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The Disruption by Digital Currencies: How and Why should they be Regulated

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ABSTRACT

The paper deals with the advent of digital currencies, and the disruption of the global markets due to the increasing innovation through Central Banking Digital Currencies and Stablecoins. Thus, the paper is aimed at tracing the trajectory of the evolution of such digital currencies, especially focussing on the regulatory aspect, in the US and European counterparts. The paper, using doctrinal methodology, examines concepts of accountability, funds transfer and legislations like the Uniform Commercial Code and the EU Directives to enquire into the applicability of the current legislations in the context of digital currencies. The paper concludes by providing critiques and suggestions for the Indian counterpart, emphasising on the aspect of self-regulation and industry standards.

Keywords: Digital currencies, CBDCs, Stablecoins, Global regulatory regime, Indian jurisprudence.

I. INTRODUCTION

Reviewing the three major recent events, first being the trial of retail digital currency developed People's Bank of China since 2014, the second being the announcement of development of Libra, a blockchain based-technology by Facebook in 2019 and the third being the disruption caused by the COVID-19 virus, thereby distorting the mechanism around cash.² According to a report published by the Bank for International Settlements in 2020³, in collaboration with the U.S. Federal Reserve, reported an assessment of "the feasibility of publicly available central bank digital currencies in helping central banks deliver their public policy objectives"⁴, while the Financial Stability Board, also known as the FSB, which is a G20 sponsored international body making recommendations and suggestions about the global financial system, issues two

¹ Author is a student at BITS Law School, India.

² Jonathan Cheng, *China Rolls Out Pilot Test of Digital Currency*, WALL ST. J. (Apr. 20, 2020, 8:22 AM), <https://www.wsj.com/articles/china-rolls-out-pilot-test-of-digital-currency11587385339>; Hannah Murphy & Yuan Yang, *Patents Reveal Extent of China's Digital Currency Plans*, FINANCIAL TIMES (Feb. 12, 2020), <https://www.ft.com/content/f10e94cc-4d74-11ea-95a0-43d18ec715f5#comments-anchor>; Libra Association, *Introducing Libra*, LIBRA ASS'N (June 19, 2019), <https://libra.org/enUS/updates/introducing-libra/>.

³ The BIS is an international body, sponsored by many of the world's central banks, which acts "as a bank for central banks." <https://www.bis.org/>.

⁴ BANK FOR INTERNATIONAL SETTLEMENTS ET AL., *CENTRAL BANK DIGITAL CURRENCIES: FOUNDATIONAL PRINCIPLES AND CORE FEATURES* (Report No. 1 in a series of collaborations from a group of central banks, Oct. 13, 2020), available at <https://www.bis.org/publ/othp33.pdf>.

reports, one on effective regulation of stablecoin, also known as the “FSB Stablecoin Report”⁵ and the other on cross border payments and challenges also known as the “FSB Cross Border Payment Report”.⁶ The BIS CBDC Report enables the categorisation of digital currencies, one of them being CBDCs, digital currencies sponsored by government central banks, while the second category consists of digital currencies which are privately issued, and these currencies are “secured by cryptography” such as blockchain, and thus privately issued currencies are known as cryptocurrencies.⁷ Digital currencies issued privately are further classified into two categories, one category being inclusive of reference assets, that is assets which are exchangeable for material assets, and thus are referred to as stablecoins, whereas the other category consists of currencies not backed by intrinsic assets, hereby classifying as generic cryptocurrencies, as exemplified by bitcoin.⁸ The paper thus focusses on the regulation and supervision of digital currencies, while following a trajectory which focusses on the critique and development of the CBDCs, shifting to how CBDCs should be further regulated.

II. CLASSIFICATION OF DIGITAL CURRENCIES

There are many challenges that are faced while developing digital currency as a form of exchange, especially around the topics of accessibility and reducing cost, the former here referring to the ease of transactions on a daily basis while the latter referring here to the access being cost-effective.⁹ Viewing these challenges, two approaches have been developed with respect to the development of CBDC structures namely account based and token based.¹⁰ In an account based CBDC structure, the currency represents an “electronically registered claim” against a deposit at a bank whereas in a token-based CBDC, the currency symbolises tokens, better known as “digital tokens” issued by the central bank.¹¹ The most classic example of a

⁵ FINANCIAL STABILITY BOARD, REGULATION, SUPERVISION AND OVERSIGHT OF “GLOBAL STABLECOIN” ARRANGEMENTS 2 (Oct. 13, 2020), available at <https://www.fsb.org/wpcontent/uploads/P131020-3.pdf>.

⁶ FINANCIAL STABILITY BOARD, ENHANCING CROSS-BORDER PAYMENTS 1 (Oct. 13, 2020), available at <https://www.fsb.org/wp-content/uploads/P131020-1.pdf>.

⁷ Harish Natarajan et al., Distributed Ledger Technology (DLT) and Blockchain 3 (WORLD BANK GRP., Working Paper No. 122140, 2017), <http://documents1.worldbank.org/curated/en/177911513714062215/pdf/122140-WP-PUBLICDistributed-Ledger-Technology-and-Blockchain-Fintech-Notes.pdf>.

⁸ Jess Cheng, How to Build a Stablecoin: Certainty, Finality, and Stability Through Commercial Law Principles, 17 BERK. BUS. L. J. 320, 322 (2020). Reference assets frequently are a governmental fiat currency. Cf. FSB Stablecoin Report, supra note 16, at 7 (“A stablecoin, particularly if linked to a fiat currency or a basket of [fiat] currencies, may become a widely used store of value”).

⁹ BANK FOR INTERNATIONAL SETTLEMENTS ET AL., CENTRAL BANK DIGITAL CURRENCIES: FOUNDATIONAL PRINCIPLES AND CORE FEATURES (Report No. 1 in a series of collaborations from a group of central banks, Oct. 13, 2020), available at <https://www.bis.org/publ/othp33.pdf>.

¹⁰ Tommaso Mancini-Griffol et al., Casting Light on Central Bank Digital Currencies 7, 29 (INT’L. MONETARY FUND, Staff Discussion Notes No. 18/08, Nov. 2018), available at <https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2018/11/13/Casting-Lighton-Central-Bank-Digital-Currencies-46233>.

¹¹ *Citizens Bk. v. Strumpf*, 116 S. Ct. 286, 290 (1995).

combination of the two is the digital yuan being developed by the People's Bank of China, while in the United States, the two recent bills passed introduced in the Congress comprised of the Banking for all Act in the Senate and the Automatic BOOST to Communities Act in the House of Representatives.¹² While scholars have argued that an account based CBDC may have lower operating costs and shall be less disruptive to commercial borrowing, hereby giving them a boost, it can also be argued that token based CBDCs are more accessible because not all consumers might have deposit accounts.¹³ Furthermore, it has also been observed that token-based currencies have stronger privacy protection, especially due to the elimination of third-party intermediaries.¹⁴ However, token based CBDCs have many challenges, some of them being restrictions to the enforcement of anti-money laundering, hindrance to rules of know-your-customer, and regulations of counter-terrorism-financing which requires knowledge and consent of the customers, and lastly impairment to the bank's ability to execute monetary policies.¹⁵ The main aspect to be addressed while regulating CBDCs is the concern around broader financial stability as also substantiated by the BIS-led Group, which maintained that a CBDC "should not compromise monetary or financial stability".¹⁶

III. REGULATING THE CBDCS AND HOW

Thus, the most beneficial way of regulating CBDCs is through a regulation framework or mechanism similar to that of a wholesale digital funds transfer, which are governed through two primary sources, that is through the Article 4A of the Uniform Commercial Code in the United States and through the European Directive on payment services in the jurisdiction of the European Union.¹⁷ The scope of Article 4A of the Uniform Commercial Code, encompasses the regulation of the Federal Reserve wire transfer network as well as the New York Clearing

¹² Raphael Auer, Giulio Cornelli, & Jon Frost, Rise of the Central Bank Digital Currencies: Drivers, Approaches and Technologies 22–23 (Bank for Int'l Settlements, Working Paper No. 880, Aug. 2020). Cf. Douglas W. Arner et al., After Libra, Digital Yuan and COVID-19: Central Bank Digital Currencies and the New World of Money and Payment Systems, 65 EUR. BANKING INST., 37 (June 11, 2020) (discussing how China's digital currency will be transferred). Although some claim that consumers lacking a bank account will be able to use China's digital currency, the details are sparse. See Karen Yeung, What Is China's Cryptocurrency Alternative Sovereign Digital Currency and Why Is It Not Like Bitcoin?, South China Morning Post (May 13, 2020, 10:35 AM) (claiming digital wallets can be used without linking to a bank account).

¹³ BANK OF ENGLAND, CENTRAL BANK DIGITAL CURRENCY OPPORTUNITIES, CHALLENGES AND DESIGN 47 (Mar. 2020 Discussion Paper), <https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/central-bank-digital-currency-opportunities-challenges-anddesign.pdf>.

¹⁴ Raphael Auer & Rainer Böhme, The Technology of Retail Central Bank Digital Currency, BIS Q. REV., Mar. 2020, at 85, 94 (observing that a "token-based system . . . would offer good privacy by default").

¹⁵ *Id.*

¹⁶ BANK FOR INTERNATIONAL SETTLEMENTS ET AL., CENTRAL BANK DIGITAL CURRENCIES: FOUNDATIONAL PRINCIPLES AND CORE FEATURES (Report No. 1 in a series of collaborations from a group of central banks, Oct. 13, 2020), available at <https://www.bis.org/publ/othp33.pdf>.

¹⁷ Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, 2015 O.J. (337) 35–127, available at <https://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=CELEX%3A32015L2366&qid=1610641825076>.

House Interbank Payments Systems (“CHIPS”), and is highly influential in the global and domestic markets, with its enactment in all 50 states of the United States.¹⁸ Moreover, Article 4A and the United Nations Committee on International Trade Law’s (UNCITRAL) Model Law on International Credit Transfers uses a similar framework for classifying transactions in case of digital funds transfers, and thus both the Article 4A and UNCITRAL Model Law influenced the EU Directive.¹⁹ Article 4A also hereby regulates risk of loss and counterfeiting, wherein risk of loss includes three different risks as to transfer of funds to a wrong person, fraud risk, including fraudulently transferring funds to a wrong person and credit risk, also known as the insolvency risk.²⁰

IV. CONCLUSION

Thus, it can be inferred that the current global banking systems and their regulations are adept and can be used to regulate Central Banking Digital Currencies (CBDCs). The main question to be now addressed is the regulatory aspect for the Indian counterpart, since the use of CBDCs and stablecoins is ultimately going to disrupt the Indian markets as well. Although India has various legislations dealing with money laundering, fraud and corruption, it shall still be beneficial to enact a new legislation or amend the current regulations to design mechanisms more adept to the regulation of CBDCs for the Indian counterpart. Thus, India should focus on either re-interpreting the current regulations in the light of the advent of CBDCs or let the corporations design the laws through a system of self-regulation. Self-Regulation would thereby ensure accountability, transparency and maintenance of stronger disclosure requirements. Thus, India too should focus on the development of regulations specific to digital currencies like CBDCs and stablecoins, to position itself as a strong global player in the market.

¹⁸ Carl Felsenfeld, *The Compatibility of the UNCITRAL Model Law on International Credit Transfers with Article 4A of the UCC*, 60 *FORDHAM L. REV.* 553 (1992).

¹⁹ Mark Sneddon, *The Effect of Uniform Commercial Code Article 4A on the Law of International Credit Transfers*, 29 *LOY. L.A. L. REV.* 1107, 1111-12 (1996); BARKLEY CLARK & BARBARA CLARK, 3 *LAW OF BANK DEPOSITS, COLLECTIONS, & CREDIT CARDS* § 17.02, (2)(d) (2020).

²⁰ The EU Directive provides banks with less discretion in the choice to accept a payment order. This could reduce the bank’s incentive to do as much due diligence as it otherwise would.