of cryptocurrency transactions decrease the risk of detectability of tax evasion. Tracing cryptocurrency transactions is complex and costly therefore it can be applied only in cases of prior suspicion of infringement, but not for systemic supervision. Section 2 of the Inland Revenue Act No of 2017 "Income tax shall be payable for each year of assessment by – (a) a person who has taxable income for that year, or (b) a person who receives a final withholding payment during that year". Section 3 of the Act states "the taxable income of a person for a year of assessment

shall be equal to the total of the person's assessable income for the year from each employment, business, investment, and other sources". The vagueness as to if the proceeds from the cryptocurrency constitutes taxable income.

#### (5) Ecosystem derogation

The amount of greenhouse gases emitted by a process or a product on the environment is commonly known as carbon footprint. It has been understood that the blockchain process uses a larger quantity of electricity and has a greater impact on greenhouse gas emissions and the direct repercussion is the impact on climate change.

### **Comparative jurisdiction**

**India:** In *Internet and Mobile Association of India v Reserve Bank of India* Reserve Bank of India highlighted the possible ways to enforce prohibition on VCs (*Internet and Mobile Association of India v Reserve Bank of India*, 2018);

(i) Initial Coin Offerings ("ICOs") ought to be prohibited and VC asset funds may to be allowed to be set-up and/or operated within the legal jurisdiction of India as also perform such transactions in India. ICOs that were in the nature of multi-level marketing or pyramid schemes can be banned.

(ii) The FEMA and its regulations can be enhanced to prevent and track remittances for the purpose of investing in VCs which are flowing out of the country under the LRS;

(iii) Enforcement agencies can take punitive action against entities/establishments that accept VCs as a medium of payment, as and when these agencies are faced with such instances; and

(iv) Regulators can issue warnings to the public and educated the public to the extent possible

In 2018 circular headed "prohibition on dealing with VCs" was issued by the Reserve Bank of India from directing the entities regulated by RBI not to deal in virtual currencies nor to provide services for facilitating any person or entity in dealing with or settling virtual currencies and to exit the relationship with such persons or entities, if they were already providing such services to them. *Internet and Mobile Association of India v Reserve Bank of India* a case where a writ petition was filed against the RBI on grounds that the Bank lacked jurisdiction in prohibiting the crypto exchanges from dealing in cryptocurrencies in India. The Supreme Court struck down the circular on the basis that there was no negative impact of the crypto on the regulating agencies India (*Internet and Mobile Association of India v Reserve Bank of India*, 2018). In the year 2019 introduced the Banning of Cryptocurrency and Regulation of Official Digital Currency Bill but has not been a reality yet.

**European Union:** Markets in Crypto Assets Regulations (MiCA) could be defined as one of the landmark legislative frameworks in the EU which intends to regulate the crypto assets within the EU and it intends to replace the existing legal framework governing the crypto assets. Contains 126 articles governing the offer and marketing of crypto assets and assets referenced tokens and e-money tokens. It also governs the offering and placing on markets of crypto assets and Cryptocurrency Assets Service Providers (CCASP).

It is obvious that the effects of technological advancement and internationalization on the global economic structure have a profound impact on the operations of business entities, cross-border investment, and international trade. All these new developments, commonly referred to as digital transformation, have generated numerous new business opportunities while also posing numerous unknown risks that are not adequately addressed by existing law.

## **5. Conclusion**

The complete banning will drive and encourage the operators, the use of VCs for illegal purposes behind the façade of loopholes in law due to the vagueness of the definition that forms VCs. On the other hand, it would be worthwhile to consider introducing a ban to a certain extent to allow the competent authorities to delve and associate into the prohibited activities since they have a legal basis for prosecution. Possibly, imposing a ban could also have a deterrent effect on the perpetrators. In the case of imposing a ban, the legislature should always be focused on specific aspects facilitating the illicit use of cryptocurrency. At the same time, it should be emphasized that Sri Lankan judicial decisions and legislative enactments cannot be colored by what other countries have done or not done but the comparative and international perspective will help in assisting the judges to arrive to an established principles of judicial decision making and not for testing the validity of an action taken based on the existing statutory scheme. It is noteworthy to mention that prohibition of an article as *res extra commercium* is a matter of legislative policy and must arise out of an Act of legislature. Since the Central Bank is the authorized and competent body empowered to take ultimate decisions on monetary policy under the Central Bank Act 2023, the Central Bank of Sri Lanka should pioneer and initiate the task of combatting against the consumer vulnerabilities, ML TF risks associated with crypto without hindering and disincentivizing the technological innovations since such suppression of innovation will have a detrimental effect especially in developing countries.

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