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**Settlement of Secondary Market transactions through custodians for India's non institution investors: The need**

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Indian Capital Market Regulator, Securities Exchange Board of India (SEBI) is examining the possibility of introducing T+1 settlement. Ambitious as it may seem, Indian Capital markets have evolved significantly over the last two decades. A mere US$200 million Market Cap in the early nineties, the market cap presently exceeds US$2.3 Trillion. From a single product, retail driven market, it has been replaced by a multi- segment diverse market with an equal play by institutional Investors including foreign Investors. Introduction of risk management, tight settlement schedules, tech driven, digital banking, low-cost access, greater emphasis on straight through processing, investor education and more, resulted in the change, driven mostly by the Ministry of Finance, Capital market Regulator, Securities Exchange Board of India (SEBI) and actively supported by the Intermediaries. Governance, attractiveness and ease of doing business significantly increased.

The continuous and increased need and focus on protecting retail Investors, to increase their participation from the current 4% to say 10% in next 5-10 years horizon demands - new solutions including mandating settlement through Custodians for Non-Institutional Investors as a significant next step.

Notwithstanding the fast-paced multiple changes and complexities, Non-institutional Indian Investors (retail), since 1875 settle their equity trades through brokerage firms while embracing complex products and multiple settlement systems. The Indian capital market expanded, became diverse and complex. SEBI and SROs ensured that Risk management in geographically daunting India worked well. Clearing Corporations permit clearing participants (PCMs - Custodians/Banks) to settle trades of their Institutional clients.

Multiple products led to multiplicity of the following - regulators, rules, regulations and byelaws, exchanges, depositories, clearing corporations, segments (equity, ETF, derivatives, commodities, fixed income etc.), settlements systems, multi-locations, ever-growing and diverse operational requirements, intermediaries etc. A multiplicity added risks, complexities, higher costs, inefficiency, to an extent hindering growth of the capital market and intermediaries, sometimes compromised investor protection measures. Non-Institutional trades have grown significantly (accounting for over 70 % of cash trades) and may continue to spiral, fuelled by multiple opportunities, larger IPOs, fast-growing economy, more investible surplus, an active secondary market, a sharp increase in the numbers of HNIs etc. Foreign Portfolio Investors (including trusts, HNIs etc.) need to appoint a Custodian in India as a pre-requisite for investing in India. However, there is no such requirement with respect to Indian Non-Institutional investors.

**Custodians' role**:

Custody being a regulated function, increases the confidence wrt settlements. The 18 SEBI regulated custodians armed with sophisticated settlement capability, skilled resources, pan- India presence, robust technology have de-risked the settlement of Institutional trades. Their financial withdrawal effected better practices than most brokerages, thereby securing the system, are trusted by large institutions, Exchanges, Clearing corporations etc. Investors risk is thus restricted to market related risks. Non-institutional clients could benefit from stronger corporate action processing.

Though trading systems are similar whether for Institutional or Non-Institutional clients, the key challenge is the multiplicity of settlement systems as distinguished by Institutional and non-Institutional.

**Challenges in the existing system**:

1. **Brokerages**: Brokerages deal in multiple segments - Institutional, PMS, Retail. However, unlike advanced markets, many of them wrt trades are engaged in non-execution related activities requiring specialist teams that settle with PCMs (in case of Institutional), with Clearing houses (non-Institutional). Wide geographical spread adds operational complexities while multiplying operational risks, costs, operational inefficiency, and paucity of staff specialized in settlement of multiple segments as new segments are added. **TSSAG founding member Roger Harrold of AlfaSec, Singapore** holds that Brokers play a key role wrt retail trade execution and take the cost of the trade as well as limited activity wrt custody. Ever evolving banking processes, longer working hours of exchanges, tight cut-off times of clearing houses and a separate one by depositories and banks are other challenges adding to costs.

Client failures to fund margins lead to greater financial stress on Brokerages, adding to costs. Brokers maintain additional margins to settle the trades of their Non-Institutional Clients. Settlement infrastructures at Brokerages get tested, failures lead to auctions and potential default in meeting settlement obligations leading to bigger crisis.

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

3. **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; stress on settlement guarantees on account of broker exposures to settlements are growing, without concurrent value add.

4. **Clients** are required to keep large balances with broking house towards margin, thus exposed to risk of brokerages potentially using client's funds to cross margin between its own client and own trades, there by adding risks.

**Why TSSAG sees merits in Custodians settle Non-Institutional trades**:

**TSSAG founding member Angelos Gregoriades of PIVOT Cyprus, Cyprus notes**, that in Europe as well as in Egypt, non-institutional (retail investors) have been settling their trades through custodian banks, even as early as since 2006. All major domestic banks (in Europe) have their own brokerage arms and Custody units – thus executing, clearing and settling transactions for their non-institutional clientele as well. On the other hand, independent brokers (not bank subsidiaries) with a substantial size, usually outsource clearing and settlement of their retail clientele to custodian banks; smaller ones are quite reluctant to outsource their retail clientele activities as they make revenue by also offering

custody services. In Europe, banks and asset managers (entities / groups that have brokerage arms and Custody) tend to promote "MUTUAL FUNDS" in addition to trade execution services and Custody to non-institutional Clients, by relying on sophisticated systems that support economies of scale, to generate transaction fees, with relatively low cost at low risk.

**TSSAG founding member Paul Hedges of PDH Consult, UK** observes that in China, retail customers have accounts directly with the CSD's. Singapore has this as an option available for non-institutional clients. HK does too, however, it's not generally taken up as the CSD makes it quite "difficult" for non-institutional clients to meet the criteria of membership. Indian CSD's (NSDL/CDSL) do not take up this activity directly and permit custodians to open accounts including of retail customers. Custodians in India have the ability to open Non-Institutional client accounts, notwithstanding the Operational issues and Internal policies. Practices in advanced Capital markets, especially in emerging countries like India, which is witnessing a rapid growth of investor participation, emphasise the need to de-risk market infrastructure, lend transparency, ensure consistency in policy and process, greater straight-through-processing and greater governance. It leverages on better practices of professional clearers.

We believe that besides enabling the faster growth of the capital markets, multiple benefits as below will accrue:

**Institutional Clients**: No change in status. No adverse impact.

**Non-Institutional client**: Assured third party settlements - no exposure to Brokers; confidentiality of settlements, investors benefit from multiple services custodians offer vs no-standard practices broker can provide, better MIS. Clients need not keep margin with each broker they intend to trade. This reduces client's risk of trading through a single broking house.

**Clearing Corporations**: Standard practices - lesser nos of participants, significantly reduces cost of multiple settlement practices, separate lower charges possible, leverage 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.

**Custodian**: Utilization of capacity; extension and standardisation of current practices across segments; sec lending; offer variety of products, more integrated services to existing (derivatives settlements), 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.

**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.

**Tax Authorities**: Concentrated settlements help to generate MIS on gains and losses.

**To conclude**: It is often suggested that having custodians settling trades for non-institutional investor would add to their cost and that there are no corresponding benefits for the involved Intermediaries. One has to look back on the situation in Indian Capital Markets in the past that offered fewer choices, higher costs of brokerages, more inefficient and opaque systems, lesser TAT, inefficient and non-STP operations etc. However Subsequent developments as highlighted above, and standards introduced by SEBI have led to the stupendous growth India has achieved in the last 2 decades.

At TSSAG, we believe that non-institutional customers won't be at disadvantage when trades are settled by custodians vs if done by brokers, as trades would be settled on T+1, thereby substantially reducing risk exposure, increasing liquidity, increased participation by investors and bring down their costs as funds while it being are made available faster. Technology being the driver will bring down the cost. Similarly, when implemented with planning, the costs won't go up but safety, risk containment, integrity will increase, and it add significant confidence and higher participation of investors while pulling more funds into markets and create wealth for the nation.

**So, should Indian Capital Markets stop investing in developments?** We at TSSAG believe that for the ambitious plans India has of enabling T+1, doubling % of investors investing in the capital markets as well as doubling the Market Cap, would need one of the significant steps SEBI could consider execution would be the streamlining of Non-Institutional settlement and have it done by Custodians. This would unlock the potential of the fast-growing Non-Institutional segment, address significant inefficiencies and risks in the Indian Capital Markets and standardise them on the same lines as it already has for foreign portfolio investors while ushering a global practice. It's our belief that Custodians are well equipped to service this new class of clientele.

It's our belief that Indian Custodians are well equipped to service this growing new class of Clientele, valued at approx$ 300 Billion of AUC.

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