

# Regulatory Hotline

January 20, 2017

## PROPOSED AMENDMENTS TO SEBI (INVESTMENT ADVISERS) REGULATIONS, 2013

- SEBI has released a consultation paper proposing clarifications / amendments to the SEBI (Investment Advisers) Regulations, 2013
- Key changes proposed include relook at exemptions to different persons (including mutual fund distributors), clarifications on concepts of 'investment product' and 'consideration', clarity on activities of research analyst and investment adviser, increased formalization and increased focus on investment advice provided through digital means.
- Mixed bag for the industry with some proposals being positive guidance while some others may impose restrictions on businesses if effectuated.

### BACKGROUND

Before the Securities and Exchange Board of India ("SEBI / Board") issued the SEBI (Investment Advisers) Regulations 2013 ("IA Regulations") to regulate the provision of investment advisory services, the said services were rendered by various market intermediaries which may or may not have been regulated by SEBI such as portfolio managers, stock brokers, merchant bankers and credit rating agencies. Such investment advisers were not obligated to register themselves as a separate class of intermediary. On August 16, 2012, the IA Regulations were approved by the SEBI Board and thereafter IA Regulations were notified on January 21, 2013 and the same came into force on April 21, 2013<sup>1</sup>.

Regulation 3 (1) of the IA Regulations mandates every person which acts as an investment adviser or holds itself out as an investment adviser<sup>2</sup> to register itself as an Investment Adviser ("IA") under the IA Regulations, unless the person is exempted from registration under the IA Regulations. Typical examples of exempt persons include regulated persons providing investment advice on specialized products such as insurance agents, pension advisors and regulated persons providing investment advice incidental to their primary activity, such as mutual fund distributors, advocates, registered stock brokers etc.<sup>3</sup>

### PROPOSED AMENDMENTS TO THE IA REGULATIONS

On October 7, 2016, SEBI released a consultation paper on amendments / clarifications to the IA Regulations (the "Consultation Paper").

SEBI, while taking note of actions of other regulators in India and abroad with respect to issuance of guidelines to investment advisors, has proposed certain amendments / clarifications to the IA Regulations. Here, we shall discuss a few key amendments / clarifications proposed by SEBI in the Consultation Paper:

#### 1. Re-look on exemption to mutual fund distributors

**Proposal:** Currently, mutual fund distributors are permitted to sell mutual fund products, provide incidental or basic advice in respect of such products and can also help in executing transactions (subject to certain conditions). With regard to the provision of such services, distributors get commission from asset management companies and may also charge execution / advisory fees to clients. However, IAs are subject to restrictions on provision of distribution / execution services such as clear segregation of division / department / entity carrying out non-IA services, maintenance of arms-length relationship etc.

In order to have a level playing field in respect of investment advisory services, SEBI has proposed that

1. mutual fund distributors be prohibited from providing incidental or basic investment advice on mutual fund products unless they migrate as IAs by registering themselves with SEBI under the IA Regulations within a period of three years;
2. no person be allowed to use nomenclature such as 'independent financial adviser', 'wealth adviser' etc. without registering as an IA;
3. persons engaging in the distribution of mutual fund products shall use the nomenclature 'Mutual Fund Distributor' and they cannot provide basic or incidental investment advice except describing product specifications without recommending any product; and
4. mutual fund distributors shifting from commission based model to fee based advisory model shall be required to register as an IA.

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**Analysis:** The said proposal by SEBI has faced stiff opposition from MF distributors citing reason that such a move would adversely impact the sector.<sup>4</sup>

The SEBI proposal requiring mutual fund distributors who provide investment advice incidental to their product to migrate to the IA Regulations must be viewed in light of such considerations and may be considered rather omnibus in scope. A more measured approach would be preferable.

## 2. Re-look on exemption from registration for certain persons

**Proposal:** SEBI has proposed a re-look at the exempted persons under Regulation 4 of the IA Regulations and has proposed mandatory registration for persons providing investment advice in respect of securities irrespective of whether such activity is ancillary to their primary activity. Exemption shall only continue for persons who are carrying out investment advisory activities permitted under other SEBI regulations, such as merchant bankers registered with SEBI, fund managers to mutual funds and alternative investment funds registered with SEBI etc. or to persons providing investment advice on specific products regulated by regulators other than SEBI such as insurance products regulated by the Insurance Regulatory and Development Authority of India ("IRDAI").

**Analysis:** The activities of professionals such as chartered accountants, lawyers etc. may involve the provision of incidental investment advice. However, the Consultation Paper is silent on the continuation of exemption for such persons. It is hoped that the SEBI is cognizant of these scenarios and that any removal of exemptions is carefully considered and does not have unintended repercussions on the conduct of business of various professionals.

## 3. Investment advisory services through a separate subsidiary

**Proposal:** Currently, banks, non-banking financial companies ("NBFCs") and body corporates providing distribution or execution services are required to keep investment advisory services segregated from such activities.<sup>5</sup> Such entities are only allowed to offer IA services through separately identifiable departments or divisions ("SIDDs"). In order to address conflicts of interest in an effective manner, SEBI has proposed that separate subsidiaries be set up for the provision of IA services and that such services should not be provided through SIDDs. Consequently, those persons offering such services through a separate department or division (as currently permitted) will be required to set up a separate subsidiary in relation to their IA services within three years.

**Analysis:** If the SEBI were to effectuate the said proposal, it will provide for easier identification of functions performed by different entities. That being said, setting up a separate subsidiary will also entail increased costs and duplication of functions for businesses.

## 4. Clarifications on 'investment product' and electronic / broadcasting media advice

**Proposal:** Since there is no existing definition of 'investment product' in the IA Regulations, SEBI has proposed defining investment product as "Investment products shall include all financial instruments that are regulated by any financial sector regulator in India. However, advice exclusively on products in non-securities market which are regulated by sectoral regulators shall be outside the scope of the IA regulations".

Further, SEBI has proposed to clarify that while persons providing investment advice in electronic, broadcasting or telecommunications media will be covered within the purview of the SEBI (Research Analysts) Regulations, 2014 ("RA Regulations"), persons advising clients after their enrolment / registration / subscription on any public media platform shall be required to comply with the IA Regulations.

**Analysis:** The said proposal is positive in that it clarifies the meanings of certain important concepts in the IA Regulations. A clarification on the meaning of "investment products" would be especially welcome considering that the proposed definition would definitively convey that certain assets which may be held for investment purposes, such as real estate assets or jewellery, are clearly outside the scope of the IA Regulations.

## 5. Clarification of the meaning of 'consideration'

**Proposal:** SEBI has proposed to clarify the meaning of 'consideration' to cover all forms of remuneration or compensation, including the receipt of any economic benefit receivable by the IA, its associates or subsidiaries in respect of the underlying securities. For example, a mutual fund distributor providing investment advice and receiving commission from a mutual fund house but not from the client will still be regarded as providing investment advice for consideration although the consideration does not flow from the client and therefore, such mutual fund distributor will be required to be registered as an IA.

**Analysis:** This would be an important clarification from the point of view of investor protection since it would prevent persons providing investment advice from avoiding registering as IAs on the grounds that there is no remuneration flowing directly from the client.

## 6. Clarity on activities of research analyst and investment adviser

**Proposal:** Under the RA Regulations, a research analyst ("RA") includes a person making buy / hold / sell recommendations with respect to securities listed or to be listed. This overlaps to a considerable extent with the function of provision of 'investment advice' by IAs. Therefore, there is considerable ambiguity regarding the scope of functions to be performed by an RA vis-a-vis that to be performed by an IA.

In the Consultation Paper, SEBI has observed that some persons take advantage of the ambiguity by registering themselves as RAs in order to avoid compliance requirements under the IA Regulations. Such persons thereafter provide stock specific recommendations and / or research services to specified clients wherein such clients are sent recommendations through e-mails or SMS without the accompanying research report as required under the RA Regulations. While SEBI has typically held these to fall within the purview of investment advisors<sup>6</sup>, it has also occasionally held that the provision of stock specific recommendations falls under the purview of RA

Regulations<sup>7</sup>. In many of the decisions referred to, SEBI has passed orders against persons for failure to register under both the IA Regulations and the RA Regulations. In order to provide clarity regarding the differences in the functions to be performed by an IA as against those performed by an RA, SEBI has proposed that all RAs shall

provide research reports to all classes of clients at the same time. In case RAs provide research services to retail clients for a separate fee, they shall act in a fiduciary capacity undertaking general obligations and responsibilities as applicable to IAs. Further, SEBI has proposed that the making of a buy / sell / hold recommendation by providing an entire research report shall continue to be governed by the RA Regulations. This implies that provision of such recommendations without an accompanying report may make a person including RAs liable to be registered as IAs.

**Analysis:** Considering the possibility of overlap between functions performed by an IA and an RA, especially with regard to the making of buy / sell / hold recommendations, it would be preferable to lay down certain more determinable criteria on the basis of which a distinction may be made. It appears that the intention is that an RA's activities should generally be more generic and not tailor-made to specific clients (unless research services are specifically sought out by the client, in which case the proposal is that they should undertake obligations and responsibilities applicable to an IA) and that a research report is essential for an RA relationship. If such is in fact the case, it would be preferable for this to be clarified as such by SEBI. Another helpful measure can be the release of a circular, possibly in frequently-asked-questions format with examples of concrete fact patterns based on which a differentiation can be made out between IAs and RAs.

## 7. Increasing formalization through 'Rights and Obligations' document and Advertisement Code

**Proposal:** Under the current IA Regulations, it is not mandatory to enter into a written document specifying the terms and conditions of the advisory services offered. SEBI has proposed that at least two days before onboarding clients, an IA shall provide a 'Rights and Obligations' document to clients stating the inter se relationship and terms and conditions of investment advisory services. The document is required to contain information / details including scope of services, type of instruments, disclosures on fees, risks, liabilities, termination etc. Further, the document should provide contacts for grievance redressal and for dispute resolution through arbitration.

Another important step towards formalization is the proposed advertisement code which would lay down certain guidelines with respect to advertisements by IAs. The objective appears to be to curtail untrue, misleading, exaggerated advertising. Advertisements should not contain performance assurances or guarantees. Factors such as limitations on the information and independence of the reports, analyses or services relied on should be disclosed.

**Analysis:** The proposal for a 'Rights and Obligations' document is an important step to ensure proper disclosure to clients. It is advisable that IAs seek help of legal counsel in drafting the 'Rights and Obligations' document.

However, with the increasing digitalization of investment advisory services (discussed below), the requirement for a two-day period between the provision of the 'Rights and Obligations' document and the onboarding of the client is anachronistic.

## 8. Increased focus on regulating digital means of advice dispensation

**Proposal:** SEBI has proposed that no person should be allowed to provide trading tips, stock specific recommendations etc. to the general public through social networking media such as Whatsapp, Facebook, Twitter etc. unless such person obtains registration under the IA Regulations or is exempt under the same. Further, no person shall organize or offer any scheme / competition / game / league on securities or related to the securities market.

Taking note of a report published by the International Organization of Securities Commissions ("IOSCO") on Social Media and Automation of Advice Tools Surveys<sup>8</sup>, SEBI in the Consultation Paper has proposed certain additional compliance requirements for IAs providing online investment advisory services using automated tools. Some of these measures include disclosures to clients on the working of automated tools and limitations of the output, usage of automated tools only for target clients for which it is designed, and subjecting the tools to audit and inspection.

**Analysis:** These proposals by SEBI indicate a laudable effort being made to adhere to global standards and provide protection to investors in the face of increased digitalization of investment advisory services and increased influence of fintech.

## CONCLUSION

The current IA Regulations has certain lacunae that SEBI is aiming to address. Currently there is substantial confusion as to when certain activities tantamount to investment advice attracting registration under the IA Regulations, when they are covered by other regulations such as the RA Regulations and when they are exempt from registration.

Since the commencement of IA Regulations, SEBI has prevented various unregistered advisory firms from rendering their services to the investors and sought reasons for non-compliance.<sup>9</sup> Yet, it has been observed that SEBI has been forbearing in most of its decisions against the unregistered persons providing investment advice and has not levied any kind of penalty<sup>10</sup>. This may be a tacit acceptance that the boundaries of "investment adviser" and "investment advice" remain uncertain in many situations.

SEBI seems to be serious in its intent in curtailing situations of conflict of interest among intermediaries such as mutual fund distributors who may also provide investment advice while conducting their primary business and receiving compensation in regard to multiple services, from either or both parties. While the intent is laudable, it is debatable whether requiring intermediaries and other professionals to compulsorily register themselves under the IA Regulations is a step forward considering that the exigencies of their business often require them to provide incidental investment advice and adopt a commission based model rather than a fee based model. It is expected that an improper removal of exemptions can add to the prevailing confusion as to who may be considered as an investment adviser. Perhaps a more measured approach towards a level playing field may be considered by SEBI.

The increased attempt at pigeon-holing and requirements of adhering to multiple regulations and regulators may affect the Central Government's initiative to enhance the 'Ease of Doing Business'. For example, a company / group

wishing to provide investment advice across various asset classes such as insurance, real estate, mutual funds etc. may have to deal with numerous regulators, adding to costs and inefficiencies.

Certain other measures proposed by SEBI such as those towards greater formalization of relations between the IA and the client, as well as the increased focus on regulating the provision of investment advice through digital means are commendable and would further the cause of investor protection.

– **Srikanth Vasudevan & Pratibha Jain**

You can direct your queries or comments to the authors

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<sup>1</sup> Regulation 1 (2) of the IA Regulations.

<sup>2</sup> "Investment adviser" has been defined to mean "any person, who for consideration, is engaged in the business of providing investment advice to clients or other persons or group of persons and includes any person who holds out himself as an investment adviser, by whatever name called."

"Investment advice" has been defined to mean "advice relating to investing in, purchasing, selling or otherwise dealing in securities or investment products, and advice on investment portfolio containing securities or investment products, whether written, oral or through any other means of communication for the benefit of the client and shall include financial planning."

<sup>3</sup> Regulation 4 of the IA Regulations. Also see, SEBI PR No. 53/2013 dated May 29, 2013

<sup>4</sup> <http://economictimes.indiatimes.com/markets/stocks/news/sebi-extends-deadline-for-comments-on-investment-advisor-norms/articleshow/55293481.cms>

<sup>5</sup> Regulation 22 of the IA Regulations.

<sup>6</sup> SEBI Order No. WTM/RKA/ISD /108/2014 in respect of Mansoor Rafiq Khanda and anr.; SEBI Order No. WTM/SR/IMD-DoF/ILO/ 39 / 03/2015 in respect of M/s, Global Mount Money Research and Advisory Pvt. Ltd. and ors.; WTM/SR/SRO-BLO/ 115/ 06/2015 in respect of M/s. HBJ Capital Services Pvt. Ltd. and ors.

<sup>7</sup> WTM/SR/SEBI/IMD/27/05/2016 in respect of Mr. Anirudh Sethi

<sup>8</sup> Accessible at <http://www.iosco.org/library/pubdocs/pdf/IOSCPD445.pdf>

<sup>9</sup> SEBI Order No. WTM/RKA/ISD /108/2014 in respect of Mansoor Rafiq Khanda and anr.; SEBI Order No. WTM/SR/IMD-DoF/ILO/ 39 / 03/2015 in respect of M/s, Global Mount Money Research and Advisory P vt. Ltd. and ors.; WTM/SR/SRO-BLO/ 115/ 06/2015 in respect of M/s. HBJ Capital Services Pvt. Ltd. and ors.; WTM/SR/SEBI/IMD/27/05/2016 in respect of Mr. Anirudh Sethi; Order No. WTM/SR/SEBI/IMD/57/11/2016 in respect of CapitalVia Global Research Limited and ors.; Order No. WTM/SR/SEBI/IMD/56/11/2016 in respect of Motivate Financial Services Private Limited.

<sup>10</sup> Recourse to penal provisions has been usually taken only in cases where of repeated offences.

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