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ENHANCING MARKET SURVEILLANCE: SEBI'S FINANCIAL DISINCENTIVES FOR MARKET INFRASTRUCTURE INSTITUTIONS

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INTRODUCTION

In the realm of Capital Markets, Market Infrastructure Institutions ("MIIs") play a pivotal role in bolstering market integrity and protection of investors. With the increase in participation by retail individual investors, increased trading activity in derivatives segment and deployment of new trading techniques and strategies by market participants, the role of MII has become even more crucial. In the light of these developments, Securities & Exchange Board of India ("SEBI") recently introduced the framework for financial disincentives for surveillance lapses ("FDSRL") at MIIs[1]. The framework shall come into effect from 1st July 2024. The guidelines are comprehensive and much needed for effective implementation of recommendations provided by the Committee on Strengthening Governance of Market Infrastructure Institutions in its 2022 Report.[2]

This article, *firstly*, focuses on the role of MIIs as discussed in the report by the Committee and recommendations provided therein. *Secondly*, it explores the recent framework introduced by SEBI for MIIs. *Thirdly*, it delves into the rationale behind this framework and analyzes its implications on MIIs and investors. And lastly, it concludes with some recommendations for the way forward.

ROLE OF MIIS

Stock Exchanges, Clearing Corporations, and Depositories are collectively referred to as MIIs.[3] As per the Report released by the Committee on Strengthening Governance of MIIs, the roles of MIIs include providing infrastructure for trading, selling, and holding securities.[4] They also carry out key regulatory and public utility functions, serving as the first-line regulator. The MIIs are responsible for the supervision of members, the monitoring of listed entities and the surveillance function. The Report recommended categorizing functions of MIIs into three verticals: critical

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[1] Framework of "Financial Disincentives for Surveillance Related Lapses" at Market Infrastructure Institutions, SEBI, available at https://www.sebi.gov.in/legal/circulars/jun-2024/framework-of-financial-disincentives-for-surveillance-related-lapses-at-market-infrastructure-institutions_83984.html, (last accessed June 13, 2024).

[2] Strengthening Governance of Market Infrastructure Institutions, SEBI, available at https://www.sebi.gov.in/reports-and-statistics/reports/nov-2022/strengthening-governance-of-market-infrastructure-institutions_64806.html. (last accessed June 13, 2024).

[3] *Sebi constitutes committee to strengthen governance of market infrastructure institutions*, Business Standard, April 2022, available at https://www.business-standard.com/article/news-cm/sebi-constitutes-committee-to-strengthen-governance-of-market-infrastructure-institutions-122040500232_1.html, (last accessed June 13, 2024).

[4] *Supra* note 2, page 19.

operations, regulatory compliance and risk management. Key Managerial Personnel ("KMP") should head the first two functions and would be at par with those heading the third vertical.[5] Critical operations and regulatory functions must be prioritized over compliance and risk management.

The Committee gave recommendations for the Board of MIIs as well. MIIs should disclose agendas and minutes of Board meetings related to regulatory, compliance, and risk management on their website. The Board or Chairperson (without MD and other executive directors) should periodically meet key officers (CRO, CRiO, CISO, Statutory Auditor) to discuss important issues. At least two-thirds of the Board should comprise Public Interest Directors (PIDs). PIDs should meet twice a year and submit a periodic report to SEBI highlighting issues of importance/concern.[6] Roles and responsibilities of all directors, especially towards regulatory, compliance, and risk management, should be clearly outlined. The Board must periodically review the adequacy of the Investor Protection Fund and Settlement Guarantee Fund, with a specific profit percentage allocated to the IPF. MIIs should develop comprehensive policies for data sharing, including appropriate delegation and an escalation matrix for sensitive information. SEBI is empowered under various statutes to take action in case these requirements are not fulfilled. In severe cases, SEBI may restrict MIIs from introducing new products/services or limit their activities.

THE FRAMEWORK FOR FDSRL

Surveillance is one of the most significant regulatory functions of MIIs as it helps detect and prevent market abuse, ensuring a fair and transparent trading environment. The new framework empowers SEBI to oversee MIIs to ensure that they are performing their surveillance duties.[7] The regulatory framework is rooted in provisions like ***Regulations 49(2) and 91A (2)*** of the Securities Contracts Regulation (Stock Exchanges and Clearing Corporations) Regulations, 2018 ("SECC Regulations")[8] and SEBI (Depositories and Participants) Regulations, 2018 ("DP

[5] *Id*, page 8.
[6] *Id*, page 9.
[7] *Supra* note 1, page 1.
[8] Securities Contracts Regulation (Stock Exchanges and Clearing Corporations) Regulations, 2018, Regulation 49(2).

Regulations")[9] respectively, that empower SEBI to take action against any contraventions by MIIs.

The framework provides that surveillance functions would include monitoring daily activities like trading, settlement, and demat transactions, supervising market intermediaries through generation of alerts, conducting snap analysis, reporting abnormal or suspicious activities, implementing surveillance decisions promptly, and taking pre-emptive surveillance measures as communicated by SEBI. Moreover, surveillance related lapses (SRLs) would include lapses in in implementing surveillance decisions, discharging surveillance activities, or reporting surveillance-related activities as per agreed timelines. For instance, non-implementation, partial implementation, or delayed implementation of SEBI's decisions, and inadequate or non-reporting of surveillance activities.

The factors that would determine the financial disincentives for a MIIs would be the annual income of the MII and the number of SRL instances in a financial year.

Total Annual Revenue (INR) of MII	First Instance	Second Instance	Third Instance
>1000 crores	25 lakhs	50 lakhs	1 crore
1000 crores- 300 crores	5 lakhs	10 lakhs	20 lakhs
<300 crores	1 lakh	2 lakhs	4 lakhs

Once SRL is identified by SEBI, it will provide the concerned MII an opportunity to make submissions. SEBI will consider these submissions before imposing any financial disincentive. However, if the penalty is imposed, it must be credited to the Investor Protection and Education Fund (SEBI-IPEF) within 15 working days. The framework for FDSRL provides some exemptions as well. It shall not be applicable in instances wherein MII has marker wide impacts, caused significant investor losses or affected the market integrity. Further, minor lapses as illustrated in the framework would be subjected to administrative proceedings, instead of financial disincentives. As per the framework, MIIs are also required to disclose details of any financial disincentives on their websites and in their annual reports. Listed MIIs must also

[9] SEBI (Depositories and Participants) Regulations, 2018, Regulation 91A(2).

comply with disclosure requirements under the SEBI Listing Obligations and Disclosure Requirements Regulations, 2015.[10]

RATIONALE & IMPLICATIONS

With the increasing complexities of trading strategies and higher trading volumes, the aim of the framework is to provide robust surveillance mechanism, which is essential to detect and deter manipulative practices and market abuse.

As per SEBI, "the role of surveillance at MIIs has become crucial in ensuring the safety and integrity of securities market in view of the significant increase in trading activity during the past few years, increased participation by retail individual investors, increased trading activity in the derivatives segment and deployment of new trading techniques and strategies by market participant."[11] Other than this, the framework also ensures proper implementation of the 2022 Report discussed above.[12] By imposing financial disincentives, SEBI aims to ensure that MIIs adhere strictly to surveillance protocols and regulatory directives, reducing the likelihood of lapses. Clearly SEBI seeks to maintain high standards of market integrity, thereby protecting investor interests and maintaining their confidence. Further, the disclosure requirements to be complied with by MIIs promote transparency, allowing investors and other stakeholders to be aware of any lapses and the actions taken. Financial disincentives encourage MIIs to allocate adequate resources to their surveillance functions, ensuring they are well-equipped to handle their regulatory responsibilities effectively.

The framework incentivizes MIIs to invest in better surveillance technologies and practices, leading to more effective detection of market abuses. They are likely to develop stronger internal policies and procedures to ensure compliance with SEBI's guidelines, thereby reducing the risk of surveillance lapses. The framework clearly delineates the responsibilities of MIIs, ensuring that they remain accountable for their actions and omissions in surveillance activities. However, at the same time, financial disincentives for lapses would be significant, especially for smaller

[10] SEBI Listing Obligations and Disclosure Requirements Regulations, 2015.
[11] *Sebi issues financial disincentives guidelines for bourses, other MIIs for surveillance lapses*, The Economic Times, June 2024, available at https://economictimes.indiatimes.com/markets/stocks/news/sebi-issues-financial-disincentives-guidelines-for-bourses-other-miis-for-surveillance-lapses/articleshow/110769719.cms?from=mdr, (last accessed June 13, 2024).
[12] *Supra* note 2.

MIIs, potentially affecting their financial stability. To avoid penalties, MIIs will need to invest heavily in upgrading their surveillance systems and training their staff, which would strain their resources. The fear of penalties might also lead MIIs to adopt overly cautious approaches, thereby stifling innovation and efficiency in their operations. Further, the increased operational costs incurred by MIIs to comply with the framework would be passed on to investors in the form of higher transaction fees or other charges, potentially increasing the cost of investing. It is also pertinent to note that enhanced surveillance measures would lead to increased monitoring of investor activities. While this is aimed at detecting manipulative practices, there would be concerns about privacy and the extent of monitoring.

CONCLUSION

The framework certainly marks a significant step closer towards enhancing effective regulatory functioning of MIIs in the securities market. It would hold MIIs accountable for their surveillance functions and mitigate market risks. The investors can contribute to this by engaging with MIIs and providing feedbacks regarding their surveillance mechanisms and market integrity. The MIIs, in response, can encourage initiatives to educate investors about the importance of market surveillance and how it affects their investments. Further, SEBI can update this framework periodically that would reflect the changes in market and technological advances. They can also organize training sessions and workshops that would help MIIs to understand and comply with surveillance systems. Adopting these simple measures can help the stakeholders in transitioning to the requirements of the framework.

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