



BHARAT WEB3
ASSOCIATION

Virtual Digital Asset Service Providers:

Road to Effective Compliance under PMLA



Foreword



Shri Vivek Aggarwal

**Additional Secretary, Department of Revenue, Ministry of Finance
Director, Financial Intelligence Unit, India (FIU-IND)
Government of India**

In this dynamic era marked by the rapid rise of emerging technologies, Virtual Digital Assets bring with them a significant opportunity for growth. However, as with any new technology, VDAs also present unique regulatory challenges. The FIU-IND has always been committed to ensuring that Virtual Digital Asset Service Providers (VDA SPs) comply with Indian laws and regulations for the protection of domestic consumers.

I am pleased to report that through our collaborative efforts with the VDA sector, we have successfully established a robust regulatory compliance framework for digital assets. This comprehensive document details this journey, outlining the progress made by domestic VDA SPs over the years, and the gradual steps undertaken by the sector to put in place robust compliance measures to ensure a compliant VDA ecosystem that has received global commendation, positioning India as a leader in regulatory compliance on the international stage.

This document also reflects our commitment to fostering a regulatory environment that not only keeps pace with innovation but also safeguards the financial system against risks associated with money laundering. Our efforts have been driven by extensive consultations with various stakeholders within the VDA ecosystem. The insights provided by these engagements have been pivotal in shaping our robust policies. This document details these efforts and the strides we have made in integrating VDAs into our financial oversight mechanisms.

I extend my heartfelt gratitude to all who have contributed to this journey— the dedicated team at FIU-IND, the Bharat Web3 Association and the VDA SP community at large. Together, we are setting the foundations for a robust digital asset framework that aligns with global best practices and addresses the unique challenges and opportunities presented by this new frontier.

I hope that through this document, all readers gain a deeper understanding of our regulatory vision and the steps undertaken to ensure that India not only adapts to but thrives in this new and transformative digital era.

Foreword



Dilip Chenoy
Chairperson
Bharat Web3 Association

As Chairperson of the Bharat Web3 Association, I am honored to introduce this comprehensive document that encapsulates the journey and substantial progress of India's Virtual Digital Asset (VDA) sector. This document not only reflects the current state of our sector but also highlights our collaborative efforts with the Financial Intelligence Unit, (FIU-IND), Department of Revenue, Government of India, aimed at crafting a robust regulatory compliance framework for digital assets.

This document outlines the strides and initiatives that have been instrumental in shaping the compliance landscape for digital assets in India. It is a testament to the potential of collaborative efforts in fostering a secure, transparent, and dynamic marketplace, paving the way for India to become a global leader in the adoption and regulation of VDAs and Web3.

I extend my sincere gratitude to Shri Vivek Aggarwal, Additional Secretary, Department of Revenue and Director, FIU-IND, Smt. Ashima Batra, Additional Director FIU-IND and other officials of FIU-IND, for their time, unwavering support, and partnership during this journey. They have been pivotal in driving and enhancing compliance and in forging a path toward sustainable growth within the VDA landscape. This collaboration has significantly strengthened the overall compliance framework for VDAs in India, aligning it with international standards.

At the Bharat Web3 Association, our commitment to strengthening the compliance architecture for the VDA sector is steadfast. We are dedicated to working closely with FIU-IND and other regulatory agencies to ensure that the VDA sector in India not only thrives but also sets a benchmark for regulatory excellence globally. We are driven by our vision to position India as a frontrunner in the Web3 revolution, transforming from a talent exporter to a hub for products and solutions.

We hope that this document will serve as a valuable resource for stakeholders within the VDA sector and beyond, illustrating the balance between innovation and regulation, and the critical role of compliance in facilitating the growth and acceptance of virtual digital assets in a rapidly evolving global economy.



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1. Introduction and Context: Setting the Stage for India's Web3 Revolution

The advent of Virtual Digital Assets (VDAs) within the realm of Web3 is redefining the contours of technology, promising a new era of decentralized and autonomous systems. The response to the Web3 revolution in India has been enthusiastic, reflecting a broader ambition to position itself as a pivotal player in the digital economy.

1.1. Embracing the Adoption of VDAs in India

The past few years have seen a significant increase in the adoption of VDAs in India with increased consumer awareness, coupled with a maturing VDA sector, and growing self-compliance helping it become more responsible. As per a global analytics report, India is the global leader in grassroots VDA adoption¹. India is also home to approximately 1000 Web3 companies and accounts for 12% of the global Web3 developer talent².

The rise of VDAs has therefore presented a novel challenge for regulators worldwide, including India. As VDA transactions gained popularity, regulators recognized the need to bring them under the regulatory ambit to mitigate risks such as money laundering and terrorist financing.

1.2. Navigating the Regulatory Landscape for VDA SPs prior to PMLA

Prior to March 2023, operations of VDA SPs existed in an uncertain regulatory environment, devoid of explicit regulations for the sector. While there were incremental regulatory developments, a lack of comprehensive regulation posed significant challenges for both service providers and government agencies in monitoring VDA transactions from an AML and CFT perspective. Below is a list of regulatory developments applicable to VDA SPs before March 2023:

- **March 2020:** Supreme Court of India on March 4, 2020, held in *Internet and Mobile Association of India v. Reserve Bank of India* (W.P. (C) 528/2018), that: (a) Virtual Digital Asset business activity is protected as a fundamental right under Article 19(1)(g) of the Constitution of India; and (b) banking services are the 'lifeline' for the trade and business of Virtual Digital Asset exchanges
- **February 2022:** Announcement of 1% TDS, 30% Capital Gains, and no offset of losses applied to VDA transactions as per Finance Bill 2022
- **February 2022:** ASCI released new guidelines for advertising and promotion of VDAs or VDA SPs
- **April 2022:** CERT-In issued directions for enhancing cybersecurity, incorporating provisions addressing VDA SPs.
- **June 2022:** CBDT (MoF) issued Guidelines for the removal of difficulties under sub-section (6) of section 194S of the Income-tax Act
- **February 2023:** The Finance Bill highlighted an amendment to the Income Tax Act, specifically section 271C, that entails penalties for non-payment of VDA TDS.

¹ The 2023 Geography of Cryptocurrency Report, Chainalysis, October 2023 Edition, <http://surl.li/srcf>

² <https://docsend.com/view/uq8ku5nugs3e34wc>



1.3. FATF Guidance Charting the Course with Global Standards

India has been a member of the Financial Action Task Force (FATF) since June 2010. The FATF has been committed to implementing international standards for anti-money laundering (AML) and counter-terrorism financing (CFT). In October 2021, the FATF updated its 2019 Guidance for a Risk-Based Approach to VDAs and VDA service providers.

This updated guidance includes updates focusing on the following six key areas including additional guidance on the risks and the tools available to countries to address the money laundering and terrorist financing risks for peer-to-peer transactions, guidance for the public and private sectors on the implementation of the “travel rule”.

The guidance on VDAs and SPs issued by the FATF provided a framework for countries to regulate these entities effectively. Being a member of the FATF, India aimed to align its AML & CFT regulations for VDA SPs with these standards, laying the groundwork for inclusion of VDA SPs under PMLA.



2. Bringing VDA SPs into the Regulatory Fold: Integration under PMLA

On 7th March 2023, the Indian government through a notification³, brought providers of services related to VDAs, referred to as Service Providers (SPs) under the ambit of the Prevention of Money Laundering Act (PMLA) by classifying them as 'Reporting Entities'. The notification was followed by detailed AML & CFT Guidelines⁴ which came into immediate effect from 10th March 2023. This development brought VDA SPs at par with banks and other financial institutions in AML, CFT and Combating Proliferation Financing (CPF) obligations and compliance.

The Indian exchanges always prioritized compliance processes, consistently striving for self-regulation even when not mandated. In line with this ethos, VDA SPs have proactively adhered to best practices in KYC and implemented tools to combat money laundering and CFT. The sector had advocated for the inclusion of VDA SPs under PMLA through budget representations and other discussions with the Department of Revenue.

2.1. Applicability

As per the PMLA Notification, the following activities when carried out for or on behalf of another natural or legal person in the course of business as an activity will be covered by the PMLA:

- Exchange between virtual digital assets and fiat currencies
- Exchange between one or more forms of virtual digital assets
- transfer of virtual digital assets
- Safekeeping or administration of virtual digital assets or instruments enabling control over virtual digital assets
- Participation in and provision of financial services related to an issuer's offer and sale of a virtual digital asset

2.2. Registration of VDA SPs as Reporting Entities with FIU-IND

VDA SPs are required to register with the Financial Intelligence Unit-India (FIU-IND) which establishes them as official Reporting Entities. As part of RE registration, VDA SPs must disclose their account details with banks/financial institutions where they hold accounts for transactions as well as for holding client money.

Obtaining reporting entity status entails VDA SPs complying with AML/CFT obligations, such as conducting risk-based assessments of their operations, implementing customer due diligence measures, monitoring transactions, and reporting suspicious activities. This was vital for VDA SPs to function and establish credibility within the financial landscape.

³ <https://egazette.gov.in/WriteReadData/2023/244184.pdf>

⁴ https://fiuindia.gov.in/pdfs/AML_legislation/AMLCFTguidelines10032023.pdf

2.3. Compliance Obligations

VDA SPs had to implement robust compliance measures to meet the regulatory requirements for obtaining reporting entity status. This involved establishing internal controls, conducting KYC (Know Your Customer) and sanctions screening procedures, integrating Red Flag Indicators as specified by FIU into the transaction monitoring system and generating alerts based on such RFIs, continuous monitoring transactions for suspicious activities, and establishing mechanisms for reporting such activities to the relevant authorities.

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|---|------------------------------------|
| 1. KYC Processes | 9. Ongoing Monitoring |
| 2. AML Measures | 10. Travel Rule Compliance |
| 3. Suspicious Transaction Reporting | 11. Employee Training Program |
| 4. Sanction Screening Programs | 12. Technology Upgrades |
| 5. Beneficial Owner Identification & Verification | 13. Collaboration with Authorities |
| 6. Enhanced Customer Due Diligence | 14. User Education |
| 7. Transaction Reporting & Monitoring | 15. Ongoing Monitoring |
| 8. Periodic Risk Assessments & KYC Update | 16. Internal Control/Audit |



“We applaud the work done by FIU-IND in being a visionary and taking the first leap towards building a compliant crypto ecosystem for India. Further, the unwavering passion, commitment and collaboration shown by the VDA SPs towards AML compliance is a testament to foster a trusted and transparent crypto landscape.”

*Mr. Rohan Bhandari
Head of Compliance and Principal Officer, CoinDCX*

3. Implementation and Evaluation: Fostering Collaboration and Strengthening Frameworks

Since the PMLA has come into effect, the VDA sector has been quick to adhere to the laws of the land. A significant factor aiding this smooth transition is that many VDA SPs and member firms of the Bharat Web3 Association (BWA) had already been voluntarily adopting compliance measures even before the PMLA was enforced. This proactive approach facilitated their adaptation to the new legal requirements, making the integration process more seamless.

3.1. Collaboration between FIU-IND and VDA SPs

- **Creation of Working Group for Red Flag Indicators (RFIs):**

The initial phase in meeting compliance guidelines involved forming a small working group to jointly develop protocols for detecting suspicious transactions. With VDA SPs initiating the effort, with support from the FIU-IND, a detailed list of typologies was compiled, drawing from attributes from traditional financial systems and data received from blockchain analytical tools.

A detailed list of typologies was created, intended for integration into the transaction monitoring systems of every VDA SP, with the aim of facilitating the reporting of suspicious transactions. The typologies pertained to issuance of VDAs, deposit and withdrawal of VDAs, customer onboarding, verification etc. among others. In May 2023, the FIU released the Guidelines for detecting suspicious transactions, incorporating the RFIs.

- **Creation of Working Group for STR Reporting Formats:**

The next step towards complying with the guidelines was to create a small working group tasked with developing the reporting formats for VDA SPs to use in reporting suspicious transactions. In May 2023, the FIU released the format for submitting Suspicious Transaction Reports (STRs), with VDA SPs expected to promptly initiate their reporting in accordance with the new format.

- **Collaboration through FPAC & ARIFAC:**

VDA SPs were also granted membership in the FIU-INDIA Initiative for Partnership in AML/CFT (**FPAC**) and the Alliance of Reporting Entities in India for AML/CFT (**ARIFAC**), public-private associations set up by FIU, starting October 2023. This led to VDA SPs discussing & collaborating with other REs such as banks and FIs.

- **Collaboration Continues:**

In November 2023, VDA SPs participated in the Asia Pacific Group workshop where they delivered presentations on prevailing typologies. Following their involvement,

VDA SPs were integrated into the FIU-led Working Group on Terror Funding (FWG-STF), aimed at enhancing the detection of Suspicious Transaction Reports (STRs).

3.2. FATF Mutual Evaluation of the VDA Sector: Raising the Compliance Bar

In June 2023, VDA SPs met with the FIU to start preparing for the upcoming FATF Mutual Evaluation which was a sector first and hence crucial. The collaboration between the FIU-IND and VDA SPs spanned a comprehensive five-month period. Throughout this duration, FIU-IND conducted a series of engagements with VDA SPs, encompassing on-site training sessions, briefings, and mock meetings. The overarching objective was to ensure thorough alignment of the VDA SP sector with both FATF and FIU-IND guidelines, fostering a culture of adherence to regulatory standards. In the timeline leading up to the evaluation, VDA SPs diligently worked towards achieving 100% compliance across key areas including Know Your Customer (KYC) protocols, AML measures, Travel Rule obligations, risk-based assessments, as well as stringent record-keeping and reporting requirements.

In November 2023, an FATF delegation evaluated India's anti-money laundering and counter-terrorism financing measures. The team met with FIU-IND officials to review the compliance readiness of VDA SPs concerning FATF guidelines. The findings of this assessment suggest that India is adopting a proactive regulatory stance, which is positive both domestically and internationally for the sector.

3.3. Extending PMLA Coverage to Offshore Entities Operating in India

As part of the compliance action against the offshore entities, FIU-IND issued compliance Show Cause Notices to 9 offshore VDA SPs in December 2023. VDA SPs operating in India (both offshore and onshore) are required to register with FIU-IND as REs and comply with the set of obligations as mandated under PMLA.

The FIU-IND issuing show cause notices specifically to offshore VDA SPs aims to address potential non-compliance with local regulations in areas of AML and CFT. These notices are a procedural step allowing these providers a chance to explain or rectify their compliance failures before any punitive actions are taken and will be a continuous affair going forward.

The impact of issuing such notices is multifaceted. Firstly, it underscores FIU-IND's commitment to enforcing national regulatory standards on international entities engaging with domestic consumers, thus protecting the local financial ecosystem. Secondly, by compelling offshore providers to adhere to stringent regulations, FIU-IND helps level the playing field between domestic and foreign service providers. Thirdly, these notices enhance the overall integrity of the VDA market by promoting transparency and accountability, which can attract more stable and long-term investments to this sector. Finally, for the offshore VDA SPs, these notices serve as a critical reminder of the need to align their operations with the regulatory expectations of the markets they serve, which can prevent future legal complications and potential exclusion from lucrative markets.



“The initiative taken by FIU-IND represents a significant milestone in fostering a regulated and transparent environment for VDAs in our country and we would like to extend heartfelt appreciation for the same. By taking this first leap, FIU-IND has demonstrated forward-thinking and a commitment to addressing the challenges and opportunities presented by the evolving crypto landscape.”

The collaborative efforts between FIU-IND and the VDA SPs underscore the importance of sector-wide cooperation in establishing robust frameworks that prioritize security, transparency, and accountability. We endeavor to double down on our efforts towards building a robust compliant system which will also play a crucial role in building trust and credibility within the sector.”

*Abhishek Singh
Designated Director, CoinSwitch*

4. Impact and Future Outlook: Shaping a Resilient and Progressive VDA Sector

4.1. From Compliance to Credibility: Transforming the VDA Landscape

Granting Reporting Entity status brings a layer of legitimacy to VDA SP operations. It also empowers FIU-IND with better oversight, potentially mitigating money laundering risks associated with virtual assets. With the introduction of the FIU guidelines and its compliance by the VDA sector, there has been a shift in how this sector was perceived and has led to growth in its adoption and trust by the masses.

The introduction of Suspicious Transaction Reports (STRs) has been pivotal for the VDA sector. REs are mandated to file STRs, and the sector puts emphasis on both the volume of reports and their quality. The identification of several emerging typologies within the VDA sector was crucial not only for this sector but also provided valuable insights into the broader traditional financial systems. STRs enabled authorities to detect and investigate major money laundering schemes and frauds. Simultaneously, they assisted the industry in identifying and eliminating bad actors, thereby facilitating a cleaner and more sustainable business environment.

While the regulatory measures have had a significant impact on the VDA sector, they also present certain challenges -

- Firstly, the compliance procedures and filing requirements are complex, and smaller VDA SPs are still adjusting to these new norms that were previously unfamiliar.
- Secondly, the costs associated with compliance have escalated, including the expenses for necessary tools and additional staff.
- Furthermore, finding professionals with the right skills and talent to handle these specialized tasks remains a significant hurdle.

These challenges underscore the ongoing need for adaptation and resource allocation within the VDA sector as it navigates the evolving regulatory landscape.



"We are fortunate as VDA intermediaries that the FIU-IND has taken a great deal of initiative in handholding us as Reporting Entities in the larger interest of ensuring a regulated environment for the sector. The proactive engagement right from forming of the regulations to the implementation and giving us constructive and meaningful feedback on our reporting is heartwarming. We are committed to continue the collaborative efforts under the aegis and supervision of the FIU-IND to bring our sector at par if not better than the best regulated entities that operate in the financial services environment."

*Muthuswamy Iyer
Senior Director (Compliance) and Principal Officer, WazirX*



4.2. Looking Ahead: India's Roadmap to Web3 Leadership

The journey of VDA SPs in India is likely to continue with the development of specific reporting formats for VDA SPs by FIU-IND. This will further streamline AML compliance for VDA SPs. The hope and aim are also to have more transparency and understanding of the potential of VDAs in the growth of the country and to have India emerge as the thought leader in adoption and regulation of Web3.

The future outlook for the VDA sector looks promising due to several factors:

- The perception of VDAs as primarily a vehicle for money laundering has significantly changed. Furthermore, the establishment of formal mechanisms for reporting suspicious activities has been a critical development.
- Even in the absence of a fully licensed regime, the current AML/CFT measures have conferred a degree of assurance, confidence, and legitimacy that was much required for the sector.
- There is now a recognition of VDA SPs at par with other regulated entities such as banking and financial institutions, thereby enhancing their credibility and accountability.

This path to obtaining reporting entity status has been characterized by regulatory evolution, industry collaboration, and the adoption of international best practices. While challenges remain, achieving reporting entity status has been a crucial step towards fostering a safe, secure, and compliant environment for the burgeoning virtual asset industry in India.



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