Blocking of Funds for Trading in Secondary Market

1. Objective

1.1. This Board Memorandum seeks approval of the proposal to provide further protection to the investors’ funds and securities, which,

1.1.1. will give investors (hereinafter also referred to as ‘clients’) an option to trade in secondary market based on blocked funds in their own bank account thereby eliminating the need to transfer funds to stock broker (hereinafter also referred to as ‘trading member’/ ‘TM’) and

1.1.2. will provide client level settlement visibility (both pay-in and pay-out) to clearing corporation (CC) by direct settlement of funds and securities between client and CC.

thereby implementing a process, which, by design safeguards clients’ assets from possible misuse/ brokers’ default and consequent risk to their assets.

1.2. <u>Benefits sought to be achieved by the proposed framework</u>

1.2.1. Independent and reliable identification of ownership of cash collateral available to CCs without the need to rely on reporting/ allocation by members [‘trading member’(TM) / ‘clearing member’(CM)], thereby eliminating possibility of fraudulent reporting by errant intermediaries.

1.2.2. Elimination of custody risk of client collateral which is retained by the members and not transferred to CC.

1.2.3. Direct settlement with CC, without passing through pool accounts of the intermediaries’ thereby providing client level settlement visibility to CC and thus avoiding the risk of co-mingling of client funds and securities.

1.2.4. Hassle-free and immediate unblocking of client’s funds and/ or return/ release of securities in case of member default.

1.2.5. No adverse impact on client pay-out even in case of member/ fellow client default.

1.2.6. In case of member default, ease of porting of non-defaulting client to another member (as there will be no need for transfer of collateral from defaulting member to another member).

1.2.7. Client continues to earn interest on blocked funds from savings account till the time amount is debited.

2. Background

2.1. Today, Indian CCs endeavour to provide protection to the investors from the default of/ mis-use by brokers through prudent risk management. The set of regulatory frameworks/ guidelines that are designed to achieve individual client collateral segregation at CCs were implemented in three phases.

2.1.1. Phase-1: Margin pledge/re-pledge mechanism (specified vide SEBI circular dated February 25, 2020)

2.1.2. Phase-2: Collateral reporting and disclosure (specified vide SEBI circular dated July 20, 2021)

2.1.3. Phase-3 Collateral allocation at CCs (specified vide SEBI circular dated July 20, 2021)

2.2. Further, SEBI introduced a block mechanism in demat accounts of clients wherein the securities given as Early Pay-In (EPI) are blocked (in favour of Clearing Corporation) in the demat account of clients undertaking sale transactions (hereinafter referred as ‘EPI block mechanism’). If sell transaction is not executed, shares shall continue to remain in the client's demat account and will be unblocked at the end of the T day. This has been implemented since August 01, 2021 and mandated for all EPI transactions since November 14, 2022.

3. Need for review

3.1. The extant processes have the following risks:

3.1.1. Risks associated with the reliance on reporting done by members for client-wise allocation of the collateral placed with the CC – There is a possibility that errant member may report wrong amount by allocating the collateral of client X to client Y or even to his own proprietary account.

3.1.2. There is a possibility of misuse of client cash collateral retained by the members and not passed on to the CC.

3.1.3. Risk associated with wrongful withdrawal of clients' cash collateral by errant members from CC.

3.1.4. Risk of non-settlement of pay-out received from CC, by trading member, to clients.

3.2. The probability of above risks get accentuated when a stock broker defaults or nears default. While the underlying reason for defaults by stock broker(s) may be different, the core of the problem lies in misuse of clients' funds and/ or securities. Apart from causing monetary loss to a large number of clients, such incidents have the potential to disturb the confidence of investors in the securities market and thus are a cause of concern.

3.3. SEBI has introduced the use of RBI approved Unified Payments Interface (UPI) with facility of blocking the funds, as a payment mechanism for retail investor applications submitted through intermediaries for public issues (IPO) from January 2019. In view of the significant advances in the payment mechanisms, it is felt that the UPI Mandate service of single block and multiple debits can be integrated with the secondary markets to provide a block mechanism (similar to pledge-like mechanism in securities) whereby the clients will be able to block funds in their own bank account for trading in secondary market, instead of transferring them upfront to the trading member, thereby providing enhanced protection of cash collateral.

3.4. Thus, an Application Supported by Blocked Amount (ASBA) like mechanism, prevalent in IPOs, can be leveraged in the secondary market as well.

4. Review Process and analysis

4.1. SEBI had discussions with the National Payment Corporation of India ("NPCI"), and clearing corporations to evaluate the feasibility and to develop the model for enabling trading in Secondary Market based on amount blocked in bank account using UPI mechanism whereby the benefits as mentioned in Para 1.2 above can be achieved.

4.2. Consultations were also held with various stock brokers and banks, wherein the proposed framework was deliberated and broadly agreed upon by the participants.

4.3. SEBI published a consultation paper on January 17, 2023 seeking comments and inputs from stakeholders and members of public on introduction of facility of blocking of funds for trading in secondary markets. Comments were received from various entities including a bank, stock brokers, a stock exchange, a clearing corporation, industry associations, custodians, investors etc. Copy of consultation paper is placed at **Annexure-1**. Further, details on public consultation may be referred at Para 6.

4.4. SEBI's proposed framework and public comments thereon were deliberated in SEBI's Risk Management and Review Committee (RMRC) during its meeting held on March 06, 2023. Views of the RMRC are provided in Para 7.

5. Proposed framework

A brief of the proposed framework is given below:

5.1. Under the proposed model, funds shall remain in the account of client but will be blocked in favour of the CC till the expiry date of the block mandate or till block is released by the CC, whichever is earlier. CC can debit funds from client account, limited to the amount specified in the block.

5.2. Further, while a UPI block upon creation shall be considered towards collateral, the same shall also be available for settlement purposes. For the clients who prefer to block lump sum amount, their block can be debited multiple times, subject to available balance, for settlement obligations across days.

The usage of same block towards margin and settlement shall bring efficiency in the ecosystem and result in lower working capital requirement for the members.

5.3. <u>Features of the proposed model</u>

5.3.1. The block will be created by client using the UPI App based on the blocking request initiated through stock broker app. While creating the blocking request under the proposed block mechanism, relevant information such as TM Code, CM Code, Unique Client Code, segment etc. shall be captured by the broker and sent to UPI.

5.3.2. The block will get created in favour of the CC and can be debited by the CC only. Since settlement will also be done by the CC with the client account directly, CC will therefore also be able to track default, if any, by clients and thus has to no longer rely on TM to get information on which client has defaulted. This implies that, in case of default of member/ fellow client, no risk shall be transferred to a UPI client. UPI clients shall be eligible for hassle free and immediate return of their funds/ securities.

5.3.3. The block shall support multiple debits – i.e., for a block created on day 1, it can be partially debited multiple times till the exhaustion of amount or expiry/release of the block, whichever is earlier.

5.3.4. The stock brokers will not be required to allocate any collateral for clients under the facility of UPI block since the CC will directly maintain/update the client collateral value based on the blocking information received from the UPI rails of NPCI through the CC's sponsor bank.

5.3.5. Settlement will be done by CC directly with clients for funds and securities, without any need to go through the pool account.

5.3.6. <u>General features</u>

a) Availing UPI block facility shall be at the option of the investor.

b) Since an investor is allowed to have trading accounts across multiple stock brokers, an investor can choose to avail UPI block facility under some broker(s) and non-UPI based trading under others. However, once opted for UPI block facility (until they opt out after fulfilling all obligations) under particular broker(s), the following needs to be adhered to in respect of UPI block facility under that broker(s):

- All cash collaterals to be provided through UPI block only.

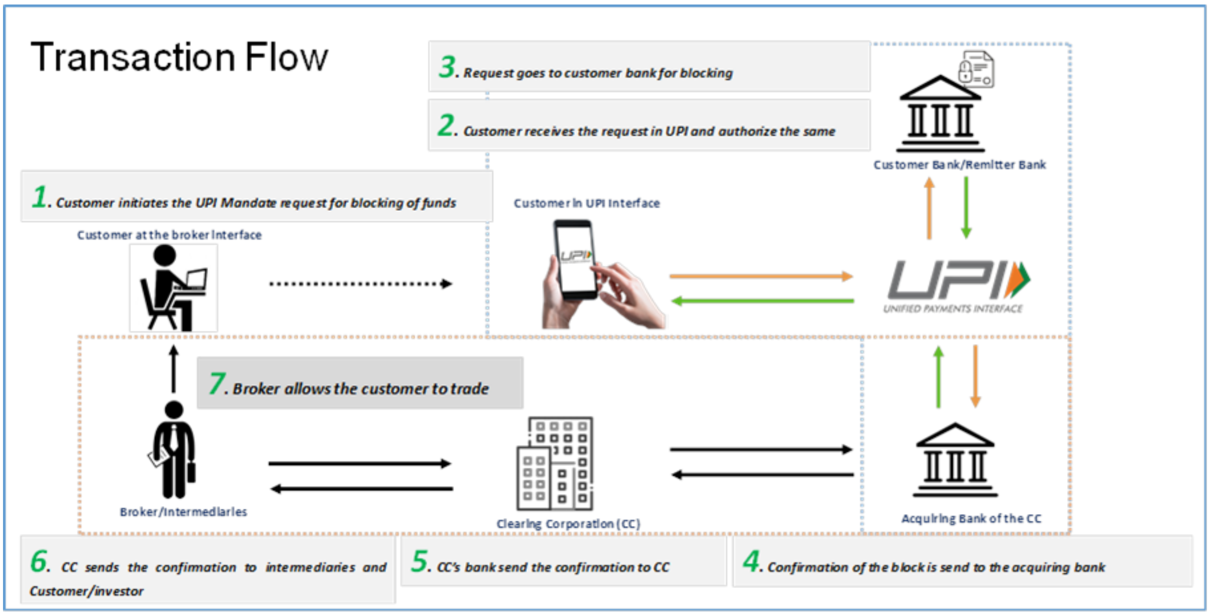
- Cash equivalent collateral such as bank guarantees (BGs) and fixed deposits (FDs) will not be permitted.
  [This has been excised for reasons of confidentiality]

- Securities collateral to be provided through pledge/re-pledge system and only those securities can be provided which are in the approved list of CC.

- Funds pay-in settlement to be done through UPI block only.

The above requirements are necessitated in view of proposed direct settlement by CC with the investors and to provide settlement visibility to CC at all times at client level

5.3.7. <u>UPI block facility – Process flow</u> – While the detailed guidelines regarding process flow shall be issued at a later stage, the same in brief, is as under:



a) Investor/ client will initiate the blocking of fund request through the 'UPI app based blocking facility' enabled in TM app.

b) The client, through the UPI app, authorizes the blocking request.

c) Through the UPI system, the request will be sent to the client's bank for confirmation of block.

d) Once the confirmation is received from client's bank, the UPI system will intimate the creation of block to the respective sponsor bank of the CC, with all the necessary fields as mentioned in Para 5.3.1, on real-time basis.

e) CC's sponsor bank passes on the information to CC, real-time.

f) The CC will provide a real-time confirmation to TM and CM (CM of the TM in the respective segment). The confirmation will be along with the status – i.e., accepted or rejected/released. Since the blocking is going to result in collateral being allocated in favour of the client, as per the existing process, the CC will send a notification (via SMS) to the client regarding the collateral being added.

g) The TM will update the trading limit of the client in their systems based on the confirmation received from the CC on real-time basis thereby allowing them to trade.

5.3.8. Settlement under the proposed model – Briefly, there shall be two rounds of Pay-in and 1 round of Pay-out.

In **Round 1 Pay-in**, settlement obligation will be calculated at client level, individually, for the clients opting for UPI block facility. There will be no netting of obligations across different clients opting for UPI block facility. Clients with payable funds will need to provide UPI block at least to the extent of obligations, and clients with deliverable securities will need to provide the same through EPI block mechanism. At the end of this deadline, the clients who have not provisioned for their pay-in (through UPI block for payable funds and/or through EPI block for deliverable securities) shall be considered as short.

Round 2 Pay-in, shall be:

- Single net settlement of funds obligation at CM level for (i) proprietary account of CM/TM, (ii) clients not opting for UPI block facility and (iii) shortages from UPI clients in pay-in round 1, including shortfall of funds in lieu of securities, if any.

  [Illustration for funds in lieu of securities: Consider a scenario when a security sold for Rs. 100 was not delivered by client and last closing price available on settlement day for the said security was Rs. 105. In such a case, the CC will not provide the pay-out of Rs. 100 to the client and in addition will debit Rs. 5 from the block amount of the client. In case the blocked amount is insufficient, then CC will debit this amount to CM.]

- Single net settlement of securities obligation at CM level for (i) proprietary account of CM/TM, and (ii) clients not opting for UPI block facility, as per the existing process.

The CMs shall be required to provide the aforementioned funds/securities obligations to the CC. If the CMs fail to fulfil the obligation, then such members shall be treated as short and relevant provisions for shortage handling/default management will apply.

Pay-out will be done in a single round after the two pay-in rounds. The CC will give pay-out of funds and securities directly to the bank and depository account of the clients opting for UPI block facility provided they have fulfilled their pay-in obligations. For all other clients and proprietary account of CM/TM, there will be single net settlement by CC as is currently done.

Further, details can be referred at Para 5.4.4 of the attached consultation paper.

5.3.9. Release of the Block - Client can request for release of block to TM through TM app. TM will request CM, and CM will request CC. In case the TM, CM and CC do not have any residual claim, the CC will release the block through UPI. Upon release of the block, the client's bank will unfreeze the amount in the account of the client. Information regarding release will be shared by NPCI with CC who in-turn will pass it on to CM and TM. Further, since the release of the block is going to result in collateral being unallocated in favour of the client, as per the existing process, the CC will send a notification (via SMS) to the client regarding the collateral being removed.

5.3.10. Various scenarios – An analysis of how various scenarios i.e. (i) prefunded purchase by client, (ii) delivery sale by client by EPI, (iii) purchase/ sale by client supported by margins and (iv) intraday cash market/ derivatives trading, would be handled under the proposed UPI block facility vis-a-vis the current process is placed as **Annexure-2**.

5.3.11. <u>Shortage Handling</u> – Details on dealing with Cash Market funds and securities shortages and shortfall in derivatives can be referred at Para 5.6 of the attached consultation paper.

5.3.12. An illustration of UPI blocking mechanism is provided at **Annexure-3**.

6. Public consultation

[This has been excised for reasons of confidentiality]

7. Deliberations in SEBI's Advisory Committee

[This has been excised for reasons of confidentiality]

8. Data analysis

[This has been excised for reasons of confidentiality]

9. Proposal and process of implementation

9.1. It is proposed to introduce the framework for 'Blocking of Funds for Trading in Secondary Market' in a phased manner. To begin with it shall be introduced as (i) optional facility for the investors ; (ii) non-mandatory facility to be provided by stock brokers and (iii) allowing stock brokers to either directly settle the brokerage with the UPI clients (for all UPI clients) or opt for CC's facility to deduct standard rate of brokerage from the UPI block of the clients. The functionality regarding brokerage collection, including client-wise brokerage, block for brokerage, etc., may be reviewed at a later stage, based on market feedback.

9.2. The proposal requires certain changes to be made in the systems and processes of stock brokers, stock exchanges, clearing corporations and existing UPI mechanism. Further, investors may also need some time for transition. Accordingly, based on the feedback from the aforesaid entities, it is proposed that we may implement the proposed framework in a phased manner for a smoother transition, as proposed below:
[This has been excised for reasons of confidentiality]

9.3. In order to operationalize the above proposal, necessary circulars/ guidelines will be issued.

10. Proposal to the Board

10.1. This memorandum is submitted to the Board to consider and approve the proposal at Para 9.1 above and authorise the Chairperson to take consequential and incidental steps to give effect to the decision of the Board.

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Annexure 1- Consultation paper on “Blocking of Funds for Trading in Secondary Market”

1. Objective

1.1. To solicit comments and inputs from stakeholders and members of public on introduction of facility of blocking of funds for trading in secondary markets which;

1.1.1. Allows investors (hereinafter also referred to as ‘clients’) to trade in secondary market based on blocked funds in one’s bank account thereby eliminating the need to transfer funds to stock broker (hereinafter also referred to as “trading member” / “TM”).

1.1.2. Provides client level settlement visibility (both pay-in and pay-out) to clearing corporation (CC) by direct settlement of funds and securities between client and CC.

thereby implementing a process, which, by design safeguards clients’ assets from misuse/ brokers’ default and consequent risk to their capital.

1.2. This consultation paper follows a series of discussions held with multiple stakeholders, including clearing corporations, NPCI (National Payments Corporation of India), stock brokers and banks.

2. Background

2.1. In the last couple of years, Indian securities market has seen tremendous growth, both in terms of volumes as well as in terms of number of participants. This increasing participation with increase of new investors in securities market also puts greater onus on SEBI to make markets safer for its participants, with a special focus on retail participants.

2.2. As per the existing framework, posting of collateral and settlement of funds/ securities are carried out in the manner mentioned below :

2.2.1. Investors / clients post collateral with their Stock broker before executing trades and carry out settlement of funds/securities through their Stock broker upon crystallisation of settlement obligations.

2.2.2. Stock brokers, for their proprietary trades and for trades of their clients, in turn post collateral with their Clearing Member (CM) and carry out settlement of funds / securities through their CM.

2.2.3. CMs for their proprietary trades and for trades of their constituents/ clients in turn post collateral with Clearing Corporation (CC) and carry out settlement of funds/securities with the CC.

2.2.4. Additionally, the existing framework allows retention of certain portion of collateral at every level, for e.g., when a client / investor posts collateral, part of it can be retained by stock broker, part by CM before passing on remaining to CC.

2.3. Thus, client's assets (whether funds collateral or funds/securities settlement pay-in) pass through stock broker and clearing member before reaching CC. Similarly, the pay-out released by CC follows a similar cycle of passing through clearing member and stock broker before reaching the client. While CCs provide final settlement instructions to their members each day, it is the stock broker who settles obligations with clients.

2.4. Given the above process flow, there is a possibility that a client's collateral retained with stock broker or CM can be misused. Similarly, the pay-out due to the client can also be at risk in case the stock broker and/ or fellow client(s) defaults.

2.5. Today, Indian CCs endeavour to provide protection to the investors from the default of member through prudent risk management. The set of regulatory framework/ guidelines that are targeted to achieve individual client collateral segregation at CCs were implemented in three phases.

2.5.1. Phase-1: Margin pledge/re-pledge mechanism (specified vide SEBI circular dated February 25, 2020)

The margin pledge/re-pledge mechanism introduced a system whereby an investor could pledge securities in favour of the stock broker / trading member, who could onward re-pledge it to the CM, and CM in turn can re-pledge the same to CC, with the securities of the investor remaining in his demat account. The margin pledge mechanism eliminates the possibility of misuse of pledged client securities since (i) securities are not transferred to the trading member and remain in the client's account ; (ii) CC has visibility at client level and accordingly is able to ensure that such securities collateral are utilised for margin requirement of the respective client.

2.5.2. Phase-2: Collateral reporting and disclosure (specified vide SEBI circular dated July 20, 2021)

Members are required to disclose on a daily basis (by next day), client-wise and asset-wise, the amount of collateral received by members from the clients, amount of collateral retained with themselves, and the amount passed on to CC. Investors can access their respective information by logging in a web portal, developed by CCs, thus providing them with a high degree of transparency and mitigating the risk of misreporting by members. These provisions have come into force with effect from October 01, 2021.

2.5.3. Phase-3 Collateral allocation at CCs (specified vide SEBI circular dated July 20, 2021)

The collateral allocation mechanism requires the members to provide client-wise allocation of eligible cash and cash-equivalent collateral placed with the CC at all times, through a real-time collateral allocation system. With the client-wise breakup of collateral available upfront, the CCs ensure that the collateral belonging to a client is used towards obligations of that client only. However, such identification / segregation of collateral is based on information provided by TM/ CM. These provisions have come into force with effect from May 02, 2022.

2.6. Further, SEBI introduced a block mechanism in demat accounts of clients wherein the securities given as Early Pay-In (EPI) will be blocked (in favour of Clearing Corporation) in the demat account of clients undertaking sale transactions (hereinafter referred as 'EPI block mechanism'). If sell transaction is not executed, shares shall continue to remain in the client's demat account and will be unblocked at the end of the T day. This has been implemented since August 01, 2021 and mandated for all EPI transactions since November 14, 2022.

3. Need for review

3.1. Specifically, the extant process has the following risks

3.1.1. Firstly, the risks associated with the reliance on reporting done by members (TM/CM) for client-wise allocation of the collateral placed with the CC - Member may report wrong amount.

3.1.2. Secondly, there is a possibility of misuse of client cash collateral retained by the members and not passed on to the CC.

3.1.3. Thirdly, the risk associated with wrongful withdrawal of clients' cash collateral by members from CC.

3.1.4. Fourthly, risk of non-settlement of pay-out by trading member to clients.

3.2. The probability of above risks get accentuated when a stock broker defaults. While the underlying reason for defaults by stock broker(s) may be different, the core of the problem lies in misuse of clients' funds and/ or securities. Apart from causing monetary loss to a large number of clients, such incidents have the potential to disturb the confidence of investors in the securities market and thus is a cause of concern.

3.3. In order to retain investors' confidence, it is imperative that the investors' funds and securities should be adequately protected from possibility of misuse/ default by a stock broker. The evolving regulatory framework has endeavoured to use technology in identifying early warning signs for any misuse of funds and securities by trading members. However, the need for more innovative solutions to plug-in any possible loopholes and minimise the risk of misuse of investors' funds/ securities by stock brokers is ardently felt.

4. Evaluation of other existing option of 3-in-1 account facility

4.1. Currently, some brokerage houses provide 3-in-1 accounts facility for trading in securities market. Under the said facility of 3-in-1 accounts, the brokerage firm provides a client with Trading account (broker's platform for trading), Demat account (for holding securities in demat form) and Bank account (where money is parked). Such 3-in-1 accounts are mainly offered by those stock brokers that are also part of a banking group. Other stock brokers also offer the said facility after tie-up with a bank.

4.2. A 3-in-1 account empowers investor to block or seamlessly transfer funds between bank account and trading account on need basis while providing great degree of convenience due to integration between these accounts.

4.3. However, the risks as mentioned in Para 3.1 above, are still not addressed owing to the following:

4.3.1. CCP relies on stock broker for information on clients' collateral and thus the risk of wrong reporting remains.

4.3.2. Although the funds are held in client's bank account, the lien is marked in favour of the broker, thus possibility of misuse of client funds by stock broker persists.

4.3.3. Since the stock broker is responsible for settlement with the client, the risk of non-settlement of pay-out by stock broker remains.

5. Proposal

5.1. In view of the significant developments in the payment mechanisms, it is felt that the RBI approved Unified Payments Interface (UPI) Mandate service of single block and multiple debits can be integrated with the secondary markets to provide a block mechanism (similar to pledge-like mechanism in securities) whereby the clients will be able to block funds in their bank account for trading in secondary market, instead of transferring them upfront to the trading member, thereby providing enhanced protection of cash collateral.

5.2. Under the proposed model funds shall remain in the account of client but will be blocked in favour of CC till the expiry date of the block mandate or till block is released by the CC, whichever is earlier. CC can debit funds from client account, limited to the amount specified in the block.

5.3. Further, while a UPI block upon creation shall be considered towards collateral, the same shall also be available for settlement purposes. For the clients who prefer to block lump sum amount, their block can be debited multiple times, subject to available balance, for settlement obligations across days. This comes with a dual advantage, whereby firstly it eliminates the need to transfer funds to the brokers and secondly, the funds blocked from savings account earn interest for the investor. Effectively, the amount which earlier used to get transferred to the stock broker for trading in secondary market will remain in the investors' bank account and can now earn interest for the investor.

5.4. Proposed framework

5.4.1. The proposed framework endeavours to streamline the processes in secondary market in order to achieve the following objectives:

a) Independent and reliable identification of ownership of cash collateral available to CCs without the need to rely on reporting/ allocation by members, thereby eliminating risk of fraudulent reporting by intermediaries.

b) Elimination of custody risk of client collateral which is retained by the members and not transferred to CC.

c) Direct settlement with CC, without passing through pool accounts of the intermediaries' thereby providing client level settlement visibility to

CC and thus the risk of co-mingling of client funds and securities does not arise.

d) Hassle-free and immediate return of client's funds and/ or securities in case of member default.

e) No impact on client pay-out even in case of member/ fellow client default.

f) In case of member default, ease of porting of non-defaulting client to another member (as there will be no need for transfer of collateral from defaulting member to another member).

5.4.2. Features

a) The block will be created by client using the UPI App based on the blocking request initiated through stock broker app. While creating the blocking request under the proposed block mechanism, relevant information such as TM Code, CM Code, Unique Client Code, segment etc. shall be captured by the broker and sent to UPI.

b) The block will get created in favour of the CC and can be debited by the CC only. Since settlement will also be done by the CC with the client account directly, CC will therefore also be able to track default, if any, by clients.

c) The block shall support multiple debits – i.e., for a block created on day 1, it can be partially debited multiple times till the exhaustion of amount or expiry/release of the block, whichever is earlier.

d) The stock brokers will not be required to allocate any collateral for clients under the facility of UPI block since the CC will directly maintain/update the client collateral value based on the blocking information received from the UPI railroads of NPCI through the CC's sponsor bank. This shall result in lower compliance cost for stock brokers. The subsequent procedures such as deemed allocation of proprietary collateral, validation of 50:50 cash collateral, risk reduction mode monitoring etc. will remain unchanged.

e) Settlement will be done by CC directly with clients for funds and securities, without any need to go through the pool account.

5.4.3. UPI block facility – Process flow

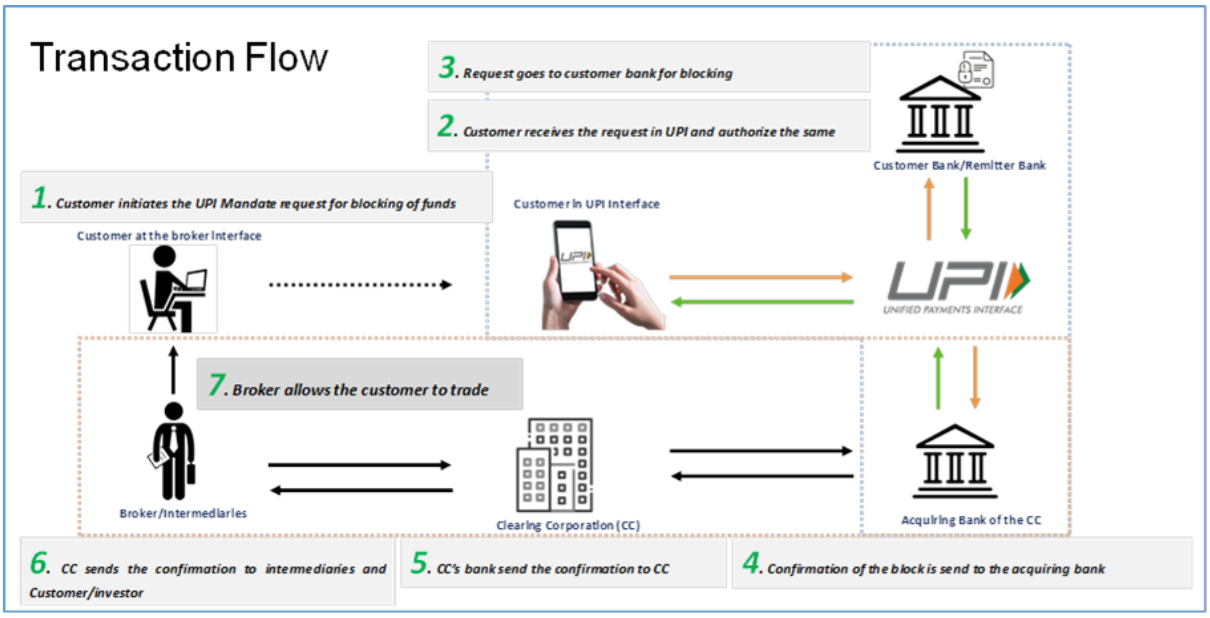
Step 1: Creation of block
• Investor/ client will initiate the blocking of fund request through the UPI app based blocking facility enabled in TM app. • The client, through the UPI app, authorize the blocking request. • Through the UPI system, the request will be sent to the client's bank for authorization. • The client bank will confirm the request based on factor of authentication as per the regulatory guidelines. • The client's bank will provide confirmation to the UPI system. • The block created will be in favour of the CC through its sponsor bank(s). • The UPI system will intimate the creation of block to the respective sponsor bank of the CC, with all the necessary fields. • CC's sponsor bank passes on the information to CC.
Step 2: Processing at CC
• On receiving the block information, CC will carry out business validations. This will include field validations (viz., valid TM/segment code, registered UCC code, sufficient maturity date, valid IFSC/account number, TM clearing in the respective segment with the CC). • If the business validations fail, the CC will immediately send a block release request to the bank and not enhance any collateral limit. • The CC will provide a real-time confirmation to TM and CM (CM of the TM in the respective segment). The confirmation will be along with the status – i.e., accepted or rejected/released. • Since the blocking is going to result in collateral being allocated in favour of the client, as per the existing process, the CC will send a notification to the client regarding the collateral being added.

Step 3: Processing at TM / CM

- The TM will update the trading limit of the client in their systems based on the confirmation received from the CC on real time basis thereby allowing them to trade.
- The TM will notify the success or release of blocking request to the client through their online portal/mobile app etc.

Reconciliation mechanism

- At the time of initiation of request, the TM will create a unique reference number for the transaction.
- Throughout the process (including before the generation of mandate and creation of unique mandate number), the reference number will be tracked.
- UPI will provide a status query facility, where the status of the transaction in the ecosystem can be queried against the reference number.
- The sponsor bank will extend API for status query to CC, and CC will extend it to TM.
- In case of transaction initiated but no response received, the status can be queried by the TM through the facility.



5.4.4. Settlement

a) Pay-in

- There shall be two rounds of pay-in.
- Round 1 Pay-in
    - The settlement obligation will be calculated at client level, individually, for the clients opting for UPI block facility. There will be no netting of obligations across different clients opting for UPI block facility. The settlement obligations shall be inclusive of standard statutory levies such as STT and Stamp duty.
    - The first deadline for pay-in will be for the UPI clients. Clients with payable funds will need to provide UPI block atleast to the extent of obligations, and clients with deliverable securities will need to provide the same through Early Pay-in (EPI) block mechanism wherein the securities given as EPI are blocked in favour of CC in the demat account of clients undertaking sale transactions. The CC shall process both funds and securities pay-in directly with the clients opting for UPI block facility.
    - At the end of this deadline, the clients who have not provisioned for their pay-in shall be considered as short.

- Round 2 Pay-in
    - The second round funds obligation shall be a single net settlement obligation at CM level for (i) proprietary account of CM/TM, (ii) clients not opting for UPI block facility and (iii) shortages from UPI clients in pay-in round 1, including shortfall of funds in lieu of securities, if any.
    - The second round of securities obligation shall be a single net settlement at CM level for (i) proprietary account of CM/TM, and (ii) clients not opting for UPI block facility, as per the existing process.
    - The CMs shall be required to provide the aforementioned funds/securities obligations to the CC.
    - If the CMs fail to fulfil the obligation, then such members shall be treated as short and relevant provisions for shortage handling/default management will apply.

b) Pay-out

- The pay-out will be done in a single round after the two pay-in rounds.
- The CC will give pay-out of funds and securities directly to the bank and depository account of the clients opting for UPI block facility provided they have fulfilled their pay-in obligations. For all other clients and proprietary account of CM/TM, there will be single net settlement by CC as is currently done.

5.4.5. Release of block

a) Client can request for release of block to TM. TM will request CM, and CM will request CC. In case the CC also does not have any residual claim, the CC will release the block. Upon release of the block, the client’s bank will unfreeze the amount in the account of the client. Information regarding release will be shared by NPCI with CC who in-turn will pass it on to CM and TM.

5.5. Various Scenarios - How various scenarios would be handled under proposed UPI block facility are provided at **Annexure-1**.

5.6. Dealing with shortages:

5.6.1. Vide SEBI circular reference number SEBI/HO/MIRSD/MIRSD-PoD-1/P/CIR/2022/153 dated November 11, 2022; the Client Unpaid Securities Account (CUSA) will be discontinued w.e.f. March 31, 2023. Going forward, the unpaid securities (i.e., the securities that have not been paid for in full by the clients), will be transferred to respective client’s demat account and auto-pledged in favour of a separate account titled “client unpaid securities pledgee account”.

5.6.2. Cash Market: Funds shortage

a) CC will provide pay-out of securities to the client’s demat account and instruct the depository to auto-pledge such securities to the TM’s “client unpaid securities pledgee account”.

b) CC will maintain the shortage amount of client. The obligation will devolve on TM’s CM, who will settle the same with CC as per proposed procedure.

c) If client provides additional block subsequently, the CC will debit the amount to the extent of shortfall and provide the same to the CM.

d) In case client fails to provide the amount, then TM can sell the shares and mark early pay-in (using the block mechanism of depositories) in favour of CC from the client’s account. Out of the pay-out due to the client, amount to the extent of shortfall will be paid to the CM who fulfilled the obligation. The remaining funds, if any, will be paid out to the client. If the sale proceeds are not sufficient to meet the shortfall, then the short amount of the client will be revised to the extent of sale proceeds.

5.6.3. Cash Market: Securities shortage

a) Funds pay-out will not be provided to the client. The amount will be withheld by CC and used towards requirement of funds in lieu of securities delivered short.

b) Funds required in lieu of securities shortage in excess of funds pay-out will be debited from block amount of client. In case of insufficient blocked amount, the same will devolve on member.

   [Illustration: Consider a scenario when a share sold for Rs. 100 was not delivered and last closing price available on settlement day was Rs. 105. In such a case, the CC will not provide the pay-out of Rs. 100 to the client and in addition will debit Rs. 5 from the block amount of the client. In case the blocked amount is insufficient, then CC will debit this amount to CM.]

c) Auction will be conducted to buy the securities short delivered by UPI clients (currently internal auctions are voluntary, but in this case the auction will be conducted suo moto by the CC).

d) If actual amount required towards auction purchase or financial close-out exceeds amount referred to in para (b) above, the same will be debited from client block. In case of insufficient client block, the same will devolve on member.

e) In case of any devolvement on member, the short amount of client will be maintained and in case any blocking is done in future, the block will be debited to the extent of shortfall and provided to the clearing member.

5.6.4. Shortfall: Derivatives

a) CC will debit block to the extent of pay-in requirements, irrespective of whether such debit causes a margin shortfall. In exceptional circumstances, if pay-in exceeds the margin, the residual amount will devolve on CM.

b) In case of margin shortfall, CM can close-out the position of the client and resultant loss will be debited to the block or resultant profit will be paid out to the client. Till the time CM closes-out the position, the provisions related to deemed allocation of proprietary collateral shall apply.

c) In case obligations have devolved on CM, any pay-out resulting from close-out of positions, or any new block created by client, to the extent of devolvement, will be provided to the CM.

5.7. An illustration of UPI blocking mechanism is provided at **Annexure-2**.

5.8. General features:

5.8.1. Availing UPI block facility shall be at the option of the investor.

5.8.2. Since an investor is allowed to have trading accounts across multiple stock brokers, an investor can choose to avail UPI block facility under some broker(s) and non-UPI based trading under others. However, once opted for UPI block facility (until they opt out after fulfilling all obligations) under particular broker(s), the following needs to be adhered to in respect of UPI block facility under that broker(s):

a) All cash collaterals to be provided through UPI block only.

b) Cash equivalent collateral such as bank guarantees and fixed deposits will not be permitted.

c) Securities collateral to be provided through pledge/re-pledge system and only those securities can be provided which are in the approved list of CC.

d) Funds pay-in settlement to be done through UPI block only.

The above requirements are necessitated in view of proposed direct settlement by CC with the investors and to provide settlement visibility to CC at all times at client level.

5.8.3. Collateral and settlement will continue to be segment-wise, and the client/TM/CM will need to transfer/reallocate collateral between segments.

5.8.4. Running account settlement will not be supported. CC will settle the account of clients using UPI block facility on a daily basis, i.e., any pay-out due to the client will be paid out to the client on the settlement day.

5.8.5. Single block limit of Rs. 5 lakhs to apply [currently applicable for UPI based securities market transaction]. However, multiple blocks can co-exist subjected to the overall limit applicable in UPI.

5.9. Requirement/ changes w.r.t. various stakeholders

5.9.1. Investors

a) Create UPI block instead of funds transfer, using UPI based blocking facility in the UPI App based on the request initiated in stock broker app.

b) Will be able to provide only UPI block and CC approved securities as collateral.

c) Provide securities for pay-in using EPI block mechanism only.

d) Ensure availability of settlement obligations by CC specified timelines.

e) Derivatives – Mark to Market (MTM) to be provided on the same day by the CC specified timelines (currently can be provided by T+1), so as to allow sufficient time to TM/ CM to arrange funds, in case of shortage at client level.

f) Will not be able to maintain running account with stock broker. CC will carry out daily settlement with investors.

5.9.2. Stock brokers

a) Offer trading facility based on blocking of funds to their clients.

b) Stock brokers shall be required to develop the necessary interface required to initiate the blocking request in UPI on their app and shall ensure the seamless transfer of investor information to CC like their UCC, TM code, CM code, amount blocked and other necessary information.

c) Develop interface with CC to capture block information.

d) Develop interface with CC to initiate block request status enquiry.

e) Make internal back-office as well as Risk Management System (RMS) changes.

5.9.3. Stock Exchanges

a) Provide interface to TMs for submission of registration requests.

b) Validate PAN of bank/demat accounts for clients under UPI block mechanism.

c) Provide interface with CC for sending requests/receiving responses.

5.9.4. Clearing Corporations

a) Establish, implement, maintain, and enforce policies and procedures that facilitate straight through processing.

b) Develop necessary interface and industry standard API along with the potential sponsor bank(s) for communication between sponsor bank and CC communication.

c) Develop new technological systems which shall be able to process the information received from the broker's app/ NPCI in respect of the block creation.

d) Send the information of confirmed block to the respective CM, TM and client.

e) Keep records of each confirmation received, and allocation and each affirmation sent with date and time stamp for each allocation.

f) Develop interface with sponsor banks for debit of blocks and credit to client.

6. Public comments are sought on the following:

6.1. Should SEBI enable trading based on blocking of funds in client bank account as against the current practice of advance transfer of funds to stock broker before order punching?

6.2. Are efforts to allow direct settlement by CC at client level a logical step on the path to provide safety to Indian securities market? If not, why?

6.3. Do you visualise any operational challenges on the proposed concept, associated processes, transaction flow, risk management etc. If yes, please explain.

6.4. Could the proposed concept lead to increase in any risks? If yes, please explain.

6.5. Should SEBI make it mandatory for all brokers to offer this facility to all clients? Please explain why or why not.

6.6. Whether trading through use of UPI block facility be voluntary or compulsory for retail investors?

6.7. How the collection of brokerage from clients opting for UPI block facility should be handled:

6.7.1. Option 1- Brokerage should be kept outside the proposed UPI framework and carried out bilaterally between the client and the stock broker.

Reasoning: Since trades pass through stock broker system, they can build functionality whereby until a particular day's brokerage is settled by client, no further trading is allowed to that particular client.

6.7.2. Option 2- CCs to deduct standard rate of brokerage from the UPI block for all clients of a stock broker along with settlement dues and pass it to the stock broker. Such rate of brokerage can be decided by the stock broker but shall be fixed atleast for a quarter. CC shall publicly display the rates specified by all brokers. In case the brokerage rate applicable to some UPI clients are different from that specified by broker, same can be settled bilaterally between the stock broker and client (broker can recover from client the short amount if applicable rate for client is more than standard rate specified. Broker can reimburse client the excess brokerage collected if applicable rate for client is lower than standard rate specified.)

Reasoning: Since CC will be debiting the settlement obligations inclusive of standard statutory levies such as STT and Stamp duty, they can develop the functionality to deduct standard rate of brokerage across all clients of a stock broker.

6.7.3. Any other solution

6.8. Any other comments, relevant to the discussion topic.

7. Considering the implications of the said matter on market participants, public comments are invited on the proposal. The comments/ suggestions may be provided as per the format given below:

Name of the person/entity proposing comments:				
Name of the organization (if applicable):				
Contact details:				
Category: whether market intermediary/ participant (mention type/ category) or public (investor, academician etc.)				
S. No.	Extract from consultation paper	Concerns/ Issues (with page/ para no.)	Proposal/ Suggestion	Rationale

Kindly mention the subject of the communication as, "Comments on Consultation paper on Blocking of Funds for Trading in Secondary Market".

Comments as per aforesaid format may be sent to the following, latest by February 16, 2023 (within 30 calendar days from the date of publication of this consultation paper on SEBI website) through the following modes:

a. Preferably by email to: vishals@sebi.gov.in; or apping@sebi.gov.in or
b. By post to the following address:
   General Manager,
   Market Regulations Department,
   Securities and Exchange Board of India,
   SEBI Bhavan, Plot No. C4-A, G Block,
   Bandra Kurla Complex, Bandra (East),
   Mumbai -400 051

Issued on: January 17, 2023

Annexure-2: Various Scenarios

[Also Annexure-1 of consultation paper]

Current process	**Proposed process**
Scenario 1: Prefunded purchase by client	
• Client transfers Rs. 150 to member. • Member may retain the client funds with itself and allocate collateral to the extent of 20% margin requirements at the CC (Say Rs. 30). • Client purchases a share for Rs. 100, the margin collection requirement is Rs. 20 which is blocked from client's allocation. • Collateral is released after the member completes the net settlement with the CC.	• Client creates a block of Rs. 150 in favour of the CC. The amount will get allocated as collateral. • The client purchases a share worth Rs. 100. The margin requirement is 20, this will get adjusted from the block (which is allocated as collateral). • STT and stamp duty will be 11 paise, which will be added to the client's obligation. The CC will debit 100.11 towards settlement at the stipulated time. • With the successful debit from the client, the securities receivable by the client will be provided in the client's depository account directly by the CC at the time of settlement pay-out.
Scenario 2: Delivery sale by client by early pay-in	
• Client uses EPI block mechanism for early pay-in. • Such early pay-in information is received by the CC from depositories. • A sell order is executed on behalf of the client.	• The client will provide securities as early pay-in through the EPI block mechanism only. • If the early pay-in information is received from depository before trade execution, there will be no margin. If the information is received subsequently, the proprietary collateral of the member

• If sell order is executed after early pay-in, then no margin is applicable at any time. • If early pay-in is received subsequent to the sell order execution, the proprietary collateral of the member will be blocked till receipt of early pay-in. • While providing pay-out to the client, the member may adjust other statutory dues (stamp duty, STT), brokerage etc.	will be blocked till the receipt of early pay-in. • Since the client has completed the settlement, the CC shall pay out funds directly in the client account. While providing the funds pay-out, CC will deduct the STT and stamp duty.
Scenario 3: Purchase/sale by client supported by margins	
• Client provides 20% margin to the member. Client can execute trades based on the margins on trade date. The client will need to provide the remaining 80% amount (in case of purchase) or deliver the security (in case of sale) till the applicable settlement deadline.	• The client may create only partial block to the extent of margin instead of entire upfront value or EPI block. The client will need to provide additional block or provide EPI block till the stipulated time. Further process will be same as discussed in Scenario 1 and Scenario 2.
Scenario 4: Intraday cash market/derivatives trading	
• Client provides margin money to the member. Client carries out intraday trading or trade in derivatives. There are no exchange-of-value delivery obligations (funds against securities or vice-versa), but only losses or gains. Losses will be deducted from the margin money given by clients and gains may be added to the margin money of client or paid out.	• In case of losses, the CC will debit the block to the extent of losses towards client pay-in. • In case of gains, the pay-out will be given by CC in the client account. The CC shall not add the pay-out to the trading capital (collateral) of the client, and if desired the client will need to create another block.

Annexure-3: Illustration – For funds settlement

[Also Annexure-2 of consultation paper]

Consider an example of a self-clearing member (SCM) with 5 clients, namely, Client 1, Client-2, Client-3, Client-4 and Client-5. Out of which Client-1, Client-2 and Client-3 opt for UPI block facility and others don't. Details of collateral posted and funds obligations of each of them are in the table below:

Client	**UPI Clients**			**Non-UPI clients**		**SCM (net of non-UPI clients)**
	Client-1	**Client-2**	**Client-3**	**Client-4**	**Client-5**	
Collateral posted (in ₹)	100	60	200	80	150	
Funds obligation (in ₹)	400	(300)	200	(400)	150	(250) (pay-out)

*The figures in parentheses () represents pay-out

Scenario 1 – All clients pay

- Client-1 creates another block of ₹300
- In Round 1 pay-in (for UPI block facility clients) CC debits ₹400 to Client-1, ₹200 to Client-3
- Round 2 pay-in – net SCM level (nil in this case)
- Pay-out by CC–
    - ₹300 to Client-2 directly, ₹250 to SCM.
    - SCM pays ₹400 to Client-4 (₹250 received from CC and ₹150 from Client-5)

Scenario 2 – UPI client default

- Round 1 pay-in – Client-1 defaults for ₹300. CC debits ₹200 to Client-3 and ₹100 to Client-1 (from available UPI block)
- Round 2 pay-in – CC demands ₹50 pay-in (shortfall of clients under UPI block facility netted with the remaining settlement obligation of SCM)
- SCM pays ₹50 for Pay-in
- Pay-out by CC - Client-2 (Under UPI block facility) receives ₹300 directly from CC, thus is not exposed to fellow client default risk (Client-1)
- In case, instead of bringing in own funds, if SCM had paid ₹50 for pay-in from ₹150 pay-in of Client-5 then he will be left with only ₹100 (balance pay-in of Client 5) to pay Client-4. TM will be in default of ₹300 to Client-4.
- Client-4 (not under UPI block facility) faces risk due to default of fellow client (Client-1)

Scenario 3 – SCM default

Client	**UPI Clients**			**Non-UPI clients**		**SCM (net of non-UPI clients)**
	Client-1	**Client-2**	**Client-3**	**Client-4**	**Client-5**	
Collateral posted (in ₹)	100	60	200	200	150	
Funds obligation (in ₹)	400	(300)	200	200	(50)	150 (pay-in)

*The figures in parentheses () represents pay-out

- Round 1 pay-in – Client-1 defaults for ₹300. CC debits ₹200 to Client-3 and ₹100 to Client-1 (from available UPI block)
- Round 2 pay-in – CC demands ₹450 pay-in (₹300 for Client-1 and ₹150 for non-UPI clients)
- SCM provides ₹200 (from pay-in received from Client-4) and defaults on the balance amount of ₹250.
- CC provides pay-out of ₹300 to Client-2 directly

- Since SCM defaults on its obligations to CC, Client-5 may not receive pay-out of ₹50
- Client-5 (not under UPI block mechanism) faces risk due to default of fellow client (Client-1)