FINTECH NEWSLETTER: UNVEILING INDIA'S LATEST LEGAL SHIFTS AND MARKET WAVES

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Authors: Namita Viswanath | Sarthak Doshi | Abhijit Chakrabarti | Himangini Mishra

INTRODUCTION

For fintech start-ups, 'funding winter' was one of the most used terms of 2023. December did not fundamentally change this narrative as the sector ended with a yearly total of just over a billion dollars in funding – the least the sector has seen since 2016. The dip has made fintech start-ups and investors proactive and cautious, and the focus seems to have shifted more towards cutting costs and increasing profitability. The Reserve Bank of India ("**RBI**") is also as proactive as ever, with final authorisations being granted to some payment aggregators and release of notification in relation to industry-centric regulations.

Separately, cryptocurrency operators were kept busy with regulatory scrutiny under the Prevention of Money Laundering Act, 2002 ("**PMLA**") and directions from the Financial Intelligence Unit, India ("**FIU**") reaching new heights, and the government pushing hard to enforce anti-money laundering regulations against foreign operators offering services in India.

In light of this, this edition of newsletter highlights the key developments and measures as well as other developments in the Indian fintech space from December 01, 2023, to December 31, 2023.

RECENT LEGAL & REGULATORY DEVELOPMENTS

RBI releases Master Direction - Reserve Bank of India (Internal Ombudsman for Regulated Entities) Directions, 2023[1]

On December 29, 2023, the RBI released the Master Direction - Reserve Bank of India (Internal Ombudsman for Regulated Entities) Directions, 2023 ("**Internal Ombudsman Direction**"). The Internal Ombudsman Directions are applicable to Banks with 10 (ten) or more banking outlets in India, deposit taking Non-Banking Financial Companies ("**NBFCs**") with 10 (ten) or more branches, non-deposit taking NBFCs with assets size of INR 5000 Crores (Indian Rupees Five Thousand Crores) and above with a public customer interface, Non-Bank System Participants and Credit Information Companies ("**CICs**") (collectively referred to as "**REs**"). The Internal Ombudsman Directions replaces and consolidates 3 (three) distinct and separate ombudsman schemes which were applicable to Banks[2], NBFCs[3] and CICs[4]. Through the consolidated Internal Ombudsman Directions, the RBI seeks to ensure uniformity in the internal ombudsman scheme applicable to all the REs and address issues identified in the erstwhile internal ombudsman schemes.

The Internal Ombudsman Directions requires the entities to appoint an Internal Ombudsman Officer ("**IO**") and a deputy internal ombudsman officer to deal with customer complaints. The IO will handle the complaints that have been already assessed and rejected by the REs. These complaints should be escalated to the IO through a fully automated complaints management software within 20 (twenty) days of pronouncement of REs' decision on the complaints. Further, the IO and REs are also obligated to ensure that the final decision should be communicated to the complainant within 30 (thirty) days from the date of receipt of complaint by RE. The final decision of the IO will be binding on the REs.

If IO overrules the decision of the RE, the RE can only disagree with such decision after the approval of its executive director in-charge of customer services. However, irrespective of whether the IO upholds or overrules the decision of the RE, the reply to the complainant should clearly state that the complaint has been examined by the IO.

RBI prohibits investment in AIFs with downstream investments in debtor companies of a regulated entity.[5]

Following requests by the stock market regulator, the RBI prohibited regulated entities such as commercial banks and NBFCs from making investment in units of Alternative Investment Funds ("**AIF**") that have downstream investments either directly or indirectly in a debtor company of the regulated entity. It has been clarified that a debtor company would mean any company in which the regulated entity currently or in the previous 12 (twelve) months had a loan or investment exposure. If in case of an AIF (in which the regulated entity invests) makes a downstream investment in a debtor company, then the regulated entity is required to liquidate its investment in the scheme within 30 (thirty) days from the date of the downstream investment. However, if a regulated entity is unable to liquidate its investment in the scheme as per the prescribed time limits it will be required to make 100% (hundred per cent) provisions on such investments.

RBI enables Card on File Tokenisation (CoFT) through card issuing banks[6]

On December 20, 2023, the RBI released directions for enabling the Card on File Tokenisation (CoFT) directly through the bank issuing such cards. Previously, customers were only permitted to create separate tokens through individual applications/websites of the merchants. Introduction of these norms will now allow the customer to tokenise its cards for multiple merchant sites at once through a single process.

The cards can only be tokenised if the process of tokenisation fulfils the requirements prescribed by the RBI including (a) explicit consent of the customer should be acquired for tokenisation; (b) consent should be obtained pursuant to Additional Factor of Authorization ("**AFA**"); (c) generated tokens should be available for the customers' account on the merchant's page; (d) the card issuer should maintain a list of merchants for whom the customer can avail the tokenisation services; and (e) the tokens should be issued by the card network or the card issuer or both. Additionally, the payment systems providers and participants providing card tokenisation services are still required to comply with the following RBI circulars- Tokenisation – Card transactions dated January 08, 2019[7], Tokenisation – Card Transactions: Permitting Card-on-File Tokenisation (CoFT) Services dated September 07, 2021[8] and Restriction on Storage of Actual Card Data i.e. Card-on-File (CoF) dated June 24, 2022[9].

RBI waives the AFA requirement for transactions valuing to INR 1 Lakh[10]

The RBI vide a circular dated December 12, 2023 has extended the waiver of AFA process for execution of e-mandates or standing instructions given on cards, Unified Payments Interface ("**UPI**") and Prepaid Payment Instruments (PPIs) for the transactions valuing upto INR 1,00,000 (Indian Rupees One Lakh) for following three categories: (a) subscription of mutual funds; (b) payment of insurance premiums; and (c) credit card bill payments. Previously, a similar relaxation was provided by the RBI through a circular dated June 16, 2022[11], wherein the RBI withdrew AFA requirements for the recurring transactions valuing upto INR 15,000 (Indian Rupees Fifteen Thousand). The notification has been issued by the RBI pursuant to its observation of an emerging need to increase the existing limit particularly for the aforementioned categories, under the Statement on Developmental and Regulatory Policies dated December 08, 2023 wherein it was noted by RBI that currently INR 8.5 Crore (Indian Rupees Eight Crores Fifty Lakhs) e-mandates are registered which are processing INR 2800 Crores (Indian Rupees Twenty Eight Hundred Crores) in transaction monthly.

Recommendations of the Monetary Policy Committee[12]

On December 08, 2023, the RBI released a statement summarising the discussions and the recommendations of the Monetary Policy Committee ("**MPC**"). The MPC made several recommendations for development of the Indian fintech sector including:

a. **Increasing UPI Transaction Limit:** The MPC has proposed that the payment limit for UPI transactions with the hospitals and educational institutions should be increased from the existing universal limit of INR 1 Lakh (Indian Rupees One Lakh) to INR 5 Lakh (Indian Rupees Five Lakh). As per the RBI, this will enable the users to make UPI payments of higher values required for transactions related to education and health purposes.

b. **Regulatory Framework for Loan Product web-aggregation:** The RBI noted that the digital lending ecosystem, which is already regulated by the RBI, also includes aggregation of loan offers from lenders. Such aggregation of loan products has raised several issues leading which are resulting in exploitation of consumers. Thereby, the RBI has decided to propose a regulatory framework for web-aggregation of loan products.

c. **Cloud Facility for the financial sector:** The RBI has proposed to establish a cloud facility for banks and financial institutions maintaining a large volume of data. Such cloud facility is set to contribute to business continuity, promotion of data privacy and security and facilitation of scalability to these institutions.

RBI extends timelines for compliance with the Fair Lending Practice - Penal Charges in Loan Accounts Directions, 2023[13]

The RBI has extended the timelines for compliance with the Fair Lending Practice - Penal Charges in Loan Accounts ("**Fair Lending Practice Directions**") notified on August 18, 2023. Initially, regulated entities had to meet the compliance from January 01, 2024. However, basis the request from regulated entities the same has been extended to April 01, 2024. Accordingly, regulated entities shall ensure that the instructions are implemented in respect of all the fresh loans availed from April 01, 2024 onwards. In the case of existing loans, the new penal charges shall apply on the next review or renewal date of such exiting loans falling on or after April 01, 2024, but not later than June 30, 2024. The Fair Lending Practice Directions requires the regulated entities to observe obligations including: (a) prohibition of any penal interest on the borrower for violation of the terms of the loan agreement; (b) imposition of reasonable and non-discriminatory penal charges; (c) disclosure of reason and quantum of penal charges in the loan agreement and Key Fact Statement (KFS); and (d) prohibition on introducing any additional interest on outstanding penal charges.

RBI releases Government Securities Lending Directions[14]

On December 27, 2023, the RBI released the RBI (Government Securities Lending) Directions, 2023 ("**Government Securities Directions**") introducing regulatory framework for Government Security Lending ("**GSL**") transactions in India. The Government Securities Directions have been issued by the RBI, pursuant to consultation process conducted by the RBI on the draft directions released on February 17, 2023.

As per the Government Securities Directions, entities eligible to undertake repo rate as per the Repurchase

Transactions (Repo) (Reserve Bank) Directions, 2018 dated July 24, 2018, and the entities pre-approved by the RBI are only eligible to deal in the government securities. Section 2(f) of the Government Securities Act, 2006 defines a 'government security' to mean any security that has been issued by the Government for raising a public loan or for any other purposes notified by the Government in its official gazette. The Government Securities Directions have permitted GSL transactions in all government securities except the treasury bills. However, in addition to all the securities, the treasury bills can also be placed as a collateral in a GSL transaction. Other securities that can be lent in a GSL transactions include (a) securities acquired through a repo transaction; and (b) securities borrowed under a GSL transaction.

A GSL transaction comprises lending of government securities in exchange of a fee and a government security as a collateral to be provided by the borrower. Upon completion of the GSL transaction, the borrower will have to return the government security to the lender and the lender will then return the collateral government security to the borrower. This transaction will take place through a trading process or platform. Further, the minimum tenor of such transaction will be 1 (one) day and the maximum tenor will be as per the duration prescribed under the Secondary Market Transactions in Government Securities – Short Selling Directions dated July 25, 2018.[15]

INDUSTRY CHALLENGES

Regulation of Virtual Digital Assets ("**VDAs**") in India witnessed interesting developments in December. The FIU, one of the primary regulatory bodies under the PMLA, sent a flurry of notices to various cryptocurrency exchanges and VDA providers asking them to register with the FIU as a 'reporting entity' under the PMLA. This followed the notification dated March 07, 2023 through which the Ministry of Finance brought all the VDA transactions under the ambit of the PMLA. The notification amended the scope of the definition 'designated business of profession' provided under Section 2(1)(sa) of the PMLA to include (a) exchange between VDA and fiat currencies; (b) exchange between one or more forms of VDAs; (c) transfer of VDA; (d) safekeeping or administration over VDA or any instruments enabling control over VDA; and (e) participating and providing financial services related to an issuer's offer and sale of VDA. Accordingly, entities involved in such 'designated business or profession' are recognised as 'reporting entities' under the PMLA, requiring such entities to register with the FIU. Along with Indian cryptocurrency exchanges and VDA providers, several foreign-based operators also received notices to comply with the registration requirements under the PMLA, thereby re-opening discussions on the extra-territorial applicability of the PMLA and the need for offshore operators to register with FIU.

In early December 2023, the government communicated that following the recent amendments to the PMLA to include VDA providers as 'reporting entities', 28 (twenty-eight) VDA service providers have registered with the FIU. Soon after, the government clarified in a Parliamentary response that the requirement to register with the FIU is equally applicable 'offshore crypto exchanges servicing the Indian Market'. This was followed by the development in the last week of December where key offshore operators (including Binance and KuCoin) were sent show-cause notice by the FIU for not complying with the PMLA, and suggestions were made to the Ministry of Electronics and Information Technology to block access to the platform URLs of these entities. The government also clarified that the obligations under the PMLA on reporting entities are 'activity based and is not contingent on physical presence in India'.

While it is clear that the intent behind these developments is to curb money laundering, have efficient reporting of suspicious transactions, and encourage registrations, the government's approach has also invariably created a chilling effect on businesses in this space. Several operators have had to shut their businesses overnight, without seamlessly closing relevant accounts and settling funds to their customers. The influx of notices and the impeding threat of being blocked from the country has also created panic and negativity among VDA providers, especially ones based overseas, including ones who do not directly handle or settle VDAs.

The government's recent actions seem to be in line with their overall cautious approach to VDAs, combined with another attempt to bridge a legislative gap through executive action. It will be interesting to see how offshore operators react to the on-going enforcement actions and whether the government changes its approach to VDAs. The FIU is increasingly keen on Indian users interacting only with FIU-registered VDA operators, and offshore operators with no physical presence in India may need to start evaluating their modus operandi for the Indian market.

MARKET UPDATES AND MAJOR DEALS IN INDIA [i]

The fintech startup ecosystem continued to experience a funding slowdown in 2023, with the total investments being pegged at USD 2.1 billion (United States Dollars Two Billion and One Hundred Million) which is approximately 63% (sixty three per-cent) lesser than the value of investments in 2022.[16] PhonePe[ii] continued to be the top-funded company in the fintech sector, which received a total of USD 750 million (United States Dollars Seven Hundred and Fifty Million) in four Series D rounds, with KreditBee[iii] also being one of the top-funded companies.[17]

Despite this reduction in investments including in the fintech space, there has been a surge of activity in this sector throughout the year and in December, especially with the RBI granting certificate of authorisation to operate as online payment aggregators to 7 (seven) entities in December,[18] which included Google India and R360 Pay.[iv]

Central Government proposes to regulate development of AI in India

In the artificial intelligence ("**AI**") space, with the aim of curbing the growing spread of deepfakes and misinformation, the Central Government reportedly commenced the process of preparing regulations for AI with the aim of fostering development, and innovation in India.[19] In the background of these proposed regulations, it was also reported that the Central Government intends to fund and support AI startups in the country, with the incentives being in line with the semiconductor industry, aimed at scaling the sector.[20] Separately, the Digital India Act, which proposes to address some of these concerns specifically will reportedly not be rolled out prior to the 2024 general elections.[21]

UPI beta phase launched in the secondary market[22]

In relation to UPI, it has been reported that the NPCI proposes to launch the beta phase for UPI in the secondary market in the turn of the year with support from stakeholders such as stock exchanges, clearing corporations, UPI app providers, and banks. This will be implemented only for the equity cash segment, and the launch would also be facilitated by Groww[v] as the brokerage app, with BHIM, Yes Pay Next and Groww as UPI apps. This facility aims to enable investors to block funds in their bank accounts for the purpose of secondary market trading, as against transferring these funds at the outset to any trading member.

ONDC to be regulated on par with the e-commerce platforms[23]

As part of a response to a question in Parliament, the Minister of State for Commerce and Industry clarified that Open Network for Digital Commerce ("**ONDC**") is operational in over 500 (Five Hundred) cities and towns in India, and clarified that all laws and regulations in India related to e-commerce are applicable to ONDC and network participants.[vi] This follows on the heels of the ONDC reportedly teaming up with Meta to encourage and educate small businesses build conversational buyer and seller experiences on social media platforms like WhatsApp, and bring them within the fold of the ONDC network.

RBI to setup a fintech repository[24]

The RBI has proposed setting up of a fintech repository to capture essential information about fintechs, which would include recording information about their products, technology stack, and financial information etc. Fintechs would also be encouraged to provide relevant information voluntarily to the repository which would aid designing appropriate policy approaches, and this is proposed to be operationalised by the Reserve Bank Innovation Hub in April 2024, with necessary guidelines being issued separately by the RBI.

MAJOR FUNDING DEALS

Finhaat, a financial product delivery platform raised USD 3 million in a seed funding round, which was led by Omnivore a venture fund. The start-up aims to deploy the fresh funds for building technological models, innovation, scaling of operations and hiring resources.[25]

Navadhan, a non-banking financial institution, focused on rural lending has raised USD 5 million in its pre-series A funding. This round was led by Prime Venture Partners, with existing investors Gemba Capital and Varanium

i. To the extent any transactions involve clients of IndusLaw, the information herein is based on statements in the media and not our professional knowledge of the relevant transaction.
ii. PhonePe is a client of IndusLaw.
iii. KreditBee is a client of IndusLaw.
iv. IndusLaw assisted R360 pay in making the filing for the payment aggregator license.
v. Groww is a client of IndusLaw.
vi. We have elaborated on the working of the ONDC in previous versions of the newsletter available here, here and here.

NexGen Fintech Fund also participating. The fresh funds will be utilised to strengthen its digital platform and in scaling the company's operations.[26]

Aye Finance,[vii] a non-banking financial company raised INR 310 crores (approximately USD 37 million) in a Series F funding round led by UK's British International Investment. The company's existing shareholder A91 Partners also participated in this round.[27]

M2P Fintech, a fintech startup acquired Goals101 which is backed by Nexus Venture Partners,[viii] a transaction behavioural intelligence platform for INR 250 crores (approximately USD 30 million). The technology of the investee company is expected to be utilised by M2P Fintech to expand its capabilities to offer unique solutions and bring a degree of personalisation in its products to its customers.[28]

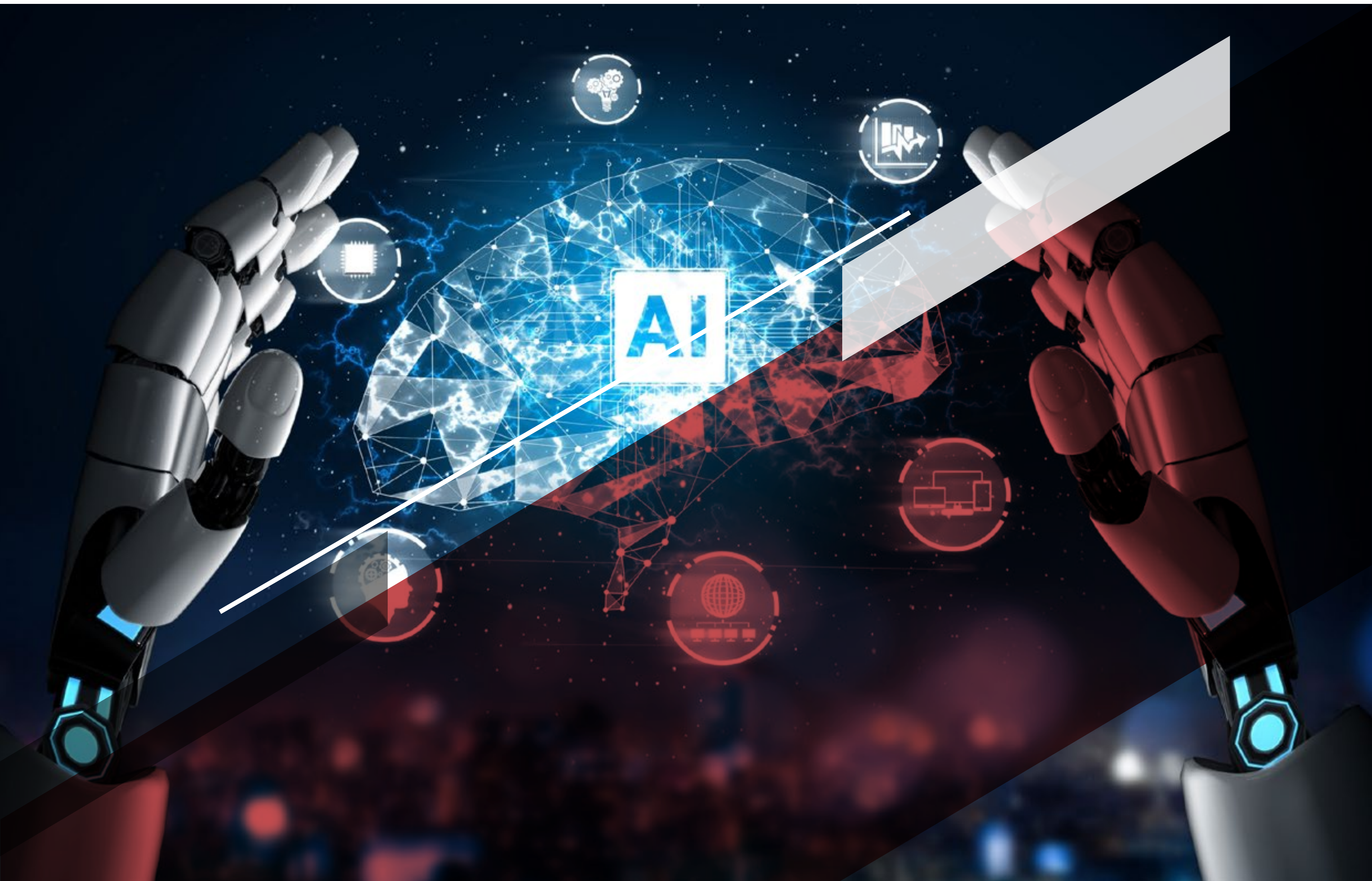
Sarvam AI, a start-up developing its own generative artificial intelligence models and headquartered in Chennai, raised USD 41 million in a Series A round of funding. This funding round was led by Lightspeed Venture Partners, with other investors such as Lightspeed, Peak XV and Khosla Ventures also participating. The fresh funds are proposed to be utilised to develop a full stack for generative AI products, including training custom AI models (being trained in Indian languages).[29]

U Gro Capital, a non-banking financial company focusing on micro, small and medium enterprises raised INR 250 crores (approximately USD 30 million) through non-convertible debentures, from a Dutch entrepreneurial development bank, FMO. The funding is proposed to be utilised to serve the diverse financial requirements of India's micro, small and medium enterprises, and continue serving this space.[30]

InCred, a non-banking financial company raised USD 60 million (United States Dollars Sixty Million) in a Series D round of funding, making it the second unicorn of 2023. High net worth clients of the company's wealth division participated in this round, along with Ranjan Pai of the MEMG Family Office. The fresh funds are proposed to be utilised to scale operations of the company.[31]

vii. IndusLaw advised Aye Finance in this transaction.

viii. IndusLaw advised Goals 101 and Nexus Venture Partners in this transaction.



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OUR OFFICES

BENGALURU
101, 1st Floor, "Embassy Classic"# 11
Vittal Mallya Road
Bengaluru 560 001
T: +91 80 4072 6600
F: +91 80 4072 6666
E: bangalore@induslaw.com

HYDERABAD
204, Ashoka Capitol, Road No. 2
Banjarahills
Hyderabad 500 034
T: +91 40 4026 4624
F: +91 40 4004 0979
E: hyderabad@induslaw.com

CHENNAI
#11, Venkatraman Street, T Nagar,
Chennai - 600017 India
T: +91 44 4354 6600
F: +91 44 4354 6600
E: chennai@induslaw.com

DELHI & NCR
2nd Floor, Block D
The MIRA, Mathura Road, Ishwar Nagar
New Delhi 110 065
T: +91 11 4782 1000
F: +91 11 4782 1097
E: delhi@induslaw.com

9th Floor, Block-B
DLF Cyber Park
Udyog Vihar Phase - 3
Sector - 20
Gurugram 122 008
T: +91 12 4673 1000
E: gurugram@induslaw.com

MUMBAI
1502B, 15th Floor
Tower – 1C, One Indiabulls Centre
Senapati Bapat Marg, Lower Parel
Mumbai – 400013
T: +91 22 4920 7200
F: +91 22 4920 7299
E: mumbai@induslaw.com

#81-83, 8th Floor
A Wing, Mittal Court
Jamnalal Bajaj Marg
Nariman Point
Mumbai – 400021
T: +91 22 4007 4400
E: mumbai@induslaw.com