

Regulatory Digest

July 09, 2024

THE FINANCIAL SERVICES BULLETIN

This is the first edition of Nishith Desai Associates' quarterly financial services newsletter in collaboration with US-India Business Council.

U.S.-India Business Council

INTRODUCTION

The Indian financial services sector ("FS") offers promising opportunities of investment and consolidation to investors and stakeholders alike, considering the recent growth of this sector in India. Factors that have contributed include the rising middle-class and favourable median age of the Indian working population, digitalisation of services offered, government focus on ease of doing business in the sector, and the increasing entrepreneurial population in India.

With this backdrop, Nishith Desai Associates ("NDA") in collaboration with the US-India Business Council ("USIBC") is pleased to launch a financial services quarterly roundup titled "The Financial Services Bulletin". Through this publication, we aim to cull out key developments in the financial services industry that, in our view, "summarise the quarter". Our roundup has been meticulously curated to ensure that key developments relevant to our stakeholders are discussed briefly.

This roundup highlights the key developments in the FS sector from April through June 2024.

REGULATED ENTITIES, CRYPTOCURRENCY AND FINTECH

1. Reserve Bank of India ("RBI") releases Draft Circulars on the Regulation of Payment Aggregators (April 2024)

Through a press release dated April 16, 2024, the RBI released two draft circulars, which have been prepared in order to: (i) bring physical point-of-sale payment providing entities into the scope of the existing definition of "payment aggregators", in line with the "Payments Vision 2025" of the RBI¹ ("Draft Circular 1"); and (ii) amend the existing guidelines that regulate payment aggregators and gateways ("Draft Circular 2").²

Draft Circular 1 indicates that going forward, all non-bank online point of sale service providers will be required to seek the prior approval of the Department of Payment and Settlement Systems, the RBI, and the Central Office for commencement of their business. Further, it also sets out the following net worth criteria that is to be maintained by non-bank entities (failing which they will be required to wind up their operations):

- Non-banks providing physical point of sale services as on date of passage of Draft Circular 1: Minimum net worth of INR 15,00,00,000 (i.e. approximately USD 1,799,331) at the time of submitting application to the RBI for authorisation, and a minimum net worth of INR 25,00,00,000 (i.e. approximately USD 2,998,885) by March 31, 2028 and all times thereafter.
- New non-banks that intend to provide physical point of sale services after the date of passage of Draft Circular 1: Minimum net worth of INR 15,00,00,000 (i.e. approximately USD 1,799,331) at the time of submitting application to the RBI for authorisation, and a minimum net worth of INR 25,00,00,000 (i.e. approximately USD 2,998,885) by end of the third financial year from the grant of authorisation and all times thereafter.

Draft Circular 2 imposes obligations applicable on the online payment aggregators such as undertaking due diligence of merchants onboarded by them, as per the RBI's KYC directions released in 2016 on the physical Point-of-Sale payment aggregators too. Further, non-bank physical Point-of-Sale payment aggregators will be required to register themselves with the Financial Intelligence Unit-India. These provisions are likely to increase operational costs for such payment aggregators.

2. RBI finalises the "Framework for Self-Regulatory Organisation(s) ("SRO") in the FinTech Sector" (the "SRO Framework") (May 2024)

On May 30, 2024, the RBI laid down a finalised version of the SRO Framework,³ incorporating feedback received from industry participants to their previous draft framework that was released on January 15, 2024.⁴

SROs are entities that are intended to be tasked with establishing and enforcing industry standards, promoting ethical conduct, and ensuring market integrity amongst their members. While the eventual goal is for each sector (of

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which regulated entities are a part) to have a separate SRO, the SRO Framework is targeted specifically for the fintech sector. The applicant for the SRO must: (i) be a Section 8 not-for-profit company as per the Companies Act, 2013; (ii) should not have a single shareholder holding more than 10% of its paid-up share capital; and (iii) should have a minimum net worth of INR 2,00,00,000 (i.e. approximately USD 239,910) within 1 (one) year after becoming an SRO. In terms of membership, currently, the membership to the SRO is voluntary and available to domestic and foreign fintech firms, with the SRO applicant having the obligation to ensure that representation across entity sizes is equal and the fee is non-discriminatory.

This framework will, once enacted, create a 'community' amongst entities that are members of the SRO and assist members with alignment to regulatory requirements, priorities and foster innovation through mutual discussions.

3. Imposition of penalties on cryptocurrency exchange Binance by Financial Intelligence Unit of India ("FIU-IND") for violation of anti-money laundering law (June 19, 2024)

On June 19, 2024, the FIU-IND has imposed a penalty of INR 18,82,00,000 (i.e. approximately USD 2,250,000) on Binance, the world's largest cryptocurrency exchange, for violations of Prevention of Money Laundering Act, 2002 ("PMLA") and allied rules.⁵ This is in furtherance of a show cause notice issued to Binance and eight other cryptocurrency exchanges in December 2023 for non-compliance with the PMLA for their operations in India,⁶ that led to it being banned in January 2024.⁷

These rules were related to the maintenance of records and reporting of suspicious transactions. The violations identified by the FIU-IND included contraventions of Section 12(1) of the PMLA read with Rules 3(1)(D), 7(1), 7(3), and 8(2) of the PMLA Rules.⁸

4. RBI's notification of the "Master Direction to the Asset Reconstruction Companies" (April 2024)

The RBI has released a new master direction to regulate Asset Reconstruction Companies ("ARCs"), that has been effective since April 24, 2024, with an aim to "ensure prudent and efficient functioning of ARCs and to protect the interests of investors".⁹

The master direction now prescribes an increased minimum net owned fund ("NOF") of INR 300,00,00,000 (i.e. approximately USD 35,986,620) to commence with asset reconstruction / securitization activities in India. Further, existing ARCs are required to ensure that such minimum NOF is met by March 31, 2026. The previous minimum NOF for ARCs was INR 100,00,00,000 (i.e. approximately USD 11,995,540).¹⁰ In terms of permissible activities, the master direction specifies that no ARC can purchase real estate or construct a structure, with the exception of 10% of its own cash that may be invested for internal purposes. A capital adequacy ratio at least 15% of the total risk-weighted assets must also be maintained. It also provides details with respect to the governance, audit and other key activities associated with the functioning of ARCs in India.

With the help of these guidelines, ARCs in India will operate more efficiently and responsibly, and the enactment of a centralised directive will create regulatory certainty.

5. RBI's recent crackdown against lenders' non-compliance with Fair Practices Code (April and May 2024)

Regulated entities (including commercial banks, cooperative banks and non-banking financial companies ("NBFCs")) bound by the RBI's "Fair Practices Code for Lenders, 2003 ("FPC") have recently been facing increased scrutiny, with the regulator actively imposing fines for non-compliance with its provisions. FPC has been created with an intent to protect borrowers from interest charging practices that may be detrimental to / have onerous terms.

Recent penalties imposed include those on IDFC First Bank, LIC Housing Finance,¹¹ and Hero FinCorp.¹² In furtherance of these investigations, the RBI issued a public notification on April 29, 2024¹³ indicating that its investigation of regulated entities for the period ended March 31, 2023 revealed the following unfair activities:

- Charging of interest from the date of sanction of loan / date of execution of loan agreement, *as opposed to* from the date of actual disbursement of the funds to the customer;
- Charging of interest rates for the entire month (in case of loans disbursed during the course of the month), as opposed to for the period during which such loan was outstanding; *and*
- Collection of advance installments but reckoning of the full loan amount for levying interest.

Accordingly, the RBI has indicated that in light of the above practices being in violation of the FPC, regulated entities are required to "review their practices regarding mode of disbursal of loans, application of interest and other charges and take corrective action" in order to ensure compliance with the law. Considering the recent scrutiny of multiple regulated entities, within the span of the last 1-2 months itself, it will be important for regulated entities to ensure compliance with this directive to prevent penalty imposition.

INSURANCE

1. Insurance Regulatory and Development Authority of India ("IRDAI") releases advertising guidelines for insurance companies (June 2024)

In order to regulate the advertisements relating to insurance and in an attempt to ensure that the public is not misled, the IRDAI recently released the "Master Circular on Operations and Allied Matters of Insurers" on June 19, 2024.¹⁴

This master circular lays down the compliance requirements for Advertisement Committees, specifically stating that insurers will be barred from advertising services that are not relating to insurance. Other restrictions on advertising include: (i) exaggerating claims of products; (ii) denigrating references to competitors; (iii) highlighting of the benefits of products without providing an assessment of its risks, etc. Further, unit-linked or index-linked products cannot be advertised as "investment products" and must clearly specify their difference from traditional insurances. Separately, each insurer must now comply with the guidelines specified by the Advertising Standards Council of India and ensure that any ratings / rankings mentioned in the advertisements are from third-party independent entities / agencies. The master circular also contains other chapters that specify the outsourcing of activities, grievance

addressal system, and other requirements to be maintained by insurers.

2. IRDAI notifies the “Master Circular on IRDAI (Registration, Capital Structure, Transfer of Shares and Amalgamation of Insurers) Regulations, 2024” (“R&C Regulations”) (May 2024)

The IRDAI notified a master circular to the R&C Regulations (which were released in March 2024) to provide guidance with respect to the forms and other compliances specified within the R&C Regulations. This master circular was notified on May 15, 2024.¹⁵ The R&C Regulations were an important development within the early part of the year as they consolidated and repealed seven regulations which governed the registration, issuance of capital, transfer of shares and amalgamation of insurance companies, into one single consolidated regulation.

The master circular notified in May 2024 lays down the applications to be submitted, clarifications, submission of returns and transitory provisions relating to the R&C Regulations and will be an important guiding factor for insurance companies going forward.

3. IRDAI notifies the “Master Circular on Corporate Governance for Insurers, 2024” (May 2024)

IRDAI's new master circular was released on May 22, 2024¹⁶ and is intended as a follow-on to the Insurance Regulatory and Development Authority of India (Corporate Governance for Insurers) Regulations, 2024 (“CG Regulations”) that were notified in March 2024.¹⁷ The CG Regulations replace the 2016 regulations on this subject and set out requirements concerning the composition of board and its committees, succession planning, treatment of related party transactions, etc.

The master circular is intended to apply all Indian insurance companies (except for foreign reinsurance branches) and must be complied with on or before June 30, 2024. The key compliance requirements include: (i) insurers being obligated to ensure that the independent and non-independent director composition on the board is optimum, and that the committees are constituted as per the composition set out within the master circular; (ii) each director being “fit and proper”; (iii) multiple disclosures being made within the annual accounts, (iv) related party transactions being subject to prior approval; and (v) imposition of an obligation on the board and management prevent misuse of corporate assets and / or through related party transactions. Further, insurers are also required to adopt a mandatory whistle-blower policy.

These regulations aim to create a more robust and ethical governance structure within the Indian insurance industry and will be instrumental in creating best practices for insurers.

FOREIGN PORTFOLIO INVESTMENT

1. SEBI issues a circular on “Disclosures of Material Changes and Other Obligations for Foreign Portfolio Investors (“FPIs”)” (June 2024)

SEBI amended the SEBI (Foreign Portfolio Investors) Regulations, 2019 (“FPI Regulations”) through the notification of SEBI (Foreign Portfolio Investors) (Amendment) Regulations, 2024 on May 31, 2024 (“FPI Amendment Regulations”). The FPI Amendment Regulations, *inter alia*, relaxed the timelines for the FPIs to intimate their respective Designated Depository Participants (“DDPs”) custodians of any material change in information. In furtherance of the FPI Amendment Regulations, SEBI also released a circular on June 5, 2024 (“Material Changes Circular”), detailing the categories of material changes, timelines for intimation of such material changes and submission of supporting documents in relation to such changes.

The FPI Amendment Regulations, read with the Material Changes Circular, removes subjectivity around the scope of ‘material change’ for an FPI, thereby, promoting ease of doing business in India. We have analysed the changes in detail [here](#).

2. SEBI issues a circular on “Framework for providing flexibility to FPIs in dealing with their securities post expiry of their registration” (June 2024)

SEBI released a circular on June 05, 2024, pursuant to the FPI Amendment Regulations, prescribing the framework and timelines for regularization and/or disposal of the securities held by the FPIs post expiry of their registration with SEBI (“Circular”). This was issued at the backdrop of a SEBI consultation paper dated February 7, 2024 and the SEBI board meeting approving the said framework, dated March 15, 2024.

Prior to the release of the FPI Amendment Regulations and the Circular, the FPIs that failed to pay the registration fee to their DDPs before the expiry of their registration, were not permitted to apply for continuance after such expiry and were required to make a fresh registration application post surrendering their existing FPI license. In order to surrender the license, the FPI was to have NIL balance in its account, and therefore, in the absence of a liquidation mechanism for unsold securities post expiry of registration, the FPIs could only authorize their DDPs to write-off such securities, i.e., extinguish them from the safekeeping account and freeze them in the FPI's demat account. The Circular tends to address and regularize such issues.

We have analysed the changes in detail [here](#).

3. SEBI issues a circular on “Participation by Non-Resident Indians (“NRIs”), Overseas Citizens of India (“OCIs”) and Resident Indian (“RI”) individuals in SEBI registered FPIs based in International Financial Services Centres in India” (May & June 2024).

The FPI Regulations prohibit NRIs / OCIs / RIs to be FPI applicants, however, permit them to be constituents of the FPIs, subject to the following conditions:

(a) *Individual and aggregate contribution cap*: The contribution of a single NRI / OCI / RI is capped at less than 25% of the corpus of the FPI, and the aggregate contribution has been restricted to below 50% of the corpus.

(b) *Control*: NRIs/OCIs/RIs are barred from exercising control over the FPIs, subject to certain relaxations provided under the Master Circular for FPIs, dated May 30, 2024.

The SEBI circular released on June 27, 2024, read with SEBI (FPI) (Second Amendment) Regulations, 2024 and International Financial Services Centres Authority's circular of May 2, 2024, permits up to 100% aggregate

MISCELLANEOUS

1. Recent trends relating to the interpretation of “significant beneficial owner” (“SBO”) of Indian companies under the Companies Act, 2013 (April and May 2024)

The reporting of SBOs is governed by Section 90 of the Indian Companies Act, 2013, read with the Companies (Significant Beneficial Owners) Rules, 2018, and has been brought in to track the ultimate beneficiary of the shares held in Indian companies. As per Indian law on this subject, all Indian companies are required to disclose an SBO (i.e. any individual with at least 10% ownership *or* control in the Indian company, either directly or indirectly) in the filings made to the Indian Registrar of Companies (“ROC”). While the law requires the Company to seek such information from each of its shareholders, such shareholders are also obligated to provide the relevant details to the company to enable it to undertake the filing.

In a recent case involving LinkedIn India,¹⁸ the ROC penalised LinkedIn India for not disclosing Microsoft’s CEO (i.e. Satya Nadella) and LinkedIn’s Global CEO (i.e. Ryan Roslansky) as the SBOs of LinkedIn India. The ROC based its order on the reasoning that these individuals ultimately held *control* over LinkedIn India through the reporting structures and their ultimate financial oversight on such structure. Accordingly, even though LinkedIn India was not directly owned by Microsoft (and accordingly did not meet the 10% ownership test), the authorities concluded that Microsoft’s control over key decisions made them SBOs that should have been reported to the ROC. We have analysed this order [here](#). A similar penalty was also levied on Samsung Display Noida Private Limited for non-compliance with the law.¹⁹

Considering the increased inflow of foreign investment into entities operating in the FS sector, it is imperative for incoming investors to note the aforesaid changing trends in the analysis of SBOs under the Companies Act, 2013, specifically considering that these may impact the manner in which they disclose SBOs to their portfolio companies going forward.

CONCLUSION

The first quarter of the Financial Year 2023-24 has seen increased regulatory activity, in terms of law-making and regulation alike. It will be interesting to witness the aftermath of these key developments during the next half of calendar year 2024.

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You can direct your queries or comments to the relevant member.

¹https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=4418.

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⁷<https://economictimes.indiatimes.com/markets/cryptocurrency/india-bans-foreign-crypto-platforms-like-binance-kucoin-what-should-investors-do-now/articleshow/106830654.cms?from=mdr>.

⁸https://www.livelaw.in/pdf_upload/financial-intelligence-unit-penalizes-binance-225-million-for-anti-money-laundering-violations-545855.pdf.

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¹¹<https://www.businesstoday.in/industry/banks/story/rbi-imposes-penalties-on-idfc-first-bank-lic-housing-finance-for-non-compliance-424541-2024-04-06>

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¹⁴RDAI/F&I/CIR/78/5/2024.

¹⁵<https://irdai.gov.in/document-detail?documentId=4885776>.

¹⁶<https://policyholder.gov.in/web/guest/document-detail?documentId=4916164>.

¹⁷IRDAI/F&I/CIR/MISC/82/5/2024.

¹⁸<https://www.mca.gov.in/bin/dms/getdocument?mds=san%252BPg76sl9tkgd5lcHzg%253D%253D&type=open>.

¹⁹<https://economictimes.indiatimes.com/industry/cons-products/electronics/mca-penalises-samsung-display-noida-for-breach-of-companies-act-norms/articleshow/110977498.cms>.

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