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International Information for International Business

Volume 19, Number 3 March 2013

India's New Investment Advisers Regulations

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Five months after granting approval to the regulations relating to registration and regulation of investment advisers at its board meeting of August 16, 2012, the Securities and Exchange Board of India ("SEBI") notified and published the much awaited SEBI (Investment Advisers) Regulations, 2013 on January 21, 2013. The Investment Advisers Regulations were issued following 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 Investment Advisers Regulations are much in line with the key points summarized in SEBI's statement on the results of its August 16, 2012, board meeting ("Board Meeting Statement")[1] (*see analysis by Vivek Mimani, Siddharth Shah, Harshita Srivastava, and Ruchi Biyani, of Nishith Desai Associates, Mumbai, at WSLR, November 2012, page 30*), some key changes have been included in the final regulations for which the industry will be thankful, including:

- extending the exemption from registration to investment advisers providing investment advice exclusively to clients based outside India; and
- extending the 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 Statement. The exemption will now also extend to managers of venture capital funds that are registered with SEBI under the former SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations").

The following is an in-depth analysis of the Investment Advisers Regulations to provide an understanding of their impact across the financial industry.

When Do You Need to Register?

The Investment Advisers Regulations were notified and published in the official gazette by SEBI on January 21, 2013, and will come into force on the 90th day from that date, *i.e.*, April 20, 2013. The Investment Advisers Regulations provide a six month breather on the requirement to register for persons acting as investment advisers immediately prior to the commencement of the Investment Advisers Regulations.

This means that all investment advisers who have commenced providing investment advisory services prior to April 20, 2013, will not be required to be registered with SEBI for a period of six months after that date. However, any investment adviser who wishes to initiate investment advisory services after the commencement of the Investment Advisers Regulations will compulsorily need to seek registration with SEBI under the Investment Advisers Regulations.

Who is Considered an Investment Adviser?

Under Regulation 3 of the Investment Advisers 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 Investment Advisers 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 himself out 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 Investment Advisers 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 is open to interpretation. However, knowing the mandate of SEBI, this term is expected to cover products relating to securities, as the SEBI Act, 1992 mandates the role of SEBI to be to "protect the interests of investors in securities and to promote the development of, and to regulate the securities market. . .", and hence investment products may be interpreted contextually to be limited to the securities market.[2]

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 telecommunications medium as may be widely available to the 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 under the Investment Advisers Regulations.

Persons Exempted from Registration and Impact on Onshore Fund Advisers

The Investment Advisers Regulations provide a comprehensive list of persons who shall be exempted from seeking registration under Regulation 3 of the Investment Advisers Regulations. This list is largely similar to the exempted person list provided in the Board Meeting Statement[3]; 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 former 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 Investment Advisers Regulations;

3) any person who provides investment advice exclusively to clients based outside India (however, if clients happen to be non-resident Indians ("NRIs") or persons of Indian origin ("PIOs"), then the exemption from registration under Regulation 3 does not apply); and

4) any other person as specified by SEBI.

The exclusion under 3) above means that any person, whether in India or outside India, who provides investment advice exclusively to a person "based outside India", other than to NRIs and PIOs, will 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 Investment Advisers Regulations.

However, it should 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 or not an investment adviser giving investment advice to any Indian resident (not being a NRI or PIO) who, at the time the advice was given, was based outside India for a temporary period will be caught under the exemption, may be ambiguous.

Eligibility Criteria for Registration as an Investment Adviser

Regulation 6 of the Investment Advisers Regulations prescribes different requirements and thresholds for registration, depending on the form of the adviser, *i.e.*, whether an applicant is a body corporate, a firm, a limited liability partnership or an individual (all of which will result in distinct treatment relating to qualifications and certification).[4]

Other key factors include previous disciplinary history in the context of the securities market, as well as any past refusal of registration by SEBI under any other regulation. Further, in the case of a bank or a non-banking financial company ("NBFC"), the applicant will have to disclose if it has been granted permission by the Reserve Bank of India to provide investment advisory services, and, if so, 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 to be taken into consideration will be whether the foreign entity has a subsidiary in India, and, if so, whether such subsidiary

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has sought any registration under the Investment Advisers Regulations. Similarly, if a foreign individual proposes to undertake investment advisory services, whether he/she has an office in India, and, if so, whether he/she proposes to undertake investment advice from such office or not will also be taken into consideration by SEBI.

Responsibilities of Investment Advisers for Risk Mitigation

One of the chief aims of the Investment Advisers Regulations is to ensure that investment advisers are held to the highest ethical and moral standards to protect the interests of their clients. Indeed, the absence of these standards in the United States contributed to several cases of abuse of conflicting positions, resulting in the Global Settlement of Conflicts of Interest between Research and Investment Banking ("Global Settlement") announced by the U.S. Securities and Exchange Commission and other U.S. regulators in April 2003.[5] SEBI seems to have taken into account the lessons learnt from experiences such as the Global Settlement, and has sought to develop extensive (but not as far-reaching as rules prescribed by the U.S. Investment Advisers Act, 1940) rules in this regard to address conflicts of interest, risk profiling and risk mitigation for persons availing the services of investment advisers.

The Investment Advisers Regulations mandate that investment advisers shall always act in a fiduciary capacity towards their clients, and shall disclose conflicts of interest as and when they arise. This is particularly important since investment advisers are likely to encounter many cases of conflicting interests arising between not just the interests of the investment adviser and those of the client, but also between the interests of multiple clients.

Further, the Investment Advisers 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 provided to the client.

The Investment Advisers Regulations also mandate an investment adviser to require prior approval from SEBI in the case of change in control of the investment adviser.[6]

Some of these obligations are discussed in more detail below:

Chinese Walls

The Investment Advisers Regulations also mandate an investment adviser to maintain an arm's length relationship between its investment advisory activities and its other activities. It is in furtherance of this requirement that the Investment Advisers 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 between its advisory activities and its other activities becomes known to the investment adviser, the investment adviser is required to disclose any such known conflicts to the client immediately.

The Investment Advisers Regulations also devote special attention to the segregation of execution of investment advisory services, especially in the cases of banks, NBFCs and other bodies corporate which also provide distribution and execution services. The Investment Advisers Regulations mandate that, even after the segregation of such services, the provision of such execution and distribution services will be subject to the investment adviser making it clear to the client that the subscription of execution/distribution services will not be mandatory for the client. In addition, such services will have to be on an arm's length basis, and any payment required to be made for the distribution and/or execution services will have to be made directly to the distributor/service provider.

Conflicts of Interest

The Investment Advisers Regulations set an extremely high threshold on disclosures relating to conflicts of interest which may arise during the course of the investment adviser's activities. This includes keeping the client informed of any conflict of interest arising from various other activities carried out by the investment adviser, and informing the client of any consideration/remuneration received by the investment adviser or its associates and subsidiaries, including 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 Investment Advisers Regulations go on to address specific cases where conflict is deemed to exist, and provide measures to mitigate such conflicts. The Investment Advisers 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 provide contrary advice within the stipulated time period without the respective departments being aware of it. In such a case, the question 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 Investment Advisers Regulations also prohibit an investment adviser from purchasing or selling securities/investment products on its own account (knowingly) from/to a client.

Know Your Client Compliance and Code of Conduct

An investment adviser is also required to follow the Know Your Client ("KYC") guidelines specified by SEBI.[7] In addition, a prescribed Code of Conduct is to be adhered to by investment advisers. The Code of Conduct prescribes the following tenets: honesty and fairness; diligence; effectively employing capabilities; obtaining all relevant information relating to clients; providing all necessary information relevant to clients; charging fair and reasonable fees; disclosing conflicts of interest; compliance with applicable regulatory requirements; and allocating relevant responsibility to senior management.

Other Important Miscellaneous Obligations and Compliances

The Investment Advisers Regulations also outline various other obligations on, and compliances to be fulfilled by, investment advisers, including carrying out risk profiling for 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 holdings 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 Investment Advisers Regulations does a fine job of plugging a gap in Indian financial services regulation without introducing overreaching provisions that could smother the industry.

There are certain anomalies under the Investment Advisers Regulations, and it is hoped that SEBI will clarify these before the Regulations enter into force.

The introduction of the Investment Advisers Regulations fills yet another void in securities market regulation hitherto left largely unregulated, and marks 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 (*see analysis by Sidharth Shah and Bijal Ajinkya, of Nishith Desai Associates, Mumbai, at WSLR, June 2012, page 23*).

The Investment Advisers 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 Investment Advisers Regulations, and burden them with added responsibility and accountability towards SEBI, in addition to the various compliances and procedures that they will need to adopt as discussed in this article.

Reacting competently to the changing dynamics of global securities law, SEBI, it appears, is hoping to strike the right balance between overregulation 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 Investment Advisers 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 brokerage 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.

NOTES

[1] SEBI statement on August 16, 2012, Board Meeting, PR No. 77/2012, available at http://www.sebi.gov.in/sebiweb/home/detail/24234/yes/PR-SEBI-Board-Meeting.

[2] Section 11 (1) of the SEBI Act, 1992.

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

[4] Applicants which are bodies corporate will have to have a net worth of INR 25 lakhs or more. Applicants that are individuals or partnership firms will have to have net tangible assets of value of INR 1 lakh or more. Existing investment advisers will have one year from the date of commencement of the Investment Advisers Regulations to meet the relevant capital adequacy requirement.

[5] 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 Blodget, 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., and UBS Warburg LLC is available at http://www.finra.org/Industry/Enforcement/DisciplinaryActions/2003GlobalSettlement/.

[6] Regulation 2(e) of the Investment Advisers 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".

[7] Circular No. IR/MIRSD/11/2012 dated September 5, 2012, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1346912729430.pdf, provides the KYC norms for the securities market.

The text of the Investment Advisers Regulations, in English, can be accessed at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1358779330956.pdf.

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