

What The Enforcement Directorate Notice To WazirX Alleges

WazirX, one of India's largest cryptocurrency exchanges, has been issued a show cause notice by the Enforcement Directorate.

The show cause notice has been issued for contravention of Section 3 (a) of the Foreign Exchange Management Act for transactions involving cryptocurrencies worth Rs 2,790.74 crore, the agency said in a notice sent to Zama Labs Pvt., the company that runs WazirX, and its directors Nischal Shetty and Sameer Hanuman Mhatre, who are co-founders of the crypto-exchange platform.

BloombergQuint has reviewed a copy of the notice.

The investigation on WazirX, carried out between March-November 2020, was started on the basis of an ongoing money laundering investigation into Chinese-owned illegal online betting mobile applications, the ED said in its notice dated June 10.

"Exact quantification of the actual amount of crypto-currency that has travelled offshore is not possible because of the completely anonymous way of record keeping of trades being done by M/s WazirX," it said.

The ED notice alleges that WazirX allows exchange of crypto tokens held in its pool accounts to wallets of other exchanges, which could be held by foreigners in foreign locations.

While carrying out such transactions, the exchange neither documents them properly, collects the requisite documents— such as A1/A2 forms prescribed under FEMA for remittances in foreign currency, nor follows the Know Your Customer norms for non-WazirX wallets, its address, the purpose of the transaction, or the IP Address of the other wallet users, it alleged.

This leaves WazirX in clear violation of the basic mandatory Anti-Money Laundering and Combating of Financing of Terrorism precaution norms and FEMA guidelines which are also applicable to Virtual Currency exchanges. Crypto-currencies have tangible value and are being used as an instrument of 'payment' and are, thus, akin to money for the purpose of FEMA.

As per Section 3 (a) of FEMA, dealing in or transferring any foreign exchange or foreign security to any person is barred, unless they are authorised under the Act, or have general or special permission from the Reserve Bank of India to do so.

The ED notice also alleges that:

- The accused Chinese nationals in the illegal online betting case had laundered proceeds worth nearly Rs 57 crore, by converting them into Tether or USDT, a stablecoin, and then transferring them to Cayman Island-registered crypto exchange Binance's wallets.
- Some WazirX users through their pool account with Binance have received cryptocurrency worth Rs 880 crore from Binance accounts, and transferred crypto worth Rs 1,400 crore to Binance accounts.
- There are glaring problems in the way WazirX is working, its book keeping, its due diligence norms and the manner of recording its transactions on blockchain. "As part of the onboarding process, they merely collect only a 'selfie photo', PAN and Aadhar scan image. No physical verification & proper due diligence of the clients is done," the notice alleged.

None of these transactions are available on the blockchain for any audit/investigation. It was found that the WazirX Clients could transfer 'valuable' crypto-currencies to any person irrespective of its location and nationality without any proper documentation whatsoever, making it a safe haven for users looking for money laundering/ other illegitimate activities.

Statement of the WazirX's Chief Executive was recorded by the ED, the notice said.

When contacted, WazirX said that the company was yet to receive the show cause notice from the Enforcement Directorate.

"WazirX is yet to receive any show cause notice from the Enforcement Directorate as mentioned in today's media reports. WazirX is in compliance with all applicable laws," said Nischal Shetty, chief executive at WazirX.

"We go beyond our legal obligations by following know your customer and anti-money laundering processes and have always provided information to law enforcement authorities whenever required." Shetty said the exchange is able to trace all users on its platform with official identity information. "Should we receive a formal communication or notice from the ED, we will fully cooperate in the investigation," he said.

But the ED notice to the exchange alleges that even in the case of other exchange transactions, only the general pool wallet ID of WazirX is reflected, and the individual wallets of the clients are not mentioned on the blockchain. "Thus, the argument of WazirX that blockchain records are completely transparent is completely negated by improper recording of the transactions on the blockchain."

WazirX has a feature that allows its users to transfer funds from their WazirX wallet to Binance wallets internally. Through this feature, users can instantly transfer various crypto

tokens such as Tether, Bitcoin, Binance and WazirX's own tokens, Ether, among others, for zero charges.

Chinese crypto exchange and blockchain ecosystem Binance had acquired WazirX in November 2019, which allowed WazirX users to buy and sell crypto with Indian rupees on the Binance Fiat Gateway.

The service allowed users to transfer tokens without the transactions getting recorded on blockchain, as it is an internal transfer between wallets of the two exchanges, a cryptocurrency investor on the platform told BloombergQuint requesting anonymity.

"It has a preferential agreement with Binance and all transactions between the clients of the two exchanges are not being recorded on the blockchain," alleges the ED notice.

Legal Ambiguity

While cryptocurrencies are currently not illegal in India, the government has been mulling regulation pertaining to these tokens for some time. A bill looking to ban cryptocurrencies had been listed in the budget session of Parliament but was not introduced.

In 2018, the Reserve Bank of India had issued a circular barring regulated entities like banks from providing services to businesses and customers dealing in cryptocurrencies. That circular was struck down by the Supreme Court in March 2020 on grounds that the action was not "proportionate" as the regulator failed to show the damage these tokens were doing to the financial system.

Since then, volumes on cryptocurrency exchanges are believed to have surged. In recent months, banks have once again started to pull back on service to crypto customers following informal guidance from the regulator, BloombergQuint reported.

On May 31, the RBI clarified that its 2018 circular is no longer valid and cannot be cited by banks as a reason to deny services.

The banking regulator, however, asked banks and other regulated entities to continue customer due diligence on the basis of other existing provisions, such as KYC, anti-money laundering, combating of financing of terrorism. Further, it asked regulated financial institutions to comply with obligations under Prevention of Money Laundering Act and provisions related to overseas remittances under FEMA.

But a lack of regulatory clarity on crypto tokens in India continues causing ambiguity on their legality. "Cryptocurrency in India still needs regulatory clarity as to whether it is treated as a virtual currency or an asset," Nikhil Narendran, technology law partner at law firm Trilegal, said. "For both cases, different FEMA rules will apply."

“In this case, the Enforcement Directorate has issued its notice citing violation of Section 3 of FEMA. But going by that logic, all kinds of crypto transactions that are done on foreign exchanges or in a peer-to-peer trade can be deemed illegal, and this may apply to other crypto exchanges as well,” he said. “However, the notice also mentions the lack of book-keeping by the exchange (WazirX), which facilitated laundering.”

(Source: www.bloombergquint.com)