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FINTECH NEWSLETTER: RECENT LEGAL DEVELOPMENTS AND MARKET UPDATES FROM INDIA

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INTRODUCTION

Fintech's potential to transform the delivery of financial services continues to take more meaningful strides as India is embracing global breakthroughs in artificial intelligence ("**AI**") and machine learning ("**ML**") technology. At present, the industry is at its most significant crossroads as automation is reaching new levels with the integration of AI and ML tools in financial institutions' decision-making processes.[1] Last month, the Reserve Bank of India ("**RBI**") notified the Master Direction on Outsourcing of Information Technology Services, where it intends to regulate the outsourcing of information technology services by regulated entities.[2]

As for digital payments, India's highly successful payment infrastructure Unified Payments Interface ("**UPI**") has also been growing as UPI transactions are projected to account for 90% (ninety per cent) of transaction volume in retail digital payments by 2026-2027.[3] The network is also turning out to be of interest from abroad as a Japanese minister expressed his country's intent to join the network for facilitation of cross-border payments.[4] Overall, this indicates exciting times for India's role in shaping global payments systems.

Cognizant of the speed with which the industry is growing, the RBI as well as other regulators, continue to take active steps towards regulating one of the most dynamic sectors at present. This newsletter highlights the key developments and measures as well as other developments in the Indian fintech space from May 01, 2023, to May 31, 2023.

RECENT LEGAL & REGULATORY DEVELOPMENTS

SEBI consultation paper on regulatory framework for fractional ownership platforms

On May 12, 2023, the Securities and Exchange Board of India ("**SEBI**") released a consultation paper proposing regulation of fractional ownership platforms ("**FOPs**") for real estate assets ("**Consultation Paper**").[5] FOPs are platforms that allow investors to buy a small share of a real estate asset. The Consultation Paper proposes to regulate FOPs as micro, small, and medium real estate investment trusts under the SEBI (Real Estate Investment Trusts) Regulations, 2014 ("**REIT Regulations**").

The Consultation Paper proposes that the FOPs should be required to register with SEBI and comply with the REIT Regulations. The Consultation Paper proposes to structure FOPs as follows:

- the FOP shall hold 100% (one hundred per cent) of the equity share capital in all Special Purpose Vehicles ("**SPV(s)**");
- the SPV(s) shall hold 100% (one hundred percent) ownership in all the underlying property(ies);
- the sponsor shall be required to hold a minimum of 15% (fifteen per cent) of the total units of the FOP for each scheme for a period of at least 3 (three) years from the date of listing of such units of such scheme pursuant to initial offer on a post-issue basis.

Among other things, the Consultation Paper proposes that the FOPs should be required to:

- have at least half of its directors as independent and not directors of the investment manager or manager of another FOP;
- have a valuation done by an independent valuer at least once a year;
- provide investors with regular updates on the performance of their investments;
- mandatorily list all the units of the FOPs scheme(s) on a stock exchange and hold all units of the FOP and investments of the FOP in SPVs in dematerialized form;
- ensure that the size of the asset proposed to be acquired in the initial offer of the scheme should be of a value between INR 25 crores to INR 499 crores (approximately USD 3.045 million to USD 60.8 million);
- ensure that the sponsor shall have a net worth of at least INR 20 crores (approximately USD 2.4 million) of which at least INR 10 crores (approximately USD 1.2 million) shall be in the form of positive liquid net worth and the investment manager shall have a net worth of at least INR 10 crores (approximately USD 1.2 million), in the form of positive liquid net worth;
- have a minimum subscription size of INR 10 lakhs (approximately USD 12,000) for the units of an FOP scheme and each unit size shall be INR 10 lakhs (approximately USD 12,000);
- ensure that the maximum subscription to an FOP scheme from any investor (other than sponsor(s), its related parties and its associates) shall not be more than 25% (twenty-five per cent) of the total unit capital;
- comply with the standard know-your-customer ("**KYC**") requirements prescribed by the RBI Master Direction on KYC, 2016 ("**KYC MD**") while registering clients.

The Consultation Paper was open for public comments till May 27, 2023. It remains to be seen if stakeholder feedback will impact the FOP framework proposed by the Consultation Paper.

Amendment to the Master Direction on KYC- Instructions on Wire Transfer

On May 4, 2023, the RBI amended the KYC MD to introduce instructions with regard to 'Wire Transfers'.[6] The amendment was implemented in order to align with the recommendations of the Financial Action Taskforce. "**Wire Transfers**" refer to any transaction carried out wherein a person or an account holder ("**Originator**") transfers money electronically through a bank or a financial institution to another person or organization ("**Beneficiary**"), allowing them to access the funds at their own bank or financial institution.

Cross border Wire Transfers now require the furnishing of accurate and complete information pertaining to the Originator and the Beneficiary, such as their name, account number, address, identification number, and transaction details. Domestic Wire Transfers, if from an account holder of the transferring financial institution or of value INR 50,000 (approximately USD 600) and above, must include Originator and Beneficiary information. The amendment has clarified that any transfer that flows from a transaction carried out using a credit card, debit card or a 'Prepaid Payment Instrument' for the purchase of goods or services will not be considered a Wire Transfer.

The financial Institution involved in processing Wire Transfers, must keep records of all Originator and Beneficiary information associated with each transfer. If technical limitations prevent this information from being included in a domestic Wire Transfer, the intermediary entity should retain it separately for at least 5 (five) years. They should also be able to identify transfers that lack the required information and have policies in place to decide whether to proceed with, reject, or suspend such transfers. Further, in line with the instructions of the KYC MD, if a suspicious transaction is detected, it must be reported to the Financial Intelligence Unit-India.

Madras High Court holds Paytm liable for unauthorised transactions; cites RBI circular on consumer protection

A Madras High Court ("**Madras HC**") ruling highlights the issues faced by customers in the fintech enabled banking system and the apportionment of liability in case of fraudulent transactions.[7]

In this matter before the Madras HC, a customer's funds were siphoned off from her bank account by hackers through the Paytm mobile application. The customer had alerted her bank of the unauthorised transaction. The customer argued that in line with the RBI Circular on Consumer Protection applicable to electronic banking transactions ("**Bank Consumer Protection Circular**") which limits the liability of customers in case of unauthorised electronic banking transactions,[8] the customer is exempt from all liability because she had informed the bank of the fraud within 3 (three) working days of the notification from the bank of an unauthorised transaction.

However, the bank's contention was that the fraudulent transaction took place at Paytm's end (to the exclusion of the bank) and hence the bank is not liable. According to the bank, the customer ought to have informed Paytm in line with RBI's Circular on Consumer Protection applicable to transactions in authorised non-banks' prepaid payment instruments ("**PPI Consumer Protection Circular**").[9]

Paytm took a similar view as the bank and noted that the customer should have reported the transaction to Paytm in line with the PPI Consumer Protection Circular within 3 (three) days.

However, the Madras HC noted that the customer had notified the bank within 3 (three) working days of receiving an alert in line with the Bank Consumer Protection Circular. Further, it was observed that the customer was not aware that the transactions took place through Paytm and there were materials on record which show that the bank and Paytm had corresponded regarding this case and Paytm was aware of the fraudulent transactions.

Considering the above, the Madras HC held Paytm liable for compensating the customer. Since the court could not directly exercise writ jurisdiction over Paytm (being a private entity), the court moulded the relief and directed the RBI to order Paytm to compensate the customer.

This is a significant decision for two key reasons: (i) the circumstances in this case seem easily replicable, hence, it would be helpful for banks and consumer facing fintech companies to establish more open communication channels to prevent and manage such frauds instead of dealing with them in silos; and (ii) the indirect exercise of writ jurisdiction over a private entity such as Paytm may open a pandora's box due to the fact that such situations are common in the fintech industry.

UIDAI proposes amendments to the Aadhaar (Sharing of Information) Regulations, 2016

On May 8, 2023, the Unique Identification Authority of India ("**UIDAI**"), in exercise of its powers conferred by Section 54 read with Section 23 and Section 29 of the Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016, proposed amendments to the Aadhaar (Sharing of Information) Regulations, 2016 ("**Regulations**").[10] The proposed amendments would expand the scope of the Regulations.

The following are the key changes to be introduced by the proposed amendments:

- The UIDAI would be able to share demographic information and a photograph of an individual with a requesting entity for authentication of e-KYC data if the Aadhaar holder consents to the authentication process.
- The UIDAI would be able to verify supporting documents of an individual submitted at the time of enrolment for or during updating their Aadhaar.
- Requesting entities would be prohibited from storing 'core biometric information' of individuals for 'buffered authentication' and sharing it with anyone for any reason whatsoever.

The proposed amendments were out for public consultation and the comments were to be submitted by June 7, 2023.

INDUSTRY DEVELOPMENTS AND CHALLENGES

RBI cancels Certificate of Registration of 8 NBFCs

The RBI has been proactive in regulating non-banking financial companies ("**NBFCs**") in the month of May. In exercise of the powers conferred on it under Section 45-IA (6) of the Reserve Bank of India Act, 1934, the RBI cancelled the certificate of registration of eight NBFCs.[11] The reasons for said cancellation of the NBFCs' certificate of registration have not been disclosed.

Google updates store policy for personal loan applications

Effective from May 31, 2023, Google has updated its Play Store policy dealing with 'personal loan' applications. Since the pandemic, an upsurge in digital lending in India through the emergence of several loan applications has been reported. However, not all of them were operating in a legitimate manner, with a host of illegal practices being reported such as charging exorbitant interest rates, breach of privacy and extortionate recovery practices. The RBI with its Guidelines on Digital Lending has been cracking down on these illegal practices.[12]

With regulatory framework in place, digital platforms such as Google are now attempting to curb such illegal digital lending applications. Although, it must be noted that Google's policy is effective not only in India but to other jurisdictions as well and seems to also focus on data privacy related aspects. Google's new policy covers apps that provide personal loans directly, lead generators, and apps that connect consumers with third-party lenders ("**Personal Loan Apps**"). Such apps must disclose the minimum and maximum period for repayment, maximum 'Annual Percentage Rate' and a comprehensive privacy policy detailing the access, collection, use, and sharing of personal and sensitive user data. Some of the key restrictions placed on Personal Loan Apps include:

- Personal Loan Apps that promote personal loans requiring repayment in less than 60 (sixty) days are not allowed;
- Personal Loan Apps primarily facilitating access to personal loans (for example, lead generators or facilitators) are prohibited from accessing sensitive data, such as photos, contacts and GPS-based precise location;
- Personal Loan Apps primarily facilitating access to personal loans must prominently disclose the names of the relevant (partner) banks and NBFCs; and
- Personal Loan Apps need to provide necessary documentation; for instance, if the app is a licensed entity such as an NBFC, it needs to submit a copy of the license. If the app is only a facilitator, it must submit a declaration to this effect.

Visa and RuPay Launch CVV-free Tokenised Transactions

Visa and RuPay have launched CVV-free tokenized transactions. While making online payments, users have to enter a 3-digit or 4-digit CVV (located at the back of a card) every time to authenticate that the transaction is being made by a legitimate cardholder. Now, users of these cards would not have to enter the CVV each time in these token-based domestic 'Card-Not-Present' transactions. CVV is only collected initially at the time of tokenisation. Subsequently, the token of the card is stored by the merchant on the customer's behalf and the customer only needs to enter the one-time password ("**OTP**") at the time of making a payment. The initial process of entering CVV (along with other card details) at the time of tokenisation and the subsequent authentication of a transaction through OTP constitutes two-factor authentication. RBI's tokenisation requirements came into effect on October 1, 2022, after multiple extensions. The elimination of the need to enter CVV has taken tokenisation to the next level, improving the overall user experience, without compromising on the security of customer data.

MARKET UPDATES AND MAJOR DEALS IN INDIA[i]

The start-up ecosystem has found it hard to raise capital as venture capital ("**VC**") funding remains sluggish. Despite this, there is some good news on the horizon for the fintech ecosystem as it is reported that global fintech-focused VC fund QED Investors is looking to invest a substantial portion of its USD 925 million fund in India.[13] The fund would focus on both venture and growth stage deals.

Some important fintech deals concluded in the month of May include:

PhonePe,[ii] following its fundraise in April has raised another round of capital, this time USD 100 million from General Atlantic, bringing PhonePe's total fundraise to USD 850 million in 2023 alone.[14] Earlier in April, PhonePe had raised USD 100 million from General Atlantic, preceded by a USD 200 million investment by Walmart.

RazorPay has initiated the process of bringing its parent entity to India.[15] Many Indian start-ups set-up a holding company outside India where the investors hold the equity while the Indian entity is a wholly owned subsidiary of the holding company. However, RazorPay is now considering reversing this structure and wants its investors to be direct holders of equity in the Indian entity. There are many reasons for this, not least of it being that the company is looking to launch an Initial Public Offering in India. However, this comes with the caveat of a massive tax bill on capital gains in India, something that fellow fintech giant PhonePe had to bear as it had moved its base from Singapore to India in 2022.

BetterPlace, a blue-collar workforce management company, has acquired Bueno Finance which provides loans to blue-collar workers.[16] Bueno Finance had seen early backing from Goat Capital, JAM Fund, and angel investors like Kunal Shah and Anupam Mittal. However, Bueno Finance had been struggling recently due to a funding winter. BetterPlace was looking to get into the lending business with a similar clientele to that of Bueno Finance.

EduFund, an edu-fintech platform has raised pre-Series A funding of USD 3.5 million led by MassMutual Ventures, the venture capital arm of US-based insurance firm Massachusetts Mutual Life Insurance Company.[17] EduFund helps users save for their ward's education across different asset classes to meet rising education costs over time. It also helps with financing needs by providing education loans and scholarships.

Fundly.ai,[iii] a fintech startup has raised USD 3 million in a round led by Accel.[18] The startup serves retailers and distributors in the pharmaceuticals supply chain equipping them to better manage their cash flow and increase margins by providing loans. The startup which has been bootstrapped since 2021 has served markets in the western and southern region in India and has disbursed funds worth over INR 140 crore (USD 17.1 million).

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. IndusLaw advised PhonePe in this transaction.

iii. IndusLaw advised Fundly.ai in this transaction.

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5. https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/regulatory-framework-for-micro-small-and-medium-reits-msm-reits-_71149.html
6. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12498&Mode=0
7. Dr. R. Pavithra v Commissioner of Police 2023 SCC OnLine Mad 3165.
8. RBI Circular dated July 06, 2017, available at link. The circular requires customer liability to be zero in case of a third party breach where the deficiency lies neither with the bank nor with the customer but lies elsewhere in the system, and the customer notifies the bank within three working days of receiving the communication from the bank regarding the unauthorized transaction.
9. RBI Circular dated January 04, 2019, available at link. The circular requires customer liability to be zero in case of a third party breach where the deficiency lies neither with the prepaid payment instrument issuer nor with the customer but lies elsewhere in the system, and the customer notifies the PPI issuer regarding the unauthorized payment transaction within three days. The circular has now been superseded with the PPI Master Directions, 2022.
10. https://uidai.gov.in/images/resource/Revised_Draft_Sharing_of_Information_Regulations_02052023_2.pdf
11. RBI press release dated May 12, 2023, available at link; RBI press release dated May 26, 2023, available at link.
12. RBI circular dated September 02, 2022, available at link.
13. https://www.livemint.com/news/india/qed-investors-to-invest-925m-fund-in-india-and-southeast-asia-focusing-on-full-stack-fintech-companies-11684945897090.html
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