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The Securities And Exchange Board Of India's New Regulations On Investment Advisors

By Vivek Mimani, Siddharth Shah, Harshita Srivastava, and Ruchi Biyani, of Nishith Desai Associates, Mumbai.

The Securities and Exchange Board of India ("SEBI") has approved the SEBI (Investment Advisors) Regulations, 2012 ("Investment Advisors Regulations"). A statement issued by SEBI on the results of its August 16, 2012, board meeting ("Statement") summarizes some of the features of the soon to be notified Investment Advisors Regulations.

SEBI previously issued a consultative paper on regulating investment advisors in 2007, followed by a concept paper issued in 2011.

While the final set of regulations is still being awaited, this article summarizes the features of the Investment Advisors Regulations as indicated in the Statement, and also highlights some issues that existing investment advisors may face upon notification of the Investment Advisors Regulations.

Investment advisors are now statutorily required to provide investment advice in the best interests of the investor. This will surely cast a much higher degree of responsibility and accountability upon investment advisors.

Needless to say, the devil lies in the details, and the fine print of the Investment Advisors Regulations will need to be studied once notified by SEBI, at which stage we shall be providing a more in-depth analysis.

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Investment Advisors Regulations Finally Introduced

After release of the concept paper on the regulation of investment advisors in 2011, SEBI has finally approved the much debated and dreaded framework regulating investment advisors. As clarified in the concept paper, the Investment Advisors Regulations shall apply to all individuals, bodies corporate and partnership firms providing investment advice. Therefore, entities engaged in selling financial products shall not be governed by these regulations.

Introduction of the Investment Advisors Regulations is the second recent development relating to the legal regime governing the Indian fund industry, after the recent notification of the Alternative Investment Fund Regulations (*see analysis by Siddharth Shah and Bijal Ajinkya, of Nishith Desai Associates, Mumbai, at WSLR, June 2012, page 23*).

India's asset management and financial advisory business has been growing at a rapid pace, and in 2007 SEBI felt the need to regulate the workings of investment advisors. The Investment Advisors Regulations emanate from a lot of consultation with the industry, which had apprehensions about the legal regime having an adverse impact on the industry.

Persons Falling under the Scope of the Investment Advisors Regulations

The Investment Advisors Regulations require all persons providing investment advice to investors in return for consideration to seek registration with SEBI. It has also been clarified that investment advice given without consideration through media at large shall not be considered as investment advice. While initially SEBI will directly register and regulate all investment advisors, eligibility criteria such as qualification and net worth requirements shall also be prescribed for investment advisors. As a result, the Investment Advisors Regulations can be regarded as an omnibus regulation requiring all investment advisors to be registered with SEBI, unless particularly exempted.

Segregation of Advisory and Distribution Activities

It is important to note that the Statement provides that remuneration/consideration for investment advice can be received only from the client being advised, and not from any other person.

Additionally, banks or bodies corporate engaged in the distribution, referral or execution business alongside an investment advisory business will now be required to segregate their investment advisory business from the rest, and provide such investment advisory services through a subsidiary or department.

Categories of Exempt Persons

While the fine print of the Investment Advisors Regulation has yet to be released, the Statement exempts certain categories of persons from registration under the regulations. These categories include:

- stockbrokers and sub-brokers, merchant bankers and portfolio managers already registered with SEBI providing investment advice that is incidental to their primary activities (exempt only from registration requirement);
- distributors registered with All India Mutual Fund Industry providing investment advice incidental to their primary activities;
- fund managers of mutual funds or alternative investment funds;
- 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 regulated by sectoral regulators; and
- persons providing general comments in good faith about market trends.

These regulations bring a large number of investment advisors under SEBI's regulatory supervision which until now fell outside its purview. While the detailed regulations in this regard have yet to be notified, SEBI has broadly classified categories of persons subject to and exempt from these regulations.

Position under U.S. Laws

Drawing an analogy from the law in the United States, where most of our securities laws have found origination, the U.S. Investment Advisers Act of 1940 generally defines an "investment adviser" as any person or firm that: 1) for compensation 2) is engaged in the business of 3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. A person or firm must satisfy all three elements to be regulated under the U.S. Investment Advisers Act, wherein these elements are construed broadly.

For example:

- With respect to "compensation", the receipt of any economic benefit suffices. To be deemed compensation, a fee need not be separate from other fees charged, it need not be designated as an advisory fee, and it need not be received directly from a client.
- With respect to the "business" element, an investment advisory business need not be the person's or the firm's sole or principal business activity.
- Finally, a person or firm satisfies the "advice about securities" element if the advice or reports relate to securities. The U.S. Securities and Exchange Commission's Division of Investment Management has stated that providing one or more of the following also could satisfy this element: advice about market trends; advice in the form of statistical or historical data (unless the data is no more than an objective re-

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port of facts on a non-selective basis); advice about the selection of an investment adviser; advice concerning the advantages of investing in securities instead of other types of investments; and a list of securities from which a client can choose, even if the adviser does not make specific recommendations from the list.

While broadly the definition and scope of investment advisor in the last consultative paper by SEBI in 2011 also contains similar elements as provided under the U.S. Investment Advisers Act, it is important to note that the U.S. Investment Advisers Act governs investment advisors providing advice about "securities". The Indian Investment Advisors Regulations, providing an omnibus framework, cover all advisors, including financial planners providing investment advice, whether or not relating to securities. However, it is important to note that the term "securities" has been very broadly defined under the U.S. Investment Advisers Act.

This move could likely impact some offshore asset managers, both private equity and hedge funds, having advisory set-ups in India, which could now potentially fall within the ambit of these regulations. However, the fine print is important to see if there are any safe harbors for such advisors who advise only offshore managers and do not advise clients directly. It is important to note that the U.S. Investment Advisers Act provides a specific exemption to foreign private advisors, subject to the fulfillment of certain conditions,

Obligations of Investment Advisors

The Statement further indicates that investment advisors, like other intermediaries, will also have to comply with their code of conduct, fiduciary responsibility, record keeping and risk profiling of clients as may be prescribed in detail in the regulations.

This set of regulations seems to complete the loop for the regulatory framework for the asset management business in India.

Until now, investment advisors were contractually governed by their investment advisory agreement for their obligations, and any breach of obligation thereunder would have constituted a breach of contract. With the regulations prescribing fiduciary obligations of investment advisors to investors, investment advisors are now statutorily required to provide investment advice in the best interests of the investor. This will surely cast a much higher degree of responsibility and accountability upon investment advisors.

Implications for Onshore Fund Advisors and Managers and the Way Forward

While pending the fine print, as stated above, it appears that SEBI has looked at the new set of regulations as an omnibus regulatory framework regulating all persons engaged in the business of investment advice, unless an entity falls within any of the exemptions specified in the regulations. For example, there appears to be no exemption for entities which are essentially providing research and advice to offshore managers/advisors of offshore private equity or hedge funds. Thus, all these entities, unless regulated as portfolio managers, would fall within the purview of these regulations, thereby triggering the need for registration. Similarly, investment managers for domestic venture capital funds which are not alternative investment funds may also require registration under these regulations. This could potentially lead to an increasing compliance burden for these entities, as they would also be treated as "intermediaries" under the SEBI Act and hence be subjected to possible audits and compliance by SEBI under these regulations.

On the positive side, besides creating a degree of accountability and responsibility for financial advisors towards their clients, since there is no minimum investment threshold for clients under these regulations, they could also potentially provide an opportunity for creation of an advisory platform for investors who may otherwise not be able to participate in a portfolio management scheme on account of the higher minimum contribution requirement of Rs 2.5 million (U.S.$46,525).

What is interesting to see here is the change in approach to policy-making from SEBI. While traditionally SEBI had always adopted the approach of need-based regulations for a specific segment of the market, the Alternative Investment Fund Regulations and the Investment Advisors Regulations seem to take the approach that any form of asset management would now be regulated by SEBI.

It appears that this set of regulations seems to complete the loop for the regulatory framework for the asset management business in India, whereby retail pools of capital will be regulated under the Mutual Fund Regulations and the Collective Investment Scheme Regulations, private pools of capital in alternate assets will be regulated under the Alternative Investment Fund Regulations, and other segregated pools of capital will be regulated under the Portfolio Management Regulations and the Investment Advisors Regulations.

While compliance costs and the associated burden that these regulations may cast upon domestic intermediaries will surely cause hardships in the short run, the completeness of the regulatory framework with this piece of regulation is likely to provide long-term certainty and stability to asset management businesses in India.

SEBI's statement on its August 16, 2012, board meeting can be accessed, in English, at http://www.sebi.gov.in/sebiweb/home/detail/24234/yes/PR-SEBI-Board-Meeting.

Vivek Mimani, Harshita Srivastava, and Ruchi Biyani are Associates, and Siddharth Shah is a Partner, with Nishith Desai Associates, Mumbai. They may be contacted at vivek.mimani@nishithdesai.com, harshita.srivastava@nishithdesai.com, ruchi.biyani@nishithdesai.com, and siddharth.shah@nishithdesai.com.