Legal Framework for Clearing Corporation

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Clearing and Settlement

The most reformed sector in the Indian economy is the financial sector as evidenced by the fact that each segment in the sector has a regulator. Within the financial sector, the most reformed segment is the securities market which has witnessed 10 special legislations in as many years, definitely unparalleled by any standard, domestic or international. Further, within the securities market, the most reformed area has been the clearing and settlement (C&S) which has seen several innovations during the last decade, though some of them are yet to permeate to the entire market. The innovations in the C&S include use of the state-of-the-art information technology in the C&S, compression of the settlement cycle, T+2 rolling settlement, securities lending and borrowing, professionalisation of trading members, fine-tuned risk management system, multilateral netting, emergence of clearing corporation (CC) to assume counter party risk, real time gross settlement / electronic fund transfer facility, straight through processing, 100% electronic trading which obviates the need for trade confirmation, finality of settlement from the moment trade is executed, delivery versus payment, dematerialisation and electronic transfer of securities, almost 100% settlement in demat form, etc. These have improved the efficiency of C&S in India considerably and Indian securities settlement system (SSS) complies with the international standards such as ISSA Recommendations 2000, CPSS-IOSCO Recommendations 2001, and G30 Recommendations 2003 in letter and spirit. In many respects, it is ahead of many developed markets.

One yardstick used internationally to measure the extent of improvement in the SSS is the GSCS Benchmarks. These Benchmarks assess the settlement efficiency in the form of a single number expressed as a score out of 100 and provide an indication of the aggregate level of post-trade operational efficiency in the securities markets and track the evolution of the settlement performance over time. The higher the score, the higher is the efficiency. These Benchmarks comprising of Settlement Benchmark, Safekeeping Benchmark and Operational Risk Benchmark have improved remarkably in respect of SSS in India as may be seen from the table below:

Benchmark	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Settlement	8.3	-16.8	-0.7	-1.2	10.0	41.9	59.6	75.8	87.7	93.6	93.1
Safekeeping	71.8	75.0	76.6	76.8	69.7	78.1	81.9	86.7	88.6	88.1	91.8
Operational Risk	28.0	0.0	16.8	23.5	47.3	43.6	51.4	59.1	64.1	66.0	67.2

Source: Various Issues of Review of Emerging Markets, GSCS Benchmarks.

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In order to bring the score to the level of advanced markets, the reforms need to focus on settlement through CC which would provide novation and settlement guarantee. This mechanism is currently used by NSE and needs to be replicated with certain modifications for the whole market. The settlement through CCs needs to be made mandatory for all exchanges and participants. While this requires a lot of institutional changes and preparedness of the market and participants, this paper proposes a legal framework to make CCs operational. All the international standards stated earlier have emphatic recommendations relating to the legal framework. For example, the CPSS-IOSCO Recommendation No.1 talks that the SSS should have a well founded, clear and transparent legal basis. The ISSA Recommendation talks that the laws should ensure that there is segregation of client assets from the principal assets of their custodians and that no possible claim can be made on client assets in the event of custodian bankruptcy or any similar event.

The settlement has two aspects. One relates to settlement by way of transfer of securities on the books of the issuer. This has been addressed adequately by an exclusive legislation called the Depositories Act, 1996 which provides for the establishment of depositories to hold securities in demat form and maintain ownership records of securities in a book entry form. Almost 100% trades on exchanges are settled by depositories and there is a well developed depository system backed by a modern legislation. The other aspect is the settlement of trades executed on the exchanges. The Securities Contract (Regulation) Act (SCRA), enacted way back in 1956 to deal with trading on and governance of exchanges, considered C&S as an integral part of trading. It did not explicitly provide for C&S, which was left to be dealt with by the byelaws of the exchanges. The byelaws generally provided for clearing houses and the exchanges traditionally set up departmental clearing houses to facilitate settlement. The members of the

Exchange acted as trading-cum-clearing members. They knew each other and traded and settled trades among themselves.

The clearing house has limitations in the age of anonymous screen based trading system which does not allow participants to assess the counter party risk of others. The markets, therefore, have evolved the CCs to provide central counter party guarantee by novation. Besides, unbundling of activities made economic sense with the exchanges and CCs specializing in trading and clearing respectively. In Indian context, NSE, which brought in screen based trading system, voluntarily restricted itself to trading and set up a CC to provide C&S services. It, however, continued to have trading-cum-clearing membership which allowed brokers to become trading members of exchange and clearing members of CC simultaneously. The law, however, did not keep pace with these developments in the C&S systems and practices.

A regulatory requirement segregated the trading and clearing functions in the derivatives segment with introduction of derivatives trading in 2001. The Securities Laws (Amendment) Act, 2004, enacted on 7 th January 2005, inserted a new section in the SCRA to provide for C&S by a CC. It provides that an Exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a recognized CC for the purpose of the periodical settlement of contracts and differences thereunder, and the delivery of, and payment for, securities. It obliges SEBI to approve such transfer if it is in the public interest or in the interest of the trade. It further provides that only a company can be recognized as a CC and its byelaws need to be approved by SEBI. The various provisions in the SCRA such as grant and withdrawal of recognition, supersession of management, suspension of business etc. as applicable to stock exchanges shall, mutatis mutandis, would apply to CCs. Thus the CCs are subjected to the same regulatory framework as the stock exchanges are. The said amendment Act also mandated corporatisation and demutualization of stock exchanges under a scheme of corporatisation and demutualization approved by SEBI. All the schemes approved by SEBI provide that the trading members shall clear and settle trades till the C&S functions are transferred to a recognized CC which shall happen within two years (one year for BSE).

The amendment provides that an Exchange may transfer the clearing functions to a CC with the approval of SEBI and SEBI shall allow such transfer in the interest of the trade and in the public interest. It gives an impression that the settlement through CC may not always be desirable. It is only an enabling provision and the exchange is at liberty not to transfer and SEBI is at liberty not to approve the transfer of settlement function to a CC. Even without such enabling provision, the market has CCs. If it is considered that the settlement through CC is desirable and better than that through a clearing house, settlement through a recognized CC need to be mandated in no uncertain terms and that too, within a definite time frame. This has been done through the schemes of corporatisation and demutualization.

Regulatory Framework for Clearing Corporation

The amended Act states that various provisions in the SCRA shall apply to CC as they apply to an exchange. These provisions empower the Central Government to frame rules in respect of the exchanges. By implication, the Central Government needs to frame rules in respect of the CCs. The provisions parallel to rules 3 to 18 of the Securities Contracts (Regulation) Rules, 1957 relating to stock exchanges need to be incorporated in the said Rules to govern the recognition, supervision, governance and working of the CCs. The rules, in particular, may provide the procedure for grant, renewal and withdrawal of recognition, the requirements of becoming a CC and clearing members, management of CC, reporting and compliance, record keeping, inspection, etc. The C&S functions can be transferred to a recognized CC if there are recognized CCs in place and the CCs can be recognized only after the rules are in place. Hence the Central Government needs to frame the Rules under the SCRA relating to CCS on a priority basis. While recognizing the CCs, the byelaws of CCs need to be approved. In fact, recognition would be granted only if the byelaws are considered to be in order. Hence the CCs need to remain ready with the byelaws so that they can be recognized and the C&S functions can be transferred to them by the time mandated in the schemes of corporatisation and demutualization.

The provisions in the Rules to be made under the SCRA and the byelaws of the CCs to be made by CCs and approved by SEBI would constitute the regulatory framework for CC. The regulations relating to depositories and depository participants, which have a lot of functional similarities with CCs and clearing members, can be used to prescribe standards in the Rules for CCs. Similarly, the byelaws and operational manual of the National Securities Clearing Corporation Limited, which is currently providing C&S services to NSE, can be used to develop a model for CCs. The Rules for Exchanges and the Byelaws of the exchanges can be used with suitable modification to frame rules for CCs and byelaws of CCs. International standards such as IOSCO standards for Central Counter Party can be used to fortify the regulatory framework. While these would guide developing the regulatory framework for CCs, the following aspects need to be borne in mind:

a. Competition

It is not necessary that each stock exchange must have its own exclusive CC. The CCs associated with a particular exchange precludes competition among the CCs and muddles up the interests of the exchange and of the CC.

Besides, since it involves huge infrastructure, many exchanges may not be able to set up and operate an exclusive CC. It may, therefore, be better if the stock exchanges use the services of a CC or a few CCs, as they share the depository services. Apart from the scale economy and avoidance of conflict of interests, such an arrangement will allow the CC to have an overall view of the gross exposure position of clearing members across the Exchanges and will be much better geared to manage the risk. However, to provide for necessary competition, it is essential that there are at least two CCs, just as this has been ensured in the case of depositories.

b. Conflict of Interest

Since we will be starting from a clean slate, it is necessary that the ownership and management are so structured that it eliminates any kind of conflict of interests. For example, we should not have a situation when we have to segregate trading rights and clearing rights, as demutualization attempts to segregate ownership rights and trading rights. The exchanges should have only trading members while the CCs have only clearing members. The role of clearing members of the CC and trading members of the Exchanges clearing through the clearing members of the CC in the ownership and management of the CC needs to be restricted or regulated. Similarly, as far as possible, the management and operations of the CC should be independent of that of the Exchanges. The CC and the Exchanges clearing through the CC should be governed by contractual relations. The role of the regulator may only be to ensure that the terms of contract are not unconscionable and the CCs do not earn rent.

c. Recognition of CCs

It should be unlawful for any CC to operate in the market unless recognised in accordance with the Rules. There may also be periodical renewal of recognition. Procedure for termination or refusal of recognition of CC should also be laid down in the Rules. SEBI should not grant recognition to any agency to operate as a CC unless it is satisfied that the agency has the prescribed capital adequacy (As is case with depositories, a net worth of Rs. 100 crore or so may be set as the minimum capital requirement for an applicant seeking recognition as a CC). Before granting or renewing recognition of a CC, SEBI must satisfy itself that the CC is a fit and proper person; it has automatic data processing systems protected against unauthorized access, alteration, destruction, disclosure or dissemination of records or data; it has secured network for continuous electronic communication among the constituents; and it has .the infrastructure and operational design and other requirements in place to discharge efficiently the C&S functions. Even the capital adequacy and other requirements for clearing members may be prescribed. They may be required to be registered with SEBI under the SEBI (Brokers and Sub-Brokers) Regulations, 1992. Since CCs need to have dedicated slack resources to meet the exigencies of settlement, it should not undertake any other activity which can have contagion effect on the adequacy of resources of the CC. Like depositories, it should be prohibited from carrying on any activity other than that of a C&S of securities transactions unless the activity is incidental to the main activity.

d. Supervision of CCs

The CC and the clearing members should be subject to the same supervision and oversight requirements as Depositories and DPs are. The CC should also abide by a 'code of conduct' to be prescribed in the Rules. SEBI should have the right to inspect the books and records, the operational standards and any other relevant matter. The Rules should prescribe the procedure for action in case of non-compliance and default. This may include suspension or withdrawal of recognition, monetary penalty etc., manner of holding enquiry / adjudication, and appeal before the Securities Appellate Tribunal.

e. Bye Laws for CCs

The CC should frame the bye laws to govern the business operations. The bye laws of CCs should have following elements: (i) the criteria for admitting exchanges to clear and settle the trades executed on them, (ii) the types of transactions and the securities to be cleared through the CC and the manner of their settlement, (iii) the eligibility criteria for admission, the code of conduct and rights and responsibilities of clearing members, (iv) the standard of business operations and the manner of interface between exchanges, custodians, depositories, clearing banks and clearing members, (v) The pattern and use of default resources such as settlement guarantee funds, (vi) maintenance of books of accounts and records, submission of reports to SEBI, appointment of compliance officer, etc. (vii) the risk management norms and the operational parameters for clearing members, (viii) procedures for ensuring finality of settlement like auction close-out and securities borrowing and lending mechanism, (ix) procedure for arbitration and declaration of defaulters etc. The byelaws may be flexible to accommodate interoperability on a global basis to facilitate C&S across different national and international systems.

f. Client Assets

A feature of the securities transaction is that the transactions are carried out by the intermediaries on behalf of their clients. The intermediaries handle the money and the securities on behalf of the clients and hold these in their custody on their behalf. At times, the intermediaries like depositories hold the assets as registered owner on behalf of

beneficial owners. They have generally been advised by SEBI to segregate their assets from those of their clients and not to commingle the assets of the clients. However, there is a doubt if the assets of the clients can be attached in the event of insolvency of the intermediaries. There is no statutory backing to protect the investors in case of insolvency of intermediaries. In order to provide this protection of assets held in trust by the intermediaries on behalf of the investors, it is necessary to provide that an investor can entrust the money or securities to any intermediary (stock broker, sub-broker, depository, depository participant, custodian of securities, CC, clearing bank and such other intermediary who are involved with C&S process) to be dealt or held on his behalf and at his instance. The intermediary shall hold such assets in trust and shall not have any right, title or interest of any nature therein. He shall only deal with such assets as directed by the investor and shall be accountable for the same. Such assets shall not in any way form part of the assets of the intermediary and no authority can attach or seize such assets. The law should provide severe penalty if an intermediary fails to segregate the assets of the clients or of the clients from his own or uses the assets of a client for self or for any other client. This aspect should have been provided in the SCRA or the SEBI Act, 1992. Till such provision is made in either of the Acts, these could be incorporated in the Rules as an interim measure to provide necessary confidence to the participants to deal with C&S agencies. Similarly, since CC guarantees financial settlement, it should have the first lien over the assets of the insolvent clearing members.

These aspects may be considered by the Central Government while drafting the Rules relating to CCs under the SCRA, the regulator to approve the byelaws of and recognize the CCs and the CCs to develop the byelaws and seek recognition from SEBI.