Regulatory Hotline

June 22, 2022

SEBI'S CONCERNS ON ALGORITHMIC TRADING BY RETAIL INVESTORS

BACKGROUND

The Securities and Exchange Board of India ("**SEBI**") vide a Press Release, dated June 10, 2022 ("**Press Release**")[1], yet again raised its concerns with regard to the algorithm trading services being offered by unregulated platforms. SEBI has cautioned investors against strategies that are being marketed with claims of huge return on investment and that similar returns would be earned in the future.

The Press Release is issued in the backdrop of the SEBI's Consultation Paper, dated December 09, 2021 ("**Consultation Paper**")[2] that proposes changes in the regulatory framework for algo trading done by retail investors and clarity required on the nature of services being provided by third party algo providers / vendors.

WHAT IS ALGO-TRADING?

Algorithmic Trading has been defined as any order that is generated using automated execution logic.[3] To simply put, algorithmic (or algo) trading uses a defined set of instructions in the form of algos to generate trading signals and place orders. The system automatically monitors the live stock prices and initiates an order when the given criteria are met. This frees the trader from having to monitor live stock prices and manually place the orders.

In India, in order to provide an algo hosted and managed by the broker to an investor, the algo requires approval of the respective stock exchange. When the broker offers the algo to the investor, such algo runs on the broker's system and not on the investor's. Whenever the algo generates a signal based on the matched criteria, an order automatically gets punched on the investor's account with no human involvement from either the broker or the investor.[4]

Several Indian stock brokers provide Application Programming Interface ("**API**") access to their clients to establish an online connection between them and their clients. The API access enables a client to use a third-party application or build its own front-end features for making investments.

INDIAN REGULATORY CHALLENGES

Currently, a large number of retail investors use the APIs provided by their stock brokers to automate their trades vide a third-party application. In such cases, though the brokers can identify the orders stemming from an API, yet, the nature of such order, i.e. whether such order is an algo order or a non-algo order, cannot be deciphered by them.

The curated platforms which offer off-the-shelf algo strategies and / or applications which allow investors to create their own investment strategies are being increasingly used by the retail investors. SEBI, in this regard, has noticed that algos deployed by the retail investors for investment purposes are being used without taking requisite approvals from the respective stock exchanges.

Considering that the algos that are being offered by the third-party service providers do not have the approval of exchanges but end up using the broker's API to execute the trades, they pose a risk of systematic market manipulation and can be detrimental to the investors' interests, especially retail investors. Further, since such algo vendors are outside the purview of SEBI, the investors, in case of any mishap, do not have a grievance redressal system for addressing their concerns.

PROPOSED FRAMEWORK

The Consultation Paper seeks to classify all orders emanating from an API as an algo order and be subject to control by the stock broker. The APIs shall be tagged with the unique algo ID provided by the exchange. Thus, the stock broker shall be mandated to take approval of all the algos from the exchange, whether used by such broker or the client.

The brokers could either provide in-house algo strategies or outsource it to third-party algo provider subject to a formal agreement with each such algo provider. Further, the stock broker shall be made responsible for all the algos emanating from its APIs and redressal of any investor disputes. The Consultation Paper also stipulates that no recognition shall be given by the exchange to the third party algo providers creating the algo.

The Consultation Paper also highlights the clarity required on whether the services provided by the third-party algo providers are in the nature of investment advice given that such services include research, analysis and recommendation of investment strategies to the investors.

In this regard, SEBI seeks the assistance of the stock brokers for achieving this much-needed clarity. It proposes for

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the stock brokers to obtain details from their clients of the nature and type of services being received from third-party algo providers, along with a confirmation that such services are in the nature of investment advice.

TAKEAWAYS

The Consultation Paper suggests that the stock brokers should shoulder the responsibility of procuring requisite approvals in the cases of deployment of algorithmic trading by third-party algo providers. As against this, the stock brokers argue that it would be a tedious task for them to obtain approvals of algos enabled through APIs, since there can be numerous customized algo strategies that could be deployed by third-party vendors based on the specific needs of the individual investors.

With an uptick in the interests of the retail investors in the recent times leading to an accelerated growth of the online curated investment / trading platforms, it becomes crucial that the securities regulator ascertains and places a service / product provider in the applicable regulated bracket, thereby, preventing any mislabelling of services (Please refer to our hotline **here**, titled '*SEBI Settlement Order – Research Analysts not to provide model portfolio products*', highlighting the said issue). SEBI, hence, should look into and provide clarity on whether third-party algo vendors act as investment advisers under the SEBI (Investment Advisers) Regulations, 2013, requiring them to be registered with and regulated by SEBI in their own independent capacity.

With SEBI is still contemplating on the necessary tweaks that may be required for the implementation of the regulatory framework proposed by the Consultation Paper, the Press Release comes with a caution to the investors to not fall prey for claims of assured returns and astronomical gains, and not share their sensitive personal details with such unregulated platforms.

– Prakhar Dua & Kishore Joshi

(We acknowledge and thank Jayadeep Manchikalapudi, Student Hidyatullah National Law University, Raipur for his assistance on this hotline.)

You can direct your queries or comments to the authors

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[1] SEBI, *Caution to Investors against dealing with unregulated platforms offering Algorithmic Trading*, PR NO. 20/2022, available at https://www.sebi.gov.in/media/press-releases/jun-2022/caution-to-investors-against-dealing-with-unregulated-platforms-offering-algorithmic-trading_59672.html

[2] SEBI, *Consultation Paper on Algorithmic Trading by Retail Investors*, available at https://www.sebi.gov.in/reports-and-statistics/reports/dec-2021/consultation-paper-on-algorithmic-trading-by-retail-investors_54515.html

[3] SEBI, Broad *Guidelines on Algorithmic Trading*, CIRCULAR NO. MRD/DP/09/2012, available at https://www.sebi.gov.in/sebi_data/attachdocs/1333109064175.pdf

[4] Supra note 2.
