

## Corpsec Hotline

January 25, 2013

### INVESTMENT ADVISERS REGULATIONS NOTIFIED – DO YOU NEED TO REGISTER?

Five months after granting approval to the regulations relating to registration and regulation of investment advisers in its board meeting of August 16, 2012, Securities and Exchange Board of India ("SEBI") has notified the much awaited SEBI (Investment Advisers) Regulations, 2013 ("IA Regulations") on January 21, 2013. The IA Regulations have seen the light of the day after two consultative papers issued by SEBI in 2007 and 2011 seeking stakeholder opinions and expert comments on substance and form relating to the framework for regulation of investment advisers.

Although the IA Regulations are much in tandem with the key points as were summarized in the SEBI board meeting minutes ("Board Meeting Minutes")<sup>1</sup> (please visit our hotline: [Investment Advisors: It's time to Register!](#) for discussion on the same), some key changes have been notified in the final regulations that the industry would be thankful for, including:

- Extending exemption from registration to investment advisers providing investment advice exclusively to clients based outside India; and
- Extending exemption from registration to fund managers of all intermediaries or entities registered with SEBI. Thus, expanding the scope of the exemption beyond managers of mutual funds and alternative investment funds, as was stated in the Board Meeting Minutes. The exemption would now also extend to managers of venture capital funds that are registered with SEBI under the erstwhile SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations").

We present below an in depth analysis of the IA Regulations to understand its impact across the financial industry.

#### When do you need to register?

The IA Regulations have been notified and published in the official gazette by SEBI on January 21, 2013 and will come into force on the 90th (ninetieth) day from such date, i.e. April 20, 2013. The IA Regulations have also provided a 6 (six) month breather on the requirement to register for persons acting as investment advisers immediately prior to the commencement of the IA Regulations.

This would mean that all the investment adviser who have commenced provisioning of investment advisory services prior to April 20, 2013 would be provided a lee-way of not being required to be registered with SEBI for a period of 6 (six) months therefrom. However, any investment adviser who wishes to initiate investment advisory services after the commencement of the IA Regulations will compulsorily need to seek registration with SEBI under the IA Regulations.

#### Who is considered an Investment Adviser?

Under Regulation 3 of the IA Regulations, any person 'acting' or 'holding itself out' as an investment adviser will be required to compulsorily seek registration with SEBI. The term 'investment adviser' has been defined broadly in the IA Regulations to mean any person who is engaged in the business of providing investment advice to clients or other persons or group of persons, for a consideration, and includes any person who holds out himself as an investment adviser by whatever name.

To understand who could fall within the ambit of the above mentioned definition of 'investment adviser', it is essential to understand the definition of 'investment advice'. 'Investment advice' has been defined under the IA Regulations to mean any 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."

While the meaning of the term 'securities' may be borrowed from Section 2(h) of the Securities Contracts (Regulation) Act, 1956, the term 'investment products' is left undefined and open to interpretation. However, knowing the mandate of SEBI, this would mean to cover products relating to securities as the SEBI Act, 1992 mandates the role of SEBI to "protect the interests of investors in securities and to promote the development of, and to regulate the securities markets".<sup>2</sup>

However, what is excluded from the above mentioned definition of investment advice is any advice given through a newspaper or magazine or through any electronic, broadcasting or telecom medium as may be widely available to public at large. Also, any advice given without any consideration, in the form of economic benefit or non-cash benefit, will not be investment advice as per the IA Regulations.

#### Person's Exempted from Registration and Impact on Onshore Fund Advisers

The IA Regulations have provided a comprehensive list of persons who shall be exempted from seeking registration

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under Regulation 3 of the IA Regulations. This list is largely similar to the exempted person list as was provided in the Board Meeting Minutes;<sup>3</sup> however, certain additional categories that are exempt from falling under the net of Regulation 3 are:

1. Any fund manager of any intermediary or entity that is registered with SEBI by this inclusion, the exemption has been extended to fund managers of venture capital funds registered with SEBI under the erstwhile VCF Regulations as well as collective investment management companies under the SEBI (Collective Investment Schemes) Regulations, 1999 in addition to the fund managers of alternative investment funds and mutual funds;
2. Any representative or partner of an investment adviser who is registered under the IA Regulations;
3. Any person who provides investment advice exclusively to clients based out of India (however, if clients happen to be non-resident Indians ("**NRIs**") or person of Indian origin ("**PIOs**"), then the exemption from registration under Regulation 3 does not apply);
4. Any other person as specified by SEBI.

The exclusion under iii) above means that any person, whether in India or out of India, who provides investment advice exclusively to a person 'based outside India', other than to NRIs and PIOs, would be exempted from registering under Regulation 3. This appears to have been aimed at, and is likely to provide relief to all the investment advisers in India, or even outside India, engaged in providing investment advisory services to an offshore fund manager of an offshore fund, as long as their investment advice is restricted exclusively to such offshore clients. If in addition to the offshore clients, the investment adviser wishes to provide any advice to a client in India or to any NRIs or PIOs, it will be required to seek registration in accordance with Regulation 3 of the IA Regulations.

It may however be noted that the exemption provision provides that the client should be 'based out of India', which may be ambiguous in its interpretation, i.e., whether an investment adviser giving investment advice to any Indian resident (not being a NRI or PIO) who, at the time when the advice was being given, was based outside India for a temporary period, would be caught under the exemption or not, may be ambiguous.

### **Eligibility Criteria for Registration as an Investment Adviser**

Regulation 6 of the IA Regulations prescribes different requirements and thresholds for registration depending on the form of the adviser, i.e. whether an applicant is a body corporate, firm, Limited Liability Partnership or an individual (all of which would result in distinct treatment relating to qualifications and certification).<sup>4</sup>

Other key factors include previous disciplinary history in context of the securities market as well as any past refusal of registration by SEBI under any other regulation. Further, in case of a bank or a Non-Banking Financial Company ("**NBFC**"), the applicant would have to disclose if it has been granted permission by the Reserve Bank of India to provide investment advisory services, and if that is the case, whether it purports to carry out the advisory activities itself or through a separately identifiable division or department.

With regard to foreign entities seeking to register as an investment adviser, a vital determining factor that will be taken into consideration would be whether the foreign entity has a subsidiary in India, and if yes, then whether such subsidiary has sought any registration under the IA Regulations. Similarly, if a foreign individual proposes to undertake investment advisory services, whether he/she has an office in India and if yes, whether he/she proposes to undertake investment advice from such office or not would also be taken into consideration by SEBI.

### **Responsibilities of Investment Advisers for Risk Mitigation**

One of the chief strains of the IA Regulations is to ensure that investment advisers are held to the highest ethical and moral standards to protect clients. Indeed, the absence of these standards in the United States led to several cases of abuse of conflicting positions, resulting in the Global Settlement of Conflicts of Interest between Research and Investment Banking.<sup>5</sup> SEBI seems to have taken into account the lessons learnt from experiences such as the Global Settlement and has sought to address the same through extensive (but not as far reaching as rules prescribed by the U.S. Investment Advisers Act, 1940) rules in this regard to address conflict of interest, risk profiling and risk mitigation for persons availing the services of investment advisers.

The IA Regulations mandate that investment advisers shall always act in a fiduciary capacity towards their clients and shall disclose conflicts of interests as and when they arise. This is particularly important since investment advisers may likely encounter many cases of conflicting interests arising between not just the interest of investment adviser and the client, but also between multiple clients. Further, the IA Regulations also prohibit an investment adviser from receiving any consideration by way of remuneration or compensation or in any other form from any person relating to underlying securities or investment products other than the client being advised by the investment adviser. The objective is to prohibit investment advisers from acting as or in conjunction with distributors / marketing agents of a given financial product, which could possibly result in non-objective / biased advice being possibly provided to the client. The IA Regulations also mandate an investment adviser to require prior approval from SEBI in case of change in control of the investment adviser.<sup>6</sup>

Some of the obligations are discussed in more detail below:

#### **■ Chinese Walls**

The IA Regulations also mandate an investment adviser to maintain arm's length relationship between its investment advisory activities and other activities. It is in furtherance of this that the IA Regulations mandate a 'Chinese wall' between the investment advisory arm and other activities of an investment adviser. However, in the event that an apparent conflict of interest becomes known to the investment adviser between its advisory activities and other activities, the investment adviser is required to disclose any such known conflicts to the client immediately.

The IA Regulations also devote special attention to the segregation of execution of investment advisory services, especially in cases of banks, NBFCs and other body corporates which also provide distribution and execution services. The IA Regulations mandate that even after segregation of such services, the provision of such execution

and distribution services would be subject to the investment adviser making it clear to the client that the subscription of execution / distribution services would not be mandatory on the client. In addition, such services would have to be on an arm's length basis and any payment required to be made for the distribution and/or execution services would have to be made directly to the distributor / service provider.

#### ■ **Conflict of interest**

The IA Regulations set an extremely high threshold on disclosures relating to conflict of interests which may arise during course of the investment adviser's activities being undertaken. This includes keeping the client informed of any conflict of interest arising from various other activities carried out by the investment adviser, informing the client of any consideration / remuneration received by the investment adviser or its associates and subsidiaries and includes informing the client of any actual or potential conflicts arising from 'any connection to or association' with any issuer of products or securities, including any material information or fact that could even possibly compromise the investment adviser's objectivity or independence.

The IA Regulations further go on to address specific cases where conflict is deemed to exist, and has put in measures to mitigate the same. The IA Regulations mandate that an investment adviser shall not enter into transactions on its own account contrary to its advice given to a client for a period of 15 days from the date of such advice. However, it may enter into such a transaction after sending a revised assessment of the situation to the client 24 hours prior to entering into such transaction. What remains largely uncertain is the inherent inconsistency in obligations imposed on investment advisers whose segregated departments may undertake a contrary advice within the stipulated time period and without the respective departments being aware of it. In such a case, the question that begs to be answered is whether SEBI will penalize the investment adviser for failing to provide notice before entering into such a transaction or for failure to maintain the appropriate Chinese wall.

The IA Regulations also prohibit an investment adviser from purchasing or selling securities / investment products on its own account (knowingly) from / to a client.

#### ■ **KYC compliance and Code of Conduct**

The investment adviser is also required to follow the Know Your Client ("KYC") guidelines specified by the SEBI from time.<sup>7</sup> In addition, a prescribed 'Code of Conduct' is to be adhered by the investment adviser. The 'Code of Conduct' prescribes the following tenets: Honesty and fairness; diligence; effectively employing capabilities; gaining all relevant information relating to the clients; providing all necessary information relevant to clients; charging fair and reasonable fees; disclosing conflict of interests; compliance with applicable regulatory requirements; and allocating relevant responsibility to senior management.

#### **Other Important Miscellaneous Obligations and Compliances**

The IA Regulations also outlines various other obligations on, and compliances to be fulfilled by, the investment adviser, including carrying out risk profiling for the clients, maintenance of prescribed records, appointment of a compliance officer, setting up procedures to redress client grievances in a timely and prompt manner and making relevant disclosures such as material information pertaining to itself, its disciplinary history, its affiliations, its remuneration, its holding or positions with respect to financial products, etc. to enable the client to take an informed decision on whether to procure the services of the investment adviser.

#### **Conclusion**

Anticipated to be one of the most dreaded regulations that possibly could have had a far reaching impact on the unregulated section of investment and financial advisers in India, the final form of the IA Regulations does a fine job of plugging a gap in the Indian financial services regulation without overreaching provisions that could smother the industry. The focus of SEBI seems to have been more to regulate the unorganized sector of investment advisers. The introduction of the IA Regulations fills yet another void in the securities market regulation hitherto left largely unregulated and is another step forward in SEBI's stated aim of streamlining the securities market in India through the introduction of 'omnibus' regulations such as the SEBI (Alternative Investment Funds) Regulations, 2012.

The IA Regulations may have a larger than life impact on several small to medium size boutique investment advisers who are now caught under the net of the IA Regulations and burdens them with the added responsibility and accountability towards SEBI, in addition to the various compliances and procedures that they will need to adopt as discussed in this hotline.

Reacting competently to the changing dynamics of global securities law, SEBI, it appears, is hoping to strike the right balance between over-regulation and protection of the securities market in India. Whether this aim is achieved or not will depend on the effective and reasonable implementation of the IA Regulations by SEBI, especially on SEBI taking a pragmatic view of the various organizational structures that financial intermediaries have adopted in India, including housing their stock broking and research teams in the same entity, by recognizing effective Chinese walls in these organizations the proof of the pudding will indeed be in the eating.

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You can direct your queries or comments to the authors

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<sup>1</sup> SEBI Board Meeting, PR No. 77/2012, available at <http://www.sebi.gov.in/sebiweb/home/detail/24234/yes/PR-SEBI-Board-Meeting> (as on January 23, 2013).

<sup>2</sup> Section 11 (1) of the SEBI Act, 1992.

<sup>3</sup> The exempted person list in the Board Meeting Minutes included - stock and sub brokers, merchant bankers and portfolio managers already registered with SEBI providing investment advice incidental to their primary activity (exempt only from registration requirement; distributors of mutual funds providing investment advice incidental to their primary activity; fund manager of mutual fund, alternative investment fund ; professionals such as lawyers, chartered accountants providing advice incidental to their professional services; persons providing advice exclusively in areas like insurance and pension products provided regulated by sectoral regulators; persons providing general comments in good faith about market trends.

<sup>4</sup> Applicants which are body corporate would have to meet a net worth of INR 25 lakhs or more. Applicants that are individuals or partnership firms would have to have net tangible assets of value of INR 1 lakh or more. Existing investment advisers would have one year timeframe from date of commencement of IA Regulations to meet the relevant capital adequacy requirement.

<sup>5</sup> Information regarding the Global Settlement with Citigroup Global Markets Inc., formerly known as Salomon Smith Barney Inc., Jack Benjamin Grubman, Merrill Lynch, Pierce, Fenner & Smith Inc., Henry McKelvey Blodgett, Credit Suisse, First Boston LLC, U.S., Bancorp Piper Jaffray Inc., Bear Stearns & Co. Inc., Goldman Sachs & Co., J.P. Morgan Securities Inc., Lehman Brothers Inc., Morgan Stanley & Co. Inc., UBS Warburg LLC available at <http://www.finra.org/Industry/Enforcement/DisciplinaryActions/2003GlobalSettlement/> (as on January 23, 2013).

<sup>6</sup> Regulation 2(e) of the IA Regulations defines "change in control" in relation to a company or body corporate to mean "(i) if its shares are listed on any recognized stock exchange, change in control within the meaning of clause (e) of sub-regulation (1) of regulation 2 of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011; and (ii) in any other case, change in the controlling interest or change in legal form." It should be noted that the term "controlling interest" has been further elaborated to mean, "an interest, whether direct or indirect, to the extent of more than fifty percent of voting rights or interest."

<sup>7</sup> Circular No. IR/MIRSD/11 /2012 dated September 5, 2012 available at [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1346912729430.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1346912729430.pdf) (as on January 23, 2013) provides the KYC norms for the securities market.

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