

Improving the Regulations for Intermediaries

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The SEBI Act empowers SEBI to frame regulations for regulating the intermediaries. In pursuance to this, SEBI has framed a number of regulations for different intermediaries and registers and regulates them under these regulations. The regulations in respect of each intermediary generally prescribe the following:

- a. the requirements of becoming an intermediary,
- b. the procedure for becoming an intermediary,
- c. the fees payable by the intermediary,
- d. the general obligations and responsibilities of an intermediary,
- e. the code of conduct to be followed by the intermediary,
- f. the procedure for inspection of an intermediary,
- g. the procedure for action in case of default, and
- h. the surrender / cancellation of certificate of registration.

The regulatory framework for intermediaries, which has been evolving since 1992, has stood the test of time and has been able to ensure, by and large, quality intermediation services in the market. This paper, however, makes a few suggestions which would make marginal improvements in the regulatory framework for intermediaries.

Repeal of Rules: There are a set of Rules framed by central government before 1995. These are SEBI (Brokers and Sub-Brokers) Rules, 1992, SEBI (Merchant Bankers) Rules, 1992, SEBI (Portfolio Managers) Rules, 1993, etc. These prescribe, inter alia, the conditions of registration of the intermediaries. In order to provide flexibility to SEBI, the Securities Laws (Amendment) Ordinance, 1995 was promulgated, which provided that the regulations to be framed by SEBI would prescribe the conditions of registration. Now the central government does not have powers to frame rules to prescribe conditions of registration. But the rules already framed by government before 1995 continue to be in force today. Even if some of the provisions of the rules have become redundant in the changed circumstances and require modification, the central government can not amend them. Hence the

obsolete rules continue and would continue to be in force. Further, though it is a requirement of the SEBI Act that the conditions of registration should be prescribed in the regulations, these are prescribed in the rules. It is, therefore, desirable that such rules are repealed and the relevant provisions from these rules, with suitable modifications, are incorporated in the regulations.

Cessation of Registration: The SEBI Act empowers SEBI to suspend or cancel a certificate of registration in such manner as may be determined by regulations. While the regulations provide for penal suspension or cancellation of registration; they do not provide a procedure for voluntary surrender of registration. Some of the regulations provide for enquiry proceedings to cancel the registration even when the intermediary surrenders his registration voluntarily. Cessation of registration of an intermediary is similar to cessation of employment of an employee. One can understand if an enquiry is instituted to suspend or terminate the services of an employee. But it is not convincing if an enquiry is instituted to accept the resignation of an employee. The requirement of enquiry causes avoidable delay in acceptance of surrender of registration. Besides, SEBI wastes its scarce resources in instituting enquiries and passing orders in respect of a large numbers of surrenders that take place every year. The regulations should, therefore, provide for cancellation of registration, if surrendered voluntarily, subject to certain compliances. The regulation should ensure pleasant entry and exit of intermediaries to/from the market.

Some intermediaries carry on business through or on behalf of another intermediary. For example, sub-brokers and depository participants deal in securities as agents of brokers and depositories respectively. If, for whatever reason, the registration of a broker/depository is cancelled, the registrations of all the affiliated depository participants/sub-brokers should be cancelled automatically. This is like if the tree is felled, its branches or leaves can not continue to have their independent existence. This, however, does not happen in the securities market. The registration of a sub-broker is considered independent of that of the broker. As a result, there are quite a large number of sub-brokers in the system, even though their affiliating brokers have

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ceased to exist. In order to remove these defunct sub-brokers from the system, SEBI has to initiate enquiry proceedings. The regulations may, therefore, provide that if a broker/depository surrenders registration or its registration is cancelled, the registration of all the affiliated sub-brokers/depository participants would be deemed to have been cancelled. Similarly, if recognition of a stock exchange is withdrawn, the registration of all the brokers and the sub-brokers of the exchange should be deemed to have been cancelled automatically. Such deeming provision may be inserted in the regulations for sub-brokers, brokers, and depository participants.

An intermediary should cease to be an intermediary as soon as it fails to satisfy any condition of registration. This means that it should not only satisfy the eligibility criteria to be an intermediary at the time of registration, it must continue to satisfy these criteria in order to remain a registered intermediary. It is akin to a company satisfying the initial conditions of listing and also the continuous conditions of listing. This requirement needs to be specifically prescribed in the regulation.

Change in Status and Constitution: All the rules framed by the central government require that the intermediaries must obtain prior approval of SEBI for any change in status and constitution. However, the rules or regulations do not define what constitutes change in status and constitution, although SEBI has clarified this through circulars in respect of some intermediaries. In the absence of clarity, some intermediaries seek approval for certain kinds of changes while some others do not. At times, SEBI inspection reveals that the intermediary has not taken prior approval of SEBI for a particular change and the intermediary contests that he is not aware that approval for such change is required or that such change does not constitute change in status and constitution. It is desirable that the change in status and constitution is defined through regulations/circulars uniformly for all intermediaries so that they know clearly what change requires SEBI's prior approval.

Uniformity in Regulations: An intermediary is an intermediary. Certain basic aspects must be same for every kind of intermediary. For example, an intermediary has to be fit and proper person; or registration needs to be granted in the interest of the market/investors, etc. While some regulations have provision for these, some others do not have. Further, some regulations require SEBI, while considering request for registration as an intermediary, to take into consideration if the applicant owes any money to SEBI, while other regulations do not so require. Similarly, the application forms are not uniform. Some applications seek information about the applicant, its directors, its associate entities, the entities with common directorship,

shareholders, promoters etc., while some others do not seek so many details. As a result, while verifying antecedents of the applicant in order to determine if he is a fit and proper person, SEBI may verify the antecedents of the people whose names are included in the application form. For example, while registering a derivative broker, SEBI does not receive the information about its associates. It may grant registration to the applicant without checking antecedents of the associates. If, however, the same person applies for registration as a merchant banker, SEBI receives information about the associates and may check the antecedents of the associates and then reject the request if there is anything adverse against any associate. This means that for the same lapse, an applicant is granted registration for one activity and denied registration for another activity.

Over a period of time different categories of participants have emerged on Exchanges. These are called brokers, trading members, dealers, traders, clearing members etc. It is not clear if the regulations relating to brokers apply to all of them, because broker means a member of the exchange, while clearing members are members of the clearing corporations, and some members of the exchange are shareholding members of the Exchange, not trading members. Further, all members on NSE are called trading members, while the trading members of derivative segment of all exchanges are called trading members. Thus a trading member of cash segment of NSE is registered with SEBI as a broker while a trading member of derivative segment of NSE is registered with SEBI as a trading member. The regulations should take note of these different nomenclatures.

Various terms, such as net worth, promoter, associates etc. used in different regulations are defined differently. These need to be defined uniformly.

Validity of Registration: Some kinds of intermediaries are granted registration for 3/5 years and are required to seek periodic renewals, while some others are granted permanent registration. It may be desirable that all intermediaries are treated uniformly and are granted registration for specified periods so that the competence and credentials of the intermediary and the persons behind it are verified at the time of every renewal.

There should be an arrangement to ensure painless and costless transfer of business from one intermediary to another within a definite time frame if the registration of an intermediary is cancelled or not renewed or transferred. The regulations should provide a time frame to shift the business of a DP/STA to another DP/STA if the registration of the former is not renewed.

The regulations do not provide procedure to be followed when an intermediary goes bankrupt or is wound up. The aspects such as the use of assets of such intermediary and the claims of the client need to be provided in the regulations.

Though regulations do not specifically provide, market participants believe that SEBI registration is a transferable/saleable commodity. Market participants at times apply to regulator for approval of transfer of registration and also at times for approval for transfer of business. It needs to be clarified that SEBI registration is not transferable. It is necessary because registration is granted only after the applicant satisfies the eligibility criteria, including the criterion of fit and proper person, prescribed in the regulations. The transferee entity needs to similarly satisfy SEBI that it is eligible and it is a fit and proper person.

Fees Payable: SEBI follows different basis for levying fees from intermediaries. Since regulatory load of SEBI depends on the volume of market transactions, the fees should be related to the volume of transactions intermediated by the intermediary. And since SEBI continues to supervise the activities of an intermediary as long as it exists, the intermediary should pay fees through out its existence, not for a few years as is the case with brokers now. Further, the process of assessment and collection of fees from intermediaries needs to be simplified. For example, in stead of collecting fees at different rates on different categories of transactions, a single rate on the entire volume of transactions can be used. Similarly, all the agencies who levy fees from intermediaries based on transactions could levy a composite fee. For example, Governments (Central and State), SEBI and Exchanges levy fees based on turnover. In stead of levying and collecting fees separately, these can be collected by the Exchange and shared with SEBI and Governments.

Unregulated Intermediaries: There is no exclusive regulatory framework for investment advisors, even though the SEBI Act specifically requires the investment advisers to obtain registration from SEBI. Similarly there is a huge category of participants called IPO distributors who are not subject to any regulatory framework. There is no regulatory framework to regulate the working of clearing corporations, which is a basic component of any efficient market infrastructure. Some intermediaries like approved intermediaries under the Stock Lending Scheme are not governed by regulations, but by guidelines. It is desirable that all kinds of people, who intermediate in some form or other in the securities market, are regulated by regulations.

Restriction on Activities: Most of the intermediaries are carrying on only one type of intermediation service because

of the restrictions placed by rules / regulations. This prevents them from reaping benefits from the economies of scale and scope and to encash synergies across complementary intermediation services. The regulations should permit the intermediaries to carry on all kinds of intermediation services simultaneously and emergence of financial power houses, which can provide competitive services in the globalised environment. Further, the number of intermediaries is too huge to have effective regulation. The regulations should promote consolidation to bring the number of intermediaries to a manageable level. For example, disincentives such as fresh fees on fresh registration, tax on transfer of assets may be withdrawn so that the existing intermediaries are encouraged to consolidate among themselves.

Disclosure: An investor normally deals in securities through an intermediary, whose acts of omission and commission can cause loss to him. In order for the investor to choose the right intermediary through whom he may transact business, it may be useful to help him in taking informed decision by making details of intermediaries available to him. The details may include the form of organization, management, capital adequacy, liabilities, defaults and penal actions taken by the regulator and self-regulatory organizations against the intermediary in the past and other relevant information. If possible, the intermediaries may be rated and their ratings be disseminated. The intermediary may be mandated to make continuous disclosures about its performance and financial positions through a web site such as EDIFAR. For example, if an intermediary fails to comply with the prescribed eligibility criteria and particularly the capital requirements, it should come to the notice of the regulator and the investors instantly. The disclosures may be mandated through regulations.

Certification: The confidence of the investors can be maintained and enhanced by making provision for professional intermediation services. Industry/SROs/Regulators have made a modest beginning, but not adequate given the dimensions of the market. A central agency, as may be accredited by SEBI, may offer a certification for each type of intermediation service. The certified people may be required to update their skills and expertise by seeking certification at periodic intervals. While this requirement should apply at the entry point for all new employees joining the intermediaries, the existing agents /employees may be allowed say, about a year, to obtain the certification. This requirement may be prescribed through amendments in the regulations as has been done in the SEBI (Brokers and Sub-Brokers) Regulations, 1992 for derivative brokers.

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In order to do accounting work, one needs the chartered accountancy qualification. For secretarial work, one needs company secretary qualification. There is no qualification which prepares a person for a career in the securities market. It is desirable that there is an institute which offers degree courses in securities market management and such degree holders are employed by market participants. While the certification may be adequate at the junior level such as dealers, a degree from the institute may be a prerequisite to hold a supervisory position with a market participant.

Electronic Servicing: Most of the regulations were framed in the early 1990s when electronic servicing was not in vogue. While all the transactions in securities are now taking place electronically and even securities are held in demat form, the intermediaries continue to deal with the regulator through papers. In the interest of efficiency, the regulations could provide for electronic registration, compliance, disclosure, surrender, etc.

Revision of Regulation: The intermediaries like if the regulations are amended after in depth consultation with them so that frequent changes are avoided. In addition to

putting on web site, SEBI may hold seminars in association with the regulated, so that proposed regulation is refined and easily acceptable by them. For example, before the regulations relating brokers are amended, there can be four seminars in four regions in the country, where the professionals, the brokers and the regulators discuss the proposed amendments in depth and arrive at the desirable form of regulation. Besides, there can be a calendar for amendments so that they can keep track of them. Like tax laws are amended through the budget once in a year, the regulations may be amended once in a year during a particular month.

Consolidation of Provisions: In addition to Regulations, various requirements and standards have been prescribed through guidelines/circulars/notifications by government and SEBI, particularly in respect of brokers. It is not easy for an intermediary to keep track of all such circulars and comply with them. It is advisable that the vital requirements/standards prescribed through various notifications over the years are culled out and incorporated in the regulations.

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