Review of Ownership and Economic Structure of Clearing Corporations

(I) Objective

To ensure that Clearing Corporations (CCs) discharge their vital function of risk management independently and in the best public interest, and to strengthen the systemic stability of the Market Infrastructure Institution (MII) ecosystem, this consultation paper seeks public opinion on a proposal to, *inter-alia*, diversify the ownership in CCs operating in equity markets.

(II) Background: Ownership, Finances and Listing of CCs

1. India's securities market has witnessed a structural change in recent times, with an exponential growth in investors, products, and volumes. The confidence of investors in the securities markets, *inter-alia*, rests on the novation and settlement finality provided by CCs, which act as a central counterparty to all trades executed on an Exchange.

2. With CCs acting as central counterparties and as first line regulators, the importance of them operating as independent, self-sufficient public utilities, able and willing to finance appropriate investments into technology, operations, human and regulatory resources, and maintain their Settlement Guarantee Fund (SGF) as appropriate, cannot be overstated.

3. While the Securities Contracts (Regulation) (Stock Exchanges and CCs) Regulations, 2012, permitted listing of Stock Exchanges, the listing of CCs is prohibited.

4. The 2018 report of the Committee on review of regulations and relevant circulars pertaining to Market Infrastructure Institutions (MIIs), headed by Sh. R Gandhi (referred to as *Gandhi Committee*), had noted that the ownership of MIIs should be dispersed and should be widely held. With respect to CCs, the committee had specifically noted that while most CCs in India were 100% owned by a single Exchange, given that CCs are risk bearing MIIs, it is highly desirable that they should be widely held. Further, the Gandhi Committee had also noted that with the CCs being sensitive and high risk-bearing and risk managing entities, listing of CCs should not be permitted.

5. Subsequently, SEBI, vide its Securities Contracts (Regulation) (Stock Exchanges and CCs) Regulations, 2018 (SECC Regulations) has laid down norms for ownership and governance framework of CCs. Regulation 18 of the SECC Regulations, *inter-alia*, lays down the following norms on shareholding in a recognized CC:

    a. At-least 51% of the paid-up equity share capital of a recognized CC to be held by one or more Stock Exchanges.
    b. No person resident in India or outside India, other than Stock Exchanges, can hold more than 5% of the paid-up equity share capital in a CC.
    c. Some other categories (depository, banking company, insurance company, their foreign counterparts including foreign stock exchange) can hold up to 15% of the paid-up equity share capital.
    d. No recognized stock exchange can hold more than 15% of the paid-up equity share capital in more than one recognized CC.

6. With respect to the finances of MIIs, the Gandhi Committee, after deliberating the generation of income and distribution of profits by MIIs, had recommended that there should be no stipulation on the quantum of profits to be made by MIIs but that there should be monitoring of reasonableness of the charges and fees levied by MIIs. Further, the committee also recommended that MIIs should disclose the resources committed to strengthening regulatory functions.

7. Furthermore, the committee on Strengthening Governance of Market Infrastructure Institutions (Mahalingam Committee, November 2022), had noted, *inter-alia*, that since MIIs perform a dual role as a public infrastructure service provider with regulatory functions, and as a profit-making corporate entity, it is important for MIIs to ensure that adequate resources are deployed in their regulatory and risk as well as the operations and technology functions.

(III) Need for review: Diversification of the ownership and shareholding in CCs

8. Currently, the CCs are subsidiaries of their parent exchanges, with parent exchanges holding practically 100% of the shareholding in their respective CCs. The dominance of the parent exchange in the ownership structure, invariably exposes a CC to the expectations of shareholders of the parent exchange, with the financial statements of CCs being consolidated with the parent exchange.

9. As elaborated earlier, in recognition of the crucial role that CCs play in risk management for public interest, and the need to ensure that commercial considerations do not come in the way of their operations, current regulations explicitly prohibit their public listing. However, CCs are currently fully owned by

their parent Stock Exchange, which are allowed to list. When the Exchange itself is listed, this also leads to the vicarious listing of its subsidiary CC.

10. The recent measures being undertaken by SEBI towards enhancing market efficiency and investor protection, such as trading supported by blocked amount in secondary markets, shortening of settlement cycles, pay-in/ pay-out validations, and direct pay outs to clients, require CCs to make significant investments towards enhancing their infrastructure and processes.

11. Additionally, with a substantial increase in trading volumes in recent years and the growing interest amongst a wide category of investors particularly in the derivatives segment, CCs would also have to augment their SGF.

12. In this regard, it has been observed that CCs are today primarily dependent on the parent exchange for infusion of capital towards augmenting their SGF. The same applies when there is a need for substantial capital investments in a CC's infrastructure, risk management or human resources. Structurally and in the short run, funding the capital requirements of their subsidiary CC may appear to be at odds with the commercial objectives of the parent Exchange and its shareholders.

13. The issues highlighted above have particularly come to focus since the introduction of interoperability in segments such as equity markets since 2018. <u>CCs now clear and settle trades of multiple competing Exchanges in such interoperable segments.</u> The CC owned by the major exchange now clears a significant majority of the trades across each of the two largest equity exchanges.

14. In this context, CCs need to be, and need to be seen to be, truly independent of exchanges particularly in such interoperable segments, so that there is a level playing field across MIIs with no perception of any perverse conflict of interest.

15. Additionally, the observed growth and penetration of markets in recent years also means that the market players and intermediaries have an implicit stake in well-capitalized and independent CCs. From a systemic stability perspective as well, having truly independent CCs and Exchanges would reduce any existing concentration risk on specific entities.

16. Globally, it is observed that some of the major CCs, such as, DTCC and Euroclear have diversified shareholding while some other CCs, such as, LCH, SGX-DC and ASX-CC are subsidiaries of the parent exchanges. As a broad generalization, it can be observed that in jurisdictions where there is a single major exchange (e.g. UK, Australia), the CCs are subsidiaries of exchanges. On the other hand, where there are multiple exchanges in a jurisdiction (e.g. US, EU) and where CCs are providing services across exchanges, the CCs tend to be widely held. Additionally, it is also observed that the Clearing Corporation of India Ltd. (CCIL) is also widely held by various stakeholders, viz, Commercial Banks, Primary Dealers and Financial Institutions.

17. Given all the above, broad-basing and diversifying the ownership of CCs operating in interoperable segments away from the parent Exchange would help strengthen the financial and operational independence of a crucial set of MIIs, ensure they can operate primarily in public interest, ensure a level playing field across MIIs, and reduce the system-wide reliance on a single large entity.

Potential route for initial divestment

18. While looking to broad base and diversify the ownership of CCs, it is important to ensure that such a transition is fair to all stakeholders (including to the current shareholders of the parent exchange) and causes minimal disruption to the capital markets ecosystem.

19. Keeping this in mind, one approach could be a pro-rata distribution of 49% of shareholding of a CC to the existing shareholders of the parent Exchange. The balance 51% of shareholding would remain with the parent Exchange to start with. The parent Exchange could then be given a period (say 5 years) to bring down this holding to 15% or lower, by selling down their stake to other Exchanges. This approach would mean that CCs would remain majority owned by Exchanges, in line with the extant Regulation 18 of the SECC. However, requiring the parent Exchange to divest 36% or more stake only to other Exchanges in a time-bound manner can present practical challenges.

20. Alternatively, the entire shareholding of a CC could be allotted to the existing shareholders of exchanges, who would then be free to trade their shares in the CC. This would allow for a clean break of the CC from its parent Exchange, in a manner that is fair to the existing shareholders of the parent Exchange. This would require a suitable amendment to Regulation 18 of the SECC Regulations, that require Stock Exchanges to own at least 51% of CCs. In addition, confirmation that such CCs can continue to be excluded from the application of the Payment and Settlement Systems (PSS) Act 2007 will be required. SEBI is in consultation with RBI regarding potential implication of PSS Act on Clearing Corporations in case shareholding of Stock Exchanges falls below the threshold of 51%.

21. If there is clarity that the PSS Act would not be applicable to SEBI regulated CCs even if they ceased to be owned by Exchanges, the diversification route highlighted at para (20) above would likely be preferred and the combined shareholding of Stock Exchanges in CCs may fall below 51%. Conversely, the diversification route stated at para (19) above, may have to be considered.

(IV) Other proposals -

Profits, dividend distribution and listing of CCs

22. It is proposed that the other principles governing CCs can remain, viz., (i) they will be allowed to operate as reasonable profit-making and dividend distributing entities, with the extant governance checks and balances, so that they can foster innovation, drive efficiencies, and attract market talent (ii) they will not be allowed to list.

23. It is proposed that CCs should evolve a fee and operating structure that allows them to operate as truly self-sufficient, robust, and efficient entities that are not dependent on their shareholders for enhancing default funds, nor for funding any new investments into technology and people. The overall fee for end investors, across Exchanges and Clearing Corporations, would not increase.

Consolidation of CCs

24. Keeping in mind that a multi-asset CC may lead to more efficient utilization of capital and resources, some consolidation of CCs will not be discouraged.

25. However, while a few CCs may merge to encourage economies of scale and financial viability, existence of multiple CCs (and other MIIs) in the Indian markets is desirable, so that there is some natural back-up and less reliance on a single 'too-big-to-fail' entity.

(V) Summary of Proposals

26. The above discussed proposals have been summarised below and public comments are being sought on the same:

    26.1. In case there is clarity that the PSS Act would not be applicable to SEBI regulated CCs, even if they were not owned by Exchanges, it is proposed that the shareholding of Clearing Corporations be diversified as per para (20) above. In such a scenario the entire shareholding of Clearing Corporations may be diversified and consequently, the Stock Exchanges may not have any shareholding in Clearing Corporations.

    26.2. Conversely, if it is clear that PSS Act would be applicable to SEBI regulated CCs in case the shareholding of Stock Exchanges falls below 51%, it is proposed that the shareholding of Clearing Corporations be diversified as per para (19) above. In such a scenario, 49% percent of the Shareholding of Clearing Corporations would be diversified while the balance 51% of shareholding would remain with the parent Exchange to start with. The parent Exchange could then be given a period (say 5 years) to bring down this holding to 15% or lower, by selling down their stake to other Exchanges.

26.3. It is proposed that the approach of pro-rata distribution of shareholding of a Clearing Corporation to the shareholders of the parent Exchange may be followed for diversifying the shareholding of Clearing Corporations.

26.4. It is proposed that Clearing Corporations would continue to function as profit making public utilities under the regulatory supervision of SEBI. It is proposed that Clearing Corporations would be required to evolve a reasonable fee and operating structure that allows them to operate as self-sustaining public utilities. The overall fee for end investors, across Exchanges and Clearing Corporations, would not increase.

26.5. It is proposed that CCs will continue to be prohibited from listing.

26.6. It is proposed that creation of multi-asset Clearing Corporations, providing clearing and settlement service, across asset classes, across Stock Exchanges would be encouraged.

26.7. It is proposed that, notwithstanding the proposed consolidation, multiple Clearing Corporations would continue to exist in the Indian markets.

27. The said consultation paper would be available for comments on SEBI website for 21 days from the date of issuance. Comments may be sent to the following, latest by December 13, 2024 via online web based platform through the following link:

https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes

In case of any technical issue in submitting your comment through web based public comments form, you may contact the following through email with a subject: "Issue in submitting comments w.r.t. Consultation Paper on Review of Ownership and Economic Structure of Clearing Corporations ".

Vishal Shukla, GM (vishals@sebi.gov.in)
Abhishek Rana, Manager (rabhishek@sebi.gov.in)

Issued on: November 22, 2024