REGULATORS MUST CONFINE TO MARKET DEVELOPMENT, AND NOT BUSINESS GROWTH, TO AVERT SUCH EPISODES

Beyond Jane Street

CKG NAIR
MS SAHOO

Respectively former member, Securities Appellate Tribunal, and former chairperson, Insolvency and Bankruptcy Board of India

THE SECURITIES AND Exchange Board of India's (Sebi) July 3 Jane Street order, hailed by commentators as a landmark, a moment of reckoning, and a wake-up call, is unique in several respects. It showcases Sebi's technological prowess in unravelling a labyrinth of high-frequency, cross-market algorithmic trades on a massive scale, and its legal acumen in establishing contraventions within the nuanced legal contours of market manipulation. And in a twist, perhaps unprecedented, the interim order included a stay, allowing the accused to continue trading, though subject to conditions, even before they responded to allegations of massive fraud in the show cause, and Sebi uncovered the full extent of the manipulation.

It is a moment of reckoning because Sebi had long warned about such risks, repeatedly highlighting over the last few years the ballooning derivatives markets and mounting retail investor losses. In January 2023, a Sebi study revealed that nine out of 10 retail investors were suffering heavy losses—though it was unclear who benefitted from these losses and whether the gains were concentrated in a few hands. Sebi widely publicised these findings as part of its efforts to educate small investors in the derivatives segment. Yet this evidence-based diagnosis of a spot-derivatives mismatch and massive retail losses, signalling possible tectonic shifts, did not trigger major regulatory reforms.

Interestingly, these findings emerged in an era of regulatory "hyperactivity", when the market faced a flurry of regulatory amendments, including fine-tuning language from "comprises of" to "consist of". Yet the first tranche of regulatory measures to address the big bubbles in the derivatives market was announced only 18 months later, and only after two further studies: Analysis of Intraday Trading by Individuals in the Equity Cash Segment (July 2024) and Analysis of Profits & Losses in the Equity Derivatives Segment (FY22-FY24) (September 2024).

On October 1, 2024, Sebi announced a package of measures to "Strengthen the Equity Index Derivatives Framework for Increased Investor Protection and Market Stability". The measures included upfront collection of option premium from options buyers; removal of calendar spread benefit on the expiry day; intraday monitoring of position limits; increase in contract size for index derivatives; rationalisation of weekly index derivatives products; and higher tail-risk coverage on options expiry day. These were to be implemented in a phased manner between November 1, 2024, and April 1.

Except for the reduction in the number of weekly index derivatives, all other measures were too modest to rein in the rampaging market. This was borne out by yet another Sebi study, released on July 7, titled "Comparative Study of Growth in Equity Derivatives Segment vis-à-vis Cash Market after Recent Measures". The study revealed that although derivatives volumes had declined somewhat, 91% of retail investors lost money in FY25, higher than in FY24.

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It was a classic case of the regulator being on the horns of a dilemma: whether to take substantive, structural measures to address the underlying ailment or to offer only symptomatic relief. Many regulators hesitate to deflate a booming market, fearing it might stunt market growth. This fear is often rooted in a distorted understanding of what market development entails. The regulator's mandate is market development, not driving business growth, a distinction essential to preventing regulatory capture and avoiding conflicts of interest.

On this, the Financial Sector Legislative Reforms Commission is explicit: "Regulators should pursue a developmental strategy that fosters the development and improvement of market-wide infrastructure and processes.....to modernise market infrastructure or market process,.... the adoption of new technology; ... to provide for product differentiation, or enlarging consumer participation; or to align market infrastructure or market process with international best practices. This goal should be subordinate to the goals of consumer protection and micro-prudential regulation, and should only be pursued where there is evidence of co-ordination failures in the market impeding the development of such infrastructure and processes."

Prevailing discourses on market development often translate into pressure for business growth. This is evident in measures such as encouraging listings through multiple windows with differential or relaxed conditions, and allowing the proliferation of derivative products on both indices and individual stocks. Single-stock futures and options (F&O), introduced in late 2001 for a limited set of large-cap companies with substantial market capitalisation, have since expanded, now covering 216 scrips on the NSE and 212 on the BSE. It is not that the quality of all these scrips has improved to justify their derivatives. Some of them hardly inspire confidence, even for spot trading. It is widely acknowledged that, barring a few exceptions, liquidity and volumes outside the Nifty 100/Sensex 100 universe are too low to justify the F&O on those scrips.

Some major indices suffer from heavy concentration. For example, in the NIFTY 50, the top two scrips account for 25% of the weight, and in the Bank Nifty they account for 53%. Many indices record negligible trading volumes. Exchange-traded derivatives on securities were legally "rescued" from being treated as wagering in 1999 through amendments to the Securities Contracts (Regulation) Act, 1956, to facilitate hedging and the orderly development of securities markets, not to create an expanded arena for punters or to generate volume-based tax, fee, or profit for the various entities.

Winds of change are visible in Sebi's approach to market development, as reflected in recent statements and public remarks by its functionaries. The need to deepen the equity segment is being emphasised more openly. Hopefully, the parametric thresholds in the current "rigorous" methodology for constructing indices, and for permitting single-stock F&O, will be revisited to exclude shallow indices and illiquid stocks.

The Jane Street episode is the culmination of a story long whispered by market observers and foretold by Sebi. This debacle also exposed the cracks in India's market structure, forcing the regulator to choose between patchwork fixes and deep reform. Though belated, Sebi should use this crisis, and the vivid, unflattering picture it has revealed of the market's structure, conduct, and performance, to drive substantive structural reforms. Guided by a broad, consistent macroeconomic-finance roadmap and a regulatory philosophy aimed at building a deeper and more stable Main Street.