



Report of the Committee on positioning IFSC as a hub for offshore trading in INR

June 18, 2021

Letter of Transmittal

Shri Injeti Srinivas
Chairperson
International Financial Services Centres Authority
Gandhinagar

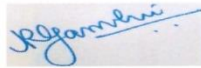
June 18,2021

Dear Sir,

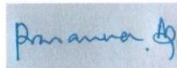
We are pleased to submit the report of the Committee on positioning IFSC as a hub for offshore trading in INR. In line with its mandate, the Committee undertook a detailed examination of global best practices in the areas of final market infrastructure and financial market regulations. The recommendations of the Committee aim to replicate such best practices in IFSC within the boundaries of Indian laws. We thank you for entrusting this responsibility to the Committee and hope that the recommendations of the Committee will help in IFSC fulfilling its goal of emerging as a hub for offshore trading in INR.

Yours sincerely

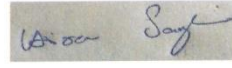

(G. Padmanabhan)
Chairperson



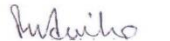
(Neeraj Gambhir)
Member



(B. Prasanna)
Member

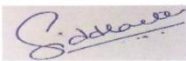


(Hiren Sanghvi)
Member

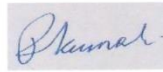

(Rajay K Sinha)
Member


(V Balasubramaniam)
Member


(Sandip Mehta)
Member



(Siddharth Bachhawat)
Member



(R. Kumar)
Member



(Supriyo Bhattacharjee)
Member



(Siddarth Banerjee)
Special Invitee

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Abbreviations

ADRs	American Depositary Receipts
AML	Anti-Money Laundering
APRA	Australian Prudential Regulation Authority
BaFin	Federal Financial Supervisory Authority
BMD	Bursa Malaysia Derivative Exchange
BRL	Brazilian Real
CCIL	Clearing Corporation of India Limited
CCP	Central Counterparty
CCR	Counterfeit Currency Report
CDSL	Central Depository Services (India) Limited
CEO	Chief Executive Officer
CFT	Combating the Financing of Terrorism
CHIPS	Clearing House Interbank Payments System
CME	Chicago Mercantile Exchange
CNY	Chinese Yuan Renminbi
CPMI	Committee on Payments and Market Infrastructures
CSA	Credit Support Annex
DDP	Domestic Depository Participants
DGCX	Dubai Gold & Commodities Exchange
EBS	Electronic Broking Services
EFIs	Eligible Foreign Investors
ESMA	European Securities and Markets Authority
ETCD	Exchange Traded Currency Derivatives
ETFs	Exchange Traded Funds
ETPs	Electronic Trading Platforms
EUR	Euro
FATF	Financial Action Task Force
FBIL	Financial Benchmarks India Pvt Ltd
FCA	Financial Conduct Authority
FCSP	Final Cash Settlement Price
FCY	Foreign Currency
FEDAI	Foreign Exchange Dealers' Association of India
FEMA	Foreign Exchange Management Act, 1999
FI	Financial Institution
FMI	Financial Market Infrastructures
FPI	Foreign Portfolio Investor
FSB	Financial Stability Board
FX	Foreign Exchange
FXPB	Fx Prime Brokerage
GFC	Global Financial Crisis

GSM	Global Securities Market
HFTs	High Frequency Trading
HKEX	Hong Kong Exchange
HKICL	Hong Kong Interbank Clearing Limited
HKMA	Hong Kong Monetary Authority
HNIs	High Net worth Individuals
HSBC	Hongkong and Shanghai Banking Corporation Limited
IBU	IFSC Banking Unit
ICE	The Intercontinental Exchange
ICSDs	International Central Securities Depositories
IDR	Indonesian Rupiah
IFSC	International Financial Services Centre
IMF	International Monetary Fund
INR	Indian Rupee
InvITs	Infrastructure Investment Trusts
INX	India International Exchange (IFSC) Limited
IOSCO	International Organization of Securities Commissions
IRDA	Insurance Regulatory and Development Authority
IRO	Interest Rate Option
ISDA	International Swaps and Derivatives Association
ITM	In the money
JV	Joint Venture
KRW	South Korean Won
KYC	Know Your Customer
LCH	London Clearing House
LSE	London Stock Exchange
MAS	Monetary Authority of Singapore
MNC	Multinational Corporation
MTN	Medium-term note
MYR	Malaysian Ringgit
NDDCs	Non-Deliverable Derivative Contracts
NDF	Non-deliverable forward
NDIRS	Non-deliverable interest rate swaps
NDO	Non-deliverable option
NICCL	NSE IFSC Clearing Corporation Limited
NLT	Negotiated Large Trade
NSE	National Stock Exchange
NTR	Non-Profit Organization Transaction Report
ODI	Offshore Derivative Instruments
OIS	Overnight index swap
OTC	Over-the-counter
OTM	Out-of-the-Money
OVD	Officially Valid Document

PAN	Primary Account Number
PB	Prime Brokerage
PFMI	Principles for Financial Market Infrastructures
PFRDA	Pension Fund Regulatory & Development Authority
PHP	Philippine Peso
PIOs	Persons of Indian Origin
PMLA	Prevention of Money Laundering Act
QCCP	Qualified Central Counter Party
RBI	Reserve Bank of India
REITS	Real Estate Investment Trust
REs	Resident Entities
RTGS	Real-time gross settlement
SBI	State Bank of India
SCRA	Securities Contracts (Regulation) Act
SEBI	Securities and Exchange Board of India
SGD	Singapore dollar
SGX	Singapore Stock Exchange
SNA	Segregated Nominee Account Structure
SRO	Self Regulatory Organisation
SWF	Sovereign Wealth Fund
TC-CCP	Third Country Central Counterparty
TR	Trade Repositories
TRS	Total Return Swap
TWD	Taiwan Dollar
USD	United States dollar
VWAP	Volume Weighted Average Price
WOS	Wholly Owned Subsidiaries

Chapter 1

Introduction

1. The vision behind setting up the International Financial Service Centre (IFSC) is to bring to the Indian shores, those financial services/markets and transactions relating to India that are currently carried on outside India by overseas financial institutions and overseas branches/subsidiaries of Indian financial institutions. This is sought to be achieved by designating a centre, for all practical purposes, as a place outside India having the same ecosystem as an offshore location, while being physically located on Indian soil. The mandate of IFSCA, the unified regulator of the IFSC, is to create a world class financial ecosystem supported by an efficient and facilitative regulatory system comparable with the best jurisdictions in the world with the goal of developing IFSC as a preferred global hub for financial services. One of the important aspects of such an endeavour is for IFSC to emerge as a hub for offshore trading in INR, otherwise known as the Non-deliverable forward (NDF) market.
2. The NDF market in INR is one of the market segments where IFSC may over time become the dominant destination. NDFs, which is an offshore market in a non-convertible currency enables trading of the non-convertible currency outside the influence of the domestic authorities. These contracts are settled in a convertible currency, usually US Dollars, as the non-convertible currency cannot be delivered offshore. Historically, NDF markets evolved for currencies with foreign exchange convertibility restrictions and controlled access for non-residents, beginning with countries in South America like Mexico and Brazil and thereafter moving on to emerging Asian economies, viz., Taiwan, South Korea, Indonesia, India, China, Philippines, etc. Apart from enabling trading in non-convertible currencies, NDF markets have also gained in prominence because of the absence of onshore regulatory controls and their consequent ease of access.
3. Reserve Bank of India (RBI) had, till recently, discouraged banks in India from making markets in offshore INR. As a result, the market is currently dominated by foreign banks on the OTC side while the volumes in the exchange traded currency derivatives (ETCD) are concentrated in exchanges like DGCX and SGX. Recently, RBI has changed its stance on INR NDFs, first by permitting FCY-INR contracts (settled in FCY) to be listed on stock exchanges at IFSC (January 2020) followed by allowing Indian banks having an IBU to participate in the NDF market in INR from June 1, 2020 out of their branches in India, through their IBUs or through their foreign branches.
4. Given the above regulatory relaxations, coupled with the other advantages that IFSC enjoys, namely free movement of capital to and from IFSC, internationally benchmarked regulations (which are in the process of being developed) and tax advantages, sets the scene for IFSC to emerge as a hub for trading in offshore INR. While the report of the Task Force on Offshore Rupee Markets (August 2019), constituted by the Reserve Bank of India, has delved into certain aspects on the offshore markets in INR and made recommendations to encourage the same in IFSC, it largely adopted a macro-approach in dealing with the issues. A need was therefore felt to delve into the operational aspects of the offshore market in INR and replicate

the enabling environment (in terms of participants, product, market infrastructure and legal and tax matters) in IFSC.

5. The Chairman, IFSCA accordingly constituted a committee on experts for “Positioning IFSC as a hub for offshore trading in INR” with the following members:

i.G. Padmanabhan, Chairperson (Former Chairman, Bank of India/ Former Executive Director, Reserve Bank of India)

ii.Hiren Sanghvi, Member (Head, FX-trading, HSBC)

iii.Neeraj Gambhir, Member (Group Executive – Treasury, Markets & Wholesale Banking Products, Axis Bank)

iv.B.Prasanna,Member (Group Head, Global Markets, ICICI Bank)

v.Rajay K Sinha, Member (General Manager, International Banking Group, SBI)

vi.V.Balasubramaniam, Member (MD & CEO, India INX)

vii.Sandip Mehta, Member (CEO, NSE IFSC)

viii.Siddharth Bachhawat, Member (Managing Director, Markets, Barclays Bank India)

ix.R. Kumar, Member (Head, Banking, IFSCA)

x.Supriyo Bhattacharjee, Member-Secretary (General Manager, Banking, IFSCA)

Shri Siddarth Banerjee, Deputy Head, Global Markets Group, IndusInd Bank was invited to join the Committee as a special invitee.

6. The general terms of the reference for the Committee of Experts were:

i.To determine the regulatory and infrastructural requirements necessary to create the necessary conditions for development of IFSC as a hub for offshore trading in INR.

ii.To assess the current regulatory and infrastructural facilities at IFSCs in light of the requirements determined.

iii.To recommend specific measures to bridge the identified gaps between (i) and (ii) in the form of a report to Chairman, IFSCA.

The committee could also examine and make recommendations on other issues of importance though not specifically mentioned in the above terms of reference.

7. Like all financial markets, the offshore market INR, consists of the following components:

i.**Instruments/products** which are bought and sold

ii.**Participants** who undertake such buying and selling

iii.**Infrastructure** to undertake such transactions and ensuring settlement

iv.**Regulation** to ensure market discipline coupled with supportive legal and tax framework

8. The approach of the committee has been to consider the above components, seek understanding of the best practices in each of the components and recommend measures to adopt the same approach in IFSC, within the parameters of Indian law. The Committee’s recommendations have been guided by the following principles:

- i. Regulations in IFSC should permit transactions in any instrument/product without bias.
 - ii. Regulations in IFSC should not be geared towards excluding any group of participants so long as they satisfy internationally accepted customer acceptance and AML requirements.
 - iii. Regulations in IFSC should be agnostic in the matter of the infrastructure used to conduct, clear and settle such transactions subject to (iv).
 - iv. IFSCA's regulatory functions should be limited to laying down principle-based rules on conducting such transactions and assessing the robustness of infrastructure through which they are conducted, cleared and settled.
 - v. IFSC's Regulatory, Legal and Taxation regime should be aligned and benchmarked to similar global financial centres so that, as a jurisdiction, IFSC is not at a competitive disadvantage.
9. Globally the stance of emerging market central banks/regulators and Governments has been to discourage offshore trading in their currencies. In some cases, such discouragement has taken the form of outright ban on offshore trading in the concerned currency by market participants (including foreign banks operating in the jurisdiction). In other cases, attempts have been made to make access to onshore markets easier to encourage foreigners to shift their transactions away from the offshore market. The Authority's (and by implication the committee's) mandate is therefore a novelty wherein an enabling environment is sought to be created for such transactions in INR. The committee has borne this fact in mind while framing its recommendations. At the same time, the committee is of the opinion that concerns over firewalling the domestic markets and economy from international flows, arising out of operations in IFSC is best left to the judgement and jurisdiction of the domestic regulators like RBI, SEBI, IRDA, PFRDA etc.
10. During its term, the Committee met on five occasions through video conference . The committee also invited the following experts and policy makers to address the committee:
- i. Ms. Dimple Bhandia, Chief General Manager, Financial Markets Regulation Department, Reserve Bank of India.
 - ii. Mr. Surendra Rosha, Group General Manager and CEO India, HSBC
 - iii. Mr. Ashwani Sindhvani, Chief Executive, FEDAI
 - iv. Mr. Anish Thacker, Partner, Tax & Regulatory Services-Financial Services, Ernst & Young LLP
11. The Committee would also like to recognise the contributions of Ms. Manisha Khuntia, Manager, IFSCA and Mr. Shivendra Pratap, Assistant Manager, IFSCA in coordinating the meetings of the committee sub-groups and drafting of the report.

Chapter 2

Participants

1. The following factors are usually considered to be the basis on which an International Financial Centre draws participants namely:
 - i. **'People'** - the availability of good personnel and the flexibility of the labour markets
 - ii. **'Business Environment'** – regulation, tax rates, levels of corruption and ease of doing business
 - iii. **'Market Access'** - levels of trading, as well as clustering effects from having many financial services firms together in one centre.
 - iv. **'Infrastructure'** - the cost and availability of property and transport links
2. The issue of “market access” directly relates to the issue of institutions who would be allowed to undertake transactions in the IFSC. These institutions broadly consist of institutions that set up their offices in IFSC (collectively termed as “Financial Institutions (FI)” in the IFSC Act,1999). Such FIs include Banking Units, Brokers, Insurance companies etc. Facing them are entities, both Indian and Foreign, (collectively called “Clients”) who while not necessarily having a place of business in IFSC, undertake transactions/enter financial contracts with FIs.
3. Guidelines for setting up various classes of FIs and the type of business that they may undertake out of IFSC has already been issued by IFSCA. It is also expected that FIs would undertake financial transactions amongst themselves (like an IBU lending to a Broker or IBU selling a derivative to an insurance company). However, for IFSC to achieve its goal of emerging as an International Financial Centre, it is necessary that Clients are incentivised to undertake transactions in IFSC.
4. Given that the global regulatory regime for trading and clearing OTC derivatives (of which NDF is a part) is now well established, IFSCA's goal should be to apply such regime in IFSC instead of attempting to reduce the risk of derivatives by discouraging speculative transactions or excluding a group of clients who are likely to undertake such transactions. In short, regulations in IFSC should not be geared towards excluding any group of clients so long as they satisfy internationally accepted customer acceptance and AML requirements.
5. While IFSCA's regulations should encourage all types of entities to undertake transactions in IFSC, the presence and continued operation and following types of entities are likely to be especially important in the development of IFSC:
 - a) **Corporate Treasuries**: Major IFCs provide the infrastructure necessary for banks to provide international treasury management services for Multinational Corporations (MNCs). These banks provide support systems that enable MNCs to: (a) optimise their cash management and working capital while at the same time generating returns from their surplus liquidity; (b) streamline their receivables using information technology solutions to monitor and optimise their daily cash flows; (c) manage their payables

through their supply chain and matching them, as far as possible, against the receivables due from customers and (d) allow transactions and investments to be undertaken across a range of currencies and financial instruments. One of the important growth avenues for IFSC would be to attract Indian MNCs to base their global treasury operations in IFSC.

- b) **Real money clients (Asset managers, Sovereign Wealth Funds etc.):** Real money clients like Asset Managers and SWFs manage portfolios of trillions of dollars, euros, pounds and yen invested in a large variety of funds and vehicles. Such clients look for an array of investment choices at home and overseas, including equities, bonds, property, commodities, and cash diversified in terms of geography or sector of activity. IFSC must create the necessary market, institutional and regulatory infrastructure to attract asset management and global portfolio diversification services undertaken by a variety of national, regional, and global asset managers. IFSC can also be a base for the Front office and Back-office activities of such clients.
- c) **Hedge funds:** They are pooled investment funds, aimed at maximising investor returns (usually with the help of leverage) and minimising risks. Their requirements are largely the same as that of Real money clients with the addition that they actively seek leverage to enhance their returns. IBUs in IFSC should be allowed to accept such funds as clients within the overall prudential norms applicable to them.
- d) **Algo and High Frequency Trading firms:** Algo (and its subset, High frequency) trading firms work as middlemen between buyers and sellers, seeking to capture on minute price discrepancies that might exist only for a short period. HFT firms rely on high-speed computers their operations supported by facilities like co-location (facility that places the HFT firm's computers as close as possible to the exchange servers, to minimise latency), real time data feeds and computer algorithms (which are usually proprietary in nature). HFTs have been seen to make the markets more efficient by reducing bid-ask spreads. HFTs tend to put through large volumes of orders in the market thereby enhancing liquidity. Regulations in IFSC should encourage HFT firms to trade on its exchanges.
- e) **Retail investors:** High Net Worth Individuals (HNIs) , both domestic as well as overseas, would be another important target participant base for IFSC. A growing demand for advice among India's high net-worth individuals (HNIs) is pushing the country's banks to offer advisory services and platforms. Many large banking groups, either have advisory businesses or have recently launched them.¹ Going forward, IFSCA should look at benchmarking its regulations for offering services to HNIs to international standards.

6. Permitting Omnibus Account structure

- a) An omnibus account as defined by IOSCO is "an account containing the collective position of more than one investor", while Bank for International

¹ Mint (Web edition), September 8,2020

Settlement (BIS) defines it as “an account structure where securities or collateral belonging to some or all customers of a particular participant is commingled and held in a single account segregated from that of the participant”. The omnibus account structure is a prevalent practice for account / position maintenance in most of the leading international FATF compliant jurisdictions having stringent KYC norms. Global investors prefer an omnibus account over a direct account for the resultant operational efficiency and cost savings. It is also an improvement over the Segregated Nominee Account Structure (SNA), currently permitted in IFSC, which requires the SNA to be registered with the IFSC exchanges thereby adding to the operational overhead apart from being cost and time inefficient.

- b) With the omnibus account structure, the custodian can offer its international clients access to multiple global markets on the basis of a single set of documents. The omnibus framework entrusts greater onus on the custodian to adhere to the regulatory guidelines and is required to ensure that adequate disclosures are made to the regulator on need basis. It is pertinent to note that omnibus structure does not dilute KYC and AML norms. The custodian is expected to follow all the established norms as prescribed in the jurisdiction in which they are operating.
- c) There are, however, challenges in identifying the ultimate beneficial owner in omnibus accounts that are held in the name of custodians, as they are not under the regulatory purview of IFSCA and the information resides outside IFSC. Such challenges have been recognised and addressed by other jurisdictions through introduction of a client identification rule which obligates the financial institution in the jurisdiction to put in place arrangements with its clients to facilitate the provision of such information to the regulator as and when demanded.
- d) Global clients already trading through omnibus account structures tend to gravitate towards markets which recognise such structures. For some global investors, lack of recognition of such a structure may be a crucial factor in its decision to enter a market. Therefore, the committee recommends that omnibus account structure be permitted at IFSC in line with international jurisdictions, with necessary provisions for recognition of ultimate beneficiary, to provide ease of market access to international investors.

Chapter 3

Products

1. The range of products available in the non-deliverable derivatives market can be broadly divided into two groups: standard derivatives and exotics (including structured derivatives). Apart from currency derivatives, trading interest in non-deliverable markets extends to rate products, credit derivatives and equity derivatives.
2. This section starts with examples of some of the products traded in IFCs, followed by the recommendations on the principles to be adopted while permitting derivative products in IFSC and associated issues. Some of the popular non-deliverable standard products traded in offshore financial centres are:

a) **Non-Deliverable Forwards:**

NDFs are foreign exchange derivative instruments on non-convertible or restricted currencies traded over the counter (OTC) mainly at offshore centres i.e., outside the direct jurisdiction of the respective national authorities. Unlike the standard forward contract which involves exchange of underlying currencies on maturity, the NDF contract is typically settled as the difference between an exchange rate agreed at the time of entering into the contract and the actual spot rate at maturity in an international currency (deliverable) mainly the USD. NDF contracts can either be traded over the counter market or at exchanges at offshore financial centres such as Hong Kong, Singapore and London.

b) **Non-Deliverable Options:**

A Non-Deliverable FX option (NDO) provides the buyer of the option the right but not the obligation to buy or sell an agreed amount of one currency in exchange for an agreed amount of another currency at a specified future exchange rate (the strike price) but using a net cash settlement made by one party to another based on the difference of the two FX rates (strike price rate and fixing expiry rate). NDOs are generally "European Style", whereby the right to exercise shall occur only on a single date (the expiry date) but may also be "American Style," whereby the right to exercise shall occur on any date up to and including the expiration date as determined by the option buyer. Anecdotal evidence (as well as Reuters page GFIINRV) suggests that an interest rate options market (both cap/floor and swaptions) exists offshore. This seems to be a much smaller market than for NDF/NDO/NDIRS. As market makers prefer to look at risks on a holistic basis and not product to product, the enablers for IRO on NDIRS also needs to be enabled and be in place at IFSC.

c) **Non-Deliverable swaps:**

A non-deliverable swap (NDS) is a variation on a currency swap between major currency and a minor currency that is restricted or not convertible. Unlike a typical currency swap where there is a periodic exchange of the two

currencies involved, periodic settlement of a NDS is done on a cash basis, generally in USD with the settlement value based on the difference between the exchange rate specified in the swap contract and the spot rate.

d) Non-deliverable interest rate swaps (NDIRS)

NDIRS allows market participants to take a view on the direction of rates as well as on the interest rate curve in the concerned market. It is also the primary instrument of choice for participants to hedge their interest rate risk in offshore markets on account of any exposure to the underlying market through investments.

Some of the popular non-deliverable exotic options traded in offshore financial centres are:

e) Barrier options:

Barrier options are options that are either activated or deactivated when the spot price of the underlying currency pair passes through some defined value referred to as the barrier. The barrier may be either European barrier (barrier condition applicable only at the time of expiration) or American barrier (barrier condition applicable all through the life of the option)

f) Digital options

A digital (binary) option is an option that either has a fixed payoff or nil pay off depending on whether the underlying currency pair has breached a pre specified barrier. They may either be categorized into European digitals (Barrier condition check at expiry only) or American touch option (barrier condition all through the life of the option)

g) Basket of options

The payoff of basket option is linked to the movement of basket of pre-specified multiple currency pairs rather than a single currency pair. Many players in offshore market trade this product to execute their views on correlation between various currency pairs.

h) Structured products:

Apart from the stand-alone options, many options in offshore markets get embedded as a part of structured product offering. One such structured product is dual currency deposit which is very popular with retail investors. Example – An investor who has placed US dollar in a dual currency deposit linked to EUR/USD may be repaid either in USD or EUR, depending on the prevailing EUR/USD rate at the time of maturity.

While the above is an illustrative list, many different products including the variants of above as well as combination of above products do get widely traded in various international centres. Participants use the above products for diverse set of purpose such as hedging, risk transformation, yield enhancement in structured deposits or pure speculation. It is this multitude

of purposes as well as market players having different risk profiles as well as horizons which provide depth to the NDF markets.

3. Adopting principle-based approach for OTC derivatives in IFSC

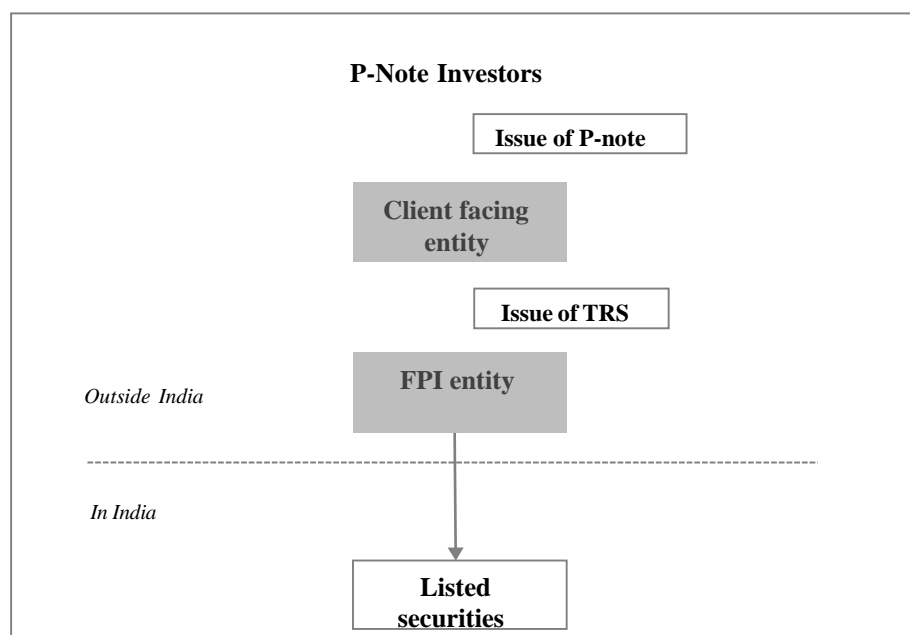
- a) IFSCA has, for the present, has adopted the RBI's "Comprehensive Guidelines on Derivatives" (with a few modifications) for undertaking OTC derivatives in IFSC. These guidelines were developed on the broad premise of usage of derivatives for the purpose of hedging. To encourage wide variety of participation in terms of products/participation as well as depth, the committee feels that IFSCA's regulations will need to be light touch in nature as well as principle based rather than be prescriptive about the category of products and the participants at IFSC. It is recommended that the guidelines be suitably tailored to:
 - i. Permit all category of products at IFSC without any restriction if the underlying product is not liable to be used as a surrogate for money laundering.
 - ii. Allow the above products either on a standalone basis or as a part of structured product.
 - iii. Allow such products either for risk management, risk transformation, yield enhancement or speculation/trading (within the leverage guidelines) as the participants deem fit.
 - iv. Put in place rules to prevent excessive leverage at the entity level.
- b) A principle-based approach would have the following key building blocks:
 - i. High Level Standards: These are core principles to guide business conduct including Integrity, Skill, Care and Diligence, Management and Control, Financial Prudence, Market Conduct and Ethics, Customers' Interests, Communication with Clients and Conflicts of Interest (Code of Conduct).
 - ii. IBUs should have the capacity to assess their risk appetite with regards to the products they deal in. Such an assessment should cover quantifiable risk factors (like credit, market, liquidity etc.) as well as non-quantifiable risk factors (like legal, reputational, strategic etc.). Such capacity should be demonstrated through the policies and procedures laid down by the IBUs and ongoing adherence to such policies and procedures ensured by the Compliance function.
 - iii. Treat customers fairly: IBUs would be required to treat their customers fairly with regards to offering products, setting up limits, pricing and valuations, complaint handling and redressal mechanism etc. The products offered to the customers would depend on:
 - a. The customer's understanding of the product and its inherent risk

- b. Execution capabilities of the IBU in terms of having traders with desired skill sets for the purpose; followed by consistent monitoring of exposures vis-à-vis market conditions.
- c) The implementation of principle-based approach is outcome oriented, preferring decision making and result analysis over detailed process. An open communication between IFSCA and market participants through diverse channels should be encouraged. This would be helpful in ensuring that the regulator swiftly responds to unconventional practices in derivatives markets and identify the hidden risks in complex products and takes corrective steps and actions as prudent.
- d) While the remit of the committee is to develop IFSC as hub for offshore INR, it is necessary to acknowledge that an international financial centre cannot meaningfully exist on the back of a single product or products linked to a single currency. IFSC too cannot be an exception to this rule. Therefore, IFSC should continue to allow the IBUs to offer deliverable products in cross currency pairs (in convertible currencies). Moreover, apart from INR NDFs, the existing dispensation of IBUs being allowed to make markets in NDFs of other non-convertible currencies like TWD, BRL, KRW etc. should continue. A ready client category exists for such non-INR NDFs like for instance of Indian multinationals who undertake business/quote for contracts in such currencies but are denied access to the onshore market in these currencies due to local regulations.

4. Permitting Offshore Derivative Instruments (ODIs) from IFSC

- a) Total Return Swaps (TRS) are OTC derivative contracts traded in global markets and allow the international investors to take exposure to the securities issued in various underlying markets. They are popularly used by global investors for taking exposure in many local markets such as China, Japan, Taiwan, Korea, Indonesia, Malaysia, Thailand, etc. For business and commercial reasons, a global investor may not want to directly invest in securities in the given jurisdiction e.g. in shares in companies listed in India or China and prefer taking the exposure through TRS. In essence, TRS represent a synthetic exposure of the investor to the referenced security which is listed or traded in a local market.
- b) Under a TRS, one party makes payments based on a set rate, either fixed or variable, while the other party makes payments based on the return of an underlying asset. In TRS, the underlying asset/ reference security are usually shares/ bonds/derivatives owned by the FPI entity. In essence, TRS represents a synthetic exposure of the investor to the referenced security which is listed and/or traded in a local market.
- c) Under the traditional model, the investor enters into a TRS contract (under an ISDA Agreement) with the client facing entity (typically a large financial institution) which would hedge its position with the financial institution's investing vehicle (i.e., the FPI entity).

- d) The FPI may hedge the risk assumed under the ODI in Indian/other international securities. Where the client wishes to unwind the TRS, the Client facing entity would correspondingly unwind its hedge, which would typically (but not compulsorily, subject to market conditions and other business considerations) lead to the FPI entity selling the said security.
- e) TRS is among the group of instruments defined as Offshore Derivative Instruments (ODIs) by SEBI (Foreign Portfolio Investors) Regulation, 2019 (as amended).



- f) Current SEBI regulations² defines ODI as any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it in India, as its underlying. The regulations allow Category I FPIs to issue ODIs to overseas investors subject to fulfilment of certain norms and satisfaction of KYC requirements. Further, current guidelines permit issuance of ODI only for the end user to hedge their cash position onshore. Further, as per SEBI guidelines, the ODI issuing FPIs shall not be allowed to issue ODIs with derivative as underlying, with the exception of those derivative positions that are taken by the ODI issuing FPI for hedging the equity shares held by it, on a one to one basis.³
- g) Certain overseas jurisdictions restrict foreign investors to directly register as FPIs and also prohibit them from trading single stock futures (e.g., CFTC in the US) In absence of P-Notes, such investors will not have an avenue for accessing the Indian derivatives market.

² Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019

³ SEBI circular CIR/IMD/FPI&C/76/2017 dated July 7, 2017 regarding - Guidelines for issuance of ODIs, with derivative as underlying, by the ODI issuing FPIs.

- h) Financial institutions in IFSC are eligible to be registered as Category I FPIs under the provisions of the SEBI (Foreign Portfolio Investors) Regulations, 2019. Such FIs are also eligible to issue ODIs against their securities held in India as underlying. As per the regulations, ODIs need to be issued “overseas”. As the term is not defined in the regulation, the ordinary meaning of the term i.e., a foreign country may be assumed for this purpose. If IFSC is treated as an “overseas” territory, then issuance of ODIs from IFSC would be permissible under the existing legal framework. However, a contrary view, which does not consider IFSC to be an overseas territory and which, therefore, means that the SCRA,1956 is applicable in IFSC, would mean certain legislative changes as outlined in the following paras would be required to be undertaken for ODIs issued in IFSC to be legal and valid under SCRA. Of course, even under the restrictive interpretation, FIs in IFSC registered as FPIs would be eligible to issue ODIs outside IFSC. However, this would not be in line with the purpose of setting up IFSC i.e. onshoring of transactions relating to India currently being undertaken at overseas jurisdictions.
- i) Section 18A of SCRA,1956 (inserted w.e.f February 22,2000) treats a contract in derivative to be legal and valid provided it is traded on a recognised stock exchange, settled through the clearing house of a recognised stock exchange and traded between such parties and on such terms as specified by the Central Government. In view of the said section, a doubt was raised about the legality of OTC derivatives such as forward rate agreements and interest rate swaps permitted under the Reserve Bank guidelines issued in July 1999. It was felt that these OTC derivatives could be deemed as wagering contracts and, as such, void under section 30 of the Indian Contract Act, 1872 and not legally valid under section 18A of SCRA. Recognising that OTC derivatives play a crucial role in reallocating and mitigating the risks of corporates, banks and financial institutions and that the ambiguity regarding the legal validity of OTC derivatives inhibits the growth and stability of the market for such derivatives, suitable amendments, effective January 9,2007, were carried out to the RBI Act, 1934.
- j) As a result of such amendment , Section 45V of RBI Act, 1934 (inserted by Reserve Bank of India (Amendment) Act, 2006) lays down that notwithstanding anything contained in SCRA or any other law for the time being in force, transactions in such derivatives, as may be specified by the Reserve Bank from time to time, shall be valid, if at least one of the parties to the transaction is the Reserve Bank, a scheduled bank, or such other agency falling under the regulatory purview of the Reserve Bank under the RBI Act, the Banking Regulation Act, 1949, the Foreign Exchange Management Act, 1999, or any other Act or instrument having the force of law, as may be specified by the Reserve Bank from time to time. It also provides that transactions in such derivatives, as had been specified by the Reserve Bank from time to time, shall be deemed always to have been valid.
- k) The definition of “securities” and “derivatives” in the RBI Act does not include equity shares or corporate bonds or derivatives on equity shares and

corporate bonds. Hence, although the IFSCA Act, 2019 transfers the powers u/s 45W of the RBI Act to IFSCA for transactions in IFSCs, IFSCA's power to allow OTC derivatives on equities through section 45V of RBI Act is similarly restricted.

- l) The Offshore Derivative Instruments (ODI) market which the FPIs may offer outside India is essentially an OTC derivatives market in Indian equity. Today, possibly because of the abovementioned interpretation of the SCRA, has resulted in the market for OTC equity derivatives existing entirely outside India, resulting in a loss of liquidity for Indian markets, a loss of income for Indian financial services firms and a loss of access to OTC derivative markets for Indian securities and investment firms. As on March 31, 2021, notional value of outstanding ODIs on Equity, Debt, Hybrid Securities and Derivatives stood at Rs.89100 crores (USD 1.2 billion approx.)
- m) To bring the ODI market back to India the Section 18A of the Securities Contract Regulation Act, 1956 needs to be amended by adding a proviso to exempt derivatives in IFSC from the requirements of the section.
- n) Further, as IFSC is modelled as offshore destination where predominantly derivatives are traded (at present), FPIs should be permitted to ODIs with futures and options (i.e., derivatives) traded on the IFSC stock exchanges as underlying. Eligible Foreign Investors (EFIs), i.e., non-individual foreign participant not registered as FPI with SEBI but desirous of operating in IFSC, may also be given similar permission to issue ODIs after putting in place the necessary reporting mechanism to IFSCA.

5. Addressing the restrictions on the activities of the foreign branches of Indian banks

- a) There are certain restrictions on activities of Indian Banks to deal in INR denominated products, other than those permitted onshore, out of offshore locations.
- b) RBI's Master Circular on Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad dated July 1, 2015, mandates that "an overseas entity, having direct or indirect equity participation by an Indian party, shall not offer financial products linked to Indian Rupee (e.g., non-deliverable trades involving foreign currency, rupee exchange rates, stock indices linked to Indian market, etc.) without the specific approval of the Reserve Bank. Any incidence of such product facilitation would be treated as a contravention of the extant FEMA regulations and would consequently attract action under the relevant provisions of FEMA, 1999." As financial institutions in IFSC are treated as persons resident outside India under FEMA, 1999, this has created a doubt amongst Banking Units (IBUs) of Indian banks about participating in the INR denominated currency derivatives markets in IFSC.
- c) Considering the fact that RBI has permitted listing of exchange traded currency derivatives denominated in INR in IFSC stock exchanges and also

allowed IBUs to undertake INR NDFs in IFSC, the committee recommends that Reserve Bank of India be requested to suitably amend the abovementioned circular to clarify that the restrictions therein would not be applicable to financial products linked to INR undertaken in IFSC.

- d) RBI's circular on "Operations of foreign branches and subsidiaries of the Indian banks – Compliance with statutory/regulatory/administrative prohibitions/restrictions" dated May 12, 2014 mandates that foreign branches /subsidiaries of Indian banks proposing to offer structured financial and derivative products that are not specifically permitted by the Reserve Bank in the domestic market, may do so only at the established financial centers outside India like New York, London, Singapore, Hong Kong, Frankfurt, Dubai, etc. At other centers, banks may offer only those products that are specifically permitted in India.
- e) In line with IFSCA's mandate to emerge as an alternative to the existing financial centres, the range of derivative and structured products to be allowed by IFSCA is likely to be wider than that permitted in the domestic markets. In order to remove doubts in this regard, the committee recommends that Reserve Bank of India be requested to clarify that the IFSC would fall within the definition of "established financial centers outside India" in the above circular.

6. Permission to introduce exchange traded products that replicates OTC contracts

- a) Structural changes in the FX market are driving more business to central clearing. According to the latest BIS Central Bank Triennial Survey of Foreign Exchange and Over-the-counter Derivatives Markets (2019), trading in over the counter (OTC) derivatives rose even more rapidly than that on exchanges. The daily average turnover of interest rate and FX derivatives on markets worldwide - on exchanges and OTC - rose from \$11.3 trillion in April 2016 to \$18.9 trillion in April 2019. OTC trading outpaced exchange trading, continuing the trend that started around 2010 and resulting in exchanges' share falling to a historical low of 41%.⁴
- b) As per BIS, OTC trading has benefited from innovations that made OTC instruments more attractive. Regulations introduced after the "Credit Crisis" of 2008, specifically the requirement of central clearing of OTC derivatives, has allowed them to replicate the historical advantages enjoyed by exchanges in terms of centralised trading and, through their use of central counterparties, simpler counterparty risk management.
- c) Given the alignment of regulatory requirements between exchanges and OTC as far as clearing is concerned, scope exists for product innovation which replicates features of OTC derivative contracts through products listed

⁴ Derivatives trading in OTC markets soars, BIS Quarterly review, September 2019

on exchanges thereby offering participants of either segment the chance to enjoy the relative advantages that each product segment offers without having to incur additional pre and post trade costs.

- d) As an example, Singapore Exchange (SGX) has, in early 2020, launched FlexC FX Futures, a product which aims to replicate a Non-Deliverable Forward and capture liquidity/volume from the OTC market. The FlexC FX future product aims to replicate seven non-deliverable (including USDINR) and two deliverable FX products. It allows a settlement price, for delivery up to 100 days in the future, to be negotiated bilaterally between two market participants and then reported to SGX for clearing. The contract sizes are relatively small, around USD 25K per contract. These futures are margined using 1-day SPAN, with margin offset benefits between these and other derivative products cleared at SGX.
- e) The main benefit of the product is in terms of margin reduction for the participants with a significantly lower initial margin (IM) requirement for futures compared with OTC contracts. Possibility of further IM reduction exists through the risk reduction that a participant may achieve through offsetting positions in other product types. The participants are also relieved of the need to undertake extensive paperwork (and the consequent negotiation on terms) required for undertaking OTC derivatives, as the existing derivative account at SGX can be used to clear this product.
- f) The contract specifications of SGX FlexC futures is as below:

Sr. No	Particulars	
1	Symbol	SGX FlexC INR/USD futures
2	Contract Name	FlexC INR/USD FX
3	Contract Type	FlexC Futures
4	Underlying	INR
5	Contract Size	INR 2,000,000
6	Contract Month	Any Business Day within 100 calendar days (inclusive of day of trade registration)
7	Tick Size	0.001 US cents per 100 Rupees
8	Tick Value	US \$ 0.2
9	Settlement	Cash settled (USD)
10	Trading Hours & Time	<ul style="list-style-type: none"> ▪ Trade Registration Hours (Singapore Time) ▪ T Session: 7.10am – 7.35pm ▪ T+1 Session: 7.35.01pm – 5.15am ▪ Trade Registration Hours on Last Trading Day (Singapore Time) ▪ T Session: 7.10am – 2.35pm ▪ T+1 Session: N.A

Sr. No	Particulars	
11	Final Cash Settlement Price (FCSP)	Reciprocal of the RBI USD/INR spot exchange rate, or publicly available equivalent successor rate that is determined by SGX-DT, multiplied by 10,000 to convert such spot exchange rate to US Cents per 100 Indian Rupees, rounded to 2 decimal places.

- g) Considering the goal of IFSC is to emerge as a hub for trading in INR derivatives, it is felt that introduction of a similar bilateral derivatives product which could be reported on and cleared through the exchanges would be an useful addition. The committee recommends that IFSCA should support the introduction of such innovative products at its exchanges.

Chapter 4

Infrastructure

1. Financial Market Infrastructures (FMIs) are key components of the financial system, delivering services critical to the smooth functioning of financial markets. Well-designed and reliable FMIs can be a source of both financial stability and operational efficiency. FMIs act as a coordinating device, bringing a network of counterparties together to support trading liquidity and the netting of exposures and settlement obligations. They also establish secure arrangements for the timely clearing and settlement of obligations between counterparties; assist institutions in the management of counterparty credit risks; and help to coordinate actions in the event of a market participant's default.
2. For IFSC to emerge as a hub for offshore trading in INR, the necessity of participants to access critical infrastructure cannot be overemphasised. While the goal is to “create” such infrastructure in IFSC, the committee recognises that such a goal can be achieved only in the medium to long term horizon. In the interim, the IFSCA’s approach should be to allow entities operating in IFSC to be able to access, wherever possible, existing financial infrastructure outside IFSC.
3. Market infrastructure at IFSC for exchange traded products

Market infrastructure at IFSC for exchange traded products essentially comprises of the participating institutions who provide services of trading, clearing, settlement, collateral management, risk management, depository services etc. A brief description of the market infrastructure institutions present at IFSC to support exchange traded derivatives follows:

- a. **Exchange**: A crucial part of the market ecosystem which provides a secondary market and a primary market infrastructure plays the key role in providing liquidity to the securities listed on its platform, thereby attracting issuers and investors to the markets. IFSC currently hosts two international exchanges India International Exchange (IFSC) Limited (India INX) and NSE IFSC Ltd. (NSEIFSC) (see Annex 1)
- b. **Clearing Corporations**: Clearing corporations play the key role of a central counter party and through the process of novation eliminate the counter party credit risk between the buyer and the seller. They follow specific risk management practices, as per international best practices, to control and manage risks thereby ensuring safety and integrity of clearing and settlement system. The clearing houses admit clearing members through whom the settlements are conducted. Clearing members are required to meet the necessary admissions criteria and place necessary collaterals with the clearing house before commencing business. The two exchanges at (a) above also run clearing corporations following international standards. (see Annex 2)
- c. **Depository**: Depository is the market infrastructure institution which holds and transfers securities in an electronic form, to mitigate risks arising out of physical

securities and ensuring speedier settlements at lower costs. A successful underlying cash market in equities, bonds, ETFs, mutual funds, REITs, InVITs etc. requires the support of an efficient depository system. CDSL IFSC Limited, a 100% subsidiary of Central Depository Services Limited (CDSL), provides depository services at the IFSC.

- d. **Clearing Banks**: Clearing banks are an important entity in the settlement system since the funds settlements are conducted through the clearing banks. IFSC has a robust banking infrastructure with most of the leading banks in India having a presence at the IFSC through their banking units. They provide various capital market related services to the trading and clearing members at IFSC. Some of them are also members of the exchanges and clearing corporations and would play a major role in the success of currency and interest rate derivatives products at IFSC. The banks have also been permitted by the regulator to trade in OTC and Exchange Traded Non-Deliverable Derivative Contracts (NDDCs) from IFSC. Some of the leading clearing banks at the IFSC are the State Bank of India (SBI), ICICI Bank, HDFC Bank, Axis Bank, Kotak Mahindra Bank, IndusInd Bank and Yes Bank.
 - e. **Intermediaries**: Besides the above institutions, the markets at IFSC are also supported by trading members, clearing members, custodians, merchant bankers etc. to complete the entire ecosystem. While trading and clearing members from India are required to establish a subsidiary to operate at IFSC, an entity from a foreign jurisdiction desirous of operating in IFSC as a trading or clearing member, can set up a branch office in IFSC to provide its services, subject to certain conditions. All other intermediaries can establish a branch office at IFSC to offer their services. These intermediaries are the crucial link between the investors, who wish to deploy funds and the market infrastructure institutions, who support the mobilisation, deployment of funds and transactions in the secondary markets.
4. **Market infrastructure for OTC derivatives** (where the overwhelming volume of INR NDF is traded today) consists of the following:
- a. Facility for trade execution
 - b. Clearing and settlement
 - c. Reporting of transactions
 - d. Dissemination of transaction data

Currently IFSC lacks its own infrastructure in most of the above areas. The discussion that follows addresses the policy choice question of creating such infrastructure in IFSC or relying on global infrastructure, wherever feasible.

5. **Facility for trade execution - Access to Electronic Trading Platforms (ETPs) and Voice Brokers**
- a. In order to trade, traders first need to communicate (either directly or through a third party) the desired quantity, type of contract and the price at which they are willing to trade, as well as other material terms and conditions. The second

step includes recording the details of the trade, contract terms and counterparty identity. These first two steps are often referred to together as trade execution.

- b. Initially, OTC contracts were negotiated over the phone, but in the late 1990s alternative trading systems, or electronic platforms, which functioned like bulletin boards for posting bids and offers began to emerge. More recently, electronic platforms for trading swaps have been developed in response to legislation implementing the G-20 trade execution mandate.
- c. The trend towards electronification in NDF markets rides on the inclusion of these instruments among those traded on the main electronic broking platforms. EBS has emerged as the electronic venue for NDF trading, while Reuters (Refinitiv) Matching has launched NDF trading in 2020. Electronification has also benefited from central clearing, which enables multilateral netting and reduces the need to post margins. The NDF market microstructure has started evolving rapidly on the back of global legal and regulatory reforms for derivatives markets. Since 2015, NDFs have started the transition from a decentralised, bilateral microstructure to one characterised by centralised trading, disclosure and clearing. The gradual phase-in of uncleared margin rules, requiring firms to post initial margins for certain uncleared derivatives, has incentivised greater central clearing of NDFs. To date, NDFs represent the only type of FX derivative with any meaningful share of centrally cleared transactions. Given the above scenario, the aim of IFSCA should be to allow the participants, especially the Banking Units, to access the widest possible choice of ETPs and Voice Brokers.
- d. From an IFSC perspective, at least one of the counterparties to any transaction will be an IFSC entity. It is expected that when a transaction is concluded over an ETP, the IFSC entity would have carried out the necessary due diligence for entering in to transacting on that ETP. These due diligence measures will include KYC related points (as prescribed by IFSC) and technology due diligence to ensure that the transactions that are carried out are safe and secure. Market discipline and natural incentives for participants are such that they only deal on those ETP that offer and demonstrate high degree of reliability, availability, scalability and security in respect of its systems, data and network. Therefore, it is prudent to let the IFSC participants determine the ETP on which they deal. Further, as the dealing for a number of these instruments happens on a number of different venues, in order to enable the IBU's to access liquidity in the best way it is proposed that to begin with there will be no registration requirements for ETPs providing services to entities operating in IFSC. In so far as data of dealing on ETP, IBU's may be directed to submit the data to IFSCA as and when required by IFSCA. From an oversight perspective, if necessary, for the immediate near term, IFSCA may recommend a directory such as ICMA ETP⁵ directory which IBU's can use for onboarding ETPs. Another approach that may be considered is to permit IBUs to onboard ETPs

⁵ <https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/electronic-trading/etp-mapping/>

that are regulated by reputed international regulators like FCA, CFTC, MAS etc.

- e. An area that may be debated upon is the nature of the ETP. ETP dealing at a broad level can happen under what are known as disclosed venues, semi-disclosed venues and undisclosed venues. In a disclosed venue, the two counterparties to a transaction know that they are dealing with one another. Accordingly, it is possible for a participant to tailor their prices to another participant/not show prices to another participant etc. The transaction, when concluded will be between the two participants and will reported as such, even if taken up eventually for clearing. In a semi-disclosed venue, the two parties are identified once a deal is concluded. Such platforms use unique identifiers for each party till the deal is concluded. In an undisclosed venue, the two counterparties to a transaction do not know who they have concluded the transaction with. When a deal is struck, two deals, one for each counterparty, are entered into with a central counterparty (CCP) nominated by the ETP, ensuring complete anonymity (the CCP ensures performance by collecting appropriate margins, sets risk limits etc.). In order to allow IBUs to participate in the markets to the fullest extent, they may be permitted to choose any of these venues depending upon their internal policies. It may be noted that in undisclosed venues IBUs will report all their transactions against the CCP (no different from the current practice on a platform like ASTROID for OIS).
- f. In the medium to long run, as IFSC gathers the necessary volumes and becomes the preferred venue for dealing INR instruments, IFSCA may consider developing a framework that lays down registration requirements for ETP. Some of the points that the framework may address include:
 - i. Offer a clear distinction between what constitutes an ETP and what constitutes a technology solution. In the above paras, the term ETP was used loosely as any platform. However, these platforms have a variety of ways of operations. For instance, some of them offer a pure aggregation of price services, without offering any kind of order matching service. There are others who offer order matching services with detailed rules on how the orders get matched. While the former may be construed as a pure technology solution, the latter may be construed as an ETP. Therefore, a definitional difference between an ETP and technology solution needs to be clarified.
 - ii. Regardless of ETP or technological solution, require registration with IFSCA. Such registration requirements may prescribe that an ETP or technology solution that is already regulated by a reputed regulator (OCC/ FCA/ ACPR/ BaFIN /RBI/ HKMA/ MAS/ FSA/ APRA) has a light touch registration requirement with IFSCA. On the other hand, approval for offering ETP/technology solution (from SRO/ IFSCA) may be prescribed if it is an entity that is primarily operating in IFSC.
 - iii. ETP to be able to disseminate data to IFSCA (or any entity nominated by IFSCA) on a near real time basis when at least one entity to a transaction is regulated by IFSCA.

- iv. Develop a framework on undisclosed venues such as reporting requirements for CCP.
 - v. Encourage ETPs to come up with new products that IFSCA/ IFSC regulated entities can promote that help participants manage their risks better.
- g. While ETPs have a large share in OTC trading, it is predominantly for liquid products (like the 1 month/ near month NDF). For other less liquid products/ tenors, price discovery usually happens through voice brokers. IFSCA currently allows voice broking services to be availed by entities operating out of/ regulated by IFSCA. Voice brokers may be empaneled by IBUs as per their internal policies.
- h. The above approach makes it easier for current players to operate in IFSC and allows market participants to potentially deal with all players on whose platforms INR products are dealt offshore.

6. Facility for trade execution - Enabling Prime Brokerage (PB)

- a. Prime Brokerage is a mechanism that allows certain financial entities to outsource their operations in trading, collateral management etc. to a third party, with an additional benefit of the third party lending its name as a credit substitute, all within a well-defined ISDA framework. By its very nature, Prime Broker assists its clients across markets and instruments. Annex 3 gives a summary of the framework that Prime Broker transactions entail.
- b. Current IFSCA guidelines do not prohibit IBUs to deal with counterparties who use PB services or avail the services of already established PBs. An IFSC regulated entity can deal with a large set of financial institutions (such as hedge funds etc.) by dealing with the PB of such entities. The PB space is largely occupied by 8-10 large global institutions, majority of whom with which IFSC entities will have ISDA/CSA documentation. Therefore, theoretically, with limited documentation and onboarding, an IBU can deal with a large set of clients by dealing with a PB, either by themselves becoming the client of a PB or by entering in to executing broker agreement with PB. The choice can be made based on the costs and the arrangements the IFSC regulated entity has with PB and the end client. As far as IBUs offering PB services from IFSC is concerned, IFSCA may consider specifying enabling considerations for the same and also regulate such arrangements. As far as dealing between IBUs and other entities who use the services of established PBs, the decision regarding the same may be left to the IBUs.
- c. Two other points relating to dealing with PBs also merit consideration. First, in the event of dealing with a PB arrangement, the deal booking will be between the IFSC regulated entity and its PB (which is an IBU). In so far as reporting goes, the deal will be reported as having been undertaken with the PB. As the IBU in theory will know who they dealt with, possible modifications in the reporting requirements to capture this information may be considered along

with examination of implications of such an action on any confidentiality agreements. Second, as the deals are all booked and settled facing the PB, it is suggested that netting across all end clients of a single PB for capital and LCR maintenance purposes be permitted.

7. Clearing and settlement – Recognition of non-jurisdictional settlement infrastructure

- a. Subject to internationally accepted norms, the mechanism for settlement of bilateral trades is best decided by parties to the transaction. As the settlement currency to derivative transactions involving INR in IFSC are to be in freely convertible currencies like USD, EUR, GBP etc., it is preferable to use existing settlement mechanisms of those currencies instead of creating any new mechanisms, wherever possible.
- b. There are competing clearing and settlement infrastructures that are available for participants. For NDF (and NDIRS), for instance, the ForexClear service of London Clearing House (LCH) is a popular choice for market participants. CCIL is another entity that is proposing clearing and settling NDF transactions, albeit only for member banks to begin with. CCIL currently offers client clearing services in both OIS and forex forward segments and it is reasonable expectation that they can extend the facility for NDF clearing to all participants. Non-Residents may find it easier to clear trades on CCIL through their PB directly or through an IBU. For this to happen, certain enablers are required like interoperability between IFSC regulated entity and India entity or an offshore PB and PB's India entity and the others are incentives that participants will have to use this settlement infrastructure.
- c. IFSCA should permit the use of any settlement infrastructure (including those outside its jurisdiction) subject to such an infrastructure being regulated in the entity's home jurisdiction. Currently IFSCA does not prescribe or have a framework for CCP settlements and IBUs are using the settlement infrastructure that suits their business need the best. Given that LCH already offers clearing facilities and CCIL by offering NDF clearing may potentially optimize costs for Banks that operate in India, IFSCA may not look at creating an alternative equivalent at IFSC. IFSCA may create enablers and work with RBI to permit entities operating at or through IFSC to be able to access the CCIL settlement infrastructure when it is in place.
- d. Another alternate settlement mechanism that can be explored in the short term is for CCIL becoming a member of LCH forex clear service and providing clearing services under a sub-account structure (similar to the CLS settlement it operates). This would allow IBUs to access a large counterparty set and can help attract volumes in a big way.

8. Clearing and settlement – Permitting full substituted compliance for collateral placement

- a. Financial entities, when dealing with institutions located outside IFSC would be required to post both variation and initial margin (collateralisation). On

collateralisation, foreign jurisdictions like Singapore, Hong Kong and Australia provide a full substituted compliance framework under which:

- i. foreign entities (including local branches) are allowed to comply with foreign margin rules that are deemed or assessed to be comparable.
 - ii. local entities are allowed to comply with foreign margin rules to which their counterparties are subject to if such rules are deemed or assessed to be comparable.
- b. For example, under the HKMA Margin Requirements, the margin requirements of Australia, Brazil Canada, the European Union, India, Japan, Republic of Korea, Russia, Singapore, Switzerland, United Kingdom, and the United States are deemed to be comparable for substituted compliance purposes from the day such requirements enter into force until a comparability assessment is completed by the HKMA. Accordingly, entities which are allowed under the HKMA Margin Requirements to apply substituted compliance may follow the margin standards of a “deemed comparable jurisdiction”. An overseas incorporated entity is required to notify HKMA its intention to follow the margin standards of its home jurisdiction or a foreign jurisdiction (provided that, in each case, such jurisdiction is a deemed comparable jurisdiction or a jurisdiction for which the HKMA has issued a comparability determination) as soon as practicable and in any event before it applies the relevant foreign standards.⁶
- c. As far as IM is concerned, ISFCA may permit IBUs to post IM as part of their overall legal entity’s IM whether out of IBU or any of its offices. This will allow netting of IM margin requirements across all operating units of the IBU.
- d. IFSCA should permit financial institutions in IFSCA and foreign entities undertaking contracts with financial institutions in IFSCA to adhere to margining guidelines of any jurisdiction whose framework is in line with policy framework on Margin Requirements for Non-Centrally Cleared Derivatives issued by BCBS and IOSCO (i.e. full substituted compliance). Further IFSCA should align with global best practices and not insist on ring-fenced collateralisation (currently IFSCA guidelines do not have any ring-fencing requirements for margining).

9. Clearing and settlement – Permitting reuse of collateral

- a. Re-use and re-hypothecation of collateral has become a major activity in financial markets. It refers to the practice of financial institutions to use collateral received in one transaction for another transaction. Institutions typically receive collateral in repurchase agreements (repos) or derivative transactions, and if eligible for re-use, may post it as collateral or use it for short sales. Re-use of collateral has become a major activity in financial markets and is a common practice across many entities in the financial system. Market participants consider re-use of collateral as an important source of funding and beneficial for

⁶ ISDA regulatory margin self-disclosure letter – Hong Kong Supplement dated March 8, 2021

market liquidity. Regulators and supervisors have raised various concerns about this market practice. The concerns related to the financial stability implications of collateral re-use have also led the Financial Stability Board (FSB) to analyse this issue more broadly and its findings of this analysis have recently been published. While the FSB sees no need for immediate regulatory action, it considers that appropriately monitoring collateral re-use at the global level will be an important step towards obtaining a clearer understanding of global collateral re-use activities.

- b. For the purpose of encouraging development of NDF market at IFSC, reducing cost for collateral management for IBUs and clients and optimum utilisation of scarce collateral, IFSCA should permit re-use of collateral in case of tripartite collateral management (including for automatic lending of securities through ICSDs like Clearstream and Euroclear) and prime brokerage custodian services. Re-use of collateral may also be permitted for bilateral contracts settled between two parties directly while sensitising the transferor to the risks associated with such transfer and possible solutions to mitigate such risks.

10. Clearing and settlement - Encouraging alternate settlement infrastructure

- a. The venue for trading and the management of risks of trades have traditionally been the role of exchanges and market infrastructure organizations such as the central counterparty clearing houses (CCPs). Going forward, blockchain and other distributed ledger technologies (DLTs) have the potential to decentralise the system and eliminate the need not only for CCPs, but also for other trusted, regulated platforms through which the markets have operated for decades.
- b. Blockchain has significant potential to disrupt this structure by replacing or dis-intermediating some of these platforms. In this model instead of having a central trusted party through which trades are settled, the record of the parties' entitlements to the assets that are being traded are held on a decentralised distributed ledger. This could have a number of advantages, including greater transparency for parties to see where ownership of assets are held.
- c. One potential scenario is to replace the CCP with a system based on a distributed ledger, so that when a trade is effected, instead of it being submitted to the clearing house that manages the risk of a counterparty default in the period between execution and settlement, instantaneous transfer of value or ownership of an asset is achieved at the point when the ledger is updated. This eliminates the requirement of a CCP because there is no risk to be managed and the centralised ledger acts as the definitive record of title.
- d. In the case of derivatives, a trade results in an open position that may remain open for a period of time. In such cases, CCPs exist to manage the risk if one of the counterparties to the trade becomes insolvent. The CCP has privileged status under law to ensure that the trade can continue to settle, because it interposes itself between both sides, and guarantees the settlement of the trade for a non-defaulting party even if another counterparty defaults. A

blockchain-based system that operates by providing instantaneous settlement on the blockchain would not be useful for derivatives, where settlement is necessarily non-instantaneous.

- e. A solution to this issue can be found by derivatives being created as pre-programmed smart contracts, capturing the obligations of the two counterparties (such as margin agreements or swap conditions). Novating the trade via a Central Counterparty Clearing House (CCP) would continue to allow dealers to net their exposures. Posting collateral to the CCP in the form of initial and variation margin can be done either by escrowing cash on a cash ledger, or by allocating assets held on other asset ledgers to a collateral ledger. In the future, if a central bank issues freely available electronic currency on demand, it would allow dealers to pledge the eligible portion of their inventory to the central bank and use central bank cash collateral when trading.
- f. The smart contract can automatically recompute exposures by referencing agreed external data sources that recalculate variation margin. Interoperable derivative and collateral ledgers would automatically allow the contract to call additional collateral units on asset ledgers to support these needs. At maturity, a final net obligation is computed by the smart contract, and a payment instruction automatically generated in the cash ledger, closing out the deal.
- g. A blockchain-based ledger, operating as a decentralised ledger, outside the responsibility of a single entity currently lacks a specific legal status under almost all jurisdictions. Nor does it benefit from any privileged protection, whether for the blockchain ledger itself or the operator of the blockchain system (if any) to protect it from the application of insolvency law to determine who owns what or what the status of a transaction is if one party to the transaction becomes insolvent. Such legal protections are available for the current market infrastructure, which benefits from extensive legal protections against challenge to the actions taken under their default powers, or the finality of settlements that occur through their systems, even where a participant in their system has become insolvent.
- h. While significant legal and regulatory changes are required for DLT based settlement to become a reality, it is necessary that the trends in this field be closely observed by IFSCA. IFSCA should, wherever possible and feasible, encourage such infrastructure to be created.

11. Clearing and settlement - Across the board netting in CCIL

As far as local clearing is concerned, CCIL has put out a concept paper detailing clearing of USD/INR NDF. One crucial area for consideration by CCIL will be netting across onshore and offshore positions and whether default fund contribution will be needed for segments separately. This could impact IM and LCR requirements and therefore costs associated with CCIL model. Further, client clearing in CCIL for NDF transactions in IFSC could be complicated (the clearing bank is Indian, the client dealing in NDF will be dealing with a branch of the Indian Bank and presumably has to be the client of an entity in IFSC and

not the Indian branch). The implication of this model needs to be discussed with CCIL.

12. Clearing and settlement - Local USD clearing

- a. Since 2000, several new systems that settle a foreign currency for participants located within the same national borders as the system itself have emerged. In 2000, Hong Kong Interbank Clearing Ltd. (HKICL) introduced the U.S. Dollar Clearing House Automated Transfer System (USD CHATS) to clear USD payments in the Asian time zone. settlement currently takes place on the books of a private bank (HSBC) in New York City. In August 2003, Clearing Corporation of India, Ltd. (CCIL), introduced a system that clears and settles interbank FX trades, including Indian rupee (INR) and USD. CCIL is a third-party member of CLS Bank.
- b. Many of these systems are substitutes for traditional correspondent banking services and offer a customised local service in the native jurisdiction, operating hours that accommodate their customers' needs and potentially better risk management through the use of more formal rules and procedures. As against the abovementioned advantages, jurisdictions that have implemented offshore US dollar clearing systems have introduced credit risk as they rely on a commercial settlement bank to maintain the USD accounts that are used in their real-time gross settlement (RTGS) schemes.
- c. Creation of a local USD clearing at IFSC has been a longstanding demand of market participants. As per the proponents, such a clearing (conceptualised as an RTGS system) is likely to bring the following benefits:
 - i. Reduction in settlement risk as risks arising due to different time zones of initiation and settlement of a trade.
 - ii. Settlements can take place faster on a real time basis benefitting the parties to the trade.
 - iii. Allow participants to monitor their cash flows and balances in real time, and accordingly manage intraday liquidity efficiently.
 - iv. Faster settlement of funds resulting in quicker turnaround of funds and the ability to transact more business.
- d. However, the scope of realisation of the above advantages has to be seen in context of the regulatory and infrastructural setup of IFSC namely:
 - i. RTGS systems settle in the central bank money (i.e., in the books of the central bank). This has the advantage of assuring participants of the finality of the settlement as well as allowing the central bank to provide temporary overdrafts to the banks in times of need. In absence of a central bank (or a monetary authority) in IFSC and as the settlement is in a foreign currency, such settlement finality would not be achieved.
 - ii. In absence of a central bank, real time settlements can take place by the participating banks maintaining balances with the clearing bank. Such balances need to be sufficiently large to settle transactions on

gross basis. The settlement bank should also be willing to provide a line of credit to the participating bank in the settlement currency. The system therefore introduces a large element of counterparty risk.

- e. The abovementioned counterparty risk may be mitigated by provision of intraday overdraft by the settlement bank to the participating banks in the form of:
 - i. Clean limits for participating banks
 - ii. Lending against high quality liquid collateral posted by participating banks.

Accordingly, the decision by IFSCA to designate a settlement bank for the proposed system must consider the operational preparedness of the bank as well as its ability to provide such limits to the participating banks.

- f. The offshore US dollar clearing systems were established when there was no facility to settle Asian USD transactions during the Asian business day. However, the implementation of the 22-hour processing day by Fedwire and CHIPS, which overlaps with the Asian business day, has eliminated the need for clearing USD offshore. CHIPS and Fedwire both have real-time payment settlement finality using central bank money, unlike the offshore systems which exposes participants to credit risk exposure to those systems that rely on a commercial bank for settlement i.e. commercial bank money versus central bank money. The risk is exacerbated for those banks that indirectly participate in these clearing arrangements because they have exposure to the settlement institution as well as to the bank that clears their transactions.
- g. The committee recommends that, in the short term, IFSCA explore a mechanism for providing faster access to Fedwire and CHIPS for IBUs. Development of a local USD clearing system, while addressing the concerns raised above, may be considered over the medium term. IFSCA should also be open to considering innovations in cross border payments like SWIFT gpi etc.

13. Reporting of transactions - Trade Reporting

- a. Post the GFC, all global regulators require reporting of OTC trades to trade repositories (TR). Some regulators (MAS) permit such TRs to be outside their primary jurisdiction (DTCC in the case of MAS), while others (HKTR in HK and CCIL in India) require reporting to local TR.
- b. Currently OTC derivatives undertaken in IFSC is being reported to CCIL's TR. Going forward, IFSCA should consider setting up its own TR. Recognition of global TRs, subject to satisfaction of issues on data confidentiality and compliance with Indian laws in this regard, may also be considered. Additionally, IFSCA should devise a methodology for making available TR data in the public domain.

14. Other issues

- a. Market hours - Exchanges in IFSC are already allowed to determine their operating hours. The Committee is of the opinion that, along the same lines, there should be no restrictions on trading hours for OTC products.
- b. Setting up a self-regulatory organisation - A SRO on the lines of FEDAI (encompassing forex, interest rate and securities market in IFSC) may be encouraged with all FIs regulated by IFSCA as members. IFSCA may consider delegating to such SRO the powers to lay down market practices, code of conduct, dispute resolution, best practices that participants are expected to follow, in line with practices followed in established financial centres.
- c. Benchmark rates : Financial benchmarks are indices, values or reference rates used for the purpose of pricing, settlement, and valuation of financial contracts. In line with IFSCs goal to emerge as an IFC, IFSCA, in consultation with market participants, should allow usage of local market benchmark rates of various jurisdictions (including those published by FBIL) for trading and settlement of derivative contracts issued/traded in IFSC. Once an SRO is established (along the lines mentioned in b) and operational, decisions on usage of local market benchmark rates can be delegated to the SRO by IFSCA.

Chapter 5

Regulatory initiatives for development of IFSC

1. Growth of businesses and deepening of flows at IFSC is critical to fulfilling the development mandate of IFSCA. In line with the above objective, increased volumes across the products and necessary flexibility in product design are required for making IFSC a flourishing financial centre. Considering that technology has revolutionized the financial sector, there is a need to give adequate space and incentives to fintech firms to innovate and cater to market requirements. In this context, the needs and suggestions of market participants like IFSC exchanges – India INX and NSE IFSC, and IBUs which are already doing business and understand the ecosystem are critical for the future growth of IFSC.
2. Suggestions for attracting businesses and deepening of flows at IFSC exchanges includes the following:
 - Negotiated block trading on exchanges.
 - Designation of market makers
 - Expanding the scope of products traded out of IFSC.
 - IFSC as a “Sandbox” for testing new products /services by the sectoral regulator.
 - IFSCA to facilitate setting up third party Collateral Management Service
3. **Negotiated block trading on exchanges:** -
 - a) The need to provide Negotiated Large Trade (NLT) facility in the IFSC exchanges was felt considering that a substantial volume of transactions are bilaterally done in OTC. The NLT mechanism is available at international exchanges like Singapore Exchange (SGX), London Stock Exchange (LSE), EUREX, Chicago Mercantile Exchange (CME), The Intercontinental Exchange (ICE), Bursa Malaysia Derivative Exchange (BMD) and Hong Kong Exchange (HKEX).
 - b) In addition to the above, the key benefits of negotiated block trades are listed as below:
 - Ease of execution at VWAP: If a Member would like to place a large volume / quantity (large- value) transaction using algorithmic trading software to ensure that the orders are executed at or near the Volume Weighted Average Price (VWAP), then this may take a substantial amount of time for execution due to lack of adequate liquidity and market-depth for effective and efficient execution. There could be multiple trades for large orders resulting in different buy/sell price. NLT gives the parties option to fix a mutually agreed price for the deal within an acceptable range for e.g. deep Out-of-the-Money (OTM) or In-the-Money (ITM) Call or Put Options, farther dated Futures, etc. usually have wide bid-ask spread / low liquidity & depth. The NLT facility would enable execution of the large order quantity at or near the VWAP directly between market

participants through mutual negotiation and the transaction shall be reported as an NLT with India INX through the online trading platform.

- Decreasing Transaction Costs for Roll-over of positions: Hedgers and arbitrageurs who would like to roll-over their Futures or Options positions from the maturing / expiring contract month to the next subsequent contract month shall immensely benefit from NLT due to bi-lateral negotiations of large order quantity at mutually agreeable price at or near the VWAP.
 - Efficient Structuring of Options Strategies: Members who structure their hedging or investment strategies using combinations of deep ITM / OTM Call / Put Options can effectively and efficiently transact using NLT. Usually deep ITM / OTM options contracts may not have active quotes throughout the trading session. Enabling NLT can substantially decrease the time to execute such transactions and to ensure effective mitigation of execution risk.
 - Utilisation of Margin Exposure : If a member has a calendar spread position or an inter product spread position and would like to unwind the position, this is subject to execution risk in illiquid contracts. Enabling NLT would facilitate execution without margin violation being triggered due to partial execution of spread orders.
 - Ability to trade mid-market: One of the biggest advantages of NLT is experienced in international exchanges by Futures market participants. The ability of entering a "midmarket" (i.e. average of bid and ask quotes) NLT offers substantial cost savings for traders.
- c) The proposed framework comprising trading and surveillance parameters, clearing & settlement mechanism, risk management, process flow, products coverage, minimum threshold value limit, etc. in line with parameters as in foreign jurisdictions is enclosed as Annexure I.
- d) Thus, it is recommended that the NLT mechanism be introduced in IFSC exchanges in line with other international exchanges so as to facilitate and bring the OTC volumes into the exchanges and also provide settlement guarantee to the participants across all derivative products.

4. Designation of market makers: -

- a) Market making is critical for creating more depth and liquidity in the currency derivatives markets. Presently, the market making is not permitted in currency derivatives segment of the exchanges at IFSC and by permitting the market making in currency derivatives products it will enhance the

liquidity in the currency contracts. Banks which are the major participant for currency derivatives must take lead in market making for currency products and with the help of market making, the IBUs will also be able to incentivise their operation cost in parallel, creating pool of liquidity in currency derivatives products.

- b) Additionally, there can be a criteria for non-banks members, if fulfilling the minimum net worth criteria of USD 675,000/- may be permitted to empanel as market makers in the currency derivatives contracts.
- c) The committee recommends that market making by IBUs/ non-bank members and other large customers / participants like HFTs, HNIs, liquidity providers etc. may be preferred to provide liquidity in currency derivatives segment of IFSC exchanges.

5. Expanding the scope of products traded out of IFSC:

- a) Singapore has emerged as one of the prime foreign exchange (FX) trading venues in the world by attracting multiple banks and other participants to its jurisdiction. In this context, inclusion of Liquidity Enhancement Scheme, offering incentives to participants on the exchanges driving additional business can be considered for implementation at IFSC. The Singapore Exchange (SGX) is offering several currency derivatives products to cater to the needs of FX players globally. In addition to FX derivatives on India rupee contracts, US dollar contracts, SGX also provides a basket based on major Asian currencies like Singapore Dollar (SGD), Chinese Yuan (CNY), Indonesian Rupiah (IDR), South Korean Won (KRW), Malaysian Ringgit (MYR), Philippine Peso (PHP) and New Taiwan Dollar (TWD) to fulfill the needs of the Asian FX markets. The entire list of the SGX FX offerings is listed as below:

Sr. No.	SGX FX Offerings	Sr. No.	SGX FX Offerings
1	AUD/JPY	11	MYR/USD
2	AUD/USD	12	PHP/USD
3	CNY/SGD	13	SGD/CNH
4	CNY/USD	14	THB/USD
5	EUR/CNH	15	TWD/USD
6	IDR/USD	16	USD/CNH
7	INR/USD	17	USD/INR
8	KRW/JPY	18	USD/JPY
9	KRW/USD	19	USD/SGD

Sr. No.	SGX FX Offerings	Sr. No.	SGX FX Offerings
10	MYR/SGD		

- b) In order to provide level playing field for the exchanges at IFSC, it is suggested that the exchanges may be allowed to introduce new currency pairs for widening the range of FX offerings in IFSC and compete with the SGX's offerings. These offerings at IFSC exchanges must cover all NDF currencies. The proposed offerings will attract large number of banks and other participants by providing them a single trade venue at IFSC.
- c) Since June 1,2020, AD banks operating an IBU have been permitted to participate in the NDF market through their branches in India, through their IBUs or through their foreign branches. Trends indicate that banks are preferring to trade from their domestic headquarters or from foreign their branches.
- d) As far as the OTC non-deliverable derivatives (like NDF) are concerned, for IFSC to emerge as a hub of such transactions it is imperative that Indian banks take a lead role in offering such derivatives out of IFSC. Apart from the tax advantages already available (discussed elsewhere in this report), the ability to onboard non-resident customers freely, ability to quote on ETPs and deal through voice brokers of their choice and the proposed principle-based approach to regulation of derivatives should be obvious encouragement for such a decision. Market-making activities needs to be well resourced with the necessary front, middle and back-office support. This can be best achieved by Indian banks shifting the part of their treasury operations, which are focussed on raising foreign exchange resources and hedging their foreign exchange positions, to their IBUs. Banks should be actively encouraged to take this approach by highlighting the cost advantage of such a move both in terms of the tax benefits mentioned above supplemented by the lower cost of operations in IFSC against those of their existing set-up (i.e. their domestic treasury or foreign branches) through which such resource raising and hedging activities are currently conducted.

6. IFSC as a “Sandbox” for testing new products / services by the sectoral regulator:

- a) The regulatory sandbox framework at IFSCA is provided via IFSC Authority circular no. F. No. 71/IFSCA/CMD-RS/2020-21, dated October 19, 2020. The framework aims at developing a world class FinTech hub at the IFSC. It grants certain facilities to entities operating in the securities market, banking, insurance and financial services, to experiment with fintech solutions, in a live environment, with limited set of real customers, for a limited timeframe, with due regard to appropriate risk mitigation and investor protection measures.

- b) Cross-border remittance is another area of development for fintech firms. The current process of cross-border remittance at IFSC is onerous, time consuming and costly. As an example, the hard copy of remittance documents is resourced to domestic offices instead of being processed by IBUs present in IFSC.
- c) Cross border remittances to be enabled for the fintech ventures and local clearing infrastructure can be introduced at the earliest to achieve parity with other financial centres like Singapore, Hongkong, Dubai etc. Efficiency in fund transfer being fundamental to success of international financial services, it is recommended that this aspect is examined in detail for improvisation.
- d) Digital assets can be an area that may be focused upon, to promote the innovation by fintech firms, presently which otherwise have scarce opportunity in domestic. Adoption of digital assets technology will be innovative forward-looking step instead of exploring the available traditional mechanism. Digital Assets being an area involving higher levels of technology and innovation, it is recommended that this is taken up as a primary initiative under Innovation Sandbox, along with creation of a fund which can be used for offering incentives to fintech firms.

7. IFSCA to facilitate setting up third party Collateral Management Service

- a) Collateral exchange with respect to OTC derivatives transactions has not been a common practice in India. As a result, the current custodial infrastructure is geared towards exchange-traded products and does not extend to OTC derivatives, especially for the purpose of meeting the IM segregation requirements (once such requirements are mandated by IFSCA). The onshore custodians who have started/preparing to start their operations in IFSC also have experience in serving the exchange-traded products segment rather than the OTC segment.
- b) Therefore, there is a need to set up one or more third party custodial service provider(s) in IFSC for OTC derivatives. Custodians provide various services to ensure the smooth settlement of OTC contracts in time. The functions of custodians are crucial for the success of the market considering the voluminous growth of these contracts in recent years. Custodians perform various functions of Contract Maintenance, Event Processing, Valuation, Payment and Settlement, Collateral Management, Reconciliation, Account Maintenance and Reporting.
- c) Ideally, there should be at least one third party custodial service provider for each type of eligible collateral in the Margin Requirements. Any third-party custodial infrastructure established in IFSC will also need to enable branches of foreign financial entities to comply with the IM segregation and other requirements under the margin rules of their home jurisdictions (e.g., requirements in relation to credit quality of the custodian and account structures) for the purpose of enabling full substituted compliance.

- d) IFSCA should take the lead in setting up such a third-party collateral management service in IFSC by undertaking discussions with leading ICSDs and other third-party collateral management service providers.

Chapter 6
Legal issues

1. Providing clarity on IFSCA's position as a "regulator" under PMLA Rules, 2005

- a) KYC guideline of RBI and SEBI have been issued inter alia under Rule 9(14)(i) of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 (PML Rules 2005). The said sub-rule empowers the 'regulator' to issue guidelines requiring 'reporting entities' to undertake client due diligence, and thus is the legal provision from which the power of a regulator to issue KYC norms flows from. Hence, it becomes important to look into the manner in which the terms 'regulator' and 'reporting entity' have been defined, to determine if IFSCA and IBUs/other IFSC entities fall within the scope of the said terms, respectively, for the purposes of issuance and applicability of KYC norms.
- b) Rule 2(1)(fa)(i) of PML Rules 2005 defines a regulator to mean a person/ authority/ government which is vested with the power to license, authorise, register, regulate or supervise the activity of reporting entities or the Director as may be notified for certain reporting entities. Hence, the definition of the regulator hinges upon the definition of a 'reporting entity'.
- c) A reporting entity is defined in Section 2(1)(wa) of Prevention of Money Laundering Act, 2002 (PMLA 2002) to mean a banking company (as under the Banking Regulation Act, 1949), financial institution (as under the RBI Act, 1934 and includes chit fund company etc.), intermediary (as under the SEBI Act, 1992), or a person carrying on a designated business or profession (as defined in the PMLA 2002). The definition of reporting entity prima facie does not include financial institutions in IFSC as defined under the IFSCA Act, 2019 as they do not fall in any of the aforementioned categories of reporting entity. Hence, a view may be taken that the term 'regulator' under the PML Rules 2005 does not include IFSCA until the definition of 'reporting entity' in the PMLA 2002 is amended to include financial institutions in the IFSC.
- d) However, an amendment in the definition of 'reporting entities' (for extending the coverage to all units in IFSC regulated by the IFSCA) may lead to a possible unintended implication as it might result in ambiguity about the applicability of the PMLA framework for the IBUs (as branches of Banking Companies - covered under the definition of reporting entity) as on date including the period since 2015. All IBUs in the IFSC as branches of Indian banks or even those of foreign banks cannot claim non-applicability of the PMLA framework as they are all subject to the Banking Regulation Act, 1949 (as amended) (with RBI's powers transferred to the IFSCA) and are hence covered under the definition of banking companies as reporting entity, irrespective of the fact whether the IFSCA is covered under the definition of 'regulator' under the PML Rules 2005.

- e) It is felt that a better option would be to amend the definition of 'regulator' under the PML Rules, 2005 to include IFSCA as the 'regulator' for financial institutions in IFSC.
- f) The Committee understands that IFSCA has interpreted the PMLA rules to the effect that it is covered under the definition of "regulator" therein and has commenced the process of drafting KYC/AML guidelines of IFSC on the basis of the above interpretation. The Committee recommends that, while continuing with the above course of action, the PMLA rules should be duly amended to clarify the position that for FIs in IFSC, it is IFSCA that is the regulator under PMLA, for removal of any doubts on this matter.

2. KYC/AML guidelines aligned to international standards (within the scope of PMLA):

- a) The Prevention of Money-Laundering Act, 2002 (PMLA) is an anti-money laundering law designed to prevent conversion of 'proceeds of crime' into legitimate assets, often involving abuse of the channels of the financial system. The applicability of the PMLA may be interpreted as extending to even 'outside India', in the context of offences of cross border implications directly /indirectly linked to India, thus covering the foreign branches / subsidiaries of Indian entities (included under 'person' as defined in PMLA). The directions from the RBI are also applicable to those branches and majority owned subsidiaries of the banking companies (REs) which are located abroad, to the extent they are not contradictory to the local laws in the host country.
- b) IFSCA is vested with the powers of an integrated regulator-supervisor - to license, authorise, register, regulate or supervise the financial institutions, financial services and financial products in the IFSCs in India. Subsequent to the IFSCA assuming the powers of the RBI as a regulator for the banking business under the respective Acts from October 1, 2020, the IFSCA (Banking) Regulations 2020 were notified on November 20, 2020. The IFSCA (Banking) Regulations 2020 (Reg 14, chapter V) provide that an IBU shall follow 'Know Your Customer' norms, combating of financing of terrorism and other anti-money laundering requirements, including reporting requirements issued by the Reserve Bank of India from time to time, unless otherwise specified by the Authority.
- c) Presently, IFSCA has adopted RBI guidelines on KYC-AML-CFT and SEBI's guidelines on FPI license by Domestic Depository Participants (DDP) to be applicable on IBUs out of the consideration of continuity till the IFSCA could come out with its own set of comprehensive regulatory framework for banking and trading related activities.
- d) While KYC-AML-CFT directions issued by the RBI, currently adopted under the IFSCA Banking Regulations comprehensively address the expectations under the PMLA framework, some of the above requirements (such as

Board-approved policy) may be applicable at the parent bank level only as presently the IBUs in IFSC are allowed to be set up only as branches. Further, the PML Rules (and accordingly, the RBI directions) require the REs to maintain the record and furnishing the information to the designated authority appointed under the PMLA in respect of all transactions including, inter alia, the record of all cash transactions of the value of more than ten lakh rupees or its equivalent in foreign currency, all suspicious transactions, all cross-border wire transfers of the value of more than five lakh rupees or its equivalent in foreign currency where either the origin or destination of fund is in India. However, since cash transactions are not permitted in IFSC and since all transactions within an IFSC or with entities in other jurisdictions (including those in India – outside IFSCs) shall be carried out in foreign currency, such provisions including those relating to Counterfeit Currency Report (CCR) and Non-Profit Organization Transaction Report (NTR) may need to be reviewed / modified suitably.

- e) The RBI directions impose the requirement of obtaining a certified copy of the officially valid document (OVD) by the REs for KYC processes. The directions provide that in case of Non-Resident Indians (NRIs) and Persons of Indian Origin (PIOs), the copy of original OVD may be certified by authorised officials of overseas branches of Scheduled Commercial Banks registered in India, branches of overseas banks with whom Indian banks have relationships, Notary Public abroad, Court Magistrate, Judge, Indian Embassy/Consulate General in the country where the non-resident customer resides. However, the RBI directions do not seem to have adequate enabling provisions for AML-KYC-CFT processes for on-boarding of non-resident customers, in a non-face-to-face scenario, for its REs.
- f) To promote IFSC as a hub for offshore trading in INR, it is important that relaxations be offered under KYC guidelines in lines with other FATF compliant jurisdictions that would ensure seamless on-boarding of investors and compliance with the FATF recommendations. A benchmarking exercise has been done on KYC norms for both retail as well as institutional investors, across other international financial centres which is enclosed at Annex 4.
- g) IBUs present in IFSC may be permitted to use the documentation and onboarding related details of clients if such clients are already onboarded with their branches / subsidiaries across the globe – this should be allowable and be in line with the Information Sharing Pact with that Country / as per regulation in that jurisdiction. This could be widened for sharing across IBU's at IFSC.

3. Choice of Governing law:

- a. Studies have found that parties to international contracts and cross-border transactions often choose the law of England and Wales as the governing law of the agreement for multifarious reasons. In various jurisdictions (especially in erstwhile British colonies), the system of law is influenced by the English Law. The English Law has a well-known, well-developed and reputable

jurisprudence. English law is further bolstered by its independence of the judiciary, the experience and reputation of judges and the high quality of UK law firms and barristers. The relative speed and efficiency with which commercial disputes can be resolved through the English courts or alternative dispute resolution mechanisms also contribute to the popularity of English law and London's reputation as an international dispute resolution centre.

- b. Contract law in Singapore is largely based on the common law of contract in England. Hence, the rules developed in the Singapore courts do bear a very close resemblance to those developed under English common law. Indeed, where there is no Singapore authority specifically on point, it will usually be assumed that the position will, in the first instance, be no different from that in England.
- c. Although in theory parties to a contract are free to choose any one of a number of systems of law as the law that is to govern their legal relationship, in practice the parties' choice is likely to be confined to either: the law of the territory in which one of the parties is domiciled or operates; the system of law that is customarily chosen to govern contracts of a similar nature in accordance with trade or market usage or a neutral system of law that the parties agree shall be the governing law. In international financial transactions choices of governing law may depend on whether finance is being raised in a specific capital market or through bilateral negotiation between the lender or lending syndicate and the borrower.
- d. Although the parties to an agreement can expressly choose a specific system of law to govern their agreement, it cannot govern all aspects of that agreement. For example, a specific system of law cannot govern the legal validity aspects, that is, the legal capacity of the parties to enter into and perform their obligations under the agreement, the due authorisation of the transaction, and the due execution and delivery of the documentation. Again, if the borrower goes into liquidation or becomes insolvent, or a receiver or administrator of the borrower or its assets is appointed by a court, legal issues arising as a result of that action will be subject to the laws of the borrower's country of incorporation.
- e. The parties to a contract cannot, except to a very limited degree, use contractual devices such as warranties, representations, and indemnities so as to avoid those local laws that contain elements of strict liability such as environmental laws etc. Thus, lenders from IFSC will need to consider a number of due diligence issues like potential lender liability at the jurisdiction where the borrowing party is domiciled or the jurisdiction where the funds are deployed by the borrower irrespective of the governing law of the contract.
- f. The choice of the method and forum for resolution of any disputes arising out of the contract has important implications such as neutrality of the forum agreed upon, applicable evidentiary and procedural rules, enforcement of awards etc.

Another important factor, when considering the choice of forum, is whether the dispute should be litigated or arbitrated.

- g. While IFSCA should leave the choice of contracting law for transactions undertaken out of IFSCA up to the contracting parties, it should sensitise its regulated entities about the issues arising out of such choice (including those mentioned in paras (d), (e) and (f) above) and recommend steps to mitigate such risks.

Chapter 7

Tax issues

1. Taxation of NRIs - Clarity on Tax exemptions in the recent budget

- a. In today's globalized world, capital is highly mobile. Businesses can choose to invest in any number of countries throughout the world to find the highest rate of return. This means that businesses will look for countries with lower tax rates on investment to maximize their after-tax rate of return. If a country's tax rate is too high, it will drive investment elsewhere, leading to slower economic growth. In addition, high marginal tax rates can lead to tax avoidance. A tax code that is competitive and neutral promotes sustainable economic growth and investment while raising sufficient revenue for government priorities.
- b. There are many factors unrelated to taxes which affect a country's economic performance. Nevertheless, taxes play an important role in the selection of an International Financial Centre and is dependent upon Tax Factors like Basic tax rates, Tax incentives, Nil or low withholding taxes, Treaty network, Anti-avoidance rules, Stability of tax laws.
- c. The report of the Task Force on Offshore Rupee Market (2019) set up by the RBI had identified that a significant market share in financial services related to India has moved to other international financial centres like Singapore, Hong Kong and London. Given the favourable tax regime tax and by virtue of it being outside the capital controls under FEMA, 1999, IFSC may bring volumes and price discovery of Rupee in the offshore Rupee derivative market back to India.
- d. In order to encourage the growth of International Financial Services Centres (IFSCs) into a world class financial services hub, it is necessary to ensure a competitive tax regime to International Financial Services Centre. Accordingly, the following incentives have been provided to units set up in the IFSC under the Income-tax Act, 1961:

Sr. No.	Product	Investor	Taxability under Indian tax laws
1	Deposits	Non-resident	Interest income on deposits made by a non-resident in IFSC Banking Unit ('IBU') is exempt from tax
2	Loans	Non-resident	Interest income on monies borrowed by IBU from a non-resident is exempt from tax
3	Non-deliverable forward contracts	Non-resident	Income accrued or arisen to or received by a non-resident as a result of transfer of non-deliverable forward contracts, entered into with IBU is exempt from tax, subject to fulfilment of such conditions as

			may be prescribed. This amendment has been brought in the Finance Act, 2021.
4	Long Term Bonds and Rupee Denominated Bonds listed on IFSC exchanges	Non-resident	Interest income on Long Term Bonds and Rupee Denominated Bonds listed on IFSC exchanges is taxable at a tax rate of 4% (excluding surcharge and cess) <ul style="list-style-type: none"> Long Term Bonds and Rupee Denominated Bonds should be issued on or after 1 April 2020, but before 1 July 2023
5	Transfer of specified securities listed on IFSC exchanges	Non-resident	Transfer of specified securities listed on IFSC exchanges by a non-resident and where the consideration for such transaction is paid or payable in foreign currency is not treated as transfer and the gains accruing thereon are not chargeable to tax. <ul style="list-style-type: none"> Specified securities include Bond, GDR, Foreign currency denominated bond, Rupee-denominated bond of an Indian company, Derivatives, Unit of a Mutual Fund, Unit of a business trust, Unit of Alternative Investment Fund and Foreign currency denominated equity share of a company
6	Category III AIF in IFSC which qualifies as a specified fund under section 10(4D) of the Act	Unit holder of Category III AIF in IFSC	Any income accruing or arising to or received by a unit holder from a Category III AIF in IFSC or on transfer of its units is exempt from tax
7	Category I or II AIF in IFSC	Unit holder of Category I or II AIF in IFSC	Category I and Category II AIF have tax pass-through status for Indian income-tax purposes (except for business income). <ul style="list-style-type: none"> Investors are taxed on income arising from investments made by the AIF as if the investments were made directly by them. Income accruing or arising or received by non-resident investors from offshore investments through a Category I or II AIF is not taxable in India. Investors can claim losses (other than business loss) of AIF on pass through basis, provided the units of such AIF are held for a period of 12 months or more. However, any business loss can be carried forward only at the AIF level.

2. Special tax regime for IBUs in IFSC registered as an FPI

- a. The Finance Act, 2021, has introduced a special taxation regime to the investment division of the non-resident IBU, registered as a Category I FPI, which is comparable to FPIs domiciled in offshore jurisdictions. The said tax regime is applicable to IBUs which have commenced operations on or before 31 March 2024. The tax framework of investment division of such IBUs located in IFSC vis-à-vis FPIs domiciled in Singapore, Mauritius or European countries investing in Indian capital markets is as follows:

Particulars	Tax rates applicable to a branch of a Foreign Bank registered as FPI* (excluding surcharge and cess)	Tax rates applicable to an IBU registered as FPI (excluding surcharge and cess)
Long-term capital gains on: <ul style="list-style-type: none"> • Equity • Debt 	<ul style="list-style-type: none"> • 10% • Exempt 	<ul style="list-style-type: none"> • 10% • Exempt
Short-term capital gains on: <ul style="list-style-type: none"> • Equity • Debt • Derivative 	<ul style="list-style-type: none"> • 15%/ 30% • Exempt • Exempt 	<ul style="list-style-type: none"> • 15%/ 30% • Exempt • Exempt
Interest income (non 194LD)	7.5% / 10% / 15%	10%
Dividend income	10%	10%

** Coming from Singapore, Mauritius or European countries etc. with whom India has a tax treaty and subject to satisfaction of tax treaty conditions*

- b. One of the taxation related challenges faced by nonresident investors is multiplicity of the income tax provisions resulting in interpretational ambiguities as well as prolonged litigations. At present, various provisions as well as exemptions relating to IFSC are scattered across numerous

chapters of the Income tax act,1961. Hence, in the spirit of ease of doing business and to provide tax clarity to all participants operating out of IFSC, it is recommended that all the taxation rules as well as exemptions relating to IFSC be consolidated under single chapter of the Income Tax Act,1961.

- c. A dedicated office of the Income Tax department which specializes exclusively on the taxation provision relating to IFSC would be immensely helpful in faster resolution of tax issues of IFSC entities. Also, over a period, such office will develop the necessary experience on the taxation of international financial transactions.
- d. Capital gains arising in the hands of persons resident outside India out of derivatives traded on IFSC exchanges are exempt from taxation. As far as OTC derivatives are concerned, Finance Act, 2021 introduced a provision to exempt any income accrued or arisen to or received by a non-resident because of transfer of NDF contracts entered into with IBU. Such distinction between taxation of exchange traded & OTC products are not prevalent in other international centers. Accordingly, it is suggested that the exemption available to NDFs be extended to all OTC derivatives undertaken in IFSC.
- e. NRIs who may have obtained PAN, may not necessarily obtain Aadhar in India or may not be eligible to obtain Aadhar since as per UIDAI guidelines, only a non-resident Indian (NRI) holding valid Indian passport can apply for Aadhaar. Thus, for such NRIs investing in IFSC, exclusion should be provided from the requirement of PAN-Aadhar linking. Such NRIs should also be allowed to make investments in IFSC and should not be liable for TDS at higher rates.
- f. Many questions like issue of taxation in case of trading profits made in OTC deals vs Exchange traded deals arise because of the applicable tax regime. Most of the peer IFCs of IFSC follow territorial tax regime. Under a territorial tax regime, international businesses pay taxes to the countries in which they are located and earn their income. This means that territorial tax regimes do not generally tax the income companies earn in foreign countries. For IFSC to be on par with competing IFCs on taxation front, a separate tax regime, based on territorial source principle, may be examined. If that is not possible, a territorial taxation system may be allowed, for specific purpose of trading profits made by entities in IFSC.

Chapter 8
Recommendations

1. Participants

- a. To manage the risk of OTC derivatives, IFSCA should implement the globally accepted regulatory regime for trading and clearing OTC derivatives. (Chapter 2, para 4)
- b. IFSC's regulatory framework should be geared towards encouraging widest possible client participation subject to such clients satisfying AML / KYC requirements and conforming to internationally accepted customer acceptance norms. (Chapter 2, para 5)
- c. Access by international clients to financial markets in IFSC should be facilitated by recognising the omnibus account structure, with suitable provisions for IFSCA to seek information about the ultimate beneficiary when necessary. (Chapter 2, para 6(d))

2. Products

- a. Adopt an outcome oriented, principle-based approach for derivative products in IFSC. (Chapter 3, para 3(c))
- b. Permit all category of products at IFSC without any restriction as long as the underlying product is not liable to be used as a surrogate for money laundering. (Chapter 3, para 3(a)(i))
- c. Allow derivatives to be undertaken either on a standalone basis or as a part of structured product. (Chapter 3, para 3(a)(ii))
- d. Allow derivatives to be undertaken for the purposes of risk management, risk transformation, yield enhancement or trading/speculation. (Chapter 3, para 3(a)(iii))
- e. Introduce entity level rules to prevent excessive leverage through the use of derivative products. (Chapter 3, para 3(a)(iv))
- f. Besides INR, IBUs should continue to be allowed to make markets in NDFs of other non-convertible currencies like TWD, BRL, KRW etc. (Chapter 3, para 3(d))
- g. In order to allow Offshore Derivative Instruments (ODIs) to be issued out of IFSC, Section 18A of the Securities Contract Regulation Act, 1956 be amended by adding a proviso to exempt derivatives in IFSC from the requirements of the section. (Chapter 3, para 4(m))

- h. Foreign Portfolio Investors (FPIs) and Eligible Foreign Investors (EFIs) should be permitted to issue ODIs with futures and options (i.e., derivatives) traded on the IFSC stock exchanges as underlying. (Chapter 3, para 4(n))
- i. RBI be requested to clarify that its restriction on Indian entities on participating in INR related products in overseas jurisdictions shall not be applicable to INR denominated products undertaken in IFSC. (Chapter 3, para 5(c))
- j. RBI be requested to clarify that the IFSC would fall within the definition of “established financial centers outside India” in its circular on “Operations of foreign branches and subsidiaries of the Indian banks – Compliance with statutory/regulatory/administrative prohibitions/restrictions”. (Chapter 3, paras 5(d) & 5(e))
- k. Allow exchanges in IFSC to introduce products that replicate features of OTC derivative contracts (like FlexC FX Futures of SGX). (Chapter 3, para 6)

3. Infrastructure

- a. IFSCA should allow the entities operating in IFSC, especially the Banking Units, to access the widest possible choice of ETPs and Voice Brokers and to facilitate this should not mandate registration requirements for ETPs offering services to entities operating in IFSC. (Chapter 4, para 5(c))
- b. From an oversight perspective, if necessary, for the immediate near term, IFSCA may recommend a directory such as ICMA ETP directory which IBUs can use for onboarding ETPs. Another approach that may be considered is to permit IBUs to onboarding ETPs that are regulated by reputed international regulators like FCA, CFTC, MAS etc. (Chapter 4, para 5(d))
- c. In order to allow IBUs to participate in the markets to the fullest extent, they may be permitted to choose all types of venues (like disclosed, semi-disclosed and undisclosed) depending upon their internal policies. (Chapter 4, para 5 (e))
- d. In the medium to long run, IFSCA may consider devising a framework for registration of ETPs that would provide services to financial institutions in IFSC. (Chapter 4, para 5(f))
- e. IFSCA to create enabling provisions to recognise and regulate Prime Brokerage arrangements. (Chapter 4, para 6(b))
- f. As far as IBUs offering PB services from IFSC is concerned, IFSCA may consider specifying enabling considerations for the same and also regulate such arrangements. As far as dealing between IBUs and other entities who use the services of established PBs, the decision regarding the same may be left to the IBUs. (Chapter 4, para 6(b))

- g. As the IBU offering PB services shall know the identity of its client that they dealt with, possible modifications in the reporting requirements to capture this information may be considered along with examination of implications of such an action on any confidentiality agreements. Further, as the deals are all booked and settled facing the PB, it is suggested that netting across all end clients of a single PB for capital and LCR maintenance purposes be permitted. (Chapter 4, para 6(c))
- h. IFSCA should permit the use of any settlement infrastructure (including outside its jurisdiction) subject to such an infrastructure being regulated by appropriate entity in the entity's home jurisdiction. (Chapter 4, para 7(c))
- i. IFSCA should align with global best practices by not insisting on ring-fenced collateralisation and allowing IBUs to post IM as part of their overall legal entity's IM whether out of IBU or any of its offices. (Chapter 4, paras 8(c))
- j. IFSCA should permit IBUs and foreign entities to comply with the margining guidelines through full substituted compliance to the margin regulations of the jurisdiction whose framework is in line with policy framework on Margin Requirements for Non-Centrally Cleared Derivatives issued by BCBS and IOSCO. (Chapter 4, para 8(d))
- k. IFSCA should permit re-use of collateral in case of tripartite collateral management (including for automatic lending of securities through ICSDs like Clearstream and Euroclear) and prime brokerage custodian services. Re-use of collateral may also be permitted for bilateral contracts settled between two parties directly while sensitising the transferor to the risks associated with such transfer and possible solutions to mitigate such risks. (Chapter 4, para 9(b))
- l. IFSCA should, wherever possible and feasible, encourage alternate settlement infrastructure using technologies such as Blockchain. (Chapter 4, para 10(h))
- m. CCIL should be requested to consider permitting netting across onshore and offshore positions and consider both the positions to arrive at the contribution to the Default Contribution Fund. (Chapter 4, para 11)
- n. In the short term, IFSCA should explore a mechanism for providing access to Fedwire and CHIPS for IBUs. Development of a local USD clearing system, while addressing the concerns about such a system, may be considered over the medium term. IFSCA should also be open to considering innovations in cross border payments like SWIFT-gpi etc. (Chapter 4, para 12(g))
- o. IFSCA should consider setting up its own TR. Recognition of global TRs, subject to satisfaction of issues on data confidentiality and compliance with Indian laws in this regard, may also be considered. (Chapter 4, para 13 (b))
- p. There should be no restrictions on trading hours for OTC products. (Chapter 4, para 14(a))

- q. A Self-Regulatory Organisation (SRO) may be encouraged with all FIs regulated by IFSCA as members. IFSCA may consider delegating to such SRO the power to lay down market practices including usage of benchmark rates. (Chapter 4, para 14(b))
- r. IFSCA, in consultation with market participants, should allow usage of local market benchmark rates of various jurisdictions (including those published by FBIL) for trading and settlement of derivative contracts issued/traded in IFSC. (Chapter 4, para 14(c))

4. Regulatory initiatives

- a. In line with other international exchanges, Negotiated Large Trades (NLT) mechanism be permitted by IFSCA on the exchanges at IFSC. (Chapter 5, para 3(d))
- b. Market making by IBUs/non-bank members and other large customers/ participants like HFTs, HNIs, liquidity providers be encouraged to provide liquidity in currency derivatives on the exchanges at IFSC. (Chapter 5, para 4(c))
- c. Exchanges in IFSC may be allowed to introduce derivative contracts in new currency pairs for widening the range of FX offerings in IFSC. (Chapter 5, para 5(b))
- d. IFSCA should actively encourage Indian banks to shift the part of their treasury operations, focused on raising foreign exchange resources and hedging their foreign exchange positions, to their IBUs at IFSC and also to set up necessary infrastructure for such activities by highlighting the cost advantage of such a move both in terms of the tax benefits supplemented by the lower cost of operations in IFSC against those of their existing setups. (Chapter 5, para 5(d))
- e. Regulatory sandbox scheme of IFSCA should encourage fintech platforms operating in areas such as cross border remittances and handling of digital assets. (Chapter 5, paras 6(b) & 6(d))
- f. IFSCA should take the lead in setting up third party collateral management service in IFSC by undertaking discussions with leading ICSDs and other third-party collateral management service providers. (Chapter 5, para 7(d))

5. Legal issues

- a. The Committee recommends that while continuing with the process of drafting KYC/AML guidelines of IFSC on the basis of the interpretation that IFSCA is covered under the definition of "regulator" for FIs in IFSC under the PMLA rules, the rules should be duly amended to clarify this position and removal of any doubt. (Chapter 6, para 1(f))

- b. Since cash transactions are not permitted in IFSC and since all transactions within an IFSC or with entities in other jurisdictions (including those in India – outside IFSCs) shall be carried out in foreign currency, provisions including those relating to Counterfeit Currency Report (CCR) and Non-Profit Organization Transaction Report (NTR) may need to be reviewed / modified suitably. (Chapter 6, para 2(d))
- c. To promote IFSC as a hub for offshore trading in INR, it is important that relaxations be offered under KYC guidelines in lines with other FATF compliant jurisdictions that would ensure seamless on-boarding of investors and compliance with the FATF recommendations. (Chapter 6, para 2(f))
- d. IBU's present in IFSC may be permitted to use the documentation and onboarding related details of clients if the clients are already onboarded with their branches / subsidiaries across the globe – this should be allowable and be in line with the Information Sharing Pact with that Country / as per regulation in that jurisdiction. This could be widened for sharing across IBUs at IFSC. (Chapter 6, para 2(g))
- e. While IFSCA should leave the choice of contracting law for transactions undertaken out of IFSCA up to the contracting parties, it should sensitise its regulated entities about the issues arising out of such choice and recommend steps to mitigate such issues. (Chapter 6, para 3(g))

6. Tax issues

- a. All the GIFT IFSC related exemptions/ taxation rules may be consolidated under single chapter of Income Tax act to ensure simplicity. (Chapter 7, para 2(b))
- b. Dedicated tax administration to be set up at IFSC to ensure smooth & predictable tax administration for IFSC units/Investors. (Chapter 7, para 2(c))
- c. Taxation for OTC Cash & derivative products at IFSC to be at par with Exchange traded products. (Chapter 7, para 2(d))
- d. Exemption relating to INR NDF for deals executed with banks introduced in 2021 finance bill to be extended to all INR derivatives executed with any IFSC entity. (Chapter 7, para 2(d))
- e. For IFSC to be on par with competing IFCs on taxation front, a separate tax regime, based on territorial source principle, may be examined. If that is not possible, a territorial taxation system may be allowed, for specific purpose of trading profits made by entities in IFSC. (Chapter 7, para 2(f))
- f. The requirement of PAN-Aadhar linking be waived for NRIs who have a PAN number but do not qualify the requirement for applying for Aadhar (i.e. holding a valid Indian passport) so that they can make investments in IFSC without being liable for TDS at higher rates. (Chapter 7, para 2(e))

ANNEXURES

Overview of exchanges at IFSC

India International Exchange (IFSC) Limited (India INX) was the first international exchange at IFSC and commenced its operations from January 16, 2017. It offers investors 22 hours trading in a range of financial market products such as index and single stock derivatives, commodity derivatives, currency derivatives, debt securities, depository receipts, Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs). India INX's average monthly turnover for the period January to March 2021 quarter stood at \$ 328 billion, a market share of 97% in futures and options (based on notional value) traded on exchanges at IFSC. India INX hosts the Global Securities Market (GSM) platform offering issuers an efficient and transparent method to raise capital. The platform offers a debt listing framework at par with other global listing venues such as London, Luxembourg, Singapore etc. Till date, GSM has handled USD 50 billion in MTN programs and more than USD 27 billion of bonds issued.

NSE IFSC Limited (NSE International Exchange) is a wholly owned subsidiary of National Stock Exchange of India Ltd. – world's largest derivatives exchange⁷. NSE International Exchange commenced its operations from June 5, 2017. The exchange offers longer trading hours and a gamut of products including Equity Index Derivatives including the flagship NIFTY50 derivatives contract, Single Stock Derivatives, Currency Derivatives, Commodity Derivatives, Debt Securities, Depository Receipts, Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs). The average monthly turnover for the January to March 2021 quarter stood at \$ 11 billion. The Debt securities market of NSE International Exchange provides a global platform to issuers to list their debt securities similar to major global jurisdictions of the world. NSE International Exchange has listed 22 issues with a total MTN programs established of more than \$ 18.3billion. The total issue size of listed bonds is around \$ 10.35 billion. NSE International Exchange is the first exchange to list the Depository Receipts at IFSC.

⁷ In terms of number of contracts traded, according to the Futures Industry Association (FIA) – for the year 2020

Overview of clearing corporations at IFSC

India International Clearing Corporation (IFSC) Limited (India ICC), is a central counterparty providing clearing & settlement and risk management services at IFSC. It clears and settles index and single stock derivatives, commodity derivatives, currency derivatives and debt securities. It is a Qualified Central Counter Party (QCCP) and also recognized by the European Securities and Markets Authority (ESMA) and the Bank of England as a Third Country Central Counterparty (TC-CCP). India ICC complies with all the rules and regulations prescribed by its regulator, IFSC Authority. India ICC is additionally required to comply with the rules and regulations that are consistent with the Principles for Financial Market Infrastructures ("PFMI") issued by the Committee on Payment and Market Infrastructure ("CPMI") and International Organisation of Securities Commissions ("IOSCO"). These rules and regulations focus on limiting systemic risk and on enhancing transparency and stability in the financial market. The clearing corporation also engages with Clearstream SA, an international central securities depository, for providing settlements in debt securities and acceptance of international sovereign securities as collateral.

NSE IFSC Clearing Corporation Limited (NICCL) is a wholly owned subsidiary of NSE Clearing Limited (formerly known as National Securities Clearing Corporation Limited). NICCL has commenced its operations since June 5, 2017. NICCL currently acts as a clearing corporation for all the trades executed on NSE IFSC Ltd. NICCL provides clearing and settlement services to its clearing members. NICCL has laid down a comprehensive set of rules that provide the operational level details on key aspects of the clearing and settlement business. NICCL has engaged with Clearstream SA, an international central securities depository, for providing settlements of American Depository Receipts (ADRs) listed on NSE IFSC and acceptance of international sovereign securities as collateral. NICCL has adopted global best practices and principle and adopted the CPMI IOSCO Principles for Financial Market Infrastructures (PFMIs) issued by the Committee on Payment and Market Infrastructure ("CPMI") and International Organisation of Securities Commissions ("IOSCO"). NICCL complies with all the Guidelines and Regulations prescribed by IFSC Authority. NICCL is a Qualified Central Counter Party (QCCP) and recognized as Third Country CCP (TC-CCP) by the European Securities and Markets Authority (ESMA) and the Bank of England.

Prime Brokerage Dealing

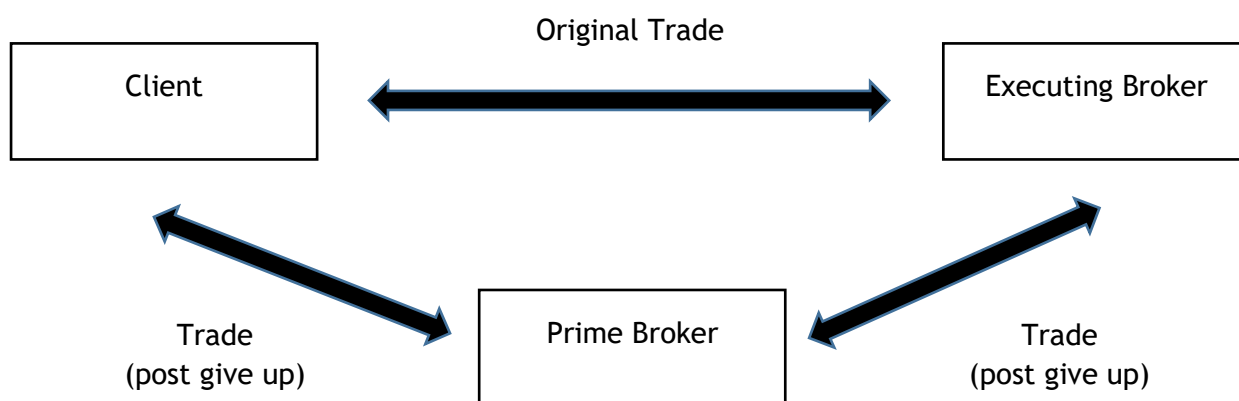
Fx prime brokerage allows an entity to source liquidity from multiple dealers while maintaining credit relationship, collateral placement and trade settlement with a single entity. Fx prime brokerage (FXPB) is the standard market practice used globally by hedge funds, trading advisors and other asset managers for trading forex products. IBUs may explore this Fx prime brokerage ecosystem to capture flows from such market players.

Give-Up arrangement

Three entities are involved in a basic give-up arrangement.

- Executing Broker
- Prime Broker
- Client or Designated Party

Initially client enters into an agreement with the prime broker which broadly permits the client to trade with other dealers on behalf of the prime broker. Client and executing broker enter into a transaction which is given up by the client to the prime broker. As a result of this give up , the executing broker ends up facing prime broker for that transaction. On other side, the client also ends up facing prime broker for the same transaction.



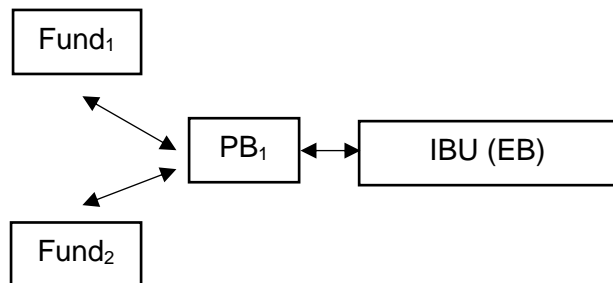
As a result of this arrangement, client eventually faces the prime broker for all the transactions entered with different executing brokers. Credit exposure for all the client transactions is against the prime broker. Operational benefits are attained in form of netting with respect to margining and trade settlement. Moreover, interaction with a single counterparty results in further ease of operations.

Modes of Operation

There are two ways through which IBUs can participate in this FXPB ecosystem.

- a. IBU acting as an Executing Broker

A client can be enabled for trading with a IBU by executing a Master Give-Up Agreement and other necessary documents with the prime broker of the client. Post completion of the documentation, any client of that prime broker can be enabled for trading through exchange of a Designation Notice (specific to a single client or fund).



b. IBU acting as a client of Fx Prime Broker

Under this mode of operation, initially the IBU needs to onboard itself as a client of Fx prime broker. Based on the internal credit assessment by the prime broker, limits are assigned to the IBU (NOP limit, settlement limit and trading limit).

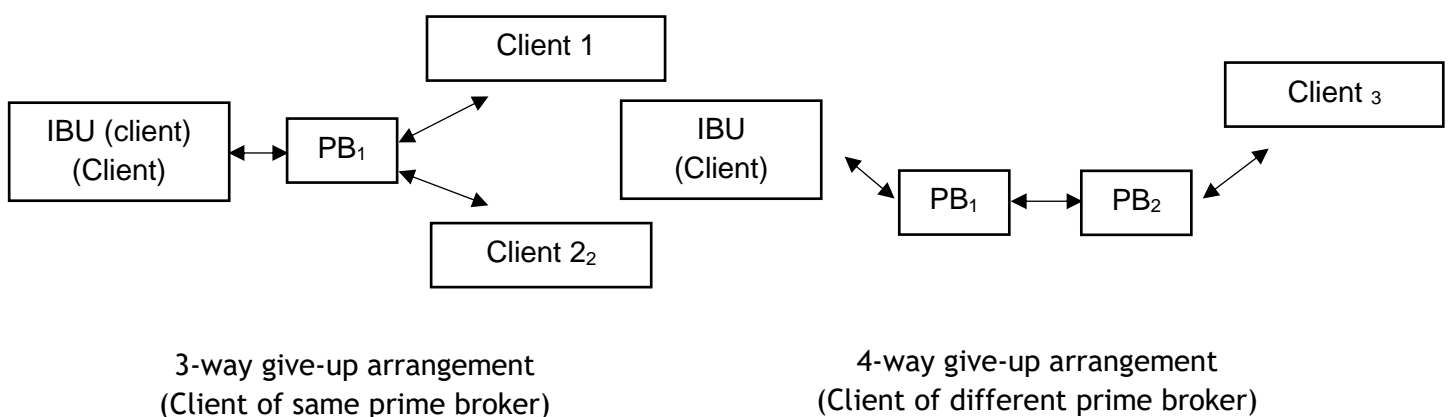
IBUs can deal with other entities as described below :

Clients that are FXPB clients of the same prime broker

To enable trading under such an arrangement, a tri-party agreement needs to be signed by all the three involved parties – IBU, Prime Broker and End Client (Fund).

Clients that are FXPB clients of the different prime broker

To enable trading under such an arrangement, a 4-way give-up agreement needs to be signed by all the four involved parties.



Typically, a set of standard documents needs to be put in place by parties concerned for trading to happen using these arrangements.

KYC documentation norms in other international jurisdictions**a.Germany- (Gwg Act (Anti-money laundering ACT))**

	Type of customer	Details required	Documents required
1	Individual	a) their first name and surname, b) their place of birth, c) their date of birth, d) their nationality and e) a residential address	<p>A valid official identity document which includes a photograph of the holder and satisfies the passport and identification requirements in Germany, in particular a <u>German passport, identity card or substitute of a passport or identity card</u>, or a passport, identity card or substitute of a passport or identity card recognised or accepted under German provisions for foreign nationals,</p> <p>2. an <u>electronic proof of identity</u> pursuant to section 18 of the Act on Identity Cards and Electronic Identification (Personalausweisgesetz) or to section 78 (5) of the Residence Act (Aufenthaltsgesetz),</p> <p>3. a <u>qualified electronic signature</u> pursuant to Article 3 no. 12 of Regulation (EU) No 910/2014 of the European Parliament and of the Council of 23 July 2014 on electronic identification and trust services for electronic transactions in the internal market and repealing Directive 1999/93/EC (OJ L 257 of 28 August 2014, p. 73),</p>

2	Legal person or a partnership	<p>a) the company, name or trading name, b) the legal form, c) the commercial register number if available, d) the address of the registered office or head office and e) the names of the members of its representative bodies or the names of its legal representatives and, if a member of its representative body or the legal representative is a legal person, the data listed under letters (a) to (d) for this legal person.</p>	<p>Verification of the identity of legal persons is to be carried out by means of</p> <ol style="list-style-type: none"> 1. an extract from the <u>commercial register or register of cooperative societies or a comparable official register</u> or directory 2. <u>formation documents</u> or equivalent substantiating documents or 3. a <u>documented inspection by the obliged entity</u> itself of the data in the register or directory.
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Singapore (MAS Notice 626)

		Details required	Documents required
1	Individual	<p>For the purposes of Customer identification, a bank shall obtain at least the following information:</p> <p>(a) full name, including any aliases;</p> <p>(b) unique identification number (such as an identity card number, birth certificate number or passport number, or where the customer is not a natural person, the incorporation number or business registration number);</p> <p>(c) the customer's –</p> <p>(i) residential address; or</p> <p>(ii) registered or business address, and if different, principal place of business, as may be appropriate;</p> <p>(d) date of birth, establishment, incorporation or registration (as may be appropriate); and</p> <p>(e) nationality, place of incorporation or place of registration (as may be appropriate)</p>	<p>i. Unique identification number (such as an identity card number, birth certificate number or passport number)</p> <p>ii. A bank shall verify the identity of the customer using reliable, independent source data, documents or information.</p>
2	Legal person or a partnership	<p>Where the customer is a legal person or legal arrangement, the bank shall, apart from identifying the customer, also identify the legal form, constitution and powers that regulate and bind the legal person or legal arrangement.</p>	<p>A bank shall verify the identity of the customer using reliable, independent source data, documents or information.</p>

Dubai (The DFSA rule book for AML)

		Details required	Documents required
1	Individual	<p>If a customer is a natural person, a Relevant Person must obtain and verify information about the person's:</p> <p>(a) full name (including any alias); (b) date of birth; (c) nationality; (d) legal domicile; and (e) current residential address (other than a post office box).</p>	<p>Items (a) to (c) should be obtained from a <u>current valid passport</u> or, where a customer does not possess a passport, an official identification document which includes a photograph. The concept of domicile generally refers to the place which a person regards as his permanent home and with which he has the closest ties or which is his place of origin.</p>
2	Legal person or a partnership	<p>If a customer is a body corporate, the Relevant Person must obtain and verify:</p> <p>(a) the full name of the body corporate and any trading name; (b) the address of its registered office and, if different, its principal place of business; (c) the date and place of incorporation or registration; (d) a copy of the certificate of incorporation or registration; (e) the articles of association or other equivalent governing documents of the body corporate; and (f) the full names of its senior management.</p>	<ul style="list-style-type: none"> • a copy of the certificate of incorporation or registration the articles of association or other equivalent governing documents of the body corporate
3	Foundation	<p>If a customer is a foundation, the Relevant Person must obtain and verify: (a) a certified copy of the charter and by-laws of the foundation or any other documents constituting the foundation; and (b) documentary evidence of the appointment of</p>	<p>(a) a certified copy of the charter and by-laws of the foundation or any other documents constituting the foundation; and (b) documentary evidence of the appointment of the guardian or any other person who may exercise powers in respect of the foundation</p>

		the guardian or any other person who may exercise powers in respect of the foundation.	
4	Express trust or other similar legal arrangement	If a customer is an express trust or other similar legal arrangement, the Relevant Person must obtain and verify: (a) a certified copy of the trust deed or other documents that set out the nature, purpose and terms of the trust or arrangement; and (b) documentary evidence of the appointment of the trustee or any other person exercising powers under the trust or arrangement.	(a) a certified copy of the trust deed or other documents that set out the nature, purpose and terms of the trust or arrangement; and (b) documentary evidence of the appointment of the trustee or any other person exercising powers under the trust or arrangement.
5	Body Corporate	(a) the full name of the body corporate and any trading name; (b) the address of its registered office and, if different, its principal place of business; (c) the date and place of incorporation or registration; (d) a copy of the certificate of incorporation or registration; (e) the articles of association or other equivalent governing documents of the body corporate; and (f) the full names of its senior management.	<ul style="list-style-type: none"> • a copy of the certificate of incorporation or registration; • the articles of association or other equivalent governing documents of the body corporate

In complying with Ongoing Due Diligence, a Relevant Person should undertake a periodic review to ensure that non-static customer identity documentation is accurate and up-to-date. Examples of non-static identity documentation include passport number and residential/business address and, for a legal person, its share register or list of partners.

Hong Kong (HKMA's Guideline on AML & CFT for Authorized Institutions)

		Details required	Documents required
1	Individual	For Hong Kong permanent residents 6, AIs should verify an individual's name, date of birth and identity card number by reference to his/her identity card.	In verifying the identity of a customer that is a natural person, an AI should verify the name, date of birth, unique identification number and document type of the customer by reference to documents, data or information provided by a reliable and independent source, examples of which include: (a) Hong Kong identity card or other national identity card; (b) valid travel document (e.g. unexpired passport); or (c) other relevant documents, data or information provided by a reliable and independent source (e.g. document issued by a government body).
2	Legal Person	AI should identify the customer by obtaining at least the following identification information: (a) full name; (b) date of incorporation, establishment or registration; (c) place of incorporation, establishment or registration (including address of registered office); (d) unique identification number (e.g. incorporation number or business registration number) and document type; and (e) principal place of business (if different from the address of registered office)	an AI should normally verify its name, legal form, current existence (at the time of verification) and powers that regulate and bind the legal person by reference to documents, data or information provided by a reliable and independent source, examples of which include: (a) certificate of incorporation; (b) record in an independent company registry; (c) certificate of incumbency; (d) certificate of good standing; (e) record of registration; (f) partnership agreement or deed; (g) constitutional document; or (h) other relevant documents, data or information provided by a reliable and independent source (e.g. document issued by a government body).

3	Partnership or an unincorporated body	<p>For a customer that is a partnership or an unincorporated body, confirmation of the customer's membership of a relevant professional or trade association is likely to be sufficient to verify the identity of the customer provided that:</p> <p>(a) the customer is a well-known, reputable organisation;</p> <p>(b) the customer has a long history in its industry; and</p> <p>(c) there is substantial public information about the customer, its partners and controllers.</p>	
4	Trust or other similar legal agreement	<p>For a customer that is a trust or other similar legal arrangement, an AI should identify the customer by obtaining at least the following identification information:</p> <p>(a) name of the trust or legal arrangement;</p> <p>(b) date of establishment or settlement;</p> <p>(c) the jurisdiction whose laws govern the trust or legal arrangement;</p> <p>(d) unique identification number (if any) granted by any applicable official bodies and document type (e.g. tax identification number or registered charity or non-profit organisation number); and</p> <p>(e) address of registered office (if applicable).</p>	<p>In verifying the identity of a customer that is a trust or other similar legal arrangement, an AI should normally verify its name, legal form, current existence (at the time of verification) and powers that regulate and bind the trust or other similar legal arrangement by reference to documents, data or information provided by a reliable and independent source, examples of which include:</p> <p>(a) trust deed or similar instrument;</p> <p>(b) record of an appropriate register in the relevant country of establishment;</p> <p>(c) written confirmation from a trustee acting in a professional capacity;</p> <p>(d) written confirmation from a lawyer who has reviewed the relevant instrument; or</p> <p>(e) written confirmation from a trust company which is within the same financial group as the AI, if the trust concerned is managed by that trust company.</p>