Why Sebi’s proposed ‘riskometer’ for the stock market is not a workable idea

The Securities and Exchange Board of India (Sebi) wants to sugarcoat the big bad world of the stock markets for retail investors. The regulator is planning to introduce an early warning system to flag risks in stocks that are overvalued, showing irregular trading patterns, or have unsustainable business models. It’s true the markets are heady and investors need to be warned. Indian markets have gained sharply in 2017 despite sluggish economic growth, poor investment demand, elusive corporate earnings recovery and the twin disruptions of the high-value note ban and introduction of the Goods and Services Tax. Markets have reached a stage where taxi drivers and paanwallahs are offering advice on stock investments. The regulator seems worried that investors will get burnt like in the aftermath of the 2008 global financial crisis. Then, retail investors fled the market. It has taken them almost a decade to hesitantly return, and mostly through mutual funds.

While the objective of the idea – to protect unsophisticated investors – is laudable, a grading system for stocks might not the best way to go about it. Such a system seems fraught with practical difficulties. Take, for instance, a case like the erstwhile Satyam Computer Services. In its heyday, it was a top-tier software stock. But if such a stock was highly graded and then the fraud disclosed, how would Sebi answer investor questions? Now, suppose, an investor has bought a stock based on a Sebi grade and it made a loss? Remember, that Sebi had such gradings for initial public offers (IPOs) but it made them optional in 2014 after it was found that they had not served the intended purpose.

Equity, by its very nature, is a risky investment. The regulator’s previous attempts to mollycoddle investors have misfired. Some years ago, the regulator had proposed a mandatory safety net mechanism in IPOs, where the promoters or the bankers were required to pledge to buy back the shares if prices fell below the issue price within a certain period. It had to pull this back after a lot of resistance.

There are plenty of ways in which Sebi can protect investors. For example, it can insist on better disclosures from listed firms. In India, despite steps taken by the regulator, disclosure standard are still poor and often information is presented in a manner that is investor unfriendly. More importantly, Sebi should spruce up its investigation and enforcement teams so that fraud and stock manipulation are detected and penalised on time. That will be the right way to make markets safer rather than a stock grading system.

END