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SECURITIES BROKING COMPANIES

Working capital requirement to increase as SEBI prohibits intermediaries from furnishing bank guarantees by pledging clients' funds

APRIL 2023

Highlights

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SEBI bars creation of BGs out of clients' funds; existing BGs created out of clients' funds to be wound down by Sep 30, 2023

Move to further fortify investor interest; however, increase in brokerage charges is likely

Working capital requirements of SBs to increase; industry consolidation to continue as small brokers with limited own capital likely to be impacted the most

- On April 25, 2023, the Securities and Exchange Board of India (SEBI) issued a circular prohibiting stockbrokers (SBs) and clearing members (CMs) from creating bank guarantees (BGs) out of clients' funds. This is another step by the regulator to strengthen investor confidence in the capital market.

- The directive prohibits SBs from creating any new BG from clients' funds starting May 01, 2023. It also requires SBs/CMs to wind down any such existing BGs by September 30, 2023. Further, the directive imposes an obligation on stock exchanges and clearing corporations to monitor BGs created using clients' funds and the subsequent phase-out process, with the aim of ensuring uninterrupted services for clients. The directive aims to address the issue of implicit leverage used by some SBs to enable their clients to overtrade. The provisions of this directive are, however, not applicable for the proprietary funds of the intermediaries in any segment and the SB's proprietary funds deposited with a CM in the capacity of a client.

- Brokers and CMs who were using BGs created out of clients' funds would witness an increase in the financing cost associated with higher working capital requirements, thereby impacting their profitability. The impact would likely be more prominent for small brokers who were also using this implicit leverage to support their clients in meeting shortfalls in their cash margin requirements. Conversely, market participants (like bank brokers), who traditionally did not depend on such arrangements, are likely to witness an improvement in their competitive position. 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.

- While the new measures may lead to some short-term disruptions for traders and investors, thereby impacting broking volumes to some extent, they are expected to have a positive impact on the capital market in the long run by ensuring greater transparency, reducing overtrading, and protecting investor interest.

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

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With issues related to fraud and mismanagement by some brokers coming to light, SEBI has taken steps regularly to strengthen the regulatory framework for securities broking entities to enhance the monitoring of SBs, protect investor interest, and increase discipline in the brokerage industry

ENHANCED OPERATIONAL AND MONITORING GUIDELINES TO ENSURE DISCIPLINE

In September 2016, SEBI issued a circular, standardising the monitoring guidelines for intermediaries. The guidelines sought to curb the misuse of clients' funds, whereby brokers shall not use clients' funds and securities for proprietary purposes.

PREVENTION OF UNAUTHORISED TRADING

In September 2017, SEBI directed SBs to document adequate evidence for transactions undertaken on behalf of clients. This was in line with its endeavour to curb the misuse of clients' funds.

HANDLING OF CLIENT SECURITY

In June 2019, SEBI further strengthened the guidelines regarding the handling of clients' securities. Securities held in the client' collateral account, client margin trading securities account and client unpaid securities account shall not be pledged/ transferred for raising funds by the broker.

COLLECTION AND REPORTING OF MARGINS IN CASH SEGMENT/PEAK MARGIN

In November 2019, SEBI introduced guidelines on margins in the cash segment to align the framework with derivatives, which was a shift from the practice of collecting margin as per brokers' policies. Thereafter, another circular was issued in July 2020. The peak margin rules require investors to maintain margins based on the maximum value of the positions taken during the day.

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

In February 2020, SEBI introduced a circular to prevent the misuse/misappropriation of clients' funds/securities. Trading/clearing members can accept collateral from clients in the form of securities only by way of a margin pledge.

50% CASH MARGIN RULE/RUNNING ACCOUNT SETTLEMENT

In 2021/2022, to protect investors from market volatility and excessive leveraging, the 50% cash margin rule was introduced in the derivatives segment. Also, the settlement of a running account of funds is to be done at least once within a gap of 30/90 days as per client preference.

Source: sebi.gov.in ICRA Research

To safeguard investor interest further, SEBI prohibits intermediaries from creating BGs by pledging clients' funds

Currently, a few SBs and CMs pledge their clients' funds with banks, which, in turn, issue BGs to the clearing corporations for a larger amount (typically 2x). This implicit leveraging increases the exposure of the market, and more importantly, exposes the funds of the clients to potential risks.

To address this issue, SEBI has barred SBs and CMs from creating BGs by pledging clients' funds starting from May 1, 2023. Existing BGs created out of clients' funds shall be wound down by September 30, 2023.

Stock exchanges and clearing corporations shall verify the compliance of the provisions of the circular in their periodic inspections/reporting. They shall also create adequate mechanisms to address cases of brokers and CMs failing to comply with the provisions of the circular by the stipulated dates.

Provisions of this framework shall not be applicable for the proprietary funds of brokers and CMs in any segment and brokers' proprietary funds deposited with a CM in the capacity of a client.

Source: sebi.gov.in ICRA Research

BGs created out of clients’ funds have been used by some intermediaries for working capital requirements

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SUPPORT SHORTFALL IN CLIENT’S CASH MARGIN REQUIREMENT, BASIS ADEQUATE NON-CASH COLLATERAL

MAINTAINING BUFFER IN MARGIN UTILISATION

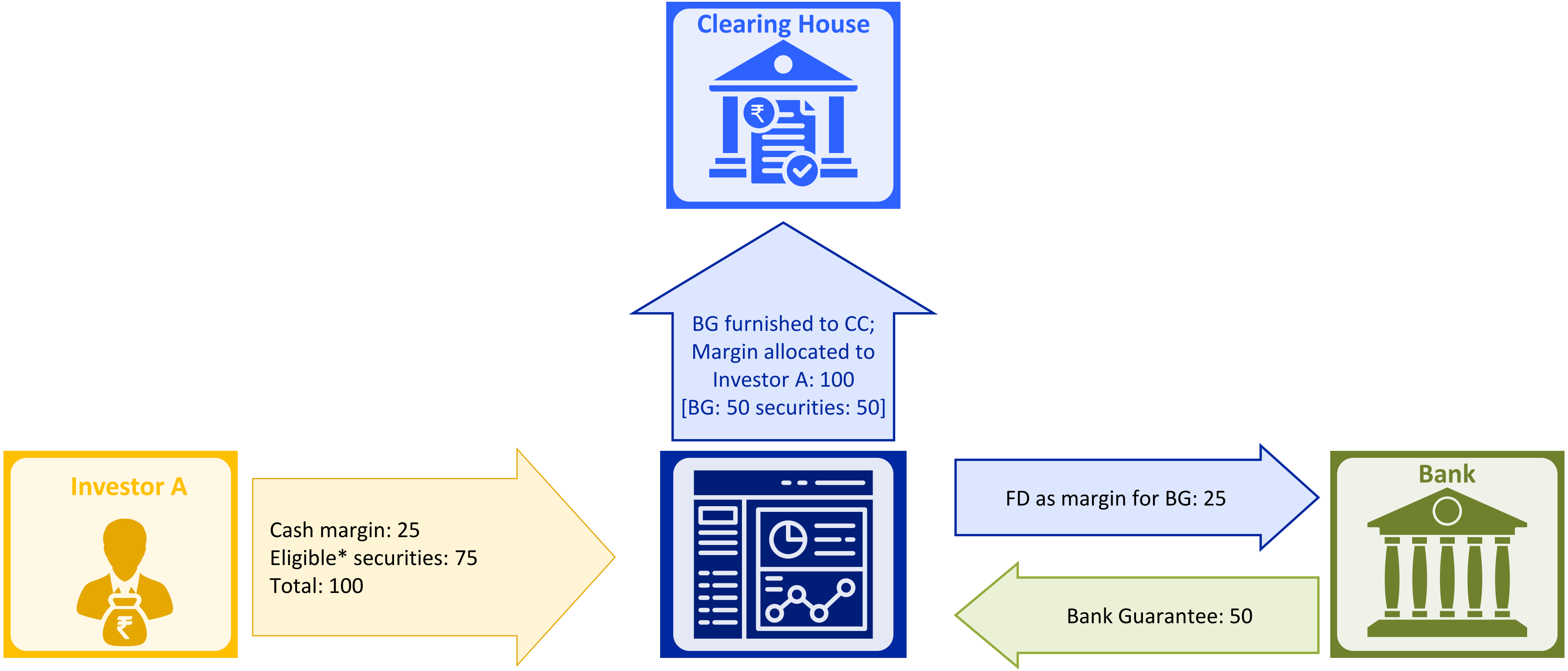
TIMING MISMATCH BETWEEN FUND FLOW/COLLATERAL PLEDGE AND TRADE EXECUTION

USE OF UNFUNDED PORTION OF BG MARGIN FOR PROPRIETARY TRADING, IF UNDERTAKEN BY A BROKER

MARGINS AGAINST UNAPPROVED/INELIGIBLE SECURITIES; INSTANT LIMIT AGAINST SALE OF SECURITIES

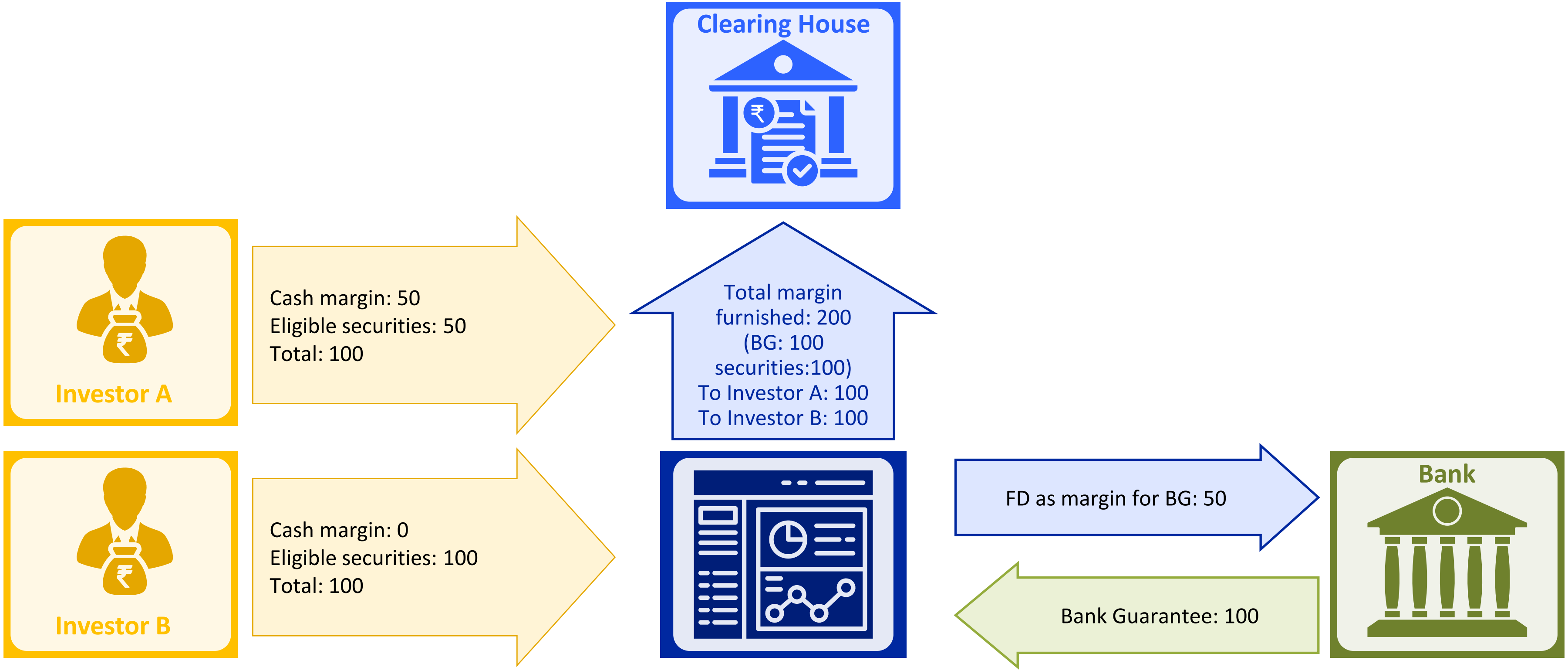
Source: sebi.gov.in ICRA Research

Illustration 1a: Support shortfall in client's cash margin requirement, basis adequate non-cash collateral



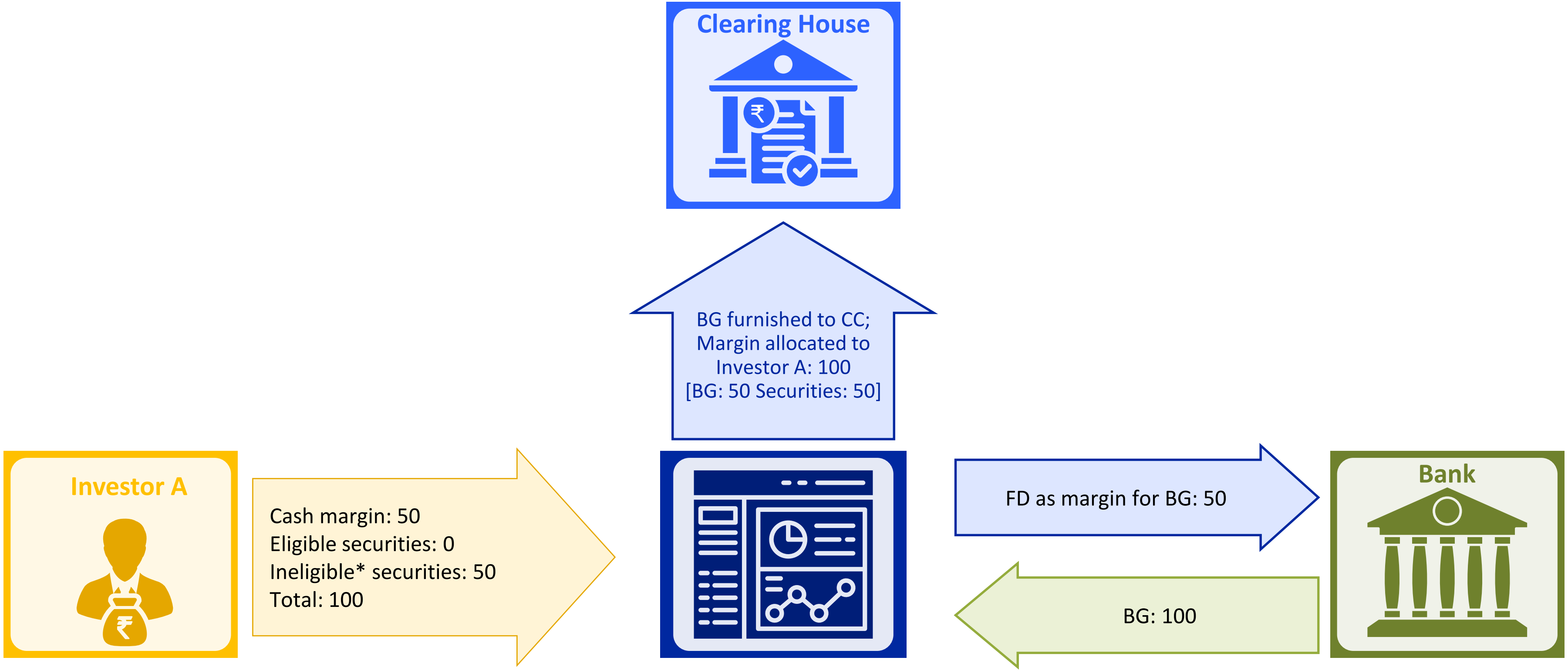
*Source: ICRA Research; *Members are required to provide liquid assets, which adequately cover various margins. A member may deposit liquid assets in the form of cash, BGs, fixed deposits (FDs), approved securities (after haircut). The total liquid assets comprise the cash component and the non-cash component, wherein the cash component shall be at least 50% of liquid assets. For the non-cash component, members are permitted to pledge Liquid (Group I) Equity Shares. The clearing corporation may revise the list of approved securities and the haircuts from time to time*

Illustration 1b: Support shortfall in client's cash margin requirement, basis adequate non-cash collateral



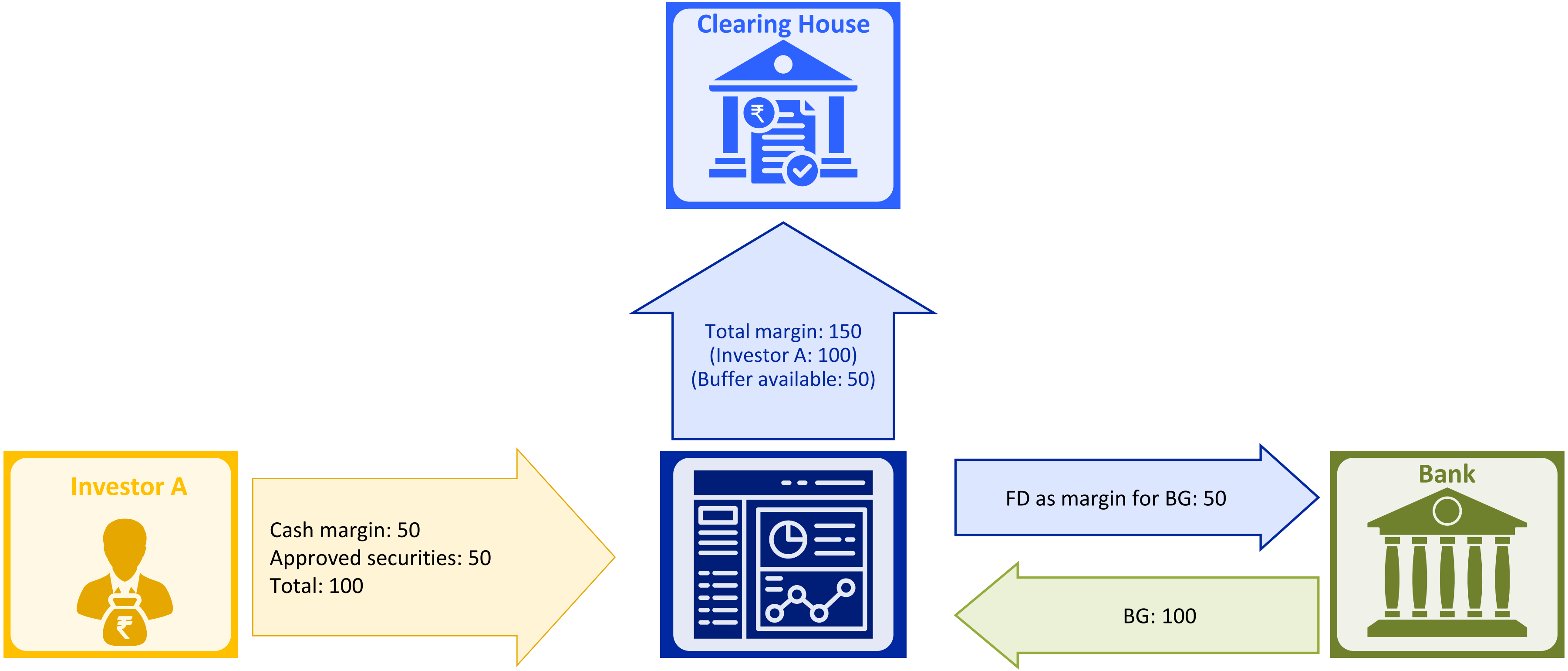
Source: ICRA Research

Illustration 2: Margin against ineligible* securities



*Source: ICRA Research; *For non-cash component of margin, members are permitted to pledge Liquid (Group I) Equity Shares. The clearing corporation may revise the list of approved securities from time to time. Besides the securities outside the approved list, approved securities from the aforesaid list can be ineligible in circumstances wherein the associated market-wide/broker-level caps are breached; Note: Brokers may also charge the clients for extending margin support illustrated above*

Illustration 3: Maintaining buffer^ in margin utilisation



*Source: ICRA Research; *As a part of the exchange's risk management systems, the trading terminals of an intermediary are constantly monitored and are automatically set into a square-off mode once the margin utilisation of the terminal exceeds 90%. To avoid such instances, the intermediaries maintain a buffer for avoiding terminal freeze during periods of high volatility or any other instances which lead to a spike in margin utilisation. In fact, as a prudent risk management philosophy, intermediaries endeavour to maintain a buffer and operate at a margin utilisation of typically less than 70%*

Higher working capital needs may impact industry's profitability, though it would benefit from enhanced transparency and investor confidence in the long term

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Impact on investors

Investor confidence is likely to improve with higher transparency in the use of clients' funds; investor funds will not be subjected to implicit leverage or other risks.

Following the implementation of the new framework, investors who had previously relied on additional cash collateral support from brokerage firms will now be required to provide more funds or cash collateral upfront for trading purposes. However, this is anticipated to reduce instances of overtrading and promote better financial discipline among investors.

Investors are likely to witness higher brokerage charges due to increasing working capital requirements and associated finance costs for brokers and CMs.

Impact on brokers/CMs

Brokers and CMs, who were using BGs created from clients' funds, would need to borrow funds or infuse additional own capital. This is likely to result in higher finance costs and hence profitability pressure. Conversely, market participants (like bank brokers), who traditionally did not depend on such arrangements, are likely to witness an improvement in their competitive position.

Brokers, who previously relied on implicit leverage to meet the cash collateral margin requirements of clients, may observe a decline in broking volumes. Particularly, smaller brokers with limited net worth and borrowing avenues will be impacted. This will necessitate upward revision in brokerage charges.

With the rising cost structure of the broking industry, the trend of consolidation in the industry is expected to continue with smaller broking players ceding market share to more established broking entities. While the implementation may impact the operations of a few market participants in the short term, the brokerage industry is likely to benefit from the enhanced transparency and reinforced investor confidence in the longer term.

Source: sebi.gov.in, ICRA Research

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Thank You!