

Presentation on Regulatory & Operational Model of Professional Clearing Member (PCM)

Securities & Exchange Commission Of Pakistan
&
Central Depository Company of Pakistan Limited

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Background

- ▶ SECP has issued draft Professional Clearing Members (Licensing and Operations) Regulations, 2017 vide SRO No.909(I)/2017 dated Sep 7, 2017 for public comments.
- ▶ The draft regulations provide for matters relating to licensing and operations of professional clearing members whereas CDC as perspective PCM is finalizing draft operational model
- ▶ The regulations requires that within three months of the grant of licence and prior to commencement of business as professional clearing member, PCM shall obtained approval of the Commission of its operational model inter alia covering therein, transactions flow, manner of execution of transactions, roles and responsibilities of professional clearing member and customers, risk management parameters, default handing mechanism, dispute and grievance handing mechanism;
- ▶ This session is being conducted to create awareness and to seek feedback on the regulatory framework as well as operational model of PCM



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Background

- ▶ Presently, all Brokers assume the responsibility of clearing and settlement of trades executed on the behalf of their clients while providing custodial services.
- ▶ Brokers requires substantial resources in terms of:
 - infrastructure; and
 - human resource
 - to offer custodial and clearing/ settlement services.
- ▶ Although custody and clearing services complement the trading business to an extent but also requires:
 - expertise in risk management; and
 - responsibility with respect to client assets under their custody.
- ▶ Custody, Clearing & Settlement exposes Brokers to reputational risk in case of any malpractice by his employee(s) or agent(s)



Challenges for Brokers

- ▶ With the promulgation of Securities Broker (Licensing & Operations) Regulations, 2016, brokers have to fulfill additional requirements which includes minimum rating, appointment of dedicated staff to monitor and ensure client asset segregation etc.
- ▶ Major challenges includes:
 - Maintenance of mandatory infrastructure along with various support solutions;
 - Extensive monitoring of number of regulatory requirements and its related costs;
 - Risks associated with mishandling of clients assets;
 - Maintenance of asset under custody;
 - Additional staffing requirements;
 - Difficult to open and manage multiple Branches; and
 - Handling of Margin Requirements and Clearing & Settlement Issues.



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Categories of Securities Broker

- ▶ With the promulgation of Securities Broker (Licensing & Operations) Regulations, 2016 it has been made mandatory that no person shall act or perform the functions of security broker unless such person is licensed as securities broker, with the SECP, under any of the following category of Securities Broker:
 - Trading Only;(being made operational through PCM)
 - Trading and Self-Clearing (TSC);
 - Trading and Clearing Broker (being discontinued).
- ▶ Based on the aforementioned categorization of securities broker, for Clearing, Settlement and Asset Custody, TO will appoint a Professional Clearing Member (PCM) to provide custody and clearing/settlement services.
- ▶ A TSC Broker may also appoint a PCM to provide custody and clearing related services.



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Possible Settlement Options for Brokers desiring to perform only trading business (Trading Only/TO brokers)

- ▶ In order to provide a viable alternative solution for the provision of trading services independently of the custodial, and clearing & settlement services, new concept of Professional Clearing Member (PCM) is introduced.
- ▶ PCM will be an institution offering custodial, clearing & settlement services to investors.
- ▶ Institution carrying out business as PCM shall not offer trading services thereby preventing conflict of interest and addressing the concerns of Broker regarding the confidentiality of client information.



Regulatory Model



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CHAPTER I - PRELIMINARY

- ▶ 1. Short title and commencement.
- ▶ 2. Definitions



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CHAPTER II - LICENSING

- ▶ 3. Application and procedure for granting a license.
- ▶ 4. Grant of license.
- ▶ 5. Renewal of license.
- ▶ 6. Procedure where license is not granted or renewed.
- ▶ 7. Cancellation of license.



CHAPTER III - LICENSING CONDITIONS

- ▶ 8. Licensing conditions.
- ▶ 9. Financial resources requirement.
- ▶ 10. Composition of board of directors and related matters.
- ▶ 11. Shareholding requirements.
- ▶ 12. Additional conditions.



CHAPTER IV - CONDUCT OF A PROFESSIONAL CLEARING MEMBER

- ▶ 13. Invitations and Advertisements.
- ▶ 14. Disclosure of financial risks.
- ▶ 15. Conflict of interest.
- ▶ 16. Confidentiality.
- ▶ 17. Duties and obligations of a professional clearing member.



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CHAPTER IV - CONDUCT OF A PROFESSIONAL CLEARING MEMBER

- ▶ 18. Establishment of relationship with customer.
- ▶ 19. Segregation of customer money.
- ▶ 20. Accounting for and use of customer money.
- ▶ 21. Segregation of other customer assets.
- ▶ 22. Periodic reporting to the customer.
- ▶ 23. Customer Complaints.



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CHAPTER V - ACCOUNTS AND AUDIT

- ▶ 24. General.
- ▶ 25. Maintenance of books of accounts and other records.
- ▶ 26. Preparation and submission of financial statements.
- ▶ 27. Appointment of auditor and related matters.



CHAPTER VI - MISCELLANEOUS

- ▶ 28. Appointment of chief executive officer.
- ▶ 29. Appointment and functions of chief compliance officer.
- ▶ 30. Submission of information and returns.



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Operational Model



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PCM Proposed Model

- ▶ Broker will appoint PCM for custody, clearing and settlement for proprietary and client trades
- ▶ PCM will provide an automated OMS for execution of orders and maintain cash and securities accounts for each client
- ▶ PCM will allocate an overall limit to a broker whereas client level limits will be fixed by PCM on recommendation of brokers
- ▶ PCM will handle risk management, clearing and settlement of trades and custody of client assets
- ▶ Broker will not be required NCCPL and CDC memberships and will only deal with trade related matters



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Roles and Responsibilities of TO

- ▶ Appoint PCM upon satisfactory completion of necessary requirements as prescribed in the Brokers Regulations;
- ▶ Execute a Bilateral Agreement with PCM;
- ▶ Coordinating and facilitating its clients;
- ▶ Perform Know Your Customer (KYC), Customer Due Diligence (CDD) and In-Person Verification (IPV);
- ▶ Suggest trading limits of clients to PCM;
- ▶ Assign and open a new client(s) code in the OMS back-office system;
- ▶ Use Order Management System (OMS) for placement of proprietary and client(s) trades;



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Roles and Responsibilities of TO (continued...)

- ▶ Communicate trade confirmations and provide account statements to its clients;
- ▶ Assist the clients in depositing shares/cash with PCM;
- ▶ Assist the clients in handling securities in CDS including portfolio transfers, transmission of shares, pledging etc.;
- ▶ Handle trade related complaints of the client(s);
- ▶ Facilitate the customers to deposit cash with PCM; and
- ▶ Establishing the responsibility of TO to deal with complaints relating to unauthorized trading



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Roles and Responsibilities of PCM

- ▶ Execute a Bilateral Agreement with the TO.
- ▶ Provision of Order Management System (OMS) consisting Trading / Risk Management System / Back office components to TO.
- ▶ Execute a tripartite agreement with TO and client(s) determining role and responsibilities of each party.
- ▶ Perform additional KYC of clients and TO's
- ▶ Formulate and assign risk management framework with respect to TO and/or its client(s), covering margin requirements, assigning trading limits and undertaking other measures as prescribed by the regulating body
- ▶ Responsibility of PCM to meeting settlement obligations



Roles and Responsibilities of PCM (continued....)

- ▶ Registration and mapping of UIN/client codes of TO/client(s) with CDS sub-accounts as per the procedures and regulation of NCCPL
- ▶ Open and maintain CDS sub-account.
- ▶ Provision of financing/SLB against trades of TO and its clients
- ▶ Open and maintain TO wise bank account(s).
- ▶ Payments of margin for all trades and exposures of TO and its clients
- ▶ Safekeeping of documents.



Roles and Responsibilities of PCM (continued....)

- ▶ Handle all clearing, settlement and custody related matters
- ▶ Sent system generated electronic alerts in respect of trades or transfer of funds/securities
- ▶ Manage and protect client assets in accordance with applicable regulatory framework
- ▶ Responsible for handling matters relating to compliance, audit and inspections of records in accordance with Rules and Regulations SECP, CDC, NCCPL & PSX



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Trading Process

- ▶ TO and its client(s) will use Order Management System (OMS) for placement of trade orders provided by PCM.
- ▶ Trade order will be filtered in OMS on the basis of pre-assigned trading limits by PCM to the TO and its client(s) and then be routed through the FIX Protocol of PSX before placement on the trading Engine of PSX for order matching
- ▶ Trades of Client(s) can be executed by their respective TO and/or directly by client(s) through online OMS, KiTS platform or any other trading platform linked with OMS at the Pakistan Stock Exchange in accordance with its rules and regulations.
- ▶ All trades executed shall be auto-initiated in the favor of PCM and auto-affirmed simultaneously.



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Trading Process (continued)

- ▶ Responsibility for risk management and clearing & settlement of all locked-in trades by a TO and/or client(s) shall reside with the PCM.
- ▶ PCM may also provide and/or arrange financing through Margin Financing System (MFS) and/or Margin Trading System (MTS) in accordance with the Leverage Market Rules.

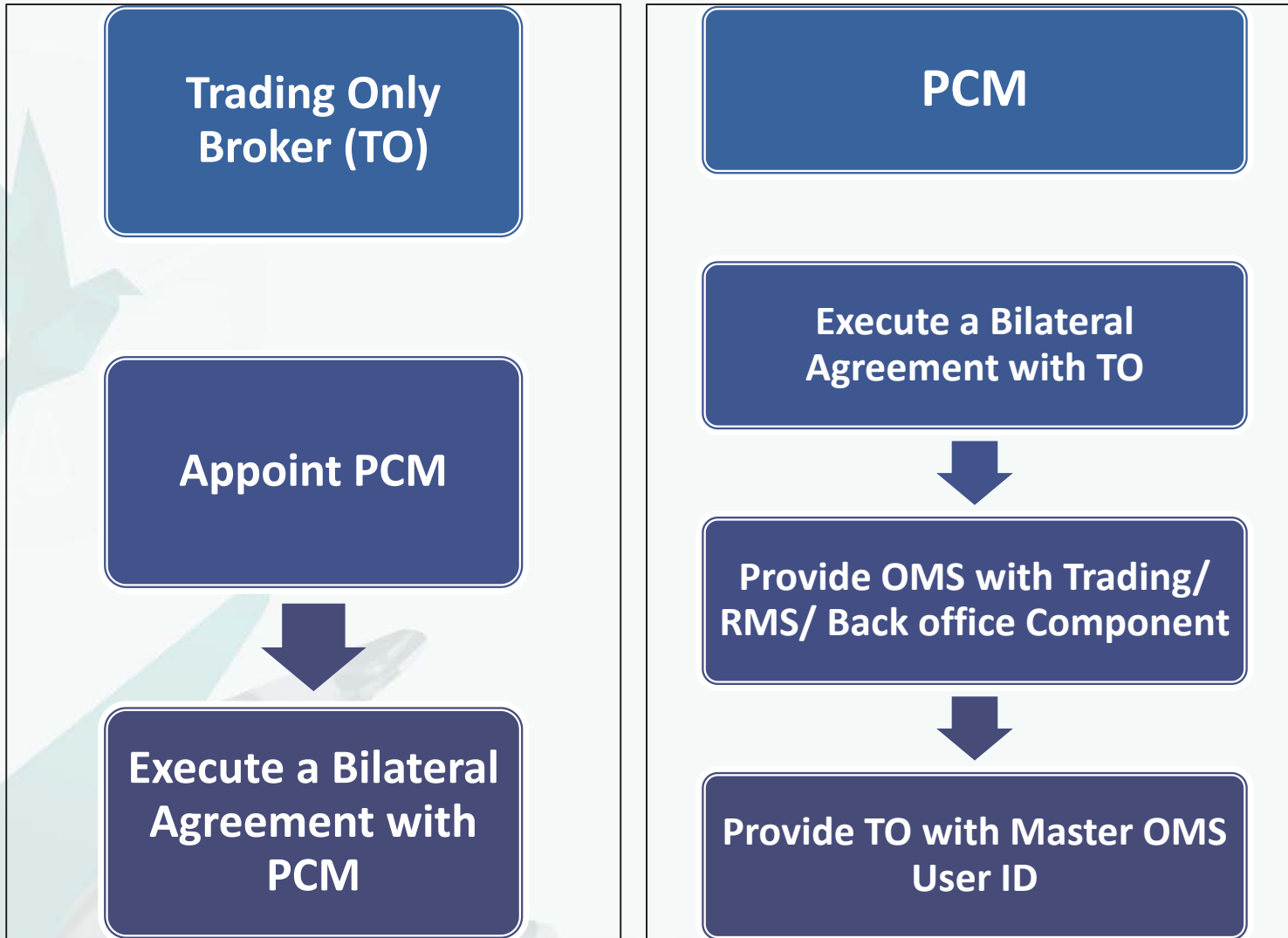


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Business Processes

Appointment of PCM by Trading Broker Only



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Business Processes

Client Account opening with PCM by TO

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Execute Tripartite Agreement with TO & Client

Over & above limited KYC of TO/ Client

UIN Registration

Open CDS sub-account

UIN Mapping of sub-account with client Code

Open TO wise Bank A/c

Assign Trading Limits to TO/ Clients

Trading Only Broker (TO)

Execute Tripartite Agreement with PCM & Client

KYC/ CDD/ IPV of client

Assign Client Code in OMS Back Office

Extend OMS Trading User ID to Client



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Business Processes

PCM

Authorized
OMS

Provided
to
TO

Trading only Broker (TO)

OMS Trading Platform

Trade entry by TO/
Clients

OMS RMS will
filter trades
based on trading
limits assigned
to TO/ Client by
PCM

Yes

Trade routed through
fix protocol of PSX

Placement of order on
KATS

Order Executed

No

Order will not pass

Settlement
responsibility of PCM



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Tariff

Description	Tariff	Remarks
	Note 2	
Transaction fee	0.05%	Note 1
Account Maintenance Fee	Rs. 250	P.A.
Connection fee Additional Connection fee	Rs. 500 Rs. 10,000	P.M
Security Deposit	Rs. 300,000	



Tariff

▶ Note 1

- Transaction fee will be levied on Market Value of the transaction. There will be one side (higher) tariff on Day Traders.
- Rational of Transaction fee:
- Since PCM will be performing more than half of the work of existing broker, therefore we have assumed PCM will share 50% of the brokerage fees;
- Brokerage fees: 5 paisa
- Average Share price: Rs. 50 per share
- PCM Transaction fee: $5 \text{ paisa} / 50 * 50\% = 0.05\%$

▶ Note 2

- PSX, NCCPL, CDC and Brokerage fees shall be charged on actual.



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Risk Management

- ▶ RMS shall be conducted at below mentioned 3 levels:
 - Professional Clearing Member (PCM)
 - Trade Only Broker (TO)
 - Client(s) of TO
- ▶ PCM shall categorize its client(s) into category A, B, C
 - Category A Client(s) – Low risk profile, maximum exposure can be allowed i.e. allowed trading in ready market/leverage/futures up to 3 times of the net assets provided.
 - Category B Client(s) – Medium risk, medium range exposure can be allowed i.e. allowed trading in ready market/leverage/futures up to 2 times of the net assets provided.
 - Category C Client(s) – High risk, lowest exposure to be allowed i.e. only delivery versus payment trading allowed.



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Associated benefits for Brokers in the proposed model

- ▶ Will be handling only trading orders;
- ▶ Have flexibility for allocation of client limits;
- ▶ Benefits of automated straight through processing (STP);
- ▶ Reduced operational cost as per the trading activity;
- ▶ Ease to open/manage new branches with minimal supervision;
- ▶ Reduced capital adequacy requirements;
- ▶ Reduced compliance and regulatory burden;
- ▶ No risk for custody default;



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Associated benefits for Brokers in the proposed model

- ▶ Low financial and reputational risk exposure;
- ▶ Outreach expansion;
- ▶ Efficient operational model;
- ▶ Reduced compliance and enforcement costs;
- ▶ Protection of client assets;
- ▶ Reduced customer complaints and claims; and
- ▶ Undertake other related business opportunities such advisory, portfolio management etc. with low risk.;



Associated benefits of Stake Holders in the proposed model

- ▶ Enhance client confidence;
- ▶ Better asset protection;
- ▶ No worries in case of closure of business by broker;
- ▶ IT based solution with ease of operation;
- ▶ Flexibility to work with multiple broker with single custody account; and
- ▶ Electronic system generated confirmations/alerts



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▶ Thank You



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