

Corpsec Hotline

August 23, 2012

INVESTMENT ADVISORS: IT'S TIME TO REGISTER!

The Securities and Exchange Board of India ("SEBI") has approved the SEBI (Investment Advisors) Regulations, 2012 ("Investment Advisors Regulations")¹. A press release of its board meeting held on August 16, 2012 ("Press Release") summarizes some of the features of the soon to be notified Investment Advisors Regulations. SEBI had in 2007 and 2011 issued a consultative paper and a concept paper on regulating investment advisors.

While the final set of regulations is awaited, this hotline summarizes the features of the Investment Advisors Regulations as indicated in the Press Release and also highlights few issues that existing investment advisors may face on account of notification of the Investment Advisors Regulations. Needless to say, the devil lies in the details and the fine print of the Investment Advisors Regulations would need to be studied once notified by SEBI at which stage we shall be providing a more in-depth analysis through a follow on update upon such notification. We have provided hereinbelow an extract from our article published on thefirm.moneycontrol.com, which deals with the provisions related to the Investor Advisors Regulations.

For full article titled "SEBI's Big Bang Changes: Impact Analysis" please [click here](#).

Investment Advisors Regulations Finally Introduced

After release of the concept paper on regulation of investment advisors in 2011, SEBI has finally approved the much debated and dreaded framework regulating the investment advisors. As clarified in the concept paper, the Investment Advisors Regulations shall apply to all individuals, body corporate and partnership firms providing investment advice and therefore entities engaged in selling financial products shall not be governed by these regulations.

Introduction of the Investment Advisors Regulations is the second development relating to legal regime governing the Indian fund industry after the recent notification of the AIF Regulations. The Indian asset management and financial advisory business has been growing at a rapid pace and therefore SEBI first in 2007 felt the need to regulate working of investment advisors. The Investment Advisors Regulations emanates after a lot of consultation from the industry which had apprehension about the legal regime having an adverse impact on the industry.

Persons falling under the gamut of the Investment Advisors Regulations

The Investment Advisors Regulations require all persons providing investment advice to investors in return for consideration, to seek registration with SEBI. It has also been clarified that investment advice given without consideration through media at large shall not be considered as investment advice. While initially SEBI will directly register and regulate all investment advisors, eligibility criteria such as qualification and net worth requirements shall also be prescribed for investment advisors. As a result, the Investment Advisors Regulations can be regarded as an omnibus regulation requiring all investment advisors to be registered

Segregation of advisory and distribution business

It is important to note that the press release provides that remuneration / consideration for investment advice can only be received from the client being advised and not from any other person. Additionally, banks or body corporate engaged in distribution, referral or execution business alongside investment advisory business will now be required to segregate their investment advisory business from the rest and provide such investment advisory services through a subsidiary or department.

Categories of certain person exempt: While the fine print of the Investment Advisors Regulation is yet to be released, the press release exempts certain categories of persons from registration under the regulations. These categories include:

1. Stock and sub brokers, merchant bankers and portfolio managers already registered with SEBI

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2020, 2019, 2018, 2017, 2014

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providing investment advice incidental to their primary activity (exempt only from registration requirement).

2. Distributors registered with All India Mutual Fund Industry ("AMFI") providing investment advice incidental to their primary activity.
3. Fund manager of mutual fund or alternative investment fund.
4. Professionals such as lawyers, chartered accountants providing advice incidental to their professional services.
5. Persons providing advice exclusively in areas like insurance and pension products provided regulated by sectoral regulators.
6. Persons providing general comments in good faith about market trends.

These regulations bring a large number of investment advisors under SEBI's regulatory supervision which were until now falling outside its purview. While the detailed regulations in this regard are yet to be notified, SEBI has broadly classified categories of persons subject and exempt from these regulations.

Position under U.S. laws

Drawing an analogy from the law in the United States from where most of our securities laws have found origination, the Investment Advisers Act of 1940 generally defines an "investment adviser" as any person or firm that: (1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. A person or firm must satisfy all three elements to be regulated under the Investment Advisers Act of 1940 (US Investment Advisers Act) wherein these elements are construed broadly. For example:

- With respect to "compensation," the receipt of any economic benefit suffices. To be deemed compensation, a fee need not be separate from other fees charged, it need not be designated as an advisory fee, and it need not be received directly from a client.
- With respect to the "business" element, an investment advisory business need not be the person's or firm's sole or principal business activity.
- Finally, a person or firm satisfies the "advice about securities" element if the advice or reports relate to securities. The Division of Investment Management has stated that providing one or more of the following also could satisfy this element: advice about market trends; advice in the form of statistical or historical data (unless the data is no more than an objective report of facts on a non-selective basis); advice about the selection of an investment adviser; advice concerning the advantages of investing in securities instead of other types of investments; and a list of securities from which a client can choose, even if the adviser does not make specific recommendations from the list.

While broadly the definition and scope of investment advisor in the last consultative paper by SEBI in 2011 also contains similar elements as provided under the US Investment Advisers Act, it is important to note that the US Investment Advisers Act governs investment advisors providing advice about 'securities'. The Indian Investment Advisors Regulations being an omnibus regulation covers all advisors including financial planners providing investment advice whether or not relating to securities. However, it is important to note that the term 'securities' have been very broadly defined under the US Investment Advisers Act.

This move could likely impact some of the offshore asset managers, both private equity and hedge funds, having advisory set ups in India which could now potentially fall within the ambit of these regulations. However, the fine print is important to see if there are any safe harbors for such advisors who only advise offshore managers and not the clients directly. It is important to note that the US Investment Advisers Act provides a specific exemption to foreign private advisor subject to fulfillment of certain conditions,

Obligation of the investment advisors: The press release further indicates that the investment advisors like other intermediaries will also have to comply with their code of conduct, fiduciary responsibility, record keeping and risk profiling of clients as may be prescribed in detail in the regulations.

Until now the investment advisors were contractually governed by their investment advisory agreement for their obligation and any breach of obligation there under would have constituted a breach of contract. With the regulations prescribing fiduciary obligation of the investment advisor to the investors, the investment advisor are now statutorily required to provide investment advice in the best interest of the investor. This will surely cast a much higher degree of responsibility and accountability upon the investment advisor.

IMPLICATIONS FOR ONSHORE FUND ADVISORS AND MANAGERS AND THE WAY FORWARD

While pending the fine print as stated above, it appears that SEBI has looked at the new set of regulations as an omnibus regulatory framework regulating all persons engaged in the business of investment advice, unless such entity falls within any of the exemptions specified in the regulations.

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For e.g. there appears to be no exemption for entities which are essentially providing research and advice to offshore managers/advisors of offshore private equity or hedge funds. Thus, all these entities unless regulated as a portfolio manager would fall within the purview of these regulations thereby triggering the need for a registration. Similarly, investment managers for domestic venture capital funds which are not AIFs may also require registration under these regulations. This could potentially lead to increasing compliance burden for these entities as they would also be treated as 'intermediaries' under the SEBI Act and hence be subjected to possible audits and compliance by SEBI under these regulations.

On the positive side, besides creating a degree of accountability and responsibility for financial advisors towards their clients, since there is no minimum investment threshold for clients under these regulations, they could also potentially throw up an opportunity for creation of an advisory platform for investors who may otherwise not be able to participate in a portfolio management scheme on account of the higher minimum contribution of Rs. 2.5 million requirement.

What is interesting to see here is the change in approach to policy making from SEBI whereby while traditionally SEBI had always adopted the approach of need based regulations for a specific segment of the market, the AIF Regulations and the Investment Advisors Regulations seem to use the approach that any form of asset management would now be regulated by SEBI. It appears that these set of regulations seem to complete the loop for the regulatory framework for asset management business in India whereby the retail pools of capital will be regulated under the Mutual Fund Regulations and the Collective Investment Scheme Regulations, private pool of capital in alternate assets will be regulated under the AIF Regulations and other segregated pools of capital will be regulated under the Portfolio Management Regulations and the Investment Advisors Regulations.

While compliance costs and the associated burden that these regulations may cast upon the domestic intermediaries would surely cause hardships in the short run, the completeness of the regulatory framework with this piece of regulation is likely to provide long term certainty and stability to asset management businesses in India.

– Vivek Mimani & Siddharth Shah

You can direct your queries or comments to the authors

¹ <http://www.sebi.gov.in/sebiweb/home/detail/24234/yes/PR-SEBI-Board-Meeting>

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