Custodians for Indian Retail Investors?

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PIVOT in July 2014 *advocated settlement of Secondary Market transactions through* ***custodians for India's HNIs (High net worth Individuals****). The note was also shared with the senior management of a leading Capital Market Institution. In our paper of 2014, we advocated that given an increasing need to protect retail Investors, ensure multiple and diverse benefits to Investors, SROs, Intermediaries, SEBI could consider mandating settlement through Custodians for HNIs as a yet significant step in developing the Capital markets. Reproduced is the note of 2014, updated by a few aspects.*

Economic Times, June 12th, 2018 Mumbai Edition reported on its front page," **SEBI weights Custodians to shield Retail Investors"**!!!

<u>Fast paced multiple changes and complexities thereof</u>

Non- institutional Indian Investors (retail), since 1875 have been settling their equity trades through brokerage firms embraced complex products and the multiple settlement systems. Indian capital market expanded, became diverse and complex. SEBI and SROs ensured that Risk management in geographically daunting India worked well, even as banking services is evolving. This was when banking was not developed, professional clearers did not exist, most brokerages were local based members of single exchanges / Clearing Corporations, and clients looked at brokerages as one stop shop in absence of viable alternates. Clearing Corporations permit clearing participants (PCMs-Custodians/ Banks) to settle the trades of the Institutional clients.

Multiple products led to multiplicity in each of the following- regulators; rules, regulations and byelaws; exchanges; depositories; clearing corporations; segments (equity, ETF, derivatives, commodities, fixed income etc.); settlements systems; locations; operational requirements, intermediaries etc. Multiplicity added risks, complexities, higher costs, inefficiency, to an extent hindering growth of the capital market and intermediaries and sometimes compromises in investor protection measures.

HNI (High Net Worth Individual) trades have grown significantly and will continue to grow, fueled by multiple opportunities, larger IPOs, fast-growing economy, more investible surplus, active secondary market, sharp increase in nos of HNIs etc. Category III FPIs (Foreign Portfolio investors) includes Individual Investors, Trusts etc. SEBI requires that they appoint a Custodian in India as a pre-requisite for investing in India.

Custodians role:

The SEBI regulated 18 custodians (of which eleven are Single Country(India) Custodians(SCCs)) armed with sophisticated settlement capability, skilled resources, pan- India presence, robust technology have helped derisk the settlement wrt Institutional trades. These institutions possess financial withdrawal to effect better practices than most brokerages and thereby have made the system more secure. Being independent, they have been trusted by the large institutions, Exchanges, Clearing corporations etc. In the interim there have been cases where the brokers have failed to settle the trades thereby putting investor's interest to risk.

<u>Current challenges - multiple settlement system</u>

While trading systems are similar whether for Institutional or Non- Institutional clients, the challenge is the multiplicity of settlement systems as also distinguished by Institutional and non –Institutional. Challengesl:

1. **Brokerages**: Brokerages deal in multiple segments- Institutional, PMS, Retail: Hence need to have team that settle with PCMs (in case of Institutional), with Clearing houses (non- Institutional). Multiplicity adds operational complexities while multiplying operational risks, costs, operational inefficiency, and paucity of staff specialized in settlement of multiple segments as new segments add. Geographical spread contributes to the complexity, together with ever changing requirements- operationally or technologically. Ever evolving

banking processes, longer working hours of exchanges, tight cutoff times of clearing houses and a separate one by depositories and banks, lack of interoperability between Clearing houses, varying client segment and their needs are other challenges adding to costs.

Client failures to fund margins lead to greater financial stress on Brokerages, who may pass on this to clients through higher costs of trading. Brokers maintain additional margins to settle the trades of their Non-Institutional Clients. Settlement infrastructures at Brokerages are being tested, failures lead to auctions. In some cases, default in meeting settlement obligations leads to bigger crisis.

2. **Custodians**: A separate process for HNI derivatives settlements, another one for all segments in case of Institutional clients while co-coordinating with Clearing Corporations; however, wrt equity settlements for the non- institutional clients they interact with the Clearing Participant (most often a broker!). The duality confounds the client and custodian and also impacts settlement /flow of cash wrt to Derivatives and Equity (being manned by separate entities). This adds to costs to investor disadvantage.

3. **Clearing banks**: Huge payin and payout put pressure on banks for clear funds at Central Bank (RBI).

4. **Clearing Corporations**: Ever increasing creation of multiple codes (equities, derivatives etc); Significantly large nos of CP codes (as brokers too have CP codes); delay in settlements or significantly larger auctions; additional costs on account of above; stress on settlement guarantees on account of broker exposures to settlements are some of the challenges.

5. **Clients:** Risk of client being required to keep large balances with broking house towards margin, wherein brokerage may use clients fund to cross margin between its own client and own trades.

Merits if Custodians settle HNI, AIF trades:

Such a practice de-risks and expands the Capital market, lends greater transparency, consistency with policy for Category III FPIs and greater governance. It leverages on better practices of professional clearers. Current laws don't prohibit settlement of trades by custodians. Thus, no Regulatory change needed.

Institutional Clients: No change in status. No adverse impact
Non- Institutional client: Assured third party settlements; seclending; No exposure to Brokers; Confidentiality of settlements, Investors benefit from multiple services custodians offer vs what broker can provide, better MIS. Client need not keep margin with each broker they intend to trade. Reduces client risk of trading through single broking house
Clearing Corporations: More standard practices; additional revenues, lesser nos of participants to deal with; Significantly reduces the cost of multiple settlement practices; separate lower charges possible; Leveraging on existing structure; lesser run on the Exchange guarantee fund. Pledged stock and margin funding can be settled without any additional risk as stock and money flows directly to lender/financer
Depositories: Less pressure on the system
Custodian: Additional AUC; utilization of capacity; extension of current practices; seclending; offer variety of products, new revenue line, more integrated services to existing (derivatives settlements) and new clients; better client confidentiality
Brokers: Significantly reduced Operational costs; brokerages concentrate on core business- Research, Trading and Investment advice; reduce tech costs; not leveraged for quality operational people; follow global norms, lesser impact on account of attrition of Operations resources
Exchanges: Settlement less risky; faster products to market (unlike waiting for brokerages to effect change), adds to risk management measures; Greater investor protection; Standardization of practices
Banks benefit: Pledged stocks settled directly between bank and clearing corporation leads to less risk
Tax Authorities: Concentrated settlements help to generate MIS of gains and losses
Issuers of PMS products: Single entity to deal with for settlement of trades; lesser nos of specialized operations teams needed; reduce costs; secure settlements; better client service

To summarize: It is important to note that a major share of Indians Retail sector is small ticket sized and thus rolling out for Non-HNI investors will significantly add costs with no corresponding benefits to the Investors and to the involved Intermediaries. Can Depositories like CDSL, NSDL perform this function? In our opinion -NOT- as the roles, competencies and requisites are quite different and would lead to further fragmentation with no benefits.

We advocate that given the multiple and diverse benefits to Investors, SROs, Intermediaries, SEBI could consider mandating settlement through Custodians for HNIs. It's our belief that a majority of the Custodians, especially the 11 SCCs are well equipped to service this new class of Clientele.

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The article forms part of PIVOT Management Consulting's thought leadership notes on Ease of doing business in Indian Capital Market. Contributions: India's Pivotal Single Country Custodians; India- Gods own country for FPIs? - Vanishing Mysticism, Enabling Ease; Collateral Challenges and other pressing topics in European Markets; Attracting FPI Investors: Fixing Perceptions, Driving Solutions; Custodian Bank-India adopting Global Trends.

Forthcoming notes on: Growing the SME space faster; Attracting FPIs- Staving challenge from other jurisdictions , Reviving the ADR/GDR market in wake of foreign listings.