



भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

CONSULTATION PAPER

DDHS – POD 1

Enabling direct participation by clients/ participants in the Limited Purpose Clearing Corporation - tri-party repo for corporate bonds

MAY 19, 2023

How to Respond

We are asking for comments on the Consultation paper by May 29, 2023.

The comments/ suggestions may be provided in the specified format to the following email ids:

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MAY 19, 2023

1. Introduction:

1.1. Deepening of bond market in India has been the avowed goal of the Government and the Regulators for the last many years. One of the pre-conditions for the development of the corporate bond market is to develop an active repo market which will assist improving liquidity in the underlying securities. A well-developed repo market in corporate bonds will facilitate:

- (a) Improved liquidity in the underlying debt securities;
- (b) The ability of the holders of debt securities to monetize them without selling the underlying;
- (c) Meeting the temporary requirement of funds, etc.

1.2. Keeping the above objectives in mind, SEBI took the initiative of setting up an exclusive Limited Purpose Clearing Corporation (LPCC) by suitably amending the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018 (SECC Regulations) in October, 2020. AMC Repo Clearing Limited (ARCL) was incorporated in April, 2021 with share capital contribution from Asset Management Companies (AMCs) based on their debt assets under management (Debt AUM). ARCL was recognized as a LPCC by SEBI in January, 2022.

1.3. Further, RBI has accorded approvals to ARCL under the Payment and Settlement Systems Act, 2007 to act as a tri-party repo agent and offer tri-party repos under section 45(W) of the Reserve Bank of India Act, 1934 and for providing Central Counterparty services for clearing and settlement of repo transactions in corporate debt securities that are traded on recognised Stock Exchanges. ARCL is due to start operations shortly.

2. Objective of this consultation paper:

The objective of this consultation paper is to seek comments/ views/ suggestions from the public on the proposal for enabling direct participation by clients/ participants in the tri-party repo segment for corporate bonds. This proposal, which is explained below, will facilitate direct participation in repo transactions in corporate bonds by entities which

cannot take direct membership of the Stock Exchange/ Clearing Corporation viz. bodies corporate, NBFCs, Insurance companies, Mutual Funds, etc.

3. Extant regulatory provisions that are subject matter of this consultation paper:

The regulatory provisions that are subject matter of this consultation paper are as under:

3.1. Regulation 10(A) of the Securities and Exchange Board of India (Stock Brokers) Regulations, 1992 (Stock Broker Regulations) reads as under:

“(1) No person shall act as a clearing member, unless he obtains a certificate of registration from the Board: Provided that no separate registration shall be required for a stock broker registered with the Board to act as a clearing member in a clearing corporation of which he is admitted as a member, subject to grant of approval by the concerned clearing corporation.

Explanation.-For the purpose of this sub-regulation, it is clarified that no separate registration shall be required for a clearing member registered with the Board to operate in more than one clearing corporation, of which he is admitted as a member, subject to grant of approval by the concerned clearing corporation.

(2) An application for grant of a certificate of registration as clearing member shall be submitted to the Board in Form AD of Schedule I through the clearing corporation of which he is admitted as a member.

(3) The Clearing Corporation shall forward the application form to the Board as early as possible, but not later than thirty days from the date of its receipt.”

3.2. Regulation 37(1) of the SECC Regulations reads as under:

“(1)Every recognised clearing corporation shall establish and maintain a Fund by whatever name called, for each segment, to guarantee the settlement of trades executed in respective segment of a recognised stock exchange:

(2)In the event of a clearing member failing to honour his settlement obligations, the Fund shall be utilized to complete the settlement.

(3)...”

3.3. Regulation 22D of the SECC Regulations states as under:

“Contribution to the Settlement Guarantee Fund

(1). The contribution to the Fund as specified in regulation 37 shall be made by the recognized limited purpose clearing corporation, the clearing members and issuers of the debt securities, in the manner as may be specified by the Board from time to time.

(2)...”

4. Operationalisation of LPCC

4.1. As mentioned earlier, ARCL, the LPCC, is going to commence operations shortly. As part of its operations, ARCL has proposed two models - proprietary model and client model.

4.1.1. Proprietary model: Under the proprietary model, any entity desirous of entering into a tri-party repo transaction shall take trading membership of Stock Exchanges and clearing membership of the LPCC. In this model, trading, clearing and settlement shall be undertaken by the entity (Trading Member/ Clearing Member) in its proprietary account i.e the principal itself will take membership as a Trading Member/ Clearing Member.

4.1.2. Client model: Under the client model, two approaches have been proposed by ARCL:

- (a) client model – direct participation and
- (b) client model – indirect participation.

4.1.3. In both the above approaches, the client (principal) will transfer collateral (debt securities) directly from its account to the account of the LPCC. However, the fund settlement, in case of client model – indirect participation, will be carried out through a Clearing Member, whereas in case of client model – direct participation, fund settlement will be carried out directly by the participant without the involvement of the Clearing Member.

4.1.4. While the proprietary model is already in place, the client model is proposed to be introduced. The introduction of '*client model*' for tri-party repo in corporate bonds will facilitate participation by entities which cannot take direct membership of the Stock Exchange/ Clearing Corporation. The need for the '*client model*' for tri-party repo in corporate bonds stems from

the fact that rule 8(1)(f)¹ of Securities Contracts (Regulation) Rules, 1957 (SCRR) restricts entities viz. bodies corporate, NBFCs, Insurance companies, Mutual Funds, etc. from taking membership of a Stock Exchange/ Clearing Corporation. Thus, this restriction precludes such entities from participating in the tri-party repo segment except through a Clearing Member.

- 4.1.5. Repo is a very short term money market instrument with most transactions with a tenure of single day. Obtaining funds on the same day is very crucial for the borrowers to use such funds. Thus, the timing of settlement is critical to ensure that funds reach the bank accounts of market participants. If settlement is done through a Clearing Member, it might cause a delay in the settlement of funds between the Clearing Member and its clients/ participants which could lead to disputes between the Clearing Members and the clients/participants; this, in turn may impact the smooth functioning of the LPCC.
- 4.1.6. The purpose of the Core SGF is to fulfil the obligations of the members and complete the settlement in the event a Clearing Member fails to honour settlement commitments, thereby fulfilling the normal settlement process and enhancing the robustness of the risk management system of the Clearing Corporations. Thus, the corpus of the fund should be adequate at all times to meet all contingencies arising on account of possible failure of any member(s).
- 4.1.7. While Regulation 22D of the SECC Regulations stipulates contribution to the Core SGF by the LPCC, Clearing Members and issuers of the corporate bonds, in view of the proposed client model – direct participation approach, in which the client/ participant is expected to settle funds directly with the Clearing Corporation, there is no explicit provision

¹ Rule 8(1)(f) of SCRR relating to the admission of members of a Stock Exchange provides that no person shall be eligible to be elected as member if - he is engaged as principal or employee in any business other than that of securities or commodity derivatives except as a broker or agent not involving any personal financial liability unless he undertakes on admission to sever his connection with such business.

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enabling contribution to the Core SGF by clients/ participants directly. Absence of such enabling provision in the SECC Regulations would give rise to a situation where the client/ participant would settle funds directly without adequate risk management measures and in the event of default, the LPCC will have to make good the shortfall on account of default by itself.

- 4.1.8. In order to strengthen the risk management system of the LPCC to meet the contingencies arising on account of possible failure of the clients/ participants as well, it is essential that the contribution to the Core SGF can also be made by clients/ participants directly in cases where the Clearing Member is not involved in the tri-party repo transactions.

5. Proposal:

- 5.1. To redress the above issues, there is a necessity to facilitate transactions directly between clients/ participants and the LPCC in the tri-party repo segment as well as to enable contribution by such clients/ participants directly to the Core SGF. Accordingly, the following amendments are proposed:

5.2. Amendment to the Stock Broker Regulations:

Insertion of a second proviso to regulation 10A (Application for registration under Chapter II - Registration of Clearing Members) providing that no separate registration with the LPCC would be required for an entity for participating in the tri-party repo segment for corporate bonds.

5.3. Amendment to the SECC Regulations:

5.3.1.1. Amendment to Regulation 22D (Contribution to the Settlement Guarantee Fund (SGF) – under Chapter IV–A: Limited Purpose Clearing Corporation) enabling contribution to the Core SGF by direct clients/ participants.

5.3.1.2. Amendment to Regulation 37(2) (Fund to guarantee settlement of trades under Chapter VI: General Obligations) empowering the Clearing

Corporation to utilize the Core SGF also in the event, a direct client/participant fails to honour its settlement obligations.

6. Benefits of the proposal to the market:

- 6.1. As emphasized earlier in this consultation paper, an active repo market is an essential pre-condition for improving liquidity in the corporate bond market. This is mainly because active players, especially market makers, are in a position to provide finer two-way quotes (bid-offer spreads), if they are able to finance their inventory of bond holdings through an active repo market.
- 6.2. In the corporate bond market, however, repo is mostly inactive with only a few transactions getting executed and that too in the bilateral repo market. There is no traction in the tri-party repo market despite the segment being in existence on Stock Exchanges since 2018. One of the primary reasons for lack of traction on the tri-party repo platform may be that the Stock Exchanges/ Clearing Corporations do not have a well-funded Settlement Guarantee Fund ('SGF') to absorb the counterparty risk as well as the credit risk of the underlying associated with repo transactions.
- 6.3. The proposals in this consultation paper would facilitate easier participation by market participants, thus ensuring greater volumes in the corporate bond repo market. This, in turn, will only serve to boost the liquidity in the secondary market for corporate bonds.

7. Public Comments:

The comments/ suggestions on the proposal may be provided by **May 29, 2023** in the format given below:

Sr. No.	Issues	Proposals/ Suggestions	Rationale

Issued on: May 19, 2023