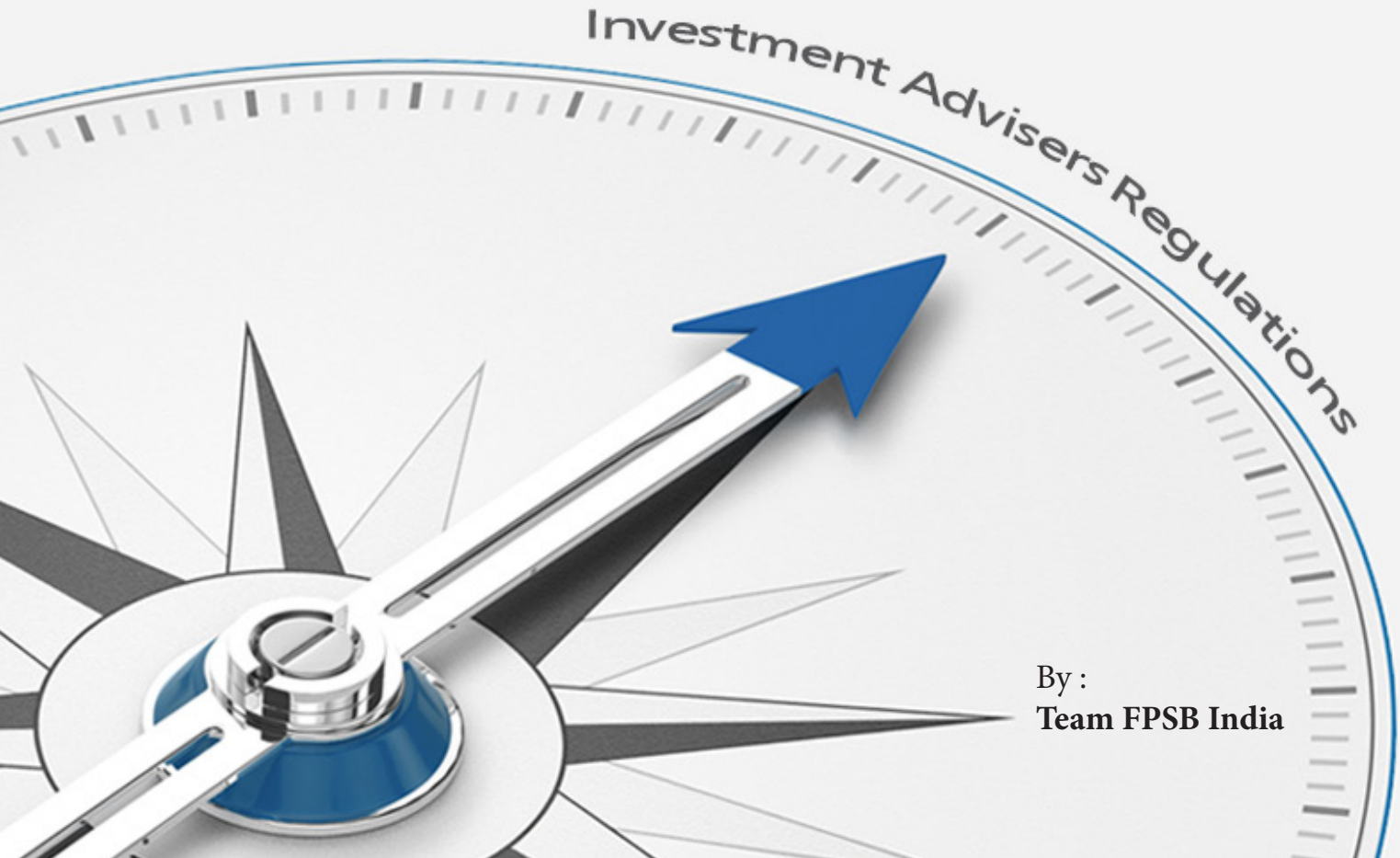
FPSB INDIA

FINANCIAL PLANNING STANDARDS BOARD INDIA

Impact of the Proposals of the Consultation Paper on Amendments to the SEBI (Investment Advisers) Regulations, 2013

Content :



By :
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Executive Summary

Securities and Exchange Board of India (SEBI) released its third Consultation Paper on Amendments to the SEBI (Investment Advisers) Regulations 2013 (**"IA Regulations"**), on January 2, 2018. The initial amendment paper was issued on October 7, 2016 followed by a revised one on June 22, 2017.

In order to prevent conflict of interests between 'advising' of investment products and 'selling' of investment products, the proposals advocate a total segregation of advice and distribution, so that a single entity cannot carry on both the activities either directly or indirectly. This is applicable to both the entities: individual as well as institutional.

A qualified survey from the financial consumers on whether they would like to approach separate entities/ individuals to get advice and then to execute transactions may be initiated. Investors in India need a lot of handholding at every stage: both advice and execution. There is also the unassailable fact that the vast majority of financial consumers are unwilling to pay separately for financial advice unless it is embedded in the price itself.

FPSB India holds the view that there should be a distinction between Advisory Practice and Distribution Business in the interests of financial consumers and to avoid a situation of conflict of interest[1] . In order to ensure this, it should be sufficient for the entities as well as individuals (as a sole proprietorship) to disclose/ declare all conflicts of interest which may create risk in potentially making the professional judgment or actions in favour of the financial consumer to maintain the transparency at all times. This would be in sync with the broad recommendations[2] (Clause 102: Dealing with conflict of interests) **made by the Financial Sector Legislative Reforms Commission (FSLRC) as well.**

In view of Section 17(a) of the IA Regulations, viz. '*All investments on which investment advice is provided is appropriate to the risk profile of the client*', FPSB India in its earlier recommendations stated that, '*All investments being made above Rs.10 lacs should be mandatorily be prescribed to be assessed by Investment Advisors under these Regulations. This will lead to robustness of investment portfolio being created by conforming to the suitability, robustness, risk tolerance, and risk appetite, as well as establish international standards. It will indirectly boost the practice of professional Investment Advisers in the interest of financial consumers*'. The same should be adopted as well.

[1] A conflict of interest may be defined as a set of circumstances that creates a risk that professional judgment or actions regarding a primary interest would be unduly influenced by a secondary interest by RIA. Primary interest refers to the principal goals of the Investment Advisory profession or activity, such as the protection of clients, the integrity of research, and the fulfillment of the fiduciary duties of the RIA. Secondary interest includes personal benefit and is not limited to only financial gain but also such motives as the desire for professional advancement, or the wish to do favours for family and friends. These secondary interests are not treated as wrong in themselves, but are objectionable when they have greater weight than the primary interests.

- Lo and Field (2009). The definition originally appeared in Thompson (1993)

[2] Clause 102. Dealing with conflict of interests

(1) A retail advisor must –

(a) provide a retail consumer with information regarding any conflict of interests, including any conflicted remuneration that the retail advisor has received or expects to receive for making the advice to the retail consumer; and

(b) give priority to the interests of the retail consumer if the advisor knows, or reasonably ought to know, of a conflict between

(i) its own interests and the interests of the retail consumer; or

(ii) the interests of the concerned financial service provider and interests of the retail consumer, in cases where the advisor is a financial representative.

- *Volume II: Draft Law – Report of the Financial Sector Legislative Reforms Commission*

On a more specific level, based on the above said inputs, the CFP[CM] certification[3], which works on the basis of client centric and ethical advisory, is expected to augment in numbers, thus facilitating the financial consumers' investment advisory needs on fiduciary basis.

This would also motivate the intermediaries to embrace investment advisory practices leading towards coexistence between investor advisory practice and distributor business as well.

Detailed impact of the new proposals and our suggestions with rationale is giving below:

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S. No.	**Pertains to Proposal**	**Suggestions**	**Rationale**
1	**Proposal 1:** There should be clear segregation between the two activities of the entity i.e. providing investment advice and distribution of the investment products/ execution of investment transactions.	The segregation between Adviser and Distributor as regards their roles and processes should be enough to deter conflicts of interest, and manage it transparently wherever such conflicts arise. However, absolute avoidance of any conflict would lead to water tight compartmentalization of entities which may be counterproductive not only for the growth of advisory and financial investments but also for the financial consumers. The same objective may be achieved by suitable disclosures and/or by other means.	The meaning of the word "segregation" as per the Merriam – Webster dictionary is, '------ *the act or process of separating or the state of being separated.*' This is consistent with SEBI's stance throughout the stages of amending the **IA Regulations.** In fact, the two subsequent amendments to the **IA Regulations** have made the distinction between the two activities more pronounced. This is in order to avoid conflict of interests between the advisory and the distribution industry. However, it is to protect and accommodate financial consumers, and not leave them isolated as regards advice.
2	**Proposal 2:** Individuals who are willing to get registered as Investment Advisers shall not provide any distribution services in financial products, either directly or through any of their immediate relatives. Similarly, individuals providing distribution services shall not provide advice for investing in financial product either directly or through their immediate relatives. "Immediate relative" means a spouse of a person, and includes parent, brother, sister or child of such person or of the spouse as defined under SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011.	The absolute segregation of individuals' businesses of advice and distribution on the basis of "immediate relative" (as defined) is not recommended. It may be looked upon as an infringement of the fundamental right prescribed under Article 19(1)(g) of the Constitution of India, viz. "*Right to practice/ carry on any profession, trade or business to all citizens subject to Article 19(6) which enumerates the nature of restriction that can be imposed by the state*". Moreover, it is not feasible to track and monitor such cases. The matter calls for suitable evaluation. While it may be necessary to segregate the activities of advice and distribution, the same can be well achieved by suitable disclosures duly signed off by the consumers/clients.	This is a recent development wherein the relatives of an individual engaged in advisory cannot engage in distribution of financial products, or vice versa. Many individuals who, prior to notification of the **IA Regulations** were engaged in both the activities have separated their respective businesses, some to their relatives as well. The said proposal will impact such entities' businesses. Moreover, it is not very practical to monitor each individual case. Individuals who do not have scalable practice of advice may like to surrender Investment Adviser license in favour of being Distributors.

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3	**Proposal 3:** Banks, NBFCs, Body Corporates, LLPs and firms who are willing to get registered as Investment Advisers, shall not provide any distribution services in financial products, either directly or through their holding company or associate company or subsidiary company. Similarly, banks, NBFCs, body corporates, LLPs and firms providing distribution services shall not provide investment advice in financial products either directly or through their holding company or Associates Company or subsidiary company. "Associate company" of an entity means a body corporate in which the entity or its director or partner holds, either individually or collectively, more than fifteen percent of its paid-up equity share capital or partnership interest, as the case may be.	The status quo as proposed in SEBI's consultation paper dated October 7, 2016 should be maintained, i.e. two legal entities should be permitted to carry out the businesses of advisory and distribution at arms-length with full disclosures. It is more feasible to track, monitor corporate businesses and audit their accounts. Furthermore, the prudential governance norms can be imposed on such entities.	This is inconsistent with SEBI's stance in their June 22, 2017 consultation paper whereby non-individual entities registering as Investment Advisers would do so through a subsidiary company. This itself was changed from SEBI's October 7, 2016 consultation paper which recommended such arrangement to be through a Separately Identifiable Department or Division (SIDD), which incidentally was in sync with the RBI circular dated April 28, 2016, requiring banks desirous of offering investment advisory services to do so either through a specifically set up subsidiary for the purpose or through one of their existing subsidiaries after ensuring an arms-length relationship. The existing subsidiaries of banks, NBFCs, body corporate, LLPs and firms will have substantially reduced stakes of 15% and below of their parents, meaning a disinterest in advisory practice, which itself is not remunerative enough currently on a standalone basis. They may choose to close down such wholly owned subsidiaries, and will have to perforce close down departments/divisions engaged in advisory in order to comply with the revised proposals.
4	**Proposal 4:** Existing Registered Investment Advisers (RIAs) who are offering distribution services through immediate relatives or through separately identifiable division or department or through holding/ subsidiary/associate company shall choose among providing investment advice or the distribution services before March 31, 2019. Similarly, Distributors who are offering advisory services through aforesaid modes shall also choose between distribution services and advisory services. From April 01, 2019, any person, including their immediate relatives or holding/ subsidiary/ associate entity, shall offer either investment advice or distribution services.	Kindly refer to our suggestions against proposals 1, 2 and 3 above where such arrangements of advice and distribution between two individuals, or between two non-individual entities can exist on a segregated level with full disclosures duly under sign offs from availing consumers/clients. This is in the interest of the personal finance ecosystem and above all the financial consumers, who might otherwise be left in isolation as regards right advice.	The interest of financial consumers with respect to right and ethical advice should be protected first and foremost. In a drive to absolutely avoid the situation of conflict, the advice may get relegated in favour of distribution. The period until March 31, 2019 would see a clear churn in the nature of businesses based on further developments in the investment advisory and distribution arena, e.g. scalability of advisory practice and remuneration aspect; the structure of commissions including trail commissions in distribution business, its losing proposition as advisers to financial consumers and further regulatory developments in distribution space.

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5	**Proposal 5:** Mutual Fund Distributors (MFDs), while distributing their mutual fund products can explain the features of products to client, and shall ensure the principle of "appropriateness" of products to the client. As per the extant SEBI circulars, appropriateness is defined as selling only that product categorization that is identified as best suited for the client. As part of disclosures to clients, MFDs shall disclose the list of mutual funds they are affiliated with and that the information provided is restricted to the mutual fund products being distributed by them. However, the client may also consider other alternate products, which are not being offered by them before making investment decision.	The "appropriateness" should be ascertained by way of a well researched and scientific questionnaire which should be filled by the investors independently, i.e. under no influence of MFD. Such questionnaire should be the basis for MFDs recommending the product with proper disclaimer and disclosures as to be prescribed by SEBI. The basis of distributing product to the investor by way of a standardized questionnaire will avoid any discretion or other advisory on the part of MFDs.	The act of ascertaining "appropriateness" involves a process of judicious assessment, thus falling under the realm and nature of Advice. This is a grey area because a distributor while ensuring "appropriateness" of a product will have to know about the client and his goals, needs, profile etc., which are all part of investment advice.