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India's common regime for equities, commodities brokers will benefit compliance

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Recent speculation that the Securities and Exchange Board of India (SEBI) has been working on a single registration mechanism for commodities and equities brokers has been welcomed by industry officials.

"Collapsing the separate regulatory regime for equity and commodities brokerage into a unified regime should simplify compliance and associated costs and potentially free up capital for brokerages operating in those segments of the capital markets," said Aditya Shukla, a senior member of the regulatory team at law firm Nishith Desai.

Long-term policy goal

One-point registration and complete fungibility between the commodities and stock markets has been one of SEBI's long-term policy goals since the securities regulator merged with the Forward Markets Commission (FMC) in September 2015. Since then, SEBI has reviewed and amended multiple regulations relating to commodities trading, intermediaries and exchanges, to bring them on a par with the country's securities regime.

The equity and commodity brokers follow different guidelines and requirements prescribed by SEBI and the erstwhile FMC, respectively, said Yogesh Chande, a partner at law firm Shardul Amarchand Mangaldas & Co. "This move is as a result of SEBI being conferred the jurisdiction over commodity markets after" absorbing the FMC, he said. "It is expected that such a move will lead to operational efficiency by bringing down the cost of operations."

"Having a unified regulatory regime for brokers operating in the equities and commodities segments is another step in that direction. From a regulator's perspective, such a measure should enhance the efficacy of the regulatory function by reducing information asymmetry, improving surveillance and providing the potential to identify systematic risk early on," said Simone Reis, co-head of Nishith Desai's mergers and acquisitions team.

Reducing compliance costs

These changes would ease the legislative burden, and every player in the commodities segment, including intermediaries, would have to comply with the same framework.

The ultimate aim of the reforms would be to reduce operational costs for intermediaries. The proposed changes would also eliminate the need to keep separate reserves for equities and commodity brokers that need to maintain net worth and base minimum capital requirements.

Investors are also expected to benefit from the creation of a single, one-term registration form for know-your-customer (KYC) purposes, which would then enable clientele to trade in both stocks and commodities.

"For a common investor this will also help with a simplified process as opposed to the one where different agreements and different sets of KYC are required," said Ravichandra Hegde, a senior associate with law firm J Sagar Associates in Mumbai.

There would also be benefits in terms of due diligence. "The proposed mechanism may help SEBI avoid undertaking multiple due diligence processes for each registration," said Bhakta Patnaik, a partner at law firm Trilegal in Mumbai.

Additionally, collateral and margins that investors have on deposit with intermediaries could also be used against positions in either market segment.

At present investors must maintain balances for securities and commodities separately, since the entities through which they trade are separate.

SEBI's new approach would also help in reducing operating costs for investors who have securities in multiple segments, Hegde said.

"Not only will the investor avoid double processing fees but will also have one basket margin facility. Most of the time, the client takes exposure only in equity and the margin for commodities trading would be lying idle. With this new approach, it would benefit such clients to a great extent," he said.

"SEBI is doing it for [the] convenience of regulating and also to benefit investors."

The proposed reforms are also expected to reduce the financial burden on brokerages and bring down their high operational costs, which Patnaik said had resulted in the shutdown of many small brokerages in the recent past. One-time registration and avoiding duplication of registration would reduce compliance costs.

"In addition, the brokers can operate on an integrated platform and will not be required to operate and carry out activities through separate entities," Patnaik said. "The investors will not have to go through two separate KYC procedures and the broker can maintain one portfolio for a customer engaged in both the segments," he said.

Joby Mathew, veteran securities lawyer and founder of Joby Mathew & Associates in Mumbai, said it remained to be seen whether extensive changes would be required to the bylaws of the exchanges and any relevant regulations.

Additionally, it is unclear to what extent a single registration mechanism would impact the SEBI (Stock Brokers and Sub Brokers) Regulations and the Securities Contracts (Regulations) Rules, which may require suitable amendments.

"There are certain issues which are expected to be addressed. For instance, how would a single registration mechanism impact the eligibility criteria … [the] adequacy of experience, minimum net worth, track record, fit and proper criteria, certification … specified for brokers. This is an area where compliance and legal staff would need to focus to see if existing eligibility criteria are impacted and the timeframes, if any, for compliance, as there could be different processes for new and existing brokers," said Saniya Kothari, an associate at the LexCounsel Law Offices in New Delhi.

Another issue requiring clarity is that, as per existing rules, the same entity cannot be engaged in securities and commodities derivatives brokerage, she said. "Once this is clarified, there may be reorganisation of entities engaging in both, from the point view of reducing operational costs," she said.

Kothari said a single registration mechanism could significantly reduce compliance for brokerages engaged in both so far as due diligence documentation and KYC compliance is concerned.

Further regulatory changes

The single registration mechanism is, however, likely to necessitate further regulatory changes.

"These amendments, in a market where a stockbroker was not [previously] permitted to offer both equity and commodity broking services, would certainly lead to additional regulatory compliance to realign the existing structures which the compliance and legal staff would need to deal with," said Moin Ladha, associate partner at law firm Khaitan & Co in Mumbai.

Likely impact on staff numbers

"It is also possible that such a move could have some impact, although unintended, on the number of staff members that are required … in the legal and compliance [teams] or in the back office," Chande said.

Nishith Desai's Shukla, however, did not think that the move would necessarily lead to high levels of redundancies for legal staff, but might instead create a more efficient profession.

Concentration of risk

Some practitioners have questioned whether the reforms might have a negative impact on risk management by transferring risk between the securities and commodities markets.

"SEBI's move is a bit surprising since they have always sought to keep the securities market and commodities market separate to avoid the overflow of risk from one market to the other. The two markets are different in terms of products and participants. I am not sure if this is really a good move as far as risk management is concerned," Mathew said.

He said it was interesting that although SEBI had control over the underlying assets in the securities market, such as shares of listed companies and debentures and other comparable instruments, it had no such control over the commodities spot market.

The reforms are also expected to allow investors to exploit arbitrage opportunities between the two markets. "Stockbrokers who also act as commodities brokers will benefit from this move of SEBI since they will get the benefit of lesser compliance costs and it frees up money," Mathew said.

New commercial opportunities

These developments are being watched closely in Chicago, home of the world's largest commodities and futures markets, where officials are hoping to see India's markets become more closely integrated with the rest of the world.

John Ruark, a partner at law firm Funkhouser, Vegosen, Liebman & Dunn in Chicago, said the changes could create new commercial opportunities if Indian regulations were more closely aligned with those in other international markets.
"All in all, the proposal looks like it will be a good modernisation for Indian markets, so kudos to SEBI," Ruark said.

Former regulator Jay Biondo, director of surveillance products design at Neurensic, said although the reforms would reduce paperwork for back-office employees, they might then need to overcome the challenge of monitoring trading activity across fragmented markets.

"If there is, in fact, an uptick in the number of traders that will be trading both commodities and equities, however, legal and compliance professionals must update their supervisory manuals to address the topic of cross-market manipulation," Biondo said.

A single registration mechanism for brokerages dealing in equities and commodities would also boost the government's "ease of doing business" initiative, Shardul Amarchand Mangaldas' Chande said. He pointed to steps from the recent past where SEBI introduced permanent registration for various categories of intermediaries.

SEBI was unavailable for comment at press time.

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