

Report submitted by Committee on Review of Regulations and Relevant Circulars pertaining to Market Infrastructure Institutions (MIIs)

To solicit the comments/views from public on suggestions pertaining to second report submitted by the Committee.

Background

A discussion paper on review of regulations and relevant circulars pertaining to Market Infrastructure Institutions (MIIs) was placed on SEBI website on February 22, 2017, for seeking public comments.

Subsequently, SEBI constituted a Committee under the Chairmanship of Shri R. Gandhi, Former Deputy Governor, Reserve Bank of India, on October 16, 2017, to review the existing framework of MIIs. The Committee submitted its report thereon March 26, 2018. The recommendations so made are under active examination of SEBI.

In the meantime, the terms of reference of the Gandhi Committee were expanded to include the desirability of classifying certain Market Intermediaries as MIIs and assess the possibility of extending the extant framework to such MIIs. On this aspect, the Committee has submitted its second report on April 25, 2018. The same is being hosted on the SEBI website for public comments.

Public Comments

Comments from public are invited on proposal contained in the above report and the same should reach SEBI latest by **May 19, 2018** in the following format:

Name of entity/ person/ intermediary/ organization: _____			
Sr.No.	Recommendation Committee	Comments/ suggestions	Rationale

The comments may be sent by email to rgcpart2@sebi.gov.in or alternatively a hard copy of the same may be sent to the following address-

General Manager
Division of Supervision & Registration-1
Market Intermediaries Supervision and Regulation Department
Securities and Exchange Board of India
1st Floor, B wing, Mittal Court
Nariman Point, Mumbai-400021

**Report of the
Committee on Review of Regulations and Relevant
Circulars pertaining to Market Infrastructure
Institutions (MIIs)**

Part-2

25/04/2018



भारतीय प्रतिभूति और विनिमय बोर्ड
SECURITIES AND EXCHANGE BOARD OF INDIA

April 25, 2018

**Shri Ajay Tyagi
Chairman
Securities and Exchange Board of India
Mumbai**

Dear Sir,

Report of the Committee to review Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012, Depositories & Participants Regulations and relevant Circulars pertaining to Market Infrastructure Institutions (MIIs)

We have immense pleasure in submitting **Part 2** of the Report of the Committee to review Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012, Depositories & Participants Regulations and relevant Circulars pertaining to Market Infrastructure Institutions (MIIs), appointed by you.

The report has examined the various issues with regard to the terms of reference on desirability of classifying certain Market Intermediaries as MIIs and assess the possibility of extending the extant framework to such MIIs. Accordingly this part is presented reflecting the Committee's considered recommendations.

The Committee has benefitted immensely from the sagacity and expertise of the esteemed members of the Committee.

We sincerely thank you for entrusting this responsibility to us.

With regards

Yours Sincerely,

**R. Gandhi
Chairman
Committee to review MII Regulations**

**G Anantharaman
Member**

**Leo Puri
Member**

**Gopal Naik
Member**

**Nagendraa Parakh
Member**

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THE COMMITTEE AND TERMS OF REFERENCE

1. The Securities and Exchange Board of India constituted a Committee under the Chairmanship of Shri R. Gandhi, Former Deputy Governor, Reserve Bank of India to review the regulations and relevant circulars pertaining to Market Infrastructure Institutions (MIIs). The other members of the Committee were:

1.1. Shri G. Anantharaman, Former Whole Time Member, SEBI

1.2. Shri Leo Puri, Managing Director, UTI AMC Ltd

1.3. Prof. Gopal Naik, Professor, IIM Bangalore

1.4. Shri Nagendraa Parakh, Executive Director, SEBI

2. Under the terms of reference, the Committee needed to review and make recommendations on the following issues:

2.1 Overall assessment/adequacy of existing MIIs' framework and identify areas for review in the Securities Contracts (Regulation) (Stock exchanges and Clearing Corporations) Regulations, 2012 (SECC Regulations) (recognition, ownership, governance, shareholding, net worth and others), Depositories and Participants Regulations, 1996 (D&P Regulations) and relevant circulars thereto.

2.2 Identifying areas for continuous improvement of systems, procedures and practices and make recommendations thereof.

2.3 Addressing suggestions/comments of public received as part of the consultation process.

2.4 Desirability of classifying certain Market Intermediaries as MIIs and assess the possibility of extending the extant framework to such MIIs.

The Committee has submitted Part-I of the report to SEBI on March 26, 2018. Terms of reference no. 2.4 is covered in Part 2 of the instant report and the same has been done

after reviewing Securities and Exchange Board of India (SEBI) Act, 1992, SEBI (Credit Rating Agencies) Regulations, 1999, SEBI (Registrar to an Issue and Share Transfer Agent) Regulations, 1993, SEBI (Debenture Trustee) Regulations, 1993, SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Report of the Bimal Jalan Committee on 'Review of Ownership and Governance of Market Infrastructure Institutions', etc.

APPROACH OF THE COMMITTEE

Background

1. Stock exchanges, Depositories and Clearing Corporations are collectively referred to as securities Market Infrastructure Institutions (MIIs). Literally, the term 'infrastructure' would mean the basic, underlying framework or features of a system; and the term 'market infrastructure' denotes such fundamental facilities and systems serving this market. Well-functioning MIIs have a positive effect on society like any other infrastructure institutions. These institutions are systemically important for the country's financial development and serve as the infrastructure necessary for the securities market.
2. In Indian milieu, there are other financial market intermediaries who provide services to the market which may be in the nature of public utilities, viz. Credit Rating Agencies (CRA), Registrar to an Issue and Share Transfer Agent (RTA), Debenture Trustee (DT). Certain characteristics of these intermediaries such as size, concentration, high market dependence on their services, etc. make them systemically important. Therefore, while these entities are systemically important institutions, the committee was asked to examine whether these institutions can be called Market Infrastructure Institutions.
3. To deliberate upon the same, a meeting of the committee with certain market intermediaries (CRAs, RTAs & DTs) was held on April 05, 2018. Each set of intermediary gave a presentation respectively to the committee which was followed by Question-Answer session. In their presentation, they have compared the extant framework for MIIs and its applicability to their structure and operations. Subsequently the committee met again on April 12, April 18, and April 25, 2018 to examine and deliberate on the existing regulations governing the abovementioned market intermediaries and proposed framework.
4. The Committee took note of trends in ownership and governance of these market intermediaries, compared them with the internationally prevailing practices and processes. The Committee has benefitted from such a comparative study in formulating its approach for the assessment and adequacy of applicability of framework of MIIs to CRAs, RTAs and DTs.

5. Thus, while framing the recommendations, the Committee has taken into consideration the views expressed by various market participants and best practices across jurisdictions. The recommendation of the Committee has been brought out herein below.

INTRODUCTION

CRAs provide investors with information regarding the creditworthiness of an instrument issued by an entity which may be one of the factors investors rely upon while making investment decisions. CRAs help measure the quantitative and qualitative risks of these entities and allow investors to make wiser decisions by benefiting from the skills of professional risk assessment carried out by these agencies. While they do not handle funds & securities of investors directly but their inputs make investors take appropriate decision to invest in the market.

RTAs maintain detailed records of both the financial and non-financial transactions carried by investors in Mutual Funds, shares etc. These agencies act as a single-window system for investors with respect to their processes of transfer and redemption of securities. This provides investors with a simplified method to receive forms of their fund houses. This also helps complete their transactions, and even receive a record of their account statements. While fund houses can also provide such information, an RTA is a one-stop contact for all investors' needs on various schemes and investments.

The Debenture Trustee is an intermediary between the issuer of debentures and the holders of debentures. DT plays a vital role of ensuring the protection of interest of debenture holders and adequate asset cover. In terms of DT Regulations, a company cannot issue debentures unless it has appointed a DT. The DT has the onus to resolve the grievances of the debenture holders.

GUIDING PRINCIPLES- Deliberations, Rationale & Key Recommendations

The issue of whether Credit Rating Agencies, Registrar to an Issue and Share Transfer Agents and Debenture Trustees are MIIIs was discussed by the Committee in light of criteria of MIIIs, viz., Essential Facility Doctrine, Networks, Economies of Scale, Sunk Cost and Natural Monopoly.

1. **Essential facility doctrine:** A commonly accepted attribute of infrastructure institutions is that the goods or services they produce are *essential* in some manner. Committee felt that this feature is met by CRAs to some extent.
2. **Networks:** Four key characteristics of network industries have been identified which distinguish them from other types of markets viz. consumption externalities, switching costs and lock-in, complementarity, compatibility and standards and significant economies of scale in production. Committee felt that this characteristic is not very conspicuous in DTs, RTAs and moderately evident in CRAs.
3. **Economies of Scale:** Economies of scale occur when the average cost of producing a good or service declines with the number of units produced. Committee was of the opinion that this characteristic is relevant only to RTAs.
4. **Sunk Costs:** Committee felt that this characteristic is not applicable to any of the intermediaries CRAs, DTs or RTAs.
5. **“Natural” Monopoly:** Committee felt that in respect of these intermediaries near oligopolistic situation prevails.

The Committee, based on the presentations made by the market intermediaries, felt that these intermediaries do not meet majority of the criteria of MIIIs. However, certain characteristics such as size, concentration, high dependence of investors on their services, market share, etc. make them significantly important. Therefore, the Committee felt that they may not be considered systemically important, however, the Committee deliberated on whether these intermediaries may be subjected to higher regulatory requirement in terms of ownership, governance and certain additional standards of essential accountability as they are significantly important, and in absence of the same, whether they pose risk to the market integrity.

A. Credit Rating Agencies (CRAs)

The Rationale:

The services offered by CRAs are *essential*. The issuer companies are required by regulations to get their instrument rated by CRAs. There is an inherent conflict of interest in the structure and operations of CRAs, i.e., CRA rates the instruments issued by the issuer company and gets paid for the same by the issuer. It is seen that in some CRAs, the ownership is concentrated, i.e., majority of the shares are held by one institution. The Committee is of the view that CRAs attain a level of significance due to reliance placed by investors on the ratings given by CRAs to the investment decisions and monitoring.

Regulatory Framework:

As per the current regulatory framework, a CRA can be promoted by public financial institution, scheduled commercial bank, foreign bank, foreign CRA or a body-corporate having a continuous net-worth of Rupees 100 crore for previous five years. Further, a CRA has to have a minimum net-worth of Rupees 5 crore. CRAs submit their Internal Audit Reports to SEBI on half yearly basis. CRAs undergo on-site inspection on periodic basis.

Ownership:

Internationally, most of the CRAs are promoted by Foreign Investment Management Company. However, it is seen that some of them are listed and widely held. For instance, S&P Global Inc. and Moody's Corporation are listed and highest percentage of shareholding is 7.97% and 12.92% respectively. They have independent directors on their Board.

The current ownership structures of CRAs in India was looked into by the Committee. Their shares are mainly held by individual shareholders, corporate bodies, foreign investors, foreign Credit Rating Agencies, Mutual Funds, Financial Institutions/ Banks, Trusts, etc. The CRAs having significant market share are listed and widely held.

The Committee was also made aware of some of the recent decisions taken by SEBI Board in the Board meeting dated December 28, 2017, inter alia, in respect of Enhanced Eligibility Requirements for CRAs in terms of increased net-worth requirements, minimum promoter holding of 26% and lock-in period of 3 years, eligibility requirements of the foreign CRA to promote a CRA in India; and also in respect of Restriction on Crossholdings wherein no CRA directly or indirectly, shall hold 10% or more of shareholding and/ or voting rights in any other CRA or have representation on the Board of any other CRA, etc.

Recommendations:

In light of the recent developments, the Committee felt that it may not be desirable to prescribe any additional ownership norms for CRAs at this stage.

Governance:

In the US, the CRAs do have independent directors on their Board. In the Indian context, current governance practices followed by CRAs were examined by the Committee. It is noted that a few CRAs have Independent Directors on their Board; some have Independent Members in the rating Committee; yet others have external members and / or internal members not associated with the same case.

The Committee deliberated on whether there is a need to change the structure of Rating Committee of CRA. Committee also deliberated on appointing Independent Members in majority on the Rating Committee of CRAs. It is observed that though different Rating Committee structures are prevalent among CRAs, nothing adverse has been reportedly noticed. Each CRA carries credibility and accountability of its rating with the users and in the market. Therefore, it is felt that it would not be presently desirable to stipulate additional norms on composition of CRA's Rating Committee.

The Committee was made aware of the Consultation Paper on Review of the Regulatory Framework for Credit Rating Agencies (CRAs) which, inter alia, included a proposal that all cases of appeal by issuers against the rating assigned to their instruments by the CRA shall be reviewed by a separate Appeal Committee which shall be different from the

Rating Committee that had initially assigned the rating, and shall consist of a majority of Independent Members.

Recommendations:

The Committee deliberated on the aforementioned proposal and recommended that the 'Appeal Committee' shall be renamed as 'Review Committee', as the word Appeal has a legal connotation to it and further, that the Review Committee shall also have independent members.

The Committee also deliberated on possibility of mandating the presence of Public Interest Directors (PID) in the Board of CRAs as they satisfy the 'Essential Facility Doctrine' and 'Public Utility' criteria. However, the committee felt that the changed regulatory requirement for CRAs are sufficient since prominent CRAs are either listed or are Public Limited Companies and have to comply with the appointment of Independent Directors in terms of LODR requirements or Companies Act respectively, the presence of PID on the Board of CRAs may not be insisted upon.

Further, the Committee has deliberated on the suggestions received vide email from one of the CRAs with respect to the issues of rotation of CRAs, compulsory dual rating, independence of credit evaluation of resolution plans of stressed accounts and regulation of the functioning of rating advisors. The Committee considered these suggestions and felt that these are beyond the scope of the committee and SEBI may look into the same on merit.

B. Registrar to an Issue and Share Transfer Agent (RTAs)

The Rationale:

Some RTAs due to their sheer size and concentration can be said to have attained a high level of significance. In India, for example, there are only 2 RTAs (Karvy Computershare Pvt. Ltd. and Computer Age Management Services Pvt. Ltd.) that service 90% of the Mutual Fund folios. One of these RTAs (i.e. Karvy) also has approx. 40% market share in corporate folios. Further, RTAs possess huge quantity of financial information, customer details, etc. and protecting all such sensitive data requires the businesses to adhere to specific principles. Any breach in data protection can be costly and would affect the customers in a large way.

Regulatory Framework:

As per the extant regulations, any person can obtain RTA registration, inter alia, by fulfilling the conditions of registrations, net-worth and fit & proper criteria. The Registrar to an Issue and Share Transfer Agent sends the periodic report to SEBI on half yearly basis within three months of the expiry of the half year. Every RTA undergoes onsite inspection on periodic basis. Further, they are monitored through the mechanism of Risk Based Supervision. SEBI has formulated Cyber Security and Cyber Resilience framework and has also issued guidelines to strengthen and raise industry standards for RTAs.

Ownership:

Globally, the regulators have emphasized on regulating the RTA function rather than regulating the RTA entities. This has allowed regulators worldwide to achieve their objective of investor protection irrespective of the ownership of RTA entity. Further, internationally, it is seen there is no explicit restriction on ownership pattern of the RTA. Presently, in India, RTAs are owned by individual shareholders, Corporate Bodies, Foreign Investors, Financial Institutions/Banks, Trusts, etc. There are no restrictions on concentration of ownership or lock-in period for promoters however, there is a requirement of taking prior approval for change in control and the new owner has to fulfill, inter-alia, fit and proper requirements.

The Committee deliberated whether the ownership norms can be enhanced for RTAs that attain significant market share and size. SEBI vide circular dated September 08, 2017 already has defined Qualified RTAs (QRTAs) as “RTAs servicing more than two crore folios”, the Committee recommends that concentration of business in a few hands may not be desirable in the interest of investors and therefore, once RTA crosses the threshold to become QRTA, enhanced ownership norms may be made applicable to them.

Recommendation:

Considering the likely impact of their services as they hold sensitive financial data of large number of investors, the Committee recommends that the QRTAs should either have a dispersed ownership or should be owned by Regulated Entities or entities in the business of RTA. The Committee is of the view that in the long run, it is desirable that QRTAs be widely held and get listed. The term Regulated Entities means the entities regulated by any Financial Sector Regulator worldwide where the Regulator is a signatory to IOSCO’s MMoU or a signatory of bilateral MoU with the SEBI, and which is not identified in the public statement of Financial Action Task Force (FATF). Accordingly, the Committee recommends that-

- i. The Regulated Entities and those who are in the business of RTA, may be free to hold ownership up to 100%,
- ii. Entities other than Regulated Entities cannot hold more than 49% collectively and 15% individually.
- iii. The ownership requirements may not be applicable if the QRTA is an in-house entity or who performs the function exclusively for one entity only.

In view of the Doctrine of Reasonable Expectation, on becoming QRTA, it may be given sufficient time, preferably 5 years, to achieve such ownership structure. The QRTA shall submit a plan to SEBI with the intent to achieve dispersed ownership over a period of time.

Governance:

Insofar as Governance norms are concerned, the Committee noted that there is no specific requirement under SEBI regulations/ circulars or under Companies Act of appointing Independent Directors on the Board of the RTA if it is a private limited company. However, in case of listed and unlisted public companies, norms for appointment of Independent Directors are governed by LODR and Companies Act respectively.

Recommendation:

The Committee felt that considering the significant role of QRTAs being played in public interest, it is desirable that the governing structure of QRTA should keep the interest of investors in mind while framing their business strategies. Therefore, composition of Board should have representation of PID and accordingly, the Committee recommends the appointment of Public Interest Directors on the Board of the QRTA. In view of the same, if Chairperson of the Board is a Non-Executive Director, then the QRTA shall have at least one-third of the Board of Directors as PIDs; and where the QRTA does not have a regular non-executive chairperson, then QRTA shall have at least half of the Board of Directors as PIDs.

C. Debenture Trustee (DTs)

As per the current regulatory framework, a person can apply for the registration as a Debenture Trustee if it is a scheduled bank carrying on commercial activity; or a public financial institution or an insurance company; or body corporate. Debenture Trustee has to maintain a net-worth of Rupees Two crore. Some of the DTs are subsidiaries of banks. The Boards of DTs are constituted of very experienced professionals and senior members of the industry. Some DTs also have 50% independent directors on Board. Every Debenture Trustee is required to submit periodic reports to SEBI on a half yearly basis and undergoes on-site inspection on a periodic basis.

The Committee noted that there are quite a few challenges before the DTs in performing their obligations and duties as debenture trustee and the function of debenture trustee is still evolving. Therefore, the Committee is of the view that the review of ownership and governance of DTs is not the immediate priority; rather the role and obligations of DTs need a comprehensive review separately.
