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SECURITIES BROKING COMPANIES

Facility for blocking of funds for trading in secondary markets – Favourable proposal by SEBI

JANUARY 2023

Highlights

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- The Securities and Exchange Board of India (SEBI) released a consultation paper on January 17, 2023 on the introduction of a facility for the blocking of funds for trading in secondary markets. This is another step by the regulator in its continuous endeavour to strengthen investor confidence in the capital market infrastructure by adequately protecting their funds and securities from the possibility of misuse/default by a stockbroker.

- SEBI has proposed that the Unified Payments Interface (UPI) mandate service of single block and multiple debits can be integrated with the secondary markets to provide a block mechanism. Under this, funds shall remain in the client's account but will be blocked in favour of Clearing Corporation (CC), which can debit funds from the client's account, limited to the amount specified in the block. While the UPI block, upon creation, shall be considered towards the collateral, the same shall also be available for settlement purposes. As a result, settlement will be done directly by CC with clients for funds and securities.

- The aforesaid proposal is a step in the right direction with the regulator aiming risk mitigation through disintermediation. The proposed framework eliminates the need to transfer funds to the brokers and hence safeguards investors' assets. Also, the amount that is transferred to the stockbroker for trading in secondary markets will remain in the investors' bank account and can earn interest for the investor.

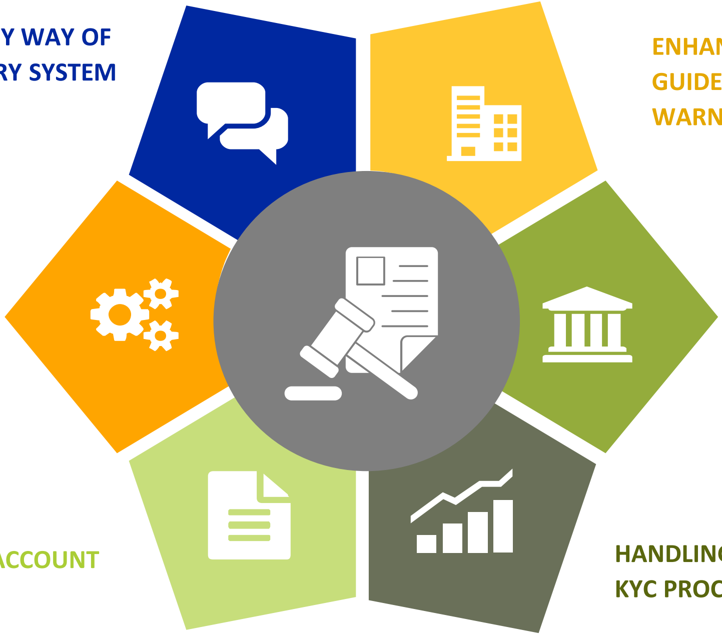
- This will, however, impact the float available with brokers and hence the interest income on float. Accordingly, brokers may have to increase brokerage charges to offset the impact. This will also result in an increase in the working capital requirements and borrowings of brokers as some brokers partially use clients' funds for placing margins on bank guarantees (BGs), and such BGs are placed with CC. Besides this, investment in developing the necessary interfaces will go up. Thus, the trend of consolidation in the broking industry is expected to continue with smaller broking players ceding market share to more established broking entities. Nonetheless, brokers will not be required to allocate any collateral for clients under the UPI block facility since CC will directly maintain/update the client collateral value. This may lower compliance burden on brokers. Overall, the proposal, if implemented, will strengthen the industry structure further and improve financial discipline, which is critical, given the fiduciary responsibility of brokers.

SEBI has been taking steps to strengthen the regulatory framework for securities broking entities

With issues related to fraud and mismanagement by some brokers coming to light, SEBI has, over the past few years, taken steps regularly to strengthen the regulatory framework for securities broking entities to enhance the monitoring of stockbrokers, protect investor interest, and increase discipline in the industry. This has been imperative for retaining investor confidence.

MARGIN OBLIGATIONS TO BE GIVEN BY WAY OF PLEDGE/RE-PLEDGE IN THE DEPOSITORY SYSTEM

ENHANCED OPERATIONAL AND MONITORING GUIDELINES TO ENSURE DISCIPLINE/EARLY WARNING MECHANISM



COLLECTION AND REPORTING OF MARGINS IN CASH SEGMENT/PEAK MARGIN RULE

PREVENTION OF UNAUTHORISED TRADING/ UNIQUE CLIENT CODE

50% CASH MARGIN RULE/RUNNING ACCOUNT SETTLEMENT

HANDLING OF CLIENT SECURITY/ KYC PROCESS AND USE OF TECHNOLOGY

Source: sebi.gov.in, ICRA Research; KYC – Know your customer

Multiple guidelines for achieving individual client collateral segregation have been implemented

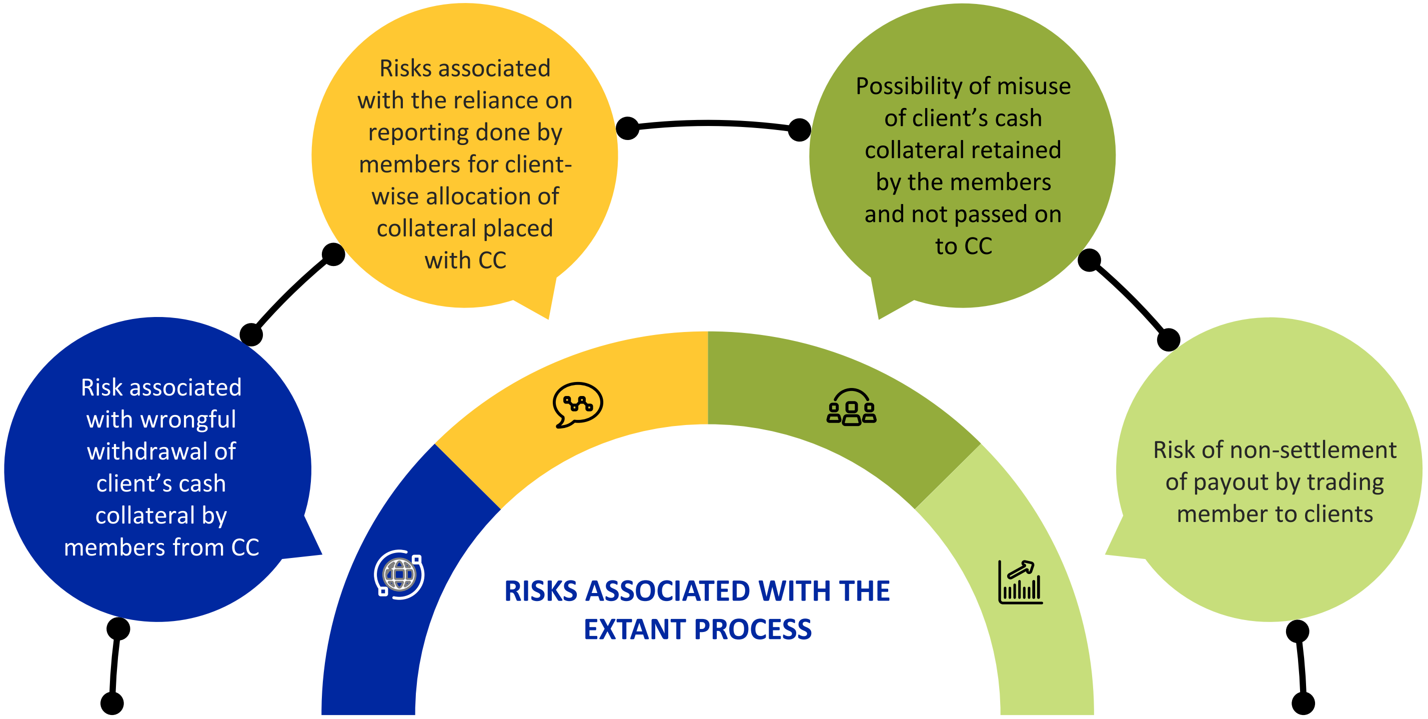
The margin pledge/re-pledge mechanism (specified vide SEBI circular dated February 25, 2020) was introduced from June 2020. Herein, an investor pledges securities in favour of the stockbroker, who re-pledges it to the Clearing Member (CM), while the CM can re-pledge the same to CC, with the investor's securities remaining in his demat account. This eliminates the possibility of misuse since the securities are not transferred to the stockbroker and remain in the client's account.

Guidelines regarding collateral reporting and disclosure (specified vide SEBI circular dated July 20, 2021) were introduced, whereby members are required to disclose (October 2021 onwards) on a daily basis, client-wise and asset-wise, the amount of collateral received by them from the clients, the amount of collateral retained by them, and the amount passed on to CC. Investors can access their respective information, thus providing them with transparency.

The collateral allocation mechanism (specified vide SEBI circular dated July 20, 2021) was implemented from May 2022, which requires the members to provide client-wise allocation of eligible cash and cash-equivalent collateral placed with CC at all times, through a real-time collateral allocation system. With this, CC can ensure that the collateral belonging to a client is used only towards that client's obligations. However, such segregation is based on information provided by the member.

Source: sebi.gov.in, ICRA Research

However, possibility of misuse of client's collateral remains



Source: sebi.gov.in, ICRA Research

SEBI has proposed risk mitigation through facility for blocking of funds for trading in secondary markets

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Proposal

- SEBI released a consultation paper on January 17, 2023, on the introduction of a facility for the blocking of funds for trading in secondary markets
- The proposal is that the UPI mandate service of single block and multiple debits can be integrated with the secondary markets to provide a block mechanism
- Under the proposed framework, funds shall remain in the client's account but will be blocked in favour of CC, which can debit funds from the client's account, limited to the amount specified in the block
- While a UPI block shall be considered towards the collateral, upon creation, the same shall also be available for settlement purposes – the block can be debited multiple times, subject to available balance
- Settlement will be done by CC directly with clients for funds and securities, without any need to go through the pool account

Impact on investors

- ⬆ Will eliminate the need to transfer funds to the brokers, thereby enhancing protection of cash collateral
- ⬆ Amount, which gets transferred to the stockbroker for trading in secondary markets, will remain in the investor's bank account and earn interest for the investor
- ⬇ Brokerage charges can increase as stockbrokers may look to offset the impact of reduced float income

Impact on brokers

- ⬇ Float available with stockbrokers will be impacted, thereby resulting in a decline in interest income. Brokers may have to increase brokerage charges to offset the impact. However, bank brokers are already using fund blocking model in bank account of customers and hence should not be adversely impacted.
- ⬇ Working capital requirements of brokers will increase. This may also necessitate upward revision in brokerage charges
- ⬆ Stockbrokers will not be required to allocate any collateral for clients under the facility of UPI block since the CC will directly maintain/update the client collateral value based on the blocking information received from the National Payments Corporation of India (NPCI) through the CC's sponsor bank. This may lower compliance burden of stockbrokers
- ⬇ Stockbrokers shall be required to invest in developing the necessary interfaces to initiate/check the status of the blocking request

Source: sebi.gov.in, ICRA Research

Proposed UPI block facility will, however, be optional for investors

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- An investor can choose to avail UPI block facility under some broker(s) and non-UPI based trading under others
- However, once UPI block facility is selected under particular broker(s), following requirements will be necessitated in view of proposed direct settlement by CC with the investors and to provide settlement visibility to CC at all times at the client level
  - All cash collateral will have to be provided only through UPI block
  - Cash equivalent collateral, such as BGs and fixed deposits, will not be permitted
  - Securities collateral will be provided through pledge/re-pledge system and only those securities can be provided which are in the approved list of CC
  - Funds pay-in settlement to be done only through UPI block

- In our view, there can be some rule-based objective criterion, which could be specified by the regulator. These could be the frequency of trading intensity or the annual trading volume or both for the compulsory migration of investors to the UPI block facility to improve the migration of customers. While it could be relatively easier for investors of discount brokers, brokers offering online platforms and bank brokerages where the investors could be tech-savvy and familiar with the nuances of the UPI block, challenges could remain for migrating other customers. Some temporary incentives could be provided to investors for the faster adoption of the UPI block

Source: sebi.gov.in, ICRA Research

Notwithstanding direct settlement between an investor and CC, securities brokers to remain an important intermediary

- Despite the direct settlement between the investors and CC, securities brokers will continue to maintain their importance as an intermediary because of other value-added services offered by them such as customised interface, research offerings, margin trading facilities, etc

- Receivable and payable positions of the brokers could reduce as such transactions will not possibly reflect on their balance sheets. Cash holdings of brokers may decline as such cash balances will now be held in the accounts of the investors

- Margins placed by brokers on stock exchanges (cash/BGs) may decline; however, fund-based borrowings could go up as brokers may need to borrow to place cash margins on residual BGs, which may have been placed previously using client funds

- Notwithstanding the UPI block by CC for an investor, if the broker allows a higher trading position to the investor, the broker will be responsible for the settlement risk for such investor beyond the UPI block by CC

Source: sebi.gov.in, ICRA Research

Illustrative scenarios (1/2)

	Current process	Proposed process
Prefunded purchase by client	▪ Client transfers Rs. 150 to member ▪ Member may retain the client's funds with itself and allocate collateral to the extent of 20% of the margin requirement at CC ▪ Client purchases a share for Rs. 100; the margin collection requirement is Rs. 20, which is blocked from client's allocation ▪ Collateral is released after the member completes the net settlement with the CC	▪ Client creates a block of Rs. 150 in favour of CC. The amount will get allocated as collateral ▪ Client purchases a share worth Rs. 100. The margin requirement is Rs. 20, which will get adjusted from the block ▪ Securities Transaction Tax (STT) and stamp duty will be 11 paise, which will be added to the client's obligation. CC will debit Rs. 100.11 towards settlement at the stipulated time ▪ With the successful debit from the client, the securities receivable by the client will be provided in the client's depository account directly by CC at the time of settlement
Intraday cash market/derivatives trading	▪ Client provides margin money to the member. Client carries out intraday trading or trade in derivatives. There are no exchange-of-value delivery obligations, but only losses or gains. Losses will be deducted from the margin money given by the client and gains may be added to the margin money of the client or paid out	▪ In case of losses, CC will debit the block to the extent of losses towards client pay-in ▪ In case of gains, the payout will be given by CC to the client account. CC shall not add the payout to the trading capital (collateral) of the client, and, if desired, the client will need to create another block

Source: sebi.gov.in

Illustrative scenarios (2/2)

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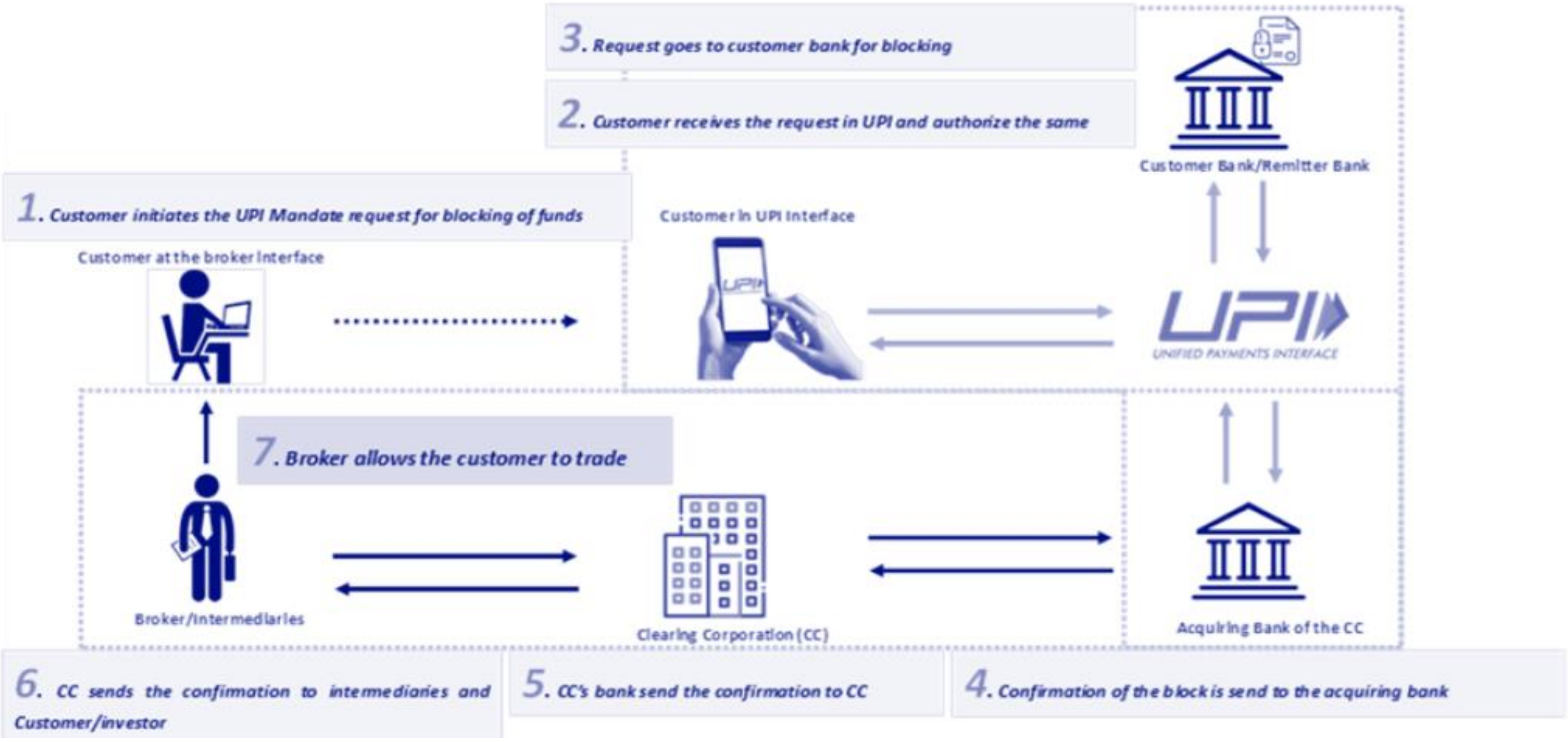
	Current process	Proposed process
Delivery sale by client via early pay-in	▪ Client uses EPI block mechanism for early pay-in ▪ Such early pay-in information is received by CC from depositories ▪ Sell order is executed on behalf of the client ▪ If sell order is executed after early pay-in, then no margin is applicable at any time. However, if early pay-in is received after execution of the sell order, the proprietary collateral of the member will be blocked till the receipt of the early pay-in ▪ While providing payout to the client, the member may adjust other statutory dues (stamp duty, STT), brokerage, etc	▪ Client will provide securities as early pay-in through the EPI block mechanism only ▪ If the early pay-in information is received from the depository before trade execution, there will be no margin. If the information is received subsequently, the proprietary collateral of the member will be blocked till the receipt of early pay-in ▪ Since the client has completed the settlement, CC shall pay out funds directly to the client account. While providing the fund payout, CC will deduct the STT and stamp duty
Purchase/sale by client supported by margins	▪ Client provides 20% margin to the member. Client can execute trades based on the margins on trade date. Client will need to provide the remaining 80% (in case of purchase) or deliver the security (in case of sale) till the applicable settlement deadline	▪ Client may create only partial block to the extent of margin instead of entire upfront value or EPI block. Client will need to provide additional block or EPI block till the stipulated time. Further process will be same as discussed in earlier scenarios

Source: sebi.gov.in

Proposed transaction flow



Source: sebi.gov.in

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Thank You!