

REPORT OF SUB GROUP I

1) BACKGROUND

This report is written as part of a review of eligibility norms for various categories of market intermediaries. SEBI has set up the Committee on Review of Eligibility Norms (CORE), various sub-groups of which are reviewing eligibility norms with respect to specific market intermediaries. This report is the result of deliberations of the sub-group – I that is looking at eligibility norms for Credit Rating Agencies, Debenture Trustees and Asset management companies (AMCs).

The sub-group is headed by Ms Roopa Kudva, MD & CEO, Crisil. The other members of the sub group are:

1. **Shri Mrs. Chitra Ramakrishan, DMD, NSE**
2. **Shri S. H. Bhojani, Sr. Partner, Amarchand Mangaldas**
3. **Shri Paresh Sukthankar, ED, HDFC Bank**
4. **Shri A. Balasubramanian, CIO, Birla Sun Life AMC Ltd.**
5. **Shri Sanjay Shah, MD, Morgan Stanley India Securities Pvt. Ltd.**
6. **Shri Milind Barve, MD, HDFC AMC Ltd.**
7. **Shri Nilesh Shah, DMD, ICICI Prudential AMC Limited**

The sub-group met on June 03, 2008. The basic categories of issues that were examined by the sub-group are:

1. Is there a need to review the minimum net worth that a CRA and DT should have? If so where should the minimum net worth be set?
2. Are there specific infrastructure requirements with respect to manpower that should be put in place for a CRA and DT to be eligible for initial and ongoing registration?
3. Any other recommendations that can strengthen and smoothen the functioning of these intermediaries.

Subsequently, on June 09, 2008 the mandate for review of eligibility norms for AMC's was also given to the sub group-I. The sub-group met on December 8, 2008 and March 17, 2009 to examine the issues pertaining to the AMC's.

2 Debenture trustees

2.1 Background

The recent increase in volumes of securitisation issuances creates a rapidly growing role for debenture trustees (DTs) in these instruments, given the vital role that DTs play in securitised issues. However their role in public issues of debt has diminished considerably, as there is little market for these issues.

Problems that DTs face today include:

- Very low fee structure, sometimes as low as a few thousand rupees, for thousands of crores of rupees of debenture issues. This makes the business unremunerative
- Lack of information from issuers
- No recourse to SARFAESI provisions and DRT for recoveries – unlike a lending institution the DT has to go to court, a time-consuming and uncertain process
- In addition, all proceedings for enforcement of security and recovery have to be undertaken initially at DT's own cost (which can be recovered only from realisation), a further disincentive to act in a situation where fees are minuscule and recovery can take years

In this situation, it is important to note that revised criteria that are too stringent might disincentivise good players by driving the costs of compliance up to onerous levels.

Since the meeting of the sub-group, the SEBI (Issue and Listing of Debt Securities) Regulations, 2008, have brought about some clarity as regards the role and rights of DTs in publicly issued and privately placed but listed debt securities.

Other noteworthy points:

- A DT's officials have no personal liability in case the DT does not perform its functions
- Under the current structure, the DT is no better placed than an investor to enforce recovery
- DTs often hesitate to act where governments are involved
- There is a need to define what kind of securities DTs are required for (public issues of debt, privately placed paper that is subsequently listed, structured transactions including securitisation, etc). To an extent, such definition will involve a broadening of SEBI's role since there will be some degree of overlap with the relevant provisions of the Companies Act.

2.2 Current Debenture Trustee regulations

Eligibility criteria:

The DT applicant should be:

- (a) A scheduled bank carrying on commercial activity
- (b) A public financial institution within the meaning of Section 4A of the Companies Act
- (c) An insurance company
- (d) A body corporate

Other criteria presently applicable for applicants:

- Should have necessary infrastructure like adequate office space, equipment, and manpower to effectively discharge their activities
- Should have experience as a debenture trustee or have in employment at least two persons who have experience in matters that are relevant to a debenture trustee
- The applicant or any person directly or indirectly connected with the applicant should not have been granted registration by the Board under the Act
- Should have in employment at least one person who possesses a professional qualification from an institution recognised by the Government in finance, accountancy, law or business management
- Any director or principal officer should not be and should not have been at any time been convicted for any offence involving moral turpitude, or found guilty of any economic offence

Role of debenture trustees:

- Act as investors' representatives in the debenture issue process after entering into specific written agreement for each issue
- Ensure that charge is created on assets offered as security by the issuer
- Ensure that debenture certificates, interest warrants, redemption amounts etc are sent to debenture holders on time
- Monitor issuers' assets to ensure that they are sufficient to cover liabilities to debenture holders
- Inspect any books of records etc to ensure that the above requirements are met
- Act immediately if there is a breach of the trust deed
- Call a meeting of the debenture holders when there is a need for such a meeting expressed by a minimum number of debenture holders, or when there is a default or any other event that affects the interest of the debenture holders
- When required, take possession of trust property in accordance with the provisions of the trust deed, enforce security in the interest of the debenture holders, and carry out any actions that are necessary
- In case of guaranteed or structured instruments, ensure that all necessary documents are executed and that the structure functions as expected
- Any other actions that may be necessary to ensure that statutory obligations with respect to debentures (such as creation of redemption reserve) have been carried out and debenture holders' interests are protected

2.3 Recommendations:

Net Worth

- The committee believes that a reasonable level of net worth is required; net worth stipulation should be for the entity and can allow net worth to be

- used across other fee-based businesses as well. This will allow participants to earn reasonable return on equity, and not burden them with large equity without corresponding returns. However, adequate safeguards are needed to ensure that the trustees' role is not diluted
- With this relaxation, the minimum net worth can be increased from the current Rs. 1 crore to Rs. 2 crores to account for inflation. But beyond this amount, the returns may not justify higher capitalisation
 - The committee also suggests that SEBI consider a two-level cut-off: a small net worth for the DT, and a much larger net worth for the promoter, akin to current regulations for Credit Rating Agencies (in turn this will require a commitment from the promoter to stay invested and involved in the DT). With this in place, serious commitment to this trustee business can be ensured through 'minimum promoter net worth' of Rs. 100 crores

Conflicts of interest

- There should be no conflicts of interest for a debenture trustee. This issue is already taken care of in the existing regulations

Funding the recovery process

- The committee recommends an investor protection fund (IPF)-like corpus for DTs to dip into, for meeting expenses like calling investors for meetings and carrying out legal proceedings. The corpus can be funded out of a small cess of a few basis points on debt issues. The fund can be replenished once recoveries occur
 - As an alternative to the corpus, the committee recommends performance guarantees and bank guarantees for issuers. A bank guarantee for some amount (Rs.5 lakh or Rs.10 lakh) can be provided by the issuer to fund the DT in calling for a meeting of investors and initiating legal proceedings for recovery in case the issuer defaults. Although banks will typically not be willing to offer guarantees with tenures matching those of all long-term instruments (especially in a situation where the issuer's creditworthiness is under increasing strain), some roll-over arrangement can be worked out
 - Another alternative is that a lump sum fee can be charged to the issuer which if unused can be refunded to the issuer without any interest after maturity of the debentures. The interest will become income for the trustee. This will be an incentive for the trustee to continue its activity. Also, the issuer can allow investors the choice of trustees out of a shortlist. The majority of investors (say 75%) can choose their trustee among the choices offered. This way, the most effective trustees will stand the best chance of being chosen and will thus have an incentive to work better
- Empowering DTs to carry out recoveries**
- The committee recommends to SEBI the possibility of extending SARFAESI/DRT mechanism to DTs. SEBI in turn can recommend the same to Ministry of Finance to make necessary amendments to the Act

- This inclusion is key to orderly development of the corporate bond market. Capital market investors' previous experience was not encouraging in terms of recovery by DTs through bankruptcy proceedings; this led many investors to shun mid-rated corporate bonds.
- The right to recover through CLB is currently available only to debenture holders, the same may be extended to DTs as well (under Section 117C(4) of the Companies Act 1956)

Information inadequacy

- It was proposed that there be a penalty on the issuer, not crippling but significant enough for management to notice, if it fails to regularly provide information

Disclosure by DTs

- The committee feels that it is desirable for DTs to disclose their performance with regard to timely creation of security, invocation of guarantee when required, etc. Such disclosure can be carried on the DT's website (such website therefore has to necessarily exist), and in filings with SEBI

Information sharing by DTs

- In case security is not created in a timely manner, or any other event occurs that might adversely affect debenture holders, the concerned DT should compulsorily inform related entities of this lapse

Renewal of License

- Licenses can be renewed subject to satisfactory track record in discharging duties with regard to diligent follow-up and timely reporting

The market perceives trustees as variable in the quality of their work and the interest they take

- It is desirable to set timelines or standard operating procedures governing specific activities of debenture trustees, such as:
 - Initiation of recovery proceedings within six months of default
 - Appointment of nominee director in terms of DT regulations within one month of default
 - Exercise of powers conferred u/s 117B(4) of the Companies Act 1956, within three months of shortfall in security cover
 - Initiating of actions related to exercise of rights of debenture holders, on a timely basis

It is suggested that all these recommendations be re-examined in light of the relevant provisions in the new draft of the Companies Act that is pending introduction in Parliament. This will be a separate exercise.

3 CREDIT RATING AGENCIES

3.1 Background

Few jurisdictions globally regulate CRAs. Among all Indian intermediaries, SEBI guidelines for CRAs are the most detailed, possibly because these were among the last sets of guidelines to be issued.

Globally there are three large CRAs: Standard & Poor's, Moody's, and Fitch Ratings. In addition, there are a number of CRAs with a national or regional footprint, some of them being affiliated to one of the three large global CRAs. In India there are four major CRAs that are registered with SEBI and operational; a fifth registration has recently been granted.

The globally prevalent 'issuer-pays' rating agency model has a structural conflict of interest, since the entity that commissions and pays for the rating exercise is also being rated. Rating agencies have to manage this conflict and prevent it from influencing rating decisions. Both regulations and internal procedures have to be designed towards this end.

It is important to have adequately strong eligibility criteria to keep inappropriate players out, but this has to be supplemented with a strong disclosure regime. Adequate disclosure and dissemination is necessary for investors to know whether a CRA has acted in time in taking its rating actions. In addition, it will ensure that investors are alerted in time on possible rating changes.

3.2 Current CRA regulations

Eligibility criteria:

The applicant

- (a) Should be a company under the Companies Act, 1956
- (b) Should specify rating as one of the main objects in Memorandum of Association
- (c) Should have a minimum net worth of rupees five crores
- (d) Should have adequate infrastructure to provide rating services
- (e) The applicant and its promoters should have professional competence, financial soundness and general reputation of fairness and integrity in business transactions, to the satisfaction of the Board
- (f) Neither the applicant, nor its promoter, nor any director of the applicant or its promoter, should be involved in any legal proceeding connected with the securities market, which may have an adverse impact on investors' interests
- (g) Neither the applicant, nor its promoters, nor any director of its promoter should have been convicted of any offence involving moral turpitude, or any economic offence;
- (h) The applicant should have, in its employment, persons having adequate professional and other relevant experience to the satisfaction of the Board;

- (i) Neither the applicant, nor any person directly or indirectly connected with the applicant should in the past have been –
- (i) refused by the Board a certificate under these regulations or
 - (ii) subjected to any proceedings for a contravention of the Act or of any rules or regulations made under the Act.
- (j) The applicant should be a fit and proper person for the grant of a certificate;
- (k) Grant of certificate to the applicant should be in the interest of investors and the securities market.
- (l) The provisions of the Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004 shall, as far as may be, apply to all applicants or the credit rating agencies under these regulations.

Promoter

Promoter should be one of the following:

- (a) A public financial institution
- (b) A scheduled commercial bank
- (c) A foreign bank operating in India with RBI approval
- (d) A foreign credit rating agency recognised law in the country of its incorporation, having at least five years experience in rating securities;
- (e) Any company or a body corporate, having continuous net worth of minimum rupees 100 crores for the previous five years

Validity of registration:

The registration remains valid if:

- (a) the CRA complies with the provisions of the Act, and all relevant regulations, guidelines, etc issued by the Board on the subject of credit rating.
- (b) information or particulars furnished to the Board by the CRA are not found to be false or misleading, and do not change subsequent to their being furnished at the time of the application without immediate information to the Board.

A CRA registration is valid for three years.

General obligations:

The following are some of the General Obligations that have been specified:

- Compliance with Code of Conduct stipulated by SEBI
- Agreement with the client
- Monitoring of ratings
- Procedure for review of rating
- Internal procedures to be framed by the CRA
- Disclosure of Rating Definitions and Rationale by the CRA
- Submission of information to SEBI
- Compliance with circulars etc., issued by SEBI
- Appointment of Compliance Officer
- Maintenance of Books of Accounts records, etc.
- Steps on auditor's report
- Confidentiality

- Rating process

Several other protective provisions exist like the regulator's right to inspect a CRA, prohibition of a CRA from rating its promoters and associates, etc.

3.3 Recommendations

Ownership

- It is recommended that all registered agencies be required to disclose publicly on their websites their shareholding pattern and the names of the owners
- It is also recommended that the question of promoters and their continuing involvement in CRAs that they promote be re-examined. Under the regulations as they stand today it is possible to 'borrow' an established company's balance sheet simply to meet the continuous net worth criterion for gaining registration

Disclosure of rating performance

- It is recommended that every CRA be required to publish, every six months, a list of its publicly outstanding ratings that have moved by more than one notch over the preceding six months (along with the number of notches moved). The entire period should be considered; therefore if a rating been downgraded twice by one notch each, it should feature on the list as a movement of two notches
- It is recommended that every CRA be required to publish one-year and three-year default rates, category-wise (eg. for 'AAA', 'AA', 'A', etc, separately) covering the entire history of its ratings
- It is recommended that every CRA be required to publish, every six months, a list of defaults over the preceding six months on debt that it has rated. Alongside the defaulted rating the CRA should mention the publicly outstanding rating immediately prior to default, and the publicly outstanding rating on the date six months before the day of default
- It is recommended that detailed disclosures should be made by rating agencies while rating PTCs in its rating rationales including names of the underlying assets in cases of CDOs
- Rating outlooks should be made disclosed for all long-term ratings on plain vanilla instruments and facilities

Discouraging 'rating shopping'

- Mandatory publication of unaccepted ratings if the rated security is listed within—say—1 year of the rating being assigned could be considered. However, any regulations on unaccepted ratings can easily be circumvented; the issue of 'rating shopping' should ideally be left to the market to decide
- RBI has allowed banks to use only accepted ratings, and the SEBI regulation could be aligned to the same

Preventing conflicts of interest

- It is recommended that a deadline be set for CRAs to separate their analytical and business development teams

4 ASSET MANAGEMENT COMPANIES

4.1 Background

This report is written as part of a review of eligibility norms for various categories of market intermediaries. SEBI has set up the Committee on Review of Eligibility Norms (CORE), various sub-groups of which are reviewing eligibility norms with respect to specific market intermediaries. This report is the result of deliberations of the sub-group that is looking at eligibility norms for asset management companies (AMCs).

The basic categories of issues that are being examined are:

4. Is there a need to review the minimum net worth that an AMC should have? If so, at what level should the minimum net worth be set?
5. Is there a need to re-look at the criteria for eligible sponsors to promote an AMC? If so what parameters should be used?
6. Are there specific infrastructure requirements that should be put in place for an AMC to be eligible for initial and ongoing registration?
7. Any other recommendations that can strengthen and smoothen the functioning of the sector

The liquidity squeeze in the market in the last quarter of 2008, resulting in redemptions from a number of debt schemes, the difficulties that they faced and the subsequent change of ownership of some AMCs, have brought these issues into immediate focus.

4.2 Current Regulations

Eligibility criteria:

The promoter (sponsor):

- (a) Should hold at least 40% in AMC (any entity holding 40% or more is deemed a sponsor)
- (b) Be in financial services for five years or more
- (c) Have had positive net worth for the preceding five years
- (d) The net worth in the immediately preceding year should have been more than the capital contribution of the sponsor in the AMC
- (e) Should have had profits after depreciation, interest and tax in three of the preceding five years, including the fifth year

These are abbreviated requirements; the full requirements are spelt out in the SEBI (Mutual Funds) Regulations, 1996

The AMC:

- (a) Should be a company formed and registered under the Companies Act, 1956
- (b) (If it is an existing asset management company) should have a sound track record (in terms of net worth and profitability), general reputation, and fairness in transactions
- (c) Should be a fit and proper person
- (d) Directors should have adequate professional experience in finance/ financial services-related fields,
- (e) Directors and key personnel should not have been found guilty of moral turpitude or economic offence/ violation of securities laws
- (f) Key personnel should not have worked for any AMC / other intermediary during the period when its registration has been suspended or cancelled by SEBI
- (g) Board of directors should have at least 50% independent directors
- (h) Chairman should not be trustee of any mutual fund
- (i) AMC should have a net worth of not less than Rs.10 crores (paid-up capital plus free reserves, less miscellaneous expenses not written off, deferred revenue expenditure, intangible assets) – certain relaxations for AMCs that were already in existence when the regulations came into force

Terms and conditions:

- (a) Any director in an AMC can take up directorship in another AMC only if he or she is an independent director, and has taken approval from the board of the AMC
- (b) Appointment of any director to be approved by trustees
- (c) No change in controlling interest of AMC without prior approval of trustees and board, written communication to unitholders and advertisement in newspaper, option to unitholders to exit without load

Restrictions:

- (a) AMC shall not act as trustee of any mutual fund
- (b) AMC shall not undertake any other business that is not in a limited and clearly-defined set of related activities (and even these can be undertaken only after meeting requirements for Chinese walls and capitalisation)
- (c) AMC shall not invest in its own schemes without full advance disclosure (and cannot charge fees on its investments in its own schemes)

Validity of registration:

Not specified in regulation

Validity of AMC's appointment:

- (a) Appointment can be terminated by majority of trustees, or by three-quarters of unit-holders,

- (b) Change in appointment of AMC subject of prior approval of board and unit-holders

4.3 Recommendations

1. Minimum Net Worth requirement for an AMC

The sub-group was of the opinion that the present minimum net worth of Rs.10 crore was too low. Although the operations of AMCs are in the nature of a pass-through, a larger net worth is required for the following reasons:

1. To build up the minimum infrastructure that is sufficient to service investors
2. To signal the company's seriousness of intent in setting up the business and inspire confidence, given that AMCs manage people's money in a fiduciary capacity
3. To ensure continuity for the AMC, and therefore provide reassurance to investors, in the event of the sponsor facing problems (this is especially relevant for foreign sponsors)
4. To bear the AMC's initial losses without facing serious financial strain
5. To provide adequate cushion to meet the requirements of growth in operations of the AMC for a reasonable time frame
6. To enable AMCs to be better placed to obtain liquidity lines from banks, if necessary, to provide some protection to investors from market-driven stress

A survey of global norms for AMC capitalisation reveals the following:

- In the US a new fund that is offering shares to the public has to have seed capital of at least USD100,000 (for each fund)
- In EU and the UK, regulations for UCITS (Undertakings for Collective Investments in Transferable Securities) link the capital to be maintained to the assets under management, with a floor (UK regulations also link it to the fund's annual fixed expense levels¹). The base capital is EUR125000 for AUM up to EUR250 million (a coverage of 0.05 per cent), with additional capital at .02 per cent of AUM in excess of EUR250 million. Notwithstanding this, the total of the initial capital and the additional amount required to be held by the company shall not be required to exceed EUR10,000,000.
- In Singapore, there are base capital requirements of SGD1 million (Rs.3.25 crore), SGD500,000, and SGD250,000, for various categories of fund managers (categorised by function, not AUM). However fund managers additionally need to take professional indemnity insurance linked to AUM.
- Japanese regulations do not specify any minimum capital for fund managers.

¹ <http://fsahandbook.info/FSA/html/handbook/UPRU/2/1>

After examining global practices and benchmarks, the sub-group believes that it is desirable to increase the minimum net worth requirement to Rs.50 crore. At this level, for an AMC with an AUM that is close to the system average of around Rs.15,000 crore, the coverage will be at a high (when compared to global norms) level of 0.33 per cent, while for smaller funds it will obviously be higher; however, the number is not prohibitively high to an extent that it would deter serious players or be anti-competitive. In addition, given that the present effort is to build up a durable regulatory framework that will stand the test of time, it is desirable to specify a net worth requirement that will support much larger AUMs. In other words the net worth coverage of AUM not only needs to be looked at from the point of view of the current situation, but also as one that would factor in growth over the next few years, especially given the low penetration level of mutual funds in India today: mutual fund AUM as a percentage of total AUM in India is around 10%, whereas the ratio for Brazil is around 40%; levels in developed economies like the US and Hong Kong are higher).

It is also recommended that existing AMCs be given an appropriate period by SEBI to build up their net worth to this level.

The following can be considered while deciding on the phasing in of the increase in net worth to Rs. 50 crore:

1. A gradual increase in minimum net worth can be stipulated, for instance starting at Rs.20 crore at the end of one year, and moving to Rs.50 crore by the end of three years
2. Distinctions can be made by product types offered by AMCs if found practical; for instance an AMC focusing only on exchange-traded funds need not have a large distribution network and the infrastructure requirements that go with it. Hence, an exemption from the net worth requirements can be explored
3. AMCs that have genuine reasons for not being able to meet the minimum requirements can apply to SEBI stating their case well ahead of the deadlines, and SEBI can then take a case-by-case view for providing exceptions

With regard to the definition of net worth, the sub-group felt that funds invested/lent back to group companies other than AMC subsidiaries should be reduced from the networth computations.

2. Sponsor criteria

Despite the pass-through nature of AMC operations, it is important for AMCs to have strong and serious sponsors. A strong sponsor would find it easier to attract – or provide – quality fund management personnel to an AMC. Also, the knowledge that a strong sponsor was backing a fund has been seen to provide comfort to investors even in times of turbulence.

One of the proposals examined was whether to restrict eligibility as sponsors to entities that are active in the financial services; it was also explored whether it would be feasible to define a list of financial services which a sponsor would have to operate in to be eligible. As a reference point, the Reserve Bank of India's 2001 guidelines for entry into banking were also studied, to understand the provisions preventing large industrial groups from promoting banks.

A key principle followed by RBI is to attempt to prevent the concentration of shareholding of a private sector bank in the hands of a few investors. The reason for this as articulated by RBI is that banks are "special" as they not only accept and deploy large amounts of uncollateralised public funds, but also leverage such funds through credit creation. They are also very important for the smooth functioning of the payment system. However, once this criterion of shareholder concentration is met, corporate bodies can also be shareholders in a private bank.

Given this "special" status of banks, and to avoid concentration of control, RBI has also looked at ultimate shareholder concentration rather than immediate shareholder concentration. This is especially applicable in the event the immediate shareholder of the bank is a financial sector entity where the objective is to ensure that it is a widely held entity, publicly listed, and a well established regulated financial entity in good standing in the financial community. At the same time where ownership is that of a corporate entity, where typically the shareholding is not as widespread, the objective is to ensure that no single individual/entity has ownership and control in excess of 10 per cent of that entity. This approach is instructive in drawing up norms for promoters of AMCs. Keeping in mind this background, and after considering several options on the above lines, it was finally decided that:

1. The Board could consider stipulating that only an entity that is regulated in some jurisdiction – as deemed appropriate by the Board – will be allowed to sponsor an AMC. In addition, while allowing an entity that is regulated in a jurisdiction outside India to sponsor an AMC, undertakings to provide any information that the Board asks for, to allow any inspection that the Board may wish to carry out, and to adhere to applicable Indian securities regulations, may be taken from the entity, besides compliance with any other requirements that the Board believes are necessary to ensure reciprocity.

The sub-group also felt that the issue of reciprocity could be explored in greater detail by the group dealing with functional issues of market participants (the General Principles Group).

2. Besides the existing criterion for recognition of an entity as a sponsor, entities whose names are part of the AMC's name or brand, or are being used to promote the AMC's fund offerings, should only be allowed to do so if they are sponsors.
3. The present definition of a sponsor as a 40% shareholder, coupled with the present requirement that a change in controlling stake of AMC shareholding requires a notice to all unit-holders allowing them to sell without exit load, creates an anomalous situation. If this controlling stake is defined as 10%, a holding of 76% going to 87%, which has no material impact on control, requires such a notice, whereas a holding of 49% going to 51%, which implies assumption of control, does not require a notice. This situation may be rectified by defining control for the purpose of this requirement as a stake of less than 50% going to more than 50%.
4. Similarly, dilution of AMC equity through IPO or ESOPs should not be looked at as a change in controlling stake.
5. **The sub-group understands that the 'fit and proper person' criteria are being re-examined by the Board, and therefore does not comment on the existing criteria. However, it is suggested that in case exclusion from the capital markets is being considered as a deterrent for wrongdoing, a stepwise structure for the period of exclusion can be considered, with the more serious offences attracting a longer period of exclusion.**

3. Infrastructure requirements for AMCs

Compulsory items in **bold**

Sr. No	Department	Rationale and Action point	Infrastructure sources
1	Investment Department	The online research databases provide extensive data and analysis on every Industry, Sector and listed as well as unlisted companies. Such databases help in creating historical profile of the companies to understand their business environment, industry dynamics and company specific fundamental data including	Capitaline or Prowess or CMIE software Dealing System Recording System Bloomberg or Reuters or News Wire. There will have to be at least two terminals of the above three, one in dealing room and investment function Subscription to funds

		financial statements. Investment research that is carried out needs to be implemented through trading room. Therefore, the investment needs to be equipped with basic infrastructure that supports the investment activities on a day to day to activities.	research (ICRA Online / CRISIL FundServices) Industry research (CRIS Infac Industry Information) CRISIL, Fitch Ratings, CARE, ICRA rating reports Economic Intelligence Services
2	Investment Dealing Function	Investment in Fixed income securities is done through trading platform provided by RBI and CCIL. It can be done through the NSE WDM as well, however, this needs to be settled through NDS / CCIL screen. AMCs will have to obtain the necessary connectivity before launching any fund.	NDS (OM) CCIL CBLO License Dealing Room should be equipped with Dealing system with fool-proof voice recording machine Bloomberg or Reuter or any other dealing system Direct Market Access (DMA) for equities and derivatives segment trades; need for maximum trading limit through DMA. 'View-only' stock exchange screen for viewing trades, confirmations, margins, settlement obligations, and transferring trade data seamlessly to back office.
3	Risk Management / Compliance	Risk Management is an integral part of AMC activities in terms of taking care of the interest of investors across all functions. Risk Management while it is more investment centric, the function looks at other risk factors in doing analysis on client concentration risk etc. Therefore, there is a need to have minimum support both in the form of people as well as software in carrying out this function	Application for monitoring compliance of Insider Trading norms Full accessibility to trading system to Compliance for limits monitoring Risk Management software such as CRISIL Risk Software, MSCI Barra or other such service providers in carrying our investment related risk exercise. This is a must to comply with regulation as well as to have

		smoothly	<p>the best practice.</p> <p>Risk Management should also be equipped with Business Intelligence Software in analysing the risk arising out of client profile, client concentration, segmentwise concentration, branchwise concentration etc.</p> <p>Branches to have separate server room with no access to any other employees.</p>
4	Operation Department	<p>Operation acts as a conduit to investment department and sales function in carrying out all the transactions viz. subscription, redemptions, investment trades, verification of trades from both external / internal limits point of view, ensuring proper documentation etc</p> <p>In case of any disaster situations/disaster recovery</p>	<p>Time Stamping Machines at each Official Point of Sales.</p> <p>DRT & BCP infrastructure with fireproof physical document storage facility.</p> <p>Strong middle office structure is suggested in carrying out the investment related function. Online system with all branches as well as Registrar in knowing the online movements of subscription/redemptions.</p> <p>Own intranet including browser based applications for immediate communication in respect of collection and redemptions across branches with HO</p> <p>Basic infrastructure to capture operational loss data, as is available in banking.</p> <p>Tie-ups with banks, CAMs, custodians and brokers to carry out settlement /</p>

			redemptions / funding in case of any disaster situation. Basic Location and basic manpower back-up to carry out functionalities in case of disaster.
5	Customer Service	Customer Service is key to success for the Fund Industry in the form of post sales service. Therefore, AMC should equip themselves with necessary support function / service before the launch of any schemes	Talisa or any other software that provides the log of all transactions of clients, commercial transaction of clients.
6	Training Needs		Training room with necessary facilities

4. Other recommendations

In terms of other recommendations, essentially what was discussed were steps that could be taken to enhance the transparency and disclosure levels in the industry which should lead to greater investor confidence and more robust operational dynamics. Some steps which could be taken are as follows:

- Make it mandatory to disclose all holdings of all schemes on website
- Specify details of all investments (including underlying exposure in case of PTCs)
- Monetary penalties on AMCs whose disclosure is inadequate
- Some reporting requirement should be there to indicate adherence to investment objective by schemes

REPORT OF SUB GROUP II

A. Preface

1. It is almost a truism that the adequacy, availability and quality of intermediaries will determine the shape and growth of Capital Market and Economy in India.
2. Some of the eligibility norms, registration process were prescribed in the early years of setting up of a new regulatory environment. With substantial passing of time, change in the size and nature of the capital markets and expectations from the Regulator, there is a need felt to review the requirements with the objective of achieving safety, security and orderly development of the Capital Market in India.
3. Accordingly, considering the importance of the role played by the intermediaries in extending the regulatory objectives and with a view to ensure that the ground rules are transparent, clear to encourage self regulation and the competition , SEBI had set up a committee to review eligibility norms of all the intermediaries.(should be the language put up by SEBI)
4. Each of the intermediaries require distinct requirements relating to skill sets depending on its role in the capital market. Accordingly with a view to ensure that the diversity of the requirements are adequately reflected in the final recommendations, the main Committee set up various Sub-Committees to examine the issues in light of the experience of the respective intermediaries
5. This Sub-Committee's membership is given in Annexure 1 and the terms of the reference are as follows:
 - a. Review of eligibility norms for registration of Merchant Bankers, Registrars and Bankers to the Issue in order to improve the quality of intermediation (should be the language put up by SEBI)
 - b. Review of the standards of conduct and international practices for the above and suggest improvement (should be the language put up by SEBI)
6. The members of the sub group are as follows:-
 - a. Sh Vallabh Bhansali, Managing Director, Enam Securities P Ltd. & Head of the sub group
 - b. Sh Motilal Oswal, Chairman & MD, Motilal Oswal Financial Services Ltd.
 - c. Ms Dipti Neelakantan, MD & COO, J M Financial Consultants P Ltd.
 - d. Sh V Shankar, MD, Computer Age Management Services P Ltd.

- e. Sh K K Mistry, MD, HDFC Bank
- f. Sh Somashekhar, MD, J Sagar & Associates
- g. Ms Preeti Malhotra, Past President, ICSI

B. Approach of the Sub-group

The sub-group deliberated on the principles which must determine its recommendations. Some of the principles are as under:-

- The recommendations must be aligned more closely to reflect the nature of each intermediary's business operations;
- The recommendations must be principle centered and must address the individual key risks each of the intermediary faces and collectively the system faces;
- The recommendations must be objective, easy to understand and easy to implement
- The recommendations must lead to a path of self regulation over a period of time

C. Eligibility norms for registration

a. Net Worth:

Sub-Committee noted the existing definition of net worth provided in various Regulations of SEBI. Presently except for Brokers where net worth is defined differently, most of the Regulations of SEBI for intermediaries has defined net worth as "Paid up capital+ free reserves- miscellaneous expenses to the extent not written off"

The Sub-Committee had the benefit of experience from the operating team at SEBI on areas where the current definition has been found inadequate to judge the prudential quality of the application. Some of the difficulties which are observed are as under:

- a. The above definition does not address the issue relating to deployment of the net worth
- b. The net worth definition does not clarify the inclusion of preference shares as part of the net worth
- c. The present definition is not aligned to the risk which intermediaries take and does not address the issue relating to quality, adequacy etc

The Sub-Committee noted the issues relating to deployment opportunity, need for capital in the business, need to provide for liquidity to meet emergency scenario and all other relevant issues before arriving at a consensus

Committee after considerable deliberations, recommends the following:-

- a. Net worth requirement should be specified in two categories- one as part of Core capital which is available at all times with the intermediaries and which is used solely for the purpose of creating infrastructure to service the Market.
- b. Risk Capital: similar to Broking, each intermediary to have a "risk capital" which will be available to them for business risks exposure. E.g. Merchant Bankers are permitted to underwrite 20 times of their net worth. For the purpose of calculation of the 20 times, only risk capital will be considered and not the Core Capital

In respect of the intermediaries under the terms of reference of the Committee, the committee noted the following:-

- a. Present requirements of Net worth in respect of Merchant Bankers is Rs 5 crores
- b. For Registrars and Transfer Agents - the current requirements are to the extent of Rs.6 lakhs and Rs. 3 lakhs respectively

The Committee considering all the representations and deliberations recommends the following:

- a. For Merchant Banking business, the Committee recommends a Core capital of Rs.10 crore
- b. Risk Capital will be commercially determined which will give the ability to underwrite
- c. In respect of Registrar to the Issue and Transfer Agents, the Committee recommends a core capital of Rs. one Crore and Rs 50 lakh respectively
- d. For Bankers to the Issue, since Basel II already provides for capital adequacy requirements, the Committee felt that segregation of the net worth from the overall net worth will not achieve any greater purpose and hence decided against recommending any specific net worth for the same.

The Committee believes that SEBI will give time and enhance the requirements gradually to help most of the players to cope up with the requirements.

Committee recommends the following additional inputs for the purpose of calculation of core and risk capital:-

- a. Core capital computation will consist of Paid up capital + Free Reserve- (Miscellaneous Expenses to the extent not written off + Inter Corporate Loans and Investments). Other deductions as provided for calculation of networth for CDS for brokers may also be considered.
- b. Preference shares if the redemption exceeds more than 5 years should be included for the purpose of the calculation otherwise not
- c. The Risk capital will be determined as = Paid up capital+ free reserve- (Core capital+ Mis.exp). The treatment of preference capital will continue to be the same

Most of the global regulators require a monthly prudential self filing on compliance. With the desired level of experience, the Committee feels that quarterly filing will be sufficient in this regard. The onus of monitoring the capital adequacy and certifying internally to the Management must be left to the Chief Financial Officer of the Company.

b. The Concept of Authorized (use globally “authorized” or “notified” or “registered”) person:

The basic focus of the existing registration requirements is on the entities since it is the entity (use “firm” or “entity” globally) carrying regulated activity which is required to obtain registration. However, regulatory regimes have long recognized that a regulated entity’s ability to meet and maintain proper standards depends crucially on the quality of its individuals, especially those in key positions.

Globally it will help to cite actual instances, individuals who perform significant influence functions are required to be approved or regd? by the Regulator before they can function in that capacity. Most of the Global Regulations define certain standards of conduct expected out of approved persons in their individual capacity over and above the conduct expected from the firm. Typically, such approved persons are required to adhere to certain principles over and above that to be adhered by the registered firms. Failure to comply with the principle will in most Regulatory regime be construed as an act of misconduct which may give rise to disciplinary or other enforcement consequences for the individual.

Significant influence person requiring approval are further broadly classified under four different categories- Governing functions- basically covering the persons responsible for directing the business, Required functions- which basically relates to apportionment and oversight functions; Systems and controlled functions- covering finance, risk, internal audit etc and Significant Management function- persons who have been entrusted with senior management responsibility to run the businesses

Approved persons are required to generally adhere to the following principles over and above those imposed on the firms:

- (a) To act with integrity
- (b) To act with due skill, care and attention
- (c) To observe proper standards of market conduct
- (d) To deal with the Regulator in an open and transparent manner
- (e) Take reasonable care to ensure that the regulated business for which they are responsible is organized so that it can be controlled effectively
- (f) Take reasonable steps to ensure that the business complies with any relevant regulatory requirements and standards

The disciplinary action will, be brought against an approved person where there is personal culpability. Culpability will arise if the person's standard of behavior falls below that which would be reasonable in all circumstances. In case of breach, the decision to initiate appropriate disciplinary action either against the firm or against the approved person are normally taken by the Regulator depending on the extent of personal culpability

In Indian context, most of the Regulations requires for 2 key employees who are qualified and have relevant experience for conduct of the business.

The following difficulties are generally noticed in this regard:-

- a. There is no employee data/ employee form filed with SEBI resulting in non standardized form of information without any ability to track the movements
- b. Fit and proper criteria are not employed on the key employees; the fit and proper criteria definition is more focused on the applicant than the persons behind or persons managing the intermediaries.
- c. The personnel risk and resultant risk to the Regulatory regime is an area completely unfocused. For every failure, the firm goes through

the disciplinary proceedings and there is no effort made to segregate the failure of the senior person and that of the firm

- d. Most of the Regulations prescribes Code for the firm; the need for the supervisory persons and separate additional Code for them are not envisaged

The Committee deliberated the concept of Authorized persons and resultant purpose it proposes to achieve. As a North Star ??? position, the Committee firmly believes that in alignment with the global regulatory regime, Indian Regulation should also move towards recognizing persons behind the firm instead of only the firm, as being responsible for all the acts, omissions and commissions.

Some members of the Committee felt that such an approval process should not result in regulating employment or movement of personnel. Taking into account all the inputs received from various members relating to quantum of people needs to go through the process, approach to be adopted etc, the broad recommendations in this regard are as under:-

- a. Initial step would be to define the core functions which will require a notification to SEBI. There are some position within the Intermediary which are crucial to manage the firm in a more appropriate manner and some other positions which are critical for the intermediaries self regulation. As far as possible, these requirements must be standardized and specified in the Regulations. Some functions like person responsible for supervision, business head, compliance, must be necessarily included in the above notification process
- b. Secondly efforts be made to standardize the notification requirement and put the same in public domain for the capital market community as a whole. In today's context there are facilities which are available for any person to verify the willful defaulters etc.
- c. The information which is displayed and available to the market may be in a specified format which must contain the basic fit and proper criteria declarations from each of the designated employees;
- d. SEBI should prescribe certain specific principles for such authorised persons
- e. While arriving at conclusions regarding the disciplinary proceedings, SEBI as far as possible must classify - whether the same is on account of the failure of the person to do his/her role correctly or on account of the firm. If the conclusion arrived at establishes clearly that the same is on account of mis conduct of the person, SEBI must initiate action against the person rather than against the firm

c. Manpower

The committee recommends that requirement of Key Management Personnel for Merchant banker, RTI/STA and Bankers to an Issue may be increased to four, who may consists of ;

- CEO - For the company as a whole
- Compliance Officer (can be common among different nature of intermediaries)
- Principal Officer under PMLA (can be the same person as the compliance officer)
- Head - Merchant Banking with professional qualification from an institution recognized by the Government in finance, law or business management **OR** an experience of at least **ten years** in related activities in the securities market
- An Officer exclusively for Merchant Banking or as the case may be with professional qualification from an institution recognized by the Government in finance, law or business management **OR** an experience of at least **five years** in related activities in the securities market.

d. Infrastructure

Most of the regulations prescribe that entity should have adequate / necessary infrastructure for effective discharge of duties assigned under the regulations and in most cases, prescribed infrastructure requirements are anachronous and are not commensurate with the nature of work handled by them.

IOSCO standard requires the following:-

- "Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk and under which management of the intermediary accepts primary responsibility for these matters.

Taking the standard as base and with a view to address key challenges in this regard faced by the various intermediaries, the Committee arrived at the following broad conclusions:

- a. Committee after considerable deliberations on the matter felt that the financial services industry is a knowledge driven industry which must rely more and more on soft infrastructure to develop its activities and contribute to the orderly development of the market. Committee recommends as a principle to emphasis more

on the soft infrastructure of the intermediaries to address the key risks arising out of its failure. In this regard, the following suggestions were made:

- Each intermediary should evolve its own supervision mechanism and Governance mechanism and submit a copy of the same to SEBI for records;
 - Each intermediary should prescribe its risk mitigation measures and document the same for reference and clarity;
 - Each intermediary should look into the area of Business Continuity and specify suitable norms in accordance with the requirements relating to that business;
 - System Audit should be made compulsorily for the intermediaries which rely heavily on technology like Registrar and Transfer Agents
- b. The Committee felt that most of the intermediaries are restricted from doing fund based activities at present. Given the nature of the function and services provided, most of the risk relates to operational risks, errors and omissions etc. With the opening up of the Insurance Sector and availability of various types of insurance to mitigate the risks, the Committee recommends mandatory Insurance Covers like Professional Indemnity Insurance Cover, Fiduciary Risk Insurance cover, should be prescribed as part of the requirement according to the nature of risks the intermediary is open to
- c. With a view to ensure that investors are not put into difficulties in case of emergency and the intermediary is up and able to provide desired level of service to the market in case of any emergency, the Committee specially recommended that the Regulation should provide for a mandatory requirement to provide for disaster recovery plan. The Committee also desired that Regulation should prescribe the minimum requirements in this regard leaving the commercial considerations to develop and establish a strong recovery mechanism
- d. The Committee also felt that the present requirement relating to record keeping, safety of the records , provision for keeping the records in electronic form should be more specifically addressed in the Regulation

D. CORPORATE RESTRUCTURING:

In an era where the necessity to continuously restructure to adjust itself to the market condition is a reality, there is a more and more need felt to have a complete clarity on how the same would be viewed by the Regulators. While some Regulations provides for seeking prior approval, most of the dynamics of Corporate restructuring process are not presently adequately covered in the Regulation resulting into operational lack of clarity and also varied practices in this regard

SEBI while granting registration focus more on the applicant, persons behind the applicant and fit and proper criteria of these persons to ensure that the market is safe and is developing in an orderly manner

Continuing the theme, the Committee felt that as long as the underlying persons on whom the fit and proper criteria has been applied continues, the same should be treated as reorganization of the business and no additional requirement should be made compulsory

However, if on account of restructuring, there is a change in control which necessitates fit and proper criteria to be applied on different persons behind the entity, the corporate restructuring should require prior approval and also a fresh registration process

To ensure that what would construe to be a change in control and not, the Committee recommends aligning the definition of control to that of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

E. OTHER SITUATIONS:

Various operational difficulties faced in implementing the Regulation were brought to the attention of the Committee from time to time. Some of the issues and the recommendations of the Committee are under:

- a. **Eligible categories for carrying capital Market activities and whether they can hold simultaneous Registration with other financial regulator**

Considering the governance requirements, the Committee strongly recommends a body corporate as the only permissible legal entity for making an application.

As regards the question as to whether the applicant may also perform other activities requiring registration with the other financial regulators is concerned, the Committee feel that the restrictions has worked well and reasonable. The markets have got adjusted to this mechanism and hence the need for a review in this regard is not felt. As long as the Regulatory purview is not unified, the Committee strongly feels that independent regulation is the safest process to achieve investor's protection and financial stability

b. Submission of renewal application before 3 months:

The Committee noted the recently introduced SEBI (Intermediaries Regulations) which provides for one time registration. Considering the fact that SEBI has already moved into the direction of one time registration concept, no recommendations are made in this regard

c. Investment by Intermediaries

Committee considered the question relating to permitting Intermediaries to invest in other businesses. Committee noted all the pros and cons and incremental risks which it poses to the intermediary and the system and recommends the following:-

- Investments in other business is possible as long as the liability in respect of such instrument/ investments are capped
- For the purpose of Prudential Norms, all strategic illiquid investments should be excluded
- The investment should not pose any hurdle nor put the intermediary in a conflicting situation visa vie the ability to carry on certain authorized function
- Investors interest are not compromised

Subject to the above, all intermediaries should be permitted to invest in related and non related investments as per the commercial requirements.

d. Outsourcing of certain activities

The Committee noted the trend of outsourcing activities and economics involved therein. The Committee after considerable deliberations felt that as long as the Intermediary is responsible for the activity the manner of doing the work should be left to the intermediary. In the event if the work is proposed to be outsourced, Intermediary should establish its credentials in managing the key output and satisfy the Regulatory Authorities in this regard.

e. Online data bases of various intermediaries

SEBI has progressively moved into e-filing of various half yearly and yearly reports. On the same lines and furthering the process, the Committee recommends complete on line data base

f. Removing the restrictions on entities in the same group to hold registration of same intermediary

SEBI has been following a process of permitting more than one entity in a group to carry a similar line of business as long as none of them have been rejected. The Committee recommends continuation of approach and feels that such decision should be left best to the commercial considerations.

g. Restrictions on carrying on activities post issuance of show cause

The Committee believes that as long as the final outcome is pronounced, no body should be made to suffer. The SEBI Act provides for a comprehensive mechanism of dealing with various violations and unless the process is completed natural justice would argue against any temporary restrictions. Committee is not in favor of restricting any activities of the intermediary post issuance of the show cause notice.

h. Surrender of registration

As this has already been incorporated in SEBI (Intermediaries) Regulations, 2008, Committee does not have any comments to offer.

i. Some other general issues:

- Some other terms like “associates”, “promoters” are varying in different Regulations- sub committee may define the term “associates” and “Promoters” uniform across the Regulations.
- Regarding recommendations for Registrar to Issues and Share Transfer Agents, comments may also be obtained from Registrars Association of India (RAIN).

The Committee wish to place on record sincere and very insightful contributions made by SEBI operating team more specifically Shri.Manoj Kumar, General Manager, Intermediaries Division and Mr. Avarjeet Singh for fantastic support provided to the Committee in arriving at its recommendations. The Committee also wishes to place on record significant contributions made in the deliberations by all the members and invitees from time to time.

REPORT OF SUB GROUP III

1 BACKGROUND:

This report is written as part of a review of eligibility norms for various categories of market intermediaries. SEBI has set up the Committee on Review of Eligibility Norms (CORE), various sub-groups of which are reviewing eligibility norms with respect to specific market intermediaries. This report is the result of deliberations of the sub-group –III that is looking at eligibility norms for Brokers (B), Sub brokers (SB), Depository Participant (DP) and Portfolio management Services (PMS).

The sub-group is headed by Ms Deena Asit Mehta, MD, Asit C Mehta Investment Intermediaries Limited. The other members of the sub group are:

1. **Shri Ravi Narain, MD, NSE**
2. **Shri Rajnikant Patel, MD & CEO, BSE (replaced by Shri M. L. Soneji)**
3. **Shri Gagan Rai, MD & CEO, NSDL**
4. **Shri V. V. Raut, MD & CEO, CDSL**
5. **Ms Manisha Girotra, Chairperson, UBS Securities India Private Limited**

The sub-group met on May 27, 2008. The basic categories of issues that were examined by the sub-group are:

1. Is there a need to review the minimum net worth that a B, SB, DP and PMS should have? If so where should the minimum net worth be set?
2. Are there specific infrastructure requirements with respect to manpower that should be put in place for a B, SB, DP and PMS to be eligible for initial and ongoing registration?
3. Any other recommendations that can strengthen and smoothen the functioning of these intermediaries.

Subsequently, on June 09, 2008 the mandate for review of eligibility norms for Custodians was also give to the sub group-III. Accordingly, the following 2 members were additionally nominated to the sub-group.

1. **Shri G. Subramanyam – Senior Vice President, HDFC Bank and**
2. **Shri Ashish Bajaj, MD, Citibank N.A.**

2) Stock Broker

2.1) Background

“Stock Broker” means a member of a stock exchange as provided under Regn 2 (gb) of SEBI (Stock Brokers & Sub Brokers) Regulations, 1992. “Member” means

a member of a recognized stock exchange (RSE) as defined under section 2 (c) of Securities Contract Regulation Act, 1956 [SCRA].

An individual or corporate body can become a member of a Recognized Stock Exchange (RSE). The eligibility criteria for being a member of a RSE are specified in Rule 8 of Securities Contract Regulation Rules, 1957 [SCRR]. The application for broker has to be forwarded through the respective stock exchange.

2.2 Current Regulations

Definition of Networth:

The capital of a member shall be computed as follows:-

- Capital + Free Reserves
- Less non-allowable assets viz. a. Fixed Assets, b. Pledged Securities, c. Member's card d. Non-allowable Securities, e. Bad Deliveries, f. Doubtful Debts and Advances (more than three months or given to Associates), g. Prepaid Expenses, h. Intangible Assets, i. 30% of Marketable securities

Apart from this there are certain margin requirements which are monitored by the Stock exchange so as to ensure that the working capital of the members is not unduly locked up.

Current Capital Adequacy Norms: The Capital Adequacy specifies that the stock broker / member shall maintain the Base Minimum Capital (BMC). The BMC is Rs 5 lakhs (Rs 30 lakhs for corporate brokers) for Bombay, NSE and Calcutta Stock Exchanges, Rs 3.5 lakhs (Rs 20 lakhs for corporate brokers) for Delhi and Ahmedabad Stock Exchanges and Rs 2 lakhs (Rs 10 lakhs for corporate brokers) excluding Madras Stock Exchange) for other stock exchanges, in case of Madras Stock Exchange Rs 20 lakhs for corporate brokers. This BMC is to be maintained in the form of cash with the Exchange (25%), long term (3 years or more) fixed deposit with the bank and the remaining shall be maintained in the form of securities with a 30% margin.

The stock broker / member shall maintain additional capital related to the volume of business. The additional or optional capital required of a member shall at any point of time be such that together with the base minimum capital it is not less than 8% of the gross outstanding business in the exchange at any point of time during the current settlement. The "gross outstanding" business of a member at any point of time shall not exceed 12.5 times of his base and additional capital requirements.

2.3 Recommendations

Net Worth

The sub group mentioned that intermediaries should be classified on the basis of risk business and agency business and that risk based business should be linked to capital adequacy. The sub group opined that that in respect of stock brokers, NSE presently had a fairly well defined definition which was aligned to the definition as per the JR Verma Committee Report. Since as per the NSE definition the value of assets and exposure to other stock exchanges are to be deducted hence the same may be acceptable definition and could be accepted and standardized.

The sub-group was of the view that the stock broker's net worth be increased to Rs. 1 crore for corporate and Rs.75 lakhs for other than corporate. The committee considered the problems faced by the stock brokers of the Regional Stock Exchanges and the present state of the regional stock exchanges and opined that the Net worth requirement could be relaxed for them initially. It was also expressed that the net worth requirement should be raised gradually to Rs.3 crore by year 2012 for the two big Stock exchanges viz., BSE and NSE and to Rs.1 crore by 2012 for RSE and that the same could be relaxed by 50% in case the stock broker is engaged in pro-trading only.

In summary, the following proposition was made:

Amt in Rs. Crores

Net Worth Requirement	By Year 2010		By year 2012	
	Corporate	Other than Corporate	Corporate	Other than Corporate
BSE & NSE Stock Brokers*	1.00	0.75	3.00	3.00
RSE Stock Brokers		0.50		1.00
Broker DPs		1.50		2.50
<i>* Networth requirement to be relaxed by 50% in case the stock broker declares that it would be engaged in pro-trading only. The Stock Exchange would facilitate preventing of client trades being fed and executed.</i>				

It was also felt that as existing in the F&O segment, in cash segment too the concept of professional clearing members should be introduced and the stock brokers be encouraged to have separate clearing members who could indulge in clearing trades.

In India, Custodians are required to confirm the trade on behalf of their institutional clients and take over the settlement obligation. It was also felt that for Investors which mandatorily need to appoint custodians, the custodian should continue to be their clearing member and for other investors, professional clearing members should be permitted who will add depth and expertise to the market.

A concern was raised with regard to the business activity by the intermediaries and requirement of networth. It was contended that if the intermediary/entity was merely engaged in an agency business, the moot thing would be risk taken on its own Balance Sheet by intermediary. In case the same is not in affirmative the concern should be more about compliance, infrastructure, etc. However, certain members stressed that in today's regime wherein the Power of Attorney is quite common the business is obviously exposed to operational risk as the terms of PoA itself at times are questioned in the event of any dispute. In this context a view was expressed that wherever the intermediary was expected to deal with public/public money eventually only body corporate be allowed to operate in the market.

3. Trading Members and Clearing Members of the Derivatives Segment and Currency Derivatives.

As per Regulation 2(gd) 'trading member' means a member of the derivatives exchange or derivatives segment of a stock exchange and who settles the trade in the clearing corporation or clearing house through a clearing member.

As per Regulation 2(ae) 'clearing member' means a member of a clearing corporation or clearing house of the derivatives exchange or derivatives segment of an exchange, who may clear and settle transactions in securities.

Currently the minimum networth required for Trading Member and Clearing Member is given below:

	Derivatives Segment	Currency Derivatives
Trading Member	Rs. 300 Lacs And min deposit of Rs. 50 lacs*	Rs 100 lacs
Clearing	Rs. 100 Lacs And min deposit of Rs. 50 lacs*	Rs 1000 lacs And min deposit of Rs. 50 lacs**

* Deposit with the clearing corporation or clearing house of the derivatives exchange or derivatives segment in the form specified from time to time.

** Deposit with the clearing corporation or clearing house of the Currency derivatives segment in the form specified from time to time.

Recommendations:

The sub group noted that the regulations for trading member and clearing member have been recently introduced and was of the opinion that a review of minimum networth is not required at this stage.

4. Sub Broker

As regards sub-brokers the sub-group felt that having regard to the existing scenario wherein the sub-brokers right to deal directly in funds and securities has been withdrawn there should not be much concern about the net worth requirement for a sub-broker. A concern was raised about the need of having sub-brokers in view of extant scenario wherein a sub-broker more or less acted as a branch of the broker, having no right to deal directly in funds and securities.

The sub-group was of the view that the sub-broker as an intermediary should be discontinued and in view thereof there may not be a relevance of any further deliberation with regard to related aspects with regard to sub-broker as an entity. The sub-group recommended disbanding of sub-brokers.

5. Depository Participant

5.1 Current Eligibility Criteria pertaining to networth is given below:

The application for DP has to be forwarded to SEBI through the respective Depository. The applicant should be any one of the following categories:

(i) a public financial institution, (ii) a bank, (iii) a foreign bank operating in India with the approval of the Reserve Bank of India; (iv) a state financial corporation, (v) an institution engaged in providing financial services, promoted by any of the institutions mentioned in sub clause (i), (ii), (iii), (iv) jointly or severally; (vi) a custodian of securities (vii) a clearing corporation or a clearing house of a stock exchange; (viii) a stock broker, (ix) a non-banking finance company, (x) a registrar to an issue or share transfer agent

The minimum net worth required is given below:

Category	Minimum Networth
For categories mentioned at sr. no (i) to (vii) above	NA
Stock Broker	Rs 50 lakhs and the aggregate value of the portfolio of securities of the beneficial owners held in

	dematerialised form in a depository through him, shall not exceed 100 times of the net worth of the stock broker (if NW is Rs 10 Cr aggregate value not applicable)
Non-banking finance company (NBFC)	Rs 50 lakhs
NBFC acting as a participant on behalf of any other person	Rs. 50 crores in addition to the networth specified by any other authority.
Registrar to an issue	Rs 10 Crore
Share transfer agent	Rs 10 Crore

5.2 Recommendation:

The sub-group noted that with regard to broker the minimum requirement as per SEBI Regulation was Rs.50Lakhs which has been raised by the Depositories, with NSDL to Rs.300 lakhs and CDSL upto Rs.150 lakhs. The sub-group felt that the net worth requirement should be increased to align with existing market conditions since the condition of minimum net worth of Rs.50 lakhs was stipulated initially when the Depository Act and DP Regulations were notified during 1996. However, it was also expressed that the requirement need not be increased abruptly. It was expressed that the net worth should be linked to particular activity.

6. Portfolio Management Services

6.1 Current Eligibility Criteria pertaining to networth and key personnel are given below:

(a) The capital adequacy requirement shall not be less than the networth of Rs 200 lacs (Earlier the NW was Rs 50 lacs which was increased to Rs 200 lacs vide amendment dated August 11, 2008). This was to be increased in two stages – upto Rs 100 lacs within 6 months from commencement of the amendment and Rs 200 lacs in the next 6 months.

(b) the principal officer of the applicant has the professional qualifications in finance, law, accountancy or business management from an institution recognised by the Government;

(c) the applicant has in its employment minimum of two persons who, between them, have atleast five years experience as portfolio manager or stock broker or investment manager or in the areas related to fund management;

For the purposes of this regulation, "networth" means the aggregate value of paid up equity capital plus free reserves (excluding reserves created out of

revaluation) reduced by the aggregate value of accumulated losses and deferred expenditure not written off, including miscellaneous expenses not written off.

6.2 Recommendation:

The sub-group noted that with regard to PMS the net worth requirement had recently been raised from Rs. 50 lakhs to 2.0 crores and therefore there may not be much to be deliberated as regards net worth requirement for a PMS. However, concern was raised about the absence of any concept of discretionary and non-discretionary PMS as was prevalent in certain overseas jurisdictions. It was felt by the committee that with regard to PMS, the concept of asset under management may be relevant to be introduced and the net worth may be pegged to the underlying assets under management. Accordingly, it was felt that the Net Worth in case of PMS may be 50 times of assets under management subject to minimum of Rs.2.0 crores.

It was felt that the custodians of PMS providers should also be permitted to rely on the KYC procedures performed by the PMS to improve investor convenience and this will also be in line with RBI regulations as well.

7. CUSTODIAN OF SECURITIES

7.1 Background

With the SEBI Act in 1992 and other regulations being put in place. An intermediary – custodian of securities continued to service mutual funds and Foreign Institutional Investors (FIIs). As there was no requirement under the SEBI Act for SEBI to register any custodian, SEBI was approving custodians as a part of the registration process of mutual fund and Foreign Institutional Investors (FIIs). SEBI notified the Custodian of Securities regulations in 1996. Until then SEBI approved 10 entities to act as Custodians, of which seven were banks and three had been set up by non-banking institutions.

While framing the custodian regulations in 1996, information was sought from already existing custodians on their operations. SEBI did not come across any jurisdiction which had regulations for custodian services. A questionnaire was sent out to several member countries of International Organization - IOSCO to ascertain their regulatory standards for custody services. Responses received from US, Hong Kong and UK indicated that custodian services are not regulated because they are not market intermediaries but service providers to the market. In the US for example, custodial services are mostly provided by banks and as such are governed by the requirements and regulations of the Federal Reserve. However, regulations for market intermediaries cast an obligation on them to ensure safe keeping of the assets of their clients. SEBI had also circulated a consultative paper vide press release dt. 29.9.95 inviting comments on the draft

regulations for custodian services. On the basis of the comments received, a memorandum was placed before the Board, in its meeting held on 31.10.1995. Subsequently, the Regulations were notified on May 16, 1996.

A) Present Scenario:

1. As on date, there are 16 custodians. Thirteen of these are banks, and other three are in the others category. On December 2005, SEBI received the first custodian application in the category of “Others” (non-bank entity) after the notification of Custodian Regulations.
2. It was decided in May 2008 that all applications to be processed as per existing regulations and any review if required shall be done separately. Pursuant to this, the first registration in the “others” category was granted to M/s. Orbis Financial Corporation Ltd. on June 17, 2008 and in-principle approval was granted to DSP Merrill Lynch Limited on October 22, 2008. Further, as on date four custodian applications in the category of “others” are in various stages of approval.
3. In view of the above, it is proposed to review all significant aspects like the eligibility norms, networth, kinds of services provided to the clients’ incidental thereto etc.
4. With the benefit of hindsight it can be stated that the custodian regulations were not detailed on account of most of the then existing custodians being Banks/Financial institutions/entities promoted by financial institutions. In addition, SEBI probably derived comfort from the fact that Banks are also regulated by RBI and hence would have dual supervision and thus result into better regulation.

A consultative note on Custodian was circulated to all the members of the subgroup.

B) ROLES AND RESPONSIBILITIES OF A CUSTODIAN:

The role of the Custodian can be defined as a) those expected as per the Custodian Regulations and b) those that are performed by custodians additionally, whether by themselves or in association with a bank.

Role as defined under the Custodian Regulations

Typically, a custodian performs the following activities on behalf of clients:

- Trade clearing and settlements: This includes electronic trade matching, confirmation on the exchanges, performing the settlements of cash and securities with the exchange clearing house etc.

- Safekeeping of Assets: Custodians safe-keep a variety of assets including shares, cash, derivatives, government debt securities, corporate bonds, structured product assets, physical securities etc. They have to ensure complete segregation and full control over all client assets. For funds, all assets that go into the composition of NAV are safe kept with custodians.
- Asset Servicing and corporate actions including
 - Processing both voluntary (e.g., Tender offers, buy backs, rights etc) and involuntary Corporate action (Bonus, Stock Split, Dividend etc).
 - Each of these events have a unique process attached to them, and custodians have to be able to support these in an automated fashion.
 - Automated notification process, adhering to proprietary electronic and SWIFT standards.
 - Follow-up of pre-advised voluntary corporate actions
 - Provide proxy voting services for clients – arranging for casting votes across locations, sending details to investors
 - Tracking, collecting and posting any income due to clients
- Providing Cash settlement services as part of settlement functions – managing funds in their bank account, providing cash projection reports to ensure timely funding, managing funds flow etc

Additional services provided by the Custodians

The below activities are being performed by almost all the registered custodians, as a value add to the customers:

- Providing market information and updates to investors which impact them
- Fund Accounting and Administration
- Providing automated and STP reports and triggers to clients
- Providing support on tax payments and processing

7.2 Current Practice for granting Custodian Registration:

1. Regulation 6 of Custodian Regulations states the eligibility criteria for granting the registration to custodians. An applicant needs to fulfill the following :-

- (a) the capital requirement of Rs 50 cr. exclusively for custodian operations
- (b) necessary infrastructure, including adequate office space, vaults for safe custody of securities and computer systems capability, required to effectively discharge his activities as custodian of securities;
- (c) the applicant has in his employment adequate and competent persons who have the experience, capacity and ability of managing the business of the custodian of securities;
- (d) the applicant has prepared a complete manual setting out the systems and procedures to be followed by him for the effective and efficient

- discharge of his functions and the arms length relationships to be maintained with the other businesses, if any, of the applicant;
- (e) the applicant is a person who has been refused a certificate by the Board or whose certificate has been cancelled by the Board;
- (f) the applicant, his director, his principal officer or any of his employees is involved in any litigation connected with the securities market;
- (g) the applicant, his director, his principal officer or any of his employees has at any time been convicted of any offence involving moral turpitude or of any economic offence;
- 2[(gg) the applicant is a fit and proper person;] and
- (h) the grant of certificate is in the interest of investors.
- (2) Notwithstanding anything contained in sub-regulation (1) the Board shall not consider an application made under regulation 3 unless the applicant is a body corporate.
- 3[Criteria for fit and proper person.
- 6A. For the purpose of determining whether an applicant or the custodian of securities is a fit and proper person the Board may take into account the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) *Regulations, 2008*.
2. Apart from the above, the applicant also need to fulfill the following requirements and furnish the same in the application form A:
- details regarding their infrastructure,
 - Vault security and access control systems
 - Systems for tracking securities
 - Risk control and operations manual
 - Details of independent internal control mechanisms for monitoring, evaluation and review of accounting safekeeping and reporting systems and procedures.
 - Details of hardware, software and communications systems, their capability, function and location;
 - Details of data storage and back up procedures and sites, their capability, function and location
 - Details of disaster recovery systems and procedures.
3. Some of the requirements as mentioned above like setting up of infrastructure, hardware, software etc. which the applicant need to fulfill at the time of filing an application require huge investments without having any assurance that they would be getting the registration after scrutiny of their application. Therefore, based on the submission made by some of the applicant, the division had decided to process the custodian application in following two phases:
- in-principle approval
 - Final approval
4. In the first phase the applicant has to provide all the relevant information

- and documents along with the application form A without making any investment on infrastructure and systems. They only require providing their proposed infrastructure and systems set up and should comply with other eligibility criteria as prescribed in Regulation 6.
5. Based on their submission the division scrutinize their application and if complies with the eligibility criteria as prescribed under Regulation 6 of Custodian Regulations, we grant an in-principle approval to go ahead in setting up all other requirements like infrastructure, systems requirements and hiring competent persons for custodian business within 12 months from the date of in-principle approval.
 6. On completion of setting up of systems requirements, the applicant is required to undergo a system audit prior to commencement of operations. The scope of the work is confirmed in consultation with SEBI.
 7. Once the applicant fulfills the in-principle conditions, it needs to file documents evidencing presence of necessary infrastructure set up to support custody operations, confirm the presence of adequate and competent persons to effectively discharge of activities as custodian of securities.
 8. Once the above documents are filed by the applicant along with the system audit report, a field visit is made to verify the followings:
 - Location / address
 - Manpower & experience, qualification of the key personnel.
 - Infrastructure (Office space, Communication facilities, Security systems, Insurance cover, Hardware & Software, Back up and disaster recovery etc)
 - Compliance, operations and risk management mechanism.
 9. Pursuant to the submission of the field visit report and based on the observations made the final approval for the commencement of custodian operations is granted.

7.3 Issue which were deliberated:

For deciding the kind of entities which should be permitted to offer custodial services and the eligibility criteria, the following points were considered:

1. **Eligible Category:** The Custodian Regulations do not specify who can apply for a Custodian registration, i.e. does not spell out the eligible categories of persons. However, the application form requires the applicants to indicate their category, as one of the following:
 - i. Bank
 - ii. Foreign Bank
 - iii. Financial Institution

iv. Others

The intent of including these categories in the application form was perhaps to capture the nature/ category of the applicants. It was by no means a restrictive list of categories of persons eligible to apply. As there are no restrictions in the custodian regulations, a restriction cannot find its way into the framework through the application form.

Further it may be noted that at the time the regulations came into being, some of the custodians were already providing services to the market place, an attempt thus appears to have been made to capture the nature/ category of the existing custodians while drafting the application form. The “other” field was kept open to accommodate, custodians who did not fit in the three categories of Bank, Foreign Bank and Financial Institution.

In the past four years SEBI received applications in the “others” category, who are mainly Brokers, NBFCs or Corporates. While all these entities meet the primary requirements of the Regulations and are hence eligible for grant of registration.

We cannot stand in judgement of SEBI decisions to give or not give Registration to Any class of entities.

2. **Capital Requirement:** As per the extant regulations, the custodian applicant has to fulfill the capital requirement of rupees fifty crores. This capital requirement has never been reviewed since 1996. A need was thus felt to review networth requirements.

As per the Custodian Regulation, networth is defined as paid-up capital and the free reserves as on the date of the application. One of the Core Committee Sub-Group viz Sub-Group – II, after considerable deliberations, recommended that the Net worth requirement should be specified in two categories:

- a. Core Capital: which is available at all times with the intermediaries and which is used solely for the purpose of creating infrastructure to service the market.
- b. Risk Capital: Similar to broking, each intermediary to have a “risk capital” which will be available to them for business risks exposure.

The following additional inputs for the purpose of calculation of core and risk capital:

- a. Core capital computation will consist of paid up capital + Free Reserve – (Miscellaneous Expenses to the extent not written off + inter corporate loans and investments)
- b. Preference shares if the redemption exceeds more than 5 years should be included for the purpose of the calculation otherwise not.

- c. The risk capital will be determined as + Paid up capital + free reserve – (core capital _ mis. Exp). The treatment of preference capital will continue to be the same.

As risk capital is not applicable in case of custodians, the committee may deliberate whether we may replace the “networth” with “core capital” as defined above.

- 3. **Providing services to the clients incidental thereto:** Most of the custodian banks are providing Fund Administration Services thought it is not includes in the regulation. It is observed that some of the custodian banks have taken a specific approval from RBI for doing this. In the past, we had also granted to do fund administration services to SHCIL on their request. Therefore, we need to include the fund administration services in the regulation with certain conditions like who can do the Fund Administration Services especially when we allow brokers, NBFC and corporate to enter in custodian business.
- 4. **Requirement for a vault:** The dematerialization of physical securities in theory eliminates the need for having a vault. However, as per the regulation, the applicant necessarily needs to have a vault for safe custody of securities.

The committee would like to deliberate whether the custodian applicant shall continue setting up a vault as required in the regulation.

- 5. **Provision for in-principle approval:** As per the existing Regulations, there is no provision for In-Principle approval to applicants. However, we had received many applications before the applicant put their systems and personnel and other requirements in place. The Division with the concurrence of the CoED, has granted in-Principle approval to two applicants out of that one applicant was granted final registration once they complied with all other eligibility criteria.

The committee would like to deliberate on granting of Custodian registration in two phase (in-principle approval & final approval).

6. Arms length relationship with other businesses:

As per the Custodian regulation the custodian of securities shall ensure that an arms length relationship is maintained, both in terms of staff and systems, from his other businesses.

7.4 RECOMMENDATIONS

7.4.1 Eligible Category:

The role of a Custodian needs to be performed in a highly automated and secure manner by reputed parties. The eligibility criteria should include:

- Entity's prior experience in safekeeping and servicing clients' assets (including tracking, providing alerts and managing corporate action) in any form, viz. Cash, Securities. The Custodians role involves taking on a high degree of operational risk, and entities should have the capability to manage the same, e.g., to manage a
 - Ability to manage financial assets on behalf of end investors.
 - Well versed with the functioning of the exchanges in India including risk management, settlement process, margining, fail trade process, settlement guarantee fund etc..
 - Active on going asset servicing with system solutions to track and reconcile.
 - Hence imperative to have a proven track record of managing financial assets on behalf of clients and capital markets experience.
- Infrastructure Requirements:
 - Seamless transaction processing between exchange systems, trading platforms, the Custodian's systems etc
 - Seamless integration between the cash and securities systems,. with consolidated statement of assets across cash and securities.
 - Proprietary electronic and SWIFT messaging capabilities
 - System capability to ensure end to end STP, which is critical given the value and volume of financial transactions managed by custodians.
 - Automated systems to process both voluntary and involuntary corporate action events.

7.4.2 Capital Requirement:

The sub Group felt that the "networth" should be replaced with "core capital ". The core capital can be set at Rs. 100 Crores.

7.4.3 Providing services to the clients incidental thereto:

The subgroup observed that the fund accounting services provided by custodians is governed by the contractual agreement with the client, e.g. mutual fund or insurance company. Each activity, including valuation policy, is determined by the client. The sub group recommend a process for approving Fund Accounting services, while keeping minimum regulations around the same.

7.4.4 Requirement for a vault:

The subgroup observed that physical securities are still prevalent in India, especially in cases like investments in unlisted companies, old physical securities, debt investments etc. Both domestic and foreign investors invest in such securities, and will require their custodians to be able to support the same.

Hence Custodians need to have the ability to manage such physical securities on behalf of client and ensure their safe custody. Custodians should be able to ensure full physical safety of such securities, and also track & reconcile these for purpose of ongoing asset servicing. Custodians should implement strong safeguard measures for such securities including vault safety, physical & premises security, controls against fire and other hazards etc. Hence it was felt that the requirement of setting up of a vault should continue, however in view of the current dematerialization scenario the specifications for a vault area can be reviewed and changed.

7.4.5 Provision for in-principle approval:

The sub group felt that the in-principle approval should be reviewed considering the back ground of the entity making the application and the preparatory work done by the said entity for the setting up of the Custodial shop. Subsequently, their infrastructure, the system capabilities and the trained / experienced resources should thoroughly be reviewed before the final approval. The system should be compatible to handle security settlements, fund settlements, holding report generations, corporate benefit accruals / receipts, the necessary reconciliations in all these fronts along with the reconciliation of the Depository and Custody holdings. The system should also be compatible to handle settlement in all segments namely Equity Cash / Equity F & O / Debt.

7.4.6 Arms length relationship with other businesses:

The subgroup agreed to the current regulation and felt that the arms length relationship should be covered during internal and external audit. The criteria for “arms length” should be explicitly defined for different types of entities like broking, portfolio managers etc.

7.5. Other Points for consideration:

7.5.1 Following Issues pertaining to Non-Bank Custodian were placed for consideration:

A) It would not be possible to deny registration on the basis of the fact that the applicant is a broking entity and thus subject to conflict issues, as they would in all likelihood, establish a separate subsidiary which would handle only custody business and apply for registration. In any case, many of our established custodians also have broking registrations, directly as a bank or through group/subsidiaries.

Eligibility criteria are necessary to prevent any frivolous entrant and mushrooming of custodians. Also, as the custodial services are a capital intensive and technology driven business and the custodian must have to must continuously adapt their technology because of the dynamic market practice and, we don't want any fake entity to become custodian and want the genuine players in the market.

B) Issues pertaining to brokers granting Custodian registration: Per se there is no heightened risk by allowing brokers to act as custodians. As the market has largely moved to dematerialized form, presence of DPs (who act on instructions of beneficial owners), risk, if any, posed by custodians have gone down.

- Though it may not be applicable to reputed corporate brokers (like Morgan, Goldman etc) have their proprietary trading as well, seeing the past practices of brokers in India of utilizing clients' securities / funds for proprietary trading, there is a risk that brokers, if acting as custodian, may use clients' securities for settling their proprietary obligations. This risk may be even more if broker is acting as custodian and DP both.
- Custodians have sensitive information about clients' portfolio. There is risk of breach of confidentiality of client information if broker act as custodian. Broker can use clients' portfolio information for its own purposes. Above risks can be mitigated by enforcing brokers to segregate their custody function from trading function. Also, custodian function of broker should be obliged to honour confidentiality of information regarding clients. That is, custody dept of broker should not share clients' information, unless there is explicit consent from the client, with its trading dept unless such information is required to be shared for normal clearing and settlement function.
- We have already registered several brokers as DPs, who in the dematerialized environment are not materially different from custodians. In terms of FII and Mutual fund regulations, these entities necessarily need to appoint a SEBI registered custodian for their activities in India. If the custodian services will be with broker and there would be no Chinese wall between the broker activities and the custodian activities, the broker may use the investment strategy adopted by mutual fund and FIIs for their own proprietary investment and influence the market. Hence, there arises a conflict of interest.
- However, if we directly deny giving registration to brokers, there are possibility that they will incorporate a wholly own entity and seek custodian registration.

C) In terms of FII and Mutual fund regulations, these entities necessarily need to appoint a SEBI registered custodian for their activities in India. It appears that in view of the increased assets being managed by the existing custodians, the custodial services is being looked at as a possible revenue source by many entities, especially considering the volume of business being transacted by FIIs and Mutual Funds. Accordingly, SEBI is likely to receive more applications under the "others" category.

7.5.2 The subgroup felt that the following points may be considered:

- As also explained in the beginning of this document (functions of a custodians), there are very significant differences between DPs and Custodians. Custodians perform a variety of functions over and above what a pure DP does, and take on significantly more operational risk. Hence regulations have to keep all these factors in mind while granting approvals to entities to act as Custodians. Some of these functions are outlined below:
 - Check for compliance with a number of regulations for client trades, using automated systems and processes. These activities are not performed by DPs, who cater to inherently retail requirements vs. institutional as managed by custodians. E.g., monitoring against various investment limits (like FII limits, PIT, SAST etc), RBI FEMA, SEBI Short sale regulations, FDI reportings (FCGPR and FCTRS) etc.
 - Custodians also do ongoing asset servicing and track corporate actions which DPs do not perform. This requires sophisticated technology and use of global messaging protocols to ensure there are no errors in the process.
 - Automated processing of both voluntary (e.g., Tender offers, buy backs, rights etc) and involuntary Corporate action (Bonus, Stock Split, Dividend, Stock consolidation etc).
 - Automated notification process, adhering to proprietary electronic and SWIFT standards.
 - Follow-up of pre-advised voluntary corporate actions
 - Provide proxy voting services for clients – arranging for casting votes across locations, sending details to investors
 - Tracking, collecting and posting any income due to clients
 - Custodians take on the exchange obligations when they confirm the trades on behalf of their institutional clients.

8. Manpower:

As regards other aspects, the sub-group was of the view that there should be certain emphasis towards capacity building and towards this importance need to be given to qualified manpower and defining the role of compliance officer.

As regards manpower and competence it was felt by the committee that as existing in certain foreign jurisdictions the concept of certifications be adopted. While already there were certain certifications mandated presently e.g. as in the F&O Segment, it was felt by the committee that in view of NISM having been established, by year 2010 it would be desirable to mandate certification for every person dealing in capital market ought to be qualified in his/her area of operation. It was also felt that a relaxation could be allowed for those intermediaries who were not expected to deal with public say a broker engaging in proprietary trading.

Regarding, the compliance officer the committee was of the opinion that while presently the regulations required a compliance officer be appointed, the role and compliance officer was not expressly defined. This assumed importance especially for intermediaries which were concurrently engaged in various capacities in the capital market and held various certificate of registration under the same entity. The committee was of the view that there was need to define the role and duties of compliance officer.

It was also felt by the committee that there were several complexities in the present environment wherein an intermediary was expected to seek separate approvals for every registration for same type of change. Similarly there was simultaneous compliance of minimum eligibility criteria. The committee was of the opinion that the registration and commencement of activity could be de-linked as akin to the listing and trading permission in case of listing of securities on a Stock Exchange.

REPORT OF SUB GROUP –IV

1 Background

The Group deliberated on the need for identification of functional issues related to market intermediaries keeping in mind not only the existing market structure but also the market structure few year down the line so as to visualize the role to be played by each intermediary. This futuristic roadmap for the market would help in providing direction to the intermediaries in terms of capacity building.

The Group felt that intermediaries could be classified on the basis of risk business and agency business and that risk based business should be linked to capital adequacy. Net worth should be related to risk exposure depending upon the role performed by the intermediary. There is a need to review regulatory requirements to enable intermediaries to set up branches/subsidiaries abroad. There is a need to address issues in the areas of governance, infrastructure, manpower, data security, outsourcing in line with current development and future of the market.

In this regard, IOSCO principles (21 to 24) which deal with market intermediaries serve as a guide on prescribing entry and other norms to various intermediaries. They are given below:

- ⇒ Regulation should provide for minimum entry standards for market intermediaries.
- ⇒ There should be initial and on-going capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
- ⇒ Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk and under which management of intermediary accepts primary responsibility for these matters.
- ⇒ There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

The minimum capital requirement for registration of each type of intermediary was discussed in detail. It is desirable that “capital adequacy” in relation to the volume of business done is stipulated for all types of intermediaries. Capital adequacy, thus, will consist of minimum capital required and risk capital. The capital adequacy should be defined in terms of Net Worth (Balance Sheet Capital). In addition to the minimum capital required, additional capital requirement (risk capital) may be prescribed for each type of intermediary

depending upon whether the intermediary performs agency type of business or otherwise.

The Group felt that SEBI may consider permitting Tier I capital and Tier II capital structure where Tier I consists of equity (owners' funds) and Tier II consist of Long Term borrowings, if the market expresses difficulty in rising the required capital in equity form.

Vision Statement: The vision statement adopted by the Group is
“Indian financial services industry shall gear up itself to serve multiple markets offering the whole range of intermediary services to the total satisfaction of client using robust, scalable, fail proof technology employing globally competent human resources strengthened by market/product/process research and innovation in a manner that it is able to withstand and better the competition from global organizations in this space.”

2 Recommendations:

2.1 Net worth

The Group recommended the following capital requirement structure for each type of intermediary after discussing the risk of carried by each type of intermediary.

Type of intermediary	Capital adequacy (minimum capital required) Rupees in Crore	Additional capital (Risk based capital)	Remarks
Stock Broker	5	12% to 15% of net position (net of margin received). If stocks are received in margin, 30% to 50% haircut shall be applied on the mark to market value of the stocks in margin for arriving at net position.	1. In order to ensure intermediaries are able to withstand the market risks, it is necessary that they are adequately capitalized. Therefore, the capital should not be less than 12% to 15% of the Risk Assets net of margins received. Writing options is a Risk Asset. Similarly, all other assets that are prone to variations in their value due to factors like

			deterioration of value of underlying assets, market price fluctuations, doubtful recovery, etc. are Risk Assets. 2. SEBI may consider prescribing a time line for existing brokerage firms to capitalize themselves as per the new norm.
Portfolio Manager (PMS)	2		
Depository Participant	3		
Registrar and Transfer Agent	5		
Merchant Banking	5	The underwriting limit shall be 20 times the net worth of the firm	
Underwriter	5	The underwriting limit shall be 20 times the net worth of the firm	
Asset Management Company	10		
Trustee Company to a Mutual Fund	1		At present no minimum net worth is prescribed for trustee company of a mutual fund. The trustee company shall have a corpus of its own to be able to fund some services it may like to hire independent of AMC like seeking legal opinion, causing special audits, etc. However, if the trustee is in the form of Board of Trustees (not being a corporate body), the corpus of such board shall not be less than Rs

			one crore deposited in a separate, clearly identifiable bank account.
Credit Rating Agency	5		The sponsors of the credit rating agency collectively shall have a capital adequacy of not less than Rs 100 Crore.
Bankers to the Issue			The capital adequacy shall be in accordance with the capital adequacy for a bank as stipulated by RBI. No additional capital adequacy is necessary.
Debenture Trustees	5		The sponsors of the debenture trustee collectively shall have a capital adequacy of not less than Rs 100 Crore.
Depository	100		
Custodian	50		

2.2 Multiple Activities:

If any entity is desirous of entering into multiple intermediary businesses, the capital adequacy shall be cumulative. For example, if a broker wants to set up a depository participant business, the capital adequacy shall be Rs 5 Crore plus Rs 3 Crore. If a broker wants to enter into PMS business, the capital adequacy shall be Rs 5 Crore plus Rs 2 Crore.

2.3 Registrar and Transfer Agents:

The group felt that it is necessary to stipulate a higher capital requirement adequacy for registrar and transfer agents. There is a shortage of good quality registrars in the country and existing registrars are not adequately capitalized to be able to provide quality service. The low capitalization leads to low recovery from services and low recovery results in lower standard of service and this vicious cycle can be broken only when the registrars are adequately capitalized. The positions on the proprietary book also shall be considered for arriving at the capital adequacy.

2.4 Requirement of registration of sub-broker:

The group felt that sub-broker need not be registered unless such sub-broker issues contract note on its name. As the broker is wholly responsible for the acts

of the sub-broker (authorized person in case of futures trading), SEBI may leave the responsibility of regulating/monitoring the sub-broker to the broker and may not be involved in registration. If sub-brokers are allowed to write contract notes on their name, or SEBI is of the view that Sub-broker registrations cannot be dispensed with immediately for any reason like need to change the legislation, etc, a new category of agents/franchisee may be introduced with an explicit provision that such agents/franchisees need not be registered with SEBI.

2.5 Setting up of branch/subsidiary abroad:

The group briefly discussed about the need to set up a policy for permitting intermediaries to set up branch/subsidiary abroad and recommended that SEBI may set up a suitable policy. An outline of the policy can be on the following lines:

2.5.1 Expansion for serving eligible investors residing in foreign country who want to operate in the Indian market:

- a. Such business can be done by a branch or subsidiary of the Indian intermediary depending up on the requirements of regulations in the foreign land.
- b. All local permissions will have to be taken.
- c. Such business should extend services only to such clients who are eligible to invest/operate in India.
- d. The Indian intermediary shall submit an undertaking that the branch/subsidiary shall be subjected to annual internal audit focusing on both operational and compliance audit and that regulator has a right to call for a copy of the internal audit report. This audit report shall be separately reported to the Audit committee.
- e. The clients shall be given the same protection as per Indian laws/regulations as if the transactions were conducted in India.
- f. If the regulator elects to inspect the branch functioning in the foreign country, all the necessary expenses of such inspection shall be borne by the intermediary. (The expenses shall include travel and hospitality applicable to any employee of the intermediary).

2.5.2 Expansion of business in a foreign country to conduct business in the foreign country:

- a. Such business can be done by a subsidiary of the Indian entity and not by the Indian entity directly.
- b. The subsidiary may acquire necessary licenses and permissions required for the same.
- c. Investments in such subsidiary by the Indian entity will be reckoned as a valid deployment of net worth of Indian entity.
- d. None of the key personnel (other than directors) of the Indian entity may assume any position in the subsidiary that may attract any personal liability/disqualification/regulatory focus.

- e. There shall not be any sharing of any asset/resource that will have an effect of impairing local business capability if there is an action on the subsidiary by a foreign regulator.

2.6 Code of Conduct for Key Employees:

The group felt that there is a need for prescribing code of conduct for key employees employed by the intermediaries to regulate employee conduct. The intermediaries are increasingly facing menaces like data tampering, data stealing, fraud on the clients, absconding from job without notice and getting employed elsewhere, etc. However, it is imperative that the criteria for defining/categorizing a defaulter need to be identified clearly. Every intermediary shall have a code of conduct for employees. SEBI may consider issuing broad guidelines on the contents of the code of conduct. SEBI, in its inspection may check whether the code of conduct is put in place and the status of implementing the same.

2.7 Reference database of defaulter clients:

The group discussed the need for setting up a reference database (like CIBIL) to identify the defaulter clients. At present, there is no database or industry wide mechanism that can help intermediaries in identifying the defaulting clients. SEBI may consider mandating that every intermediary shall subscribe to such database and update the database with the details of defaulting clients such that other intermediaries may refer to the database before entering into any relationship with a new client. Use of PAN as client identity proof is very helpful in setting up such a facility. SEBI may consider discussing with CIBIL for creation of such facility in the interest of intermediaries.

2.8 In addition to the minimum capital requirements, intermediaries shall build in strengths in the area of governance of their businesses, technology, internal control, risk management and human resource management. The following road map for the development of these competencies may be considered:

- 2.8.1 The form of organization shall be a corporate form (company form) clearly segregating ownership rights and functional responsibilities. Functional responsibility shall be left to competent individual specialists in the areas like compliance, technology, operations, funds management, risk and finance. Person so appointed shall be registered with the regulator and be accountable to the shareholders, board of directors and the regulator. If the entity is in to multiple businesses, each business should have a principal officer who shall be accountable to the shareholders, board, regulator and clients. The board of directors should have appropriate representation of independent and executive directors.

- 2.8.2 Capital Market Intermediaries are increasingly depending up on Technology for delivery of quality service. Technology should be given a legal status and receive appropriate level of regulatory focus. Use of technology in discharge of regulatory obligations like disclosures to the investors, regulators, etc by communication through website; emails; delivery of services using electronic forms transaction processing, use of non-human forms of point of service like kiosk, internet facility, etc should be recognized and well regulated such that the business entities can avoid investments in paper based processes.
- 2.8.3 Every intermediary shall set up operational and compliance manuals for each line of activity; set up operations and internal audit processes with a focus on risk management and risk mitigation. The persons in charge of these functions shall be adequately senior in the hierarchy and shall be answerable for their functions to the board of directors and regulator.
- 2.8.4 All those employees who are named as key or accountable to regulator and shareholders shall be qualified in some form and be under the regulatory jurisdiction. It may be in the form of certification or registration with regulator. This will help regulator and intermediary to expect a minimum standard of competence for the line of activity. SEBI may evolve appropriate qualification/registration norms for the same.
