

**Consultation paper for review of net worth criteria of Trading Member (TM) /
Clearing Member (CM) / Professional Clearing Member (PCM) / Depository
Participant (DP)**

1. Background

- 1.1. The risk management framework of Stock Exchanges / Clearing Corporations (CCs) in India, inter-alia, prescribes a deposit based capital requirement for their trading members (TMs) / clearing members (CMs). Entry level and continuing net worth criteria for market participants has also been prescribed by SEBI from time to time.
- 1.2. The intermediaries such as TM, CM and DP handle funds and securities of clients for collateral/margin, settlement and holding purposes. Such handling of funds and securities results in their clients having a credit exposure against them. From the point of view of market safety, it is crucial that the risk of loss of clients' assets in the event of default by the intermediary is mitigated, regardless of such default being on account of own trading or non-trading losses of the intermediary or due to default of another fellow customer.
- 1.3. The current regulations specify a minimum net worth requirement for intermediaries, determined almost 20 years ago and is not defined on the basis of the quantum of exposures or the level of business activity of the intermediary.
- 1.4. Hence, it is desired to develop risk-based capital adequacy norms for the intermediaries that would provide reasonable comfort regarding loss-absorption capacity of the intermediaries and mitigate the risk of spillover of losses to non-defaulting clients.
- 1.5. The Dr. L C Gupta Committee formula for computation of net worth is as follows:

Capital + Free reserves

Less non-allowable assets, i.e.

a) Fixed assets

- b) Pledged securities
- c) Member's card
- d) Non-allowable securities (unlisted securities)
- e) Bad deliveries
- f) Doubtful debts and advances*
- g) Prepaid expenses, losses
- h) Intangible assets
- i) 30% of marketable securities

*Explanation – includes debts/advances overdue for more than three months or given to associates.

2. Current net worth requirements

Trading Member (TM) / Clearing Member (CM)

2.1. The net worth requirement for CM in equity derivatives segment was specified in June 1998. For currency derivatives segment, the net worth requirement for TMs and CMs was specified in August 2008, while that for Self Clearing Member (SCM) was specified in May 2011. For commodity derivatives segment, the net worth requirement for members was specified in September 2015.

2.2. The net worth formula has also been specified in Schedule VI of the SEBI (Stock Broker) Regulations, 1992 (Substituted vide amendment in 2013). SEBI (Stock Broker) Regulations, 1992, specify the net worth and deposit requirement for stock broker / TM, CM and SCM in equity cash, equity derivatives, currency derivatives and debt segment as under:

Table I						
Segment ↓	Stock Broker**		Clearing Member		Self-Clearing Member	
	Net worth	Deposit	Net Worth	Deposit	Net worth	Deposit
	Amount (Rs crore)					
Cash	*	*	*	*	*	*
Equity Derivatives	*	*	3	0.5	1	0.5

Currency Derivatives	1	*	10	0.5	5	0.5
Debt	0.5	*	3	*	1	*

*As specified by Board from time to time

** As defined in SEBI (Stock Broker) Regulations, "stock broker" means a person having trading rights in any recognised Stock Exchange and includes a trading member.

2.3. The net worth and deposit requirement for members dealing in commodity derivatives segment is as under:

Table II				
Type of member ↓	Net worth (Rs crore)		Deposit (Rs crore)	
	For the members of		For the members of	
	National Commodity Derivatives Exchanges	Regional Commodity Derivatives Exchanges	National Commodity Derivatives Exchanges	Regional Commodity Derivatives Exchanges
Stock Broker / Trading Member	Nil	Nil	Nil	Nil
Self-Clearing Member	1	*	0.5	*
Clearing Member	3	*	0.5	*

*As specified by Board from time to time

2.4. The net worth for TM / CM can be specified by the Board from time to time.

However, no net worth requirement has been specified for TM, CM and SCM in cash segment. Net worth has also not been specified for TM in equity derivatives segment in the SEBI Regulations. This has been left to the Stock Exchanges to specify.

2.5. Stock Exchanges have specified net worth as per formula prescribed by L C Gupta Committee for membership in various segments. Different Stock Exchanges have different minimum net worth requirement for their trading members for each segment. The net worth / range of the net worth requirement for various types of membership in different segments prescribed by the Stock Exchanges are as under:

Table III				
Segment ↓	Membership type			
	TM	TM & SCM	TM & CM	PCM
	Net worth (Rs. crore)			
Cash	0.25 - 0.75	1	3	3
Equity Derivatives	0.25 - 1	1	3	3
Currency Derivatives	1	5	10	10
Commodity Derivatives	0.10 - 0.50	1	3	5
Debt	0.50	1	3	3

2.6. It is observed that the minimum net worth requirements for TMs varies from Rs 0.10 crore to Rs 1 crore for various segments or different Stock Exchanges. Also, it is observed that the highest requirement of net worth is for membership of currency derivatives segment.

2.7. SEBI Stock Broker Regulations specify that the quantum of net worth to be maintained by the TM / CM shall be collectively reckoned for all segments. It therefore means that if a TM / CM has a net worth which is higher, then he may not be required to maintain separate net worth for the other segments requiring lower net worth.

Depository Participants

2.8. The existing net worth requirement for stock broker depository participant is Rs. 50 lakhs and aggregate value of portfolio of securities (AVPS) of the BOs held in dematerialized form in a Depository through the entity shall not exceed 100 times of the net worth. The stock broker depository participant has to comply with net worth requirements separately for each depository. Where the net worth is more than Rs. 10 crores, the limits on AVPS is not applicable.

2.9. The existing minimum net worth requirement for stock broker depository participant is Rs. 3 crores at NSDL and Rs. 2 crores at CDSL. The net worth requirement for limited depository participant is Rs. 1 crore at both the

Depositories, subject to certain restrictions on business and/or limited period as decided by the respective depositories.

3. Need for revision in net worth requirement

3.1. The Indian capital market operations involve: (a) prudential margining of trades, (b) holding of client securities by centralized depositories and restrictions in the use of client securities by brokers under PoA, and (c) requirement for settlement of running account of client funds, which is held by the TM / CM. The failure of the capital market intermediaries to meet client obligations may arise out of the operational risk, using client money for other client or proprietary trading. The current minimum capital norms do not adequately address these risks.

Trading Member (TM) / Clearing Member (CM)

3.2. The market witnessed a number of defaults by some Trading members (TMs) / Clearing Members (CMs) in which funds and securities of clients were misutilised by them. To protect the interest of investors from such fraudulent TMs / CMs, SEBI Committees viz. Risk Management Review Committee (RMRC) and Secondary Market Advisory Committee (SMAC) have suggested SEBI that the net worth requirement of TM / CM needs a relook and may be increased. The balance sheet net worth of the stock broker should be monitored and it should be commensurate with the operational risk being taken by the stock broker with respect to its clients.

3.3. The client's market risk faced by TM/CM is broadly covered with the implementation of upfront collection of margin from clients in cash and derivatives segment, however, the risk of misuse of client's fund at the hand of TM/CM needs to be protected. The net worth should focus on protection of client fund and also to create an entry barrier and therefore net worth requirement which was stipulated years ago, needs a significant increase.

3.4. SEBI has also specified default waterfall with respect to Core Settlement Guarantee Fund (SGF). In case of default waterfall of CC for any segment, the

monies of the defaulting member are first in the order, which makes it even more important to have well capitalised TM / CM.

3.5. Net worth requirements of other SEBI registered intermediaries such as the Asset Management Company was revised from Rs. 10 crores to Rs. 50 crores in 2014. Net worth requirement for Portfolio Managers was revised from Rs. 2 crores to Rs 5 crores in 2019 and net worth requirement for Credit Rating Agencies (CRAs) has also been revised from Rs. 5 crores to Rs. 25 crores. However, there has been no revision in net worth requirement of TMs / CMs since last several years.

3.6. In view of the considerable increase in turnover in various segments of the Stock Exchanges over the period of years and that the significant increase in number of investors participating in the securities market, it seems appropriate that a review of net worth of the members in different segments of the Stock Exchanges may be carried out.

Depository participant

3.7. As a depository participant (DP), the capital market intermediaries do not own the client securities on their balance sheet. The recent change in the approval process of off market transfer of client securities, which requires express permission from the client through an electronic delivery instruction slip (eDIS) or an OTP, has significantly reduced the risk of abuse of client securities by the DPs. However, operational risk related concerns such as fraudulent eDIS / Delivery Instruction Slip (DIS) still persist.

3.8. The role of a DP has reduced considerably with the introduction of pledge-repledge, restricted use of PoA and introduction of block mechanism in case of sale of securities by clients, which are executed through the systems of Depositories and Clearing Corporations. Linking of custody value with net worth may not be required because DPs have a limited role in handling client's securities and they only act as a facilitator. All the transactions are recorded in books of depositories.

4. Review of net worth criteria was discussed in Secondary Market Advisory Committee (SMAC) meeting held on November 26, 2020. It was proposed that minimum net worth for TM should be Rs.1 crore, for SCM should be Rs.10 crore, for CM should be Rs.25 crore and for PCM, it should be Rs.50 crore. Chairman, SMAC informed the committee that world over the Clearing Corporations (CCs) do not run only on margins. When the margin fails, the CCs world over would look at the net worth of the CM and CM in turn would look at the net worth of the TM. It has been learnt from the global experiences that it is not possible to bring down the risk only with the margins and a lot of capital is needed to cover the risk that is not covered by margins. The capital adequacy should be examined for both sides i.e. the TM level exposure to clients' funds and securities, and to market in turn of open position and for CM level, there should be second line of defence beyond margins in the form of net worth.
5. In line with the decision in the SMAC, NSE was asked to submit a proposal on capital adequacy norms for TM/CM/SCM/PCM in consultation with all the Stock Exchanges and Clearing Corporations, review net worth of depository participants in consultation with the Depositories and review formula prescribed by L C Gupta Committee for calculation of net worth. NSE appointed Professors of IIM, Ahmedabad and IIM, Kozhikode to carry out a study. Based on the recommendations made under the study, NSE submitted the proposal on review of Net Worth Criteria of TM/CM and DP.
6. NSE proposed (as suggested by other MIIs) that the base net worth requirement should be kept at minimum level and proposed to increase the net worth requirement for TM to Rs. 75 lakhs. NSE proposed to maintain the same base net worth for Self clearing member, clearing member and professional clearing member. NSE proposed that net worth of the TM/CM shall be aggregate of base net worth and 10 percent of average cash balances of client retained with TM/CM across segments and / or exchanges, in previous six months. In addition to that, to meet the contingency of market risk, the TM/CM shall also maintain a net worth equivalent to 100 percent of average margins applicable for member proprietary positions during last six months and shall also maintain 10 percent or 5 percent of

average margins applicable for client accounts in last six months by TM & CM respectively. It was also desired that NSE should revisit the proposal based on actual net worth of its existing TM/SCM/CM/PCM, as submitted by members to exchange on half yearly basis. Based on actual net worth of TMs/CMs, base capital requirement could be decided.

7. A revised proposal of a base minimum net worth requirement as well as client business linked additional variable net worth for members, was submitted by NSE. A virtual meeting was held on July 19, 2021 with all Stock Exchanges, Clearing Corporations and Depositories to discuss the revised proposal on Review of net worth of trading member, clearing member and depository participant. It was observed that existing base net worth requirements are very miniscule compared to the business that TMs are undertaking and the number of clients that they have. SEBI now grants a single registration and thereafter, segment-wise/exchange-wise permission is granted for trading in respective segment/exchange. Therefore, one base net worth of the member qualifies for registration and also for taking membership on other segments/exchanges. However, the requirement of net worth should go up for a member based on the client's funds retained by him for trading across segments/exchanges. The trade risk is covered by upfront margin requirement and hence need not be linked for net worth requirement.

8. Proposal

TM/CM Net Worth

- 8.1. In view of the detailed deliberations held with Market Infrastructure Institutions (MIIs), net worth requirements for members shall be Base Net worth or variable net worth as given below, whichever is higher.

Type of Member	Base Net Worth to begin with (Rs. crores) (By October 2022)	Base Net Worth After 1 year (By October 2023)	Variable Net Worth (w.e.f. 01.10.2022)
TM	-	1	10% of average daily cash balance of clients retained with the member across segments/exchanges in the previous 6 months. This shall be calculated on 30 th September and 31 st March every year.
TM-SCM	3*	5	
TM-CM	10	15	
PCM	25	50	

*The existing requirement of minimum net worth of Rs. 5 crores shall remain applicable to the TM-SCM in currency derivatives segment.

- 8.2. If a member satisfies the net worth criteria as applicable to a certain category of membership in any one of the Stock Exchanges, then that will satisfy the net worth requirement for other segment(s) / Stock Exchange(s) as well. If a member satisfies the net worth requirement as applicable to SCM, then such member shall also satisfy the net worth requirement as SCM of other exchanges / segment.
- 8.3. The net worth requirement shall go up linked to client's funds retained with the member. In case TM deposits the client's fund with CM / CC, then maintenance of additional net worth as TM, would not be required. Only the trading member retaining client's funds with them shall be required to keep net worth equivalent to 10% of the average client funds retained by them during previous six months or base minimum net worth as prescribed, whichever is higher. Where the TM deposits the client funds with CM, the computation of variable net worth at the

level of CM shall also include the funds of the clients of TM, deposited by TM with the CM.

DP Net worth

- 8.4. In case a stock broker seeks to act as a Depository Participant, it is proposed that the net worth of DP shall be equivalent to that proposed for TM-SCM, which is Rs. 3 crores by October 2022 and subsequently Rs. 5 crores by October 2023. The aggregate value of portfolio of securities linked to net worth shall not be required.
- 8.5. DPs will have to eventually achieve the net worth equivalent to that of a SCM/CM/PCM. The TM shall not be recognized as DP and they would use the depository participant services of their respective CM's. Only CM/PCM shall act as standalone DPs.
- 8.6. There shall be one net worth requirement across MIs. No separate minimum net worth shall be prescribed individually by any MI. Net worth for broker shall also be counted as net worth required for DP.
- 8.7. The above proposed net worth requirements for TM/CM/PCM/DP are the minimum and Exchanges/ CCs/ Depositories shall be free to prescribe any higher net worth requirement for their members.

Dr. L.C. Gupta Committee formula for Net Worth

- 8.8. The computation of net worth shall be as prescribed by L C Gupta Committee, however, following clarifications are proposed:
 - 8.8.1. For share capital, compulsorily & mandatorily convertible debentures / bonds / warrants which are convertible within a period of 5 years from the date of issue.
 - 8.8.2. That free reserves shall include Profit & Loss, General Reserve, Securities Premium, Preference Share Redemption Reserve, Capital Redemption Reserve etc. but will not include reserves created by revaluation of assets.

- 8.8.3. Shares owned by TM/CM and pledged to Clearing Corporations / clearing members shall not be deducted from net worth.
- 8.8.4. Under the non-allowable asset head of 'Doubtful Debts and advances', 'Any Debts or Advances (except trade debtors of less than 3 months)' shall be non-allowable asset.

9. **Public Comments**

Considering the implications of the said matter on the market participants, public comments are invited on the above proposals. Comments may be sent by email or through post, in the following format:

Name of entity / person proposing comments:			
Name of the organization (if applicable):			
Contact Number & Email Address :			
S. No.	Reference paragraph of the discussion paper	Suggestion / Comments	Rationale

[Note: Kindly mention the subject of the communication as "Comments on consultation paper for review of net worth criteria of Trading Member (TM) / Clearing Member (CM) / Depository Participants (DP)" and specify whether you are a market intermediary/ participant (mention type/ category) or public (investor, academician etc.)]

Comments on the above proposals may be sent latest by October 18, 2021

1. By email to Shri Gaurav Kumar at gauravk@sebi.gov.in

OR

2. By post to the following address:

Shri Narendra Rawat

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