

# KNOWLEDGEWARE

## MARCH 2018

### REGULATORY

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**Editorial:**

Dear Esteemed Readers,

The last quarter of financial year 2017- 18 witnessed some unfortunate events on banking front that are estimated to have removed millions of dollars from some banks' balance sheets. The fallout is some obvious defensive reaction from regulators and shaken investor confidence.

The financial 2018-19 dawns in the background of some serious global uncertainty. The challenge therefore will be to bring back the investor confidence and make regulatory framework strong and business friendly at the same time.

The advent of Ind AS 115 Revenue from Contracts with Customers brings in a paradigm shift in recognition, measurement and disclosure requirements especially for companies with complex transactions, multiple components of revenue or variable amounts of consideration. Those who operate in telecom, software, engineering and real estate industry will be the most affected. Although it is applicable in the next financial year, but considering the impact on how and when to recognize revenue and the extensive disclosure requirements, especially the listed companies have a very short time for implementation and they need to hit the ground running for first quarter of FY 2019.

We share herewith the March 2018 Newsletter covering key regulatory updates in India.

The Banking regulator, Reserve Bank of India (RBI) released few important directions/circulars:

- Discontinuance of issue of LoUs and LoCs as trade credit for imports into India by AD banks with immediate effect. The regulator's action is in the backdrop of some recent revelations in public sector banks.
- Tight guidelines for hedging commodity price risks and freight risks in overseas markets, which will come into effect in forthcoming financial year, by limiting the tenor of all bank instruments in trade finance areas and disallowing hedging of price risk in gold, gems and precious stones.
- RBI has reiterated to Government-owned NBFCs that submission of returns as required by various RBI directions/regulations should not be delayed for any reasons.

The Capital Market regulator, Securities & Exchange Board of India (SEBI) has also issued important circulars in this month:

- Certain clarifications explaining compliances to be ensured in allowing investment by Category II FPIs regarding "Easing of access norms for investment by FPIs".
- All Reporting Financial Institutions (RFIs) have been advised to take certain necessary steps as mentioned in the circular to ensure compliance with requirements specified in the Common Reporting Standards for carrying out the necessary due-diligence and reporting for Foreign Portfolio Investors.

We hope you find the edition an interesting read.

Thank you.

Happy reading!

Yours Sincerely,

B.K.Khare & Co.

Knowledgeware Team

## Reserve Bank of India (RBI)

### Discontinuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits

Erstwhile Reserve Bank of India (RBI) regulations permitted Authorized Dealer (AD) banks to approve trade credits in the form of Guarantee/Letter of Undertaking (LoUs) /Letter of Comfort subject to prior approval of the RBI.

Further, in order to promote investment activity and to further liberalize the procedures relating to trade credits for imports, it was decided to accord general permission to ADs to issue guarantees/LoUs/LoCs in favor of overseas supplier, bank and financial institution, up to USD 20 million per transaction for a period of up to one year for import of all non-capital goods permissible under Foreign Trade Policy (except gold) and up to three years for import of capital goods, subject to prudential guidelines issued by RBI from time to time.

Now, RBI has discontinued the permission for issuance of LoUs and LoCs as trade credit for imports into India by AD banks with immediate effect. However, Letters of Credit and Bank Guarantees for Trade Credits for imports into India may continue to be issued subject to compliance with the provisions contained in Department of Banking Regulation Master Circular on "Guarantees and Co-acceptances".

The regulator's action is in the backdrop of the widely reported fraud where LoUs were obtained from a scheduled bank SWIFT network and that too without adequate collateral and were used to raise money in overseas Bank branches. This led to a huge loss to the Indian banks and market speculation estimates the astronomical sums involved.

Importers or buyers are set to see a hit on their costs of funds due to discontinuance of practice of issuance of LoUs and LoCs.

***Circular No.:Notification RBI/2017-18/139 A.P. (DIR Series) Circular No. 20, March 13, 2018***

## Hedging of Commodity Price Risk and Freight Risk in Overseas Markets(Reserve Bank) Directions

Hedging of Commodity Price Risk and Freight Risk in Overseas Markets (Reserve Bank) Directions, 2018 shall come into force from April 1, 2018.

Residents hedging their commodity price risk and freight risk under a specific approval from Reserve Bank of India (RBI) given under the approval route based on the previous set of guidelines would be permitted to continue hedging under the said approval till June 30, 2018 or the last date specified in the approval, whichever is earlier.

The new directions have specified commodities whose price risk may be hedged as under:-

- a) In case of direct exposures to commodity price risk: All commodities (except Gold, Gems and precious stones)
- b) In case of indirect exposures to commodity price risk: Aluminium, Copper, Lead, Zinc, Nickel. This list of eligible commodities would be reviewed annually.

It also defines products that are permitted to hedge such exposure:-

- a) Generic products
  - i. Futures and forwards
  - ii. Vanilla options (call option and put option)
  - iii. Swaps
- b) Structured products
  - i. Products which are combination of either cash instrument and one or more generic products
  - ii. Products which are combination of two or more generic products

The new directions have laid down the Operational guidelines to be followed in respect of hedging exposure:

1. Banks may permit eligible entities to hedge commodity price risk and freight risk overseas using permitted products and may permit remittance outside India of foreign exchange in respect of such transactions after satisfying themselves that
  - a. The entity has exposure to commodity price risk or freight risk, contracted or anticipated
  - b. The quantity proposed to be hedged and the tenor of the hedge are in line with the exposure
  - c. In case of OTC derivatives, the requirement to undertake OTC hedges is justified
  - d. In case of hedging using a benchmark price other than that of the commodity exposed to, the requirement to undertake such hedges is justified
  - e. Such hedging is taken up by the management of the entity under a policy approved by the Board of Directors of a company or equivalent forum for other
  - f. The entity has the necessary risk management policies in place
  - g. The entity has reasonable understanding of the utility and likely risks associated with the products proposed to be used for hedging
2. OTC contracts shall be booked with a bank or with non-bank entities which are permitted to offer such derivatives by their regulators
3. Structured products may be permitted to eligible entities who are (a) listed on recognized domestic stock exchanges or (b) fully owned subsidiaries of such entities or (c) unlisted entities whose net worth is higher than INR 200 crores, subject to the condition that such products are used for the purpose of hedging as defined under these directions

4. All payments/receipts related to hedging of exposure to commodity price risk and freight risk shall be routed through a special account with the bank for this purpose
5. Banks shall keep on their records full details of all hedge transactions and related remittances made by the entity
6. Banks shall obtain an annual certificate from the statutory auditors of the entity confirming that the hedge transactions and the margin remittances are in line with the exposure of the entity. The statutory auditor shall also comment on the risk management policy of the entity for hedging exposure to commodity price risk and freight risk and the appropriateness of the methodology to arrive at the quantum of these exposures
7. Banks shall undertake immediate corrective action in case of any irregularity or misuse of these directions. All such cases should be reported to Chief General Manager, Financial Markets Regulation Department, Reserve Bank of India

**Standby Letters of Credit (SBLC) / Guarantees** - Banks are permitted to issue Standby Letters of Credit (SBLC) / Guarantees, for a maximum period of one year, on behalf of their clients in lieu of making a remittance of margin money for commodity hedging transactions entered into by their customers. Banks should ensure that these SBLCs / Guarantees are used by their clients for the intended purpose.

**Realization and repatriation of foreign exchange** - Realization and repatriation of foreign exchange due or accruing to an eligible entity resulting from permitted transactions under this direction shall be guided by the provisions of the Foreign Exchange Management (Realization, repatriation and surrender of foreign exchange) Regulations, 2015

**Report to Reserve Bank** - Banks shall submit a quarterly report to the Chief General Manager, Financial Markets Regulation Department, Reserve Bank of India. In case of no transactions, a "Nil" report may be submitted by the bank.

The banks will be required to keep full details of all hedge transactions and related remittances made by the entity. Further the tenor of all bank instruments in trade finance areas will be limited to a maximum of one year.

By disallowing hedging of price risk in gold, gems and precious stones, RBI has tightened the guidelines for hedging commodity price risks and freight risks in overseas markets, which will come into effect from the next financial year.

***RBI/2017-18/138 A.P. (DIR Series) Circular No. 19 dated March 12, 2018***

## Reporting and Accounting of Central Government Transactions

The Banking Regulator rolled out a circular dated March 19, 2018 advising the procedure to be followed for reporting and accounting of Central Government transactions (including CBDT, CBEC, departmentalized ministries and non-Civil Ministries) at the Receiving/Nodal/Focal Point branches of bank for the Financial Year 2017-18.

The Government has decided the date of closure of residual transactions for March 2018 to be fixed for April 10, 2018 for FY 2017-18.

In view of the ensuing closing of government accounts the receiving branches including those not situated locally, should make special arrangements such as courier service etc., for passing on challans /scrolls etc., to the Nodal/Focal Point branches so that all payments and collections made on behalf of government towards the end of March are accounted for in the same financial year.

To sum up, the Nodal/Focal Point branches would require to prepare separate sets of scrolls, one pertaining to March residual transactions and another for April transactions during the first 10 days of April 2018. The Nodal/Focal Point branches should have also ensured that the accounts for all transactions (revenues/tax collections/payments) are effected at the receiving branches up to March 31, 2018 in the accounts for the current financial year itself and are not mixed up with the transactions of April 2018. Also, while reporting transactions pertaining to March 2018 up to April 10, 2018, the transactions of April 2018 should not be mixed up with the residual transactions relating to March 2018.

***Circular No.: RBI/2017-18/142DGBA.GBD.No.2324/42.01.029/2017-18***

Submission of returns by the Government-owned Non-Banking Financial Companies (NBFCs)

As per the Master Directions dated September 29, 2016 of RBI in respect of Non-Banking Financial Company Returns, NBFC's were to submit various weekly, monthly, quarterly, half yearly and annual returns. RBI has reiterated to Government-owned NBFCs that as prescribed under directions, submission of returns should not be delayed for any reasons; an NBFC should strictly adhere to the timelines.

Further RBI circular RBI/2017-18/141 DNBS.PD.CC.No 1925/66.08.001/2017-18 states as below:

- 1) All NBFC's should put in place system for filing periodic returns with RBI, as detailed in the aforesaid Master Directions, to the extent applicable to them
- 2) The returns should be compiled on the basis of the figures available in the books of accounts of such NBFCs and filed with the RBI on-line (using the COSMOS software package) by an authorized official of the NBFC, who should be specifically authorized in this regard
- 3) The first set of returns were to be filed with effect from the: (i) last Friday of December 2017 for the weekly return; (ii) quarter ended - December 31, 2017 for the quarterly returns; (iii) half-year ending March 31, 2018 for the half-yearly returns; and (iv) year ending March 31, 2018 for the annual returns.
- 4) All weekly, quarterly returns upto December 31, 2017 shall be submitted by April 15, 2018. Thereafter, these returns shall be submitted within the timeline stipulated in the Master Direction on returns to be submitted by NBFCs.
- 5) Government-owned Non-Banking Financial Companies should comply with Master Direction – Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016 dated September 29, 2016.

***Circular No.: RBI/2017-18/141 DNBS.PD.CC.No 1925/66.08.001/2017-18***

## Securities and Exchange Board of India (SEBI)

### Clarifications in respect of investment by Category II Foreign Portfolio Investors (FPIs)

In continuation of SEBI circular No. CIR/IMD/FPIC/ 26 /2018 dated February 15, 2018 regarding “Easing of access norms for investment by FPIs”, SEBI has issued certain clarifications explaining compliances to be ensured in allowing investments by Category II FPIs.

Following clarifications were made in respect of investments by certain category II FPIs which mainly explain compliances to be ensured w.r.t. investors investing through FPIs:

1. The collective investment vehicle of private banks/ merchant banks investing on behalf of clients need to ensure the following:
  - a. The client/ investor should have fulfilled know your client norms. The beneficial owners (BO) of client/ investor of bank should be identified in accordance with Rule 9 of Prevention of Money Laundering (Maintenance of Records) Rules, 2005.
  - b. The client/ investor or their BO should not be Resident Indian/ NRI/ Overseas Citizen of India.
  - c. The client/ investor is not resident in a country identified in the public statement of Financial Action Task Force as:
    - i. a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
    - ii. a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies;
  - d. The client/ investor should not have opaque structure(s), as defined under Explanation 1 of Regulation 32(1) (f) of SEBI (Foreign Portfolio Investors) Regulations, 2014 or Bearer share structure.
  - e. The collective investment vehicle of the Bank (other than for ODIs) should be broad based (more than 20 investors and no investor having more than 49% stake) and there should be common portfolio for all clients/ investors.
2. Presently, appropriately regulated broad based insurance/ reinsurance companies are investing proprietary funds and for unit linked/ investment products. In this regard, it is clarified that investment in India by insurance/ reinsurance companies must be maintained as an undivided common portfolio. Segregated portfolio or investor/ policy-holder level investment structure shall not be permitted.
3. In respect of other appropriately regulated persons permitted as Cat. II FPIs viz. Asset management companies, investment managers/ advisers, Portfolio managers, Broker-dealer and Swap-dealer. It is clarified that:
  - a. They are permitted to invest their proprietary funds,
  - b. These appropriately regulated persons by taking separate registration can also invest with client funds as an ODI Issuing FPI or after fulfilling the condition of being broad based and having a common portfolio. However, asset management companies having thematic portfolios can also have segregated structure if each theme is broad based.

4. All other investment restrictions and due diligence requirements as applicable to FPIs shall continue to be applicable on entities referred at (1) to (3) above.

***CIR/IMD/FPIC/47/2018 March 13, 2018***

### Clarification Circular pertaining to Investor Protection Fund (IPF) and Investor Service Fund (ISF)

The capital market regulator, Securities and Exchange Board of India (SEBI) is seen to be leaving no stone unturned for increasing the public participation in capital markets.

SEBI issued a circular dated June 13, 2017, in which it issued guidelines covering broad contours of Investor Protection Fund (IPF) and Investor Service Fund (ISF).

Subsequently, SEBI has received representations from the national commodity derivatives exchanges (NCDEs) for clarifications and consideration of their requests with respect to some of the clauses of the said circular. After examination thereof, the following clarifications have been issued by SEBI.

- i. It is clarified that the unutilized IPF Interest Income accruing during a specific financial year can be carried forward to the next financial year to enable effective utilization of such money by the exchanges during such extended period.
- ii. NCDEs are hereby permitted to utilize IPF interest income for undertaking research activities related to commodities market, provided every such research activity / project is undertaken only after obtaining prior written approval of the trustees of the IPF Trust, who would inter alia, record the reasons, relevance and stated objectives of the research project while according approval to such activity/ project. Further, the Board of the exchange may be apprised of the research programs / activities being undertaken at least once in every quarter or half year of a given financial year.  
There will be an overall cap on the total amount, not more than 10% of the interest amount of IPF, which can be spent on Research activities related to commodities market. IPF shall frame a policy towards identifying / recognising public and private academic institutions, professional bodies, trade (physical market) associations and industry bodies / chambers through / with whom such Research activities shall be undertaken / organised / sponsored.
- iii. Clause 7.3 of the circular dated June 13, 2017 provided that the IPF of the exchange shall be utilized for the clients of SEBI registered members. In this connection, it has been clarified that exchanges may also use the IPF of the exchange for meeting their liabilities towards the clients of members not registered with SEBI, if the same is allowed under the byelaws of the exchange.
- iv. SEBI has prescribed certain expenditures which are to be met from the ISF and not IPF. However since ISF is of recent origin, its corpus may be inadequate. NCDEs have therefore requested to permit utilization of interest on IPF in lieu of ISF for expenditures meant only for ISF. Accordingly, the NCDEs have been granted 3 years period starting April 1st, 2018 to permit utilization of interest on IPF for activities of ISF also.

The exchange may utilize income earned on the corpus of IPF towards promotion of investor education and awareness programmes through seminars, lectures, workshops, publications (print and electronic media), training programs etc. to enhance literacy and to promote participation in the commodity derivatives market or any other mandated purpose.

***CIR/CDMRD/DCE/CIR/P/2018/49***

## Due diligence and reporting requirements under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS)

In the SEBI circulars No. CIR/MIRSD/2/2015 dated August 26, 2015 and No. CIR/MIRSD/3/2015 dated September 10, 2015 SEBI had informed all intermediaries regarding due diligence and reporting requirements under Rules 114F to 114H of the Income- tax Rules (hereinafter referred as Rules) and Guidance Note on FATCA and CRS issued by the CBDT, New Delhi, vide F.No.500/137/2011-FTTR-III dated August 31, 2015

Accordingly, all Reporting Financial Institutions (RFIs) have been advised to take following necessary steps to ensure compliance with requirements specified in the aforesaid rules for carrying out the necessary due-diligence and reporting for Foreign Portfolio Investors (FPIs):-

- i. Obtain valid self-certifications/ FATCA and CRS declaration forms with documentary evidence as part of the account opening documentation in relation to FATCA/ CRS as specified in Rule 114H. Indicative self-certifications for individuals and entities are provided as Appendix D and E in the Guidance Note on FATCA and CRS.
- ii. In accordance with CBDT clarification dated February 19, 2016, Custodians are required to carry out due diligence on the accounts held by Global Custodian (GC) end-clients. However, for carrying out due diligence, the Custodian may rely on the FATCA/CRS documentation done by GC for the account holders including the self-certification. Further, it has been clarified that the obligations for due diligence and reporting remain that of the Custodian who is also able to access all documents in relation to an account holder.
- iii. Create a process/system to capture and validate the information collected through valid FATCA/ CRS declaration forms.
- iv. Develop framework for carrying out due diligence procedures and for maintaining reporting information, as provided in Rule 114G and 114H
- v. Furnish the relevant information in Form 61B in respect of the identified reportable accounts as defined in Rule 114F(6) on or before the date prescribed in accordance with sub-rules (7), (8) and (9) of Rule 114G for every calendar year.
- vi. Develop a system of audit for compliance with Rules 114F, 114G and 114H of Income-tax rules.
- vii. Ensure compliance with updated rules/ circulars/ notifications/ instructions/guidance notes issued on the subject by Central Board of Direct Taxes (CBDT) from time to time.

RFIs are also required to certify to SEBI on annual basis regarding compliance with the provisions of Rules 114F to 114H of Income-tax rules relating to FATCA / CRS. This certificate would be a part of the audit report on internal controls submitted to SEBI annually.

Designated Depository Participants (DDPs) should grant registration to a foreign Portfolio Investor (FPI) only after obtaining valid self-certification/FATCA/CRS declaration forms. DDPs shall submit a certificate in respect of new registration(s) granted during every month at the end of the month that all due-diligence procedures, including obtaining of valid self-certification/ FATCA/ CRS declaration, have been followed before granting the said registration to FPI.

During inspection of DDPs/ Custodians, SEBI will examine the compliance with, *inter-alia*, the requirement of certificate to SEBI regarding self-certification and due-diligence at the time of new registration.

***Circular No.: IMD/ FPIC/CIR/P/2018/53 Mar 21, 2018***