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

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I. Regulatory updates & its expected impact

1.1. Securities & Exchange Board of India

1.1.1. Procedure for seeking prior approval for change in control of Portfolio Managers

This circular supersedes Circular No. SEBI/HO/IMD/IMD-I/DOF1/P/CIR/2021/564 dated May 12, 2021, the procedure for obtaining prior approval in case of change in control of Portfolio Managers. The revised circular lays down the procedure for applying for change in control of portfolio manager, in a scenario where NCLT approval shall be required.

Impact:
It aims at streamlining the process of providing approval to the proposed change in control of Portfolio Manager including for cases where NCLT approval shall be required so that there is complete synchronization of regulatory approvals required between NCLT and SEBI.

1.1.2. Investor Grievance Redressal Mechanism

In case of disputes between member and client for matters arising out of transactions in the stock exchange including of civil nature shall first refer the complaint to the IGRC and/ or to arbitration mechanism provided by the Stock Exchange before resorting to other remedies available under any other law. The requisite time period of 3 months has been prescribed for availing arbitration mechanism of Stock Exchange in case a complainant/member, who is not satisfied with the recommendation of the IGRC shall avail the arbitration mechanism of the Stock Exchange.

1.1.3. Adjustment in derivative contracts for dividend announcements

The adjustment in derivative contracts shall be carried out in cases where dividends declared are at or above 2% of the market value of underlying stock. The revised threshold, as stated above, would be applicable for dividend announcements done on or after the effective date of the circular i.e 29 June 2022.

1.1.4. Guidelines for Large Value Fund (LVF) for Accredited Investors under SEBI (Alternative Investment Funds) Regulations, 2012 and Requirement of Compliance Officer for Managers of all AIFs

LVFs are exempt from filing their placement memorandum with SEBI through Merchant Banker and incorporate comments of SEBI, if any, in their placement memorandum i.e. LVFs can launch their scheme under intimation to SEBI. The placement memorandum for LVF schemes filed with SEBI, shall be duly signed and stamped with an undertaking by CEO of the Manager to the AIF (or person holding equivalent role or position depending on the legal structure of Manager) and Compliance Officer of Manager to the AIF and submitted in the prescribed format. Extension of tenure beyond two years shall be permissible for LVF subject to terms specified in the contribution agreement.

All AIFs shall ensure that Manager to AIF designates an employee or director as Compliance Officer who shall be a person other than CEO of the Manager (or such equivalent role or position depending on the legal structure of Manager).

Impact:
Mandatory Appointment of a compliance officer for all AIF's shall establish a stronger governance culture for AIFs and was a much needed move with the increase in investors money flowing through AIF structures. Further, reduced compliances formalities for establishing Large Value Funds shall encourage greater participation by Large Value Accredited Investors.

1.2. Reserve Bank of India

1.2.1. Processing of e-mandates for recurring transactions

The RBI witnessing changing consumer habits permitted the card issuers for processing of recurring transaction through e-mandates, after Additional Factor Authentication (AFA). The resulting acceptability and the success of the facility, has led the RBI to enhance the transaction limit to INR 15000.

1.2.2. Report of Regulatory Review Authority (RRA)

RRA was constituted for the discovery of changes in the operations of the regulator, as a measure to be in-line with the colossal and rapid changes in the financial eco-system. The RRA has put forth its recommendation in 5 crucial aspects of RBI's functioning:

- Ease of compliance and Regulatory Burden-
  Provision of additional material viz. FAQ's, brief statement of intent along with notifications shall be made. All the applicable reporting requirement shall be available in a specific category on the website namely "Regulatory Reporting"

- Streamlining the Reporting Mechanism-
  To make the reporting mechanism effective and robust in respect of the changing environment, the following updates shall play a paramount role:
  a) Elimination of Paper based returns
  b) Discontinuation of redundant returns and Merger of returns where possible
  c) Reviewed periodically within the timeline as prescribed by the return-prescribing departments
  d) Ad-hoc returns introduced for specific purpose shall have a sunset clause of maximum 6 months

- Issuance of Regulatory instructions

Standardized formats for the RBI Directions/circulars/notifications and public consultation before finalization has been mandated by RRA. The existing and future Master Directions shall also be updated on a timely manner

- Dissemination and ease of accessibility of regulatory instructions
  Improved website layout and real time updation of the content. Improved accessibility for users by improving interaction and ease for navigation

- Withdrawal of Obsolete and redundant instructions
  A standard marking on the circulars that are time-barred and old/obsolete/redundant shall separate them from the current and updated documents; eliminating confusion among the users.

Impact:
The recommendation of RRA shall benefit the entities regulated by RBI and the society at large as it prescribes procedures that provide ease of business, elimination of redundant practices and documents.

1.2.3. Payment Vision 2025

The core theme for the document *"E-Payments for Everyone, Everywhere, Everytime."* (4Es) and the vision is to provide every user with Safe, Secure, Fast, Convenient, Accessible, and Affordable e-payment options.

The document lays down goals under the 5 headings to guide the achievement of the vision as highlighted:

i. Integrity
   Measures to ensure the integrity of the payment system viz. alternate authentication mechanism(s) for digital payment transactions, usage and relevance of LEI in all payment activities, expand interoperability to contactless transit card, Enhance scalability and resilience, leverage existing its online dispute resolution system for detecting frauds, enhance oversight, Payee look-up (for tracking), etc. have been set as targets by the regulator for improving the integrity of the Payment system as a whole.

ii. Inclusion
   Technologies and effective system utilization viz. geotagging of digital payment, evaluate the guidelines for PPIs, framework for regulation intermediaries in payments ecosystem and BigTechs/Fintechs, One Nation One Grid clearing and settlement perspective, Internal Ombudsman scheme, increase in market trading and settlement hours, Upscale customer outreach and awareness, etc. for effective inclusion in the payment system. Although, large scale inclusion of the market has been the highlight achievement of Payment Vision 2019-21 , the facilities listed above shall further provide ease to transact and attract further inclusion

iii. Innovation

Innovation in terms of framework for Internet over Things (IoT), upgradation of RBI system to ISO 20022 standards, linking credit cards to UPI, payment system for online merchant payment through internet/mobile banking, review for multiple payment identifiers and guidelines for BNPL shall enable the multi-fold benefits to the payment eco-system.

iv. Institutionalisation
The existing payment eco-system requires strong institutionalization programs; viz, review of legislative aspects of PSS Act, Payments Advisory Council (PAC) to assist BPSS, National Card Switch for card transactions at PoS engagement and involvement in international forum, etc., for its effective and optimum utilization.

v. Internationalisation
Witnessing the success of the Indian payment eco-system and the global demand and recognition of the same, RBI has planned goals for accessing the international markets through means such as Global outreach of RTGS, NEFT, UPI and RuPay cards, Expand SFMS, InFiNet frameworks, 2-Factor Authentication for cross-border transaction, inclusion of INR in Continuous Linked Settlement, introduction of Central Bank Digital Currencies, etc.

Impact:
The document outlines the outlook of the payment eco-system in the coming years. The document is essential for the regulated entities to harness itself for the prospective regulations by RBI and enables the users at large to understand the intent of the RBI.

1.3. International Financial Services Centre Authority

1.3.1. Investment in Bullion Depository Receipts (BDR) on India International Bullion Exchange (IFSC) Limited (IIBX)

With respect to the declaration of the BDR as Financial Instrument and the related services as Financial Services, the same got recognized as security under the SCRA Act 1956.

Residents in India are permitted to remit funds, under Liberalised Remittance Scheme (LRS) route, to IFSC and invest in the securities issued by entities/companies other than those resident in India. However, RBI vide its notification dated 16th Feb 2021, specifically disallowed the resident individuals from engaging in the said transaction.

Although, the subscription to the BDR shall be allowed to the Qualified Jewellers by the IFSCA as also notified by the RBI vide its notification dated 07th June 2022.

Impact:
The regulations are amended in IFSC to render the centre a suitable and favourable environment to the existing as well as to attract the new entities. The Regulations streamlining and clarity is of utmost importance for any international company to consider operating in the centre.

1.3.2. Amendments and additions to IFSCA-banking-handbook

Amendment in General Directions

1.3.2.1. The regulator has introduced a mechanism of in-principle approval at its discretion prior to issuance/denial of the grant of license.

1.3.2.2. A formalized mechanism for addressing the queries of IFSC Banking Units (IBU) has been framed, in relation to:

- The IFSCA (Banking) Regulations, 2020 (as amended)
- IFSCA Banking Handbook

Amendment in Conduct of Business Directions

1.3.2.3. Investment in the Indian securities shall be allowed to IBU under FPI route of RBI.

1.3.2.4. A non-individual entity enjoying credit facility with any branch or banking subsidiary of the Banking company of which the IBU is a branch shall be included in the list of Deemed Professional Client.

1.3.2.5. Restrictions on activity of providing credit - Section rewritten to:

- Clarify the applicability of restrictions under the Banking Regulation Act, 1949 to IBUs of Indian and Foreign Banks
- Lay down the restrictions placed by the Authority
- Clarify that restrictions by the home regulator of the IBU shall be applicable

Amendment in Prudential Regulations

1.3.2.6. The return to be submitted for IFCSA have been refined as the regulations gain prominence. Also, any 2 Authorized Individuals of the IBU which shall now not necessary be Risk Manager and Compliance Manager

1.3.2.7. Further, the IBU is not required to intimate the authority for changes in the market price or trading volumes of the instruments of the IBU or entities in its group as was required earlier

1.3.2.8. The regulator has prescribed the intimation for any breach of IFSCA Banking Regulations, rules, directions, circulars and guidelines applicable for IBUs

1.3.3. Proposed IFSCA finance company (amendment) regulations

The Regulator has put in place the following proposed amendments for public comments:

1.3.3.1. Additionally, the IFSC shall eliminate the classification of specialized activity and classify the activities therewith; namely credit enhancement, factoring and forfaiting of receivables, as core activities

1.3.3.2. The Regulator has prescribed the access to Branch/Finance Unit (FU) Route of operating in IFSC to the Incorporated Finance Companies operating outside India subject to:

- The FU shall undertake activities as permitted in the regulation
- The Parent of FU shall be incorporated and regulated by a financial regulator

1.3.3.3. Although the conduct of non-core activities shall be as per the guidelines of the regulator, the FC/FU carrying on multiple permissible activities shall maintain higher of the minimum capital / owned funds / net worth prescribed for the activities.

1.3.3.4. In case, the FC/FU has a registration/authorisation under any regulations of IFSCA shall not be required to obtain a separate registration unless it intends to engage in activities which are not covered under the regulations under which registration is obtained

Impact:
The regulations if implemented shall grant foreign companies flexibility to opt the branch model in addition to the existing FC model for its operations. The IFSC is a business eco-system with developing regulations, resulting in frequent amendments in the regulations.

1.3.4. Equivalent status to CCPS supervised by IFSCA

Recognition of Central Counterparties (CCPs) under supervision of IFSCA namely; India International Clearing Corporation (IFSC) Limited and NSE IFSC Clearing Corporation Limited by the European Commission

2. Discussion Papers

2.1.1 Risks Associated with Mutual Funds

SEBI has prescribed a Risk Management Framework (RMF) for Mutual Funds, which provides a set of principles or standards, which inter alia comprise the policies, procedures, risk management functions and roles & responsibilities of the management, the Board of AMC and the Board of Trustees.

It spells out the various criteria for identification of risks and states that the RMF should address the following key questions:

a. What are the different types of risks faced by the mutual fund/AMC and its mutual fund schemes?
b. What is the probability of the happening of each of the above risks, considering the control environment and automation within the AMC, external factors or dependencies such as market infrastructure, outsourced activities, etc. and available historical risk data?
c. What is the likely impact of key risk events, in terms of financial loss, reputation loss, impact on investors/ unit holders and regulatory action?
d. What are the emerging or new risks due to new business lines, new products, statutory changes, changes in external environment or market infrastructure, etc.?

Further, Key risks can be divided in to two broad categories, i.e. Scheme Specific risks and AMC Risks.

A. **Scheme specific risks**

The scheme specific risks are the risks majorly associated with the core activities of investment and portfolio management.

The scheme specific risks may be divided in to the following categories.

i. Investment risk

Investment risk can be defined as the probability or likelihood of occurrence of losses relative to the expected return on any particular investment.

ii. Credit risk

The credit risk relevant to mutual funds is the issuer credit risk attributable to individual securities and the negative outlook on specific sectors or industries and its consequent impact on the credit exposures.

iii. Liquidity risk

Thinly traded securities carry the danger of not being easily saleable at or near their real values. Further, all securities run the risk of not being saleable in tight market conditions at or near their real values.

iv. Governance risk

Governance risk is a risk that the persons who are in position of power or fiduciary responsibility towards the holders of security (equity/debt), do not act in the best interest of such stakeholders, rather compromise the interest of such stake holders for their personal gain.

B. **AMC specific risks**

The AMC specific risks are the risks associated with the functioning of the mutual fund business by the AMC.

The AMC specific risks may be divided in to the following categories:

i. Operational Risk

Operational risk refers to the risk of loss resulting from inadequate or failed processes, people and systems or from external events, e.g. internal fraud, external fraud, physical damage caused by nature or man-made, etc

ii. Technology, Information Security and Cyber Risk

Given the huge dependence on technology, any system failure could trigger a variety of risks, e.g. operational risk, compliance risk. etc. Technology Operations should support processing and storage of information, such that the required information is available in a timely, reliable, secure and resilient manner.

iii. Reputation and Conduct Risks

The risk of damage to the firm's reputation that could lead to negative publicity, costly litigation, a decline in the customer base or the exit of key employees and therefore, directly or indirectly, financial loss or revenue shrinkage

iv. Outsourcing Risk

Inadequate management of outsourced processes lead to errors, frauds, Inefficiencies, poor quality investor services, breach of fiduciary duties data pilferages and long-term impact on reputation and contractual obligations.

v. Sales and Distribution Risk

As most AMCs outsource or use other channels for distributing products, such as banks, IAs, brokers, NBFCs, Distributors, etc., there is a need of monitoring risks associated with managing distribution channels and processes, commission pay-outs, brokerage disbursements, sales expenses, etc.

vi. Financial Reporting Risk

Absence of internal control over financial reporting with regard to the mutual fund schemes, may pose the following risks:

a. Improper maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets
b. Absence of reasonable assurance that transactions are recorded as necessary to permit calculation of NAV and preparation of financial statements in accordance with generally

accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of the management and the Board.

c. Failure to prevent or timely detect unauthorized acquisition, use, or disposition of assets that could have a material effect on the NAV and/or financial statements

vii. Legal & Tax Risks

Legal & Tax risk is the risk of loss to an institution which is primarily caused by:

a. A defective transaction.
b. A claim (including a defence to a claim or a counterclaim) being made or some other event occurring which results in a liability for the institution or other loss (for example, as a result of the termination of a contract).
c. Failing to take appropriate measures to protect assets (for example, intellectual property) owned by the institution.
d. Change in law
e. Misinterpretation of statutes and regulations.
f. Failure to collect or pay appropriate taxes, or submit required returns or information

viii. Talent Risk

Talent risk is the risk of not having the right people in place at the right time to drive current and future business growth.

Compliance Risk

The compliance risk shall be applicable for both investment management activity (scheme specific risk) and business activity of AMC (AMC specific risk).

Failure by the AMC to meet its regulatory obligations or manage changes in legal statutory and regulatory requirements may result in investigations, fines, financial forfeiture, or regulatory sanctions and material loss to investors and the organization.

SEBI has laid down comprehensive guidelines for each of the aforesaid risks, specifying the mandatory and recommendatory elements for managing each risk, which is required to be complied by the AMC & the Mutual Fund

Note: This is just a broad compilation of the risks associated with the Mutual Fund, one should read the offer document for each scheme of mutual fund carefully to understand the exact risks associated with it.

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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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