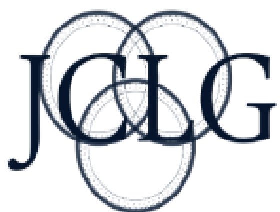
Volume VII Issue II 2025

Journal on Governance

Special Issue: 2nd NLUJ - IndusLaw Corporate Law Review Summit, 2024

www.jclg.in ISSN No. 0976-0369



A National Law University, Jodhpur Publication

JOURNAL ON GOVERNANCE

VOLUME VII ISSUE II

(2ND NLUJ-INDUSLAW CORPORATE LAW REVIEW SUMMIT, 2024)

JANUARY 2025

The Journal on Governance (also known as 'Journal on Corporate Law and Governance') is published by the Centre for Corporate Governance at National Law University, Jodhpur.

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Cite as 7 J. on Governance [ii] 2025
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Published by:

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National Law University, Jodhpur

NH-65, Mandore, Jodhpur – 3424304

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FOREWORD

It gives us immense pleasure to present Volume VII, Issue 2 of the Journal on Governance on behalf of the editorial board. The current issue marks the successful culmination of the second edition of the 2nd NLUJ- IndusLaw Corporate Law Review Summit, 2024 ("the Summit") sponsored by the Indus Law, along with SCC Online – SCC Times as the knowledge partners for the summit. The Summit received an impressive one hundred and forty submissions and served as a crucial platform for diverse perspectives and valuable insights to converge, bridging the theory- practice gap and deepening understanding of corporate law. The selected papers presented at the Summit are published in this issue.

The first article titled "Regulating Virtual Banks: Towards a Technology-Centric Regulatory Approach?", authored by Dr. Law Sau Wai offers a compelling critique of the limitations of existing technology-neutral regulations in governing the rapidly evolving virtual banking sector. Highlighting unique challenges such as cybersecurity threats, technology dependencies, and operational vulnerabilities, the article contrasts the regulatory frameworks in Asia, where virtual banking licenses are more prevalent, with those in other jurisdictions. Drawing from extensive legal analysis and expert interviews, the piece underscores the need for a tailored, technology-centric framework that addresses licensing, consumer protection, risk management, and data security. Sau advocates for cross-border cooperation and innovative measures to ensure a level playing field while safeguarding trust, resilience, and accountability in this digital-first banking paradigm.

The second article "A Critical Analysis of SEBI's Crackdown on 'Gamification' of Stock Trading: A Conservative Move?", authored by Kartavya Rajput provides a comprehensive examination of SEBI's recent efforts to regulate fantasy stock gaming platforms in India, with a particular focus on the May 2024 circular restricting the sharing of real-time stock price data. The author critically analyzes SEBI's move, which aims to address concerns about unregulated markets, speculative behavior, and the risks of creating parallel trading environments. While the circular seeks to safeguard investor protection and market integrity, the article identifies significant shortcomings, including the

potential stifling of investor education and a lack of clarity surrounding the legality of non-monetary and educational platforms.

Drawing on international regulatory practices, the author underscores how such platforms can serve as valuable tools for financial literacy and risk-free learning for users if properly regulated. The article advocates for a more nuanced approach, recommending measures such as tiered regulation, enhanced transparency, responsible gaming mandates, and enabling authorized stock exchanges to host such platforms. Concluding that SEBI's approach may have been overly cautious, the author calls for a balanced framework that promotes innovation while mitigating systemic risks, ensuring both investor education and protection are prioritized.

The third article titled "An Examination of Legal Adequacy and the Ripple Effect of Investigations into Front-Running within Asset Management Companies,", authored by Andrea Vanspall and Zareen Fatima, critically explores the challenges posed by front-running in India's mutual fund industry. The piece delves into the regulatory gaps within the SEBI framework, which, despite implied prohibitions, lacks explicit provisions against front-running. Through case studies like the Quant Mutual Fund investigation, the article examines the operational flaws, such as inadequate surveillance and whistleblower mechanisms, that enable such unethical practices. Highlighting global best practices and legal precedents, it offers recommendations for a robust regulatory overhaul, including third-party monitoring, enhanced evidence standards, and AI-driven data analysis. The article underscores the need for proportional penalties and stronger institutional safeguards to protect investors and uphold market integrity.

The fourth article titled "From Speculation to Stability: Sailing through SEBI's Regulatory Index Derivatives Framework Proposal", by Prabhav Tripathi & Kshitij Srivastava critically analyzes the Securities and Exchange Board of India's (SEBI) recent Consultation Paper aimed at curbing speculative trading in the derivatives market. Highlighting the exponential growth of retail participation post-COVID-19, the article examines the risks of hyperactive speculative trading, including volatility, liquidity fragmentation, and financial losses incurred by retail investors. It evaluates SEBI's proposed measures, such as rationalization

of strike prices, adjustments to minimum contract sizes, upfront premium collection, and increased margins near expiry, assessing their potential impact on market stability and investor protection. By addressing compliance challenges and emphasizing the importance of a gradual implementation process, the article advocates for a balanced approach to foster a secure, resilient, and inclusive derivatives market in India.

The fifth article titled "The Regulator Strikes Back! Analyzing the Reign of NFRA as an 'Independent' Audit Regulator", authored by Gurasis Singh Grover and Aryan Gupta, scrutinizes the operational and jurisdictional complexities surrounding the National Financial Reporting Authority (NFRA). Triggered by major financial scams, NFRA was established as a regulatory body to oversee auditing standards. However, its expansive powers, such as the ability to debar auditors, retrospective penalties, and overlapping jurisdiction with ICAI, have raised concerns. Drawing comparisons with the PCAOB in the U.S., the article critiques NFRA's lack of ethical standards, operational independence, and procedural safeguards, arguing that these deficiencies compromise its efficiency and fairness. The authors concludes that while independent audit regulation is necessary, a balanced approach that ensures transparency, cooperation with ICAI, and adherence to global best practices is imperative to uphold both professional integrity and economic stability.

The sixth and final article in this issue, titled "Blink and You'll Miss It: The Fast Lane of High-Frequency Trading and Legal Bumps in India", authored by Yash Sharan and S.K. Subhiksha, critically examines the systemic risks and regulatory shortcomings surrounding High-Frequency Trading (HFT) in India. The piece delves into the challenges posed by HFT, including market volatility, manipulation techniques like quote stuffing, and the competitive inequities stemming from costly technological infrastructures. Through an analysis of SEBI's regulatory framework, including the PFUTP and PIT regulations, the article highlights gaps such as the lack of cross-border enforcement and the inadequacy of proposed models like shared colocation services. Drawing from global practices, the authors advocate for adaptive strategies like dynamic circuit breakers, AI-driven surveillance, and robust international cooperation. The article concludes that a balanced, transparent, and technology-driven regulatory

framework is essential to ensure market fairness and investor protection without stifling innovation.

All in all, we are sure that this issue should offer a wealth of information and insight to a reader, and some of the suggestions and observations may also assist in provoking a constructive discussion and deliberations on addressing these emerging issues in the field of corporate law.

We take this opportunity to thank certain persons who made the publication of this issue a success. Our first and foremost thanks go to our collaborators who shared and supported our vision, placing immense trust in us—The IndusLaw, whose generous sponsorship ensured that the Summit's objectives were not only met but exceeded and our knowledge partner, SCC-Online and SCC Times.

Our heartfelt thanks to our patron and vice-chancellor, NLU-Jodhpur, Prof. (Dr.) Harpreet Kaur, and the distinguished members of the Journal's Board of Advisors for their unwavering support. Special recognition is extended to panelists on the theme "The Future of Sustainable Finance in India", Ms. Neeati Narayan, Principal Associate at IndusLaw, Dr. Surbhi Kapur, Associate Professor at Jindal Global Law School, Dr. Monica Pradyot, Assistant Professor at the School of Law, UPES Dehradun, and Dr. A Sridhar, Assistant Professor at NALSAR University of Law and Ms. Ruth Vaiphei, Assistant Professor at NLU Jodhpur, for moderating the panel discussion.

We would like to extend our heartfelt thanks to Dr. Risham Garg, Associate Professor at NLU Delhi, Dr. Sudhanshu Kumar, Associate Professor at NLSIU, Ms. Neeati Narayan, Principal Associate at IndusLaw, Dr. Surbhi Kapur, Associate Professor at Jindal Global Law School, Dr. Monica Pradyot, Assistant Professor at the School of Law, UPES Dehradun, and Dr. A Sridhar, Assistant Professor at NALSAR University of Law who meticulously adjudicated the paper presentation competition at the Summit. On the same note, we would like to thank Mrs. Sonal Naik, Head- Human Resources at IndusLaw and Ms. Bhumika Indulia, Senior Associate Editor at SCC Online-SCC Times for their roles in collaboration are in order for the winners of the Summit and the authors of this issue for emerging victorious through the rigorous selection process.

Finally, our heartfelt appreciation goes to the Editorial Board of 2024-25, the backbone of this Journal. Editors across different tiers of the review process devoted countless hours to the myriad tasks essential for the successful culmination of this issue. Being a part of the Journal is a source of immense pride, and the success of the Journal is undoubtedly a reflection of the collective efforts of its devoted members. We hope that the vision of the editorial board in advancing the discourse on corporate law resonates with our readers.

Bhuvnesh Kumar & Sharad Panwar

Editors-in-Chief, Journal on Governance

National Law University, Jodhpur

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REGULATING VIRTUAL BANKS: TOWARDS A TECHNOLOGY-CENTRIC REGULATORY APPROACH

Dr. Law Sau Wai[*]

ABSTRACT

*This article examines the legal aspects of virtual banking as a fintech ("**Financial Technology**") platform. It emphasizes the need for a thorough review of the regulatory framework governing virtual banking, focusing on its organizational structure, business scope, and operational model. The article argues that the current technology-neutral regulations are inadequate in addressing the long-term effects of technology in the banking sector. Therefore, it proposes a technology-centric framework specifically designed for virtual banking, which would govern the use of devices, software, and online dispute resolution channels. This framework would enable both banks and regulators to regain control over technology implementation, effectively managing virtual banking risks and challenges while ensuring regulatory oversight and accountability. The article is based on extensive legal analysis conducted internationally, with a focus on the Asia region where virtual banking licenses are prevalent, and incorporates insights from interviews with virtual bank executives. The article aims to provide a comprehensive overview of the distinctive features of virtual banking and its regulatory landscape, and to identify the need for a tailored framework that safeguards the integrity and security of virtual banking operations.*

Keywords: Virtual Banking, Bank Digitalization, Financial Technology, Cyber Law.

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[*] *Dr. Law Sau Wai serves as a Lecturer (Assistant Professor) specializing in Corporate and Commercial Law, at University of Reading, United Kingdom.*

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I. REGULATING TECHNOLOGY IN BANKING

The rapid advancement of financial technology has paved the way for virtual banking, a digital-only platform that offers a wide array of financial services to customers. While virtual banking presents numerous benefits, including increased accessibility and convenience, it also brings forth a pressing issue: the absence of specific laws and regulations governing its operations. This article reviews the current virtual banking regulations, considers the challenges posed by the current technology-neutral regulatory landscape, and distinguishes the need for technology-centric regulation and promises for the overall structure of such a framework.

The international landscape of virtual banking is rapidly evolving, and policymakers, regulators, and practitioners rely on valuable resources from organizations such as the Bank for International Settlements ("**BIS**") to navigate this complex domain. The BIS, through its various committees and publications, provides comprehensive insights into the regulation and governance of virtual banking.

One focus is on fintech financing, which encompasses digital banks and fintech platforms. The BIS's Financial Stability Institute ("**FSI**") has published a paper called "Regulating Fintech financing: digital banks and fintech platform" that delves into the regulatory aspects of fintech financing.[1] This paper explores new technology-enabled business models related to deposit-taking, credit intermediation, and capital-raising. It covers topics such as digital banking-specific licensing frameworks, initiatives to facilitate market entry, fintech balance sheet lending, and crowdfunding. It covers five major areas: data privacy; money laundering; cyberattacks; customer protection; and investor confidence. Whilst it

[1] Johannes Ehrentraud et al., *Regulating Fintech Financing: Digital Banks and Fintech Platforms,* BIS (Aug. 27, 2020) https://www.bis.org/fsi/publ/insights27.pdf.

is acknowledged that the delivery of the banking services of digital bank is over the internet, which is clearly different from traditional banks,[2] the issues arising from the delivery channel have not been investigated in depth.

Another crucial aspect is cryptocurrencies. The Basel Institute on Governance has produced a working paper, "Regulating cryptocurrencies: challenges and considerations", that explores the legal and regulatory dimensions of cryptocurrencies.[3] This publication provides insights into government policies, enforcement actions, and case studies related to crypto assets. As virtual currencies gain prominence, understanding the legal and regulatory challenges presented is vital for policymakers and regulators seeking to strike a balance between innovation and consumer protection. Yet, the very purpose of cryptocurrencies is to avoid centralized governance from banks or regulators; it is very difficult to enforce issues on fraud, money laundering, and other illicit practices when the legal nature of cryptocurrency remains undetermined in most jurisdictions.[4]

The Basel Committee on Banking Supervision ("**BCBS**"), as the primary global standard setter for prudential regulation, plays a pivotal role in shaping the international landscape of virtual banking. The BCBS's publications cover a wide range of topics relevant to banking supervision. These include capital adequacy, accounting standards, cross-border issues, core principles for effective banking supervision, credit risk, market risk, money laundering, operational risk, and transparency and disclosure. Notable publications include Basel III, which addresses capital adequacy, market risk, and liquidity, providing a comprehensive regulatory framework for banks. Additionally, the BIS's Committee on Payments and Market Infrastructures ("**CPMI**") focuses on ensuring the safety and efficiency of payment and market infrastructures. Their publications cover principles for financial market infrastructures, payment systems, securities settlement, and retail payment instruments. By establishing robust frameworks for payment systems and market infrastructures, the CPMI contributes to the stability

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[2] *Id.* at 9-10.
[3] Federico Paesano, Regulating Cryptocurrencies: Challenges and Considerations (Basel Inst. on Gov., Working Paper 28, 2019), https://baselgovernance.org/sites/default/files/2019-06/190628%20Working%20Paper%20Cryptocurrency%20Regulations.pdf.
[4] Bejan, C.A. et al., *Considerations About the Regulatory Framework of Cryptocurrency,* 159 (IE 2023).

and resilience of the virtual banking ecosystem. The Committee on the Global Financial System ("**CGFS**"), another BIS committee, assesses global financial market stability and structural underpinnings. Their publications explore various aspects of international banking, financial crises, risk management, market liquidity, and more. By examining the systemic risks associated with virtual banking and analyzing the structural foundations of global financial markets, the CGFS provides valuable insights for policymakers and regulators. Lastly, the Irving Fisher Committee on Central Bank Statistics ("**IFC**") promotes discussions on statistical issues relevant to central banks. By strengthening the relationship between data compilers and users, the IFC enhances the quality and availability of statistical information crucial for understanding the international financial system. Whilst they are all applicable to virtual banking, none of them directly addresses the presence of virtual banking platforms.

The international landscape of virtual banking is complex and dynamic due to its mobility. Organizations like the BIS, through its committees and publications, offer invaluable resources covering the products and services that could apply to virtual banks. By leveraging these insights, stakeholders can navigate the evolving landscape of virtual banking, ensuring both innovation and stability in this rapidly changing sector. However, these efforts fail to question the current regulatory practice of using the established regulations that cover traditional banks and applying them to virtual banks. The regulation of the digital platform itself is not explicitly governed.

This article investigates the regulation of virtual banking platforms. Asia has emerged as a prominent region with a higher number of virtual banking licenses compared to the Western counterparts. This allows us to identify the distinct features of virtual banking regulation through licensing only. This article is a result of an extensive comparative study, evidenced with focus group findings between March 2021 and October 2022 conducted with retail banking clients, senior executive, investors and bank executives of virtual banks. These interviews provided valuable insights into the distinct regulatory challenges and opportunities specific to virtual banks operating in Asia. By combining the expert perspectives with a rigorous analysis of the regulatory landscape, this paper aims to provide an Asia-specific overview of the regulatory framework of virtual banking and

contributes to the scholarly understanding of the evolving virtual banking regulatory landscape. It also advocates for a new regulatory technology-centric framework that should be adopted in this digital era.

II. CURRENT REGULATORY LANDSCAPE OF VIRTUAL BANKING

Terms such as virtual banks, digital banks, challenger banks, or internet banks are used interchangeably in different jurisdictions. They usually provide virtual-only core banking services like deposit-taking, payments, lending and investments. When delivering hitherto conventional banking services, providing better value propositions, or enriching customers' experiences when interfacing online with banking services, the use of powerful and innovative technical solutions like AI, blockchain, IoT, data analytics enable virtual banks to operate without needing to have physical bank branches and need fewer resources, thereby providing cost savings that can be passed on to consumers.[5]

However, the convergence of innovative technology and banking may give rise to new risks in virtual banks. For example, the adaptation of Application Programming Interfaces ("**APIs**"), which involve collaborations with third parties in hosting systems on virtual private clouds, could trigger privacy data issues when managing customers' personal data. Further, the deployment of cloud technology outside of the jurisdiction of the main operation may contribute to cross-border data transfer issues. Engagement with third parties may also enhance exposures to cyberattacks and cybercrimes.[6]Reliance on third party devices and software in delivering these platforms should not be ignored as banks would have no control over any malfunctioning of third-party devices and software.[7]

Considering these new kinds of risks arising from collaborative activities with third parties, closer cross-border cooperation with other major fintech hubs across the world could be helpful for addressing associated operating risks linked to virtual-only banking activities. However, virtual banks licenses may not facilitate

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[5] Peter Yeoh, *An International Regulatory Perspective of Digital Banks*, 41(6) BUS. L. REV. 205, 213 (2020).
[6] *Id.*
[7] Law, S., *Promoting Financial Inclusion Through the Launch of Virtual Banks? Empirical Insights from Hong Kong Banking Customers,* 37(11) J. I. B. L. R. 429, 439 (2022).

collaboration between banks and other non-banking entities. One example is DBS Singapore, which sets up subsidiaries to run all its virtual-only operations to segregate them from its main operations.[8]Increasingly, virtual banks emerge as partnerships between big tech platforms with a huge clientele base and conventional banks.[9]

Therefore, regulatory authorities generally keep close vigilance over virtual banking activities but might overlook the impact on the wider financial system arising from collaboration with non-banking third parties not regulated under the existing regulatory regime. The use of emerging technologies to disrupt conventional banking activities may also bring unforeseen operational risks, as well as linkages to nefarious activities like money laundering, tax evasion, and the transactions of illegal products. Thus, virtual banks are regulated similar to that of conventional banks and are subject to expensive banking regulatory compliances after a license is granted.[10] Yet, not all jurisdictions have virtual banking licenses. Whilst most jurisdictions, such as United Kingdom, United States, China, and the European Union apply established banking laws and regulations to virtual banks,[11]those that grant licenses to virtual banks under a specific regulatory framework are mostly, if not all, in Asia *(Table 1)*

Table 1: Regulation of virtual banking in selected jurisdictions

Specific Virtual Banking Licensing and Regulatory framework	Virtual Banking regulated under general regulatory framework
Hong Kong, Chinese Taipei, Korea, Singapore, Malaysia, the Philippines, Pakistan	Argentina, Australia, Brazil, Canada, China, Dominica, European Union, Japan, Indonesia, New Zealand,

[8] DBS, *Driving Digital Transformation Through Partnerships,* DBS BANK (May 2020) https://www.dbs.com.sg/corporate/insights/driving-digital-transformation-through-partnerships.

[9] Yeoh, *supra* note 5.

[10] Bank for International Settlements, *supra* note 1 at 12.

[11] *Id.* para 1, para 16. *See also,* Alliance for Financial Inclusion, *Policy Framework on the Regulation, Licensing and Supervision of Digital Banks*, AFS (Nov. 23, 2021) https://www.afi-global.org/wp-content/uploads/2021/11/DFSWG-framework_FINAL.pdf.

	Nigeria, Russia, South Africa, United Kingdom, United States

Source: *Alliance for Financial Inclusion*[12]

Notable financial centers like Hong Kong and Singapore have designed special licensing regimesthrough licensing requirements, together with the use of established regulations, unlike those in Anglo-Saxon/European economies that rely on the use or adaptations of established laws and regulations. Further, Asian jurisdictions that are particularly active in the deployment of exponential technologies in financial services take the position that virtual-only banks should obtain an additional license for non-traditional banks. The rationale that non-financial institutions, such as big tech platforms, could become majority shareholders of virtual banks and participate in the core aspects of banking activities, and hence bank regulators should review their capacities before allowing entry.[13]However, this explanation may not justify why established laws and regulations could not serve the same purpose when covering virtual-only banking platforms, and it does not provide a rationale for mandating the need for an additional license.

III. THE THREE DISTINCT FEATURES OF A VIRTUAL BANK LICENSE

The original initiative to license virtual banking was to ease the entry barriers for market participants.[14]There are three specific requirements that are distinctly applicable to a virtual banking license, which relates to ownership and control, business scope and operational model.

A. ORGANIZATIONAL STRUCTURE– OWNERSHIP

[12] *Id.* at 14.
[13] Yeoh, *supra* note 5.
[14] Deloitte, *Development of Digital Banking License Framework in Asia Pacific*, DELOITTE (Dec. 27, 2019) https://www2.deloitte.com/content/dam/Deloitte/my/Documents/risk/my-risk-regulatory-requirements-digital-banks.pdf.

A virtual bank incorporated in Hong Kong should be majority owned by a bank or financial institution, or through a holding company incorporated in Hong Kong, that is also subject to capital adequacy. A similar requirement exists in Singapore where, for a DFB, the company must be controlled by Singaporeans and headquartered in Singapore. Foreign businesses can apply for this license, provided they form a joint venture with a Singapore company and the joint venture complies with the headquarters and control requirements. DWB licenses are opened to all businesses. In Malaysia, licensees will be assessed on whether it is in the national interest. Although there is no requirement of ownership there is a preference that controlling equity interest resides with Malaysians. In South Korea, a non-financial company can own up to 34% of an internet-only bank whilst in Taiwan the amount can be up to 60%, but at least one of the founders needs to be a bank or financial holding company with a shareholding of 25% or above.[15]Ownership appears to be crucial because virtual banks are usually new ventures subject to higher risk, therefore support from those with a track record and who can act as parent company is crucial.[16] There has been no analysis or explanation about why majority control in terms of nationality has been a requirement but it could be related to both moral and legal commitment to the region.[17] In reality, the FinTech companies are still the major owners of virtual banks.[18]

Virtual banks in Hong Kong require board members and senior management staff to have the requisite knowledge and experiences for discharging their duties (but not specifically in financial technology) and having material outsourcing approved by the HKMA in compliance with the principles. The *Philippines* requires at least one member of the board and one senior management officer to have a minimum of three years of experience and knowledge in operating a business in the field of technology and e-commerce; whilst Taiwan requires at least one

[15] Bank for International Settlements, *supra* note 1 at para 11, para 13.

[16] HKMA, *Authorization of Virtual Banks*, HKMA (May 5, 2000) https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/guide-authorization/Chapter-9.pdf.

[17] Monetary Authority of Singapore, *Digital Bank Licence*, MAS (2019) https://www.mas.gov.sg/regulation/Banking/digital-bank-licence.

[18] Sally Chen et al., *Virtual Banking and Beyond*, BIS (Jan. 27, 2022) https://www.bis.org/publ/bppdf/bispap120.pdf.

member of the board to have more than five years of experience in financial technology, e-commerce or telecommunication business.

It should be noted that what is not governed is cross-border operations and collaboration with fintech companies, which are non-bank institutions not subject to the regulatory requirements. The mobile nature of virtual banks means they are more prone to cross-border risk, and extensive collaboration will force virtual banks to have a higher regulatory burden when collaborating with fintech companies.

B. BUSINESS SCOPE

There is limited business scope for virtual banks. In Hong Kong, virtual banks "normally target" retail banking clients and SMEs.[19] Although there is no explicit prohibition of the client segment who can be targeted, the product range is limited; for example, out of eight virtual banks in Hong Kong, only two offer business accounts. The product range is also limited to simple loan services, credit cards, debit cards, insurance, and foreign exchange.[20]The minimum capital requirement for a virtual bank in Hong Kong is HK$300 million.

In Singapore, DFBs have a phase-in arrangement where there is no time requirement but rather a minimum paid-up capital requirement from S$15 million (restricted DFB). The restricted DFB licensee has to comply with an aggregate deposit cap of SGD 50 million deposits from a limited scope of depositors, be covered by a deposit insurance scheme, and observed capital and liquidity rules similar to local banks. At the stage, the licensees will be restricted to simple credit and investment products, have no more than two banking operations in overseas markets, have no minimum account balance and fall below fees, comply with unsecured credit rules, and have no access to automated teller machines ("**ATMs**") or cash deposit machines (commonly regarded as CDMs) networks, other than the offering of cashback services. To migrate to DFB status, the applicant must have a minimum paid-up capital of SGD 1.5 billion, but will not

[19] Hong Kong Monetary Authority, *Digital Banks,* HKMA (2024) https://www.hkma.gov.hk/eng/key-functions/banking/banking-regulatory-and-supervisory-regime/virtual-banks/.
[20] Hong Kong Monetary Authority, *supra* note 23.

be restricted by a deposit cap, and can operate as a fully functioning bank.[21]The key requirements for a DWB license include a minimum paid-up capital of SGD 100 million and compliance to capital and liquidity rules similar to existing wholesale banks. In addition, a DWB will not be able to take Singapore dollar deposits from individuals of less than SGD250,000, but is free to open and maintain deposit accounts for MSEs and corporates. There is a similar requirement in Malaysia, with the amount of paid up capital stated at different phases withRM100million at the foundational phase, reaching RM300 million (S$99 million) at the end of the fifth year. Notably, there is no explicit restriction of the scope of their products or services and hence their scope is mainly restricted by their business strategy and targeted segment.[22]

The minimum capital requirement for a virtual bank in Taiwan is NT$10 billion, which is the same as required for setting up a conventional commercial bank. The minimum capitalization of virtual banks in the Philippines should be P1.0 billion (50% lower than that for a commercial bank). Any individual (either foreign or local) or non-bank corporation may each own or control up to forty percent only of the voting stock of a virtual bank.

The phenomenon under consideration pertains to the emergence of small-scale banks in the market that exclusively offers digital services. These banks adopt client onboarding procedures that deviate from those employed by traditional banks, resulting in a limited geographical scope of client outreach. Specifically, virtual banks can only target individuals with internet access, as their services are exclusively accessible through online platforms. However, the virtual banks lack the ability to control internet availability for potential clients. This predicament engenders uncertainty regarding the source of clients and the potential of innovative strategies to attract new assets. Consequently, virtual banks are characterized by modest dimensions and a restricted range of products. An additional concern pertains to technology risk, which currently lacks a dedicated category within capital requirements. Although virtual banks may allocate

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[21] Monetary Authority of Singapore, *Monetary Authority of Singapore Eligibility Criteria and Requirements for Digital Banks*, MAS (2023) https://www.mas.gov.sg/-/media/Digital-Bank-Licence/Eligibility-Criteria-and-Requirements-for-Digital-Banks.pdf.

[22] Bank for International Settlements, *supra* note 25 at 14, table 2.

provisions to address technology-related risks, the realization of such risks cannot be resolved solely through liquidity or capital measures. This is due to the inherent uncertainty surrounding the reliance of banks on third-party devices and software.

C. OPERATIONAL MODEL

There are operational restrictions on virtual banks. In Hong Kong, there is an explicit requirement for a virtual bank to operate without any physical branches, but it must have a physical office in Hong Kong. It must maintain an explicit objective to promote financial inclusion and hence cannot impose a minimum deposit requirement. In Singapore, on top of the no minimum deposit balance, the limitation of physical access to clients has been made explicit by prohibiting access to ATMs or cash deposit machines. Both DFB and DWB licensees can only have one physical place of business for conducting activities within the proposed business scope.[23]The operation of virtual banks is in practice more restrictive than the regulatory requirements; the key challenges for regulators have been reported to be to ensure no regulatory compromises despite convenience, as well as issues around data governance[24] Yet, arguably these issues are equally applicable to non-conventional banks. Nonetheless, a physical branch or office may be necessary for potential customers who need help in onboarding and for existing customers who need special attention under certain circumstances, e.g., when making complaints, or gaining access to cash when digital networks are down.[25] In Malaysia and Singapore, virtual bank applicants are required to demonstrate during the application process their ability to serve customer needs and reach underserved and hard-to-reach market segments. In other jurisdictions, there is a more general expectation for virtual banks to help promote financial inclusion.[26]In the Philippines, a virtual banking license applicant must provide a detailed review and assessment of the supporting information technology systems

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[23] Monetary Authority of Singapore, *supra* note 28 at 3–4.
[24] Bank for International Settlements, *supra* note 1 at para 13.
[25] Alliance for Financial Inclusion, *Policy Framework on the Regulation, Licensing and Supervision of Digital Banks,* AFI (Nov. 23, 2021) https://www.afi-global.org/wp-content/uploads/2021/11/DFSWG-framework_FINAL.pdf.
[26] *Id.*

and infrastructure vis-a-vis the digital banking business model which is performed by a competent independent third-party IT expert.

Regulatory sandboxes are currently offered by more than 70 countries as a means for virtual banks to test innovative products and services within a controlled environment. This initiative presents virtual banks with unique opportunities to experiment with and refine their offerings, thereby facilitating progress within the virtual banking sector. It is important to note that sandboxes are not exclusively available to virtual banks, as traditional banks may have distinct operational models that may not align with sandbox participation. The existence of sandboxes emphasizes the necessity of consumer education and awareness. Users must be adequately informed about the functioning of the virtual banking platform and be equipped with the knowledge required to navigate and operate the platform effectively. Unlike physical banks, where human staff members are available to assist clients with their inquiries, virtual banks necessitate that clients take full responsibility for mastering the operation of the platform. Consequently, consumer education becomes imperative to ensure that users are well-versed in utilizing the virtual bank's services and know how to respond in the event of any operational issues or deviations from expected functionality.

These three features have important implications that lead to unveil the insufficiency of purely adopting existing regulatory requirement.

First, is that these requirements are explicit in the eyes of clients without the need for any further enquiries, indicating that the regulatory requirements might have direct impacts on the services clients receive and these impacts have been incorporated into the licensing requirements without the need to write them down.

Second, is their focus on the technology requirements, made through imposing the mandate of financial inclusion. In the Basel Report listing the technology related licensing requirements of digital banks,[27] there are four major requirements, relating to a fitness and propriety test, track record in technology, third-party assessment of IT systems, and financial inclusion. Except for Taiwan,

[27] Bank for International Settlements, *supra* note 1 at para 13, table 2.

all countries listed have a mandate of financial inclusion, therefore virtual banks are destined to advance technology in the banking industry.

Third, there is no subsequent indication of how to improve the technology literacy of clients, contrary to traditional banking where financial literacy is a key mandate; for example in Hong Kong there is a need to treat retail customers fairly.[28]Although the regulatory requirements are largely the same as in conventional banking, these notable added requirements make it critical to acknowledge that virtual banking could be a separate segment of its own as it operates a brand new channel to provide banking services and products. Largely, clear objectives from the regulators incorporated in the licensing requirements integrated into the regulatory regime makes the regulatory requirements of virtual banks tighter than those of non-virtual banks. This could create a possible loophole for non-virtual banks to not be subject to these requirements, even though they could equally build the same technology-centric platform for their clients.

IV. TOWARDS A TECHNOLOGY-CENTRIC REGULATORY APPROACH FOR VIRTUAL BANK

The absence of specific virtual banking laws and regulations poses significant challenges for the industry and regulators. To address this, comprehensive virtual banking regulations should be established to create a level playing field, ensure fair competition, and protect consumers across the banking landscape. Such regulations should cover licensing requirements, prudential standards, consumer protection measures, risk management guidelines, and data privacy and cybersecurity provisions. The existing gap between virtual banking and traditional banking regulation comes from technology as a medium of delivery of service. A technology-centric regulatory approach should bridge this gap to cater for the paradigm shift from a physical mode to an online-only mode, while maintaining

[28] HKMA, *Treat the Customer Fairly Charter*, HKMA (Oct. 14, 2020) https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/consumer-corner/TCF_Charter.pdf.

the trust and confidence clients have built through human touch and a physical presence.[29]

A comprehensive focus group study was conducted between October 2021 and March 2022, involving interviews with a total of 64 individuals. The aim of the study was to explore and gather insights into the perceptions and experiences of individuals regarding the utilization of virtual banking services. Additionally, in order to gain expert perspectives on regulatory frameworks, four industry experts were interviewed. The experts included the Chief Risk Officer of a virtual bank in Hong Kong, an investor of a virtual bank in Taiwan, and a senior executive from a virtual bank. Through the analysis of the focus group discussions and the insights provided by the experts, several key themes emerged. These themes shed light on the regulatory landscapes surrounding virtual banking and their implications for the industry. By synthesizing the perspectives of the expert opinions, the following noteworthy themes have been identified:

A. THE ABSENCE OF VIRTUAL BANKING SPECIFIC LAWS AND REGULATIONS

The absence of a dedicated legal and regulation framework designed for virtual banking presents a challenge. There is an apparent regulatory gap under the technology-neutral regulatory approach as existing laws may not fully capture the complexities and challenges of this evolving sector. One obvious gap is the absence of physical space for clients as a contingency in case the virtual platform fails to operate. This presents a competitive disadvantage to the virtual bank as its access to clients is limited to internet users, and they have no control over who will have access to the internet. Another gap is that there is no clear guidance to which existing regulations should be followed. Some are obviously out of place as they have been designated for physical branches. Participants also observed that the client onboarding requirements is different among different virtual and conventional banks:[30]

[29] Law S.W., *Banking Made Easy: The New Theory of Digital Financial Inclusion from a Users' Perspective*, 4(4) INT. J. ELECT. BAN. 336-380 (2024).
[30] *See*, focus group with Participant 24 (Oct 2021), Participant 43 (March 2022), Participant 59 (March 2022).

"It is unfair that we are subjected to the same set of regulations because our mode of operation is entirely different. The fact that we operate solely in the virtual realm is both a blessing and a curse. It limits our avenues for business expansion as we cannot control who will go to the internet."[31]

"Sometimes, I find it challenging to meet certain regulatory requirements that seem to be designed specifically for traditional banks. For instance, I question whether it is necessary for us to ensure that the ramp leading to our branch has the correct slope to ensure accessibility and financial inclusion. Or should these requirements also apply to our office, which is not open to our clients?"[32]

Without specific virtual banking laws and regulations, there is a lack of clarity and guidance for industry participants and regulators alike. This gap creates uncertainty regarding compliance requirements, consumer protection, risk management, data privacy, and cybersecurity. Moreover, it leaves room for potential regulatory arbitrage, where virtual banks may exploit regulatory loopholes or operate in a less regulated environment compared to their traditional counterparts.

B. ENSURING FAIRNESS: BRIDGING THE GAP BETWEEN VIRTUAL AND CONVENTIONAL BANKING

While virtual banking operates in a digital space, it is important to recognize that conventional banks also have a virtual presence through online banking platforms. It would be unfair and impractical to solely focus on regulating virtual banks without considering the virtual operations of traditional banks. Both types of banks face similar challenges in the digital realm, such as cybersecurity threats, data protection, and customer authentication. Therefore, regulations should aim to create a level playing field, ensuring fair competition and consumer protection across the entire banking landscape, irrespective of whether the services are delivered virtually or through physical branches:

"Virtual banks operate exclusively in a virtual environment, whereas traditional banks have the capability to operate both physically and virtually. This imbalance

[31] Interview with Chief Risk Officer (March 2022).
[32] Interview with an executive of a virtual bank (March 2022).

creates an unfavorable situation for virtual banks, as traditional banks can easily control the number of physical branches to achieve cost savings. The notion that virtual banks inherently possess cost advantages is, in fact, misleading."[33]

"I think the government should have more regulations to emphasize the issues of cyber security, protections on personal information and other transaction records. Because virtual bank services have no physical back up, virtual bank is more vulnerable to cybersecurity risk, we need more protection from the law and regulation in this aspect."[34]

Therefore, a perception that virtual banks have lower costs to operate may be a misnomer because they would have to invest more to secure the trust and confidence of clients to make a virtual-only platform is as convenient as a traditional bank. In fact, Participant 37 rightly observed that in Hong Kong, whilst digital payments are not as common, virtual banks need to rely on a traditional bank's ATM machine for clients to withdraw their cash. This means that they must open a traditional bank account anyway. The presence of the virtual bank might not be as beneficial when the geographical divergence is not as influential in other countries. There seems to be a repeated effort to issue a virtual bank license and impose restrictions on them.

C. THE NEED FOR VIRTUAL BANKING REGULATIONS

To address the regulatory gap and ensure fairness, there is a pressing need to establish virtual banking regulations. These regulations should encompass various aspects, including licensing requirements, prudential standards, consumer protection measures, risk management guidelines, data privacy provisions, and cybersecurity protocols specific to virtual banking:

1. *Licensing Requirements*

Clear and transparent criteria should be established for granting licenses to virtual banks, ensuring that only qualified and reputable entities enter the market. On top of the usual factors such as capital adequacy, management expertise, and operational capabilities, technological resilience should be thoroughly examined

[33] Interview with a virtual bank investor (March 2022).
[34] Interview, *supra* note 39.

to ensure that the risk of over-reliance on third-party devices is properly mitigated. Necessitating a specific license for a virtual bank is current practice but this does not explain why it is essential and it is unclear how it differs from a non-virtual bank license. I propose that the reasons why a virtual bank needs a specific license include ownership and control, business scope and operational model (part IV), which ensure non-bank corporate owners have the capacity and commitment to run a banking business as they are likely to provide the technology that virtual banks need. These owners do not solely operate a virtual bank and therefore their commitment must be examined.

2. *Prudential Standards*

Virtual banks should be subject to prudential standards that ensure the stability and soundness of their operations. The usual standards of capital adequacy and liquidity requirements are still important but virtual banks face technology risk rather than the usual credit and market risk. However, there should be a more forward-thinking approach to not just prevent the occurrence of risk events driven by the market, but also the risks arising from technology turbulence, such as how virtual banks can maintain services in an event of a cyber-attack or electricity shut down. Virtual banks are particularly vulnerable to external attacks. Therefore, there is an added meaning of prudential standards.

3. *Consumer Protection Measures*

Regulations should prioritize consumer protection by mandating the transparent disclosure of terms and conditions, fair treatment of customers, online mechanisms for resolving disputes, as well as the need fora contingency plan for business continuity. Virtual banks should be required to implement robust customer authentication processes and safeguards to protect customer data and privacy. Training should be provided to clients to equip them with data and technology literacy. Also, a dispute resolution mechanism is a critical issue as customers would be forced to raise their disputes through "typing", and it can become more difficult for clients to collect evidence of disputes as all statements are presented online. Specific measures should be taken to ensure customers are aware of how to escalate their complaints given the change of communication

methods – for example, the change from face-to-face communications to the use of a chatbot.

4. *Risk Management Guidelines*

Virtual banks should be equipped with comprehensive risk management guidelines that address technological risks, cyber threats, operational vulnerabilities, and business continuity planning. These guidelines should also encompass anti-money laundering and counter-terrorism financing measures. The focus is no longer on capital adequacy because a virtual bank can could easily be disrupted due to issues with their supplier's technology. An analogy is a power company providing electricity to banks, with the requirement from a government to provide back-up power in case of disruption. Such requirements become very difficult when the technology supplier is not governed in the same jurisdiction – global collective efforts become essential.

5. *Data Privacy and Cybersecurity*

Regulations must carefully address the specific data privacy and cybersecurity risks associated with virtual banking. Virtual banks should be required to implement robust data protection measures, encryption protocols, intrusion detection systems, and incident response plans to safeguard customer information and prevent unauthorized access. The real risk is associated with difficulties in enforcement because of cross-jurisdictional issues, which equally call for collective efforts to be made to ensure that common standards and enforcement mechanisms are applied globally.

The findings from the focus group study and expert interviews provide valuable insights into the perceptions and experiences of individuals regarding virtual banking and shed light on the regulatory landscapes in this domain. The identified themes of the regulatory landscape specific to virtual banking are the backbone of building trust and confidence for a virtual-only platform, as disrupted by the transformative potential of virtual banking, the criticality of effective risk management practices, and the significance of collaboration and partnerships:

"Why bother with a virtual-only bank? Because the banking industry as a whole is transitioning towards virtual operations, and it is foreseeable that eventually all

banks will become virtual banks. It is only logical that all banks should be subject to the same regulatory requirements, as virtual banks currently face similar business restrictions. Ensuring a level playing field in terms of regulatory compliance is essential for fair competition and the overall development of the banking sector."[35]

Nevertheless, many of the aforementioned attributes are common to both virtual and traditional banks. The key issue lies in the lack of recourse when errors occur, which applies to both types of institutions. Consequently, comparable regulatory frameworks are also applicable to traditional banks, as previously discussed. The primary distinction arises from the virtual-only nature of neobanks (otherwise known as digital-only banks), where a physical presence is either prohibited or not required. Thus, a more comprehensive examination of the licensing framework is necessary.

Consider a scenario in which a traditional bank experiences a computer system malfunction. In such cases, clients have the option to visit a physical branch and inquire about their transactions. Banks typically maintain physical branches to accommodate these clients. However, in the case of virtual banks, where can clients turn to for assistance? The risk arises when all traditional banks transition to a virtual-only model, as the situation would be disastrous if there is no specific resolution process in place to address issues arising from reliance on third-party software and devices. It is commonly predicted that virtual banking will become the norm, as all banks ultimately aim to establish a virtual or virtual-only presence, enabling broader client outreach at minimal costs. To maintain the trust and confidence that have traditionally been fostered through physical presence, regulators should adopt a forward-looking approach and undergo reform to account for the technology-driven elements inherent in this banking channel.

V. WHAT IS NEXT?

The rapid proliferation of online financial services and activities has heightened the importance of the underlying internet infrastructure for the stability and

[35] Interview, *supra* note 38.

functioning of the financial system. As Arner, Buckley, and Zetzsche (2018) observe, the growing digitalization of finance has rendered the accessibility and reliability of critical financial websites and online platforms a key operational and systemic risk consideration for regulators.[36] This dynamic necessitates a more coordinated approach to governing the availability of internet and website domains used for core financial functions.

Financial authorities should seek to establish a regulatory partnership with internet governance bodies and domain name registrars, as advocated by Dempsey (2020).[37] Such a partnership could involve setting guidelines for the prioritization and protection of domains vital to financial stability, as well as streamlined procedures for resolving outages or ownership disputes that could disrupt financial activities. Collaborated efforts of this nature, drawing on the technical expertise of internet organizations and the regulatory purview of financial authorities, will be essential for mitigating the operational and systemic risks posed by potential failures or disruptions to critical online financial infrastructure.

By taking a proactive role in this domain, policymakers can help fortify the resilience of the digital financial ecosystem. Establishing this type of regulatory partnership should be a priority for financial regulators in the years ahead.

A CRITICAL ANALYSIS OF SEBI'S CRACKDOWN ON 'GAMIFICATION' OF STOCK TRADING: A CONSERVATIVE MOVE?

*Kartavya Rajput**

ABSTRACT

The growing popularity of fantasy stock gaming platforms has raised significant regulatory concerns for SEBI. These platforms, while providing a risk-free environment for users to engage

[36] Arner, D. et al., *FinTech, RegTech, and the Reconceptualization of Financial Regulation*, 37(3) NORTHWESTERN J. INT'L L. & BUS. 371-413 (2018).

[37] Dempsey, J., *Stabilizing the Internet's Domain Name and Addressing System: An International Public-Private Partnership Approach*, 21(1) GEORGETOWN J. INT'L AFF. 92-101 (2020).

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in trading, also pose risks by potentially creating unregulated markets and fostering unrealistic trading behaviours. To deal with these concerns, SEBI issued a circular on May 24, 2024, prohibiting the sharing of real-time stock price data with these platforms. In this paper, the author aims to critically examine this circular and its impact on fantasy stock gaming platforms. Apart from this circular, the paper also highlights the efforts of SEBI and stock exchanges to restrain the operation of these platforms. Although the author acknowledges the positive steps of SEBI to protect the investors' interests, he also underlines the potential drawbacks of the circular, including the hindrance to investor education and the creation of regulatory ambiguities. The objective of this paper is to evaluate SEBI's move and suggest improvements for a more nuanced and balanced regulatory framework. In conclusion, the author has recommended focusing more on "regulating" these platforms to ensure responsible and ethical gaming rather than adopting conservative measures to stifle the operation of these platforms. In this way, the educational value of these platforms will be effectively utilized by the users and regulation of these platforms by SEBI will ensure investor protection as well.

Keywords: Real-Time Price Market Data, Fantasy Stock Gaming Platforms, Virtual Stock Trading, Investor Protection, Investor Education.

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I. INTRODUCTION

Everyone has a fantasy that they invest in stocks, and it gets doubled or tripled, and they make a large amount of money. But the stock market is not a clear one-way path; it is a roller coaster ride where financial thrill becomes a nightmare in no time. One trades in stocks hoping that they will soar in a few days, but when they plummet, the investor suffers a huge loss. The whole world of stock trading is labyrinthine. In such a complicated world, fantasy stock gaming platforms allow people to test all their marketing strategies with negligible financial risk. In other words, the "fantasy" of making money with stock trading without fear of losing money has become possible to achieve with fantasy stock gaming platforms where they get financial rewards for predicting the rise or fall of 'virtual stocks.'

These virtual trading platforms use real-time stock market data, such that the performance of virtual stocks mirrors the price fluctuations of the actual stocks on the real stock exchange. Such stock gaming platforms like Indian Trading League, Threedots, Bullspree, etc., are in trend in India and attract an astronomical number of users. The predominant issue with the functioning of these platforms is that they instil reckless behaviour in the investors as they start equating their virtual success with their prowess in real market trading. Moreover, one more major concern is that these platforms may establish parallel unregulated stock exchange markets where investor protection is compromised.

Recently, on 24th May 2024, the Securities and Exchange Board of India ("**SEBI**") issued a circular titled "*Norms for Sharing of Real-Time Price Data to Third Parties*" ("**the Circular**").[1] The circular spells a death knell on fantasy stock gaming platforms, restricting their access to real-time market data, which was their basis for generating large wealth of money. This circular was passed against the backdrop of several attempts from SEBI, NSE, BSE, etc., to stop the operation of fantasy stock gaming platforms. In this paper, the author will critically analyse

[1] SEC. & EXCH. BD. OF IND., NORMS FOR SHARING OF REAL-TIME PRICE DATA TO THIRD PARTIES, CIRCULAR NO. SEBI/HO/MRD/MRD-POD-3/P/CIR/2024/56 (2024), https://www.sebi.gov.in/legal/circulars/may-2024/norms-for-sharing-of-real-time-price-data-to-third-parties_83572.html.

the SEBI's measures to ban such platforms and underline problems emanating from such steps. Subsequently, the author will attempt to suggest solutions to deal with challenges and eliminate inherent loopholes in the framework.

This paper is divided into "***eight***" parts, including this introduction. Part II explains how virtual trading platforms are a problem for SEBI. Part III delves into the circular and describes what it entails. Part IV sheds light on the history of SEBI's steps against the virtual stock trading platforms. Part V appreciates and welcomes the move of SEBI to protect the interests of investors. Part VI highlights the ramifications of the measures taken by SEBI and discusses uncertainties in the existing framework of SEBI. Part VII explores solutions to deal with the challenges. Part VIII finally concludes the discussion on the contemporary issue and suggests some possible steps that SEBI can undertake to resolve the imminent concerns.

II. WHY VIRTUAL TRADING OF STOCKS IS A PROBLEM? - LOOKING FROM SEBI'S LENS

In virtual stock trading platforms, users can create virtual portfolios of stocks, and their performance depends on the actual performance of those stocks on the stock exchange. These platforms take a nominal entry fee and provide financial incentives to the winners of the contest. The prizes for the winners are so lucrative that they have the ability to attract users to trade in 'virtual stocks' and create disinterest in trading in actual stocks because of the sheer difference in the element of financial risk. The only loss that users will bear while playing on these fantasy platforms is their nominal entry fee. On the other hand, in the actual stock market, an investor loses not only real money invested but also broker's fees, stock exchange fees, etc.[2]

SEBI compared these activities to "*dabba trading*",[3] an illegal practice where orders are placed through unauthorised channels. In this system, trades are

[2] Reena Zachariah, *Sebi Cracks Down on Gaming Apps Involved in Virtual Trading*, ECON. TIMES (May 27, 2024) https://economictimes.indiatimes.com/markets/stocks/news/sebi-cracks-down-on-gaming-apps-involved-in-virtual-trading/articleshow/110448870.cms?from=mdr.

[3] Chakraborty, *Behind Closed Doors: Exploring Illegal Dabba Trading*, INVENTIVA (June 2, 2024) https://www.inventiva.co.in/stories/behind-closed-doors-exploring-illegal-dabba-trading-and-sebis-regulatory-crackdown/.

executed based on the prices of stocks or commodities without actually placing the trades on an official stock exchange. Herein, the trades do not take place in actual stocks. Rather, such trading is a form of betting where the client bets on the price movements of stocks or commodities. This practice is illegal in India as it creates a parallel unregulated stock market.[4]

Similarly, virtual stock trading platforms that offer financial incentives and use real-time stock price data potentially create a parallel unregulated stock market. These platforms simulate a real market trading environment without oversight, posing great risks to investors and challenging the regulatory framework. Stock exchange earns money from sharing stock price data, but the unregulated use of such data in virtual stock gaming platforms jeopardizes the investors' interests and compromises their protection.

Moreover, players develop unrealistic expectations and a misleading sense of confidence in their trading abilities based on their virtual success, which pushes them to engage in risky behaviour in the actual trading, underestimating the financial risk involved there.

Some of these platforms run for free without involving any financial incentives. When monetary incentives are not involved, such activities don't remain an issue ethically, financially, and legally. Rather, they are effective ways of educating investors about the stock market, and 'learning by doing' is the best way to learn. We will adequately discuss this in the later parts where it has been underscored that the role of stock gaming platforms for educational purposes has been casually ignored by SEBI.

III. THE "CIRCULAR"

SEBI intends to curb the speculative use of real-time data and foster market integrity, stability, and investor confidence, and protection. Along these lines, SEBI issued a circular dated May 24, 2024, to curb the misuse or unauthorized use of real-time price data. In order to do so, SEBI restricted the sharing of this data with third parties, including various platforms. In the circular, the platforms

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[4] Malhi, Gupta & Pandey, *Analysing Fantasy Stock Gaming Regime from SEBI's Lens*, MONDAQ (July 15, 2024) https://www.mondaq.com/india/gaming/1492414/analysing-fantasy-stock-gaming-regime-from-sebis-lens.

that are referred to are online gaming platforms, apps, websites, etc., that provide virtual trading services or fantasy games, which are based on the movement of real-time share prices of listed companies. Also, the platforms that offer monetary incentives based on the performance of virtual stock portfolios are specifically targeted by SEBI through this circular.

The SEBI issued this circular in the exercise of the powers conferred under Section 11(1) of the SEBI Act, 1992[5] read with Regulation 51 of the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018[6], Section 26(3) of the Depositories Act, 1996[7] and Regulation 97 of SEBI (Depositories and Participants) Regulations, 2018[8] to protect the interests of investors in securities and to promote the development of, and to regulate the securities market. To serve this purpose, the SEBI instituted the following regulations through this circular[9]:

i. It directed market infrastructure institutions ("**MIIs**"), including stock changes, clearing corporations and depositories, and registered market intermediaries to, not to share real-time price data with third party, except where sharing of such information is required for the orderly functioning of securities market or for fulfilling regulatory requirements.

ii. It imposed a condition on MIIs or market intermediaries to enter into agreements with entities with whom they share real-time price data, stipulating the activities for which the data will be used and justifying that it is required for the orderly functioning of the securities market. These agreements must contain provisions to prevent any kind of misuse of the data by the entities.

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[5] The Securities and Exchange Board of India Act, No. 15 of 1992, §11(1) (Ind.).
[6] Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, No. SEBI/LAD-NRO/GN/2018/38 of 2018, §51 (Ind.).
[7] The Depositories Act, No. 22 of 1996, § 26(3) (Ind.).
[8] Securities and Exchange Board of India (Depositories and Participants) Regulations, No. SEBI/LAD-NRO/GN/2018/40 of 2018, §97 (Ind.).
[9] Securities & Exchange Board of India, Norms for Sharing of Real-Time Price Data to Third Parties, Circular SEBI/HO/MRD/MRD-PoD-3/P/CIR/2024/56 (May 24, 2024).

iii. It also required a review of such entities and activities for which such data is shared by the Board of MIIs or market intermediaries at least once in a financial year.

iv. It allowed the market price data to be shared for investor education and awareness activities without offering any kind of monetary incentive to participants. But this data will not be real-time. It will be one day old.

v. It created an obligation upon the MIIs and market intermediaries to conduct proper due diligence while sharing such data.

Through this circular, SEBI has negated the viability of the existing business models of fantasy stock gaming platforms that are premised on using real-time market price data. Subsequent to this circular, many such platforms are forced to shut their operations or reconsider their business models to become more investor-education or awareness-oriented.[10]For example, Kunal Shah-backed Trinkerr paused its gaming product to contemplate the next course of action. And, Dream sports-backed Investro has been discontinued.[11]

IV. HISTORY OF SEBI'S ATTEMPTS TO BAN FANTASY STOCK GAMING PLATFORMS

The circular has not been the first incident where SEBI has gone after these platforms. Also, this decision has not come out abruptly. In 2016, SEBI tried to ban these virtual platforms for good. One of the most notorious celebrities, Mr. Raj Kundra, Shilpa Shetty's husband, was the man behind this as well. He was the owner of 'Stock Race,' where contestants chose a stock, currency, or commodity and predicted the rise or fall in the price over the next 60 seconds. The winners get prizes ranging from silver coins to cars. Apart from Kundra's 'Stock Race,' there was the 'Indian Trading League,' which has been in this field for quite a long time. Kapil Dev, the 1983 World Cup Winning Cricket Captain, was the brand

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[10] Taxmann, *SEBI Cracks Down on Real-Time Price Data Misuse*, TAXMANN.COM (May 28, 2024) https://www.taxmann.com/research/company-and-sebi/top-story/105010000000024018/sebi-cracks-down-on-real-time-price-data-misuse-new-guidelines-unveiled-experts-opinion.

[11] Naina Sood, *SEBI Circular Rings Death Knell as Many Stock Gaming Apps Shut Down*, MONEY CONTROL (July 10, 2024) http://www.moneycontrol.com/technology/sebi-circular-rings-death-knell-as-many-stock-gaming-apps-shut-down-others-rethink-business-models-article-12760314.html.

ambassador of the game. Moreover, there were separate leagues for commodities, women, and even students, which were run by SAMCO, a share and commodities brokerage.[12]

In 2016, SEBI held itself back from completely banning such platforms but issued a cautious warning dated August 30, 2016[13], to investors that participating in such stock market games would be at the investor's own risk, cost, and consequences as they are neither approved nor endorsed by SEBI/ SEBI recognized exchanges. SEBI also pointed out that in case of any kind of disputes arising from this, the following recourses will not be available to the investor:

i. Benefits of investor protection under SEBI/ Exchange (s) Jurisdiction

ii. Exchange dispute resolution mechanism

iii. Investor grievance redressal mechanism administered by exchanges.

Further, on October 07, 2016, SEBI issued a consultation paper proposing amendments/ clarifications to SEBI (Investment Advisers) Regulations, 2013 ("IA Regulations").[14] It is re-emphasized here that such schemes/ competitions/ games/ leagues, etc., were not endorsed or approved by SEBI, and no recourse is available to investors from SEBI if there is any loss incurred by investors in these competitions. In order to protect the interest of investors, it was proposed in the consultation paper that such schemes/ competitions/ games/ leagues are not organized at all; but these proposals were not effectuated.

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[12] Finshots, *SEBI's crackdown on fantasy stock gaming explained*, FINSHOTS (May 28, 2024) https://finshots.in/archive/sebi-crackdown-fantasy-stock-gaming-virtual-trading-explained/.

[13] SEC. & EXCH. BD. OF INDIA, SEBI CAUTIONS INVESTORS, PR NO. 137/2016 (2016), https://www.sebi.gov.in/media/press-releases/aug-2016/sebi-cautions-investors_33094.html#:~:text=Aug%2030%2C%202016&text=It%20has%20come%20to%20the,involve%20distribution%20of%20prize%20monies.

[14] SEC. & EXCH. BD. OF INDIA, CONSULTATION PAPER ON AMENDMENTS/CLARIFICATIONS TO THE SEBI (INVESTMENT ADVISERS) REGULATIONS, 2013, 11 (2016), https://www.sebi.gov.in/reports-and-statistics/reports/oct-2016/consultation-paper-on-amendments-clarifications-to-the-sebi-investment-advisers-regulations-2013_33435.html.

Later, on November 16, 2016, NSE issued a revised Code of Advertisement for Stock Brokers[15] that was in partial modification of the circular dated August 12, 2016. Annexure III of this revised code provided that:

"In relation to any schemes/ leagues/ competitions, etc., launched by members or by any third party/ Group Company/ associate of the member, members are requested to ensure strict compliance with the following requirements:

a. Stock Broker or its associates/group company cannot directly or indirectly sponsor or be associated with any schemes/leagues/competition, etc., which may involve the distribution of monies/prizes/gifts/medals, etc.

b. No reference to the Stock broker's name, logo, etc., can be made in any schemes/leagues/competition, etc.

c. Stock Broker cannot share any information of their clients with a third party, even with the client's consent, in case schemes/leagues/competition, etc. any third party is involved in launching

d. Stock Broker cannot take any financial liability, including any contingent financial liability, on account of any schemes/leagues/competition, etc. launched by a third party."

The legality of these circulars was challenged in *SAMCO Securities Ltd. v. SEBI, 2017*[16], before Bombay HC for being violative of Article 19(1)(g) of the Constitution of India, which provides a right to carry on business, trade, or profession. SEBI argued that the massive rise in client base and turnover of SAMCO was on account of monetary incentives offered to clients for trading through SAMCO as its stockbroker. SEBI also argued that such schemes, rather than educating and promoting a habit of informed decision making, drive the investors to make rash, reckless and risky decisions to maximize their profits and to win the monetary reward. The court held that circulars do not have any bearing on the primary business of SAMCO, which is to carry on stock-broking activities and not promote or participate in leagues or competitions, and the guidelines that are issued were to achieve the object that investors are not misguided and lured

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[15] NAT'L STOCK EXCH. OF INDIA LTD., REVISED CODE OF ADVERTISEMENT FOR STOCK BROKERS, Circular Ref. No. 291/2016, Annex. III (Nov. 16, 2016), https://www.nseindia.com/trade/members-code-of-advertisement.

[16] SAMCO Securities Ltd. v. SEBI, (2018) SCC OnLine Bom 2784 (Ind.).

into trading on the pretext of receiving monetary incentives from the brokers. It is for these reasons the court held that circulars were not violative of Article 19(1)(g). The court further opined that even if, for the sake of argument, it is assumed that Article 19(1)(g) is being violated, the circulars still fall under the protection of reasonable restrictions that are imposed in the interest of the general public.

Moreover, NSE has taken several steps in relation to the sharing of stock market data:

1. As per para 8.4 of the Data Usage and Data Sharing Policy of NSE, it prohibited the sharing of market data to individuals/ entities engaging in gaming, virtual trading, or an activity of a similar nature.[17]
2. In October 2022, NSE Data and Analytics Ltd., the data and info-vending arm of the NSE, issued 'cease and desist' notices[18] to six stock-gaming platforms to stop using its data for commercial purposes and even sought Rs 10 crores as damages for misuse of data, violation of IP rights, cost for loss of revenue and reputational loss. An NSE official said that the stock exchange has no issues sharing its data for educational purposes only, but many of these platforms are making money using this data via betting, gambling, prediction, creating pools, and so on.
3. On April 20, 2023, NSE issued a circular[19] prohibiting usage of its data for the purpose of gaming and virtual trading as it goes against the principles of fair and transparent trading.

[17] NAT'L STOCK EXCH. OF INDIA LTD., DATA USAGE AND DATA SHARING POLICY¶ 8.4, 6 (2024), https://nsearchives.nseindia.com/web/sites/default/files/inline-files/NSE_DataUsageandSharingPolicy.pdf.
[18] Kapil Marwaha, *NSE Cease and Desist Order for Stock Gaming Apps*, TRUE DATA (Nov. 17, 2022) https://www.truedata.in/blog/nse-cease-and-desist-order-for-stock-gaming-apps.
[19] NAT'L STOCK EXCH. OF INDIA LTD., USAGE OF NSE DATA ONLY FOR TRADING PURPOSE, Circular Ref. No. 35/2023 (2023), https://archives.nseindia.com/content/circulars/COMP56426.pdf.

As we now know the complete backdrop of the latest circular of SEBI that restricted the sharing of market data to stock gaming platforms, it is imperative to analyse the circular and explore its upsides and downsides.

V. POSITIVES OF THE MOVE

Indeed, the step of the SEBI to curb the sharing of real-time market data is commendable as it was aimed at protecting investors from unregulated stock market platforms. These platforms have the ability to sideline the actual regulated stock market and attract investors because of their risk-free environment. Regulated trading and investing in the stock market serves an essential economic purpose in the capital and commodities markets. Apart from not serving this vital economic purpose, these platforms function on a completely non-transparent and unethical basis that detriments the investors' interests.

As these platforms are completely unregulated, they do not provide sufficient disclaimers to the users that success in their virtual platforms would not ensure their success in the actual stock trading market and, thus, play responsibly and don't try to replicate risky investment behaviour in the actual securities market.

Undoubtedly, by this move, the SEBI has ensured investor protection and promoted market integrity and stability. However, it failed to contemplate the other challenges associated with this grey area where these stock gaming platforms operate. Moreover, there are several ramifications of this circular, which were not properly deliberated by SEBI. In the next part, the author has underlined such shortcomings in the circular and how SEBI has digressed from its role as a regulator and has adopted a conservative approach to blanketly ban the sharing of real-time market data with third parties without considering their impact on investor education.

VI. SHORTCOMINGS IN THE EXISTING FRAMEWORK OF SEBI

A. NOTHING ON LEGALITY- STILL A GREY AREA

Despite curtailing access to stock market data, the legality of stock market games has been clouded in uncertainty. Being unregulated does not mean they are illegal. However, by the recent circular it can be concluded that virtual trading

platforms can't use real-time market data now. Thus, practically their operation has been banned consequent to this circular. Still, such platforms can operate if they switch to purely educational purposes.

Fantasy stock gaming platforms operate in a legally grey area as they may fall within the definition of derivatives under the Securities Contracts (Regulation) Act, 1956 ("***SCRA***"). The definition of securities under section 2(h)(ia)[20] includes a derivative. Section 2(ac) of the SCRA[21] defines a derivative to include, *inter alia*, "*a contract which derives its value from the prices or index of prices of underlying securities*." Moreover, as per Section 18A of SCRA,[22] contracts in derivatives are legal and valid if such contracts are traded on a recognised stock exchange.

Fantasy stock gaming is also a contract in derivatives between the owners of the platforms and subscribers of the platforms. This contract derives its value from the prices of the actual securities in the stock exchange. The owners earn money from the entry fee charged by the users, and users get winning prizes from the organizers, and their earnings are dependent on the prices of stocks. These are contracts in derivatives, but their legality is questionable as they are not traded on a recognised stock exchange. Furthermore, SEBI's notification No. LAD-NRO/GN/2013-14/26/6667 dated October 3, 2013[23], prohibits persons from entering into "*contract[s] for sale or purchase of [derivatives]*" without SEBI's permission, except for, *inter alia*, derivative contracts permissible under the SCRA.

Notably, the financial exchange between the parties is important to qualify as derivative contracts. If such platforms do not charge entry fees and do not offer monetary incentives, they would not constitute derivative contracts.

Thus, direct clarity on the legality of the operation of fantasy stock gaming platforms is required from the side of SEBI. It should clarify whether only fantasy stock gaming platforms that offer monetary incentives are banned and not the ones that do not offer monetary incentives. The real-time access to market data

[20] The Securities Contracts (Regulation) Act, No. 42 of 1956, § 2(h)(ia) (Ind.).
[21] The Securities Contracts (Regulation) Act, No. 42 of 1956, § 2(ac) (Ind.).
[22] The Securities Contracts (Regulation) Act, No. 42 of 1956, § 18A (Ind.).
[23] SECURITIES AND EXCHANGE BD. OF INDIA, Notification under sections 16 and 28 of Securities Contracts (Regulation) Act, 1956, pt. III sec. 4, No. LAD-NRO/GN/2013-14/26/6667 (2013), https://www.sebi.gov.in/sebi_data/attachdocs/1380791858733.pdf.

has been curbed, and the sharing of market data in general has been tightened. Thus, these platforms have only one option, that is, to switch to investor education to remain compliant with security laws. But all this is tantamount to spelling an indirect death knell to all these platforms. Some clarity on the legal standing of these platforms is much needed from the side of SEBI.

B. INVESTOR PROTECTION V. INVESTOR EDUCATION

As per Section 11(2)(f) of the SEBI Act, 1992[24], promoting investors' education is one of the essential duties or functions of SEBI. So as to ensure investor protection, SEBI has ignored its other important function, which is to promote investor education.

The circular provides for data to be shared with the third party with a delay of one day for educational purposes. It failed to foresee that the pattern of stock prices for the previous day would already be out and known to the people, and they wouldn't be able to test their investing skills. This will essentially defeat the purpose of these education platforms.[25]

Many of these fantasy stock games are the best way to learn by practicing in a risk-free environment. Not only has this circular rendered it meaningless,[26] but it also has added hurdles to the obtaining of even historical data easily. The circular has created a heavy compliance burden on MIIs and market intermediaries to share these data, which includes conducting due diligence and executing agreements with the recipients of the data, mentioning the activities for which it will be used, and justifying that it is required for the orderly functioning of the security market, timely review of the list of recipients by the board of MIIs and intermediaries. The educational platforms will be subjected to a higher matrix of scrutiny and intervention by the intermediaries. Thus, their ability to serve as valuable learning tools will be significantly undermined.

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[24] The Securities and Exchange Board of India Act, No. 15 of 1992, §11(2)(f) (Ind.).

[25] Ashutosh Shukla, *SEBI's Crackdown on Fantasy Stock Trading Apps: Implications and Future Prospects,* THE COMPETITION AND COMM. L. REV. (June 26, 2024) https://www.tcclr.com/post/sebi-s-crackdown-on-fantasy-stock-trading-apps-implications-and-future-prospects.

[26] Akshata Gorde, *Fantasy Gaming Crackdown May Make Things Tricky For Education Platforms,* FIN. EXPRESS (May 30, 2024) https://www.financialexpress.com/jobs-career/education-fantasy-gaming-crackdown-may-make-things-tricky-for-education-platforms-3506346/.

C. A LACUNA- STOCK GAMING PLATFORMS WITHOUT MONETARY INCENTIVE AND WITHOUT ANY EDUCATIONAL VALUE

There are many fantasy stock games, like Moneybhai, that run for free, do not offer monetary incentives, and are not specifically run for educational purposes. It is not clear, whether SEBI really wants to target such platforms as well through its circular or not. Purely educational platforms get the data with a one-day delay. But what about platforms like Moneybhai? It seems that the circular has pushed even non-monetary platforms into the ambit of the ban.[27]

VII. RECOMMENDATIONS

A. PROPER REGULATION INSTEAD OF BANNING

SEBI's concerns regarding fantasy stock trading platforms stem from issues related to transparency, investor protection, and the potential to create an unregulated parallel market. Instead of banning these platforms outright, SEBI could have considered implementing a more nuanced regulatory framework. This approach would include stricter disclosure requirements, transparency mandates, and controls over the platforms' operational conduct, similar to those imposed on traditional stockbrokers.[28]

For instance, SEBI could require these platforms to run constant disclaimers warning users about the risks of translating simulated trading success into real-world trading. This would address concerns about investors being misled into thinking that their performance in fantasy trading reflects actual trading skills. Moreover, SEBI could impose limits on how much users can spend or the amount of time they spend on these platforms, similar to responsible gaming guidelines used in other industries. These measures would ensure that these platforms do not overshadow actual stock markets or create a risky, unregulated market environment.

[27] Outlook Business Desk, *Explained: Why SEBI is Banning Gaming Apps Involved in Virtual Trading,* OUTLOOK BUSINESS (May 30, 2024) https://www.outlookbusiness.com/markets/explained-why-sebi-is-banning-gaming-apps-involved-in-virtual-trading.

[28] Arora and Kashish Khandelwal, *SEBI's Bar on Sharing Live Stock Market Data: Implications for Virtual Trading Apps,* TRILEGAL LEXOLOGY (June 12, 2024), https://www.lexology.com/library/detail.aspx?g=11e3e81b-186e-4d91-b6b5-48b5deb2731e.

Furthermore, while these platforms might not have the resources to be regulated on the same level as larger financial institutions, SEBI could establish a tiered regulatory system similar to the one created by the Ministry of Electronics and Information Technology ("**MeitY"**) for online gaming platforms.[29] Such a system would allow these platforms to continue operating while still contributing to SEBI's regulatory oversight through fees or other charges, thus ensuring a balanced approach between innovation and regulation.

This balanced approach could also draw from international practices, such as those in Hong Kong, where similar platforms are regulated in a way that promotes investor education while safeguarding market integrity. However, SEBI's current stance, particularly its restrictions on real-time data access for these platforms, may hinder their ability to provide meaningful educational value and could lead to a decline in their utility for users.

B. STOCK GAMING PLATFORMS REGISTERED WITH THE STOCK EXCHANGE

Similar to the stock exchange of Hong Kong, the stock exchanges of India, NSE, or BSE may organize these games themselves on platforms authorized by them. This way, the misuse of real-time price market data will be prevented, and also, the purpose of investor education will be preserved. Even SEBI may launch a fantasy gaming app similar to Saa₹thi 2.0 or install a gaming feature in this app only.[30]

In Australia, too, such platforms can function only through the authorization of the Australian Securities and Investments Commission ("***ASIC***"). Similar requirements can be transposed in India, and the operation of fantasy stock gaming platforms must be allowed only with the authorization of SEBI. A complete ban should not be imposed on such platforms because they are one of the best means of investor education.[31]

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[29] The Information Technology (Intermediary Guidelines and Digital Media Ethics Code) Rules, 2021, Gazette of India, Extra., Pt. II, Sec. 3(i) (Feb. 25, 2021).

[30] Garv Arora, *Regulating the Stock Game: SEBI's Norms for Fantasy Trading Platforms,* INDIA CORP LAW (July 06, 2024) https://indiacorplaw.in/2024/07/regulating-the-stock-game-sebis-norms-for-fantasy-trading-platforms.html.

[31] *Id.*

C. CLARITY ON LEGALITY OF FANTASY STOCK GAMING PLATFORMS AS US

Section 1a (47) of the US Commodity Exchange Act[32] defines swap, inter alia, as any agreement or contract that provides for any sale, purchase, or payment that is dependent on the occurrence or non-occurrence of an event associated with a potential financial, or commercial consequence.[33]The US Securities and Exchange Commission ("***US SEC***"), in the matter of Forcerank LLC,[34] held a platform allowing users to rank stocks based on their predicted performance upon payment of a fee and promising financial rewards to the top ranks as a "swap" transaction based on security. Since, the platform offered and sold swaps to each player in each game without carrying out these transactions on a national stock exchange, such transaction was held to be violative of securities law.

Moreover, in the case of "*Stock Battle*,"[35] a fantasy stock gaming platform using real-time market data and offering monetary incentives to users, was sent a cease-and-desist order by the US SEC for they were dealing in unregulated security-based swaps. It was given the option to get registered with the recognized stock exchange, but it didn't have enough funds and, thus, opted to rather shut down its operations.

Section 18A of SCRA, 1956,[36] also makes the dealing in derivative contracts as legal and valid when they are traded on a recognised stock exchange. However, SEBI has not recognised the contracts between such platforms and users as contracts in derivates. Thus, fantasy stock games do not have an option to get registered with the stock exchange, unlike the USA.

VIII. CONCLUSION

[32] Commodity Exchange Act of 2022, § 1 a (47), 42 Stat. 998, §23 (2022).
[33] Aamir Kapadia & Shivam Yadav, *A Critical Analysis of SEBI's Crackdown on Fantasy Trading*, INDIA CORP LAW (July 04, 2024) https://indiacorplaw.in/2024/07/a-critical-analysis-of-sebis-crackdown-on-fantasy-trading.html#:~:text=On%2027%20May%202024%2C%20the,entities%20(primarily%20fantasy%20stock%20gaming.
[34] In the Matter of Forcerank LLC, Securities and Exchange Commission, USA, File No. 3-17625 (October 13, 2016) https://www.sec.gov/files/litigation/admin/2016/33-10232.pdf.
[35] *Supra*, at Note 30.
[36] The Securities Contracts (Regulation) Act, No. 42 of 1956, § 18A (Ind.).

SEBI's recent circular restricting the sharing of market data with fantasy stock gaming platforms is a welcome move as it intends to protect the interests of the investor. Even though, the purpose of SEBI was laudable, the approach was too much conservative and cautious. Instead of direct banning of these fantasy stock gaming platforms, an option oriented towards regulation of these platforms should have been explored by SEBI. Many of these platforms entail educational value, and thus, intending to shut down all such platforms would not be the best measure. Firstly, educational platforms will lose their viability if the data is shared with them with a lag of one day. Secondly, virtual trading on platforms is the most practical and effective way of learning by doing. Therefore, a complete crackdown on the operations of stock gaming platforms is an extreme step taken by SEBI. Furthermore, despite this crackdown on stock gaming platforms, their legality has not been addressed by SEBI, and they are still operating in a legally uncertain territory.

A more nuanced regulatory framework could balance the need for investor protection with the benefits of investor education. Additionally, taking cues from other jurisdictions, such as the regulation of fantasy stock trading platforms by recognized stock exchanges, could be a viable solution to the conundrum.

To conclude, while SEBI's measures are a step towards addressing potential risks associated with fantasy stock gaming platforms, a more balanced and nuanced regulatory approach is required. SEBI can ensure that these platforms don't create a parallel market and encourage risky behaviour in investors by focusing on proper regulation of these platforms. This way, the educational value of these platforms will be effectively utilized. Moving forward, in this internet age, users are prudent enough not to misconstrue that virtual success will guarantee success in the real stock market as well. Nowadays, users engage in several fantasy games and hone their skills. Proper disclaimers are run on these platforms to ensure responsible gaming. Thus, ensuring "responsible gaming" and operating such games on the clear authorization of and registration with the stock exchange should be the focus of SEBI rather than banning fantasy stock platforms, fearing that it will lead to the development of a parallel unregulated stock market.

AN EXAMINATION OF LEGAL ADEQUACY AND THE RIPPLE EFFECT OF INVESTIGATIONS INTO FRONT-RUNNING WITHIN ASSET MANAGEMENT COMPANIES

Andrea Vanspall and Zareen Fatima[*]

ABSTRACT

Asset Management Companies occupy a pivotal role in a state's economy, driving market mobility and diverse investments. Their primary operation lies in the management of mutual funds and occupies an intermediary role between investors and the market. Such a fiduciary relationship aims to enrich the investor with diversified investments, expert opinions, and strategic market interactions. The Securities and Exchange Board of India (Mutual Funds) Regulations 2003 serves as the father law for establishing a code of conduct for the AMCs and trustees. However, the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 prevails if the Code of Conduct is broken. Predictably, mutual fund managers engage in 'front-running' resulting in market abuse and the gain of illegal profits. Although the law does not explicitly deal with the offense of front-running, the regulatory framework drawn by SEBI enables the Court to determine liability in such cases. The problematic discontinuance in the legal framework to justify the penalty for front-running has resulted in several AMCs paying an intangible penalty before the ascertainment of its guilt for unfair trade practice. Effects of this concept appear to be amplified in the context of the loose interpretation of liability along with the chasm existing within the laws governing the same. This article deals with determining the efficiency of the legal framework for the prevention and punishment of front running and its adequacy against the backdrop of the non-statutory consequences faced by the AMCs.

Keywords: Front-Running, Asset Management Company, Over-penalisation, SEBI Regulations.

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I. LAW AS A DETERRENCE TOOL FOR FRONT-RUNNING

Asset Managers occupy a Fiduciary role for the investors entrusting them with their funds. This role is often tainted with unfair trade practices in securities, a trend emerging from the illegal utilisation of Unpublished Price-Sensitive Information ("**UPSI**"). More often than not, it is Front-running which is resorted to by trustees or Asset Managers. The said practice was first recognised in the Circular released on May 25th, 2012 for an amendment to the Consent order mechanism which defined front-running as the "*usage of non-public information for directly or indirectly, buying and selling securities or entering into future contracts in advance of a substantial order on an impeding transaction in the same or related securities in anticipation that when the information becomes public the price of such securities may change*[1]". Ironically, the concept of 'Front-running' has not been recognised in any unfair trade-related SEBI regulations.

Nevertheless, it does find itself an implied recognition under Regulation 4 (2) (q) of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003, ("**PFUTP Regulations**") which provides for instances of "*manipulative, fraudulent or unfair trade practice if it involves the order in securities by a person who may hold unpublished price sensitive information regarding a*

[1] Securities and Exchange Board of India, Circular CIR/EFD/1/2012 (May 25, 2012).

substantial impending transaction"[2]. Section 3 is a general provision that brings unfair trade practices in securities in contravention to the Act within its ambit[3]. In pursuance of identifying statutory deterrence to front running, the SEBI (Mutual Fund) Regulations, 1996, regulation 18 read with regulation 25 (22) (b) (ii) places a duty on the Asset Managers to ensure no undue advantage has been given to any associates working within the Asset Management Company ("**AMC**") in a manner that is detrimental to the interest of investors (unitholders).[4] A similar restriction is observed under Section 12 A (e) of the Securities and Exchange Board of India Act which reads, "that a person shall not deal in securities directly or indirectly while possessing non-public information".[5]

More specifically, SEBI had also introduced a Code of Conduct for the Fund Managers and Asset Management Company under Schedule V Part B of the Mutual Fund Regulations, 1996[6] wherein Dealers and Fund Managers shall:

"(a) always communicate in an unambiguous, transparent, accurate, and professional manner to promote effective communication that supports a transparent Market;

(b) conduct all communication during market hours through recorded modes and channels only."

However, the Amendment to the Circular for mandating additional disclosures by FPIs released by SEBI on August 1st, 2024[7] amends the Regulation to meet the relaxation requirements of the AMCs in removing the mandate to record face-to-face communications, including out-of-office interactions. Other mandates introduced included establishing confidential channels for employees, directors,

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[2] Securities and Exchange Board of India, Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market Regulations, 2003, Gazette of India, pt. III sec. 4, Reg. 4(2) (July 17, 2003).

[3] Securities and Exchange Board of India, Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market Regulations, 2003, Gazette of India, pt. III sec. 4, Reg. 3 (July 17, 2003).

[4] Securities and Exchange Board of India (Mutual Fund) Regulations, 1996, Gazette of India, Extraordinary, pt. III sec. 4, Reg. 18 & 25 sub-rule (22) cl. (b) (ii) (Dec. 9, 1996).

[5] Securities and Exchange Board of India Act, No. 15 of 1992, § 12 A cl. (e) (Ind.).

[6] Securities and Exchange Board of India (Mutual Funds) (Second Amendment) Regulations, 2019, Gazette of India, pt. III sec. 4, Reg. 2 (Sept. 23, 2020).

[7] Securities and Exchange Board of India, Amendment to Circular For Mandating Additional Disclosures By Fpis That Fulfil Certain Objective Criteria, Circular SEBI/HO/AFD/AFD-POD-2/P/CIR/2024/104 (Aug. 1, 2024).

trustees, and other stakeholders to raise concerns about suspected fraudulent, unfair, or unethical practices[8] and procedures to adequately protect whistle-blowers.

Another scheme for preventing market abuse is the SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023 ("**USTSM Regulations**") which fortifies the practice of unusual trading into defined terms. The regulations state a trading pattern of a single person or a group of connected persons shall also be deemed an Unusual Trading Pattern even if the activity appears normal in isolation since the same may project a pattern when analysed together with the trades of that person[9]. These regulations are yet to be notified post deliberate discussion and consultation with the AMCs.

II. THE QUANT - INVESTIGATION ONTHE PREMISE OF FRONT-RUNNING

The Quant Mutual Funds case highlights the ease of perpetration of the offense. Surveillance systems relied on by SEBI suspected cases of front-running. Executives of Quant were alleged to have knowledge of the impending transactions and to have used that information to make ill-gotten gains.

The transactions of front-running are usually carried out by the buy-buy-sell method, where the front runner buys the securities before the "buy" order of the client is placed, or the sell-sell-buy method, where the front runner sells the securities before the client. On discerning irregular patterns with Quant's transactions, SEBI investigated the premises of the AMC in Hyderabad and Mumbai and questioned the concerned) personnel.[10]

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[8] Securities and Exchange Board of India (Mutual Fund) Regulations, 1996, Gazette of India, Extraordinary, pt. III sec. 4, Reg 29 (Dec. 9, 1996).

[9] Securities And Exchange Board of India, CONSULTATION PAPER ON DRAFT SEBI (PROHIBITION OF UNEXPLAINED SUSPICIOUS TRADING ACTIVITIES IN THE SECURITIES MARKET) REGULATIONS, 2023, Reg. 2 cl. (j) (2023) https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-draft-sebi-prohibition-of-unexplained-suspicious-trading-activities-in-the-securities-market-regulations-2023_71385.html.

[10] *SEBI Raids Quant Mutual Fund HQ Amid Front-Running Allegations,* NEWS 18 (June 26, 2024) https://www.news18.com/business/sebi-raids-quant-mutual-fund-hq-amid-front-running-allegations-8945623.html.

In an attempt to placate the investors, the CEO of Quant has promised ardent commitment to comply with and assist the SEBI investigation. Initially, Quant commented that the investigation is routine in the mutual fund industry and merely an attempt by the regulator to collect and analyse data. The fund house, however, later communicated that the procedure was not part of a regular process but was carried out under a court order of search and seizure, which could presage a more pressing allegation of a serious nature.[11]

III. A SLEW OF FRONT-RUNNING CASES

SEBI investigations of suspected front running are not isolated in the field of mutual funds. In 2022, it launched an investigation into the trades of Axis Mutual Funds on being alerted of irregular transactions that did not fall in the ordinary course of trading on the stock market. The investigation involved searching premises and seizing electronic records, including WhatsApp messages. This uncovered a slew of illegal activities of numerous other entities and proceedings were initiated against them by SEBI. Subsequently, the inspection resulted in the banning of twenty such bodies from the securities market and a seizure of Rs. 30.55 crores.

In 2023, SEBI banned five people[12] from the securities market for front-running in the trades of Life Insurance Corporation of India from January to March of 2022. One of the five was an employee of the state-owned corporation and is suspected of having provided non-public information to carry out the offense. This enabled the market regulator to impound[13]

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[11] *Quant Mutual Fund Confirms Search-And-Seizure Ops, Says Sebi's Data Collection "Not Part of Regular Process*", MONEY CONTROL (July 13, 2024) https://www.moneycontrol.com/news/business/quant-mutual-fund-confirms-search-and-seizure-ops-says-sebis-data-collection-not-part-of-regular-process-12768321.html.

[12] Securities and Exchange Board of India, SECURITIES AND EXCHANGE BOARD OF INDIA CONFIRMATORY ORDER UNDER SECTIONS 11(1), 11(4), 11B AND 11D OF THE SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992 WTM/AN/ISD/ISD-SEC-2/30088/2023-24, (2024). https://www.lexsite.com/eDocs/WTM-AN-ISD-ISD-SEC-2-30088-2023-24.pdf.

[13] *LIC Issues Clarification on Employee's Role in Front-Running of Big Client's Trade*, BUSINESS TODAY (Mar. 20, 2024) https://www.businesstoday.in/markets/stocks/story/lic-issues-clarification-on-employees-role-in-front-running-of-big-clients-trade-422127-2024-03-20

Such frequent instances befalling the mutual funds market are a clear manifestation of faulty or lacking surveillance systems and robust whistleblower mechanisms in asset management companies.

IV. THE DOMINO EFFECT OF QUANT INVESTIGATION

Initiation of the probe has had little to no effect on the performance of the Assets,[14] however, apprehension among the investors was apparent. From June 24 to June 30 of 2024, clients withdrew Rs. 2,800 crores marking the first outflow of the year, a clear reflection of anxiety among the investors.[15] The amount constituted approximately 3 percent of the total Assets Under Management of the fund house. The five largest mutual funds offered by the fund house witnessed outflows following the allegations,[16] in tandem with the knee-jerk reaction expected by experts.[17]

Recognizing the Quant front-running fiasco as a clear case of misaligned incentives, SEBI has issued guidelines to detect market manipulations like front-running and insider trading. In 2020, SEBI issued stringent rules such as recording conversations of all forms between the fund manager, broker, and dealers during market hours, Bloomberg Terminals, submission of periodic declarations that no case of front running has occurred in the fund house in relation to any of the key personnel, director or trustee, etc, onerous on the fund house. Despite its austerity, SEBI opined that the rules majorly pertained to detecting defaulting employees without much accountability on the part of the fund house.

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[14] Surbhi Khanna, *Quant Mutual Fund Crisis: How NAVs Have Been Impacted Since Sebi Investigation*, ECON. TIMES (June 28, 2024) https://economictimes.indiatimes.com/mf/analysis/quant-mutual-fund-crisis-how-navs-have-been-impacted-since-sebi-investigation/articleshow/111335793.cms?from=mdr

[15] Shravani Sinha, *Quant Mutual Fund Sees Major Outflows Amidst Sebi Investigation; Raises Stake in Reliance, Cuts In LIC,* PERSONAL FINANCE (July 9, 2024) https://www.goodreturns.in/personal-finance/quant-mutual-fund-sees-major-outflows-amidst-sebi-investigation-raises-stake-in-reliance-cuts-in-lic-1356265.html

[16] Nishant Kumar, *Quant MF Sebi Probe: Can It Impact Fund Investors' Wealth? Here's What Experts Say*, LIVE MINT (June 24, 2024) https://www.livemint.com/market/stock-market-news/quant-mf-sebi-probe-can-it-impact-fund-investors-wealth-heres-what-experts-say-11719216350416.html.

[17] *Id.*

AMCs lobbied to relax the earlier mentioned mandate to record communications, and following the Quant case, SEBI mandated compensatory internal frameworks in exchange for allowing face-to-face calls not to be recorded. The new guidelines require the fund houses to integrate robust whistle-blower mechanisms and institutional frameworks to detect market abuse. Such systems will enable internal identification contrary to the current trend of SEBI's recognition of irregular or suspicious market trends.

The Circular dated 1st August 2024 stipulates the provisions to be implemented in the framework[18]. The standard of implementation of the guidelines will be stipulated by the Association of Mutual Funds in India and shall be binding on all AMCs. According to the guidelines:

- AMCs are required to have a surveillance system that records and alerts them of potential market abuse.
- The AMC is required to process available data of communications, following the alerts. If suspicious activity is detected, they must take suitable action and promptly escalate the matter to the Trustees and Board of Directors.
- Policies and procedures approved by their respective Boards of Directors must be in place to examine and act on potential cases of market abuse.
- It is mandated that all alerts are reported to SEBI, providing details on the procedure followed by the AMC to mitigate the alert.

Finally, the Chief Executive Officer, Managing Director, or any officer of similar rank, and the Compliance Officer will be accountable for its implementation. SEBI aims to expedite the implementation of these guidelines and has noted that certain AMCs are enroute to achieving execution before the premeditated deadline of six months. [19]

[18] Securities and Exchange Board of India, *supra* note 7.
[19] Shravani Sinha, *supra* note 16.

V. THE CHASM OF REGULATIONS GOVERNING FRONT-RUNNING

Front-running is undeniably an unethical and illegal offense of a serious nature. On the contrary, no Indian regulation recognizes the offence explicitly. Its essentials, however, were first observed under Regulation 6 (b) of The SEBI (Prohibition and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995[20]. This embarked on the beginning of the controversy surrounding the fixation of liability for this offense, the threshold limit of evidence required to prove the offence, and the inadequacy of the latest regulations relating to unusual trading practices.

A. AN EXPANSIVE INTERPRETATION OF 'INTERMEDIARY' AND ITS DANGEROUS REFLECTION IN THE FIXATION OF LIABILITY ON FRONT-RUNNERS.

The earlier regulation 6(b) of the SEBI PFUTP Regulations 1995, resorted to vague terms namely, '*a person*' and '*pending execution of any order of his client*' to refer to the practice of front-running. The provision only included brokers within its scope[21]. Nevertheless, the obligation bestowed on the trustees to submit a half-yearly certificate to SEBI declaring no instance of front-running had occurred in the hands of the AMC[22], gave an inferred understanding of front-running applying to persons apart from brokers within its scope.

The aforesaid inference was affirmed by Regulation 4 (2)(q) of the SEBI PFUTP Regulations, 2003 which introduced the term 'intermediary' and 'substantial impending order' of the clients for this practice to suffice as front running.[23] 'Intermediary' is defined as stock brokers, sub-brokers, share transfer

[20] The Securities and Exchange Board of India (Prohibition and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995, Gazette of India Extra-Ordinary, pt. III sec. 4, Reg. 6 cl. (b) (July 13 2003).
[21] The Securities and Exchange Board of India (Prohibition and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995, Gazette of India Extra-Ordinary, pt. III sec. 4, Reg. 6 cl. (b) (July 13 2003).
[22] Securities and Exchange Board of India (Mutual Fund) Regulations, 1996, Gazette of India, Extraordinary, pt. III sec. 4, Reg. 18 cl. 23 (Dec. 9, 1996).
[23] Securities and Exchange Board of India, Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market Regulations, 2003, *supra* note 2.

agents, bankers to an issue, trustees, registrars, merchant bankers, underwriters, portfolio managers, and Asset Management Companies[24]. In this spirit, the Securities Appellate Tribunal ("SAT") in *Shri Dipak Patel v. SEBI (2012)*[25]ruled prohibition of front running only when carried out by Intermediaries. The same observation was upheld in *SujitKarkera v. SEBI* (2013)[26].The literal interpretation of the Regulations lasted until the Securities Appellate Tribunal gave way to a liberal interpretation for fixing the liability under front-running by *Vibha Sharma v. SEBI (2013)*[27]verdict. SAT held that any person connected to the transaction of front-running regardless of its intermediary status may be punishable for the offence. The Supreme Court affirmed this fresh connotation in *SEBI vs. Shri Kanaiyalal Baldevbhai Patel* (2017)[28]of 'intermediary' under Regulation 4(2)(q) of SEBI Regulations by bifurcating the instances of front-running into 'Tippee Trading', 'Self-Front running', and 'Trading Ahead'. The specific practice of third-party trading based on unpublished personal sensitive information was recognised as tippee trading, thereby penalising the indulgence of a party apart from an intermediary.

The draft SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023 ("USTSM Regulations") fosters the aforementioned Apex Court judgment by fortifying unusual trading patterns in terms of bringing a group of persons whose transactions are unusual when analysed holistically, though, such transactions appear to be normal and ordinary when read in isolation, as mentioned earlier. Additionally, the regulations have terminated the need for repetitive unfair trading patterns to prove front-running and have replaced it with any transaction (even a single transaction) relating to unpublished information of the substantial securities order[29]. Therefore, the

[24] Securities and Exchange Board of India (Intermediaries) Regulations, 2008, Gazette of India Extraordinary, pt. III sec. 4, Reg. 2 (g) (May 26 2008).
[25] Dipak Patel v. Adjudicating Officer, Securities and Exchange Board of India, 2012 SCC OnLine SAT 217 (Reversed).
[26] Sujit Karkera v. Adjudicating Officer, Securities and Exchange Board of India, 2012 SCC OnLine SAT 234 (Reversed).
[27] Vibha Sharma v. Securities and Exchange Board of India, 2013 SCC OnLine SAT 66.
[28] SEBI v. Kanaiyalal Baldevbhai Patel, 2017, 15 SCC 1.
[29] SECURITIES AND EXCHANGE BOARD OF INDIA*, supra* note 9.

settled law has widened the scope of front-runners and decreased the threshold of evidence to prove the same.

The aforesaid discontinuity presented by the Regulations and judgments involves a liberalized interpretation of 'intermediary' against the backdrop of the serious penalty for such a grave offence. In this light, it seems incorrect for SEBI to rely on the principle of 'preponderance of probability'[30] to ascertain the evidentiary value of facts involved in the matter it investigates.

The consequences of mere initiation of an investigation into the affairs of Quant Mutual Funds as analysed earlier in this article, cannot be ignored. Therefore, apart from statutory penalties, the AMC and intermediaries suffer great losses once they are under the spotlight for alleged wrong-doings. Hence, a loose interpretation when fixing liability in front-running does more harm than good owing to its disproportionality with the penalties arising from the same.

B. THE CAVITY IN REGULATIONS FOR UNUSUAL TRADING PRACTICES, 2023.

It is worthwhile mentioning that the USTSM Regulations, 2023 were drafted in response to challenges faced by the Securities Board in investigating the matters of front-running. The backdrop of the draft largely blamed the tools of the digital era to evade the clenches of SEBI. Encrypted messaging apps namely, WhatsApp, BOTIM, Telegram etc which entail disappearing messages enabled the wrong-doers to erase the evidence. Interestingly, the USTSM Regulations do not fill the void created by the digital age in the investigation rather, SEBI deemed it ideal to loosely place liability on any third party to reduce the burden of evidence gathering on the part of the Board.

VI. GLOBAL STRATEGIES TO PREVENT FRONT-RUNNING.

A reflection of the global perspective is required at this juncture owing to the lacunae existing in the Indian Regulations. Certain developed countries with established trade practices, namely the United States, can provide a fresh

[30] SECURITIES AND EXCHANGE BOARD OF INDIA, *supra* note 9 at 2.2.

perspective on the issue. However, caution must be enacted in attempting to adopt foreign practices as one's own. The Indian market is unique to the country's economic demographic and undoubtedly, laws to govern the land must come from the land itself.

United States of America: The Securities and Exchange Commission ("SEC") in 1988 described front-running to the United States Congress as involving a trade of "stock, option, or future while in possession of non-public information regarding an imminent block transaction that is likely to affect the price of the stock, option, or future." Rightfully, the SEC classified the practice as violative of the integrity of the market. In the United States, the Securities and Exchange Commission has two requirements to establish a case of front-running.

Firstly, if the knowledge becomes public, and; *secondly*, if the information becomes obsolete. In both instances, it will no longer be considered a case of exploiting yet-to-be public information, thereby dissolving the charge of front-running altogether. [31]

Moreover, the Financial Industry Regulatory Authority is a Congress-approved not-for-profit organization that monitors dealers and brokers across America and ensure a fair playfield market, and utilizes innovative technology including AI to accomplish its goals. [32]

Accordingly, the New York Stock Exchange declared front-running as a transgression of the just and equitable principles of trade. The Exchange clarified that it is not needed to prove loss on the part of any party due to an unfair advantage being taken by a person privy to a piece of non-public information. On similar lines, the Chicago Board Options Exchange, Inc. noted that mere possession of knowledge of the imminent transaction would not constitute an offense of front running, but the act of selling or buying options or securities while in possession of non-public material information will bring it under the purview of the same.

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[31] Manish Kumar Singh, *Analysis of front running under SEBI regulations, 2003*, 7(6) INT'L J. OF L., 25-28 (2021)

[32] *FINRA*, https://www.finra.org/about.

European Union: The Market Abuse Regulation of the European Union mandates the establishment of a system to deter market manipulation and insider trading. It has also mandated mechanisms to encourage reporting of suspected malpractice. Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation called on Member States to implement measures to curb the practice of market abuse. [33]

Canada: Universal Market Integrity Rules (UMIR)of Canada defines front-running as a transaction involving a trade of options, futures, or index in any of the three methods- entering the order themselves, soliciting a third party to make an order, or leaking the confidential information to another party.[34]

VII. CONCLUSION AND RECOMMENDATIONS

Front-running is a severe offense requiring stringent and justifiable provisions for prevention and punishment. Nonetheless, it is inadequate and inharmonious with the principle of proportional penalty. The Quant Mutual Funds investigation has garnered attention to the contemporary problematic interpretations of law for fixation of liability in matters of front-running. SEBI has proposed a legal framework to overcome the challenges and inadequacies of law experienced in matters of front-running. However, the regulations are inherently biased towards the investigating Board and do not pervade the lacunae in law.

Furthermore, the AMC must follow an institutional framework as notified by SEBI to curb the cases of front-running. Interestingly, the nascent nature of the aforesaid framework renders it difficult for SEBI to anticipate the lacunae in its implementation which conceives a need to scrutinize them. In this light, the authors put forth a set of suggestions to ensure the legal framework is bulletproof and justifiable for the alleged offenders.

1. *Reducing the Power Conferred on AMCs*

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[33] OFFICIAL JOURNAL OF THE EUROPEAN UNION, DIRECTIVE 2003/6/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 28 JANUARY 2003 ON INSIDER DEALING AND MARKET MANIPULATION (MARKET ABUSE) O.J. (L 096) 16-25. (2003) https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX%3A32003L0006.

[34] CANADIAN INVESTMENT REGULATORY ORGANISATION, UNIVERSAL MARKET INTEGRITY RULES, (2024), https://www.ciro.ca/media/7526/download?inline.

To err is human, and fallacies in systems regulated by individuals must be expected. The new SEBI requirements of the internal framework replace the strict norms that existed earlier, which allowed for greater control and oversight in the hands of SEBI. The regulations fixate the primary responsibility of detecting and deterring market abuse on the fund house itself. Essentially, the AMC handles all alerts. Notably, the requirement to report to SEBI creates a potential conflict of interest since it shall affect investor perception of the Company and reduce its credibility.

Quant saw significant outflows after the front-running allegations. Likewise, Axis Bank Mutual Funds are yet to reel from the consequences of the front-running case levied against them. With such stakes, it is not inconceivable that diligent reporting of market abuse will not take place. Apprehension of negative outcomes can deter the fund house from complying with the provisions. SEBI must be cautious of attempts to manipulate data to conceal persons or acts to protect the AMC's interests.

Outsourcing the monitoring system to a third party could significantly reduce the possible manipulation of the surveillance systems. AMCs could hire external agencies to monitor the transactions and trading patterns and alert them of possible manipulations. Third-party involvement will also ensure stricter compliance with statutory regulations, such as reporting all alerts to SEBI.

2. *Increasing the Standard for Evidence*

The threshold limit of evidence to prove serious offenses must be kept high to ensure a justifiable investigation and finding, or else the current scenario proposed by the USTSM Regulations of SEBI lead to the interlinking of potentially innocent managers to front-running despite the exaggerated consequences of the same which in essence defies our justice system.

3. *Use of Technology*

The AMCs can utilize modern technologies and, in certain circumstances, artificial intelligence to collect, compile, and even analyse data. Furthermore, SEBI investigations could be expedited with the introduction of modern technology.

Implementation of such technologies must come with precautionary measures to ensure its non-compromise. All efforts should be taken to secure the flow of data from cyber threats such as data leaks, privacy concerns, hackers, etc. At present, artificial intelligence is a budding technology, and should an AMC choose to integrate it into its systems, it must consider its nascent nature and limit its decision-making capabilities. Authorized personnel must overview the working of the technology with policies and procedures formulated to manoeuvre contingencies.

4. *Establishing a Robust Whistle-blower Mechanism*

Finally, the regulations require the implementation of a whistleblower mechanism. The regulation itself is vague, and the AMFI is not required to specify the required standard for the same. While confidentiality and protection of the whistleblower must be guaranteed, the following measures can be taken to make the system more robust:

The U.S. Congress established the SEC program for whistleblowers to incentivize and encourage whistleblowers to provide accurate and timely information. Whistleblowers are eligible for an award of up to 10 to 30 percent of the number of ill-gotten gains, provided that the information is original and leads to a sanction of at least 1 million dollars. On similar lines, it is proposed that the current Indian policy of capping the award at Rs10 Crore for credible information must be replaced with a remuneration tied to the sum recovered.

According to the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, all listed companies must have a vigilance system monitored by the Audit committee to ensure that the whistleblower mechanism is in place, which places unlisted companies beyond its scope of regulation. The standards to be followed by the listed companies are largely discretionary, with private companies formulating their own systems and requirements. The requirements to necessitate an investigation by authorities are not uniform and could lead to opportunities to allow the prevalence of bias. Essentially, whistleblower's complaints result in prejudice against the company and expose them to losses and legal prosecution. With such a backdrop, the

establishment and strict enforcement of morally attuned whistleblower mechanisms will likely not flourish.

Anonymity is paramount, and the most pressing concern of any whistleblower is the possibility of harassment or prosecution. In this light, it is proposed that certain guidelines must be issued by SEBI to ensure minimum protection and procedural safeguards to be followed by all listed companies.

Hence, the recurring instances of front-running in the market, complemented by the obscure nature of the crime, necessitate the requirement of a robust, efficient, and stringent system, both external and internal to the institution. The framework and whistleblower mechanism mandated by SEBI can be a step forward in the right direction, provided that the regulator monitors the efficiency of the internal mechanism and penalises defaults to deter any violations on the part of the institution.

FROM SPECULATION TO STABILITY: SAILING THROUGH SEBI'S REGULATORY INDEX DERIVATIVES FRAMEWORK PROPOSAL

*Prabhav Tripathi & Kshitij Srivastava**

ABSTRACT

With technological and strategic advancements in trading activity, the last decade recorded exponential growth in trading volume and turnover stemming out of the derivatives market. Despite the blunt risks and excessively leveraged nature of these products, the global proliferation of index derivatives contracts has no end in sight. In the Indian context, these lucrative financial instruments attract retail investors who function on speculative trading, leading to inadvertent credit risk exposure. The issue is further exacerbated as the imbalance arising from fluctuations in positions on index contract expiry days results in high market instability, price volatility and endangered investor protection mechanisms. Predictably, such hyperactivity leads to the materialization of risks in the form of losses that the investors incur beyond their capacity. In its quest for risk-aversion awareness against the prevailing inclination towards derivatives at the center of the financial universe, the Securities and Exchange Board of India translated the proposals on regulatory amendments into a Consultation Paper.

The article examines the efficiency of the derivatives market mechanism while mapping the scope of the futures & options segment in India. Furthermore, it delves into the study of behavior patterns of retail investors and small-scale traders in Indian stock exchanges by highlighting empirical data on market participation in recent financial years. Subsequently, the substantial risks associated with speculative trading, from a theoretical as well as practical aspect, are also brought to the forefront. Scrutinizing the viability of the seven key proposals, the article analyzes the Consultation Paper concerning the regulation of index derivatives contracts for increased investor protection and market stability. To determine the extent to which these proposed measures cater to the existing issues in the securities regime, the article provides a thoughtful critique and identifies the potential shortcomings or compliance hurdles. The article moves towards a conclusion with strategies and recommendations to strengthen the macroprudential surveillance of the derivatives market and foster regulator-investor collaboration.

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Keywords: Index Derivatives, Derivatives Market, Speculative Trading, Futures and Option.

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I. INTRODUCTION

The post-COVID-19 era has been witnessing a massive influx of retail investors' participation in the Indian capital market. Increased access to technology and swift aid through mobile financial services platforms is opening the gate to novice players and providing them with the opportunity to trade on the stock exchanges. As of31 May 2024, the demat accounts in India stand at 15.8 crore, with a rise of 12.2 crore accounts since April 2020.[1] At this stage, the Securities and Exchange Board of India **("SEBI")** stands at the cusp of a cautionary approach in regulating the market while not adding barriers to the investors' new-found motivation. In the interest of boosting capital formation, the SEBI has investment opportunities across various categories in place. The derivatives market serves as one such category that promotes better price discovery and allows better risk management.[2] Although the derivatives regime

[1] Tirthankar Patnaik et al., *NSE Market Pulse*, National Stock Exchange India (June 1, 2024) https://nsearchives.nseindia.com/web/sites/default/files/inline-files/MarketPulse_June2024.pdf.

[2] Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, 91 N.Y.U. L. REV. 1104, 1108 (2016).

pushes to improve market liquidity, the individual and new traders often step into its murky waters, incurring significant losses. Notably, this results from the spikes of speculative hyperactivity in trading volumes as the expiry date approaches and the absence of proper risk management or surveillance measures.[3]

The allure of quick profits blinds retail investors to the inherent risks of derivatives trading, thus creating a precarious investment ecosystem. Derivatives require a deep understanding of market dynamics, pricing models, and leverage, which is unlike what happens in traditional equity investments. The presence of a high degree of leverage offers potential for magnified returns but simultaneously exposes investors to disproportionately large losses as well.[4] An average retail investor lacks the requisite financial literacy and risk management experience and resultantly falls into heightened speculative activity, leading to catastrophic losses.

Derivatives are generally considered to be of four types: forward, futures, swaps and options, of which only the futures and options are indexed with the stock market.[5]The risk faced by the retail investors in these indexed derivatives is exacerbated, particularly as the contract expiration approaches as the speculative activities are at their highest. These speculations are driven by short-term trading strategies that can lead to significant price distortions. Retail investors inadvertently engage in speculative trades that expose them to price fluctuations after being driven by herd behavior in the absence of sophisticated risk mitigation strategies.[6]

Futures and options contracts enable investors to predict the future price movements of underlying assets and hence create room for speculation.[7] Futures contracts impose an obligation on the seller to deliver and on the buyer to purchase the underlying asset at a predetermined price on a predetermined future

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[3] Sathya Swaroop Debasish, *Investigating Expiration Day Effects in Stock Index Futures in India*, 1(1) J. ECO. BEHV. STUDIES. 9, 10 (2010).

[4] Hendrik Bessembinder & Paul J. Seguin, *Futures-Trading Activity and Stock Price Volatility,* 47(5) J. FIN. 2015, 2018 (1992).

[5] R.W. Anderson & K McKay, *Derivatives Markets*, *In Handbook of European Financial Markets And Institutions,* (X. Freixas et al. eds.) (2006).

[6] Joseph Zoller, *Futures & Options*, 40(1) FIN. ANALYSTS J. (1984).

[7] Stanley B. Block & Timothy Gallagher, *The Use of Interest Rate Futures and Options by Corporate Financial Managers,* 15(3) FIN. MAN.. 73, 76 (1986).

date. Options contracts differ from futures contracts as they do not impose an obligation to the buyer to either buy or sell the underlying asset at a predetermined price and only confer the right to trade the underlying asset, exercisable before or on the contract's expiration date. Both of these indexed derivatives are essentially leveraged instruments, which allow the investors to exercise control with relatively smaller capital requirements. The tendency of retail investors to act as a herd and get involved in speculative activities underscores the need for enhanced regulatory oversight to safeguard retail investors from potential financial vulnerabilities.[8]

SEBI, in response to these risks, has promulgated a 'Consultation Paper on Measures to Strengthen Index Derivatives Framework for Increased Investor Protection and Market Stability' (hereinafter "Consultation Paper")as part of its functions provided under Section 11(1), Section 11(2)(d) and Section 30(1) of the SEBI Act, 1992.[9]The primary objective of this paper is to balance the benefits of derivative markets with the need to safeguard market integrity by addressing the burgeoning speculative activities, particularly by individual investors. SEBI has acknowledged, through the paper, that while derivatives markets are theoretically designed to promote market efficiency and facilitate risk management, any unchecked speculative behavior can undermine these objectives. The paper proposes a series of measures aimed at strengthening investor protection and promoting market stability.[10] These measures prevent the derivatives markets from becoming a source of systematic risk, while SEBI ensures that the markets remain a viable tool for hedging and price discovery.[11]

II. BEHAVIOR PATTERNS: RETAIL PARTICIPATION AND PROFIT & LOSS IN INDEX DERIVATIVES SEGMENT

The structure of the traditional equity derivatives contracts carries a month-long tenure. However, this contract tenure is limited to a week's expiry in the case of options contracts on a benchmark or sectoral index.[12] Exchanges, individually,

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[8] Feiran Xiang, *Financial Derivatives: Application and Risk Management,* 2 ICEDBC. 890, 891 (2022).
[9] Securities and Exchange Board of India Act, No. 15 of 1992, (Ind.).
[10] Partha Sarathi Roy & Tanupa Chakraborty, *Efficiency of Indian Equity Futures Market-An Empirical Analysis with Reference to National Stock Exchange,* 24(6) GLOBAL B. REV. 1326, 1327 (2023).
[11] Joseph Zoller, *supra* Note 6.
[12] SEC. & EXCH. BD. OF INDIA, CONSULTATION PAPER ON MEASURES TO STRENGTHEN INDEX DERIVATIVES FRAMEWORK FOR INCREASED INVESTOR PROTECTION AND MARKET STABILITY 1

take upon their discretion the rubrics of these weekly contracts while also setting the expiry day for the options. An overall shuffling in the choice of contract expiry dates has been made by exchanges to avoid the expiry of all contracts on a specific day of every week since the reintroduction of weekly derivatives contracts in May 2023.[13] Notably, due to the freshly introduced specifications, all five trading days in a week now have an expiring weekly index derivative contract to raise the activity and liquidity of the market.[14] The modifications undertaken by BSE with other exchanges also strive towards better regulatory governance and efficiency over the regulatory regime.

Based on this, studying the changing dynamics of the market and the corresponding behavior of the participants becomes pertinent to identifying the exposure to risks and catering to them. The shift in trading activity by individual traders from the period Financial Year 2019 to Financial Year 2022 and beyond has been remarkable enough to allow a comparative analysis in terms of participation and profitability by relevant authorities. Across all the products in the equity F&O portion, the top 10 brokers reported the number of unique individual traders to be 45.2 lakhs during the latter Financial Year **("FY"),** which saw a jump of over 500% over merely three years.[15] The highest share in FY 2022 participation of individuals belonging to the 30-40 years age group signifies more disposable income and higher risk tolerance in dealing with complex financial instruments than the younger and older groups.[16]

(2024), https://www.sebi.gov.in/reports-and-statistics/reports/jul-2024/consultation-paper-on-measures-to-strengthen-index-derivatives-framework-for-increased-investor-protection-and-market-stability_85279.html.

13 *Id.*

14 BSE INDIA, CHANGE IN EXPIRY DAY OF SINGLE STOCK DERIVATIVES IN EQUITY DERIVATIVES SEGMENT (2024), https://www.bseindia.com/markets/MarketInfo/DispNewNoticesCirculars.aspx?page=20240430-50.

15 SEC. & EXCH. BD. OF INDIA, ANALYSIS OF PROFIT AND LOSS OF INDIVIDUAL TRADERS DEALING IN EQUITY F&O SEGMENT 3 (2023), https://www.sebi.gov.in/reports-and-statistics/research/jan-2023/study-analysis-of-profit-and-loss-of-individual-traders-dealing-in-equity-fando-segment_67525.html.

16 *Id.*

An increasing share of turnover is strengthening the index options segment. As the data suggests, an investment of each ₹100 had only ₹2 contribution in index derivatives in FY 2018, which has now risen to ₹41 in FY 2024. However, the overall increased client participation in this sphere has failed to prevent 89% of individual players from incurring losses in the equity F&O segment.[17] In FY 2024 itself, a trading loss of ₹51,689 crore has been cumulatively suffered without adding transactional costs by unique investors and proprietorship firms in the derivatives market of NSE.[18] Alternatively, non-individual players, including high-frequency traders and Foreign Portfolio Investors, have generally reported offsetting profits in the same arena.

By putting the numbers in perspective, it is observed that the entire segment runs on hyperactive and abnormal trading activity by unique players with relatively smaller capital, leading to the realization of implications. The absence of risk architecture and metrics allows free participation in a market where the traders are prone to incur losses. With the expansion of the securities market ecosystem beyond the Tier-1 cities, the overall lack of financial knowledge and higher speculative trading activities exposes the market to instability, which may subsequently translate into long-term investment discouragement.

The issue around speculative hyperactivity proliferates in index options as they approach the expiry day. As the derivatives move towards the expiry of options, the rate of the premium undergoes a time decay, thereby diminishing the value of the options contract, notwithstanding the price movement of the underlying asset. It is estimated that participants initiate positions and square them off with unreasonable speculation in a span of less than three minutes.[19] Irrespective of the odds of success, F&O trading provides cheap bets due to lower premiums, leading to more volatility on expiry days against non-expiry days. This concentrated hyperactivity, in turn, brings down the average open position of a retail investor to nearly thirty minutes and disrupts the derivatives market ecosystem. Furthermore, the presence of multiple option strikes at uniform price intervals in

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[17] *Id.* at 5.
[18] SEC. & EXCH. BD. OF INDIA, *supra* note 12.
[19] *Id.* at 5.

index derivatives creates stretched gaps across the price line and scatters the liquidity across them, resulting in sudden price movements.[20]

Apart from the net losses reported in options contracts, the trading trends highlight a net trading loss in transaction costs of around 23% for loss-makers in FY 2022.[21] These transaction costs include an aggregate of clearing fees, brokerage fees, fees as prescribed by SEBI, and GST, among others. A high transaction cost is an indicator of frequent trading activity, as the costs are proportional to the quantity of trades executed.[22]

Therefore, the market behaviour suggests that the gross losses incurred by retail investors and unique traders in the index derivatives are not preventing individual participation in the F&O segment. The quantity of outstanding derivatives contracts (in terms of large Open Interest) and the unusual hoard of investment in risky avenues without limitation on leverage places the entire structure void of market stability and investor protection. Ease in regulations and low barriers to entry in the derivatives further encourage retail participation in adequate exposure to risk.[23] With the new traffic in stock exchanges and premium requirement going as low as one-tenth in the last five minutes before expiry against the amount on the day before, the index derivatives segment poses as a lucrative and accessible way to deal in options contracts, though the likelihood of profitability is less. Notably, a common response to contracts brews hyperactivity on expiry day and transpires into high market volatility.[24]

Understanding the complexities that the existing practice carries for the individual retail investors in the F&O segment, the SEBI recently published a Consultation Paper discussing the measures that may be undertaken in order to strengthen the framework of index derivatives.[25] The Consultation Paper, with the

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[20] S.J. Grossman & M. H. Miller, *Liquidity and Market Structure*, 43 J. FINANCE. 617, 617 (1988).
[21] SEC. & EXCH. BD. OF INDIA, REPORT: ANALYSIS OF PROFIT AND LOSS OF INDIVIDUAL TRADERS DEALING IN EQUITY F&O SEGMENT 6 (2023), https://www.sebi.gov.in/reports-and-statistics/research/jan-2023/study-analysis-of-profit-and-loss-of-individual-traders-dealing-in-equity-fando-segment_67525.html.
[22] Joseph Zoller, *supra* note 6.
[23] Feiran Xiang, *supra* note 8.
[24] Sathya Swaroop Debasish, *supra* note 4.
[25] SEC. & EXCH. BD. OF INDIA, *supra* at 12.

objective of increasing investor protection and market stability, proposed seven key regulatory measures to stifle speculative trading that dampens profitability. Each measure, suggested by the Expert Working Group that was formed by the SEBI for this purpose, attempts to systematically limit the easy accessibility of players carrying small capital and divert them to relatively safer investment opportunities in the market, preventing unanticipated losses.[26]

III. ANALYSIS OF THE PROPOSED MEASURES IN SEBI'S CONSULTATION PAPER: TOWARDS A REGULATORY APPROACH

It is the obligation of the Stock Exchanges/Clearing Corporations to provide products for trading in the derivatives market and also a platform facilitating trade in these products in the absence of any friction while simultaneously ensuring online real-time risk management to create a more efficient, stable, and transparent financial system by allowing the traders to operate with confidence and contribute to accurate price-setting.[27]In its consultation paper, SEBI has proposed seven measures that shall be adopted by the Exchanges and Clearing Corporations. SEBI's objective for introducing these measures is to regulate the market, which in consequence will regulate the business in the stock exchanges.

A. RATIONALIZATION OF STRIKE PRICE FOR OPTIONS

Among the seven measures, the first measure proposed by SEBI is to rationalize strike prices for options. In the existing practice in the options market, various "strike prices" at fixed intervals are offered around the current market price of the index. These intervals cover around 7% to 8% of possible index movements when the options are introduced. However, as the index moves, the exchange has the authority to introduce new strike prices during the day if the movement in the index warrants such requirement. However, for short-term options contracts, having an excessive number of strike prices dilutes trading activity across multiple strike prices.

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[26] *Id.*at 7.

[27] Partha Sarathi Roy, *supra* note 10.

An excessive number of strikes leads to a dispersion of trading volume for every single strike, hence diminishing the possibility of executing trades without impacting the price. This phenomenon is called liquidity fragmentation, and it can further cause abrupt and unanticipated price movements. This uncertainty creates more opportunities for artificial trading activities and, as a result, potentially distorts the pricing of the options contract. To counter the inception of such distortion, SEBI has proposed to rationalize the strike intervals by maintaining narrower strike intervals within a range of 4% of the prevailing index value while expanding the interval between strikes as strike prices diverge further from the prevailing index value, ranging from 4% to 8%.[28] This measure will reduce the number of strikes available at extreme corners of index values and, as a consequence, concentrate liquidity. By introducing no more than 50 strike prices for an index derivative at the time of the launch of the contract, this measure also has the potential to successfully consolidate trading activity and mitigate volatility.[29]

It is proposed that once the contract is out for the public, new strike prices will be introduced on a daily basis depending upon the necessity and in accordance with the proposed strike intervals to minimize the risk of excessive proliferation by reflecting the actual availability of strike prices.[30] To put this proposal into its maximum potential and avoid volatility and disparity in the strike price, SEBI has suggested that all exchanges should coordinate and adopt these principles uniformly, following a 'joint discussion.'[31]

This measure can be largely seen as limiting the choice for traders, which could negatively impact their ability to execute specific trading strategies that rely on a wider range of strikes and also impact the hedging strategies for traders who view options as a tool for an effective risk management strategy.[32]These limitations can be addressed by implementing a mechanism where strike intervals are adjustable and adapt as per the requirements of the market; it would ensure that the investors

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[28] SEC. & EXCH. BD. OF INDIA, *supra* note 12 at 8.
[29] *Id.*
[30] *Id.*at 9.
[31] *Id.*at 9.
[32] Feiran Xiang, *supra* note 8.

have access to a wider range of strikes during the time slots that witness heightened activities. In order to allow for greater precision in trading and hedging strategies,[33]the introduction of customized strike price bands and multiple expiry contracts could come as a rescue against these limitations of SEBI's first measure to regulate the business of stock exchanges with respect to the trading of options contracts.[34]

B. UPFRONT COLLECTION OF OPTIONS PREMIUMS

As its second measure, SEBI has proposed that the Trading Members **("TM")** and the Clearing Members **("CM")** be required to collect options premium from options contract acquirers (long positions) upfront. This measure is in alignment with SEBI's objective to mitigate risks associated with non-linear pricing and high implicit leverage. The same does not apply to traders who are delivering options contracts (short positions) because these positions typically require margin.[35] The proposal differs from the status quo on the grounds that currently, the TMs and CMs are not under an explicit mandate to collect options premium from buyers before allowing them to establish their long positions, while the proposal shifts this regime towards a lessrisky alternative. This proposal particularly safeguards the retail investors by discouraging them from acquiring positions beyond their collateral capacity, and hence, the measure diminishes the systemic risk prevailing in the long position.

C. REMOVAL OF CALENDAR SPREAD BENEFIT ON EXPIRY DAY

Calendar spread benefit refers to the significantly reduced margin requirements when an offsetting position on a future expiry is present.[36] The third measure, as proposed in the paper, raises concerns with the existing practice of calendar spread benefit, pointing towards the increased basis risk on expiry day and the liquidity risks that follow. These risks arise on the expiring day of a contract against which the trader has availed calendar spread benefit, and the offsetting contract

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[33] Robert J. Shiller, *The Theory of Index-Based Futures and Options Markets,* 8 (2(16)) ESTUDIOS ECONÓMICOS 163, 167 (1993).
[34] Joseph Zoller*, supra* note 6.
[35] SEC. & EXCH. BD. OF INDIA*, supra* note 12 at 10.
[36] Sathya Swaroop Debasish, *supra* note 4.

supplementing the same derivative lies on an away-month expiry.[37] On the expiring day of a contract, the volatility is at the highest, this is—specifically—owed to the heightened trading activity in the hope of making large profits quickly. This volatility in the expiring contract and the relatively subdued activity in the away-month expiries create a disparity between these two offsetting positions. This disparity gives birth to liquidity risk, which essentially refers to the risk of incurring losses on away-week/month options because they are generally less liquid, and hence, they are hard to close on the same day as the expiring contract.

The proposal eliminates the margin benefit given on the calendar spread benefit, applicable only on contracts expiring on the same day. SEBI, through this measure, proposes to mitigate the high-level risks associated with the practice in the status quo.[38] This proposal was placed by the regulatory authority in light of the observed skew in trading volumes on expiry days when compared with those of non-expiry days. This measure implicitly discourages speculative practices by retail investors and prevents them from dealing in positions that might be beyond their financial capabilities, trading strategies and resources and, as a result, reduces the confidence of the individual players in the derivatives market.[39]

Given that this measure will only be applicable to the contracts expiring on the same day, SEBI has not addressed in its consultation paper how retail investors will be discouraged from maintaining positions in advance of the contract's expiration by a day or two.[40] This lack of clarity and omission casts doubt on the efficacy of this measure and creates room for circumvention of the proposal by the retail investors, thus potentially undermining the applicability of the same. To effectively address this issue, SEBI can implement a phased increase in margin requirements where it can start the first phase of the increment several days ahead of the contract's expiration. The effect caused by this measure will be in alignment with that of SEBI's intended consequence, however, in the absence of the

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[37] Trevor Chamberlain, Sherman Cheung & Clarence Kwan, *Expiration-Day Effects of Index Futures and Options: Some Canadian Evidence,* 45(5) FIN. ANALYSTS J. 67, 71 (1989).
[38] SEC. & EXCH. BD. OF INDIA*, supra* note 12 at 10.
[39] *Id.*
[40] *Supra* note 37 at 70.

potential loophole where retail investors might hold positions a day or two before expiration.

D. INTRADAY MONITORING OF POSITION LIMITS

The different market participants and product types have set position limits on the specifications of SEBI. This position limits control of the number of contracts that can be held in the trading of a financial instrument. At the end of each trading day, the Market Infrastructure Institutions **("MII"),** including clearing Corporations and stock exchanges, are responsible for monitoring the limits in place and flagging any breach that might have taken place, wherein the options or contract quantity is beyond the ceiling limit.

Though the procedure ensures that no positions beyond the prescribed cap are held after the market closes for the day, breaches that take place throughout the trading day go undetected. On the day of the derivative contract expiry, excessive positions might be held by a retail investor during market hours and brought back to a permissible quantity at the end of the day, thus escaping the radar of the MIIs. Adhering to the process of holding more positions than allowed in a specific product market, such a participant takes a dominating position in the segment and increases the profit potential by having more exposure to price movements. In these cases, retail investors find themselves in an advantageous position by generating a larger share of profits with more contracts and extracting quick gains from short-term price fluctuations.

Keeping the above in consideration, the Consultation Paper proposes to monitor the position limits for the index contracts on an intra-day basis.[41] This would, further, require the stock exchanges and clearing corporations managing this function to adopt better technological mediums for efficient observation. To achieve a dedicated system of full-time monitoring, the proposal by SEBI suggested working on a comprehensive roadmap while laying down an adequate short-term solution as a prior step.[42]

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[41] SEC. & EXCH. BD. OF INDIA*, supra* note 12 at 11.
[42] *Id.* at 12.

At first glance, an increase in observing the intraday positions in index derivatives contracts for reporting any breach or violations may seem to be a positive proposal. However, the approach of the SEBI in this context calls for higher logistical requirements and an increase in managerial capacity to maintain efficiency. As a better alternative, time and effort can be made towards simply constructing a technology-based system to prevent a breach of position limits, whether done deliberately or erroneously. A technical barrier, mandated for all platforms providing accessibility of derivatives contracts, would be more viable and cost-effective in ascertaining market stability. Furthermore, an increased threat of overregulation looms over the participants, if the initial proposal is implemented, tougher restrictions in utilizing the apparent opportunity to hold larger positions may put the Indian investors ata disadvantage to the markets of other countries.

E. REVIEW OF MINIMUM CONTRACT SIZE FOR INDEX DERIVATIVES CONTRACTS

While the value of benchmark indices and the market as a whole has continued to grow in recent years, the contract sizes fixed in 2015 are no longer in consonance with the current scale and capacity of the market. Due to inflation, the real value of money experiences erosion and provides a fresh definition to the purchasing power of individuals. The minimum derivatives contracts size, as set in 2015, has maintained a stagnant prescribed range of ₹5 lakhs to ₹10 lakhs.[43]Taking into account the rise in individual capital in the last decade, more participants are eligible to afford the derivatives with minimum contract size. The existing sachets of products allow more trades, having cheap implicit leverage in the market. Nevertheless, the financial risks associated with the derivatives contracts remain high and concentrated. These risks carry the potential to magnify losses that may even exceed the initial investments, disrupting the market flow and endangering the participation of small-scale investors.

[43] SEC. & EXCH. BD. OF INDIA, REVIEW OF MINIMUM CONTRACT SIZE IN EQUITY DERIVATIVES SEGMENT, Circular No. CIR/MRD/DP/14/2015 (2015), https://www.sebi.gov.in/sebi_data/attachdocs/1436782665000.pdf.

Derivatives are inherently riskier financial instruments. If the minimum contract sizes remain the same with the current rate of increase in income, the opportunity to participate in these murky products expands to retail investors who deal in securities with smaller amounts of capital. By revising the minimum contract range as per the evolving market structure, a higher barrier of entry shall prevent the small-scale participants from investing in expensive index derivatives. Subsequently, the scope of investment in the derivatives shall be limited to large-scale investors and institutions that have significant capital to trade and absorb the impact of loss.

The SEBI proposes to adjust the minimum contract size of index derivatives in accordance with the growth in index points.[44] The adjustments are suggested to be implemented in a phase-wise manner for the market to adjust gradually to the revised regulatory measures. In the first phase, the minimum contract size is proposed to be set in the new range of ₹15 lakhs to ₹20 lakhs.[45] After six months of this phase, the second phase shall further push the range to ₹20 lakhs to ₹30 lakhs.[46] Thus, significantly raising the wall of minimum contract size would make it difficult for retail investors to climb.

The exclusion of small-scale participants due to this proposal shall potentially result in lower trading volumes, reducing the market liquidity. Moreover, the roadmap provided in the Consultation Paper barely explains the process behind the revision of this regulatory requirement for smooth compliance. The release of an official SEBI document that comprehensively highlights the steps of transition and system upgrades would be pertinent before any adjustments are implemented.

F. RATIONALIZATION OF WEEKLY INDEX PRODUCTS

The weekly contracts, in the current practice, expire across different indices and exchanges on each of the five trading days of the week. This practice mirrors a Zero Day to Expiry **("0 DTE")** structure, which implies that the contracts are expiring on a constant basis, which leads to the movement of speculative capital

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[44] SEC. & EXCH. BD. OF INDIA, *supra* note 12 at 12.
[45] *Id.* at 13.
[46] *Id.* at 13.

from one expiring contract to another.[47] This practice is particularly destructive to the financial health of individual investors as they get involved in high-risk trades in the hope of capitalizing on short-term price movements and get caught up in unpredictable price swings towards the closing of trade.[48]

The sixth measure, as mentioned in the consultation paper, proposes the rationalization of Weekly Index Products in order to better protect market stability by proposing that weekly options contracts should be limited to a single benchmark index per exchange. This would take effect from the reduced number of expiries occurring throughout the week and reduced speculative trading associated with daily expirations.[49] SEBI intends to push the investors to focus on a single index, make trading activity more concentrated, and potentially reduce volatility and improve the overall stability of the derivatives market.[50]

G. INCREASE IN MARGIN NEAR CONTRACT EXPIRY

As the options contracts approach the expiry day, trades happen at lower premiums with high potential risk. In such situations, traders effectively deal with high implicit leverage as the time sensitivity may trigger huge percentage shifts in the derivative's value due to minimal changes in the underlying asset. Thus, as the behaviour pattern shows and the data in the Consultation Paper reflects, trading activity near the expiry day increases the market volatility, exposing traders to sudden price swings.[51] In the present practice, the margin set aside in the case of index derivatives contracts does not adjust in accordance with the augmentation in risk factors. While the contracts tread on a tightrope, there is an absence of adequate financial buffers to safeguard the interests of investors and restrict their participation, which the lucrative low premium prices encourage.

SEBI has proposed to limit transactional hyperactivity in the near expiry period that might materialise due to the control of large positions by bearing nominal upfront costs. In pursuance of the above, the Board has suggested raising the

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[47] *Id.*
[48] *Supra* note 37 at 68.
[49] SEC. & EXCH. BD. OF INDIA, *supra* note 12 at 13.
[50] *Id.* at 14.
[51] *Id.* at 14.

margin percentage that investors need to set aside as prior capital to cover potential losses. This margin acts as a financial cushion to absorb sudden price shocks that an index derivatives contract may encounter for any reason whatsoever. It is proposed that for the start of trading day before expiry, a 3% increase shall be made to the Extreme Loss Margin **("ELM")** to counter unexpected and unfavourable price movements.[52] Similarly, a further increased Extreme Loss Margin of 5% shall be secured on the actual expiry day.[53] Hence, as the players move closer to the expiry day, the margin will rise, mimicking the spike in risk.

A financial buffer like this would act as a welcome step in changing the market dynamics and loss-making tendencies of small-scale individuals who take risks beyond their capacity. The increase in margin requirement to permit trading in the last two days of index derivatives contracts would help investors evaluate their capital standing and assess risk-handling capabilities in case the market moves sharply. Market disruptions, additionally, would be minimized as the target participants would fail to meet the regulatory obligation stipulated in the proposal and exit the market before the risk matures.[54] Lastly, the high costs to be levied in holding large positions near the expiry of contracts would provide investors the opportunity to understand the associated risk exposures and promote responsible trading.

IV. THE WAY FORWARD: PROTECTING INVESTORS' INTEREST AND MARKET STABILITY

The Consultation Paper intends to strengthen the framework surrounding index derivatives with the objective of increasing investor protection and market stability.[55] These measures succeed in majorly addressing all the inherent risks in the derivatives market and are likely to encourage a less speculative but more structured market.

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[52] *Id.* at 15.
[53] *Id.* at 15.
[54] Ira Lee Sorkin, *Reacting to a Regulatory Investigation into Derivatives Market Activity*, 66 FORDHAM L. REV. 755, 755 (1997).
[55] Dan Awrey, *The Mechanisms of Derivatives Market Efficiency,* 91 N.Y.U. L. REV. 1104, 1104 (2016).

The future of index derivatives will include the reduction in speculative activity as the most noticeable change. This will be a result of concentrating liquidity and reducing the likelihood of abrupt price movements and liquidity fragmentation once rationalization of strike prices takes place. The measure conclusively discourages artificial trades, which distort market prices, by fostering a more stable pricing environment.[56] The same measure, however, tends to fail the investors who rely on trading strategies involving a broader selection of strike prices. This failure can be addressed simply by the SEBI by introducing adjustable strike intervals and customized strike price bands to provide flexibility depending upon the market to create a balance between liquidity concentration and strategic flexibility.

SEBI has also made it a requirement for the TMs and CMs to collect options premiums from options contract buyers upfront in order to ensure that the traders do not operate beyond their financial capacity. Reduction in systemic risk by discouraging over-leveraging by retail investors is expected as a result of this measure. Furthermore, this measure is also likely to discourage the number of individual players who start investing in the index derivatives market without complete knowledge of the potential risks and losses that are involved, thereby creating a shift towards more prudent and risk-aware participation and contributing to a more resilient market structure.[57]

In the future, the market is less likely to witness speculative activities that exploit the market due to the prevailing calendar spread margin benefits. This is expected as a result of SEBI's decision to eliminate such benefits on the expiry day of the contract and diminish some of the risks associated with calendar spreads. However, this measure may also inadvertently push the investors to alter their trading strategies just before the day of expiration of the respective contract and hence bypass the intended impact of the measure. To address this issue in totality and in alignment with SEBI's objectives to release these measures, phased increments in margin requirements ahead of expiration by gradually increasing the

[56] SEC. & EXCH. BD. OF INDIA, *supra* note 12 at 17.
[57] *Id.*

cost of holding positions could significantly discourage speculative activities in the days leading up to the expiry of the contract.

The current practice in the intra-day trading of index derivatives fails to detect excessive positions held during trading hours, which leads to market manipulation and excessive profit-making. SEBI intends to solve this issue by proposing intra-day monitoring of position limits for index contracts, which will have a hand in shaping the future of these securities by acting as a proactive approach to ensure that no single investor holds a disproportionate share of the market during trading hours. In its implementation stage, this measure is likely to impose higher logistical demands and impractical managerial capacity to maintain efficiency. Both of these limitations can be addressed properly by implementing a technology-driven system for enforcing position limits that will ensure that no investor reaches an excessive position at all and, therefore, prevent the position from ever escalating to the extent of the monitoring stage.

SEBI's intended objective while adjusting the minimum contract sizes is to reduce the risks associated with small-scale participants trading in high-risk products by limiting their participation in the derivatives market to more capitalized investors.[58] The measure, however, holds a potential threat of reduction in market liquidity owing to higher eligibility criteria for the investors to enter the market. In order to prepare against this threat, SEBI should ensure a slow and well-communicated transition focusing on market adaptability in the absence of disruption. A comprehensive roadmap and clarity in communication from the regulatory Board will ensure that the market remains inclusive while still protecting the less experienced retail investors.

In the proposed setup of the derivatives market, investors will have no other avenue but to avoid speculative trading in the weekly index products as SEBI plans to limit them to a single benchmark index per exchange and streamline trading activities in order to reduce the volatility caused by the current "Zero Day to Expiry" structure. This change will likely promote a more focused and stable trading ecosystem with fewer disruptive price swings. The direct benefit of

[58] *Id.* at 12.

establishing a more predictable market will be realized by the investors as they place more emphasis on long-term strategies rather than short-term speculation.[59]

The final measure by SEBI ensures that the future of the index derivatives market consists of investors, particularly retail investors, who are encouraged by responsible trading practices and not tempted by the allure of low premiums.[60] The increase in margin requirements near expiry is expected to serve as a financial cushion that absorbs the likelihood of sudden and severe losses.[61] SEBI, through its seventh measure, proposes to raise the cost of holding large positions close to expiry in order to promote a more cautious approach to trading and ultimately enhance market stability.

V. CONCLUSION

The measures proposed through the Consultation Paper are tools to enhance investor protection and promote market stability in derivative markets while ensuring that capital formation is sustained. These measures are expected to curb speculative hyperactivity, particularly among the individual players in the index derivatives market. The implementation of these measures is likely to ensure more responsible trading practices and reduced market volatility.

Essentially, these measures are likely to change the future of index derivatives with increased emphasis on concentrated liquidity, reduction in abrupt price movements and a relatively stable trading ecosystem. The implementation of these measures, in the absence of suggestions to bridge the gap from theoretical solutions to practical implementation, may invite certain challenges, such as the potential for reduced market liquidity or increased logistical demands.

The proposals portray the restriction of market access to the herd of novice investors as a measure to protect these players from taking up risks that are beyond their holding capacity and may turn out to be fatal to their finances. By maintaining this balance between limited market entry and a variety of associated risks, SEBI intends to achieve the objectives of market efficiency and ensuring a secure trading

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[59] *Id.* at 18.
[60] *Id.* at 18.
[61] *Id.* at 15.

environment for all kinds of investors, depending upon the sophistication put into their risk management strategies.

Envisioning the implementation in the longer term, it can be expected that these measures will help enhance investor confidence, which will contribute to the overall growth and stability of the Indian capital markets by creating a more predictable and sustainable environment for investing. However, the change cannot take place overnight and will only be successful if encouraged by a slow and well-communicated implementation process to allow the market stakeholders and participants to adapt to the new ecosystem. In the process, SEBI will also have to be receptive towards adjustments based on market feedback to maintain an inclusive and resilient market.

These reforms have the potential to contribute to a more predictable and sustainable market, where both experienced and novice investors can co-exist with confidence, with proportionally sophisticated risk management practices to uphold the market's integrity. The regulatory framework, in addition to fortifying investor protection, also lays the groundwork for long-term growth and stability in the Indian market of index derivatives.

THE REGULATOR STRIKES BACK! ANALYZING THE REIGN OF NFRA AS AN 'INDEPENDENT' AUDIT REGULATOR

Gurasis Singh Grover and Aryan Gupta[*]

ABSTRACT

*In the wake of an attempt to regulate the conduct and functioning of regulating authorities after recent scams such as the Satyam scam in 2009 and Punjab National Bank scam in 2018, the Government of India formulated the National Financial Reporting Authority ("**NFRA**"). However, right from its inception, controversy surrounded this body since the way it operates has been receiving limelight but for the wrong reasons. Retrospectivity in its operations to the effect that it can bar the practicing licenses of regulators has questioned the very existence of NFRA. This 'grey' area even though resolved by the recent judgment in the case of Mr. Harish Kumar T.K & Ors. v. National Financial Reporting Authority has been settled but the same has not been taken in well by the auditors who already have The Chartered Accountants Act, 1959 to comply with.*

*Hence, this paper comes up with original ideas of de-tangling auditors from several legislations to comply with. Building upon an amalgamation of adjudication, arguments, and observations from the court room proceedings in the case of Mr. Harish Kumar T.K & Ors. v. National Financial Reporting Authority as well as the ongoing batch matter of Deloitte Haskins & Sells LLP v. Union of India & Anr. in the Delhi High Court, this research would showcase the fact that NFRA is yet another layer of red taping with a strong objective but supererogatory powers. The researchers would conclude and further contribute by providing novel suggestions such as ethical standards for NFRA while taking the route of successful independent agencies such as the Public Company Accounting Oversight Board ("**PCAOB**") of the United States of America ("**US**").*

Keywords: NFRA, Institute of Chartered Accountants of India, Chartered Accountant, Limited Liability Partnership, Satyam Scam.

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[*] *Gurasis Singh and Aryan are in the fourth year of their B.B.A. LL.B. program at IIM Rohtak.*

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I. THE INCEPTION

On 1st October, 2018, the Government of India vide notification S.O. 5099(E), constituted the National Financial Reporting Authority by invoking Section 132 (1) of the Companies Act 2013.[1] The recent Punjab National Bank Scam ("**PNB scam**")[2]which usurped an amount of around $2 from fugitives, Nirav Modi and Mehul Choksi hastened the process of notifying the inception of NFRA.[3] This was done to add another layer of overseeing accounting and auditing norms at all listed and unlisted companies. With the question if NFRA could bring back the amounts usurped, the actual background behind inception of NFRA needs to be brought into limelight.

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[1] National Financial Reporting Authority Rules, 2018, Gazette of India, pt. II sec.3(i), Rule 4 (Nov. 14, 2018).

[2] '*Explainer: How Nirav Modi cheated PNB of Rs 14,000 crore through fraudulent Lo Us'*, ECON. TIMES (Nov. 9, 2022) https://economictimes.indiatimes.com/news/india/explainer-how-nirav-modi-cheated-pnb-of-rs-14000-crore-through-fraudulent-lous/articleshow/95410291.cms.

[3] MP Shorawala, '*National Financial Reporting Authority: Is there really a need for yet another regulator?*' FINANCIAL EXPRESS (Mar. 12, 2018) https://www.financialexpress.com/opinion/national-financial-reporting-authority-is-there-really-a-need-for-yet-another-regulator/1094816/.

The researchers were fortunate enough to attend the court hearing in the case of Mr. *Harish Kumar T.K v. NFRA*[4](“**Harish Kumar case**”) and *Deloitte Haskins & Sells LLP v. Union of India &Anr.*[5](“**Deloitte Haskins case**”) from the period of July 13, 2023 to December 1, 2023 and various parts of this research are inspired and inferred from the same. As observed from the court proceedings, NFRA’s inception is based on similar lines as the PCAOB which is an independent audit regulator in the US and the International Forum of Independent Audit Regulators (“**IFIAR**”). However, the powers of this newly constituted body supersede even the powers of the Institute of Chartered Accountants of India (“**ICAI**”) which poses a question concerning the overlapping jurisdiction when it comes to regulation of auditors.[6]

When it comes to imposing fines or suspend audit firms, NFRA follows its counterparts like the PCAOB like debarment of licenses of audit firms. However, there is no mention of the ethical standards of NFRA while PCAOB must mandatorily follow the Ethics Code[7], rule EC-1 of which states that the Ethics Code is applicable to present and former Board members and staff.[8]

Another question arises in the very constitution of NFRA wherein as per Section 132 (3), the appointment of members has no mention of a qualified Chartered Accountant (“**CA**”) in the committee. Peer review is lacking in the very selection of members wherefore it is also necessary to mention that someone with expertise in even finance or law could be a part of the committee which completely deviates from the objectives of NFRA from its international counterparts. Whilst the court observed contentions from NFRA asserting its alliance with international standards, the procedures and appointments are completely deviant. To corroborate the claims, we shall now consider a notification released by the

[4] Mr. Harish Kumar T.K v National Financial Reporting Authority, Company Appeal (AT) NO. 68 of 2023 & I.A. No. 2007-2009 of 2023 del (NCLAT).
[5] Deloitte Haskins & Sells LLP v Union of India & Anr, W.P.(C) 1065/2021 & Company Appeal. 9896/2021 (NCLAT).
[6] Saumya Bhargava, *'Birth of Independent Audit Regulation in India: An Analysis with US Perspectives'* OXFORD BUSINESS LAW (Oct. 26, 2018) https://blogs.law.ox.ac.uk/business-law-blog/blog/2018/10/birth-independent-audit-regulation-india-analysis-us-perspectives.
[7] PCAOB, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD BYLAWS AND RULES – ETHICS CODE (2003) https://pcaobus.org/Rules/Documents/Ethics-Code.pdf.
[8] *Id.* at EC-1.

US Securities and Exchange Commission ("**SEC**") which highlights a vacancy a member in PCAOB,

"The PCAOB is governed by a Board of five members, two of whom shall be or have been CPAs, and three of whom must not be or have been CPAs. Board members must have a demonstrated commitment to the interests of investors and the public and an understanding of the responsibilities for and nature of the financial disclosures required of issuers, brokers, and dealers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures."[9]

Simple yet effective, this notification points out the fact that independence must not only exist on paper but also in practice.

Procedures of PCAOB and NFRA also differ greatly which would be highlighted as the paper progresses.

Thus, a ripple effect of numerous powers being granted to NFRA motivated the researchers to question the very operational validity of NFRA inspired by adjudicatory proceedings in the Delhi High Court and National Company Law Appellate Tribunal ("**NCLAT**") coming up with the below mentioned principal claim,

"Professional skepticism in case of alleged functional and ethical misconduct of auditors should not invoke such great penalty as has been practiced by NFRA right from its inception. Questions of retrospective application in its quasi-criminal penalties and focus on summary procedure for disciplinary proceedings hamper the objective for which NFRA was constituted. Hence, steps must be followed to ensure NFRA follows ethical standards and elaborate procedures backed by established statutes similar to its international counterparts."

While judgment in the Harish Kumar case opposes the contentions proposed by the auditors, the researchers will strive to bring to lighttwo research objectives as mentioned below:

[9] Press release, U.S. Securities Exchange Commission, SEC Seeks Applicants for Public Company Accounting Oversight Board Seat, (Feb. 7, 2003) https://www.sec.gov/newsroom/press-releases/2023-23.

1) Violation of natural justice principles by NFRA and its irregular operating procedures

2) The Chakravyuh of penalties by NFRA and its questionable retrospective application.

II. STRIKE OF THE REGULATOR: THE CONUNDRUM OF POWERS OF NFRA

Section 132 of the Companies Act2013 with the NFRA Rules 2018 highlight the various powers granted to NFRA which is, arguably, the most powerful of any regulatory body.

A. THE COMPANIES ACT, 2013

Section 132 of the Companies Act, 2013 in its very 2nd subsection, being 132(2) contains a non-obstante clause which is used to override the effect of any other statute on the statute where the word 'notwithstanding' is used.[10] This means that ICAI and proceedings against auditors which is elaborated in the First and Second Schedule of CA Act 1949 are rendered ineffective in respect of this section.

According to subsection (2) clause (a) of the section, NFRA has the power to make recommendations to the Central Government for accounting standards which seems ironic, since the Chairperson of NFRA itself is appointed by the Central Government. So, questions relating to the independence of this committee are raised by the researchers since audit regulators are expected to be *'operationally independent.* Furthermore, the practice followed by PCAOB is appointment of members by the SEC, which in itself is an independent agency.[11]

Compliance with accounting standards, quality of service of professionals associated with compliances of such standards along with other prescribed

[10] Bhumika Indulia, *Circumscribing Non-Obstante Clauses: Tracing the New Jurisprudence*, SCC ONLINE (June 16, 2023) https://www.scconline.com/blog/post/2023/06/16/circumscribing-non-obstante-clauses-tracing-the newjurisprudence/#:~:text=Understanding%20non%20obstante%20clauses,over%20other%20provisions%20or%20enactments.

[11] The Board, PCAOB, https://pcaobus.org/about/the-board#:~:text=The%20five%20members%20of%20the,the%20Secretary%20of%20the%20Treasury.

functions are some of the powers of NFRA defined under clauses (b), (c) and (d) of Section 132. Undefined lines of separation between CA Act, 1949 and NFRA often lead to entirely different procedures of investigation between the two bodies and thus hamper the rights of CAs. These complexities of overlapping jurisdictions, as observed during the court proceedings, would be elucidated in **Chapter III**.

Suo moto investigative powers and the powers of a civil court as vested in Code of Civil Procedure 1908 as dealt with in Subsection (4) clause (a) and (b) of Section 132 compels us to believe that there is a clear removal of distinction between an *administrative body* (which NFRA was envisioned to be) and an *investigative body* which performs *adjudicatory functions* (which NFRA is made by providing it with such powers). This ambiguity on top of no express provision detailing the procedure for trial of CAs further supplies fuel to this mis-directed fire.

The elephant in the room or rather elephants in the room are the penalties, which NFRA can levy on either the professional or the firm which is dealt in Section 132(4)(c) will be introduced in this part but willbe further dealt with in **Chapter III**.

(A) Pecuniary penalties which amount to an amount between Rs. 1 lakh and 5 lakhs

Not less than Rs. 5 lakhs but which may extend to ten times of the fee received, for firms.

(B) Debarring the member from engaging himself or itself inpracticing as member of the Institute of Chartered Accountant of India for a minimum period of six months or for such higher period not exceeding ten years as may be decided by Authority.

Rules 10 and 11 of the NFRA Rules, 2018 further add to this long chain of powers by providing for disciplinary proceedings which may be initiated by NFRA in case of monitoring or enforcement or oversight activities or based on the reference received from the Central Government. In such a case, a show cause

notice can be sent which is essentially one of the facts in the Deloitte Haskins case.

Even in case of disposing the disciplinary proceedings, Rule 10 (6) provides for:

"(a) no action;

(b) caution;

(c) action for imposing penalty against auditor under sub-clause (A) of clause (c) of sub-section (4) of section 132 or for debarring the auditor from engaging as such under sub-clause (B) of clause (c) of sub-section (4) of section 132 or both."

Such mammoth penalties raise a contention that these powers are much more than the civil liabilities, the disciplinary proceedings which results in debarment of professionals ought to be quasi-criminal in nature as has been dealt with in the case of *An Advocate v. Bar Council of India and Ors.*[12]

"3. (i) essentially the proceedings are quasi-criminal in character inasmuch as a Member of the profession can be visited with penal consequences which affect his right to practice the profession as also his honour; under Section 35(3)(d) of the Act, the name of the Advocate found guilty of professional or other misconduct can be removed from the State Roll of Advocates. This extreme penalty is equivalent of ***death penalty*** *which is in vogue in criminal jurisprudence.*

…

A disciplinary proceeding by a statutory body of the Members of the profession which is statutorily empowered to impose a punishment including a punishment of such immense proportions in quasi-criminal in character"[13]

The punishments in the above case were also concerned with removal of the advocate's name from the rolls of the Bar Council and suspending him from practice for a period deemed fit by it. NFRA, which can confer punishments as harsh as this, would be under the ambit of quasi-criminal proceedings.

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[12] An Advocate v. Bar Council of India and Ors. MANU/SC/0023/1988 (Ind.)

[13] *Id.*

Hence, what relates to as '*equivalent of death penalty*' as inferred by the Hon'ble Supreme Court of India can be provided for by NFRA in not a detailed procedure but by a mere summary procedure as defined by Rule 10 (6). This infamy creates a whole new ball game which now questions the very functioning of NFRA as discussed in the subsequent chapter. [**Emphasis supplied**]

III. VIOLATION OF NATURAL JUSTICE PRINCIPLES BY NFRA AND ITS IRREGULAR OPERATING PROCEDURES

A. ICAI & NFRA: A GLIMPSE

"The Institute of Chartered Accountants of India (ICAI) is a statutory body established by an Act of Parliament, viz. The Chartered Accountants Act, 1949 (Act No.XXXVIII of 1949) for regulation and development of the profession of Chartered Accountants in the country."[14]

To the uninitiated, this phrase which comes at the beginning of *'About us'* page of ICAI, leads to the fact that it is ICAI, which was introduced by the CA Act 1949 regulates the CAs in the country, for it is the CAs which are the backbone of Indian economy in public interest. This body, though operating under the administrative control of Ministry of Corporate Affairs ("**MCA**"), Government of India is in practice since 1949 and is regarded as one of the pivotal bodies in the realm of commerce and finance. Its effectiveness can be understood from the fact that the common CA aspirants and practitioners regard its role. One such example is highlighted below:

"As the country's premier accounting body, the ICAI has been instrumental in promoting financial transparency, ensuring adherence to accounting standards, and fostering investor confidence"[15]

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[14] *The Institute of Chartered Accountants of India'*, https://icai.org/new_post.html?post_id=165&c_id=195#:~:text=The%20Institute%20of%20Chartered%20Accountants%20of%20India%20(ICAI)%20is%20a,Chartered%20Accountants%20in%20the%20country.

[15] Mayank Khandelwal, *The Impact of ICAI on the Economic Environment in India*, LINKEDIN (June 10, 2023) https://www.linkedin.com/pulse/impact-icai-economic-environment-india-mayank-khandelwal/.

It functions as an *'operationally independent body'* since a prescribed exam is to be cleared for being a member of ICAI and the top brass is elected by the members itself rather than being appointed by the Central Government[16] unlike followed by NFRA.

The court proceedings for the Deloitte Haskins case, reiterated the contention of NFRA that this body was created after the despicable trident scams such as the Satyam scam in 2009[17], Fortis hospital fraud in 2018[18] and the PNB scam in 2018. However, it is worth noting that concerns regarding

> *"[NFRA's need to] infrastructure, talent, technology and a high-quality membership to keep pace with the times."*[19]

was considered by giants such as Grant Thornton even before its inception. Recent trends of conflicts of interest with ICAI poses another pertinent question about whether there was really a need to establish NFRA or was strengthening of ICAI not given enough thought?

B. OVERLAPPING JURISDICTIONS OF ICAI AND NFRA

NFRA and ICAI both have been established based on similar objectives[20] and hence, locking an expected outcome. The ICAI has been empowered with establishing a Disciplinary Directorate to investigate the professional misconduct of auditors under Clause (7) of Part I of the Second Schedule read with Sections 21 and 22 of the Chartered Accountants Act 1949 while the NFRA can impose

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[16] *FAQs for Members Located Outside India,* https://www.icai.org/new_post.html?post_id=2101.

[17] *Satyam scam: All you need to know about India's biggest accounting fraud,* HINDUSTAN TIMES, (Apr. 9, 2015) https://www.hindustantimes.com/business/satyam-scam-all-you-need-to-know-about-india-s-biggest-accounting-fraud/story-YTfHTZy9K6NvsW8PxIEEYL.html.

[18] *Sebi issues demand notices to 5 entities in Fortis Healthcare fund diversion case*, ECONOMIC TIMES, (June 23, 2023) https://economictimes.indiatimes.com/markets/stocks/news/sebi-issues-demand-notices-to-5-entities-in-fortis-healthcare-fund-diversion-case/articleshow/101224265.cms.

[19] Vishesh C Chandiok, *NFRA for changing rules of business*, GRANT THORNTON (Oct. 8, 2015) https://www.grantthornton.in/press-room/nfra-for-changing-rules-of-business/.

[20] Rajat Deb, *Limning Auditing Indian Auditors,* 12(1) JINDAL JOURNAL OF BUSINESS RESEARCH, (2023).

'quasi-criminal' liabilities as well as pecuniary provisions not only on auditors but also the auditing firms.[21]

The procedures followed by the two bodies are also extremely different. Section 21A (2) which previously dealt with formation of a disciplinary board for the CAs considered summary procedure for all cases before it.[22] Summary procedure was followed that too for a maximum punishment of 3 months under Section 21A (3) (a) which has been further elaborated in **Chapter V**. It is noteworthy that after the 2022 amendment vis-à-visThe chartered accountants, the cost and works accountants and the company secretaries (Amendment) Act, 2022, the summary proceedings were removed and the Board was now required to follow any specified procedure which may include faceless or virtual hearings.[23]As observed during the court proceedings in the case of Deloitte Haskins, only one part of Schedule I dealt with summary procedures and that too has been amended now. Moreover, the procedure in Schedule II is a full-fledged trial, the disciplinary proceedings dealt with Rule 11 of NFRA Rules, 2018 proceeds solely with the summary procedure. Rule 11 dealing with issuing of a show cause notice to the auditor can virtually lead to penalties akin to the death penalty wherefore, in the name of timely disposal, NFRA can adamantly do so by summary procedures solely! A truly ground-shaking action by a regulatory body that regulates already regulated individuals! (NFRA further regulates CAs who are already regulated by ICAI.)

Section 21B of the CA Act, 1949 confers a fine of Rs. 5 lakhs and permanent debarment which is the reason why a detailed procedure for trial has been laid down in Schedule II of the CA Act, 1949 while none of these demarcations exist for what is regarded as a 'much-needed move- creating NFRA.'

A bare reading of NFRA Rules 2018 and its jurisdiction compels us to reiterate the fact that it is empowered by ensuring compliance with auditing standards. It looks at how auditing is carried out, it orders audits, checks procedures and further

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[21] *Id.*
[22] The Chartered Accountants Act, No. 38 of 1949, §21A (Ind.)
[23] The Chartered Accountants, the Cost and Works Accountants and the Companies Secretaries (Amendment) Act, No. 12 of 2022, (Ind.)

issues orders. No past orders, or future issues are considered by NFRA because a pure summary procedure is followed. We must also consider that misconduct is drawn from the CA Act itself and hence a 'grey' cloud is created over the overlapping jurisdictions of ICAI and NFRA.

If NFRA has been granted the power to conduct disciplinary proceedings, there is nothing which can stop it from conducting a separate proceeding for every audit which may even go against the auditors and thus would render the disciplinary board under CA Act, 1949 futile. Thus, NFRA eclipsing ICAI has been highlighted in this sub section which now leads us to considering how natural justice and fundamental rights of CAs are violated when NFRA takes an *'agnipariksha'* in the name of disciplinary proceedings.

C. VIOLATION OF FUNDAMENTAL RIGHTS AND NATURAL JUSTICE PRINCIPLES

Natural justice principles occupy the highest pedestal in operations for any organization, regulatory, investigatory, or adjudicatory. Hearing the other side or as the Latin maxim goes '*audi alteram partem*' is an important balancing feature for the 'Lady justice'. NFRA regrettably shadowed these principles too.

Unlike PCAOB, NFRA which can penalize firms or auditors for ethical or professional does not itself have a set code of ethics. Rather what is showcased is a mere 1-page NFRA Charter, a bare reading of which compels one to think of it as trivial pointers.[24]

It was observed during the pleadings that certain financial reports such as Audit Quality Review Report ("**AQRR**"), Draft Audit Quality Review Report ("DQARR") and Supplementary Audit Quality Review Report ("**SQARR**") are checked upon wherein a reasonable opportunity of filing a reply is not given to the firm. No proper justification of how and what laws are violated is included if we consider the facts of both the above-mentioned cases.

[24] Nfra Charter, *NATIONAL FINANCIAL REPORTING AUTHORITY*, https://nfra.gov.in/nfra-charter/#:~:text=Persons%20who%20work%20for%20NFRA,unflagging%20drive%20for%20their%20work.

Article 14 of the Indian Constitution[25] states that each person is equal in the eyes of the law and it is the duty of the State to not deny to any person equality before the law or the equal protection of the laws.[26] Professionals are no exception neither are auditors, everyone has a basic right to equality which cannot be undermined till there is a reasonable classification based on intelligible differentia.[27] Forming two separate bodies to monitor the same set of professionals is not justified in the first place. Adding on to that separate procedures which vary from case to case[28] further add to the perils of CAs which deny them their right to equality.

D. MISCELLANEOUS IRREGULARITIES IN OPERATIONS OF NFRA

1. *Unjustified vicarious liability*

Apart from the above-mentioned multi-levelled irregularities concerning NFRA, specific to the case of Deloitte Haskins, NFRA erroneously attributed the partner's wrongdoings of alleged professional and ethical misconduct to the whole firm without proper reason. It made Deloitte Haskins & Sells LLP liable for the acts of its partners though as per Section 27 of the Limited Liability Partnership, 2008 ("**LLP Act**") which defines the extent of liability of an LLP. Attributing the wrongdoings of a few partners to the whole firm is not justified especially when such hefty penalties can be levied. As observed from the proceedings, Section 27 (2) of the LLP Act deals with personal liability of partners that too in civil law. Applying the same for criminal penal provisions or even quasi-criminal provisions is not justified on part of NFRA which made the entire firm liable for acts of some of its partners.

2. *No separate work divisions*

[25] INDIA CONST. art.14.

[26] Hanamant Karanure, *Article 14 - Equality Before Law and Equality protection of the law,* MANUPATRA (June 2, 2022) https://articles.manupatra.com/article-details/Article-14-Equality-Before-Law-and-Equality-protection-of-the-law.

[27] Shri Ram Krishna Dalmia v. Shri Justice S. R. Tendolkar, (1959) SCR 279 (Ind.), See also E.P. Royappav v. State of T.N (1974) 4 SCC 3 (Ind.)

[28] National Financial Reporting Authority, *DEWAN P.N. CHOPRA & CO (Apr. 13, 2022)* https://www.dpncindia.com/blog/wpcontent/uploads/2020/04/NFRA_Report.pdf.

According to Section 132 (1A) of Companies Act, 2013 the NFRA shall perform the functions through prescribed divisions. This subsection is rendered futile since whether it is any report DQARR, SQARR or AQRR, all are handled by the same division. In practicality, the same division reviews and then investigates the audits which again highlights that NFRA is hearing another beat when it contends its procedural similarity with PCAOB which, under Rule 4 of Bylaws and Rules of the Public Company Accounting Oversight Board has a different Division of Registration and Inspections and Division of Monitoring among other divisions.[29]

IV. THE 'CHAKRAVYUH' OF PENALTIES BY NFRA AND ITS QUESTIONABLE RETROSPECTIVE APPLICATION

This chapter revolves around the issues raised in the cases of batch matter of Deloitte Haskins as well as Harish Kumar. Wherefore, NFRA conducted its investigation and penalized the auditors based on Financial Reports of financial year 2008-09till financial year 2017-2018. The notification released by the MCA dated 01.10.2018, and the MCA also notified on 24.10.2018 as effective date for coming into force of Section 132(2), (4), (5), (10), (13), (14) &(15) of Companies Act, 2013.[30] Hence, jurisdiction of NFRA over those reports which were audited even before its constitution was challenged.

As has already has been elaborated in previous section, the procedures of NFRA differ greatly when compared to ICAI and PCAOB but what further complicates this labyrinth is the retrospective application of penalties by NFRA. The judgment of Harish Kumar case mentioned NFRA may use its penalties in a retrospective manner by considering a tunnel vision of how only procedural amendments can be retrospective in nature.

There is yet another well-settled principle of law that any enactment which substantially affects the rights of people cannot be applied retrospectively[31], and

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[29] *Public Company Accounting Oversight Board Bylaws and Rules – Rules – Inspections* 2004, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://pcaobus.org/Rules/documents/section_4.pdf.

[30] *Supra* note *169*.

[31] Commissioner of Income Tax (Central), New Delhi v. Vatika Township Pvt. Ltd, (2015) 1 SCC 1 (Ind.)

therefore, NFRA, which does not contain an express provision for its retrospective application must proceed prospectively considering natural justice principles. It is also well settled that the law is not settled in cases where the retrospectivity of a statute is in question where no express provision is stated. To corroborate the same, in the case of *Union of India &Anr. v. M/s Ganpati Dealcom Pvt. Ltd.*[32] it was held that:

"17.10 It is well settled that the legislature has power to enact retroactive/retrospective civil legislations under the Constitution. However, Article 20(1) mandates that no law mandating a punitive provision can be enacted retrospectively. Further, a punitive provision cannot be couched as a civil provision to by-pass the mandate under Article 20(1) of the Constitution which follows the settled legal principle that "what cannot be done directly, cannot be done indirectly" ...."[33]

As stated earlier their disciplinary proceedings function by levying quasi-criminal penalties and hence no doubt regarding its sole prospective application should be in dispute.

The Hon'ble NCLAT, in the Harish Kumar case considered the contention of violation of Article 20 (1) of the Indian Constitution but invalidated the same by simply stating that it did not apply to the facts of the case which is a narrow reasoning given by the NCLAT. Professionals are permanently debarred from service and even ICAI barred auditors but only in extreme cases[34]since the powers have been enshrined considering the many stakeholders regulated by the body. NFRA on disposal of show cause notice can permanently debar the auditor or the firm, which, beyond reasonable doubt, does affect substantive rights of the petitioners. This uncertainty between substantive and procedural capacities of NFRA Rules has been explained in **Chapter V**.

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[32] Union of India &Anr. v M/s Ganpati Dealcom Pvt. Ltd, Civil Appeal No. 5783 of 2022 (SC).
[33] *Ibid.*
[34] Mannu Arora, *ICAI won't spare any CA guilty of fraud but don't paint everyone with the same brush: President Debashish Mitra*, ECON. TIMES (Mar. 23, 2022) https://cfo.economictimes.indiatimes.com/news/icai-wont-spare-any-ca-guilty-of-fraud-but-dont-paint-everyone-with-the-same-brush-president-debashis-mitra/90387351.

The Hon'ble Supreme Court in the landmark judgment of *Keshavan Madhava Menon v. The State of Bombay*[35] held that it is a cardinal principle that every statute is prima facie prospective unless it is expressly made to have a retrospective operation.

This principle of law follows from the legal maxim *'Nova constitution future is form amimponeredebetnon praeteritis'*, which translates to a new law ought to regulate what is to follow, not the past. The same view point has been taken in *Monnet Ispat& Energy Ltd. v. Union of Indian &Ors.*[36] where the Apex Court held that this principle operates until and unless there is an express provision in the statute stating retrospective applicability of the statutes.

Yet another point is raised from the fact that quasi-criminal penalties which can be applied on the auditors by NFRA which if applied retrospectively, would further diminish the natural justice principles over NFRA's modus operandi.

V. ANALYSIS OF THE HARISH KUMAR CASE

This chapter deals with the judgment of the Harish Kumar case in detail and shall critically analyse that how the NCLAT in this case gave a green flag to the unprecedented powers of NFRA leaving behind an unresolved conflict between ICAI and NFRA. However, before analysing the judgment it is sine qua non for the readers to be acquainted with the facts. The appellants in this case consisted of four CAs working under the firm K. Varghese & Co. Chartered Accountants ("**firm**"). The four appellants were appointed as the branch auditors of Dewan Housing Finance Ltd. ("**DHFL**") for the financial year 2014 – 2015 and were then reappointed for further four consecutive financial years that is 2015-16, 2016-17, 2017-18 and 2018-19. In 2022, NFRA ordered the firm to produce the audit files of the branch audits for the financial year 2017-18 which was complied with by the firm. On the grounds of fraud, invalid appointment of the branch auditors, violation of Standards of Accountings, NFRA instituted an Audit Quality Review and charged the appellants for professional misconduct. NFRA in its order on 13/04/2023, found the four appellants guilty on the above-mentioned grounds.

[35] Keshavan Madhava Menon v. The State of Bombay, (1951) SCR 228 (Ind.)
[36] Monnet Ispat & Energy Ltd. v Union of Indian & Ors., Civil Appeal No. 3285 of 2009 (SC).

NFRA consequently debarred the appellants from appointment as auditors for one year and were also imposed a penalty of Rs. 1,00,000 each.

The major issues framed by the NCLAT were:

1. Role of NFRA v/s ICAI on disciplinary matters of Chartered Accountants.
2. Retrospective v/s prospective applicability of provisions as contained in Section 132 of Companies Act, 2013 as well as NFRA Rules, 2018.
3. Violation of Principle of natural justice with respect to separate division of NFRA.

The NCLAT, for the purpose of resolving the 1st issue made some observations which appeared to be self-contradicting as explained below. While deliberating over this issue, NCLAT initially observed that the role of NFRA is distinct from that of ICAI, but later NCLAT went on to observe that ICAI and NFRA, both have disciplinary jurisdiction over the chartered accountants, and that NFRA has overriding jurisdiction over ICAI. This observation of the court has created a situation of tussle as the government has conferred similar powers upon two different authorities which differ in procedure and operations. Thus, a situation of conflict is inevitable. It must be considered that all the functions relating to the registering, regulating of the CAs, laying down the code of ethics and accounting standards are vested with ICAI along with the power to penalise the CAs for any kind of professional misconduct. Now, establishing another authority with almost similar or, so to say, extreme powers to punish the CAs for professional misconduct undermines the faith and the credibility of the decades long established statutory authority.

Another point of contention that becomes important to be deliberated upon is about the composition of these two authorities. ICAI constitutes of 40 members out of which 32 are to be elected by the CAs themselves.[37]On the contrary, NFRA

[37] ICAI, *Investors Education and Protection Fund Authority*, https://www.iepf.gov.in/content/iepf/global/master/Home/AboutUS/AboutIAP/Partners/icai.html#:~:text=The%20Council%20constitutes%20of%2040,Ministry%20of%20Finance%20and%20other.

can have a maximum of 15 members which are appointed by the Central Government.[38] By creating NFRA, the Central Government undermined the autonomy and independence of ICAI. As asserted in this judgment, the auditing process is very critical for the country's economy, hence, it is very crucial that the authority that is responsible for regulating such crucial aspect of our economy remains free from any external influence and be in the hands of those, who understand the process the best. This could be understood better by drawing an analogy with the National Judicial Appointment Commission ("**NJAC**"). In 2014, the Central Government brought NJAC to replace the traditional collegium system to appoint the judges, thus, giving more power in the matter of appointment of judges. The Supreme Court struck down NJAC by giving the reasoning that this will hamper the independence of judiciary which is of paramount importance in a democratic country.[39] Thus, on a similar parlance, by establishing NFRA the government has granted the body a plethora of powers which is dangerous for the autonomy and smooth functioning of the auditors as well as ICAI. This situation, hence calls for certain amendments, not to leave NFRA dormant but to bring both the regulatory bodies on a separate yet cooperative footing.

For the second and third issues relating to the retrospective application of NFRA and violation of natural justice principles, we need to consider the fact that it is a settled precedent that any law made, per will have a prospective application. Also, in cases involving substantive statutes, a prospective application is assumed while, on the contrary, a procedural law is presumed to be applied retrospectively.[40] The Supreme Court in the case of *Commissioner of Wealth Tax, Meerut v. Shravan Kumar Swarup*[41] clearly made a distinction between substantive and procedural laws. The court in this case asserted that the laws that define the rights and duties of natural or artificial persons are substantive in nature and the laws that lays down the method in which those rights and duties shall be implemented are procedural in nature. Based on this principle, it can be inferred

[38] The Companies Act, No. 18 of 2013, § 132(3) (Ind.)

[39] Supreme Court Advocates on Record Association & Anr. v Union of India, (2016) 5 SCC 1 (Ind.)

[40] Hitendra Vishnu Thakur and Ors. v. State of Maharashtra and Ors., (1994) 4 SCC 602 (Ind.)

[41] Commissioner of Wealth Tax, Meerut v. Shravan Kumar Swarup, (1994) 6 SCC 623 (Ind.)

that NFRA in its entirety cannot be proclaimed to be procedural in nature, since the NFRA Rules, in extension of Deep Ocean of powers, also defines an authority and further lays down its functions thus also bearing substantive characteristics. Thus, retrospective application of NFRA rules cannot be presumed especially when there is a lack of an express provision.

The Supreme Court in the case of *Zile Singh v. State of Haryana*[42]held that a statute can be applied retrospectively when it is explicitly mentioned in the statue or when the same can be implied from the reading of the statute. Another striking assertion inferred from the Harish Kumar case was that the penalty provisions vested with NFRA are less with respect to those with ICAI. A question is thus raised that when an authority such as ICAI already has ample powers why then was there a need for another authority as NFRA, regrettably, this question did not find mention in the judgement. Thus, there is a lack of ample intent of the reasons to make NFRA function retrospectively.

As already discussed in **Chapter III**, the amendment to the CA Act 1949 removed the provision of summary procedure. This is because of the reason which was observed during the proceedings in the case of Deloitte Haskins. It was inferred that it was not just to include summary proceedings in any of the Schedules since, primarily, the instances of professional misconduct given under Second Schedule are far graver and serious in nature than that of the First Schedule so having a summary procedure even in First Schedule trounced the objective of regulating the auditors in a harmonious manner. On the other hand, NFRA can impose penalties higher that of the Board of Discipline just by following a summary procedure which as explained above in **Chapter III** is against the principles of natural justice. The NCLAT in an ironical turn of events, itself recognized importance of the role of auditors in the Indian economy but then the judgment preferred harsh punishments on the auditors which raises concerns over the arguably biased ratio of this case. A case involving a fraud of around Rs. 31,000 Crores does reveal the breach of duty on the part of the auditors. Disposing it with a mere summary procedure rather than a complete trial

[42] Zile Singh v. State of Haryana, (2004) 8 SCC (Ind.)

not only threatens the principles of natural justice but also raises questions on the fairness of the procedure. As Lord Hewart said,

"Justice must not only be done, but must also be seen to be done," [43]

It is necessary that every aspect of a fraud of such high magnitude is investigated in a proper and detailed manner and is not disposed in a hasty manner for it was held in the case of *State Bank of India v. Central Information Commission &Anr*. Wherein while dealing with expeditious disposal of appeals, the Hon'ble Supreme Court held:

"Justice hurried means justice buried, is old saying which has to be kept in mind." [44]

It can thus, be argued that, NCLAT regrettably adopted one-sided approach while deciding this case and in a way recognized that NFRA is a far superior organisation than ICAI, however it must be considered that mere establishing of an authority will not prevent scams, but it is necessary to ensure that all the standards of accountings are effectively being implemented by the firms and the regulators do not unnecessarily interfere with their functioning.

VI. SUGGESTIONS: TIME TO AWAKEN THE FORCE YET AGAIN!

Having an authority to oversee the workings of any department and to impose penalties and punishment in cases of breaches of duty is necessary to create a deterrence in that department; however, it may not be sufficient. A balance must be maintained between regulations and ease of doing business. Working under a stringent authoritative umbrella as NFRA, hampers the efficiency of professionals since the auditing process is complicated by multiple regulations aimed at preventing scams. While this may be necessary to prevent frauds but there is not sufficient corroboration to the above finding on the part of NFRA.[45]While, scams including the Satyam scam, PNB scam happened during the reign of ICAI, NFRA has not proved to be quite the non-permeable authority as it was expected to be

[43] Rex v Sussex Justices, (1924) 1 KB 256.
[44] State Bank of India v. Central Information Commission &Anr., CWP-8046-2013 (P&H HC).
[45] Shalini Perumpral and others, *The evolution of Indian accounting standards: Its history and current status with regard to International Financial Reporting Standards* 25 Advances in Accountings 106, 111 (2009).

since there has been an increase in financial frauds in India.[46]It is very well possible for stakeholders to find and exploit loopholes and auditor regulation is no exception. It is the need of the hour to amend the current laws and minimize the loopholes to the extent possible by primarily eliminating the conflict between NFRA and ICAI.

The Companies Act 2013, prescribes that NFRA shall work in divisions.[47] However, as observed from the proceedings of the Harish Kumar case that till now no such divisions have been specified. NFRA has been given inter alia the responsibility of conducting Audit Quality Review, investigating fraud matters and imposing penalties for proven professional misconduct by auditors.[48] Thus, proper divisions within NFRA are necessary for efficient function.

The distinction between ICAI and NFRA is in the grey. NFRA Rules, 2018, prescribe the classes of companies over which NFRA has the authority to regulate, but ICAI already has the power over these companies which extends the absurdities. There should be clear specification with respect to the companies and the types of matter they can take cognizance of.

As already discussed in **Chapter V**, for investigation into the matters of professional misconduct which leads to scams and frauds of nature, a summary procedure is neither just nor suitable. It no doubt results in speedy investigation and disposal of cases but, when the interest of a country's economy is at stake, the quality of investigation is of more importance rather than the time. Thus, there should be a detailed procedure of investigation in serious matters of fraud.

In the case of *S. Kumar v. Secretary ICAI &Ors.* the court asked the government to constitute an authority which will be in consonance with the PCAOB functioning in the USA with respect to its objectives, powers, and functions.[49] However, NFRA falls out of line with the PCAOB. The members of the PCAOB are appointed by the Securities Exchange Commission, while, the constitution of

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[46] *Financial frauds in India rose 65% between 2021 and 2022: Finance Ministry*, BUSINESS STANDARD (July 28, 2023) https://www.business-standard.com/economy/news/financial-frauds-in-india-rose-65-between-2021-and-2022-finance-ministry-123072800204_1.html.

[47] The Companies Act, No. 18 of 2013, § 132(1A) (Ind.)

[48] *Supra* note *169*.

[49] S. Kumar v. Secretary ICAI & Ors., (2018) 14 SCC 2018 (Ind.)

NFRA undertakes a major role of the government. NFRA is also funded by the government which is unlike international standards. NFRA will remain independent on papers solely until segregated completely from shackles of the government in terms of its constitution. This will subject the functioning of NFRA to skepticism and will always raise doubts on their fairness and impartiality because the loophole of government interference might be in the limelight. Thus, it becomes crucial that NFRA becomes more autonomous. It must be considered that NFRA has been established through NFRA Rules, and it takes not much time for the Central Government to amend the rules. Unlike statutes, government can easily amend rules according to their own wish, mere by a notification in the official gazette.[50]

The government that formulated NFRA Rules also has the power to amend them. While the researchers wish that economic frauds are eliminated, one must also consider the implications of lacking standard ethical procedures for a newly formed regulatory authority with significant powers. Hence, the primary step shall be formulating an 'Ethical Code of Conduct' for NFRA which is a step with multiple positive results, analogous to PCAOB. Composition of PCAOB is also much more elaborate which can be followed, if not imitated, by the regulatory authorities in India.

Another striking attribute of PCAOB is its own internal oversight to further add to its value and counter any conflict of interests. This is the Office of Internal Oversight. NFRA can again take cues to avoid conflicts of interest, something, which has surrounded this body right from its inception.[51]

*"The Office of Internal Oversight and Performance Assurance ("**IOPA**") provides independent, objective assurance designed to add value to the organization. The Office provides internal examination of the programs and operations of the PCAOB to help ensure the internal integrity, efficiency, and effectiveness of those programs and operations. To ensure its own internal*

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[50] General Clauses Act, No. 20 of 1977, §23 (Ind.).

[51] Robin Banerjee, *Nfra: is it 'nafrat' or 'lafra' for icai?*' ECON. TIMES (Sept. 21, 2021) https://cfo.economictimes.indiatimes.com/.

audit work quality, IOPA follows the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing."[52]

NFRA has been given the power to debar the member or the firm in the case of proven professional misconduct. In respect of the LLP firm, the firm and its partners will have unlimited liable for any defrauding act, or any other act done for fraudulent purposes. However, there is no clarification with respect to in which cases, NFRA will debar the firm. It is fit to assume an analogy of a sword hanging on the heads of the auditing firms because this increases the chance of arbitrary use of powers by NFRA, which could disrupt the harmonious functioning of the auditing firms.

The primary objective for any regulatory authority is to work in cooperation with the entities it is regulating rather than exposing them to any unnecessary scrutiny or arbitrary penalties. These are some suggestions that if incorporated, can create an ecosystem whereby auditors can be encouraged to perform their duties and functions more diligently and in a responsible manner. There are many auditors who perform their functions with utmost honesty and professionalism and their interests should not be compromised while punishing the ones who failed to perform their duty.

VII. CONCLUSION

After analyzing each aspect of functioning of NFRA, the intent behind constituting NFRA and the effects it has in a practical sense seem to fade into different directions. While the contentions behind constituting NFRA revolve mostly around the financial scams during the reign of ICAI creating another institution at a time when financial scams have still not reduced to a considerable level creates a counterproductive effect since what was brought in to carry out expeditious disposal of cases via summary procedures, has been strangled in a quicksand of paperwork, which has not produced the desired results. Whether this step is a hasty decision or a misdirected collapse remains to be seen. Not much time has passed since the baton was transferred to NFRA, although much heat has already been faced from those governed.

[52] *INTERNAL OVERSIGHT,* PCAOB, https://pcaobus.org/about/internal-oversight.

The modus operandi of NFRA remains penalizing firms and auditors for interpreting management standards as per its own understanding which may likely be a missed opportunity, might be a missed shot since in the Deloitte Haskins case no mention of which ethical standards were violated by the auditors was found in the reviewed reports. Improper reasoning and superfluous powers remain its sword and shield respectively which is used to wage wars with the auditing firms which now have two regulators to comply with.

Striking off NFRA are not what we, as researchers desire, since independent audit regulators is a practice usually followed around the world but ethical standards, which are not yet being followed by NFRA, are the norm[53] which is not yet being followed by NFRA and hence a proper cooperation between NFRA and ICAI is required for protecting interests of accounting professionals who ensure that the economic stability is maintained. Extreme provisions can easily weaken this backbone, rendering the economic system vulnerable to mishaps.

"What we need is Star Peace and not Star Wars"
- Mikhail Gorbachev, Former President of the Soviet Union.[54]

BLINK AND YOU'LL MISS IT: THE FAST LANE OF HIGH-FREQUENCY TRADING AND LEGAL BUMPS IN INDIA

Yash Sharan and S.K. Subhiksha[*]

ABSTRACT

*High-frequency trading ("**HFT**") is an algorithmic trading strategy characterised by high-speed trading, an extremely large number of transactions, and a very short-term investment horizon. This innovation has been hailed as a double-edged sword, promising opportunities, and exposing risks that traditional frameworks are ill-equipped to manage. The dynamic nature of HFT challenges existing regulations rooted in a slower trading environment leaving critical gaps*

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[53] Christopher Hodges, *Ethics in Business Practice and Regulation' (2015) 10 Law and Corporate Behaviour: Integrating Theories of Regulation and Enforcement,* https://assets.publishing.service.gov.uk/media/5a7f3f18e5274a2e87db4afc/Prof_Christopher_Hodges_-_Ethics_for_regulators.pdf.

[54] Steven R. Weisman, *Gorbachev calls for 'star peace',* NEW YORK TIMES (Nov. 28, 1896) https://www.nytimes.com/1986/11/28/world/gorbachev-calls-for-star-peace.html.

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*in investor protection. The fast-paced trading has reinforced systemic risks such as market volatility, and market inequality. This article critically examines the shortfalls in Indian regulations concerning HFT in three substantial parts. Part I delves into an analysis of the existing systemic risks posed by HFT. Part II undertakes a two-fold analysis. Firstly, it analyses the regulatory challenges in regulations such as the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations ("**PFUTP**") and the SEBI's Prohibition of Insider Trading Regulations ("**PIT**") regulations. Secondly, it aims to assess the adequacy of the Securities and Exchange Board of India ("**SEBI**") proposed models to overcome systemic risks ranging from shared colocation services to free access to tick-by-tick ("**TBT**"). Part III argues for a comprehensive framework that addresses the lacunae in the current set-up, borrowing from established global practices that would solidify India's commitment to Investor protection. Finally, the paper closes with a summary of the entire analysis, highlighting the way forward that would bolster Investor protection standards, focusing on enhancing transparency, tightening oversight, and ensuring a level playing field for all market participants.*

Keywords: High-Frequency Trading, Algorithmic Trading, Investor Protection, Market Volatility.

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I. INTRODUCTION

In the early hours of May 6, 2010, the global financial markets experienced an unprecedented event now known as the "Flash Crash".[1] Within minutes, the Dow Jones Industrial Average plummeted nearly 1,000 points, wiping out trillions of dollars in market value before rebounding almost as quickly. The culprit? High-Frequency Trading ("**HFT**"). This was not an isolated incident,[2] starkly highlighting the dual-edged nature of HFT: while it offers traders equipped with sophisticated algorithms the potential for enormous profits, it also exposes the market to systemic risks and unpredictable disruptions.

Algorithmic Trading ("**AT**") refers to the use of pre-programmed instructions for executing trades through automated systems. This type of trading relies on sophisticated algorithms, complex mathematical models, and delegated decision-making processes to enable traders to execute a high volume of orders within very short time frames, allowing them to capitalise on fleeting opportunities in the fluctuating securities market.[3] HFT encompasses algorithmic strategies that are executed automatically and within extremely short time frames, typically on a sub-second scale. As a specialized subset of AT, HFT involves latency-sensitive strategies and leverages advanced technologies, such as high-speed networks and colocation, to connect and trade on various trading platforms.[4] HFT has emerged as a powerful tool in today's technology-driven environment and enables traders to gain significant profits in short timeframes. However, the rapid pace and complexity of HFT have raised concerns that need to be carefully addressed. The volume-intensive trade in milliseconds can trigger price swings, impacting market stability. HFT can exploit market information by detecting large trades in progress, allowing firms to front-run these trades and profit, thereby compromising market fairness and integrity. These concerns coupled with technophobic concerns - a pattern observed throughout history whenever new technologies emerge - have

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[1] Jill Treanor, *The 2010 'flash crash': how it unfolded,* THE GUARDIAN (Aug. 18, 2024) https://www.theguardian.com/business/2015/apr/22/2010-flash-crash-new-york-stock-exchange-unfolded.

[2] Dr Arze Karam, *High Frequency Trading and Liquidity Crisis,* DURHAN=M UNIVERSITY (April 2021) https://www.durham.ac.uk/business/impact/finance/high-frequency-trading-and-liquidity-crisis/.

[3] Manal Shah, *Algorithmic Trading in India*, THE SECURITIES BLAWG (Aug. 25, 2018) https://www.thesecuritiesblawg.in/post/algorithmic-trading-in-india.

[4] *Id.*

shockingly driven few scholars to call for a complete shutdown and withdrawal of AT including HFT from the market.[5]

While these concerns are not completely unfounded, they do not warrant drastic measures that would deprive the market of undeniable benefits like liquidity, and profit maximisation.[6] These views stem from the belief that AT, especially HFT is a sudden and market disruptive innovation. Contrarily, HFT is merely a natural progression to the developments that have been occurring over decades, given the multiple drivers that have fuelled its rise such as new market access models, innovative free structures, reduced latency, and increased competition and fragmentation of order flow. The interaction among these drivers led to the popularity of HFT.[7]

In the Indian context, HFT has emerged as a growing phenomenon over the past few decades.[8] India's financial markets have undergone rapid modernization, with the introduction of electronic trading platforms, enhanced connectivity, and sophisticated trading tools. The Securities and Exchange Board of India ("**SEBI**") has played a pivotal role in encouraging these developments, implementing regulations that support technological advancements while striving to maintain market integrity. Despite these advancements, the prominence of HFT in India is not without its challenges. The unique market structure, evolving regulatory environment, and growing reliance on technology have raised specific concerns that must be addressed to ensure the stability and efficiency of the market. Analysing these challenges is crucial for drafting holistic regulations that cater to the specific needs of the Indian market.

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[5] Prashant Pranjal & Abhinav Kumar, *Put the technology genie back in the bottle: A critique of algorithmic trading,* 28 TAXMANN 31 (2012).

[6] Religare Broking, *High-Frequency Trading in India: A Detailed Guide to Getting Started,* RELIGARE BROKING (June 07, 2024) https://www.religareonline.com/blog/high-frequency-trading/.

[7] Peter Gomber et al, *High frequency trading,* SOCIAL SCIENCES RESEARCH NETWORK, 1, 9-12 (2011) http://ssrn.com/abstract=1858626.

[8] Divya, *High Frequency Trading (HFT) landscape in India*, MEDIUM (Jan. 28, 2024) https://medium.com/@divyaapillaii/high-frequency-trading-hft-landscape-in-india-770a682dee33.

II. THE COMPLEXITIES OF HIGH-FREQUENCY TRADING: ANALYSING THE SYSTEMIC RISKS

HFT is not inherently de-stabilising since it can increase liquidity and reduce market volatility. Moreover, HFT is indicative of the existing structural economic issues rather than being the cause of the issues. However, HFT's potential to exacerbate market volatility has been a hotbed of recurring debate.[9] The large-scale trading in extremely short periods, liquidity withdrawal, frequent order placements, and cancellations during uncertainty result in market volatility.

Manipulative techniques like quote stuffing[10], spoofing[11] and layering[12]have been found to create artificial demand in the market, misleading other traders and gaining profits. An example of this would be the case of JPMorgan.[13] The banks' traders used HFT strategies to place large orders with no intention of executing them, creating a false impression of market demand and influencing prices, and JPMorgan was heavily penalised. The SEBI Prohibition of Fraudulent and Unfair Trade Practices Regulations ("**PFUTP**") is equipped to address these kinds of challenges, however accounting for the unique challenges posed by HFT such as the borderless functioning of HFT will pave the way for holistic investor protection.[14]

HFT is also feared by scholars to exacerbate existing market inequalities.[15] HFT technologies have huge setup and operational costs, placing them beyond the reach of small and medium firms. Additionally, HFT aims to capitalize on latency

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[9] Greg MacSweeney, *The Great HFT Debate Is Yesterday's News*, WALLSTREET & TECHNOLOGY (Aug. 4, 2014) https://www.wallstreetandtech.com/trading-technology/the-great-hft-debate-is-yesterdays-news/d/d-id/1268849d41d.html?.

[10] Jared F. Eggington et al, *Quote Stuffing,* 45 FIN. MANAGEMENT (Jan. 19, 2016) https://onlinelibrary.wiley.com/doi/10.1111/fima.12126.

[11] P. Ramesh Babu et al, *A Comprehensive Analysis of Spoofing*, 1 INT'L J. OF ADV. COMP. SCI. AND APPL. (2010).

[12] Giliberto Capano, *Reconceptualizing layering—From mode of institutional change to mode of institutional design: Types and outputs*, 97 PUBLIC ADMN. 590, 604 (2019).

[13] Deepali Aggarwal & Zarnash Khan, *The Spoofing Puzzle: Deciphering Market Manipulation, 1,1.*

[14] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to securities market) Regulations, 2003, Gazette of India (July 17, 2003).

[15] Renata Karkowska & Andrzej Palczewski, *Does high-frequency trading actually improve market liquidity? A comparative study for selected models and measures*, 64 RESEARCH IN INTERNATIONAL BUSINESS AND FINANCE (2023).

by taking advantage of the time delay between when data is generated and when it is received, thereby creating a competitive edge. The SEBI through its circular on AT and colocation has tried to propose measures that would mitigate unfairness. While the intent is praiseworthy, it fails to address various concerns rendering the measures insufficient.

Further, HFT raises serious concerns regarding trading errors driven by technological glitches or malfunctions leading to unintended market disruptions and financial losses. Irrespective of the nature of the mistake, this causes a serious threat to investor protection. The infamous "Algorithmic Trading Malfunction" incident at Goldman Sachs, where a technological glitch resulted in a rapid influx of trades and the consequential market price disruption highlights the significance of addressing this issue to fortify commitment to investor protection.[16]

Additionally, the SEBI's circular, "*Measures to strengthen Algorithmic trading and Colocation*" [17]mandates regulation, control, and supervision over the use of secondary servers, which cache files from primary servers to enhance system performance. While SEBI has issued guidelines allowing exchanges to create their own rules, many exchanges have neglected this responsibility, leading to potential rule circumvention. The Securities Appellate Tribunal in *NSEIL v. SEB*I underscored the need for proper guidelines to monitor collocation services, especially those employing secondary servers, to prevent market manipulation and ensure equal access for all market participants. [18]The case revealed that the absence of standardized regulations allowed certain brokers preferential access, compromising market integrity by enabling them to trade faster than others. This unequal access, facilitated by secondary servers in Tick-by-Tick ("**TBT**") systems, highlights the need for SEBI to enforce strict guidelines. The lack of accountability in framing and enforcing these guidelines has left the system vulnerable to

[16] *Federal Register: Regulation Automated Trading*, COMMODITY FUTURES TRADING COMMISSION (Nov. 27, 2015) https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/federalregister112415.pdf.

[17] Measures to strengthen Algorithmic Trading and Co-location / Proximity Hosting framework, 2018, SEBI/HO/MRD/DP/CIR/P/2018/62 (Apr. 09, 2018).

[18] National Stock Exchange of India Ltd. v. Securities and Exchange Board of India, (2023) Appeal No.333 of 2019, para 123 (Ind.)

exploitation. The lack of standardised regulations and accountability in managing secondary servers represents a systemic risk by allowing preferential access to certain brokers, which undermines market fairness and integrity. This unequal access creates vulnerabilities that can be exploited, leading to potential market manipulation and heightened volatility.

III. EVALUATING SEBI'S APPROACH TO HIGH-FREQUENCY TRADING: REGULATORY SHORTCOMINGS AND MODELS

The overarching issue with HFT is the lack of adequate regulations that cater to its specific challenges. Current regulations in India inadequately address these issues by applying outdated rules to unique technological challenges and struggles to keep pace with rapid advancements in trading technology. Unfair trade through market manipulation, frequent surveillance and maintenance are few aspects wherein there exists certain protection. Series of circulars by SEBI such as the broad regulations on AT provides broad contours that acts as a step towards regulation. They provide mandate for testing and surveillance however these guidelines are not sufficient to protect investors since surveillance and testing can only go so long towards protecting the interests of investors. The following sub-headings aim to address the specific regulatory concerns pertinent to various regulations.

A. REGULATORY CHALLENGES

1. *The Role of PFUTP Regulations and SEBI's Jurisdictional Authority*

The PFUTP regulations aim to prevent unfair and fraudulent trade practises. The broad ambit of the term "fraud" under regulation 2(c) of PFUTP helps in regulating the use of HFT for market manipulation.[19] This section encompasses "any act" including those using technology to influence people to trade in securities regardless of whether the methods are deceptive or lead to wrongful gains or avoidance of losses.[20] Market manipulation using HFT aims to induce

[19] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to securities market) Regulations, 2003, Gazette of India, pt. III sec. 4, Reg. 2 (July 17, 2003).
[20] Pyramid Saimira Theatre Ltd. v. The Securities and Exchange Board of India, (2010) Appeal No.242 of 2009 (Ind.)

people to trade in securities so that the HFT proprietary firm gains an unfair advantage. Additionally, specific risks of manipulation like artificial volatility, layering and quote stuffing are specifically prevented by Regulation 4 while Regulation 3 prohibits the dealing of securities or the use of technology to deal in securities that might create market volatility.[21] Despite the lack of a special focus on HFT the act serves to be adequate in dealing with HFT market manipulations.

However certain lacunae do exist. The lack of specific recognition of the potential market manipulation using HFT has resulted in no provision for cross-border enforcement. HFT operations are characterised by their fast-paced transactions that extend beyond boundaries. SEBI's territorially limited powers complicate enforcement of the PFUTP against foreign HFT firms engaging in manipulative practices that affect the Indian securities market.

However, in light of the effects doctrine articulated in *Haridas Exporters v. All India Float Glass Manufacturers Association*,[22] which allowed the **Monopolistic and Restrictive Trade Practices** ("**MRTP**") Commission to assert jurisdiction over foreign entities if their actions adversely affected competition within India, SEBI similarly possesses the authority to extend its jurisdiction over cross-border securities transactions and entities situated outside India. This principle was reaffirmed in *SEBI v. Sterlite Industries*[23], where SEBI exercised jurisdiction over foreign entities based on the impact or nexus of their securities with India. However, this doctrine remains somewhat ambiguous, potentially encroaching on the sovereignty of other states and raising concerns about jurisdictional overreach. Therefore, while SEBI's authority in such matters is established, there is a need to establish clear standards for cross-border enforcement to avoid conflicts with international sovereignty. Cross-border enforcement can permit a framework of protection that is accessible to retail investors and provides a concrete means for SEBI to ensure investor protection, including the investors using HFT.

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[21] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to securities market) Regulations, 2003, Gazette of India, pt. III sec. 4, Reg. 3, 4 (July 17, 2003).

[22] Haridas Exporters v. All India Float Glass Manufacturers Association, 2002 (6) SCC 600 (Ind.)

[23] SEBI v. Sterlite Industries, (2003) 45 SCL 475 (BOM).

B. INTERPRETIVE INEQUALITIES AND UNPUBLIC PRICE-SENSITIVE INFORMATION IN HFT

The SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**PIT**") regulations[24] aim to prevent insider trading by regulating the use of Unpublic Price-Sensitive Information ("**UPSI**") that is used to trade, placing other market participants at an unfair disadvantage. These regulations were framed to cater to the problems of insider trading posed by traditional trading, primarily focusing on explicit insider information.

However, HFT, with its rapid processing introduces legal dilemmas and challenges. HFT firms, equipped with advanced technological tools, continuously analyse market data, rapidly identifying patterns and extracting UPSI from publicly available market data, including quotes and volumes. Interpretive inequalities refer to the inequalities that are created as a result of disparity in means to process information, resulting in advantageous positions to those possessing better technological infrastructure. This UPSI, while derived from public sources, falls outside the definition of insider information but remains inaccessible to retail investors due to technological limitations. This situation creates a grey area that can be exploited, affecting the fairness of the market—an issue that the PIT regulations are originally designed to address in order to ensure a level playing field.

Ticker tape arbitrage exemplifies this phenomenon.[25] HFT firms access ticker tape data to obtain information about price fluctuations, enabling them to execute trades within milliseconds—an opportunity not available to other market participants. The failure to acknowledge the dynamic challenges posed by HFT contributes to this grey area, underscoring the need for effective regulatory measures to uphold market fairness and integrity.

C. A CRITICAL REVIEW OF SEBI PROPOSED MODELS

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[24] The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Gazette of India, pt. III sec. 4 (Jan. 15, 2015).

[25] *What is Ticker Tape-A Comprehensive Guide*, RELIGARE BROKING (Mar. 28, 2024) https://www.religareonline.com/knowledge-centre/share-market/what-is-ticker-tape/.

SEBI's recent circular concerning measures for strengthening the AT framework proposes six major solutions aimed at transforming the dynamics of AT in India.[26] While the authors concur with the functionality of few proposals, they remain sceptical regarding the utility of shared colocation centres and free access to TBT.

1. *Order to trade ratio*

Order to Trade Ratios ("**OTR**") refers to number of orders placed, modified or cancelled over number of executed transactions of the HFT user.[27]Large firms that have the capacity to use HFT technologies often use strategies based on cost of business and not morals and ethics. This means that even an immoral practice will be employed if the cost of business to profit ratio is favourable. In light of this, the reduction of OTR penalty exemption threshold from 1% to 0.75% forces firms to move away from cost manipulative strategies by increasing the cost of relying on them. They help stabilize the market and ensure fairness by curbing rapid order placements and cancellations, while also controlling the ratio of orders to trades. This approach lowers volatility and promotes a more equitable trading environment. However, it is essential to ensure proper compliance and implementation.

2. *Shared Colocation services*

The next major concern revolves around shared co-location. This proposal of SEBI aims to provide shared colocation centres to address concerns regarding free access and market inequality. While the intent behind this model is commendable, the idea serves to be more harmful than provide benefit. The authors believe that despite few concerns[28] with the current set up, it does not warrant the setting up of shared colocation centres. Shared colocation centres aim

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[26] MEASURES TO STRENGTHEN ALGORITHMIC TRADING AND CO-LOCATION/PROXIMITY HOSTING FRAMEWORK, CIRCULAR NO. SEBI/HO/MRD/DP/CIR/P/2018/62 (2018), https://www.sebi.gov.in/legal/circulars/apr-2018/measures-to-strengthen-algorithmic-trading-and-co-location-proximity-hosting-framework_38605.html.

[27] Hizmete Ozel, *Billing of High Frequency Trading (hft) Users With Order to Trade Ratio (otr) Method 2* (2023).

[28] *The 3 Biggest Challenges of Colocation (And How to Overcome Them)*, LIBERT CENTER ONE (Mar. 2, 2020) https://www.libertycenterone.com/blog/the-3-biggest-challenges-of-colocation/.

to reduce market inequality, but inequality typically refers to restricted access to essential needs. In the case of small and medium investors, their nature of operations does not necessitate HFT or colocation services for several reasons.

Firstly, the nature of operations of small and medium investors does not warrant HFT and colocation services. These investors predominantly adopt long-term investment strategies such as value investing, index funds, or mutual funds, prioritising the gradual accumulation of wealth through sustained asset holding over extended periods. Their investment strategies are typically rooted in fundamental analysis and a focus on long-term growth potential rather than the opportunistic exploitation of temporary market movements. The principal function of colocation services, which is to reduce latency and enable swift responses to market fluctuations, is of limited consequence to these small and medium investors.

Even for small traders, who may engage in trading activities with greater frequency, the primary focus often lies in personal interest and the acquisition of experiential knowledge, rather than in competing with sophisticated HFT entities. The inherent complexity and financial burden associated with the deployment and maintenance of infrastructure render colocation services unnecessary and financially prohibitive for this investor segment. Even with the provision of the proposed shared colocation services the financial burden is not entirely eliminated due to high maintenance costs, the potential penalties that they might face due to high costs involved in complying with regulatory requirements, losses due to cyber-security risks etc.

Furthermore, small and medium investors typically execute trades in lower volumes relative to large institutional investors or HFT firms. The advantages conferred by colocation services are more pronounced in the context of high trading volumes, where marginal gains can aggregate to substantial profits. Consequently, the significant costs associated with colocation services cannot be justified for the modest trade volumes characteristic of small and medium investors. Overall, the immediacy afforded by colocation services does not align with the operational ethos of these investors.

Secondly, the diminution of the competitive edge that HFT and colocation services offer becomes redundant by universalisation of colocation services by virtue of shared colocation services. The competitive advantage offered is contingent on ability of firms to execute trades faster than other market participants through reduced latency. However, providing shared colocation services to all market participants, including those whose operations do not require such services, undermines the competitive advantage they are meant to offer. The premise of HFT becomes obsolete if all participants possessed equivalent access to low-latency trading, as the strategic advantage conferred by speed would no longer be the exclusive to entities capable of investing in advanced infrastructure.

Thirdly, this proposal that seeks to foster fairness and equal access might exacerbate existing market inequalities rather than the objective they seek to achieve. As previously established the financial burden despite shared colocation services, market saturation due to universalization, lack of high-volume trading, might reduce the margin of profits or even result in losses to these investors. On the contrary, the larger HFT firms can divert resources towards updating, innovation and optimisation with help of shared colocation services. Therefore, Large firms would gain more profits while the margin of profits to other investors drastically reduces. Moreover, the increased demand and competition, consequential of shared colocation centres might lead to arbitrary decisions regarding who gets access to the limited centres, perpetuating market inequality further.

Other than this there also exist fundamental drawbacks in the model proposed itself. The shared colocation services would result in high costs for SEBI. Other than the high installation costs, the on-going maintenance costs and costs incurred in updating the technology to keep in pace with new developments would increase the financial burden on SEBI.

Indian security market is one of the largest in the world with approximately 5000 listed companies and approximately 100 million active demat

accounts.[29] Considering such circumstances crowding of infrastructure is a very real possibility that might lead to potential inefficiencies. Should many market participants seek to utilize the same colocation facilities, the benefits of reduced latency could be undermined by the resultant traffic congestion, thereby impairing trade execution speeds and creating additional technical complications.

The universal provision of access to colocation services could inadvertently incentivize a broader spectrum of firms, including those lacking the requisite expertise, to engage in high-frequency trading. This could lead to heightened market volatility and the potential for reckless trading behaviour. The influx of inexperienced participants may trigger a cascade of unforeseen consequences, including market manipulation and systemic risks, thereby opening a "Pandora's box" of regulatory and financial challenges.

3. *Proposals Concerning Knowledge Parity in Trading*

The problem of unfairness that HFT poses is compounded by the lack of adequate knowledge. SEBI proposes to resolve this in a three-pronged approach; measurement and publishing of latency, increasing the depth of snapshot of 5 best bids, and providing free TBT.[30] While the former two approaches can go a long way in addressing information asymmetry, the latter may face significant shortcomings. This proposal aims to find a balance between ensuring free market access and mitigating the operational costs for trading members. By providing TBT data feeds at no charge, the proposal seeks to enhance transparency and market efficiency. However, the issue stems from a fallacious identification of the root cause. The underlying disparity in the market arises from small firms' inability to afford advanced technological infrastructures and their lack of technological expertise compared to that available to large HFT proprietary firms. Providing free access to TBT data will not rectify this issue; instead, it will likely amplify the competitive edge of larger firms by significantly lowering their operational costs, thereby placing smaller firms in an even more disadvantaged position. For instance, a large trading firm with advanced algorithmic trading systems could

[29] Sundar Sethuraman, *In a first, India's demat tally surges past 150 million mark in March*, BUSINESS STANDARD (Apr. 06, 2024) https://www.business-standard.com/markets/news/india-s-demat-tally-crosses-150-million-mark-for-the-first-time-in-march-124040501034_1.html.
[30] MEASURES FOR STRENGTHENING ALGORITHMIC TRADING FRAMEWORK, *supra* note 27.

utilize free TBT data to enhance its trading strategies and divert the resources to achieve higher profitability, while a smaller firm with fewer resources might struggle to keep pace, ultimately widening the gap between them.

This concern is mirrored in the Australian Securities and Investment Commission guidelines[31] implementation challenges, where larger firms monopolize the advantages of free data access, further marginalizing smaller players who lack equivalent technological capabilities. Even if smaller firms manage to secure the capital for infrastructure investments, the ongoing costs of maintenance and regulatory compliance, that require capital-intensive monitoring and testing infrastructure will perpetuate, if not exacerbate, the existing imbalance. This phenomenon is exemplified by the implementation difficulties encountered by the EU under the Markets in Financial Instruments Directive II ("**MiFID II**"), where compliance costs have similarly disadvantaged smaller market participants.[32]

IV. POSSIBLE SOLUTIONS

The lack of a comprehensive framework concerning HFT is the common thread that binds all the concerns raised. This framework must be brought in immediately to prevent any long-lasting damage. Mere circulars that provide a broad framework leaving it to the exchanges to make rules within them is not adequate as experience has proven time and again. In light of this urgent need for such a framework, the authors propose and analyse various solutions under different categories that would contribute to such a framework.

A. REGULATORY AMENDMENTS

The authors propose the amendment of PFUTP regulations to enable well-established standards for cross-border enforcement. The *effects doctrine*[33] that is

[31] MINISTRY OF TREASURY, *Performance of the Australian Securities and Investments Commission* (2014), https://ministers.treasury.gov.au/sites/ministers.treasury.gov.au/files/2019-05/Govt_Response_Performance_of_ASIC.pdf.
[32] MIFID II: TOP CONSIDERATIONS AND CHALLENGES, DEUTSCHE ASSET MANAGEMENT (Oct.2017) https://www.ecb.europa.eu/paym/groups/pdf/fxcg/2017/20171005_Item_3_MiFiD_II_Top_considerations_and_challenges_DeAM.pdf.
[33] Haridas Exporters v. All India Float Glass Manufacturers Association, *Supra* note 23.

analogous to the conducts and effects test has also been criticised by the US Supreme Court in the case of *Morrison v. National Australia Bank Ltd* to be hopelessly vague.[34] The proposed amendment in PFUTP must be refined to introduce certainty. The scope of terms conduct and effect must be clarified. Conduct should include digital and algorithmic activity as well as actions by third-party intermediaries that facilitate trade in foreign jurisdictions to ensure effective regulation. Incorporation of a quantitative threshold to determine significant effects on the domestic market to trigger jurisdiction can reduce arbitrary decisions. Systemic risks like market volatility and liquidity crisis. The inclusion of the presumption of intent clause and international cooperation mandates can ensure effective regulation. Additionally, the introduction of a minimum contacts standard where any foreign entity with a minimal level of trading activity, client base, or assets in the domestic market is automatically subject to the conduct and effects test is essential for robust protection. However, to prevent conflict with international law and prevent impinging on the sovereignty of other countries, the amendment must be preceded by Treaties (both bilateral and multilateral) and Memoranda of Understanding ("**MOUs**") with several foreign regulators must be entered. This international cooperation coupled with enhanced powers would permit better regulation of HFT.

In the long term, dedicated efforts must be undertaken to create an international regulatory body that would address these cross-border issues concerning HFT. This has been under discussion in various international forums like G20 and the International Organization of Securities Commissions ("**IOSCO**"). The financial stability board and IOSCO could be models, which can be used to form international bodies to regulate HFT.[35]

Regulatory coordination and international cooperation are essential for addressing the global nature of HFT. Firstly, India could implement the creation of a dedicated HFT task force within the SEBI to address HFT-related problems with the help of the knowledge and experience of international counterparts.

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[34] Morrison v. National Australia Bank, 561 U.S. 247 (2010).

[35] *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, International Organization of Securities Commission (FR09/11 2011) (July, 2011) https://www.iosco.org/library/pubdocs/pdf/ioscopd354.pdf.

Participation in global regulatory forums would afford India an opportunity to participate in the development of international regulation while at the same time harmonizing its regulation with that of the rest of the world. Entering into information exchange treaties with the major financial hubs would further strengthen India's capacity to track cross-border HFT, plug the existing regulatory loopholes, and improve the efficiency of punitive measures. Market structure reforms are also important as they have a positive impact on the availability of capital. It has been suggested that reviewing tick sizes[36] across securities and the adoption of a dynamic tick size regime could enhance the price discovery process while at the same time addressing the problems posed by predatory HFTs. Exploring alternative trading mechanisms like frequent batch auctions or midpoint crossing networks would create a more level playing field by reducing the advantages of speed in continuous trading environments.

Moreover, the limitations within the PIT regulations need to be addressed to effectively regulate the unfair advantages gained through HFT practices. The definition of insider trading must be re-evaluated to encompass the grey areas arising from interpretive disparities. To enhance investor confidence and uphold the stability and integrity of the securities market, it is essential to mitigate information arbitrage resulting from asymmetrical access to market information. This necessitates amending the definitions of insider information. However, extreme caution must be exercised in delineating the boundary between permissible information processing for trading and the generation of UPSI from publicly available data. Striking the right balance is crucial: overly broad definitions could impede HFT operations by restricting essential information processing, while overly narrow definitions might fail to address the unfair advantages enjoyed by HFT firms due to their technological capabilities.

B. SURVEILLANCE, TESTING, AND SECURITY

To protect market integrity in the context of HFT, the regulatory framework must incorporate stringent provisions for surveillance and testing. The SEBI's proposals for simulated markets and algorithm tagging represent efficient

[36] *What is 'Tick Size',* THE ECONOMIC TIMES (DEC. 11, 2024) https://economictimes.indiatimes.com/defaultinterstitial.cms.

mechanisms to prevent HFT-induced market disruptions. Simulated markets, which replicate real-time market conditions, are effective in identifying errors and vulnerabilities, including those that might remain hidden during normal operations but could become detrimental during periods of volatility.[37]

The existing regulations, which include risk control mechanisms such as price checks, quantity limits, and system upgrades, should be rigorously enforced and updated to address emerging risks. The Indian securities market requires real-time supervision similar to that of the US. It can include measures such as employing artificial intelligence ("**AI**") to decrypt the concocted mechanism governing HFT. This can aid in achieving greater algorithmic transparency through AI-powered supervisory tools. It can consider resorting to AI since it can prove handy in maintaining a register of orders. In addition, AI-powered natural language tools can assist in identifying redundant, obsolete, and inconsistent orders. With AI-oversight platforms, HFT can communicate efficiently with the users resulting in constant modification of the register of orders. Further, using AI can generate workable translations of the orders facilitating cross-border transactions.

Besides, compulsory registration and auditing of proprietary AI instruments would provide even more control. Policymakers should also look at different algorithms to analyse their design and operation allowing them to judge risks with an essential understanding of mechanisms at hand. Reporting the aggregate metrics of AI activities frequently could go a long way towards making the market much more transparent to the participants as it would provide them with valuable information on new trends and threats.

To further enhance cyber security, surveillance, and testing protocols should explicitly address cyber threats. Implementing advanced threat detection systems, regular penetration testing, and ensuring that all systems adhere to the latest cyber security standards can mitigate these risks.

C. SECONDARY SERVERS

Firms should not be allowed to strategize for locations that they prefer through some behind-the-scenes manoeuvring, hence the importance of an open and

[37] MEASURES FOR STRENGTHENING ALGORITHMIC TRADING FRAMEWORK, *Supra* note 27.

random server placement model. Mandating that stock exchanges make public the criteria used to allocate server space and the secondary servers helps the various parties in the market know what to expect. Randomized allocation minimizes any form of evasion by the firms to get the best server resources hence asserting fairness. But when it comes to the ongoing fight for maintaining the market's purity, it is equally crucial to have a sound cybersecurity system. Implementation of high-security features with restricted access to secondary servers that virtually make it impossible to use or manipulate the data without authority. Through use of tamper-evident systems, any form of alteration or unlawful access is immediately noticed and discouraged thus the security of trading information. They should weigh heavily on firms that engage secondary servers in a bid to produce unfair outcomes. They might include fines or fines and penalties, suspension or cancellation of trading privileges, deduction of credits, or other punitive actions. Similarly, making stock exchanges responsible for operation of their co-location services, such as those of the secondary server, guarantees that such bodies fulfill their required duties. When putting into practice these solutions the market is not only protected from fraudsters but also the fundamental aspects of common crypto trading fairness and responsibility are being promoted as the basis of a healthy ecosystem. All these solutions are contingent on proper mechanism in place to ensure implementation and enforcement of the same.

D. MINIMUM LIFETIME ORDERS

In addition to the proposed reduction in OTR limits for penalty exemption minimum lifetime for orders must be enforced. This compels market participants to maintain their orders for a specified period, reducing likelihood of manipulative strategies like layering and or "ghost" orders that distort the true state of the market. This strategy has been subject to criticism that this would impede market participants' ability to react to exogenous events since the minimum periods have to expire before orders can be modified. Moreover, it is feared that this would lead to HFT to develop strategies that exploit the fact that orders are fixed for a specified period. To address these challenges a dynamic limit could be introduced. This dynamic limit would adjust the minimum lifetime based on current market conditions, such as volatility, trading volume, and the type of security being traded. Furthermore, this system would mitigate potential negative effects on market

efficiency by ensuring that liquidity providers are not unduly trapped by their orders during times of significant market shifts. Furthermore, the dynamic limit would allow changes to the threshold, permitting the incorporation of safeguards if any deceptive strategy is designed to exploit the fixed duration. This would ensure that the market remains competitive and that the benefits of order lifetimes are not undermined by strategic manipulation.

HFT has transformed the financial markets with its algorithm-driven, high-speed trading strategies. While this innovation has brought about greater liquidity and efficiency, it has also introduced significant risks, such as market manipulation, flash crashes, and systemic instability. To address these challenges, various jurisdictions have implemented regulatory measures tailored to their unique market environments. However, the global nature of financial markets necessitates a cross-jurisdictional approach to ensure consistency, effectiveness, and fairness. This section explores innovative and legal solutions such as speed bumps, circuit breakers, and other regulatory measures, while integrating cross-jurisdictional perspectives to offer a cohesive global framework.

E. SPEED BUMPS: SLOWING DOWN HFT WITHOUT STIFLING INNOVATION

Speed bumps have emerged as a nuanced regulatory tool for mitigating the challenges posed by HFT across various global markets. Speed bumps are regulatory measures aimed to bring in the trade execution, which consequently reduces the benefits obtained from fast technology. These delays are normally in milliseconds however, they may seriously affect HFT techniques that rely on executing trades more speedily than other frameworks.[38]

These mechanisms introduce intentional delays in order processing since the regulators try to equal the chances for both HFT firms and other market members. The US SEC and the TSX Alpha Exchange of Canada are the pioneers of different models of speed bumps with a varying level of effectiveness. In the US, randomized order processing delays have been adopted and in Canada they also

[38] Notice of Filing of a Proposed Rule Change to Introduce a Liquidity Provider Protection, Securities and Exchanges Commission, Release No 34-86168; File No. SR-CboeEDGA-2019-012, https://bit.ly/4dyFIYb.

have features such as minimum quantity limits and negative fee schedules.[39] Cross-jurisdictional analysis reveals two main types of speed bumps, namely the symmetric and the asymmetric. While symmetric speed bumps equally delay all orders, asymmetric ones impose selective delays, although preferred types of trades may be affected as well. The success of these mechanisms has been rather moderate. Whereas asymmetric speed bumps have been estimated to have cut low-latency investment by only about 20%, symmetric models have revealed insignificant effects on a wide range of financial instruments.[40] Nevertheless, critics have raised valid concerns over their ability to distort the market efficiency through delaying the formation of prices, decrease the depth of the market, and even create new technological battles due to the fact that HFT firms will modify their algorithms to counter imposed delays. Furthermore, this may increase the operational costs in exchanges, and hence the cost of trading amongst the markets parties may be affected.

However, the replication of these models may not be the best for India since the Indian securities market differs from those of the developed countries in terms of structure and nature of securities available. Instead, an adaptive, a dynamic approach is suggested. India could benefit from dynamic speed bumps that would have the delay time depending on the actual market conditions and volatility levels. This would be better than the current structure since it would provide a dynamic way of regulating the market as opposed to the current structure that provides a static solution. Besides, the sector-based implementation could reduce the volatility created by HFT selectively and without affecting the entire market. Transparency can be increased by introducing a publicly visible 'delay clock' for each order to make it fair and reduce information advantage. Periodic reviews would enable the regulators to capture other strategies in application of HFT and ensure that the speed humps remain relevant over a given period. Further, the incorporation of machine learning could enhance this mechanism through the identification and mitigation of manipulative HFT strategies in real-time. With the help of the information received from other countries and their adaptation to the

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[39] *Committee on Capital Markets Regulation, Nothing But The Facts,* https://capmktsreg.org/wp-content/uploads/2019/12/Nothing-But-The-Facts-Asymmetric-Speed-Bumps.pdf.

[40] Maraina Khapko & Marius Zoican, *Do speed bumps curb low-latency investment? Evidence from a laboratory market*, 55 J. OF FINANCIAL MARKETS (2021).

Indian context, it is possible to create appropriate legislation that will preserve the stability of the market and encourage the use of new technologies for the further organization of a fair-trade process.

F. CIRCUIT BREAKERS: HALTING UNCONTROLLED MARKET VOLATILITY

Circuit breakers are regulatory tools designed to temporarily halt trading when the market experiences extreme volatility.[41]By pausing trading, circuit breakers give the market time to absorb information and prevent panic-driven decisions that could exacerbate price swings.

These circuit breakers are useful safeguards in today's highly unpredictable financial markets where they are used to suspend the trading process during big fluctuations in prices provide a cooling-off period to stabilize the market. Since HFT grows more prominent in the Indian securities market, improving current circuit breaker implementations is integral for stability. Regarding the circuit breaker regimes, different jurisdictions have adopted different measures around the world in relation to market shocks. The US instituted a multiple tiered system that leads to a halt at certain points of market drop after the 2010 Flash Crash.[42] The European Union ("**EU**") under the MiFID II directive requires trading venues to suspend trading for a specific time in case of price volatility in order to promote fairness in all its member countries.[43] On the other hand, China uses a tiered circuit breaker mechanism that relates to the CSI 300 Index with halts at 5% and 7% respectively, as an indication of a more stringent approach to the market regulation.[44] The above examples show that different countries have adopted different circuit breaker models depending on their market structure and the regulatory approach.

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[41] U.S. EQUITY MARKET RESILIENCY DURING TIMES OF EXTREME VOLATILITY, NEW YORK STOCK EXCHANGE,https://www.nyse.com/network/article/nyse-increases-resiliancy-during-extreme-volatility.

[42] David Easley et al, *The Microstructure of "Flash Crash": Flow Toxicity, Liquidity Crashes and the Probability of Informed Trading*, 32 THE JOURNAL OF PORTFOLIO MANAGEMENT 118, 128 (2011).

[43] Guidelines on calibration of circuit breakers and publication of trading halts under MiFID II2017, ESMA70-872942901-63 (European Union).

[44] *China's circuit breaker: impact on funds,* DEACONS (Jan. 8, 2016), https://www.deacons.com/2016/01/08/chinas-circuit-breaker-impact-on-funds/.

Building on the strengths of India's existing index-wide circuit breaker system, based on the movements of BSE Sensex or Nifty 50; however, there is scope for improvement in order to address the unique problem of HFT trading. Firstly, the dynamic thresholds where machine learning algorithms set circuit breaker levels on the real-time basis depending on the historical volatility and the current market conditions. This adaptive mechanism would afford much more protection at a finer level, as it could respond to high fluctuations in volatility without having to introduce unnecessary pauses to the market. However, if the specific security circuit breakers for the highly liquid stocks or the stocks that are vulnerable to HFT manipulation is used it would be more helpful addition to the index wide system. To prevent subsequent shocks after stoppage the gradual resumption mechanism is suggested to bring the market back to normal gradually so as not to cause fluctuations in prices. In addition, extending the use of circuit breakers to equities, derivatives, and Exchange Traded Funds("**ETFs**"), with linked securities, would mitigate volatility cross-over in integrated markets which are apparent in the current trading floor. One of the critical components of these enhancements is a sound communication procedure of the circuit breaker activation and the time line of resumption to all the participants which otherwise leads to panic trades. Furthermore, the broadening of circuit breakers to include correlated assets in equities, derivatives, as well as ETFs would help to eradicate volatility cross-overs within the interconnected markets, thus eradicating the systematic risks inherent in the today's trading platforms.

Technology plays a central role in the deployment of these improved circuit breakers in an HFT-driven environment. It is crucial to invest in superior real-time monitoring systems capable of handling large data streams in matter of microseconds to identify trigger events. Another aspect is the cross-exchange coordination as a centralized system coordinating the circuit breakers' implementation would avoid the arbitrage of regulations and differences in the trading venues. In addition, employing the regulatory sandboxes to experiment new circuit breaker designs and their interactions with HFT algorithms will allow for the development of a better solution before being used in live trading.[45] These

[45] Manal Shah, *Enabling framework for fintech sandbox*, THE SECURITIES BLAWG (May 28, 2019), https://www.thesecuritiesblawg.in/post/enabling-framework-for-fintech-sandbox.

sandboxes could reflect extreme market conditions, so that regulators could monitor, and adjust the effectiveness of additional features such as dynamic thresholds and cross-asset mechanisms. Thus, India can make its circuit breaker system stronger by implementing these technological advancement and other regulatory innovations which will help to address the issues related with HFT which is very much complicated while maintaining the market integrity. The implementation of these solutions would also safeguard investors while at the same time creating trust in the new environment that is emerging in the financial sector in India. Increased expenditure in the technological support for the cross-exchange connectivity, real time surveillance, and regulatory sand boxes for testing circuit breakers will improve the stability of the Indian financial market amidst HFT environment without compromising investor confidence and market integrity.

G. OTHER MEASURES

Although, speed bumps and circuit breakers are integral parts of the framework to regulate HFT, a set of measures should be developed to create a balanced, efficient and stable market. Data acquisition and monitoring are some of the vital steps that need to be improved. India should consider adopting efficient real-time surveillance systems capable of observing order flows and trades in intervals as small as microseconds so as to enable regulators to address the risk of destabilizing HFT strategies in real-time. An effective order audit trail, which is comparable to the US Composite Audit Trail, could help regulators recreate the events that took place in the market and investigate manipulative practices in the future, thus reducing their occurrence.[46]

There are also transparency and disclosure measures that add to the existence of a healthy market. It would be helpful if brokers were forced to identify orders that stem from HFT algorithms so that they could be monitored and studied more easily. It is suggested that broad categories of trading strategies used by HFT companies should be required to disclose, but specific details should not be

[46] Press Release, Securities and Exchange Commission, SEC Approves Plan to Create Consolidated Audit Trail (Nov. 15, 2016), https://www.sec.gov/newsroom/press-releases/2016-240.

disclosed because it would help the regulator to maintain trust. The provision of aggregated HFT metrics such as the trading volumes and order to trade ratios will be useful to all the stakeholders. The certification of trading algorithms before they are deployed into the market, which guarantees the orderly conduct of business once they are in action, is a form of check that goes a long way in preventing the creation of disruptive dynamics. It is evident that well-designed incentives can bring HFT practices in line with other market quality goals. By developing a complex plan of liquidity provision that would incentivize real value addition while avoiding exploitation of this model by high frequency traders, the benefits of this business model could be realized. Order priority based on the time-weighted and rebate schemes for the investors with a longer investment horizon would provide a market balance while the fees based on volatility would act as stabilizers during the periods of high volatility, thus discouraging the trades that might destabilize the market. In the end, technological infrastructure reforms are most important factor that guarantees fairness. It would level the playing field to regulate co-location services stringently, make network latency the same, and open up market data for everyone. Regular technological audits would also guarantee adherence to these standards and would be helpful in identifying any other inherent systematic risks that would improve the stability and efficiency of the market to the benefit of all the stakeholders.

V. CONCLUSION

As the digital age propels financial markets into uncharted territories, HFT emerges as both a harbinger of innovation and a crucible of regulatory challenges. As we have explored throughout this article, it also serves as a crucible for some of the most complex legal and ethical challenges of our time. The current regulatory framework in India falls short in addressing the dynamic challenges that HTF poses to traditional frameworks. The triumph of India's commitment to investor protection lies at the effectively addressing the hurdles discussed in the article.

To surpass the hurdles of HFT, fundamental changes are suggested, several fundamental reforms are proposed. Amendments to the PFUTP regulations will empower SEBI to take stronger cross-border actions through international cooperation and treaties, while a clearly defined effects doctrine ensures broad

jurisdictional reach. Establishing a global HFT body and a SEBI task force, along with dynamic order and resting limits, will enhance market integrity. Extending insider trading regulations, supported by real-time AI monitoring and cybersecurity measures, can close existing legal gaps. Variable speed bumps, smart circuit breakers, mandatory algorithm certification, and sector-based disclosures offer selective volatility control, fair technological infrastructure, and incentivized liquidity. These measures collectively aim to build a balanced and globally integrated financial system.

Rather than restricting or allowing complete freedom in HFT, the focus should be on adaptive frameworks that evolve with technological advancements. AI-based surveillance, adaptive circuit breakers, and regulatory sandboxes present innovative ways to align law, technology, and finance. The 2010 Flash Crash highlighted the dangers of HFT, yet regulatory approaches need to be both robust and flexible to address the complexities of modern financial markets. Enhanced PFUTP regulations, obligations on foreign entities, and addressing unorthodox manipulative practices like quote stuffing are vital steps.

The policy principles that must therefore be promoted include investor protection, transparency, and fairness which when promoted will encourage a market that is innovative and efficient and which at the same time will support equity and integrity. In moving forward to the next phases of analysis of HFT the key is continued engagement between the regulators and markets and technology specialists to ensure that any potential that HFT offers is realizing the majority of its benefit responsibly and positively to the structure of an improved, more cohesive and self-sustaining financial system.

The path forward demands a delicate balance, akin to a high-wire act performed on the global stage. It calls for regulators to become not just enforcers, but visionaries; for market participants to embrace not just profit, but responsibility; and for technologists to consider not just what can be done, but what should be done. This harmonization of interests is not merely aspirational – it is essential for the continued vitality and integrity of our financial markets.

Articles

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Journal On Governance

ISSN: 0976-0369

Published By;
The Registrar,
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NH-65, Mandore,
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