



Investment Adviser Regulations:

A NEW REGIME IN INDIA

By Darshika Kothari & Aditya Jhaveri, AZB & Partners, Advocates & Solicitors

In the early days of February 2013, Richard Ketchum CEO and Chairman of the Financial Industry Regulatory Authority ("FINRA"), drew the curtains on a debate that threatened to alter the regulatory landscape for the roughly 11,000 strong United States investment adviser industry. The debate centered on regulatory oversight of investment advisers – while investment advisers are currently governed by the U.S. Securities and Exchange Commission ("SEC"), FINRA had been making concerted efforts to bring them in its fold since about 2008. Having met with severe opposition from various investment adviser bodies and a not-too-forthcoming U.S. House of Representatives, FINRA (for now) abandoned its efforts.

This forms an interesting backdrop for events closer to home in India. On the 21 January 2013, the Securities and Exchange Board of India ("SEBI") released the final SEBI (Investment Advisers) Regulations, 2013 ("IA Regulations"). Investment advisers were previously unregulated in India. With the enactment of the IA Regulations, SEBI has finally sought to plug this gap. In fact, SEBI has long sought to regulate investment advisers as is demonstrated by two consultative papers on the subject issued by SEBI in 2007 and 2011.

These regulations are an important milestone in SEBI's attempts to bring the Indian securities markets in line with global standards. Having had the benefit of accessing the regulation of investment advisers in developed jurisdictions, SEBI in its 2011 consultative paper had sought for investment advisers to be regulated through a self regulatory organization. This intention was perhaps in line with experiences from jurisdictions such as the United States where FINRA claims that the SEC has struggled with resources for effective oversight of the investment adviser ecosystem – on average it apparently only manages to inspect the books of each investment adviser once in 11 years. However, to avoid any potential teething issues which a new self regulatory organization may have, the IA Regulations provide for regulatory oversight by SEBI with the power to recognize a self regulatory organization for regulation of investment advisers at a later date.

Coming to the crux of the regulations, SEBI has defined "investment advice" as advice relating to investing in,

“These regulations are an important milestone in SEBI's attempts to bring the Indian securities markets in line with global standards.”

purchasing, selling or otherwise dealing in securities or investment products, and advice on an investment portfolio containing securities or investment products, whether written, oral or through any other means of communication for the benefit of the client and includes within its scope financial planning. An investment adviser is defined as a person who for consideration is engaged in the business of providing investment advice and includes any person who defines himself as an investment adviser, by whatever name called.

Three relevant points emerge from the definitions of investment advice, investment advisers and the categories of persons exempt from registration requirements as investment advisers:

- As part of the regulations, investment advice provided exclusively to foreign residents is exempt. Notably however, the regulations are silent on exemption on the basis of the underlying security for which advice is given – i.e. whether the security itself is foreign or domestic. All investment advice provided to Indian residents on domestic securities is covered under the IA Regulations. The broad definition of "securities" that may be borrowed from Section 2(h) of the Securities Contracts (Regulation) Act, 1956, implies that advice given to Indians on foreign securities is also covered under the regulations and investment advisers who provide investment advice to Indians on foreign securities may possibly need to register themselves under the IA Regulations.
- Presently, portfolio managers (commonly known as wealth managers) are governed by the SEBI (Portfolio Managers) Regulations, 1993. The primary activities of portfolio managers typically involve administration or management of a portfolio of securities and rendering advice in relation

- to the portfolio of securities. To the extent that portfolio managers are involved primarily in providing investment advice and do not administer or manage their clients' portfolio, SEBI's intention appears to be to eventually regulate such persons under the IA Regulations.
- The IA Regulations are likely to have a significant impact on small independent investment advisers who were so far not regulated and who would now be caught under the net of the IA Regulations. The IA Regulations mandate an investment adviser to maintain an arm's length relationship between its investment advisory activities and other activities and the smaller independent financial advisers may find it difficult to create different departments for distribution and advisory.
- SEBI has also exempted a number of entities from mandatory registration as an investment adviser. These include an insurance agent or broker offering advice solely for insurance products, a pension adviser advising on pension products, a mutual fund distributor providing advice incidental to its primary activity, advocates, solicitors, law firms, chartered accounts, company secretaries, cost accountants, actuaries and fund managers of mutual funds and alternative investment funds, providing advice incidental to their primary activity.

In addition, stock brokers, portfolio managers and merchant bankers are also exempt; however, they would be required to comply with the general obligations of investment advisers as stated in the IA Regulations. These general obligations (applicable to all investment advisers and specifically also to stock brokers, portfolio managers and merchant bankers despite being exempt from registration) require an investment adviser to act in a fiduciary capacity towards its clients, disclose all conflicts of interest when they arise, maintain an arm's length relationship between activities as an investment adviser and other activities, maintain a high degree of confidentiality and critically, restricting receipt of consideration from any person other than the client being advised.

Maintaining an arm's length relationship between activities as an investment adviser and other activities would entail creating information barriers between the investment advisory arm and other activities carried out by the same entity. In the Indian context, advisory functions are often housed in the same legal entity which also carries out broking/ investment banking and other activities. It therefore remains to be seen if the mandated system of information barriers will be effective. Where two separate divisions of

an enterprise have been maintained, will such divisions be able to receive compensation in relation to the same products – for investment advisory services from an investor and for other services (such as investment banking), from the product provider or issuer of the product?

Prior to the IA Regulations, there was no restriction on an investment adviser from receiving consideration from both the product provider and the client being advised, which often resulted in conflicts of interest. A restriction on receipt of consideration from any other person than the client being advised seeks to perhaps address this concern. While SEBI's intentions seem to be to protect the interest of the investors, market practice in India is to the contrary. Typically investment advisers in India receive consideration from product providers and not the investors and, therefore, this restriction may impose additional costs on investors.

The IA Regulations also list a number of other responsibilities for investment advisers. A stock broker, for example, cannot invest in a contrary fashion in a security it has provided advice for up to a period of 15 days (it must provide advance intimation to its client 24 hours in advance if it proposes to do so). Other responsibilities include maintaining risk profiling standards, comprehensive disclosures of all possible material information, maintaining a record of rationale through which the advice given was determined as well as determining full suitability of a client to the advice provided and record maintenance requirements.

“The IA Regulations are likely to have a significant impact on small independent investment advisers who were so far not regulated and who would now be caught under the net of the IA Regulations.”

In terms of eligibility requirements, SEBI has prescribed qualification norms for an investment adviser. Capital adequacy for corporate investment advisers is approximately US\$50,000 (INR 2.5 million) and that of individuals or partnership firms is approximately US\$2,000 (INR 0.1 million). An investment adviser must have a professional qualification or a post-graduate degree or diploma and also a minimum of five years previous experience in financial markets. SEBI has also directed investment advisers to, within a period of two years from commencement of the IA Regulations, get certified through an appropriate course with the National Institute of Securities Market ("NISM") (an autonomous public trust originally set up by SEBI to promote securities education) or any other accredited NISM course.

“Effective implementation of the regulations will remain the biggest challenge and the industry hopes for a pragmatic approach by the regulator.”

Retail Indian investors have long clamored for reliable, trustworthy and responsible investment advice. The SEBI-mandated definition of an investment adviser is sweeping and covers a wide range of intermediaries. Regardless of who it comes from, the general flavor of investment advice for Indian investors often doesn't live up to the highest fiduciary standards. A product-pushing approach, a conscious overlook of customer understanding and an entrenched product-centric (rather than customer-centric) characteristic of financial counsel are all unfortunate, but real features of investment advice today. While trying to strike the right balance between getting the unregulated investment advisers within its fold and protecting the securities market in India, some may argue that the IA Regulations unwittingly overregulate the unorganized sector of investment advisers by imposing onerous conditions on compensation in addition to other compliances and procedures to be followed. Effective implementation of the regulations will remain the biggest challenge and the industry hopes for a pragmatic approach by the regulator. ●●

About the Authors



The co-author is a Partner at AZB & Partners, Advocates & Solicitors, India.



The co-author is an Associate at AZB & Partners, Advocates & Solicitors, India.

The co-author is a Partner at AZB & Partners, Advocates & Solicitors, India. Views expressed are personal

The co-author is an Associate at AZB & Partners, Advocates & Solicitors, India. Views expressed are personal

*For more information on the FINRA story, please see:
http://newsandinsight.thomsonreuters.com/Securities/News/2013/02_-_February/Exclusive__U_S__watchdog_backs_off_over_financial_adviser_regulation/*

Disclaimer: This material should not be construed as professional legal advice and is intended solely as commentary on legal and regulatory developments affecting the private equity community in emerging markets. The views expressed in this bulletin are those of the authors and not necessarily those of their firms. If you would like to republish this bulletin or link to it from your website, please contact Holly Freedman at freedmanh@empea.net.