STOCK BROKERS' PARTICIPATION IN COMMODITY EXCHANGES

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With a view to bringing in the experience and expertise of the stockbrokers to the commodity (derivatives on commodities) exchanges, it is being suggested that the stock brokers should be allowed to become members of commodity exchanges. While there is a consensus on this proposition, there is a lot of disagreement on modalities of doing so. This paper discusses one main disagreement, namely legal permissibility, that is, whether the securities laws permit stock brokers to become commodity brokers also, and if so, how to ensure that the risks of one market do not spill over to the other.

Legal Provisions

The laws relating to stock exchange membership is contained in rule 8 of the Securities Contracts (Regulations) Rules, 1957 (SCRR) and rules of the stock exchanges. The SCRR prescribes certain requirements to be included in the rules relating to admission of members of a stock exchange. The clauses (1) and (4A) of rule 8, which are most relevant for the purpose of discussion in this paper, read as under:

"(1) No person shall be eligible to be elected as a member if—

(*a*) he is less than twenty-one years of age;

(b) he is not a citizen of India; provided that the governing body may in suitable cases relax this condition with the prior approval of the SEBI;

(*c*) he has been adjudged bankrupt or a receiving order in bankruptcy has been made against him or he has been proved to be insolvent even though he has obtained his final discharge;

(*d*) he has compounded with his creditors unless he has paid sixteen annas in the rupee;

(*e*) he has been convicted of an offence involving fraud or dishonesty;

(f) he is engaged as principal or employee in any business other than that of securities except as a broker or agent not involving any personal financial liability unless he undertakes on admission to severe his connection with such business: Provided that the SEBI may, for reasons sufficient in the opinion of the SEBI, permit a recognised stock exchange to suspend the enforcement of this clause for a specified period on condition that the applicant is not associated with or is a member of or subscriber to or shareholder or debenture holder in or connected through a partner or employee with any other organisation, institution, association, company, or corporation in India where forward business of any kind whether in goods or commodities or otherwise is carried on or is not engaged as a principal or employee in any such business;

(*g*) [deleted in November 1988]

(*h*) he has been at any time expelled or declared a defaulter by any other stock exchange;

(*i*) he has been previously refused admission to membership unless a period of one year has elapsed since the date of such rejection."

"(4A) A company as defined in the Companies Act, 1956, shall also be eligible to be elected as a member of a stock exchange if—

(*i*) such company is formed in compliance with the provisions of section 12 of the said Act;

(*ii*) such company undertakes to comply with such financial requirements and norms as may be specified by the SEBI for the registration of such company under sub-section (1) of section 12 of the SEBI Act, 1992;

(*iii*) [deleted in October 1994]

(iv) the directors of the company are not disqualified from being members of a stock exchange under clause (1) [except sub-clause (b) and sub-clause (f) thereof] or clause (3) [except sub-clause (a) and sub-clause (f) thereof] and the Directors of the company had not held the offices of the Directors in any company which had been a member of the stock exchange and had been declared defaulter or expelled by the stock exchange; and

(*v*) not less than two directors of the company are persons who possess a minimum two years' experience: (*a*) in dealing in securities; or (*b*) as portfolio managers; or (*c*) as investment consultants."

Historical Perspective

A look at the evolution of the requirements for membership is useful for better appreciation of legal position. Till 1985, the SCRR [Rule 8 (1), (2) and (3)] required that in order to be a member, a person shall (i) be above the age of 21 years, (ii) be a citizen of India, (iii) have certain experience, and (iv) not suffer from any of the prescribed disqualifications. Disqualifications prescribed were that the candidate for membership must not (a) be bankrupt / insolvent, (b) have compounded with creditors, (c) be convicted of an offence involving fraud or dishonesty, (d) be expelled or declared a defaulter by any other exchange, (e) have been refused admission to membership during the preceding year, (f) be engaged as principal or employee in any business other than that of securities except as a broker or agent not involving any personal financial liability (This requirement can be relaxed by government for a specified period on the condition that he does not get associated with any organisation where forward business of any kind whether in goods or commodities or otherwise is carried on), and (g) be a member of any other association which deals in securities, or be a director, partner or employee of a company whose principal business is dealing in securities (He can not associate directly or indirectly with any other exchange). Rule 8 (4), then in vogue, prohibited a company to become a member of a stock exchange.

Thus, the above framework envisaged broking as a profession dependent on individual skills and emphasized on individual attributes. It permitted only individuals to become members. The individuals could form partnerships between or among them. It restricted liability of members by prohibiting them from associating with any organisation carrying on forward trading and from becoming member of 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. It also did not allow a broker to become members on more than one exchange. A broker was not allowed to advertise for business purpose or issue circulars or other business communications to persons other than his clients. A circular issued in May 1974 by Government permitted mass mailing by members to their own clients. All these emphasized that broking was a profession, not a business.

The High Powered Committee on Stock Exchange Reforms constituted in 1984 realised the limitations of individual brokers and recommended in 1985 that limited companies should also be admitted as members. It also recommended that the Rules, Regulations and Byelaws of stock exchanges may be amended so as to permit members to issue advertisements for business purposes in newspapers or any other media. Implicit in the recommendation was that the broking houses need to be converted from profession to a business entity.

By a notification in June, 1986 Government replaced clause (4) to Rule 8 to remove prohibition on companies to become members. The new clause permitted companies to become members of the stock exchanges subject to the condition that (i) the company is formed in compliance with section 322 of the Companies Act, 1956; (ii) all the directors of the company have unlimited liability; and (iii) a majority of the directors are members of the exchange and also shareholders of the company. In order to encourage companies to become members, clause (4) was amended in July 1987 to provide that the directors of company who are members of the exchange (not all directors) would have unlimited liability. Government could relax clause (4) requirements to admit IFCI, IDBI, LIC, GIC, UTI, ICICI, subsidiaries of these organisations or of SBI or nationalised banks. The requirements of clauses (1), (2) and (3), which are applicable for individual members, were not made applicable to the corporate members. Further, the entities such as IFCI etc. were allowed to become members without fulfilling any of the requirements applicable to individual members under clauses (1), (2), (3) or the requirements applicable to corporate members under clause (4). This means that the restrictions such as association with any organisation dealing with any forward business or with any other stock exchange are not applicable to these members. The non application of these restrictions was apparently to avoid unreasonable restriction on the freedom of trade of a business entity. Similarly, the requirement of experience was not applicable to corporate members who, as a business entity, could hire the services of professionals.

Rule 8 (1) g was repealed in November 1988 to permit a person to become member of more than one exchange. The circulars issued in December 1988 and August 1991 specified the norms relating to multiple membership in stock exchanges. These circulars require: (i) The original stock exchange should give to the other stock exchange, whose membership is sought by the applicant member, a confidential report regarding the conduct and behaviour of the member. (ii) The multiple membership should be acquired at the same price as is available to public. (iii) The rates of admission fee, security deposit and annual subscription in respect of multiple membership should be same as are applicable to other members. (iv) Disciplinary action such as reprimand, warning, fines and suspension may be confined only to the stock exchange where it is taken with intimation to other stock exchanges. If a member is expelled from one exchange, he would automatically stand expelled from all other stock exchanges where he is a member. (v) Default by a member at one stock exchange should automatically lead to his being declared a defaulter at other stock exchanges. However, apportionment of the assets of defaulter members against the claims must be done strictly exchange wise. If there is, however, a surplus of the assets at any particular stock exchange, the same may be distributed against the claims at other exchanges.

Despite these initiatives, the corporate membership did not take off. The legal changes were effected to open up the membership of stock exchanges to corporates with limited liability, so that brokerage firms may be able to raise capital and retain earnings. Rule 8 (4A) was inserted by a notification in November 1992 to facilitate entry of companies with limited liability as members of stock exchanges subject to the condition that (i) the company should be formed under section 12 of the companies Act, 1956, (ii) such company complies with such financial requirements and norms as may be prescribed by SEBI, (iii) majority of the directors of the company are shareholders of the company and not less than 40% of the paid up capital is held by these directors, (iv) the directors are not disqualified for being members of stock exchange under clause (1) [except sub clause (f)] or clause (3) [except sub clause (f)] and the directors of the company had not held office of directors of any company which had been member of a exchange and declared defaulter or expelled by the stock exchange and (v) not less than two directors of the company possess minimum two years' experience. Thus a self contained provision was made for corporate membership and it was clearly specified that which of the requirements applicable to individual members

under clauses (1) and (3) would be applicable for corporate members. Since the working of the clause (4A) was found restrictive, the provisions were liberalised by a notification in October 1994. Sub clause (iii) of Clause (4A) relating to minimum shareholding by directors was deleted. Sub clause (iv) of Clause (4A) was amended to exempt the directors also from the requirement of sub clause (b) of clause (1) and sub clause (a) of clause (3) relating to citizenship of India. Thus the directors, not the corporate member, need to qualify all the requirements applicable to individual members under clauses (1) and (3) except sub clauses relating to association with non-securities business and citizenship of India. In pursuance to sub clause (ii) of clause (4A), SEBI specified in May 1994 the financial requirements and norms for admission of a company as a corporate member. It prescribed minimum paid up capital, maintenance of net worth, and such other additional financial requirement as may be specified by the exchanges. It was also clarified that if a corporate member seeks membership on more than one exchange, these requirements shall be fulfilled in respect of each of the exchanges.

Clause (5) of the Rule 8 provides that the provisions of clause (1), (3) and (4) shall, so far as they can, apply to admission or continuation of any partner in a firm, which is a member of the stock exchange. Though clause (4) was replaced in 1986, reference to clause (4) in clause (5) was, probably inadvertently, not deleted.

In order to encourage existing members to corporatise themselves, which was considered desirable for development of the securities market, the Income Tax Act, 1961 was amended to exempt capital gains tax payable on the difference between the cost of the individual's initial acquisition of membership and the market value of that membership on the date of transfer to the corporate entity. The SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 were also amended to exempt turnover based fees payable by the converted corporate entity for the period for which the erstwhile proprietorship / partnership entity has paid the fees. In response, many brokerage firms reorganised themselves into corporate entities. At the end of March 2002, 3,786 brokers out of 9,502 were corporate bodies.

Legal Permissibilty

Thus it appears that 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 relax norms for individual brokers, to allow corporate entities to take up broking activity and the brokers to operate on multiple exchanges indicate efforts in this direction. The brokers were also allowed to issue advertisements in a limited way. In order to promote membership as business entities, the members operating as business entities have been provided certain facilities / relaxations. Thus, there is a complete U-turn in the sense that companies, which were explicitly prohibited from becoming members, are given incentives to become members. In fact, a few exchanges on their own do not even permit individuals to become members on specified market segments.

The SCRR currently provides for five categories of members, namely individuals, partnerships, section 322 companies, section 12 companies and IFCI like bodies. The rule 8 (1) is a specific provision for individual members, who are prohibited from undertaking any non-securities business by rule 8 (1) (f). An individual member is, however, permitted to undertake non securities business only as a broker which does not involve any personal financial liability. He can also undertake non securities business if SEBI suspends enforcement of this clause for a specified period. SEBI can not relax this clause to enable a member to undertake any business of forward trading. The provisions of rule 8 (1) do not apply at all to section 322 companies or IFCI like entities, who are governed by rule 8 (4). The rule 8 (1), except rule 8 (1) (b) and 8 (1) (f), is applicable for directors in case of section 12 companies, as the disqualifications of directors in clause (4A) (iv) exclude the applicability of sub-clause (f) of clause (1) of rule 8. This means that the SCRR does not prohibit a corporate member to undertake any non securities business. A corporate member can undertake non securities business, as a broker or otherwise. The SCRR also does not prohibit a corporate member from dealing in forward business of goods or commodities, which is specifically prohibited for an individual member. In view of the above, it is clear that while individual and partnership members can act as commodity brokers not involving any personal financial liability, corporate brokers can become commodity brokers involving even financial liability.

In the change circumstances, it is desirable that only corporate are allowed to become members of stock exchanges. These corporate can hire professionals to provide professional broking services. The corporates should be required to satisfy the requirements of membership such as financial soundness and infrastructure while their employees should be required to acquire skills to provide broking services. They should not have any restriction on their freedom of business subject to respective regulations. They should comply with securities laws in respect of securities transactions, with commodities laws in respect of commodities transactions and with other relevant laws in respect of other activities. The compliance requirements of different laws for different activities should be additive, not derogative.

It is not enough, if the securities laws allow a stock broker to become a commodity broker also. As a natural corollary and in the interest of freedom of trade and business, commodity brokers should also be allowed to become stock brokers. It may be worth while to explore the possibility of allowing stock exchanges to provide trading platform for commodities and the commodity exchanges to provide trading platform for securities. This means that there would be only one kind of exchange which would provide facility for trading of securities, commodities, and any other product.

The stock exchanges were allowed to provide trading platform for trading of derivatives of securities in June 2000. The restriction in clause (1) (f) did not come in the way because members traded in securities, which included derivatives. If derivatives were not included within the ambit of 'securities' in the Securities Contracts (Regulation) Act, 1956 by the Securities Laws (Amendment) Act, 1999, the individual members would not have been able to trade in derivatives in view of proviso to clause (1) (f), which does not allow a member to be associated with any organsiation dealing with any kind of forward trade. However, the inclusion of derivatives within the definition of securities has created an anomalous situation in the sense that the main provision allows a member to trade in derivatives while the proviso does not permit a member to associate with any organsiation dealing with derivatives. This happens because the SCRR was not amended in sync with the amendment in definition of 'securities'.

Risk Management

Since there is no ban on an individual stock broker to act as commodity broker and on a corporate stock broker to act as commodity broker or take up any fund based activity, which is rightly so, there is a need for close cooperation among the regulators to ensure that the stock brokers carrying different activities do so in a disciplined manner. Since the same broker would operate in both securities and commodities exchanges, it is necessary to put in place fire walls to prevent transmission of risk from one market to the other. One can draw useful lessons for this purpose from the stock market itself where the same member operates on different exchanges and even on different segments of the same exchange. It is possible that a particular member operates on three market segments (cash, debt and derivatives) of the National Stock Exchange of India Limited, and also on three separate exchanges simultaneously. And there is an arrangement to prevent transmission of risk from one segment to another and from one exchange to another. The ideal approach is to fully secure the positions of members by adequate collateral, so that there is absolutely no risk in any market and hence there is no scope for transmission of risk from one market to another or no need to restrict any activity of brokers.

While specifying financial requirements and norms for corporate members in May 1993, SEBI has clarified that a corporate member seeking membership on more than one exchange has to fulfill the financial norms in respect of each of the exchanges. Such member would also maintain separate and segregated accounts in respect of each of the stock exchanges of which he is a member. Similarly exchanges have put in place the risk containment measures such as independent capital adequacy requirements, exposure norms, margin requirements for different market segments (cash, debt and derivatives), which have common brokers. A mechanism, on lines of the 1991 circular for multiple membership, could be put in place to facilitate members to operate on both commodity and stock markets.

Allowing the stock brokers to enter the arena of commodity markets raises the issue of supervision of member brokers. Stockbrokers, as market intermediaries are registered with SEBI, while as members of commodity exchanges brokers are registered with the FMC. Thus, there would be a need to spell out the regulatory responsibility of enforcement of the regulations relating to common brokers in the commodity and stock markets, between stock exchanges, SEBI and Forward Markets Commission and commodity exchanges to avoid any regulatory gap or overlap.

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