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K C Mehta & Co LLP
Chartered Accountants

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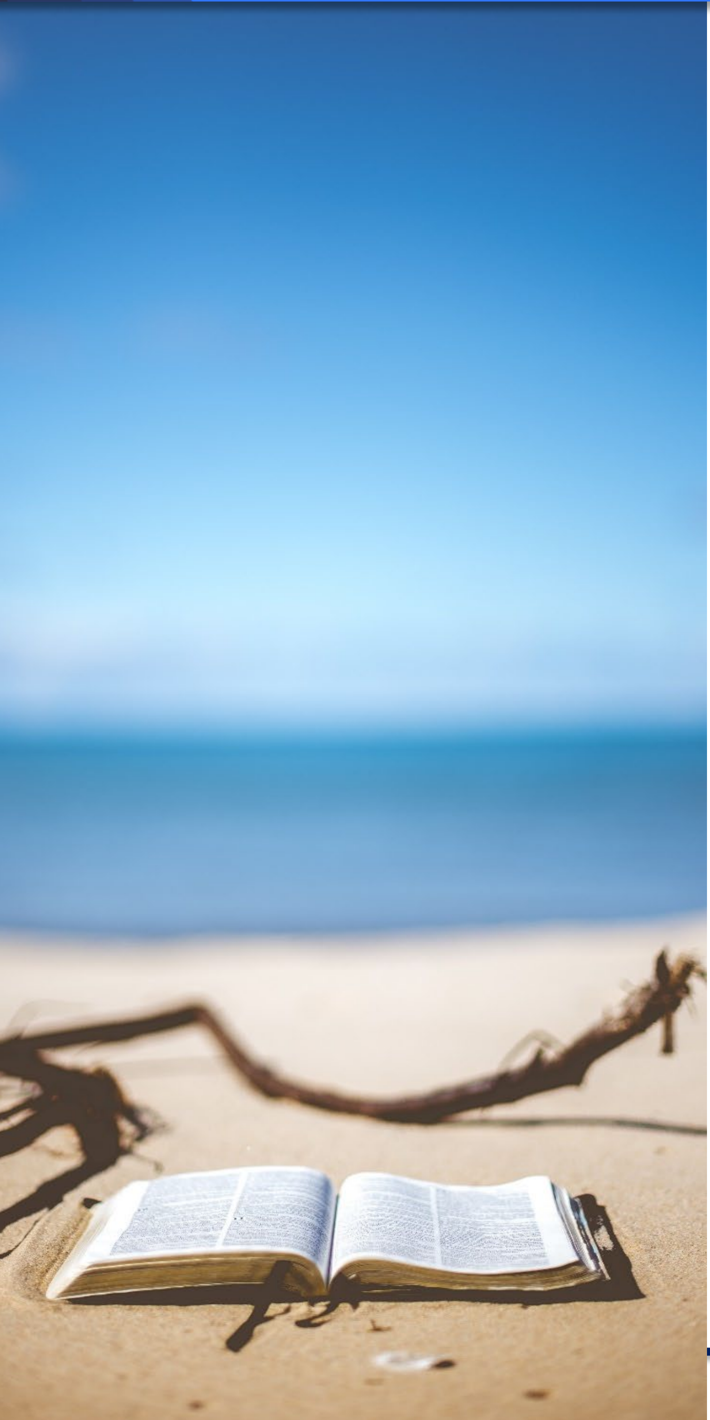
Finance & Market

FinTech Entities Framework

A Walkthrough



Background

Recently, the global tech-giant, Google, has announced its intention to set up a fintech operations center in the prestigious International Financial Services Center (IFSC) jurisdiction located in the GIFT City near Gandhinagar, Gujarat. This investment would provide a gargantuan impetus to the credibility and prestige of the IFSC itself.

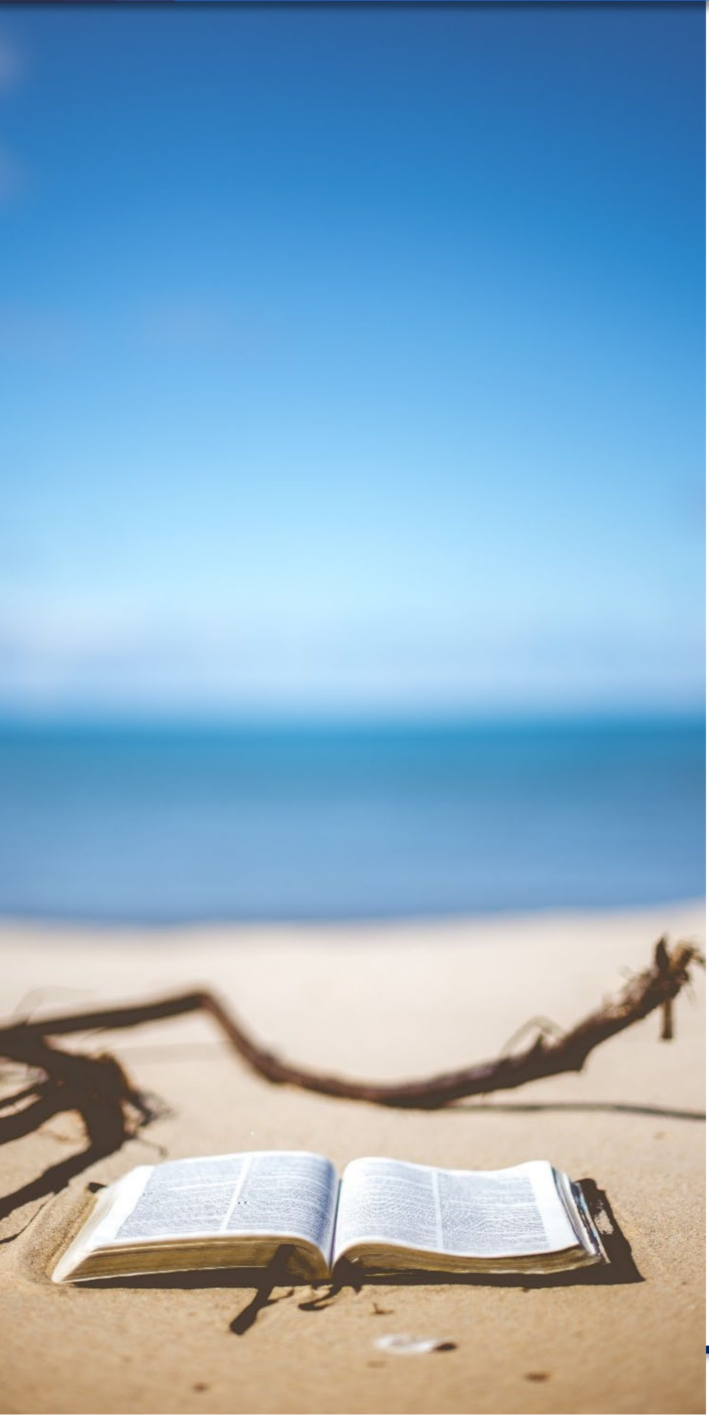
There are multiple benefits of a fintech entity operating from the IFSC like a 10-year income tax holiday, exemption from applicability of GST, significant foreign exchange regulation relaxations and the list of regulatory ease continues. Over and above the existing relaxations, credit needs to be given to the most alert and vigilant regulator, - IFSCA[1], which is constantly on its toes to address the grievances of its stakeholders by quickly introducing sensible amendments to their existing framework to add to this regulatory ease.

In this guide, we have made an attempt to explain in detail the FinTech Entity framework under which tech companies like Google are entering the IFSC jurisdiction in India through their fintech / techfin business arm.

Today, financial technology ('fintech') is seen as the core disruptor of every aspect of the traditional financial system. Fintech covers everything from mobile payment platforms to high-frequency trading (HFT), and from crowdfunding and virtual currencies to blockchain. Indian entrepreneurs have shown a lot of promise in the recent times with their innovative products and solutions which provide immense value addition to the existing financial services ecosystem. In order to promote the Indian FinTech players and attract more talent globally, the IFSCA introduced Framework for FinTech Entity in the IFSC through a circular[2]. This framework provides a dynamic regulatory environment for FinTech entities in the IFSC in the form of the concept of 'sandbox'.

1 International Financial Services Centre Authority

2 Circular No. F.No. 521/IFSCA/FinTech/FE Framework/2022-23 dated 27.04.2022.



Permissible Activities for FEs in IFSC

There are two categories of permissible activities in IFSC for FEs under this framework –

- FinTech: Describes the financial technology solution [itself] which results in new business models, processes, or products in financial services. E.g., the online payment mechanism.
- TechFin: Covers an advanced or emerging technology solution in allied areas/activities which aid/assist activities in relation to financial products, financial services, and financial institutions. E.g., an E-marketplace for farmers.

Interestingly, the FinTech Entity framework encompasses extensive domains of services by introducing the 'techfin' activities which consist of areas like InsureTech, Agri Tech, Defence Tech, Supervisory Tech and numerous other areas as listed under Annexure – I, Para B of the framework.

Authorization as a FinTech Entity (FE) in the IFSC

Certain eligibility conditions are in place for applicants to get authorization from IFSCA as FinTech Entities. A domestic FE can be set up in the form of a company, LLP or as a branch/subsidiary of an Indian/Foreign company or LLP in the IFSC. For an FE from outside India, in addition to previously mentioned conditions, it is mandatory to belong to an FATF compliant jurisdiction.

Note that having obtained IFSC authorization, an FE must transact only in freely convertible foreign currency. However, FEs may pay their administrative expenses in INR by maintaining an SNRR account (Note that this is a common feature among all frameworks introduced by the IFSCA)

FEs desirous of establishing their operations in the IFSC have two alternative routes of doing so based on their product/business model –

1. Direct Authorization
2. Limited Use Authorization (also referred to as 'Sandbox' Authorization)

Direct Authorization

Note that, in contradiction to popular belief, FinTech Entities need not necessarily develop a breakthrough, innovative technology to operate in IFSC. It is possible to adopt a well-established and well-known technologies / business model like that of a payment gateway or online payment service provider and register this business to operate in the IFSC under direct authorization route.

Although the term 'direct authorization' is not used in the framework, for the purpose of this article it refers to an authorization to directly commence operations in IFSC without entering into sandbox. For securing **direct authorization**, the applicant must have a deployable / working solution as well as a revenue earning track record in at least 1 of the last 3 financial years. This is the most essential condition for an FE to get registration in IFSC.

Limited Use Authorization

A limited use authorization authorizes the applicant to function in the sandbox framework. In line with the popular notion, it is this limited use authorization, which demands an *"idea or solution should be innovative enough to add significant value to the existing offering related to financial service or financial product regulated by IFSCA"* in order for the applicant to be granted such license.

Sandbox – an innovation in itself!

Concept of Sandbox and its variations

Concept of 'sandbox', as the name suggests, is developed for FEs to test their products/solutions in a live environment with certain relaxations from generally applicable regulations for a limited period of time. There are mainly three categories of sandboxes –

- Innovation Sandbox: This is an environment developed for FEs to test their ideas/solutions in isolation from the live market based on the data made available to them by the Financial Institutions operating in the IFSC.
- Regulatory Sandbox: This is a 'live' environment with limited set of real customers for a limited period of time where FEs operating in the IFSC are granted certain relaxations from applicability of certain regulations.
- Inter-Operable Regulatory Sandbox: Like the innovation sandbox, this also describes an environment built for testing new financial technology solutions and ideas. The only factor which distinguishes this from innovation sandbox is that this covers those products/solutions which fall within the regulatory ambit of more than one domestic financial sector regulators.

Apart from providing the FE with a 'real world' testing ground for its idea/solution, the sandbox also provides another significant benefit in the form of relaxation of select regulations. However, the applicant FE is required to specifically apply for such relaxations to the IFSCA and also demonstrate why it would not be able to operate/test its solution without such regulatory relaxation. In other words, there are no blanket regulatory exemptions which are additionally granted to FEs in the sandbox.

Entry and Exit from the Sandbox

To register into any of these sandboxes, the idea/solution developed by any FE must exhibit –

1. **Genuineness of Innovation:** The idea/solution should be such that it adds significant value to the existing offering related to financial services / products.
2. **Genuine need to test:** There should be a genuine need for testing such idea/solution in a live environment. The applicant must also demonstrate that such idea/solution cannot be developed without relaxing certain regulatory requirements which are sought.
3. **Limited prior testing:** Before applying for testing in sandbox, limited offline testing of idea/solution should have been carried out by the applicant.
4. **Direct benefit to users:** There should be identifiable benefits to the customers.
5. **No risks to the financial system**: should have proper risk management strategy – incorporating appropriate safeguards to mitigate identified potential risks.
6. **Testing readiness of the solution:** The applicant should have the necessary resources to support testing in sandbox. To demonstrate this the applicant should have in place proper testing plans and testing scenarios with clear objectives, parameters, and success criteria.
7. **Deployment post-testing:** There has to be an intention as well as the ability to deploy the solution on a broader scale. This should be demonstrated by sharing a proposed sandbox exit and transition strategy.

Based on the fulfilment of these criteria to the satisfaction of the IFSCA, the FE is granted a 'Limited Use Authorization' (LUA) to develop and test the proposed solution in the sandbox. Post such authorization the FE shall move on to the testing stage and operate its solution in sandbox.

The maximum permitted duration for the said testing phase in the sandbox is 12 months (may be extended further by 6 months if requested by FE). The FE must submit a final report to the IFSCA within 30 days of the expiry of the testing period. This report shall lay down the key learnings derived from the tests. At the end of the testing period, the LUA shall expire and the IFSCA shall determine whether the particular FE should be permitted to continue with its operations in the regular IFSC jurisdiction (i.e., out of the sandbox).

It is possible for the FE to specifically obtain regulatory exemptions from various requirements which the IFSCA shall consider on case-to-case basis and may provide such relaxations for the said FE only in respect of its operations in the sandbox. Note that where the FE has requested and availed regulatory exemptions from the IFSCA for the duration of testing period, then such relaxations shall also end on expiry of the testing period unless it is demonstrated to the satisfaction of the IFSCA that the solution is reliable and adequately addresses the risks identified.

FE may also exit the sandbox on its own volition by giving a prior written notice of 30 working days to the IFSCA to this effect. Upon successful exit from the sandbox, if the FE desires to carry out its operations from the IFSC, then it may do so if authorized as such by the IFSCA.

FinTech Incentive Scheme, 2022: For Innovative Solutions

The IFSCA (FinTech Incentive) Scheme, 2022 (Scheme)[3] was notified on Feb 04, 2022, with the principal objective to promote India, more particularly the IFSC jurisdiction, as a world class FinTech Hub by providing financial support to eligible applicants in the form of specific grant(s) as specified in the Scheme.

This Scheme is envisaged to benefit – Domestic FinTech players seeking to expand overseas or expand into the IFSC jurisdiction. It is also beneficial to Foreign FinTech players seeking to access the Indian domestic market or just the IFSC market in India.

This incentive coupled with the FinTech Entity framework developed by the IFSCA has paved a clear path for the small & growing domestic FinTech players to spread their wings across the globe!

Who is eligible for the Scheme?

The primary condition is that an applicant has to undertake to use technology in its core business model which solves the problem being targeted (same condition as set out in the FinTech Entity framework for sandbox's limited use authorization).

In order for such eligible Fintech Entities (FE) to claim the grant incentive –

- Eligible FEs must be a part of IFSCA's Regulatory Sandbox or Innovative Sandbox, or
- Eligible FEs must participate in IFSCA's supported Accelerators or Cohorts or Special Programs, or
- Eligible FEs must be referred to by regulatory/supervisory bodies having MoU with the IFSCA for strengthening identified area of common interest.

However, an entity which has received any grant from the central or state government schemes for the same activities shall not be eligible to apply under the Scheme.

The Incentives under this Scheme

There are six (6) categories of Incentives which are provided under this Scheme. All such incentives are monetary grants with certain performance related conditions attached to them. Such monetary grants shall be disbursed on reimbursement basis, i.e., on due submission of proper documents like invoices, contracts etc.

A table summarizing such incentives is provided below –

Grant Category	Grant Amount	Grant Description
FinTech Start-up Grant	INR 1.5 million	For developing a Minimum Viable Product (MVP) and related 'go-to- market' initiatives for a start-up with a novel FinTech idea or solution.

3 Notification No. IFSCA/2021-22/GN/022. dated 02.02.2022.

Grant Category	Grant Amount	Grant Description
Proof of Concept (PoC) Grant	INR 5 million	For the purpose of conducting a Proof of Concept (PoC), either in Indian markets or overseas, by an early or mature FE in domestic market or overseas.
Sandbox Grant	INR 3 million	Shall be Utilized by FEs to experiment with innovative products or services in IFSCA Regulatory or Innovation Sandbox.
Green FinTech Grant	INR 7.5 million	Shall be utilized towards developing solutions facilitating sustainable finance and sustainability linked finance, including 'Environmental, Social and Governance (ESG)' investments.
Accelerator Grant	INR 1 million	Shall be utilized for supporting an eligible Accelerator applicant for capacity building, build capabilities around mentors, bringing investors, bringing more projects or PoC, tie ups, etc.
Listing Support at IFSC	INR 1.5 million	Shall be utilized for supporting Domestic FEs aspiring to go for listing on stock exchanges recognized by the Authority.

In addition to the above, there are guidelines[4] issued by the IFSCA which provide the mechanism to claim such incentives. These monetary incentives are reimbursement-based monetary grants. Accordingly, the eligible applicant shall submit the relevant documents evidencing payment of such expenses which shall be scrutinized by the Internal Committee to verify if they are eligible for reimbursement under the grant or not. For actually releasing the disbursement, the Scheme provides an estimated period of 30 working days from date of submission of all documents. Further there are milestones prescribed by the IFSCA in the form of FAQs[5] which provide for limits to the claim of grant based on each successive milestone achieved.

There are certain basic conditions to be fulfilled for sanction of grants extended under the Scheme –

- FE shall duly designate and authorize a representative who shall be interacting with the IFSCA.
- FE or its implementation team shall operate from the IFSC during the sandbox or accelerator period.
- On successful completion of the sandbox/accelerator program, FE shall incorporate an entity at IFSC and seek registration as such if applicable.
- FE shall undertake not to implement a successful solution using the grant under the Scheme in any other jurisdiction for 3 years.

In case of failure to meet any of the conditions of sanction of such grant, FE shall be liable to return the grant to IFSCA along with simple interest at the rate of 8%.

[4] Guidelines for implementation of the IFSCA (FinTech Incentive) Scheme, 2022. Circular no. F. No. 389/IFSCA/FIP/2021-22 dated 12.09.2022.

[5] Frequently Asked Questions (FAQs) On Milestones & Illustrative Permissible Expenses For Reimbursement Under IFSCA (FinTech Incentive) Scheme, 2022 (updated till 15.12.2022)

Answer to some basic questions

1. **What exactly constitutes 'FinTech' under the FinTech Entity framework?**

   The framework envisages an extremely broad meaning to the term 'FinTech' which includes, ideas/solutions resulting in new financial services itself (e.g., online payment services), as well as ideas/solutions which aid assist activities in relation to financial services (e.g., e-marketplace for farmers).

2. **Who can avail the FinTech Incentive Scheme, 2022 benefit?** Broadly, any FinTech entity which is a part of the sandbox framework, is eligible to avail the FinTech Incentive Scheme, 2022, subject to the conditions mentioned thereunder.

3. **Is it mandatory to register in the sandbox (i.e., Limited Use Authorization) before obtaining authorization as a FinTech Entity in the IFSC?**

   No. The applicant may directly apply for authorization as FinTech Entity in the IFSC by filing application provided in Annexure-II of the framework circular. From the framework, it is clear that the sandbox is specifically created for those entities which have an idea/solution which requires further testing in a live environment. This would not be the case for all FinTech entities.

4. **Should the applicant company mandatorily be a start-up relating to FinTech?**

   The applicant FinTech entity need not be a start-up. However, even a start-up entity may apply to get authorization as a FinTech entity if it fulfils the conditions laid down under the framework.

5. **Is it a pre-condition to have an 'innovative' or 'disruptive' fintech idea/solution to be eligible for setting up operations in IFSC?**

   No. Such pre-condition is only for limited use authorization (i.e., for operations in sandbox) and not for direct authorization as explained earlier in brief.

Conclusion

In today's hyper-competitive global landscape, we find that it is imperative to increase not only efficiency but also effectiveness. The best means to achieving this end is information technology. Financial Services, being the backbone of any economy, is an area where the ever-increasing competition coupled with the ever-rising demand of its services has resulted automation and financial technology becoming the need of the hour. In such a scenario, the FinTech Entity framework in the IFSC presents itself as the greatest opportunity for growth of financial technology and innovation. There are many incentives of setting up operations in the IFSC as FinTech entity, but no other incentive is as great as the ecosystem consisting of –financial service entities, financial institutions and banks – that the IFSC in Inda provides. A niche customer base in the IFSC and across the globe, up for grabs to the Indian tech- entrepreneurs!

About kcmGuide

kcmGuide *is a special publication prepared by area specific experts at K C Mehta & Co LLP. This publication is intended to provide overall guidance on select topics / areas that may be of interest to readers. The idea is to provide to the reader an overall perspective on a particular topic in the form of a Guide which could serve as a referencer while practically dealing with the topic.*

Locations

Ahmedabad
Arpit Jain
Level 11, Tower B,
Ratnaakar Nine Square,
Vastrapur,
Ahmedabad - 380 015

Phone: + 91 79 4910 2200
arpit.jain@kcmehta.com

Bengaluru
Dhaval Trivedi
FF - 4/1, Rudra Chambers,
#95, 11th Cross, 4th Main Rd,
Malleshwaram,
Bengaluru - 560 003

Phone: +91 99983 24622
dhaval.trivedi@kcmehta.com

Mumbai
Bhadresh Vyas
315, The Summit Business
Bay, Nr. WEH Metro Station,
Gundavali, Andheri East,
Mumbai – 400 069

Phone: +91 22 2612 5834
bhadresh.vyas@kcmehta.com

Vadodara
Milin Mehta
Meghdhanush,
Race Course,
Vadodara - 390 007

Phone: +91 265 2440 400
milin.mehta@kcmehta.com

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