Placed below is a Report of the sub group formed by the Secondary Market Advisory Committee (SMAC) on the issue of 'Capital Adequacy Norms and Net Worth Criteria' for stock brokers. The report is placed for eliciting public comments. It may be noted that report does not necessarily reflect the views of SEBI on the issue. SEBI would be considering the comments received from different sources before taking a final view on the issue.

Public comments on the report may be sent to **SEBI, Division of Policy and Supervision-1, Market Intermediaries Regulation and Supervision Department**, **World Trade Centre, 29th Floor, Cuffe Parade Mumbai 400 005 or emailed to ashishk@sebi.gov.in or faxed to 91-22-22164482/22164494 latest by October 29, 2004.**

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# Report of the Sub-Committee of SMAC

# on

# Net worth & Capital adequacy norms for brokers

The Secondary Market Advisory Committee (SMAC), at its meeting held on February 17, 2004 discussed the issue of net worth and capital adequacy for brokers. The key issue as outlined in the agenda item for discussion was whether the overall exposure of a member broker should also have some correlation with its net worth, apart from the capital deposit made with the exchanges. The argument proposed was that given the need for brokers to have sufficient liquidity at all times to meet their obligations, the business they do should be in proportion to the net worth of the brokers.

SMAC had noted that that there are basically two kinds of risks as far as brokers and their dealings are concerned. The first category of risk was the systemic risk posed by the broker to the exchange which was well covered under the existing risk management system and capital adequacy norms. The second category of risk was the one posed by a broker default to its own clients. The arrangements available to cover this risk needed a review. In this context, SMAC set up a sub-committee to examine this issue and recommend to the main committee a sensible course of action.

The members of the sub committee included representatives of BSE, NSE and a few other members of SMAC. The terms of reference of the sub-committee are given at Annexure - 1. The sub-committee held two meetings on March 23, 2004 and on April 6, 2004 respectively.

At the outset, the committee felt that it was important to clearly identify the problem that was sought to be addressed by the use of net worth.

**Systemic Settlement Risk**

The first area where net worth could be available as a potential criterion is in addressing the settlement risk. However, the sub-committee noted that the experience with net worth in any kind of risk management situation has been poor. Net worth has proven to be largely notional and illusory in a stress situation as it is the first item to be transferred out of the firm by managers, leaving nothing with which to face the risk. The legal environment exacerbates the situation where it is virtually impossible for a third party to get hold of the assets of the entity before they are removed. While this is true of all business situations that a broker may deal in, it is particularly true of a real time business such as exchange settlement. Thus, net worth is unlikely to offer any real cover against risk management in these situations.

The sub-committee was of the view that the current settlement risk management framework, which consists of VaR coupled with Expected Tail Loss (ETL), has served the market well and withstood the test of time in the face of unprecedented volatility. To cite just one example, in a recent case, two securities witnessed intra-day volatility of approx. 40% with very high open positions. The risk management system held up adequately in the face of such extreme price movements. It is not clear that there is an important problem here that net worth requirements can be called upon to solve.

**Broker Default Risk for Clients**

Even though systemic settlement risk is being handled efficiently by the exchanges, the sub-committee expressed concerns about the risk faced by the clients from a default by their own brokers. The Committee was not persuaded that net worth would offer a potential solution to this problem either, for much of the same reasons as were applicable in the case of systemic settlement risks. In fact, if net worth offers poor protection to the exchange / clearing corporation to secure their dues from defaulting brokers, it is extremely unlikely that individual investors will do any better in securing their dues from broker net worth.

The sub-committee noted that at present, exchanges maintain significant Investor Protection Funds (IPFs) to cover the risk faced by clients from defaults by their broker. Currently, at the two main exchanges, BSE & NSE, this cover extends up to an amount of Rs. 10 lakhs in the case of default of a member. This system is akin to the arrangement for protecting small depositors from defaults in the banking system. In fact, if anything, the eligibility amount of Rs. 10 lakhs is generous in defining small investors, when compared with the limit of Rs.1 lakh that is presently used by DICGC in the context of bank failure.

In terms of the performance of the IPF, the sub-committee noted that rejections of claims have been mainly due to improper documentation, where the investors have been unable to provide sufficient proof of the deals in question. Investors who deal with unregistered intermediaries have been the largest victims. The sub-committee was of the view that the IPF should motivate investors to deal only with the registered intermediaries.

Under the IPF framework, credit risk against the broker is not valid for investors who have positions of more than Rs.10 lakh with a single broker. The sub-committee felt that this risk should be addressed by means of a disclosure framework for brokers so that such investors are in a position to take informed decisions based on the disclosures. This was analogous to the framework of the banking sector where the tools of market discipline (i.e. stock market listing, subordinated debt issuance etc.) convey greater information about banks to the large depositors.

On another front, the sub-committee noted that the deposits given by clients to the brokers as margin money are also covered under IPF in the event of a default by the broker. However, there was a distinct possibility of funds / securities so placed with the brokers being identified as deposits / loans by them in their books and not shown specifically as margin money for securities trading. In such a situation, the investors would lose the cover of IPF. The sub-committee, therefore, recommended that brokers be required to clearly state on the client receipts whether the funds are by way of margin money or are for any other purpose. The exchanges should also disseminate this requirement widely to the investing public so that investors may adequately protect their margin deposits.

**Risk owing to Proprietary Dealings of Brokers**

The committee was of the view that substantial credit risk to clients emanates from the proprietary dealings of brokers, of which clients have no knowledge. When judging between the credit risk of broker A versus broker B, the investor needs to know the size and risk of proprietary positions, in order to make judgments about credit risk.

The sub-committee also expressed concerns that some brokers may collect margin monies from their clients and use the same to claim exposure benefit for their proprietary transactions.

Several approaches were suggested by the sub-committee to address the above issues. One was to require a complete segregation of proprietary business from the brokers' agency business. This did not find unanimity on the grounds that it would entail huge costs for the brokers as they would have to duplicate the entire setup for proprietary dealings.

The second proposal was to ensure through regulation that brokers do not receive the benefit of clients' monies and securities for exposure on their proprietary dealings. This suggestion found favour with the sub-committee which recommended that "proprietary trading" should be clearly defined and include categories like self, group companies, directors, partners, subsidiary companies etc.

A third possibility was to alert investors to the creditworthiness of brokers with the use of credit rating of brokers. The discussion was mixed on this suggestion. It was felt that rating may not be a useful tool on account of the following reasons:

? Inability of rating agencies to capture information in advance.

? Rating *per se* is a post mortem activity.

? Time period involved in rating the brokerage houses.

? Annual rating of brokers is too infrequent to be useful.

? Non accountability of the rating agencies.

? High costs of rating.

The sub-committee felt that while credit rating may not prove to be an effective instrument to help investors to protect themselves against possible broker default, it may still be worthwhile to allow brokers to have the *option* of obtaining a credit rating. This proposal has merit for the following reasons:

? Credit rating would allow a professional analysis of information about a broker and present it to investors in a simple and meaningful way.

? Credit rating would be optional; it would not be a tax on the system.

? Over the years, credit rating companies are likely to improve their knowledge and skills leading to better ratings.

The sub-committee also felt that in case credit rating for brokers has to be introduced, it should be more in terms of rating of compliances/infrastructure.

The sub-committee was also of the view that a system for disclosure of some relevant information about brokers to the investors would be a more useful tool for the investors. The disclosures may include:

? Disciplinary action (s) taken by SEBI / exchanges. It is expected that this disclosure would give the investors information about the quality of processes, and the compliance culture present in the brokerage firm.

? Aggregate open proprietary position. This would convey the scale of proprietary trading of the brokerage firm.

? VaR of the open position. This would convey the riskiness of the proprietary position of the broker. For example, some brokers which exclusively do arbitrage in their proprietary book would show up as having a large gross proprietary position, but have an extremely low VaR. This would signal to the investor that the credit risk owing to proprietary trading is small.

On the question of disclosure of disciplinary actions, it was felt that many of the violations observed during inspection of brokers are procedural in nature and to that extent may not give an entirely meaningful picture of the trustworthiness of the brokers. Moreover, fines imposed by the Exchanges / SEBI are in the form of an aggregate number and may not give an adequate idea of the nature and gravity of offences. Nevertheless, the committee felt that if the information is presented properly, it would allow clients to build a useful assessment of the broker, particularly since the mapping table used by exchanges in converting a violation into a monetary penalty seeks to reflect the materiality of the violation.

While disclosure of VaR was considered an attractive proposition, there was concern that a typical retail investor may have trouble interpreting the VAR number and relating it to the credit assessment of their broker. With regard to benchmarking of VaR numbers, while this could certainly be an issue initially, over time, the committee felt, investors would get a sense of how to interpret the numbers and would be able to relate it to the credit assessment of their broker. This process will be eased by the fact that Indian investors already have many years of experience of relating to VaR numbers in the context of the margin system.

**Net worth and Multiple Broker Businesses**

The sub-committee also discussed the concerns arising out of brokers undertaking various activities in addition to the brokerage activity such as depository participant, lending to customers, commodities trading, underwriting, merchant banking, securities lending and borrowing, portfolio management, RTA, margin trading etc.

Though the sub-committee had not found merit in using net worth as a tool of risk management for brokerage activity, it felt that net worth may serve as a useful eligibility / license criteria for brokers to undertake other businesses as this would reflect the ability of the person / organization to meet the requisite infrastructural / business capacity requirements. The sub-committee agreed that each business undertaken by a broker has specific requirements of technology, compliance, client servicing etc., all of which require certain minimum resources. A minimum net worth would give the confidence in the organisation's ability to adequately invest in and run the business. The sub-committee, therefore, recommended that net worth be prescribed as an eligibility / license criteria for each specific business a broker may engage in.

In this context, the sub-committee felt that instead of using one standard net worth criterion, the various activities handled by brokers should be classified into clusters of businesses / activities for the purpose of arriving at a suitable net worth criterion. Accordingly, the sub-committee classified the activities into three broad categories viz:

1. Basic broking activity (agency broking business and/ or proprietary business)
2. Advisory business (merchant banking)
3. Asset handling business (margin trading, securities lending and borrowing, underwriting, depository participant, portfolio management etc.)

The sub-committee recommended net worth slabs for the above activities as follows:

| **Type of Activity licensed to brokers** | **Net Worth Eligibility for the Activity** |
|---|---|
| Base license (either proprietary or agency) | Rs. 50 lacs |
| Proprietary and Agency | Rs. 100 lacs |
| Pure advisory business (IPOs / / RTA.) | Rs. 25 lacs |
| Asset handling (underwriting / securities lending or borrowing of own funds, margin trading, depository participant / portfolio management) | Rs. 50 lacs for each of the activity |

It also recommended that the above net worth requirement for the brokers should be worked out on a cumulative basis.

In terms of implementation, the sub-committee felt that the existing brokers may be given a time of 3 years to enhance their net worth to meet the above requirements. However, any new company / existing company wishing to undertake fresh business should be required to meet the above net worth criteria. The sub-committee also recommended that brokers should be required to submit a net worth certificate on an annual basis within 60 days from the tax date.

The sub-committee recommended this approach as it focuses on the minimal investments that are required to create a credible organization, including investments in technology and processes. The intent is not to introduce stringent entry barriers and reduce competition in the brokerage industry, but is to reduce operational risks and improve the minimal standards for processes and organizational capacity.

## Computation of Net Worth

It is observed that the circular(s) issued by Exchanges on net worth computation and treatment of various components for the purpose of computing net worth are adequately broad based and may be adopted with some minor changes such as

| Items | Treatment for net worth computation |
|---|---|
| Fixed Assets other than immovable property | To be considered at book value / depreciated value |
| Investments | To be considered at market value as on the date of submission |

**SUMMARY OF SUB-COMMITTEE'S RECOMMENDATIONS:**

1. Daily (and aggregated) disclosure of key information about brokers such as information on disciplinary actions taken against brokers by SEBI / exchanges, aggregate open proprietary positions and VaR number of open positions should be introduced.
2. Optional credit rating of brokers, at the discretion of the brokers, may be introduced. Moreover, rating of compliances/ infrastructure may be considered.
3. Net worth should be prescribed as an eligibility / license criteria for each specific business a broker engages in and net worth slabs for each activity of business should

be introduced. This is to minimise operational risks, and ensure minimal investments necessary run a credible organization and sound processes.

4. The current net worth definition adopted by the exchanges is appropriate, with certain modifications.
5. Brokers should not receive the benefit of exposure on their proprietary dealings based on their clients' monies and securities. Moreover, "Proprietary trading" should be clearly defined.
6. A requirement should be imposed on the brokers to clearly state the purpose for each deposit taken by it on the receipts for such deposits and these receipts must be handed over to the clients. Deposits for margin money should be distinctly identified so that the clients get protection up to Rs. 10 lakhs under Investor Protection Fund in case there is a default of a broker.

## ANNEXURE-I

**TERMS OF REFERENCE**

It is expected that the review of net worth and capital adequacy norms of the brokers would cover the following:

1. To study and compare the net capital rule/capital adequacy norms as prevalent in 7-8 jurisdictions.

2. To consider and formulate an operationally useful definition of net worth.

3. To consider whether net worth should be an entry level criteria or it should be a continuous risk management criteria and linked to exposure/leveraging.

4. To compare and formulate, if necessary, net worth criteria for different types of activities of a broker such as underwriting, DP etc. as well as different types of trading profile- proprietary trading, trading for clients etc.

5. To consider whether risks other than settlement risks may be covered by prescribing the net worth criteria.

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