

CONCEPT PAPER ON REGULATION OF INVESTMENT ADVISORS

1. *Background*

- 1.1** Section 11 (2)(b) of SEBI Act empowers SEBI to register and regulate working of Investment Advisors and such other intermediaries who may be associated with securities market in any other manner.
- 1.2** As decided by SEBI Board in its meeting dated March 22, 2007, SEBI had posted a consultative paper on the “Regulation of Investment Advisors” on its website inviting public comments. Based on public comments received on the consultative paper as also the USAID (Fire Project), a memorandum was placed before the SEBI Board proposing a regulatory approach for Investment Advisors. It was proposed that the Regulations shall be implemented through an SRO. As Investment Advisors offer products across asset classes, it was felt that the respective regulators may take a view and formulate similar norms and code of conduct. Accordingly a reference was made to the HLCC on Financial and Capital Markets.
- 1.3** HLCCFM in its meeting held on December 22, 2008 set up the D. Swarup Committee to re-examine the issue. The committee submitted its report to government in December 2009 which was discussed in the HLCCFM meeting in March 2010. Subsequently, regulatory issues relating to Wealth Management and / Private Banking undertaken by banks were discussed by the FSDC Sub-Committee in its meeting on March 4, 2011.
- 1.4** In this background, SEBI has developed a framework for regulation of investment advisors through the SRO route.

2. *Tackling Conflict of Interest in Distribution of Financial Products*

- 2.1** It is axiomatic that any industry, in order to achieve scale and high productivity, must be free of internal contradictions and conflicts of interest. Financial sector is no exception. The financial product distribution space is particularly fraught with these conflicts between the manufacturers of financial products like banks, mutual funds, and insurance companies, etc. and the distributors which sell these products who call themselves by various names like agents, financial advisors, financial planners, etc.
- 2.2** It is necessary to resolve or at least mitigate these conflicts, especially in the case of financial products because of their two peculiar characteristics. Firstly, the products are

intangible and conceptually more difficult to understand. Secondly, the pay-offs are in a distant future and can be camouflaged by several factors external to the product. It is in this context that the distributors occupy a key role; all the more so considering the low levels of financial literacy and awareness in India.

2.3 Two major conflicts of interest in the financial product distribution space are the following:

- a. Dual role played by distributors as an agent of investors as well as of the manufacturers. This is due to the fact that with respect to many financial products, agents receive their payments from two sources: commissions from the manufacturers (either directly or through deductions from the investment amount of investors), and advisory fees or other charges received from the investors. This immediately raises the question: whose interests do they represent: the manufacturers' or the investors'? This question has also been raised in the Devendra Swaroop Committee report on 'Minimum Common Standards for Financial Advisors and Financial Education'. This prevalence of divided loyalties may not be in the best interest of all the stakeholders concerned. It often results in a situation where the distributors are loyal to only themselves. They would happily churn investors' portfolio and also squeeze more commission from the manufacturer.
- b. A situation might arise where distributors are likely to be partial to, and would sell more products of the manufacturer who is the best paymaster; and ultimately, other manufacturers would scramble to do the same, thus leading to a race to the bottom. Thus, there is an inherent conflict in the activities of an agent/distributor distributing similar products of various manufacturers.

2.4 There could be many possible solutions to these issues - the most obvious and the easiest being enhanced disclosures. However, in a country like India where levels of literacy are low and financial literacy even lower, disclosures have a limited effect.

2.5 The Financial Services Authority, UK, had outlined plans to ban commission payments for product providers and enforce financial advisors to agree on fee payments with clients upfront. It defined two categories of service: independent and restricted, on the basis of which advisors would charge the fee. Examples of restricted advice may be where advisors offer advice only about the products of a particular manufacturer; or about the products from a defined list of manufacturers. Independent advice would include unrestricted advice based on a comprehensive and fair analysis of the relevant

market. However, there is a kind of restricted advice called 'basic advice'. With Basic Advice, the consumer is asked some pre-scripted questions about their income, savings and other circumstances to identify the consumer's financial priorities and suitability for a stakeholder product, but a full assessment of their needs is not conducted nor is advice offered on whether a non-stakeholder product may be more suitable. 'Basic advice' is excluded from the new rules i.e. in case of basic advice, commissions can be paid and the new advisor charging rules are not applicable to the same. Also, non-advised or execution only sales would be remunerated only by commission and would not fall within the ambit of the advisor charging rules. Thus, in the FSA model, the first conflict of interest as per para 2.3(a) seems to have been addressed by ensuring that the distributor/advisor owes allegiance to only one paymaster at a time-either the manufacturer or the investor.

2.6 SEBI, with effect from August 01, 2009, had banned entry loads in mutual fund investments and had mandated that the upfront commission should be paid directly by the investors to the distributors based on factors like assessment of the service of the distributor. However, the distributor continued to earn trail commissions from the Asset Management Company at the same time. Thus, the first conflict of interest was only partially mitigated in this model.

2.7 In this paper, we are attempting to deal with only the first type of conflict of interest. The possible model for tackling this conflict of interests may be the following:

- a. The person who interfaces with the customer should declare upfront whether he is a financial advisor or an agent of the manufacturer.
- b. If he is an advisor, he would be subject to the Investment Advisors Regulations; and would require a much higher level of qualifications. He would act as an advisor to the investor on all financial products. He would receive all payments from the investor and there would be no limits set on these payments. On the other hand, there will be agents who will be associated with the manufacturer and would receive their remuneration from them. However, they will be prevented from styling themselves as financial advisors and will have to call themselves as agents only.
- c. This will resolve the first conflict of interest as in para 2.3 (a).

3. *Structure of Proposed Regulations*

3.1 The proposed regulatory framework intends to regulate the activity of providing investment advisory services in various forms by a wide range of entities including

independent financial advisors, banks, distributors, fund managers etc. The investment advice may be provided for investments in various financial products including but not limited to securities, insurance products, pension funds, etc. While the activity of giving investment advice will be regulated under the proposed framework through an SRO, issues relating to financial products other than securities shall come under the jurisdiction of the respective sectoral regulators such as action for mis-selling, violation of code of conduct, conflict of interest etc. The SRO set up for the regulation of Investment Advisors shall follow the rules/regulations laid down by respective regulators for products falling in their jurisdiction, including but not limited to suitability and appropriateness of the products.

- 3.2** The SRO formed to regulate investment advisors will be registered under the SEBI (Self Regulatory Organization) Regulations, 2004. SRO will have sufficient resources to perform its functions. Its duties would include registering and setting minimum professional standards, including certification of investment advisors, laying down rules and regulations and enforcing those; informing and educating the investing public; setting up and administering a disputes resolution forum for investors and registered entities etc. Persons desirous of registration as Investment Advisors shall obtain registration with the SRO established for the purpose. The SRO will be entitled to charge a fee for granting registration and an annual fee.
- 3.3** Complaints / disputes arising out of investment advisory services will be taken up by the SRO with the respective regulatory authority, while the complaints regarding the financial products and their manufacturers will be handled by the respective regulators.
- 3.4** Investment Advisors tend to call themselves by varied names viz. wealth managers, private bankers etc. This causes much confusion as to their role and responsibility. Hence the regulations will provide that no person can carry on the activity of offering investment advice unless he is registered as an Investment Advisor under the regulations. On the other hand any person who has obtained the certificate of registration as an Investment Advisor must necessarily use the word “investment advisor” in his name.

4. Definitions

4.1 Investment Advisor

Investment advisor for the purpose of the regulations shall be any person or entity that provides investment advice directly or indirectly for a consideration, which may be received directly from the investor or who holds himself out as an investment advisor.

4.2 Investment Advice

Investment advice shall be an advice written, oral or through any other means of communication given regarding investment of funds in financial products or products that are traded and settled like financial products purportedly for the benefit of the investor. It shall include:

- (a) Financial advice; or
- (b) Financial planning service or
- (c) Actions which would influence an investment decision and are incidental to making an investment/investment decision.

5. Coverage

5.1 Individuals

The following set of individuals would need to get registered under the regulations to be able to provide Investment Advisory Services:-

- a. *Independent Investment Advisor*– Independent Investment Advisors are professionals who offer independent advice on financial matters to their clients and recommend suitable financial products or products that are traded and settled like financial products.
- b. *Representatives of investment advisors or intermediaries* who on behalf of the investment advisor or intermediary provide investment advice to investors: Representative would mean a person, in the direct employment of, or acting for, an investment advisor, who performs on behalf of the investment advisor any investment advisory service, whether or not he is remunerated, and whether his remuneration, if any, is by way of salary, wages, commission or otherwise, and

includes any officer of an investment advisor who performs for the investment advisor any investment advisory service whether or not he is remunerated, and whether his remuneration, if any, is by way of salary, wages, commission or otherwise;

5.2 *Non-individuals*

The following set of non-individuals (corporate entities) would need to get registered under the regulations to be able to provide Investment Advisory Service:

- a. *Banks providing investment advisory/ wealth management services:* In India Banks are allowed to perform only Investment Advisory Services. Those banks which provide similar services would be required to get registration under these regulations.
- b. *Any entity, other than an individual person* - representing investment advisor, who on behalf of the investment advisor provides investment advice to investors : Representative would mean a person, acting for, an investment advisor, who performs on behalf of the investment advisor any investment advisory service, whether or not it is remunerated, and whether its remuneration, if any, is by way of, commission or otherwise, and includes any officer of such an entity who performs for the investment advisor any investment advisory service whether or not he is remunerated, and whether his remuneration, if any, is by way of salary, wages, commission or otherwise;

6. *Persons Exempt from the regulations*

6.1 A person shall be deemed not to be engaged in the business of providing investment advice, if the advice is solely incidental to some other business or profession and the advice is given only to clients of the person in the course of such other business or profession and the advice does not specify particular securities and is limited to general comments made in good faith in regard to trends in the securities market, the economic situation of the country.

6.2 The following shall be exempt from registration under these regulations:

- a. An advocate and solicitor or law firm, whose offer of financial advice is solely incidental to his legal practice.



b. Chartered accountants who are registered under the Institute of Chartered Accountants of India providing of any investment advice is solely incidental to the accounting practice.

c. Any person who publishes magazine/newspaper and holder of a permit issued under the Newspaper and Printing Presses Act (Cap. 206), where —

I. the newspaper is distributed generally to the public in India;

II. the advice given, or analysis or report issued, is promulgated only through that newspaper;

III. that person receives no commission or other consideration, apart from any fee received from subscription to or purchase of the newspaper, for giving the advice, or for issuing or promulgating the analysis or report; and

IV. the advice is given, or the analysis or report is issued or promulgated, solely as incidental to the conduct of that person's business as a newspaper proprietor.

However, a request will be made to the respective governing councils to enforce a code of conduct for such newspapers.

d. Any person who owns, operates or provides an information service through an electronic, or a broadcasting or telecommunications medium, where —

I. the service is generally available to the public in India;

II. the advice given, or analysis or report issued is promulgated only through that service;

III. that person receives no commission or other consideration, apart from any fee received from subscription to the service, for giving the advice, or for issuing or promulgating the analysis or report; and

IV. the advice is given, or the analysis or report is issued or promulgated, solely as incidental to that person's ownership, operation or provision of that service.

However, request will be made to respective governing councils to enforce a code of conduct for such information service provider.

- e. Any stock broker or sub-broker as registered under SEBI(Stock Broker and Sub-Broker) Regulations, 1992, who provides any investment advice as per Regulation 7 read with Schedule II of SEBI (Stock Broker and Sub-broker) Regulation, 1992 and not charging any consideration for such advice.
- f. Any person offering exclusively insurance broking services under regulation of Insurance Development and Regulatory Authority.

7. Registration Requirements

7.1 The Individuals who wish to get registered under these regulations would need to satisfy the following criteria:

- a. Individuals should acquire a Professional Qualification from a recognized institute for e.g. Chartered Accountancy form ICAI, MBA in Finance or similar qualification from a recognized university or should have at least 10 years of relevant experience; and
- b. Certification from NISM or such other organization approved by SEBI for this purpose
- c. The individuals should conform to the Fit and Proper Criteria s laid down in Schedule II of SEBI (Intermediaries) Regulations, 2008.

7.2 Entities who wish to get registered under these regulations would need to satisfy the following criteria:

- a. Capital Adequacy Requirement: Entities would need to maintain a minimum net worth which would be separate from the net worth required for other activities.
- b. Key personnel: Entities should have at least 2 key personnel having the relevant experience exclusively for such activity. Such key personnel should also acquire the certification from NISM or such other organization as approved by SEBI for this purpose and have minimum qualification as prescribed.
- c. The entity should conform to the Fit and Proper Criteria laid down in Schedule II of SEBI (Intermediaries) Regulations, 2008.
- d. The applicant must have adequate infrastructure to enable it to discharge its functions as an Investment Advisor.

8. *Obligations of an Investment Advisor*

8.1 *Fiduciary Responsibility to Investors*

All information received and provided by the investment advisor would be in fiduciary capacity. The investment advisor will be responsible to maintain confidentiality of the investment advice provided to the client and information provided by the client. Advice should be given by the advisor in the best interest of the investor.

8.2 *Suitability and Risk Profiling*

The Investment Advisors or their representatives would be required to do adequate risk profiling of the client before any investment service is provided to them. Based upon the risk profiling performed by the investment advisor or their representative suitable investment advice should be provided. The records of such risk profiling and investment advice should be maintained by the Investment Advisor.

8.3 *Advertising and Marketing Material*

Investment Advisors should not use any advertisement that contains any untrue statement of material fact or that is otherwise misleading. They should not use or refer to testimonials (which include any statement of a client's experience or endorsement).

Refer to past, specific recommendations made by the advisor that were profitable, unless the advertisement sets out a list of all recommendations made by the advisor within the preceding period of not less than one year and complies with other specified conditions.

8.4 *Conflict of Interest*

No financial incentives/ consideration would be received from any person other than investors seeking advice. In case of advice regarding investment in entities related to the investment advisor, adequate disclosures shall be made to investor regarding the relationship.

8.5 *Maintaining Records*

Records in support of every investment recommendation /transaction made which indicates the data, facts and opinion leading to that investment decision would be maintained by the Investment Advisor. Records should be retained for at least 5 years.

Systematic record of all advises provided would be kept including audio recording of any oral advice given.

8.6 Fees and Charges

The Investment Advisor would clearly indicate to its clients the fees and charges that are required to be paid by them. An investment advisor shall disclose to a prospective clients all material information about itself, its businesses, its disciplinary history, the terms and conditions on which it offers advisory services, its affiliations with other intermediaries and such other information as is necessary him to take an informed decision whether to avail of its services.

9. Execution Services

Investment advisors shall not accept funds / securities from investors, except the fee for investment advice. If Non-individual investment advisors (corporate entities) offer assistance in execution services such as broking, custody services, DP services, accounting etc., they must make appropriate disclosures, clarify that the investor is under no obligation to use their services and maintain arms length relationship through creation of Chinese walls. The choice of opting for execution services offered by investment advisor should be left to the investors. Fees and charges paid to service providers should be paid directly to them and not through investment advisors.

10. Outsourcing

Other than sourcing of research reports, no other part of investment advisory activity can be outsourced.

11. Liability

The investment advisors shall not be liable for civil or criminal liability in respect of advice given unless the advice is negligent or mala-fide in nature. Any dispute between the investment advisor and his client would be resolved through grievance redressal mechanism or arbitration created by SEBI

12. Entities registered as Portfolio Managers

Portfolio Managers who provide only investment advice would need to be registered only as investment advisors after their present registration expires. Portfolio Manager

Regulations would be amended in view of the proposed AIF Regulations as well as the Investment Advisor Regulations.

13. Public Comments

Public Comments are invited on the Concept Paper on Regulation of Investment Advisors. All comments may be forwarded by e-mail to Shri Manish Tekriwal, Manager, Investment Management Department, Division of Funds - 1 at manisht@sebi.gov.in latest by 1730 hours on October 31, 2011.