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Redefining FinTech Compliances through Self-Regulatory Organizations in India

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Introduction

In today's rapidly evolving markets, characterized by technological advancements and information proliferation, effective regulation is essential. While ultimate regulatory responsibility lies with official regulatory bodies, the development of Self-Regulatory Organizations (SROs) is seen as a strategic move to enhance market integrity and effectiveness. SROs have varied formats across different global markets, often predating statutory regulation in various sectors.

SROs are voluntary bodies driven by their members, responsible for establishing self-regulatory organisations and enforcing rules to ensure fair, ethical, and efficient practices within their respective industries. Unlike mere industry associations, SROs actively oversee market participants, licensing firms engaged in market activities, and enforcing regulatory standards under the supervision of main regulatory bodies. They serve as the first level of regulation, fostering a disciplinary culture among industry players and assisting regulators in achieving their objectives. The main aim of implementing an SRO model for regulation is to minimize government intervention in industry operations while simultaneously promoting the natural, equitable, and ethical development of entities within the ecosystem.

Historically, the execution of self-regulation by SROs has not always been optimal. Nonetheless, SROs encompass a range of entities such as exchanges, associations, and depositories, playing crucial roles in maintaining market integrity. Prominent examples include the National Association of Securities Dealers (NASD) and National Stock Exchanges like the NYSE in the United States, Sa-dhan[2] and MFIN[3] for microfinance in India as well as the Investment Dealers Association (IDA)[4] in Canada. Beyond financial markets, effective SROs can also be found in other industries, such as the American Arbitration Association

[2] https://www.sa-dhan.net/

[3] https://mfinindia.org/

[4] https://www.osc.ca/en/industry/market-regulation/self-regulatory-organizations-sro/investment-industryregulatory/ida-rule-review [4] https://www.adr.org/

(AAA)[4] and American Medical Association (AMA)[5], where they establish performance standards, safeguard member interests, and work to fortify their respective sectors.

The main objective of the implementation of the SRO model for regulation is to create a robust framework wherein the state intervention is minimal in industrial operations while promoting equitable, organic and ethical growth of entities within the ecosystem. The initial initiation of the SRO model in regulation began when RBI had included Payment System Operators[6] under its purview. However, this approach faced criticism due to doubts originating about the SRO's independence and its being a toothless body.

Financial Inclusion through FinTechs

Access to financial services is pivotal for driving economic growth, alleviating poverty, and nurturing societal progress. However, a substantial segment of the global population remains underserved by conventional banking infrastructures, restricting their access to financial inclusion. In India, the banking and financial sector has undergone significant changes since the global financial crisis of 2008, largely driven by the emergence of fintech companies. Fintech has led to cost optimization, improved customer interaction, and streamlined transactions (Kanupriya Gupta 2023). Since 2010, fintech has played a vital role in decentralizing banking services, managing payments, transforming maturity, sharing risk, and allocating capital. Fintech firms now constitute the fourth segment of the Indian financial system, alongside large and mid-size banks, small finance banks, and regional, rural, and cooperative banks (Pervez 2022).

Fintech in recent times has disrupted the financial services realm, presenting new avenues for broadening access to financial products and services. Financial inclusion encompasses the availability, accessibility, and affordability of financial services to both individuals and businesses (Jain 2023). Fintech, through its innovative utilization of technology and data, holds the potential to reshape financial services fundamentally. By harnessing digital platforms, mobile devices, and advanced analytics, Fintech solutions can overcome the limitations of traditional banking systems, thereby facilitating the provision of financial services to previously marginalized individuals and businesses.

[5] https://www.ama-assn.org/

[6] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11986&Mode=0

SROs in FinTech

The G20 Financial Inclusion Action Plan (FIAP) report (G20 Financial Inclusion Action Plan 2023) promotes responsible, scalable, and affordable technology to enhance financial inclusion. It emphasizes the need for interoperable and reliable digital infrastructure to accelerate the provision of digital financial services. Fintech firms must act responsibly within regulatory boundaries and prioritize the interests of their customers. Public policy, both in India and globally, is focused on achieving universal financial inclusion through technology and expects firms to demonstrate responsible behaviour.

With numerous players entering the market and the rapid expansion of this sector, SROs have become an essential component of the fintech ecosystem. Establishing an SRO in the fintech industry can play a crucial role in **promoting accountability** and **responsible growth** within the fintech industry. It addresses concerns about market integrity, data privacy, cybersecurity, and risk management. SROs encourage **ethical practices and reduce misconduct**. Leading to a reduction in instances of misconduct among certain fintech entities, such as imposing excessively high-interest rates and engaging in harassment of borrowers. They impartially **oversee self-regulation,** ensuring compliance and imposing penalties when needed. SROs not only protect the interests of industry members but also play a crucial role in safeguarding the rights of workers, customers, and other participants within the ecosystem. Thus, SROs complement existing regulations and enhance the regulatory framework already in place.

Functions of SRO include:

- **Facilitating Communication:** SROs serve as a channel for communication between members and regulatory bodies such as the RBI, enabling dialogue in both directions.
- **Setting Standards:** They establish industry benchmarks and norms, promoting professionalism and upholding market integrity.
- **Education and Training:** SROs offer training for member personnel and organize awareness initiatives to promote best practices.
- **Resolving Disputes:** They institute consistent frameworks for grievance redressal and dispute resolution, ensuring fairness and efficiency.

Benefits of establishing SROs:

- **Sector Proficiency:** SROs bring industry expertise, enhancing discussions and educational ventures.
- **Establishes ethics:** SROs encourage ethical conduct, enhancing trust within the industry.
- **Monitoring:** They act as watchdogs, deterring unscrupulous and unethical behaviours within the sector.

Establishing an SRO is crucial for reducing the influence of unethical lenders, promoting ethical behaviour, improving lending infrastructure, and developing adaptable regulatory strategies. The FinTech SRO (SRO-FT) is envisioned to operate impartially, credibly, and accountably under regulatory oversight. Its primary objective is to promote healthy and sustainable growth of the fintech sector while facilitating a smooth transition to regulatory compliance when required. This collaborative and inclusive approach leads to the overall objective of nurturing a resilient and transparent financial ecosystem, emphasizing integrity and transparency.

Recognition of SROs by a regulatory body (RBI) in India

The Draft Framework released by the Reserve Bank of India (RBI)[7] seeks to establish and endorse a "self-regulatory" strategy, enabling the RBI to mobilize the innovative potential of FinTech companies while mitigating the unique risks they may pose to the financial system. To strike this equilibrium, the RBI has suggested forming an SRO, which, after receiving a formal acknowledgement (though not mandatory), would operate as a FinTech SRO (SRO-FT).

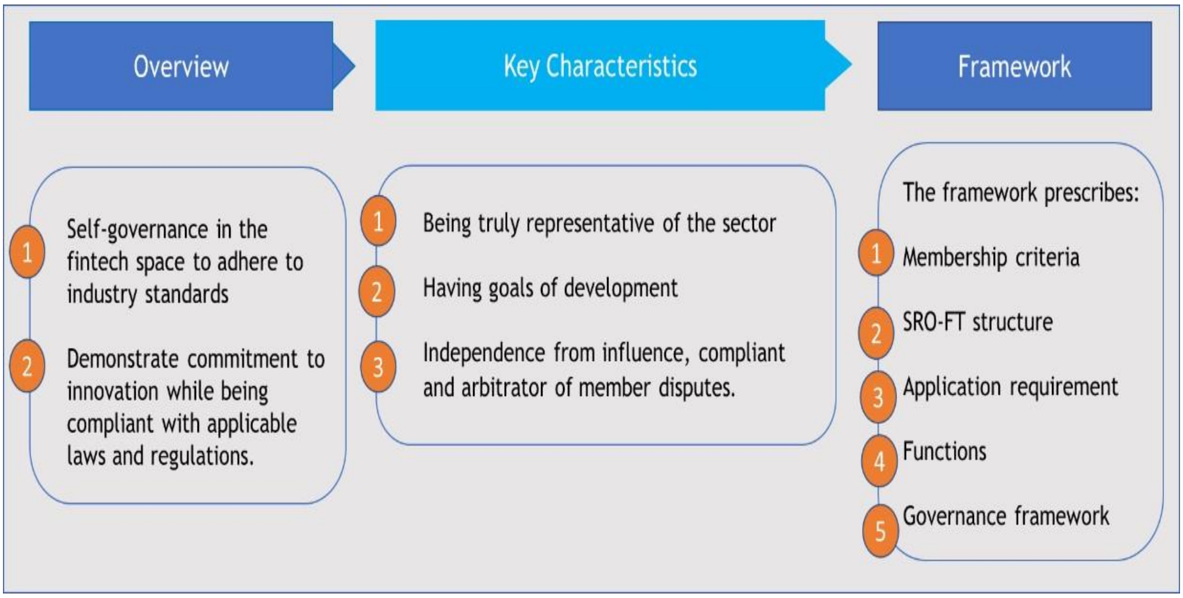

Fig 1: Overview of the draft framework of RBI for SROs

The RBI proposed SRO-FT (Deloitte 2024), outlined in the draft framework is widely being acknowledged by FinTech companies of India, as it is a positive step to offer invaluable guidance moving forward. Within this framework, FinTech firms anticipate benefiting from the SRO-FT's role as a mediator, facilitating

[7] https://rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1260

communication between its members and regulatory bodies such as the RBI (Abhishek Ray 2024). This collaborative approach aims to effectively tackle industry-specific challenges and establish a regulatory framework tailored to the unique needs of the FinTech sector. Additionally, planned training and awareness initiatives are expected to keep members abreast of industry advancements and regulatory compliance requirements. Further, consumers would especially gain from the SRO-FT, as it will establish ethical standards and ensure responsible practices among member firms, thereby safeguarding consumer interests.

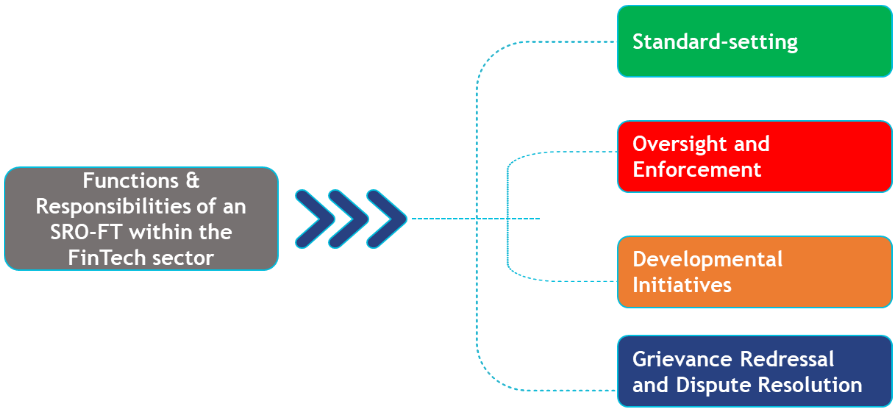

Fig 2: Functions & responsibilities expected from an SRO-FT within the FinTech sector

The Draft Framework mandates that an SRO-FT must fulfil the following responsibilities to the RBI:

- **Collective Representation:** Acting as the unified voice of its members in discussions with the RBI, addressing broader sectoral issues.
- **Information Sharing and Compliance:** Providing regular updates to the RBI on sectoral developments and member violations, ensuring adherence to regulatory standards.
- **Consultation and Collaboration:** Consulting with the RBI on taxonomy development, executing assigned tasks, and providing requested data.
- **Reporting and Engagement:** Submitting annual reports and periodic returns to the RBI, participating in interactions, and offering comprehensive insights into the FinTech sector.
- **Regulatory Oversight:** Allowing the RBI to inspect books and audits, and complying with RBI directives.

A broad eligibility structure for an entity in India to become an SRO-FT has been depicted through an infographic (Bhattacharjee 2024) below:

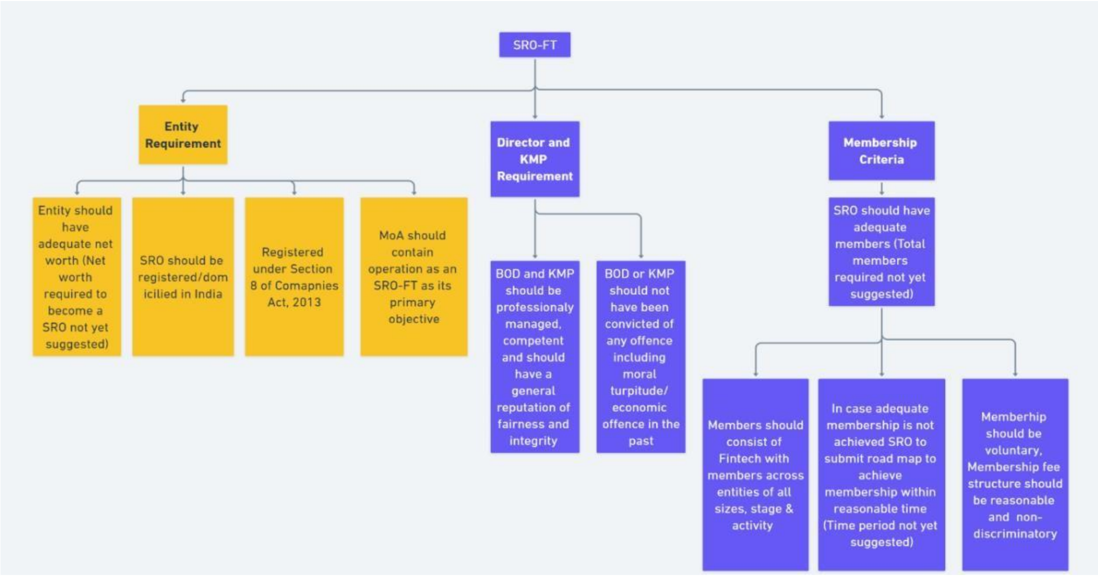

Fig 3: Eligibility criteria to become an SRO-FT in India, Source: (Bhattacharjee 2024)

The RBI may also prescribe such other conditions as may be required to ensure that the functioning of the SRO-FT does not become detrimental to the public interest.

Roles and responsibilities of an SRO

1. Ensuring adherence to industry standards and ethical conduct within the FinTech sector.
2. Promote responsible innovation while ensuring consumer protection, data security, and privacy.
3. Responsibilities include setting standards, rules, codes of conduct, and governance benchmarks.
4. Overseeing the FinTech sector through surveillance mechanisms, offering guidance on undesirable practices.
5. Promoting understanding of regulatory requirements, conducting training programs, and disseminating sector-specific information.
6. Encouraging research and development, facilitating responsible innovation and studies within the sector.
7. Establishing efficient frameworks for grievance redressal and dispute resolution among members.
8. Emphasizing customer education on FinTech products and services.
9. Acting as a bridge between the FinTech sector and the regulatory body, ensuring compliance with statutory and regulatory frameworks.
10. relaying sector-specific insights, addressing regulatory concerns, and contributing to the overall development of the FinTech sector.
11. Acting as the collective voice of its members in engagements with the regulatory body, prioritizing the sector's interests.

12. Maintaining transparency and equitable treatment for all members, promptly reporting any violations to the regulatory body.
13. Developing scalable technology solutions for detailed insights into FinTech entities' activities.
14. Collaborating with the regulatory body in developing and updating the taxonomy for FinTechs.
15. Carrying out assigned tasks, reviewing proposals, and supplying requested data to the regulatory body.
16. Regular reporting and periodic interactions with the regulatory body.
17. Allowing the regulatory body to inspect its books or arrange audits as required.
18. Discharging additional functions specified by the regulatory body and providing guidance on regulating entities in the FinTech sector.

A critique of the draft framework released by RBI

Self-regulation as suggested by an SRO, being reliant on self-funding, creates uncertainty in balancing stakeholders' conflicting interests. Dominant market players could potentially influence SRO structures by favouring their interests, pooling resources, and further marginalizing smaller players. This may result in autocratic practices by the dominant players such as market entry barriers, restrictive membership, and biased standards. Other possibilities include, excluding certain members from the market, SRO members might collaborate to create a regulatory environment favouring their interests, leading to under-regulation instead of overregulation (Karthika S. Babu 2024). The only oversight mechanism within the organization is independent directors, whose autonomy may be subject to debate. Ultimately, inefficient self-regulation could be a burden to the state regulators with the task of alleviating the resulting costs.

Determining the number of SROs shouldn't only focus on uniformity but also on coordinating the interests of all stakeholders. For example, In the US, multiple SROs alongside state and federal regulators demonstrate how a diverse regulatory ecosystem can represent various stakeholders' interests effectively. The draft framework should clearly outline the limitations of SROs' enforcement authority. Merely assigning and drafting SROs responsibilities with vague guidelines, such as the RBI's discretion on the 'fit and proper status' of applicants, risks introducing subjectivity and arbitrariness into the process.

Conclusion

Regulations don't directly encourage or discourage innovation, however, they can either promote or hinder it based on how regulators approach innovation. Traditionally, regulations are usually adjusted, and legislations are adapted before financial intermediaries can launch new products. However, this process can be slow, taking years and potentially rendering the regulatory framework outdated by the time it is finalized (Beck 2020). A regulatory approach that is open and adaptable is essential, emphasizing the establishment of a balance between promoting financial innovation and monitoring the anticipated risks.

Regulating the fintech sector is complex due to its diverse entities and activities. Relying on a single SRO may not be effective. Instead, categorizing fintechs into sectors and implementing specific regulations for each could be a better approach. However, in India, a few dominant players hold the majority of the market share, making it challenging to establish fair self-regulation. The draft framework released by RBI lacks measures to address this issue, leaving the responsibility on the sector to decide on the number of SROs, their establishment process, and governance mechanisms. Merely expecting SROs to act impartially and transparently isn't sufficient to address these concerns (Karthika S. Babu 2024).

Introducing a self-regulatory system in India's fintech sector is complex given the current market dynamics. While the RBI's initiative is welcomed, uncertainties remain regarding the effectiveness of SROs. Since SROs derive their authority from members' consent, their performance over time will determine market trust. RBI must proactively oversee SROs due to the possibility of regulatory failures, as seen in the UK and Canada. The RBI needs to coordinate and further regulate to establish the SRO model effectively. Coordinating with unregulated players like payment service providers and technology service providers poses an additional challenge. Effective communication and coordination between SROs and the RBI are essential for overcoming self-regulation challenges. The framework's primary endeavour should be to establish a feedback system benefiting both SROs and consumers. A sustainable ecosystem should be developed wherein RBI could potentially regulate the self-regulators which could help the SROs function fairly and transparently.

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