

## Broking Industry - 10 Years Hence

M. S. SAHOO\*



If I extrapolate the current trend for a few years from now, I visualize three major changes in the broking industry. They are:

- a. the number of entities providing broking services would at best be 100,
- b. there will be no stand alone provider of broking service, and
- c. broking will have sharp client focus.

### **The number of entities providing broking services would at best be 100.**

Let us look at statistics relating to brokers on cash equity segments of exchanges. There are about 9,000 registered stock brokers in the market. The number has remained almost constant over last 8 years. It has rather started declining since 2001. This is despite manifold increase in the volume of trades. Take the case of NSE. The number of brokers on NSE reduced from 1013 at the end of March 1997 to 887 at the end of March 2003. The number of trades executed on NSE, however, increased from 26 million during 1996-97 to 240 million during 2002-03. This means that though the number of brokers reduced by 13% over 1997-2003, the number of trades executed by them increased by 823%. A broker of NSE on average handled 25,000 trades in 1996-97 while it handled 2,70,000 trades during 2002-03 - the average capacity of a broker increased ten times over 7 years. Further, the number of brokers on active exchanges is about 1500, the number of active brokers on active stock exchanges is about 500, top 100 brokers account for 62% of turnover, the share of top 100 brokers in total turnover of NSE increased from 44% in 1997-98 to 62% in 2003-04. These figures indicate increasing concentration of business among few brokers and big brokers are becoming bigger and bigger while small are be-

coming smaller and smaller and disappearing from the market.

Two developments contributed to this trend. They are: broking entities got corporatised and the technology became available and affordable for corporate brokers.

Let us first look at corporatisation of broking entities. Till 1985, only individuals were allowed to become brokers. Rule (8) (4) of the SCRR, then in vogue, prohibited a company to become a broker of a stock exchange. This framework envisaged broking as a profession dependent on individual skills and emphasized on individual attributes. It permitted only individuals to become brokers and explicitly prohibited companies to become brokers. It restricted liability of brokers by prohibiting them from associating with any organisation carrying on forward trading. It did not allow an individual to become broker on more than one exchange. It did not allow a broker to carry on non-securities business except as a broker not involving any financial liability. Nor did it allow him to advertise for business purpose or issue circulars or other business communications to persons other than his clients. All these indicate that broking was considered a profession, not a business.

The thinking changed and the need for better broking service was felt. By a notification in June, 1986 Government removed prohibition on companies to become brokers. It initially permitted section 322 companies to become brokers of the stock exchanges subject to the certain conditions. The conditions were also liberalized later on. The prohibition on becoming a broker of more than one exchange was withdrawn in November 1988. De-

\*Mr. M.S.Sahoo, Chief General Manager, SEBI. The views expressed are of the author only and not of SEBI. Email ID : msahoo@sebi.gov.in.

spite these initiatives, the corporate brokering did not take off. The legal changes were effected in November 1992 to open up the brokering of stock exchanges to corporates with limited liability. In order to encourage existing brokers to corporatise themselves, which was considered desirable for development of the securities market, the Income Tax Act, 1961 was amended in 1997 to exempt capital gains tax on corporatisation of broking entity. The SEBI Regulations, 1992 were amended in January 1998 to provide for fee continuity benefit on conversion. In response, many brokerage firms reorganised themselves into corporate entities. At the end of March 2003, about 40% brokers were corporate bodies.

Thus a conscious effort has been made to convert broking from a professional activity to a business activity and brokerage entity from proprietorship form to corporate form. The changes in law to allow corporate entities to take up broking activity, the brokers to operate on multiple exchanges, brokers to issue advertisements in a limited way, incentives to corporatise broking entity etc. indicate efforts in this direction. There is a complete U-turn in the sense that companies, which were explicitly prohibited from becoming brokers, are now encouraged to become brokers. This trend would continue, now that the regulators, exchanges, brokers and investors have tasted the fruits of corporatisation in terms of quality of service and compliance, and the day is not far off when individuals will be prohibited from becoming brokers. And the existing individual brokers may be forced to corporatise or quit and corporates may be induced to become brokers. These corporate brokers can hire professionals to provide professional broking services. The corporate would be required to satisfy the requirements of brokering such as financial soundness and infrastructure while their employees would be required to have/acquire skills to provide broking services. Thus ten years from now, the market would have only corporate brokers, who would employ qualified professionals to render broking services.

The other contributing factor is technology, which provided scalable solutions to automate the secu-

rities transactions. In course of time the technology became affordable. The exchanges provided electronic trading platform. Brokers embraced technology not only because it was necessary to access electronic trading system of the Exchange, but also because it made business sense - improved the efficiency of their operations, provided huge economies of scale, and made compliance function much easier.

The corporatisation enabled brokers to invest heavily in technology. This allowed them to undertake additional business at negligible or zero marginal cost. If a broker puts in additional 1000 orders on the NEAT trading system today, it really does not add to his cost. On the other hand, the cost of setting up systems and ensuring compliance with ever increasing rules and regulations of SEBI and Exchanges became too heavy for small brokers to break even. This is because of the nature of business of broking and the technology, which provide substantial economies of scale after a threshold level of investments. This trend would continue - big brokers will continue to invest in technology and human resources and grow bigger, while small brokers would fail to do so and consequently fail to provide quality service to clients and to meet ever increasing compliance requirements and gradually withdraw from the market. This is exactly parallel to the business of stock exchanges, where big exchanges have become bigger and small exchanges have become smaller. As one or two stock exchanges can now cater to the needs of the entire market, a few brokers, with financial muscle and available technology, can also cater to the needs of the whole market. A bank with 13,000 branches can offer trading terminals in all its branches and if a few banks do so, clearly there is no space for 10,000 brokers in the market.

This would precipitate further if smaller exchanges disappear; then about 8000 brokers will also disappear overnight.

Thus 10 years from now, I do not see more than 100 brokers in the broking industry. I would not be surprised if there are only 100 intermediaries in the securities market providing different kinds of

intermediation services. Of the 100 brokers envisaged, the majority would be trading members while there would be a few clearing members. These clearing and trading members would operate across the segments, and across the exchanges and even across markets.

**There will be no stand alone provider of broking service.**

Currently brokers enjoy a sort of monopoly. The trading platform of an Exchange is accessible to brokers only. While granting this protection, *i.e.* reserving an exclusive area of trade for brokers, the law prohibits them from taking up any other fund based activity. They can not do broking in non-securities; nor can they do non-broking business. Many brokers consider this restriction as unreasonable, particularly in the liberalised environment. It was okay when a broker was an individual professional. It does not gel well when a broker is a corporate business entity. How can you say that a corporate entity can do only one kind of business? Can one prescribe that a corporate, engaged in cement production, can not produce cement? Many brokers, therefore, demand freedom of business and trade guaranteed in the constitution; they would like to undertake any kind of business - broking in non-securities, and even non-broking activities in securities market or elsewhere. They would like to act as banker, an insurance agent, trade in commodities futures, and even engage in manufacture of steel. Some of them are thinking to enforce their freedom of trade and business through a court intervention. The authorities are not oblivious of such demand. They are gradually diluting the restriction. They have diluted this restriction in case of corporate brokers, and specified agencies such as IDBI, NABARD etc. They have recently permitted brokers to undertake broking in commodities, though in a truncated manner. They have allowed brokers to do some kind of fund based activity incidental to broking such as margin trading and stock lending. Banks, even though engaged in fund based activities, have been allowed to undertake broking. The clearing members in the derivative segments have freedom to take up any activity. This trend would

continue and soon brokers would have absolute freedom to undertake any other business or activity.

When they would have such freedom or the restriction is withdrawn, they would also lose the associated privilege. As brokers demand freedom to undertake any other activity, other economic agents similarly demand freedom to undertake broking activity. A merchant banker, a commodities broker or a NBFC would like to do broking. Every economic agent demands absolute freedom of business and trade. In course of time, state must fulfil this demand and if not fulfilled, it will be enforced by Courts. This means that existing brokers would face competition not from poor broker cousins, but from financial power houses. The entities having huge financial muscle power and carrying on various activities in financial market would offer broking services. In such circumstances, many of the existing brokers will go out of business unless they join or create a big financial power house. Ten years from hence, there would be about 100 such financial power houses who will be providing various financial services, including intermediation services in securities market and broking. And each such power house would be a one stop shop for all financial products/services. It will have license to act as a banker, a commodities broker, a portfolio manager and a securities broker simultaneously. There would be no stand alone provider of broking service.

**Broking will have sharp client focus.**

The demutualization of exchanges is imminent and inevitable. This will segregate the trading rights from ownership and management. Both authorities and brokers realize that the business works better if trading rights and ownership rights are in different hands. Authorities want demutualization to avoid conflict of interest. The brokers, with strong motivation for business, feel that their interests are better protected by non-interested professional management. They like to concentrate on business rather owning and managing exchanges.

As a result of demutualization, the exchanges would lose the status of self regulatory organiza-

tion. Associations like ANMI/BSE Brokers' Forum would be SROs and will be recognized/registered by the regulator as such. They would not only be an industry association to promote the interest of its brokers as it is today, they would also regulate the conduct of its brokers in public interest. They would have strict entry and eligibility criteria and only after one satisfies their requirements; it would be registered as broker by Exchange or SEBI. However, there will be a few such SROs, who would compete among themselves as Exchanges do today. As a result, public interest would get precedence over the interest of the brokers. In public interest, the SROs would make huge investments to upgrade the quality of broking service.

With demutualization, the exchanges would not have incentive to restrict the number of brokers. Brokership would be available on tap. One would no more buy brokership card at a hefty price from market. There would be free entry and free exit to broking industry and any body and every body complying with the requirements of broking will be registered as broker. This would introduce perfect competition, which would force brokers to concentrate on business, not on exchange management. The competition would come not only from existing brokers and financial power houses but also from clients who would have direct access to trading platform. The competition would demand higher transparency and good corporate governance and ensure utmost care of the clients. Every detail of the broker would be available in the market. The regulator/Exchange or SRO would maintain databases where the details of every broker, including its management, associated entities, financial soundness, track records of service, punishments, etc. would be available and a client would use these details for choosing its broker. Even the brokers and SROs would seek rating and such rating would also be available on the web. I understand that the rating agencies have already developed models to rate various market intermediaries, including brokers. The rating and branding would play a crucial role in attracting clients. These would require continuous nourishment which would force the brokers and SROs to be more client oriented. This would force

them to innovate consistently to render better services to clients at lower charges.

Another factor which will increase client focus is technology. It has completely changed the architecture of securities transactions. It has made the trading platform accessible to clients through the internet and mobile devices. It would continue to play a much bigger role in the days to come in execution of trades and monitoring of positions in the market. It would enable exchanges to directly map the ultimate clients having a distinct identification number, which can be linked to their bank and the depository accounts. The clients would execute their trades themselves and systems would be potent enough to check the availability of funds in their bank accounts or securities in their depository accounts before execution of orders. Indeed, the system would lock in funds in the bank account and the securities in the DP account before executing an order. A reverse transaction would unlock the said funds or securities and make room for further trading by the clients. As execution and monitoring of trades would be taken care of by technology, it would be a paradigm shift in the market microstructure and clients would not need to go through a broker. If this happens, there will be pressure on authorities to allow clients to access trading platform directly, and law will be changed accordingly. Thus the broker will have competition from fellow brokers as well as clients.

This does not mean that the brokers will have no business. There is no requirement of using an intermediary to buy NSC from post office or a life insurance policy. But most such transactions are facilitated by intermediaries. The clients in securities market have access to trading platform through the Internet. But the volume of trades executed through the Internet is still insignificant. It is because clients value the assistance of a better equipped person and like to transact through him. If transactions are so simple like buying over the counter medicine, clients can do trades directly. But if it is buying prescription medicines, clients would need the assistance of a qualified person. Even all clients would not be equipped to undertake simplest of simple transactions. What would,

therefore, happen is that the some clients would undertake plain vanilla transactions directly. They may not mind to transact through a broker if the broker charges a very nominal amount for its services. The fact that the marginal cost of undertaking a transaction is close to zero, and the nominal broking charges can attract the clients to broker for plain vanilla transactions would keep the broking charges to minimum. Some other clients would need assistance of a broker even for simple transactions. Most clients would need assistance for transactions in sophisticated instruments.

Innovations are very fast in financial market. Newer and newer products with complicated features are coming up every day. Thus there would be two niche segments in the market. One is market for traditional products where the clients can trade directly. In the other market, where new sophisticated products are traded, the clients would need to use brokers. The volumes in the second niche market would be much higher as we see derivatives volumes are now higher than the volumes in cash markets. In order to service in the second niche market, the brokers will redefine their competencies and skills set. They will reposition themselves as consultants or advisors to the clients as their role on the execution of the trades would come down drastically.

Thus I visualize a scenario where there would be at best 100 financial service providers who would also provide broking service with sharp client focus.

### **The above structure will throw up a few issues.**

It emerges from above that 9,900 brokers would disappear in next 10 years. But this may not happen automatically and may not be painless. Many exchanges have zero volumes for more than 5 years now, but no exchange has closed down so far. It is because of market rigidities and the pains associated with any closure. Similarly, there would be 100 entities providing broking services, while 9,900 registered brokers will remain on record without any business. What to do with these 9,900 brokers? Not only the infrastructure and resources of these 9,900 brokers would be a national waste,

they would also create risk for the system. An idle mind is devil's workshop - they would continue to be supervised by SEBI even if they do not have any business. The authorities and the brokers need work towards painless closure of broking units through a process of consolidation. The brokers and the authorities should jointly work out a strategy to replace the ill-equipped under utilized industry of 10,000 brokers by a strong professional well capitalized industry of about 100 brokers. The brokers need the support and assistance of the authorities to convert themselves to financial conglomerates, which can compete even at global level. There are two main hurdles to consolidation which need to be removed. One, while the broking entities consolidate, there would be transfer of assets and liabilities and various transactions between/among existing/emerging broking entities. Such transactions would attract taxes, including capital gains tax. The fear of payment of such taxes would discourage the brokers to come together. The kind of exemption available on consolidation of industrial units could be extended to consolidation of broking entities. Second, SEBI should also facilitate consolidation by providing fee continuity benefit to the emerging entity, if the erstwhile consolidating entities have paid full fees. This would be analogous to the incentives granted by Government and SEBI for corporatisation of broking entities in 1997-98. The brokers should come forward to merge/amalgamate with one another in the interest of their growth and survival.

The other issue is monitoring and compliance. If an entity provides services in the jurisdictions of three different regulators, and also provides three kinds of services in each jurisdiction, there would be regulatory overlaps and gaps. This would induce activity based regulation - each regulator shall monitor his area of activity. Three different activities of an entity would be regulated by three different regulators. In addition, a common agency floated by all the regulators shall monitor the activities of each financial power house which provides different kinds of services, including broking. The authorities need to prepare for this kind of environment.