

Concept Note
Online Only Brokers

1. Background:

Social media and technology are changing how businesses engage with their customers and with each other. For brokers, technology can help to boost information flows and value-adding analytical capabilities on one side and take costs out of distribution and service on the other. Electronic/ online brokers are either:

- i. Extensions of existing brokers, who view the Internet as another channel through which they can provide their clients with access to a variety of services, or
- ii. Purely web-based, office-less brokerages that take advantage of low overhead costs.

The explosive growth of electronic brokers has provided investors with worldwide access to a variety of financial services. This essentially borderless environment requires securities regulators to determine when and how their regulations will apply to these activities.

2. Types of Online Brokers worldwide:

Generally there are three types of online brokers currently working worldwide:

Type	Services Offered	Advantages	Disadvantages
Full-Service Brokers	Trading, Investment advice, Research, Retirement planning Tax advisory etc.	<ul style="list-style-type: none"> • One-stop shop for all investment-related services. • Ideal for new beginners to make informed decisions 	Relatively high fee
Discount Brokers	Only assist in trading. Does not include: Investment advice, Research, Retirement planning, Tax advisory	<ul style="list-style-type: none"> • Lower cost • No need to worry about biased investment recommendations • Access to basic educational resources to help you do it yourself 	<ul style="list-style-type: none"> • No advice or guidance • Possible hidden fees • Less hands-on customer service
Robo-Advisors	Online platforms that offer algorithm-driven trading with very little human element involved	<ul style="list-style-type: none"> • Cost-competitiveness • 24/7 availability • Relatively small account balance requirement • Efficiency 	Lack of personalized services

3. International precedents

i. Malaysia:

In May 2017, the Securities Commission Malaysia granted a **restricted Capital Markets Services License** to **Rakuten Trade** to deal in listed securities and provide investment advice. Rakuten Trade is Malaysia’s first full-fledged online equity broker and provide to investors access to an integrated online share trading platform that includes account opening, trade execution, settlement & confirmation, research & trading

ideas as well as rewards and knowledge. Rakuten Trade is a joint venture between Kenanga Investment Bank Bhd and Rakuten Securities Inc, one of the largest online brokers in Japan.

ii. Australia:

In Australian Stock Exchange(ASX), other than full service/wholesale broker, there is another category of “online brokers” that offer no recommendations or advice regarding the appropriateness of your decision, hence their brokerage fees tend to be lower. This is an attractive option for investors confident in their share market knowledge and trading decisions. They are typically either internet based or telephone based.

iii. Hong Kong:

As per the licensing information booklet of Securities and Futures Commission(SFC), Hong Kong, persons which are engaged in internet trading (internet brokers) are licensed by, or registered with, the SFC for:

- Type 1 regulated activity (dealing in securities);
- Type 2 regulated activity (dealing in futures contracts);
- Type 3 regulated activity (leveraged foreign exchange trading).

As per SFC’s Report on the 2019-20 thematic cybersecurity review of internet brokers, more than one-third of firms licensed for Type 1, 2 or 3 regulated activities provide internet trading services to their clients. Further, as per the Cash Market Transaction Survey 2019 of Hong Kong Exchange, for the year 2019, retail online trading accounted for 57% of total retail investor trading (down slightly from 61% in 2018), and 11% of the total market turnover.

4. Proposal of introducing new category of Online Only Brokers

4.1 Objectives:

- a) To expand market outreach through introduction of concept of the ‘Online Only Broker’.
- b) To reduce the risk of clearing and custody defaults.
- c) To encourage new participants to start brokerage business at lower preliminary infrastructure and operational costs by using electronic means only.
- d) To allow existing brokers to switch to this new category to lower their overhead costs and use electronic means to focus on the core business of trading instead of clearing and settlement.
- e) To utilize the new broker regime, where Online Only brokers will focus on trading and customer onboarding like a Trading Only(TO) broker and use Professional Clearing Member(PCM) or Trading and Clearing(TC) brokers to perform clearing function and hold custody of securities.

4.2 Proposed Structure and Permissible Activities:

- a) The Online Only Broker shall mandatorily offer online account opening as per the online onboarding framework approved by the Securities and Exchange Commission of Pakistan.
- b) The Online Only Broker shall operate as a sub-category of TO broker that by using online means can only execute trades on behalf of its customers and shall not be allowed to undertake proprietary trading;
- c) The Online only broker shall not be eligible to settle executed trades or keep custody of securities or money owned by its customers.
- d) Limited custody model shall not be allowed.
- e) Online Only Broker shall not deal in cash. Every dealing in cash shall be handled through PCM.
- f) Client segregation requirements shall not be applicable on the Online Brokers.
- g) The license for Online-only broker shall only be granted to applicant who has entered into arrangement with a PCM or TC broker for clearing and settlement of trades;

- h) The Online Only broker may also provide advisory services, subject to compliance with the Securities Adviser Licensing Regulations.
- i) All trading services shall be provided through online mode only and no trading terminal will be provided to customers in any office. It shall ensure that no physical place be made available for trading at any premises of Online Only Broker.
- j) The Online Only broker shall not have any agent or branch for providing trading services. However, they shall be allowed to open customer/account facilitation centers as per PSX Regulations.
- k) Must display prominently at the website and each communication to the customers that it is not allowed to keep custody or handle cash of customers.
- l) As business model of online only broker shall be highly dependent on robust IT infrastructure, the broker shall ensure meeting any specific standards relating to IT infrastructure as may be prescribed by the PSX and SECP from time to time for seamless provision of service, protection of customer information and data security against the cyber threats. Online Only Broker may be required to implement adequate risk management practices to ensure that it has,
 - i. procedures and controls to monitor and test the system and infrastructure on a regular basis;
 - ii. adequate cyber-security mechanism;
 - iii. operational and technical controls systems to manage the risks; and
 - iv. all electronic communication is digitally signed, encrypted and secured with a backup stored in soft and secured form.
- m) Online only broker shall be allowed to trade in Ready, DFC and MTS markets only and its customers may avail financing extended by PCM only through MFS market in first phase. However, the Only Online broker shall not act as financier in MFS market.

4.3 Licensing regime for Online-only Broker:

Applicants desirous of obtaining Online-only broker license shall comply with all the licensing, reporting and ongoing compliance requirements as applicable on Trading-only brokers under the Securities Brokers (Licensing and Operations) Regulations, 2016, whereas:

- a) The online-only broker shall maintain a minimum Net worth of PKR 7.5 million.
- b) Issuance of TREC by PSX to Online-only broker at significantly reduced rates along with minimal documentation;
- c) Reduced license fee, reduced license renewal fee and reduced documentation requirements for obtaining license. The SECP may reduce its licensing fee for Online only broker to Rs. 50,000 instead of Rs. 100,000 and renewal fee to Rs. 25,000 instead of Rs. 50,000.

4.4 Other incentives

The other incentives are as follows:

- a) Online Only Brokers may be allowed to charge lower brokerage commission (50% less than normal minimum brokerage)
- b) Online Only Brokers may be allowed to operate as a Single Member Company
- c) No Base Minimum Capital(BMC) requirement. However, Online Only Broker shall maintain minimum deposit of Rs.1 million with exchange.
- d) Presently only brokers with a net worth of PKR 25 million can offer internet based trading under the PSX Regulations. This is also suggested to be reduced to PKR 7.5 million.

- e) Presently the CEO, Chief Compliance Officer and Head of Sales of brokers are required to obtain mandatory certification of “Pakistan Markets and Regulations Program” and “fundamental of Capital Market”. It is proposed that any one of these persons may obtain relevant certification.
- i. Less stringent compliance and infrastructure requirements, including:
 - ii. No mandatory requirement for credit rating and BMR
 - iii. QCR rated auditors shall be allowed
 - iv. No compliance requirements relating to customer asset segregation including reporting requirements pertaining to customer assets such as fortnightly reporting etc.
 - v. It can outsource its AML/CFT compliance function to PCM

4.5 Benefits:

The new proposed category will offer the following benefits:

- a) Increased investor outreach and financial inclusion
- b) Enhanced investor convenience as they can make perform activities like account opening, investments, divestments and modifications without having to physically visit a brokerage office/branch.
- c) Lower entry and overhead costs for new entrants
