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Growing Asia's Markets

24 June 2021

Shri Sudeep Mishra,
General Manager,
Market Regulation Department,
Securities and Exchange Board of India (SEBI)

By Email

ASIFMA Comments on Consultation paper on Segregation and Monitoring of Collateral at Client level

Dear Shri Mishra,

We thank the Securities and Exchange Board of India ("SEBI") for the continued support and engagement with the Asia Securities Industry and Financial Markets Association ("ASIFMA")[1] regarding the development of the capital markets. In this letter, we refer to the consultation paper[2] launched by the SEBI on 10 May, titled "Consultation Paper- Segregation and Monitoring of Collateral at Client level".

On behalf of our members, we appreciate SEBI's intentions to ensure protection of client collateral. However, we have observed some challenges that will arise due to the proposed framework in the consultation paper. We have listed those challenges as below for your kind consideration.

1. Collateral Allocation

As per the proposals: 1) the current flexibility of collateral deposited on Exchange by Clearing member ("**CM**") will be removed; and 2) CM will have to disclose and allocate Collateral deposited to Prop account, separately to each client account. These measures will diminish the existing operational convenience which a CM had in managing Collateral on the Exchange, and the collateral management will become more complex and dynamic. Furthermore, the proposal will require significant changes to our technology infrastructure and will increase operational risk. Finally, brokers will face material impact to their commercial structure and will therefore potentially impact the client profitability and pricing. Hence, we recommend that a mechanism for allocation and subsequent reallocation of collateral at client level intraday should be provided. There are times when clients make withdrawals or infuse funds intraday at different times. Such a mechanism will ensure that clients are able to get real time benefits for any additional margins they place.

[1] ASIFMA is an independent, regional trade association with over 150 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional and consulting firms, and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive, and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

[2] "Consultation Paper- Segregation and Monitoring of Collateral at Client level", *Securities and Exchange Board of India*, 10 May 2021. https://www.sebi.gov.in/reports-and-statistics/reports/may-2021/consultation-paper-on-segregation-and-monitoring-of-collateral-at-client-level_50090.html

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At present, though most CMs maintain internal records of clients' funds, the funds deposited on the Exchange are mostly managed in an omnibus manner. To allow client level asset identification and thereby withdrawal only from the cash collateral received from the respective client, CMs would have to manage client collateral at the individual client level. This would take away cost efficiencies available today and could result in increased cost of business for end client. Moreover, the change would entail considerable rebuilding of operational processes and associated significant investments. Notably, structures like *Legally Segregated, Operationally Commingled* ("**LSOC**") on a client level followed in the US and *Individually Segregated Accounts* in Europe also entail intensive operational setup and are expensive for the market. We recommend SEBI to consider operational as well as financial impact on the market as a whole (end clients, Trading members, and CMs) while evaluating potential measures to achieve client asset protection.

2. Blocking of Margins

Currently, the Exchange blocks the margins from the total collateral deposited by CM. As per the proposals, the margins arising out of a trade of a client will be blocked from the Collateral allocated to that client by its CM. Since the Trading Member ("**TM**") prop and Client collateral have to be segregated on the Exchange, till trades get approved by CM, TM Prop collateral will be utilized. This will result in TM having to increase their existing collateral on Exchange, resulting in increased cost to the TM. There is also a possibility of double margining when a Broker executes a trade for a client (who also is clearing through them) till the trade is approved. This may result in either the Broker increasing their own collateral or taking a higher buffer margin from Client, to cover the higher margin, resulting in increased costs. The CM carries out risk checks including position limits and margins. Hence, the margins should be blocked at Custodian Participant ("**CP**") code level to avoid double margining as CP level margin segregation is available within the exchange. We recommend that when the order placing TM is also the CM for a client, the margin blocked should be at the CP code level.

3. Risk Reduction Mode

Currently, a CM is moved to risk reduction mode when the margin utilization exceeds 90% of total collateral deposited by CM with the Exchange. This is easy and convenient to monitor for the CM. However, as per the proposal, a client-wise check is proposed on margin sufficiency, with a new formula making it more complex to monitor. Hence, we recommend retaining current approach of monitoring 90% of threshold at the CM level and providing further guidance on monitoring end-client accounts.

4. Default Management

CCPs should evaluate appropriateness of their existing default management process in the light of proposed enhanced measures for client asset protection. In particular, upon a default of a CM, CCPs should allow full portability of the defaulted member's clients' positions and associated collateral. Further, where a CM default is driven by a client default, CCPs should be able to protect collateral of fellow non-defaulted clients and allow its portability to other non-defaulting members. In order to ensure there is full transparency on this matter, we request SEBI to provide detailed operating guidelines to the CCPs on how these changes can be incorporated in the CCP by-laws.

5. **Additional Comments**

While the objective to prevent the misuse of clients' collateral by the TM or CM is important, there are existing controls in place to prevent this, such as the SEBI enhanced reporting framework, End of day /Peak margin disclosure made by CMs, Half-yearly internal audits, and the Exchange on-site inspections. We believe that if these new measures are implemented, it will require significant changes to the CM's risk monitoring systems / processes and will be a huge burden operationally and economically. The proposed measure depends on the Broker's disclosure on Client collateral, and the accuracy of which can be verified by the Exchange only after an inspection of the Broker's books and records, which is the current state. Several other jurisdictions in the region such as Taiwan and South Korea also have the same model that exists in India currently i.e., no disclosure required on which client's collateral is being deposited. SEBI could consider approach in line with UK's FCA Client Money rules, that adopt rule-based approach such that penalties are levied on clearing members for breach of any client money rules.

Current consultation paper lacks the following details, and hence we request SEBI to provide further clarity on the following: a) can CM opt to treat affiliate and third-party clients under two separate LSOC (Such mechanism exists in Hong Kong); and b) impact on affiliate positions/collateral in case of CM default. Also, it would be helpful if central counterparty ("**CCPs**") can clearly include following items in their rule book: a) details on default management procedure i.e., methods to close out open positions using Auction or Partial tear-ups; and b) details of Default Management committee and sufficient participation from existing CMs.

ASIFMA and its members again thank the SEBI for the ongoing constructive engagement with the industry, and we would welcome any opportunity to have follow-up discussions. In the light of significant operational and commercial impact of this initiative, we recommend engagement with the industry participants through working groups with representation from CCPs, TMs, CMs, end-clients and SEBI to discuss and consider alternative reporting requirements. The alternative mechanism would aim at striking a balance between operational efforts and safeguarding clients' interests. We appreciate your thoughtful evaluation of our Industry recommendations which are genuinely meant to be helpful and constructive. We look forward to building a strong partnership with SEBI, to help improve and further develop India's capital markets. Should you have any questions, please do not hesitate to contact me (lchao@asifma.org or +852 2531 6550).

Sincerely,

Lyndon Chao
Head of Equities and Post Trade
Asia Securities Industry & Financial Markets Association