Proposed Guidelines on Authorisation of Primary Dealers (PDs) in India

Introduction

The system of PDs in the Government Securities (G-Sec) market was introduced in 1995 to strengthen the infrastructure in the G-Sec market, improve secondary market trading system, which would contribute to price discovery, enhance liquidity and turnover and encourage voluntary holding of G-Sec amongst a wider investor base and make PDs an effective conduit for conducting open market operations (OMO). The current guidelines to authorise PDs in the Indian G-Sec market were prescribed in the year 1995 when the PD system was introduced in India.

2. As on March 31, 2011, there were twenty PDs, of which twelve were banks carrying on Primary Dealership business departmentally (Bank-PDs) and the remaining eight were non-bank entities, known as standalone PDs, registered as NBFCs under section 45-IA of the RBI Act, 1934.

3. The share of PDs (both bank-PDs and standalone PDs) in primary auctions of T-Bills and Central Government dated securities has been significant since the year 2006 when RBI stopped participating in primary auctions. During the year 2009-10, the share of PDs in T-Bills and G-Sec stood at 61.49 per cent and 42.01 per cent respectively. Thus, PDs have provided depth and volume to the Indian G-Sec market by playing an active role in both primary and secondary segments of the G-Sec market.

Need for review of authorisation process

4. *Increase in roles and responsibilities of standalone PDs:* The Indian G-Sec market has evolved since the inception of the PD system. The roles and responsibilities of PDs have also changed over a period of time. Since July 2006, in addition to the core PD business, PDs have been allowed to undertake certain specific diversified activities such as trading in equity and equity derivatives; equity oriented mutual funds, underwriting public issues of equity etc. There have also been significant market developments such as introduction of 'when issued' market, short sale of G-Sec, Interest Rate Futures, repo in corporate bonds etc., where PDs have been allowed to participate. Active participation of PDs in corporate bond market has also been envisaged. PDs are also expected to make extra efforts to widen the investor base in G-Sec market by attracting players such as provident funds, pension funds, cooperative banks, trusts, NGOs and other institutions and retail investors. Viewed in this context, there is a need to have experienced and well capitalized PDs in the Indian G-Sec market to promote competition and to complete the market borrowings of Government (both Central and state) in an orderly manner.

5. *Varying requirements for Indian and foreign entities:* As per the existing guidelines, a subsidiary/ joint venture set up by an entity incorporated abroad is eligible to start PD business in India without having any track record in Government securities in India. However, similar criteria is not made applicable for subsidiary of a scheduled commercial bank/s / All India Financial Institutions and companies registered under the Companies Act, 1956. Entities falling under this category are required to be engaged predominantly in the securities business and in particular the G-Sec market before they make an application for PD business i.e. some of the new entities do not satisfy the eligibility criteria, though their other Group companies may be active in securities business. Thus there is divergence in the requirements prescribed for Indian and foreign entities.

6. *Facilities from RBI:* The G-Sec market, over the years, has been expanding, especially, due to the manifold rise in government borrowings, increasing trading volumes and introduction of new products in the G-Sec market. Besides, the number of market participants has increased with new entrants like mutual funds (MFs), insurance companies, trusts, corporates, etc. Further, PD authorisation provides a host of facilities like access to Current Account facility with RBI, access to Subsidiary General Ledger (SGL) Account facility (for G-Sec), permission to borrow and lend in the money market including call money market and to trade in all money market instruments, memberships of electronic dealing, trading and settlement systems (NDS platforms/INFINET/RTGS/CCIL), access to the Liquidity Adjustment Facility (LAF) of RBI, access to liquidity support from RBI under a scheme separately notified for standalone PDs and favoured access to open market operations by RBI. Since PD authorisation makes these entities eligible for many facilities from RBI, while considering entry of new PDs into the market, it would be desirable to take into consideration the existence of a sound capital base, effective risk management systems, sound corporate governance and proven track record in the G-Sec market of the applicant entities.

7. Hence, there is a need to review the existing authorisation policy to make it more equitable and transparent to ensure that the new PDs meet their roles and obligations in the debt market in an effective manner. These requirements become more relevant in the current scenario when the borrowing requirements of the Government are large.

Relevant eligibility conditions prescribed in our Guidelines

8. The eligibility conditions for becoming a PD have been given in the Master Circular RBI/2010-11/81 IDMD.PDRD. 01 /03.64.00 / 2010-11 dated July 1, 2010. The institutions eligible to apply for the primary dealership are given in paragraph 1.3 of the Master Circular *ibid*. They are as under:

Paragraph	Institutions	Eligibility conditions
1.3.1(i)	Subsidiary of scheduled commercial bank/s and All India Financial Institutions	Dedicated predominantly to the securities business and in particular to the G-Sec market.
1.3.1(ii)	Company incorporated under the Companies Act, 1956	Engaged predominantly in the securities business and in particular the G-Sec market.
1.3.1(iii)	Subsidiaries/ joint ventures set up by entities incorporated abroad	With the approval of Foreign Investment Promotion Board (FIPB).
1.3.1(iv)	Banks which do not have a partly or wholly owned subsidiary undertaking PD business	• Minimum net owned funds (NOF) of Rs.1,000 crore • Minimum CRAR of 9 per cent • Net NPAs of less than 3 per cent and a profit making record for last three years

9. In addition to the above, it has been prescribed that a non-bank entity (i.e. institutions falling under 1.3.1(i), 1.3.1(ii) and 1.3.1(iii) above) applying for permission to undertake PD business shall obtain Certificate of Registration as an NBFC under Section 45-IA of the RBI Act, 1934 from the Department of Non-Banking Supervision, Reserve Bank of India. (Paragraph 1.3.4 of the Master circular *ibid*). The non-bank applicant shall have net owned funds (NOF) of a minimum of Rs. 150 crore. In the case of a PD intending to diversify into permissible activities, the minimum NOF shall be Rs.250 crore. NOF will be computed in terms of the explanatory note to Section 45-IA of Chapter III-B of the Reserve Bank of India Act, 1934. (Paragraph 1.3.5 of the Master Circular *ibid*).

Cross country experience for authorisation of PDs

10. Internationally, selection criteria for PDs *inter alia* include an entity's financial strength as indicated by minimum capital, an active role of the entity in the G-Sec market ensured by its minimum obligations in primary market turnover of G-Sec/T-Bills through auctions and its ability in the secondary market to undertake effective trading in G-Sec. Some of the countries also have long term commitment to deal in the G-Sec market from the PDs. A summary of eligibility criteria for PDs in different countries is given in Annex.

11. In January 2010, Federal Reserve Bank (FRB), New York adopted a revised policy for the administration of relationships with PDs. The revised policy includes a more structured presentation of the business standards expected of PDs, a more formal application process for aspiring dealers, an increase in the minimum net capital requirement from USD 50 million to USD 150 million, a seasoning requirement of one year of relevant operations before a prospective dealer may submit an application and clear notice that the FRB, New York may take any number of actions against a noncompliant dealer. As per conditions stipulated for seasoning requirements, the FRB, New York

will consider an application from a prospective PD only if it (1) has been a U.S. broker-dealer or bank for at least one year prior to the submission of the application; and (2) has been engaged in the business areas relevant to the functions of a PD for at least one year prior to the submission of the application. In addition, aspiring PDs must satisfy operational, compliance, legal, and regulatory requirements consistent with prudent counterparty risk management and the needs of the FRB, New York. Further, as per the PDs Act of 1988, a foreign-owned dealer or bank may not be newly designated, or continue to be designated, as a PD in cases where the Board of Governors of the Federal Reserve System (Board) and the New York Fed have concluded that the country in which a foreign parent is domiciled does not provide the same competitive opportunities to U.S. companies as it does to domestic firms in the underwriting and distribution of Government debt.

12. In UK, any firm wishing to be recognised as PD (called as Gilt-Edged Market Maker (GEMM)) shall have following: (i) a viable business plan including demonstrable market demand and the potential to bring new investors to the gilt market, sufficient to enable that firm to achieve a target market share within a reasonable time frame; (ii) sufficient balance sheet capabilities to support their intended activities; (iii) a credit rating at least equivalent to DMO's prevailing minimum acceptable counterparty limit; (iv) adequate staffing resources, technical capabilities; and (v) long term commitment to the UK Government bond market. All newly appointed PDs in the UK are treated as candidate GEMM for a period no longer than one year. At the end of candidature period or even before, Debt Management Office (DMO) would announce whether the firm has been granted full-time Primary Dealer called as Gilt-Edged Market Makers (GEMM) status or not, depending on its attainment of minimum market share, auction participation, client penetration, or other specified target within the specified period.

13. Brazil has two categories of dealers to trade with Central Bank of Brazil and national treasury of Brazil: a group of PDs aimed at primary offers and money market operations, with up to 12 institutions and a group of specialist dealers aimed at outright operations in the secondary market, with up to 10 institutions. Selection criteria includes minimum capital, compatible with the capital requirements of a commercial bank, involvement in primary and secondary G-Sec markets, capability to remain market makers and participation in open markets.

14. Thus, the international best practice with regard to entry of new PDs consists of sound and enhanced capital norms, adequate experience and expertise in the G-Sec market and prudent risk management measures. Authorisation for standalone PDs in India can be considered very selectively, provided that the entity has sound financials, demonstrated ability to add value to the G-Sec market and participate actively in Government borrowing programme.

Proposed PD authorisation guidelines

15. As discussed above, it has to be ensured that the new PDs are adequately equipped to participate meaningfully in all auctions of Central Government securities and T-Bills, including an underwriting commitment and play an active role in the debt market. Hence, there is a need that the prospective primary dealers have a track record of relevant experience on which an assessment of the entity's operational performance, control environment, and compliance position may be based. Moreover, if applicant PD is already registered as an NBFC for a year or so, the due diligence and 'fit and proper' criteria could be better assessed.

16. In view of the above and with a view to putting in place transparent regulatory guidelines on eligibility of a PD and also to remove divergence between minimum requirement for Indian entities and subsidiaries/ joint ventures set up by entities incorporated abroad, it is proposed that the eligibility criteria for an entity to apply to RBI for undertaking the activities of a PD would be as under:

Institutions	**Eligibility conditions**
Subsidiary of scheduled commercial bank/s and All India Financial Institutions	• Should be registered as an NBFC under Section 45-IA of the RBI Act, 1934 for <u>at least one year</u> prior to the submission of application. (new eligibility condition) • Should have minimum net owned funds of Rs.150 crore/Rs.250 crore as defined in the Master circular on operational guidelines to PDs. Before commencing PD business, applicant entity has to submit an external auditor's certificate to this effect. • Should have exposure in the securities business and in particular to the G-Sec market for at least one year prior to the submission of application. Exposure for this purpose would be as under: i. Applicant's turnover in the G-Sec business during the year preceding the year of application of PD should be at least equal to 15 per cent of its total turnover, ii. It's assets in G-Sec during the year preceding the year of application of PD should be at least equal to 15 per cent of its total assets, and iii. Turnover in G-Sec on behalf of mid-segment (Provident Funds, Urban Cooperative banks, Regional Rural banks, Trusts, etc.) and retail (individual) investors in India should be at least equal to 15 per cent of their total turnover in the G-Sec business during the year preceding the year of application of PD. (new eligibility condition)
Company incorporated under the Companies Act, 1956	• Should be registered as an NBFC under Section 45-IA of the RBI Act, 1934 for at least one year prior to the submission of application. (new eligibility condition) • Should have minimum net owned funds of Rs 150 crore/Rs.

	250 crore as defined in the Master circular on operational guidelines to PDs. Before commencing PD business, applicant entity has to submit an external auditor's certificate to this effect. • Should have exposure in the securities business and in particular to the G-Sec market for at least one year prior to the submission of application. Exposure for this purpose would be as under: i. Applicant's turnover in the G-Sec business during the year preceding the year of application of PD should be at least equal to 15 per cent of its total turnover, ii. It's assets in G-Sec during the year preceding the year of application of PD should be at least equal to 15 per cent of its total assets, and iii. Turnover in G-Sec on behalf of mid-segment (Provident Funds, Urban Cooperative banks, Regional Rural banks, Trusts etc.) and retail (individual) investors in India should be at least equal to 15 per cent of their total turnover in the G-Sec business during the year preceding the year of application of PD. (new eligibility condition)
Subsidiaries/ joint ventures set up by entities incorporated abroad	• Should have approval of Foreign Investment Promotion Board (FIPB). • Should be registered as an NBFC under Section 45-IA of the RBI Act, 1934 for at least one year prior to the submission of application. (new eligibility condition) • Should have minimum net owned funds of Rs 150 crore/Rs.250 crore as defined in Para 1.3.5 of the Master circular on Operational Guidelines to PDs. Before commencing PD business, PD has to submit an external auditor's certificate to this effect. • Should have exposure in the securities business and in particular to the G-Sec market for at least one year prior to the submission of application. Exposure for this purpose would be as under: i. Applicant's turnover in the G-Sec business during the year preceding the year of application of PD should be at least equal to 15 per cent of its total turnover, ii. It's assets in G-Sec during the year preceding the year of application of PD should be at least equal to 15 per cent of its total assets, and iii. Turnover in G-Sec on behalf of mid-segment (Provident Funds, Urban Cooperative banks, Regional Rural banks, Trusts etc.) and retail (individual) investors in India should be at least equal to 15 per cent of their total turnover in the G-Sec business during the year preceding the year of application of PD. (new eligibility condition) • The parent foreign company directly or through its subsidiaries should have been in PD business for three years or more in active markets. (new eligibility condition) • Should suitably ring fence its system from its parent and

	associates so as to ensure sanctity of its data and avoid any undue spillover of risk to its own operation. (new eligibility condition)
Banks which do not have a partly or wholly owned subsidiary undertaking PD business and intend to undertake PD business departmentally	• Minimum net owned funds (NOF) of Rs.1,000 crore • Minimum CRAR of 9 per cent • Net NPAs of less than 3 per cent and a profit making record for last three years

17. Existing PDs would be given two years time period to comply with the minimum turnover requirement of 15 per cent of their total turnover in the G-Sec business during the preceding financial year, to be achieved on behalf of mid-segment (Provident Funds, Urban Cooperative banks, Regional Rural banks, Trusts etc.) and retail (individual) investors.

18. Further, an applicant shall not be considered for authorisation as PD if it has been subject to litigation or regulatory action or investigation that the Reserve Bank determines material or otherwise relevant to the business of PD, within the last one year. In making such determination, the Reserve Bank would consider, among other things, whether and how such litigation/regulatory action/investigation have been resolved and the applicant's history of such matters and will consult with the appropriate regulators for their views.

Exit/Termination Procedures:

19. RBI may suspend or terminate a Primary Dealer, as it may deem fit, in the following circumstances:

i. Violation/circumvention of the regulatory guidelines or the terms and conditions of the undertaking executed by a PD with the RBI.

ii. Failure to meet the performance criteria and capital standards on an ongoing basis.

iii. Repeatedly providing bids and offers in the primary and/or secondary market that are not reasonably competitive.

iv. RBI is of the view that the PD has attempted to manipulate the market; involved in market abuse; made an incorrect representation or certification; failed to provide information required under the extant guidelines, or provided information that was incorrect, inaccurate, or incomplete.

v. If it appears, in the Reserve Bank's judgment that the PD has an inadequate or weak control environment.

vi. If a PD becomes the subject of, or involved with, regulatory or legal proceedings that, in the judgment of the Reserve Bank, unfavorably impacts the PD business.

vii. PD intends to surrender PD authorisation on its own. In such a case, the PD should discuss the orderly unwinding of any positions held, agree the timing and date of termination of PD operations, and the content of any announcements to be made to the market, by the Reserve Bank. In the interests of discouraging ‘fair-weather’ trading and ensure that a PD is available in the market even when the market condition is not favourable, the Reserve Bank would not like to approve an application from the same firm for a fresh PD authorisation for some considerable period of time.

20. RBI would notify the PD of its intention to impose a sanction, and would provide the PD with an opportunity to submit its view, before taking a final decision.

21. RBI would ensure that a PD’s exit is carried out in a way that does not cause undue disruptions to other market participants.

22. Such suspension or termination would be made public by RBI through press release. An announcement in this regard shall be made preferably on the last working day of the week, with the sanction effective from the close of business on the same day.

Annex

Requirements for becoming Primary Dealer in different countries*

Country	Selection criteria	PD Institutions
Argentina	Minimum capital and involvement in G-Sec	Commercial and investment banks
Austria	Involvement in G-sec, placement power and efficient trading	Investment banks and foreign institutions
Belgium	Involvement in G-Sec market and placement capacity	Commercial and investment banks
Brazil	Minimum capital, compatible with the capital requirements of a commercial bank, involvement in primary and secondary G-Sec markets, capability to remain market makers, participation in open markets and relationship with the trading desk	Commercial and investment banks, brokers and foreign institutions. There are 22 PDs registered.
Canada	Minimum capital, involvement in G-Sec markets and PDs must be official Government Securities Dealers (GSDs)	Commercial and investment banks, and brokers
Czech Republic	Minimum capital, investment in G-Sec market and minimum obligations on Government bonds and T-bills	Commercial and investment banks, and brokers
Finland	Minimum capital, involvement in G-Sec market, and long term commitment in to dealing in this market	Commercial and investment banks, and foreign institutions
France	Minimum capital and involvement in G-Sec market	Investment banks. 19 PDs are registered with Agence France Tresor
Ireland	Minimum capital and involvement in G-Sec market and ability to distribute Irish bonds	Commercial and investment banks, brokers and foreign institutions
Italy	Minimum capital and involvement in G-Sec market and suitable organization to obtain a widespread and efficient placement of securities	Commercial and investment banks, brokers and foreign institutions
Mexico	Involvement in G-sec market. Only five institutions can be PDs and are named for a period of six months. Institutions compete to become market makers and get selected as PDs	Commercial banks and brokerage houses which trade with securities.
Netherlands	Minimum capital and involvement in G-Sec market and geographical distribution of their turnover, promotion activities and commitment	Commercial and investment banks, and foreign institutions

Singapore	Involvement in G-Sec market, minimum credit rating of B/C by KBW/IBCA, staffing requirement of at least two dealers with experience in fixed income and track record in other developed bond markets and a minimum trading limit of S$300 million in the SGS and T-bills market.	Commercial banks. There are 12 PDs registered with MAS.
UK	Involvement in G-Sec market, members of recognized investment exchanges, produce viable business plan, potential to bring new investors to the gilt market, sufficient balance sheet capabilities to support their intended activities, a credit rating at least equivalent to DMO's prevailing minimum acceptable counterparty limit, adequate staffing resources, technical capabilities and long term commitment to UK Government bond market. All newly appointed PDs in the UK are treated as candidate GEMM for a period no longer than one year. At the end of candidature period or even before, DMO would announce whether the firm has been granted full-time PD called as Gilt-Edged Market Makers (GEMM) status or not, depending on its attainment of minimum market share, auction participation, client penetration, or other specified target within the specified period. The DMO has no fixed notion of the number of PDs that it is prepared to recognize at any one time.	Commercial and investment banks and security houses. There are 18 PDs registered with UK DMO.
USA	Aspiring dealers must satisfy operational, compliance, legal, and regulatory requirements consistent with prudent counterparty risk management and the needs of the New York Fed, must have a minimum capital of USD 150 million and must meet the business standards expected of PDs. The	Commercial and investment banks, and foreign institutions. There are 18 banks/broker-dealers registered as PDs with Fed Reserve Bank New York

	institution shall not have been convicted of a felony crime. The New York Fed will consider an application from a prospective PD only if it (1) has been a U.S. broker-dealer or bank (as set forth in section C above) for at least one year prior to the submission of the application and (2) has engaged in the business areas relevant to the functions of a PD for at least one year prior to the submission of the application. Consistent with the PDs Act of 1988 (the Act), a foreign-owned dealer or bank may not be newly designated, or continue to be designated, as a PD in cases where the Board of Governors of the Federal Reserve System (Board) and the New York Fed have concluded that the country in which a foreign parent is domiciled does not provide the same competitive opportunities to U.S. companies as it does to domestic firms in the underwriting and distribution of Government debt.	

*Source: IMF Working Paper: PDs in Government Securities: Policy issues and select countries' experience-March 2003