BASILSTONE
CONSULTING PRIVATE LIMITED

atharv

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Basilstone Consulting is pleased to present to you the **April 2022** issue of atharv, covering regulatory insights as well as discussion papers. This issue covers the following areas:

1. Regulatory updates & its expected impact

1.1. Securities & Exchange Board of India

1.1.1. Guidelines in pursuance of amendment to SEBI KYC (Know Your client) Registration Agency (KRA) Regulations, 2011

- KRA's shall act as repository of KYC data in the securities market and shall be responsible for storing, safeguarding and retrieving the KYC documents and submit to the Board or any other statutory authority as and when required.
- KRA's shall independently validate records of those clients (existing as well as new) whose KYC has been completed using Aadhaar as an OVD. The records of those clients who have completed KYC using non-Aadhaar OVD shall be validated only upon receiving the Aadhaar Number.
- The process of validation has been prescribed in the said circular.
- The validation of all KYC records (new and existing) shall commence from July 1, 2022.

Impact:
This amendment puts an additional responsibility on KRAs to independently validate KYC records of all clients uploaded on their system by the Registered intermediaries and maintain an audit trail of the upload/modification/download with respect to KYC records of clients.

1.1.2. Comprehensive Risk Management Framework for Electronic Gold Receipts (EGR) segment

SEBI has notified a comprehensive risk management framework for EGR segment on the stock exchange, in continuation to paving the way of operationalization of Gold Exchange.

1.2. Reserve Bank of India

1.2.1. Establishment of Digital Banking Units (DBUs)

RBI has prescribed regulations for all Domestic Scheduled Commercial Banks (excluding Regional Rural Banks, Payments Banks and Local Area Banks) for providing Digital Banking services as a separately identified Digital Banking Unit of the Bank.
The regulations encompass areas of Permissibility to open DBUs, Infrastructure & Resources, Cyber Security, Minimum Products & Services to be offered and Reporting requirements, amongst others.

Impact:
The regulations pave way for the Banking Sector to enter the Fintech space in a regulated environment, which would not only act as a catalyst to the Financial Inclusion goals, but also ease the day-today convenience of banking interactions.

1.2.2. Compliance Function and Role of Chief Compliance Officer (CCO) – NBFCs

RBI has issued regulations for setting up and functioning of the Compliance Function and Appointment & responsibilities of Chief Compliance Officer of NBFCs falling in the Middle Layer (ML) and Upper Layer (UL). NBFC-UL and NBFC-ML shall put in place a Board approved policy and a Compliance Function, including the appointment of a Chief Compliance Officer (CCO), based on the Framework given, latest by April 1, 2023 and October 1, 2023, respectively.

The regulations prescribe directions for identification & assessment of compliance risk, scope & coverage of compliance function, responsibilities of Senior Management & compliance function, apart from mandated requirements of adopting a Compliance Policy, Compliance Programme, Qualifications & Staffing, etc.

Impact:
RBI's regulations convey the regulator's intention for NBFCs to have an independent compliance function to address the Compliance Risks of NBFC-ML and NBFC-UL. The shifts in the regulatory space of NBFCs suggest due focus of the regulator being drawn to the systemic importance of NBFCs, apart from Banks, as tools of financial inclusion.

1.2.3. Disclosures in Financial Statements - Notes to Accounts of NBFCs

RBI has prescribed additional minimum disclosure requirements, apart from those previously prescribed, which is applicable to all NBFCs for annual Financial Statements of year ending 31st March 2023 and onwards.

1.2.4. Loans and Advances – Regulatory Restrictions – NBFCs

The regulator has prescribed the regulatory restrictions on NBFCs for Loans and Advances to Directors, Senior Officers, and Real Estate Sector w.e.f. 01st October 2022. Majority of the restrictions are applicable to NBFC-ML and NBFC-UL, while NBFC-Base Layer is mandated to only have a Board approved policy, apart from disclosures prescribed.

1.2.5. Scale Based Regulation (SBR) for NBFCs: Capital requirements for Non-Banking Finance Companies – Upper Layer (NBFC-UL)

RBI has prescribed the minimum Common Equity Tier 1 (CET1) ratio of 9% for NBFC-UL (Other than CICs), to be maintained on an ongoing basis.

1.2.6. Credit Card and Debit Card – Issuance and Conduct Directions, 2022

The regulator has issued comprehensive directions pertaining to issue and conduct of Debit Cards and Credit Cards. A major change in the RBI's regulatory environment is that the customer is now permitted to opt for a change in the billing cycle of credit cards, apart from others.

1.2.7. Guidelines on Compensation of Key Managerial Personnel (KMP) and Senior Management in NBFCs

Reserve Bank of India has issued directions on adoption of various governance mechanisms to determine the compensation of Key Managerial Personnel (KMP) and Senior Management of Middle Layer and Upper Layer NBFCs, w.e.f. 01st April 2023. The directions focus on classification between fix and variable pays and lays down principles for its classification, along with inclusion of restrictions on guaranteed bonus and Malus / Clawback clauses.

Impact:
Stated NBFCs would now be required to have a minimum governance framework and policy parameters for compensation of KMPs and Senior Management. This would assist align the risk-remuneration across the industry by setting an internal oversight mechanism.

1.3. International Financial Services Centre Authority

1.3.1. Guidance framework on Sustainable and Sustainability linked lending by financial institutions

IFSCA has notified that from the FY beginning 01 April 2023, the IBUs (IFSCA Banking Units) and FC/FUs (Finance Company/Finance Units) undertaking lending as one of the permitted activities shall have atleast 5% of their gross loans and advances directed towards green/social/sustainable/sustainability-linked sectors/facilities. Guidelines have been prescribed to achieve the same.

Impact:
This shall result in adoption of principles aligned with the existing international standards viz. green/ social loan principles developed by loan market association (LMA), bond principles developed by the International Capital Markets Association (ICMA), Climate Bond Standards by Climate Bonds Initiative and any other similar recognised standards.
Banks and financial institutions are one of the key players who can support this transition by directing financial flows to sustainable and climate-friendly solutions via lending or by raising capital for sustainable and sustainability-linked projects.

1.3.2. Framework for FinTech Entity in the International Financial Services Centres (IFSCs)

The framework is for fintech entities across the spectrum of banking, insurance, securities, and fund management in the International Financial Services Centres (IFSC) and is in furtherance of its mandate to develop and regulate financial products, financial services and financial institutions in the International Financial Services Centres.
There will be a dedicated Regulatory Sandbox for FinTech products or solutions namely IFSCA FinTech Regulatory Sandbox. The IFSCA has been empowered to grant Limited Use Authorisation within FinTech Regulatory Sandbox to the eligible financial technology entities in IFSC.

The entities would also be able to avail Grants under the IFSCA FinTech Incentive Scheme 2022.

The framework also incorporates the Inter Operable Regulatory Sandbox (IoRS) mechanism which aims to facilitate testing of innovative hybrid financial products/services falling within the regulatory purview of more than one financial sector regulators.
It has been proposed to set up a Regulatory Referral mechanism which shall be governed as per the provisions of the Memorandum of Understanding (MoU) or collaboration or special arrangement between IFSCA and corresponding overseas Regulator(s).

Impact:
This framework shall boost the establishment of a world class FinTech hub within the International Financial Service Centre.

1.3.3. IFSCA (FinTech Incentive) Scheme 2022

The principal objective of the scheme is to promote the establishment of a world class FinTech Hub, comparable with those located in advanced International Financial Centres (IFCs) across jurisdictions, at International Financial Services Centre (IFSC) in India by providing financial support to FinTech activities in the form of specific grant(s) as specified in the scheme, based on their eligibility and fulfilment of terms and conditions as may be specified. This scheme shall be open to the following:
a) Domestic FinTech's seeking access to overseas markets;
b) Domestic FinTech's seeking listing on IFSCA recognised stock exchanges;
c) Foreign FinTech's seeking market access to IFSCs in India and work within the Authority's regulatory framework;
d) Foreign FinTech's seeking access to domestic market under Inter-Operable Regulatory Sandbox (IORS) framework;
e) Domestic FinTech's extending business to the IFSCs either by way of authorisation or registration or through the regulatory sandbox

1.3.4. IFSCA (Fund Management) Regulations 2022

The Regulations have been issued in furtherance of IFSCA's objective to develop a best-in-class regulatory regime for funds and fund managers within IFSC that will support the growing aspirations of the asset management industry and development of IFSC as a leading global destination for the industry.
The Key Highlights of the regulations are as follows:

1. A unified registration for multiple fund activities by regulating the fund manager instead of the existing approach of regulating the Funds
2. A green channel route to launch Venture Capital Schemes or non-retail schemes soliciting money from accredited investors
3. Substance requirements for the FME have been defined;
4. Recognition of family investment fund;
5. Liberal co-investment regime through a special purpose vehicle (SPV) or through a segregated portfolio by issuing a separate class of units.

6. Introduction of Special Situation Funds (SSFs) to invest in special situation asset to incentivize funds with a distressed strategy
7. Innovation to fund activities (Fund Lab) by giving power to the IFSCA to provide relaxations from the applicability of all or any of the requirements of the Regulations
8. Permission to funds to invest up to 20% of corpus in physical assets such as real estate, bullion, art or any other physical asset.
9. Funds with focus on ESG sectors/strategies permitted to be launched
10. Launching of retail schemes such as mutual funds opening avenues for cross-border investments. They can also launch Exchange Traded Funds (ETFs), which can be either equity, debt, commodity, hybrid, actively managed, etc. Gold and Silver ETF fund managers can invest in Bullion Depository Receipt.

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2. Discussion Papers

2.1. Changing dynamics of the Mutual Fund Industry in India – An Introduction

The Evolution

Mutual funds play a very active role in financial markets all around the world. However, in India the first mutual fund company was the government sponsored Unit Trust of India, which was established in 1963 and was the only mutual fund available to investors until public sector banks became eligible to offer mutual funds in the 1980s. The SBI Mutual Fund became the first NON-UTI mutual fund in India in the year 1987. But it was in 1993 when the private sector was also allowed to compete and there was a surge in the growth of assets under management.

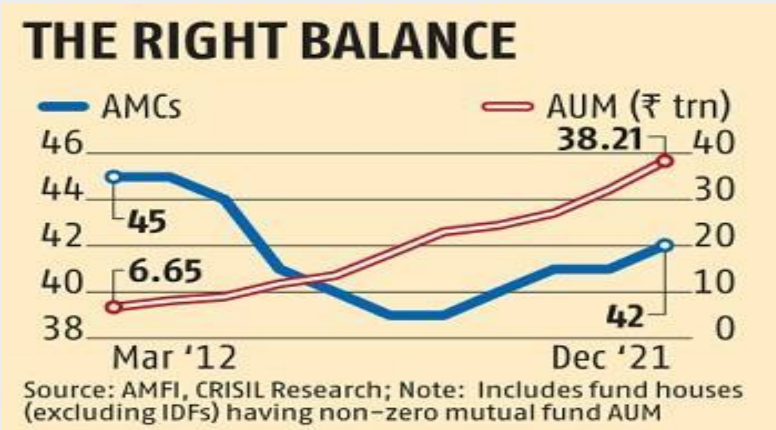
The SEBI Mutual Fund Regulations came into existence in 1996 after the passing of the Securities and Exchange Board of India (SEBI) Act of 1992. Furthermore, The Association of Mutual Funds in India (AMFI), a non-profit organization, was founded in 1995 as the industry developed, with the objective of promoting healthy and ethical marketing practices in the mutual fund industry of India.

The Growth

After the onset of a regulatory framework, the Mutual fund companies have extended and grown exponentially with the help of foreign institutions setting companies in India through joint ventures and properties.

At present there are 47 Mutual Funds registered with SEBI and additionally 10 Mutual Funds awaiting the Mutual Funds License, out of which 3 have been granted In-Principle Approval, as on 31 December, 2021.

Albeit, the assets under management (AUM) for the domestic mutual fund (MF) industry has jumped six-fold in the past decade to Rs 38.2 trillion, but what's surprising is that the number of asset management companies (AMCs) managing at least some AUM have declined from 45 to 42, as per an AMFI-Crisil Research.



Though there lies immense growth potential, it also brings along its own set of problems, which makes it challenging for small players to survive the intense & cut throat competition. The Top 5 AMC's share the largest AUM today and the industry is projected to grow at a much higher rate than the last decade.

With the changing set of dynamics in the Mutual Fund Industry, the regulators have also felt the need to re-evaluate the role and eligibility of the Sponsor of a Mutual Fund to facilitate growth and innovation in the industry.

Recent Regulatory Action

SEBI, the regulatory authority for Mutual Fund has set up a Working group to evaluate the possibility of an alternative set of eligibility requirements to sponsor a Mutual Fund, to enable new players who would otherwise not be eligible to act as sponsor.

Further, also examining the conflicts that may arise if pooled investment vehicles or private equity act as a sponsor and the need for sponsor to dilute its stake in AMC from the existing requirement of 40 % of Net worth of AMC and the alternative pathways that may be adopted by the sponsor in this regard.

This move was already indicated by the regulator with notifying a higher net worth requirement in case of non-fulfilment of eligibility requirements vide amendment dated 05.03.21.

Presently, the eligibility requirements of sponsor are as below:
The sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions and sound track record for this purpose shall include:

i. *be carrying on business in financial services for a period of not less than five years; and*
ii. *ensure that the networth is positive in all the immediately preceding five years; and ensure that the networth is more than the proposed capital contribution of the sponsor in the asset management company and ensure that in case of change in control of the existing asset management company due to acquisition of shares, the networth of the sponsor is more than the aggregate par value or market value of the shares so acquired, whichever is higher; and*
iii. *he sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year*
Provided that the applicant shall have a networth not less than rupees one hundred crore in case the aforementioned requirement is not fulfilled.

This shall help in not only fostering healthy competition within the Mutual Fund Industry but also result in consolidation of small players so as to achieve economies of scale. With the new eligibility norms, it also expected to receive a fresh flow of capital to boost the mutual fund industry and also encourage innovation.

Additionally, it is also been decided to review the roles and responsibilities of the Trustees so that they can focus on fiduciary obligations and supervisory roles cast on them and operational obligations can be further delegated to AMC. Also, identifying responsibilities of trustees for which they can avail services of professional assurance agencies and recommending required financial resources to be made available to the trustees to independently discharge their obligations.

Conclusion

The changes recommended by the regulator is a welcome move for the private equity players who will bring along some fresh thoughts and perspective to the mutual fund industry, but how beneficial the entry of the new players will be on the investors, will be known only in the time to come.

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About Basilstone

Basilstone Consulting Private Limited ('Basilstone") has been promoted to partner with the society and its businesses to achieve their true potential and help realize their vision. We work closely with our clients and enrich their growth by offering them solution driven consultancy services in the areas of strategic planning, incubation, impact analysis, idea validation, product validation, feasibility study, synergy evaluations, fund raising, restructuring, transaction advisory, representation – guiding on regulatory / non-regulatory meetings, succession planning, Inbound and outbound investment, due diligence, dealing with regulatory / statutory authorities, etc.

We, at Basilstone aim to position ourselves as the 'Go to Consultants' for **Simple Solutions & Value Creation** recognised by our clients for delivering ultimate desired results.

The Purpose of Basilstone is to provide simple solutions and create value backed by:

Strong Processes

In-Depth Knowledge

Invaluable Experience

Deep-Rooted Values

We clearly resonate ourselves with the ever-growing Basil, inspiring us to imbibe the quality of being natural and pure while we adapt to changing conditions and innovation. The rock-solid Stone is representative of our endurance, stability, permanence and our determination, paving the path of value creation for our clients and our firm allegiance to our principles.

Basilstone is the quintessential blend of traditional values and modern thoughts which are echoed in the experience, enthusiasm and energy of its people and translated in the services rendered to its clients.

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