

**COMMENTS**

**BY**

**FOUNDATION OF INDEPENDENT FINANCIAL ADVISORS ON  
SEBI's CONCEPT PAPER**

**ON**

**INVESTMENT ADVISORS,**

**2011**

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*Annexure I - Regulatory Checks in other jurisdictions*

*Annexure II - Comments of various IFAs*

Securities and Exchange Board of India (SEBI) has released a “*Concept Paper on Investment Advisors, 2011*” (Concept Paper) on proposed regulations for investment advisors. These proposed regulations will have a significant impact on the on how Independent Financial Advisors (IFAs) operate in India.

We are a forum of independent financial advisors that represent the **IFA community**, who are engaged in advising investors on investments in mutual funds and other financial products, and also execution of the same for their clients through their respective individual ARN Nos. for mutual fund Investments. We are in the process of incorporating a Section 25 non profit company under the name of Foundation of Independent Financial Advisors (FIFA). We appreciate the consultative approach adopted by SEBI by inviting comments to the Concept Paper.

Before dwelling on the specific aspects of SEBI’s Concept Paper, we would like to highlight the evolution of IFA regime and its impact in India.

## **A. Evolution of regulatory framework**

It was in 2007 that SEBI released its draft regulations governing investment advisors as “*Draft SEBI (Investment Advisors) Regulations, 2007*” (Draft Regulations 2007) in the Indian financial market. The Draft Regulations 2007 suggested **structural changes** in the nature of service provided by these advisors with **restrictive definitions** and **highly regulated disclosure norms**.

In the meantime, in 2009, SEBI released the Circular on 30<sup>th</sup> June, 2009 on the “**no load regime**”, wherein the investors were empowered to decide the commission paid to distributors in accordance with the level of service received and to bring about **more transparency** in payment of commissions and to **incentivize long term investment**. The year 2010 saw some regulatory issues relating to wealth management and private banking. To further strengthen the investor protective regime, SEBI introduced the Concept Paper in 2011.

The issue arises from the fact that in the proposed regulations, SEBI has sought to separate the Advise and the sales and execution function by creating two categories of intermediaries -“Advisor” and “Agent” and restricting the investment advisors to receive remuneration from Clients and “agents” to receive commission form manufacturers. Currently Advisors/Agents are allowed to distribute the financial products, in addition to rendering advisory services, and receive a combined remuneration for the distribution of the product and the advisory function performed by them. This ensured that the advice which is inevitable linked to the sale of the financial product was maintained.

### **A.1. IFA’s business**

IFAs are typically small to medium size financial advisors whose **primary role is to advise** their clients towards investments in mutual funds and other financial products, and also execution of the same for their clients through their respective individual ARN Nos. for mutual fund Investments. IFA community

consists of professionals, including CAs, MBAs, CFAs, CFPs, Engineers, Post Graduates and Ex-servicemen who endeavour to provide independent advice to their clients by keeping their client's interest as the main purpose of the service and also by regularly improving their skills and knowledge on the financial products that they advise their clients on. Due to this very unique nature of the dual role of independent advice and also of the execution part, the classification of such individuals as IFAs has been done by the manufacturers or AMCs to distinguish them from the other distributors, who constitute banks and institutions.

IFAs in particular have very **different business model** as compared with other intermediaries such as banks and national level distributors. IFAs in particular have more **personalized relationships** and do a lot more of hand holding of the client as compared to the other categories of intermediaries. They invest a lot of time in educating investors regarding financial markets and various financial products available to them.

### **A.2. Need for financial inclusion and penetration in the financial market**

With the developing financial market in India, there is an express need for the more **financial penetration** of the retail investors in the financial market. For this purpose, it is necessary that structured regulations are put in place which not only make products available to the clients but in effect enhance the knowledge of the investors, therefore achieving the **financial inclusion** in the financial market.<sup>1</sup> Further, the need of the hour in the financial sector is the active **participation of retail investors** so that the equity in the financial market increases and this is possible only when proper advice is provided to these investors to enable them to make an informed decision about the investment. There is a high possibility that with the implementation of these regulations, it may not be financially viable for the advisors to provide only investment advice to these investors which, in turn, may prove detrimental to the market as a whole.

### **A.3. Need for balancing the interest of various stakeholders**

SEBI as a regulator has to **protect the interest of retail investors** and to promote the development of the securities market and for matters connected with it, which would mean that SEBI would work towards the need of the investors and also the demands of the financial market along with the various stakeholders like the investment advisors.

With the advent of the no load regime, the IFAs are already not allowed to charge commissions from the mutual funds/AMCs in the form of entry load for the mutual fund products sold. By further restricting their stream of income from product distribution, very few advisors will be eager to seek registration with SEBI as an 'advisor' and as a result, there would be non-availability of the investment advisors to the investors. It is pertinent to realize that selling and execution of the financial products are **inter-dependent** with the

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<sup>1</sup> The term "financial inclusion" is the delivery of financial services at affordable costs to sections of disadvantaged and low income segments of the society.

advice for the financial products offered by the IFA, mostly because of the demand/expectation of the investors that the advisors should play a dual role of advisory as well as the execution of the financial products. Therefore SEBI is worsening the condition of investors who are not fully aware of the market and are not ready to pay for the added cost for the advice offered by an IFA on a financial product.

## **B. Approach to policy formation**

The key for any successful **policy formation** and **implementation** is the approach undertaken by the legislators/regulators to its formation which consists of understanding the existing market structure, the issues in the existing structure, the needs of the investors and the service providers and the impact of the policy on all the stakeholders. Therefore, both the process and the approach to formation of a particular regulation play a significant role. In order to ensure effective and proportionate investor protection regime, it is important that **all stakeholders participate** in the process of formulation of the regulations.

The following demonstrates the approach followed by Financial Services Authority (FSA) of United Kingdom and by SEBI in the introduction of a new policy on Investment Advisors.

### **B.1. Approach of FSA in United Kingdom**

SEBI in its Concept Paper has heavily relied on the UK regime which proposes to move to an Adviser charging model. However, it is pertinent to note that the United Kingdom, through the FSA has been considering the proposed alterations over a period of time. After depolarization of IFAs, the FSA sought to enhance investor protection by introducing a more investor friendly regime whereby IFAs would be subject to choosing between providing independent advice, restricted advice and basic advice.

- In June 2007, a discussion paper was published by FSA setting out the thinking of the FSA based on the working of five groups of practitioners, consumer representatives and other stakeholders. The regulator held 100 public meetings to explain and discuss the proposed regulations.
- In April 2008, an Interim Report was published by FSA, summarising the feedback on the discussion paper and setting how the FSA had modified the thinking to reflect on that feedback.
- FSA did further research and analysis and discussions with stakeholders on the Interim Report.
- **FSA realized though that there was a merit in making the nature of different services much clearer to consumers and have a clear distinction between “advice” and “sales”, and concluded that the implementation could result in many, predominately less affluent, consumers having significantly reduced access to advisory services.**
- **FSA also noted that that the majority of consumers buying the investment products need help not only to identify their needs but also to encourage them to take action. Pure**

**execution services can offer only limited assistance and are predominantly used by those consumers that have a pretty clear idea of what they want at the outset.**

- The proposals were taken and a Consultation Paper was drafted by the FSA in June 2010 and the work was taken forward by the FSA under the “Retail Distribution Implementation Programme”.
- It is only after making the public aware of such proposals and holding meetings with the various stakeholders, the final regulations will be effective only from 31<sup>st</sup> December 2012.

Therefore, even a developed economy like the UK, realizing the varied impact of such a regulation on both the investors and the advisors is encouraging the industry to take steps to transition before the regulations come into effect. Further, FSA has equipped all the stakeholders better to deal with the changes sought to be implemented with these regulations.

## **B.2. Approach of SEBI in India**

The primary concern of SEBI, as highlighted in the Concept Paper is that of investor protection. The regulator has highlighted the fact that the investors in India are not financially literate and require **investor-protective regulations**. Therefore, there is a greater need to allow **sufficient time** for the investors to understand the structure being proposed in its entirety. This mandates that the investors are clearly informed about the proposed changes such that they can be involved in the entire process of consultation with the regulator, before the regulations are introduced.

Although SEBI introduced the Draft Regulations in 2007, no further initiatives were taken to allow both the investors and the advisors to propose their suggestions. SEBI has now introduced the Concept Paper which was released after a gap of four years, and SEBI has invited comments on the same from all the stakeholders. Before providing a solution, the issues and concerns of all stakeholders have to be discussed and addressed.

The investors, who are the primary concern of SEBI, have relied on a particular investment process for generations in so far investments are concerned. By abruptly introducing a new system, SEBI is not serving the interest of the investor. It is not the objective of SEBI which is being questioned but it is the method of implementation of these objectives. Financial literacy, expansive discussions and proper consultations are needed not only with the IFAs but, with the investor groups as well, to create a **balanced and harmonious environment** for proper **financial expansion and penetration**.



### **Approach to be adopted by SEBI**

- *Demonstrate the need for the proposed change*
- *Involvement of various stakeholders in the whole process*
- *Understanding the impact these changes would have on various stakeholders especially the investors*
- *Educating the investors about the proposed changes*
- *Provide transition time*
- *Adequate steps to be taken in transition period to ensure fair application of the regulations*

## **C. Structures adopted in various other jurisdictions**

A comprehensive analysis of the investment advisor regime in different jurisdictions throws light on the specific needs for the implementation of guidelines regulating them. A perusal of the regime in various jurisdictions reflects that even the developed economies faced the same issues regarding the conflict of interest between the advisory services and the distribution services. However, with a proper regulatory body overseeing the functioning of all registered/licensed advisors accompanied by extant disclosure provisions, the interests of both investors and advisors is preserved whereby the advisors can receive remuneration both in the form of fees, commissions or a combination of both. SEBI should analyze the implementation of these regimes such that an effective mechanism is devised regulating investors and advisors alike.

### **C.1. Singapore**

*Governing Regulations:*

The Financial Advisors Act, 2001<sup>2</sup> read with Financial Advisors Regulations, 2002<sup>3</sup>.

*Definition of Financial Advisors:*

The term “financial advisor” means a person who carries on a business of providing any financial advisory service, but does not include any person specified in the First Schedule, for example advocate solicitor, law corporation etc.

*Independent Advisors:*

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<sup>2</sup> [http://www.mas.gov.sg/resource/publications/consult\\_papers/FAAConsultation.pdf](http://www.mas.gov.sg/resource/publications/consult_papers/FAAConsultation.pdf)

<sup>3</sup> [http://www.mas.gov.sg/resource/legislation\\_guidelines/fin\\_advisors/fin\\_advisors\\_act/sub\\_legislation/Financial\\_Advisors\\_Regulations.pdf](http://www.mas.gov.sg/resource/legislation_guidelines/fin_advisors/fin_advisors_act/sub_legislation/Financial_Advisors_Regulations.pdf)

The Regulations state that all licensed financial advisors would not qualify as an “Independent Advisor”<sup>4</sup>, if:

- They either receive commission/incentive from manufacturers of financial products which may create a product bias, or
- They act with any restrictions, directly or indirectly, or
- They act with a conflict of interest created by any association with product manufacturers.

It is pertinent to note that this regime does not impose absolute restrictions in so far as banning financial advisors from receiving commissions is concerned. Regulation 21 suggests that those financial advisors who want to use the term ‘independent’ for giving independent advice are restrained from representing a particular financial manufacturers interests to the investors and from receiving any form of remuneration/gratitude from them. Therefore, it only provides an option to the advisors to either represent themselves as a “financial advisor” or be categorized as an “independent advisor” with restrictions.

*Fee structure:*

- **The advisors are allowed to charge fees either in the form of commission, trailer fee or as advisory fee, without any restriction**<sup>5</sup>. However a person falling within the ambit of an ‘Independent Advisor’ cannot charge a commission from a product manufacturer under Regulation 21 of the Act. Any person who contravenes with this provision will be held as guilty of an offence.

*Disclosure:*

- An advisor shall disclose, to every client and prospective client, all material information relating to any designated investment product that the licensed financial advisor recommends to such person, including the terms and conditions assigned to the products, the benefits to be derived by investment in the product, fees and other charges to be imposed by investment in financial product and any other disclosures which the client may require.
- Any contravention of this provision shall be guilty of an offence and shall be liable on conviction to a fine not exceeding \$25,000 or to imprisonment for a term not exceeding 12 months or to both.

## **C.2. United Kingdom**

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<sup>4</sup> [http://www.mas.gov.sg/legislation\\_guidelines/fin\\_advisors/fin\\_advisors\\_act/FAA\\_Guidelines.html](http://www.mas.gov.sg/legislation_guidelines/fin_advisors/fin_advisors_act/FAA_Guidelines.html)

<sup>5</sup> [http://www.mas.gov.sg/legislation\\_guidelines/fin\\_advisors/fin\\_advisors\\_act/FAA\\_Guidelines.html](http://www.mas.gov.sg/legislation_guidelines/fin_advisors/fin_advisors_act/FAA_Guidelines.html)



### *Governing Regulations:*

The FSA is the governing authority which postulates regulations for investment advisors.

### *Independent Advisors:*

Until 2005, the UK followed a polarization regime whereby advisors were categorized as agents of product manufacturers or independent advisors. Post the polarization regime, the category of advisors is divided into three: tied advisors (working for one financial institution), multi-tied advisors (offering products from a selection of the market and usually paid on a commission basis) and independent financial advisors who must offer their clients the option to pay for advice by fee as an alternative to commission. Independent Financial Advisors are those advisors who do not have any association with product manufacturers and advise the client independently and act solely on behalf of the investor.

The new Retail Distribution Review (RDR) scheme has been proposed by the FSA which is to be implemented from 31<sup>st</sup> December 2012 whereby there will be a ban on receiving commissions by the independent advisor. The remuneration of advisors under RDR as proposed in the new regime, advisors will be required to set their own charges for advice, and product provider influence over advisor remuneration will be removed as far as possible. Both independent and non-independent advisory firms will have to disclose, separately, the costs of advisory services, and differentiate these from the underlying product costs.

The proposals in this scheme include the distinction between independent advisors and restricted advisors. A third type of advice has also been contemplated known as basic advice. This advice is based on the advisor seeking a specific set of questions relating to financial products and therefore there is no actual investment advice which is given. With the introduction of this regime, the FSA seeks to regulate the conflict of interest which may arise.

Independent advisors are those advisors who do not have any contractual right with manufacturers of financial products, those who do not have any bias towards any product and give a fair value of the products available for investment.

On the other hand restrictive advisors limit their product range to the manufacturers they represent and would only permit them to receive only advisory fee but only for the advice provided for the restricted products.

However both these advisors will have to disclose their nature of advice to the clients for them to make an informed decision.

### **C.3. United States of America**

#### *Governing Authority:*

The Investment Advisors Act, 1940<sup>6</sup>.

*Investment Advisor:*

An investment advisor is an advisor who is capable of providing financial services for compensation, either directly or indirectly, on the value of securities, as to the advisability of investing in products, purchasing and selling securities or preparing reports and analysis on investment products.

*Fee Structure:*

The Act does not stipulate the segregation of the fee structure into “fee-based” and “commission based advice”. The compensation as mentioned in the Act may be in the form of fee from investors, commission for product manufacturers or a combination of both.<sup>7</sup>

Referring to the above-mentioned regime, it is noted that like other jurisdictions, USA too does not impose absolute restrictions on investment advisors from charging fees, commission or a combination. With the implementation of a strong disclosure regime the United States has balanced the interest of both the advisor and investors.

It is however pertinent to note that the USA is also moving towards a more investor friendly fee-based (option given to advisor between advisory fee and/or commission) and fee-only (advisory fee by the investors) structure in order to prevent a conflict of interest.

*Disclosure:*

- The registered firms have to file an ADV disclosure form with the SEC within 45 days. This form needs to be updated at least once a year and contains two parts. Part I which is primarily for the use by the SEC describing the nature of business of the Advisor and Part II which provides for detailed disclosures to the clients on the type of services, fee schedule and conflict of interest which may arise.
- The form should contain detailed disclosures about the advisor, his business, the fee structure and the financial product.
- The client should be given a full disclosure on the conflict of interest which may arise out of an investment product such that the client can make a well informed decision and preserve his interests.

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<sup>6</sup> <http://www.sec.gov/about/laws/iaa40.pdf>,  
[http://www.sec.gov/about/offices/oia/oia\\_investman/rplaze-042006.pdf](http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042006.pdf).

<sup>7</sup> [www.sec.gov/rules/interp/1987/ia-1092.pdf](http://www.sec.gov/rules/interp/1987/ia-1092.pdf)

- The Investment advisor is under an obligation to disclose the different capacities in which he might act vis-à-vis the client.
- There should be a detailed disclosure as to the nature and extent of his interests in so far as receiving commissions from a particular product manufacturer is concerned.

## D. Primary objectives of the proposed Regulation

### Primary concerns raised by SEBI

- *Investor protection*
- *Conflict of interest*

#### D.1. Investor protection

A primary driver for the proposed regulations seems to be protection of the investors in the **evolving Indian financial markets**. Financial products by their nature are complex and the pay offs associated with the same are not immediate as the same are dependent on various external factors.

#### D.2. Conflict of interest

The dual role played by distributors as “agents” and as “advisors” may result in dual remuneration from both the product manufacturer and the investor. SEBI is concerned that this could give rise to the **conflict of interest** between representing the interests of the investors and the interest of the product manufacturer which could put to question the loyalty of the advisor/distributor. SEBI has discussed conflict arising out of mis-selling of products and then talked about the problem of sale of products of the manufacturer who **pays the best commission**. In the Concept Paper, SEBI has noted that it has tried to resolve the first conflict of interest<sup>8</sup> only.

## E. Impact on various stakeholders

The introduction of the proposed regulations in the Concept Paper will have a deep impact on the entire financial community as a whole. The proposed regulations seek to implement new and drastic changes in the still **evolving financial market**. This complete overhaul would have potential impact on the investors as well the advisors. It is imperative to understand **market’s appetite** for these changes and together with the impact on various stakeholders.

<sup>8</sup> Para 2.7 (c) of the Concept Paper

## E.1. Investors

An **investor's confidence** and **trust** in a well-functioning market for financial services promotes financial stability, growth, efficiency and innovation over the long term. The change in the regulatory and the policy focus on the protection of the investor results *inter alia* from the increase in number of opportunities and risks to individuals and households in various segments of financial services, as well as the increase in **complexity of financial products**, at a time when the **access to financial products** and the **level of financial literacy** remain low in India.

The regulatory framework should reflect and be proportional to the **demand** of the financial products from investors, their rights and responsibilities together with strong and effective **legal** and **enforcement** mechanisms.

### **Needs and Expectation of an investor**

- *To obtain information on the financial products*
- *To obtain the most appropriate advice considering his needs, and risk profile*
- *Right to choose the financial products*
- *Trust and fiduciary relationship with advisor*
- *Right to choose the different services from the same advisor performing dual role*
- *Disclosure and transparency*
- *Strong enforcement mechanism including penalty for wrongdoings*
- *Cost effectiveness*

#### *E.1.1. Impact of the proposed regulations on the investors*

- *Lack of investment advice for retail clients:* With the enforcement of the proposed regulations, which restrict the remuneration of IFAs, only a few IFAs will choose to act as advisors. It will be increasingly difficult for the investors to seek any form of the advice due to lack of availability of advisors. We believe that while it is debatable that the regulation will benefit the large clients it has unintended consequence of reducing the availability and accessibility to investment advice for a significant number of predominantly less affluent customers.
- *Non availability of “trusted advisors”:* Investors who are advised by IFAs tend to build a long-term relationship with them as they depend largely on the advice given to them. Therefore, a relationship is built based out of trust and the IFA becomes a “**trusted advisor**” to the investor. The proposed regulation will jeopardize the investor-advisor trust relationship as there will be barely any availability of such advisors who will be willing to perform only advisory functions as majority of the IFAs would shift to acting as distributors only. This signifies that rather than working in favor of investors, these

regulations will make it harder for them understand the nuances of the financial market hence lead to **shrinkage in their participation** in market and **financial exclusion** of the investors from the financial market especially the retail investors.

- ***Preference towards embedded products:*** There is a preference of investors towards embedded products which are associated with a consolidated price. These products are therefore embedded with the price of the product and the fee for advice on the product. This makes investment less cumbersome for the clients as they do not have to worry about separate modes of payment. For example, prior to the SEBI's ban of entry loads no mutual fund distributors/advisors were charging fees. In order to empower the investor in deciding the commission paid to distributors in accordance with the level of service received and to bring about more transparency in payment of commission and incentivize long term investment, SEBI vide the Circular of 30<sup>th</sup> June 2009 mandated the following: a) there shall be no entry load, b) the upfront commission to distributors will be paid directly by the investor to the distributor which would be based on assessment of various factors including the services rendered by the distributor.

As encouraged by the regulator, the Asset Management Companies asked all distributors to upgrade the value ads provided to the investors. However, only a few advisors were able to charge fees from the investors, while the rest of the advisors suffered due to the mindset of the investor and the preference for an embedded cost structure.

- ***Change in investor's behavioral preference:*** It is pertinent to note that in a low financial literate country, these regulations will demand the investor behavior to change drastically. For the past few decades the business model followed by investors has been the same, whereby they receive a composite service from an IFA which includes advising on the investment products as well as executing the same. This change will make investors more confused in separately choosing an advisor for the financial products and a separate agent for execution of such advice.

Post the no entry load regime, small IFAs have been marginalized as they were unable to receive upfront commission from the manufacturer and have their clients adapt to paying fees for their advisory services, which lead to elimination of some small IFAs. As a consequence, the retail investor base that such IFAs serviced didn't have anyone to advise them during the financial crisis leading to a negative effect on market penetration, this could have been avoided if the market was given some time to adjust to the change in regulation. Similar consequences may occur if market participants are not given reasonable time of at least a few years to adjust to the proposed regulations.

- *Increase in the cost for investors:* Investors are subject to an increase in the total cost they would have to incur as a result of first appointing an advisor for the advising on the investment and subsequently appointing the agent for purchasing an investment product. This makes the entire process more costly and more cumbersome.

## **E.2. IFAs**

The retail investment market in India is characterized by low level of knowledge and financial capability. As a result the consumers are unaware of the different investment products available, the long-term nature of these products and their needs. Therefore, they rely heavily on the services provided to them by advisors who give them structured options most suiting their needs. On the other hand the long-term business for the advisor strives on providing the investor with a trusted advice so they are able to retain the clients and their businesses grow on the spread of word by their existing clients. The dynamism of the relationship between a client and an IFA revolves around the concept of trust and fiduciary relationship. This reflects that there is interdependence between the service provider acting as a trusted advisor and the client.

### *E.2.1. Client base of IFAs in India*

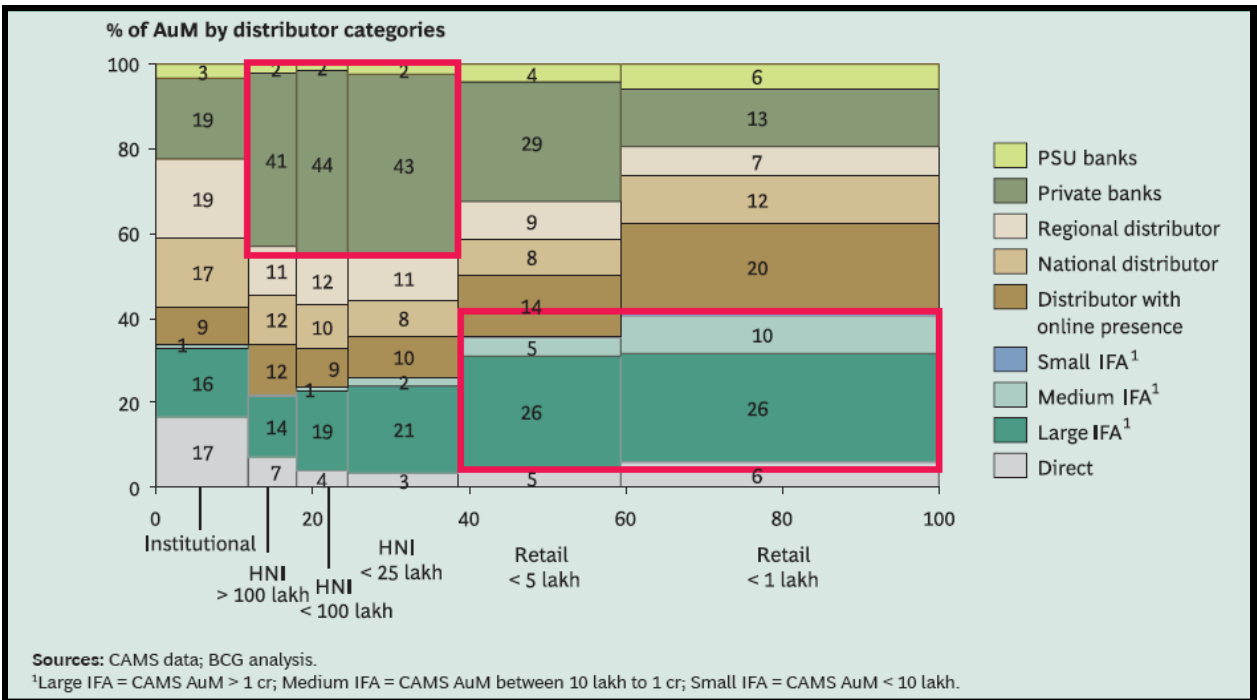
The IFA community covers the entire gamut of the investment community, which involves retail clients, high net worth individuals (HNIs), corporate, trusts and financial institutions. Almost all IFAs will have a combination of two or more of these client types and they serve these clients in different ways as per the needs of that client.

For some large corporate, HNIs, etc. the advisory role of an IFA may be limited but still be there in some form or the other and the focus may be more towards execution whereas for some retail, HNI, trusts, companies, etc the role of an IFA may only be advisory in nature and the execution may only be incidental to that advice or a combination of the two scenarios for some clients.

The BCG Report on *“Equity Mutual Funds: Charting your Course with a Compass”* of June 2010 (BCG Report) indicates that nearly 100,000 IFAs are registered with AMFI and nearly 80 percent of IFAs sell other financial products in addition to mutual funds - for example, life insurance, small savings, general insurance. Of the 100,000 IFAs registered many are dormant and inactive. Most IFAs typically sell mutual funds of three or four asset management companies (AMCs). The national and regional distributors typically have a more organized and formal setup compared to IFAs with many of them

having their own branch network, sales force, and online channel. In addition, many of them aggregate some of the sub-brokers' business.<sup>9</sup>

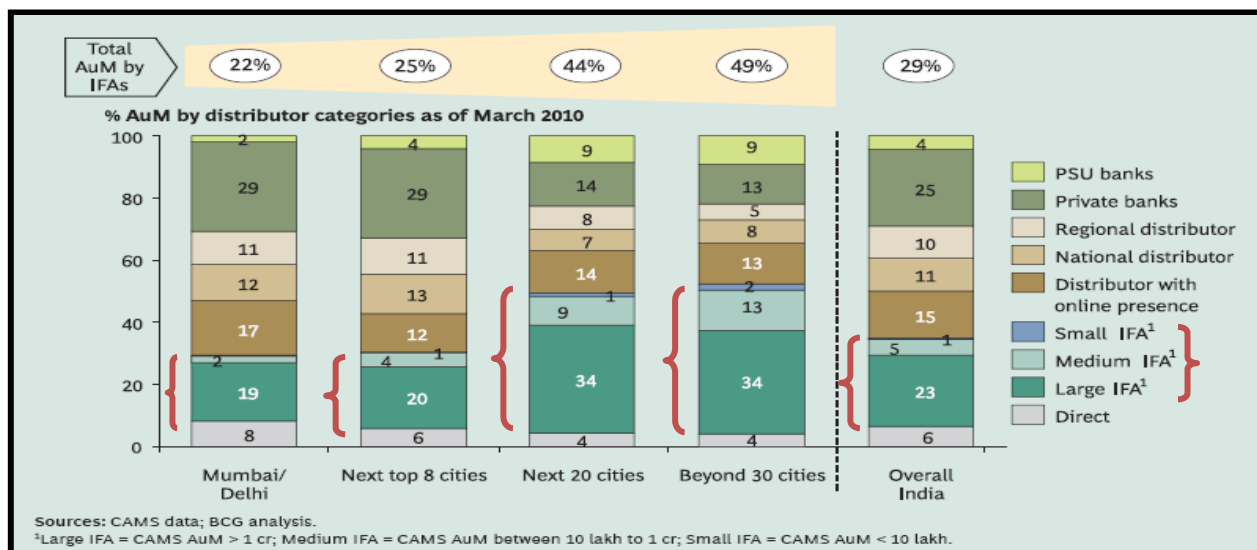
With regard to distribution of the mutual funds, on the customer front, IFAs service 30 to 35 percent of retail investors, while private and foreign banks service nearly 40 to 45 percent of the HNI investments as shown in Chart 1.



**Chart- 1 AuM Distribution across distributor categories & investor segments as provided in the BCG Report**

**IFAs are dominant in smaller cities and 'retail' segments, whereas banks dominate in top cities and the HNI segment.** The other interesting aspect concerned the prevalence of channels of distribution by location and customers. On the location front, not surprisingly, IFAs are much larger in smaller towns. On the customer front, IFAs service 30 to 35 percent of all retail investors (less than 5 lakh), while private and foreign banks service nearly 40 to 45 percent of the HNI investments, as shown in Chart 2 .

<sup>9</sup> Source: The BCG Report June 2010



**Chart - 2 Channel mix by top cities as of March 2010 as provided in the BCG Report**

With the advent of the no load regime, small IFAs have completely disappeared which has resulted in the decrease in the level of penetration in the market by investors as the business model of the small IFA's became unviable. With the proposed regulations, more number of IFAs will restrict their services to only selling investment products rather than helping an investor with proper investment advice. Therefore, IFAs play an **important role** in the retail market.

It is submitted that clients are only superficially aware of investment products. A lack of consumer knowledge has resulted in these investments being '**push products**', i.e., products which need to be brought to the knowledge of the investors and this process is undertaken by IFAs wherein IFAs try to educate the clients.

The role of IFA is not merely to cherry pick the financial products and suggest it to the client. Rather, the IFAs are compelled by their business model to conduct an in depth study about the needs of the client and risks and rewards associated with each products before making a recommendation to the client.

*E.2.2. Impact of the proposed regulations on the IFAs:*

- It is largely observed that because of a **lack of financial understanding**, the clients often seek advice of the IFAs to structure their investments without paying a separate advisory-fee. With the proposed regulation separating the advisory and execution role, it will become extremely difficult for



IFA's to function as their business model will become unviable as the component on commission charged from the manufacturer would disappear.

- For an advisor providing advice to the client and executing the advice are an integral part of his function and even the investors expect a composite service and therefore restricting this will impact the services he can provide to the client.
- Similarly, though the stock brokers are regulated by SEBI, they also advise and execute and their functions are not segregated. There also arises a conflict of interest, as the broker's interest is in churning his income which is based on number of times the investors' buys and sells as the investor is looking for return on investment. Ultimately, it's the investor decides to deal with that broker who gives him a good advise along with execution. Therefore, the regulator should give the choice to the investor in case of advise to be given by the IFAs as done in case of stockbrokers who are also regulated by SEBI.
- It is not possible to charge Indian investors for the time spent on investor education given the early stages of development of India financial markets. Therefore, if an investment advisor is prohibited from charging commission from the manufacturer, there may not be enough financial incentive in the industry, given the current penetration levels, to allow investment advisors to spend the time and effort required to educate investors about the mutual fund industry and the various products available.
- Post the no entry load regime introduced by SEBI in the mutual funds industry, only a few advisors have been able to charge fees in lieu of the entry load from the investors. This dual income is now being considered a conflict of interest. This concern is misplaced as client pay the fees of their own will and based on their assessment of the services provided. After the ban of entry load, only 5% of the IFAs were able to charge investors fees for their advisory services in lieu of the entry load payment from the manufacturers. Remaining 95% are still dependent on receiving commissions from the manufactures for the services provided by them to the investor and the manufacturer. As a result of the proposed regulations, 95% of IFAs will be forced to sell products instead of providing advisory services.
- The current system has been functioning for years without any drastic changes hence, introducing such a regulation without properly understanding the impact on various stakeholders, will result in

complete chaos for the advisors. The direct impact of such changes will be felt on these advisors as they will have to devise new business models to continue their source of income. SEBI should therefore consider giving appropriate time to the IFAs to get accustomed to these fundamental structural changes.

#### **Needs of an IFA**

- *Transition time is needed*
- *Need for a level playing field between independent advisors, distributors and institutional players*
- *Providing a composite advisory and execution function is the key value add provided by IFAs*
- *Secure a mode of payment for the services rendered by IFAs*

### **E.3. Industry**

The watertight compartmentalization by SEBI of the “advise” and “sales/execution” service would be harmful primarily for the investor, the development of the industry especially the developments of the mutual fund industry as a vehicle to mobilize savings from retail investors.

### **F. Proposed Model**

*This model suggests an alternative to the regulations proposed by SEBI. This provides a step-by-step proposal which maintains the interest of both the advisors and the investors. Briefly, registered advisors will have to adhere to strict disclosure norms which will entitle him to function both as an advisor and an executioner whereby the client will have the ultimate option of choosing the nature of service which is required by the advisor.*

#### **Step I**

The registered advisor under the SRO would perform both services, that of an advisor and an executioner of the advice.

### **Step II**

The client will seek the advice of the advisor in his capacity as either a “client” subscribing to advisory service only or an as an “investor” subscribing to the execution of the investment advice or both. The structure of the fees to be charged from the client would be disclosed:

- “fees” as an independent advisor;
- “commission” as a distributor; or
- “both” commission and fees to act in the dual capacity.

### **Step III**

The complete disclosure norms governing the advisors will be mandatorily made available to the client comprising all disclosures of the nature of service being provided, investment products being offered, fee structure etc. Based on these disclosures, the client will have to make a choice as to the nature of services required, thereby giving choice to the investor.

### **Step IV**

If the client chooses only advisory services, the fee will be paid by the client only on the advice. The client will not be bound to any agreement which may prevent him from terminating the services of the advisor after the investment advice has been provided. The client will therefore be free to undertake the services of any other advisor for the purpose of execution of the investment advice. Product providers should be allowed to facilitate payments to advisors, for example, through deductions from customers’ accounts, with the permission of the customer.

### **Step V**

Once the advisory agreement has been executed, the role of the advisor as an executioner will commence and the client would then become an investor of the financial product executed by the advisor.

## **G. Recommendations**

FIFA respects the efforts taken by SEBI for the investor protection and put forth the following as recommendations based on the experience of the IFAs and the challenges faced by them:

- Investor as a stakeholder to be involved in the process of formulation of regulations;
- The retail segment in the Indian market requires a push and IFAs are instrumentation in bring about that push, therefore IFA should be permitted to provide both advice and sales/execution function to the retail clients;
- 
- No water tight compartmentalization of advice and sales/execution of financial products;
- Choice to be given to the investors;
- To have enforcement mechanism in place including penal provisions for misselling;
- To have a transition period of a few years to adopt the regulation;
- Where there are no caps to the expenses of a product like a structure products, commission disclosure should be made compulsory and where there are caps on the expenses to be charged on the products, the disclosures can be waived off.
- FIFA to assist SEBI in drafting of the Code of Ethics required for the IFAs.
- FIFA to assist in comparative analysis of the various jurisdictions on investment advisor regulations.
- FIFA to assist in determining appropriate qualification criteria for advisors.

## **SEBI's CONCEPT PAPER**

**ON**

**INVESTMENT ADVISORS,**

2011

**PART 2 - SPECIFIC COMMENTS & SUGGESTIONS**

## PART II

Sr no	Subject-matter	Suggestion	Rationale
1.	<p>Definition Investment Advisor and Investment Advice</p> <p><i>Clause 4.1- "Investment advisor" for the purpose of the regulation shall be any person or entity that provides investment advice directly or indirectly for a consideration, which may be received directly from the investor or who holds himself out as an investment advisor.</i></p> <p><i>Clause 4.2 – "Investment advice" shall be an advice written, oral or through any other means of communication given regarding investment of funds in financial products or products that are traded and settled like financial products purportedly for the benefit of the investor.</i></p> <p><i>It shall include:</i></p> <p><i>(a) Financial advice; or</i></p> <p><i>(b) Financial planning</i></p>	<ul style="list-style-type: none"> <li>• The definition of investment advisor should clearly make a distinction between an investment advisor, an independent advisor and a distributor.</li> <li>• Investment advisors should be allowed to receive advisory fee, commission or a combination of both except if they choose to qualify as an 'independent advisor'</li> </ul>	<ul style="list-style-type: none"> <li>• The investment advisors would have a choice to determine the capacity in which they want to represent themselves before the client.</li> <li>• This creates two categories of advisors: those who are investment advisors receiving both forms of remuneration and secondly those who are solely independent advisors who are not associated with any product manufacturer.</li> <li>• The clients would also have an option of "one shop stop" for their financial planning.</li> <li>• By retaining the option of investors acting as an advisor to investors and as an agent of distributor and thereby receiving payments under both the capacities would help the financial market growth and even provide a smooth transition to a "single" capacity approach.</li> <li>• By way of clear distinction in terms of roles, the regulator would not only facilitate the growth of the market but also help them to check on the business models</li> </ul>

Sr no	Subject-matter	Suggestion	Rationale
	<p><i>service or</i></p> <p><i>(c) Actions which would influence an investment decision and are incidental to making an investment/investment decision.</i></p>		<p>adopted by the investment advisors in the financial market.</p> <ul style="list-style-type: none"> <li>• This clause is very widely worded which would bring within its ambit all such persons whose actions would influence the financial decision of an investor in any way. A consequence of such a wide ambit would entail SEBI to mandate a large number of persons to be regulated under this provision and have an effective enforcement mechanism.</li> </ul>
2.	<p>Registration requirements</p> <p><i>Clause 7.1 the individual who wish to get registered under these regulations would need to satisfy the following criteria:</i></p> <p><i>(a) Individuals should acquire a Professional Qualification from a recognized institute for e.g. Chartered Accountancy form ICAI, MBA in Finance or similar qualification from a recognized university or should have at least 10 years of relevant experience; and</i></p>	<p>SRO should decide on the qualification criteria after discussions with the IFAs as to the appropriate method of providing such qualifications to existing IFAs.</p> <ul style="list-style-type: none"> <li>• There should be only “qualification requirements” and not capital adequacy requirement.</li> <li>• A single member team or a single member team along with support staff should be allowed to be registered.</li> </ul>	<ul style="list-style-type: none"> <li>• The key component in providing advice to a client is the knowledge and ability of investment advisor to understand the dynamics of the financial market. Therefore, “intellectual capital” runs the business of the investment advisor and not the “capital” itself.</li> <li>• Mandating two key personnel would eliminate number of highly component advisors from this category.</li> </ul>

Sr no	Subject-matter	Suggestion	Rationale
	<p><i>Clause 7.2 (a) Capital Adequacy Requirement: Entities would need to maintain <b>a minimum net worth</b> which would be separate from the net worth required for other activities.</i></p> <p><i>Clause 7.2 (b) Key personnel: Entities should have <b>at least 2 key</b> personnel having the relevant experience exclusively for such activity. Such key personnel should also acquire the certification from NISM or such other organization as approved by SEBI for this purpose and have minimum qualification as prescribed.</i></p>		
3.	<p>Conflict of Interest</p> <p><i>Clause 8.4: No financial incentives should be received from any other person than the investors seeking advice.</i></p>	<ul style="list-style-type: none"> <li>• Implementation of disclosure norms on the nature of business of advisors, fee structure, any conflict which may arise from a particular product to address conflict of interest.</li> </ul>	<ul style="list-style-type: none"> <li>• This would provide clients information on the investment advice without curbing the advisors from receiving commissions from product manufacturers.</li> </ul>



Sr no	Subject-matter	Suggestion	Rationale
4.	<p>Fees and Charges</p> <p><i>Clause 8.6 : The Investment Advisor would clearly indicate to its clients the fees and charges that are required to be paid by them. An investment advisor shall disclose to a prospective clients all material information about itself, its businesses, its disciplinary history, the terms and conditions on which it offers advisory services, its affiliations with other intermediaries and such other information as is necessary him to take an informed decision whether to avail of its services.</i></p>	<ul style="list-style-type: none"> <li>The regulations should enable the investors to pay advisors for all the ancillary services received by them in connection with the investment advice and/or the execution.</li> </ul>	<ul style="list-style-type: none"> <li>As investors lack financial literacy they often ask advisors for ancillary advice both in their capacity as advisors and as agents of the manufacturer of the financial product. There should provision for express payments for these services.</li> </ul>

Sr no	Subject-matter	Suggestion	Rationale
5.	<p>Execution service</p> <p><i>Clause 9... If Non individual investment advisors (corporate entities) offer assistance in execution services such as broking, custody services, DP services, accounting etc., they must make appropriate disclosures, clarify that the investor is under no obligation to use their services and maintain arms length relationship through creation of Chinese walls. The choice of opting for execution services offered by investment advisor should be left to the investors. Fees and charges paid to service providers should be paid directly to them and not through investment advisors.</i></p>	<ul style="list-style-type: none"> <li>• Non individual advisor can be permitted to assistance in execution services provided the investor is given an option to accept/reject the services offered.</li> <li>• Further, non individual should agree to maintain Chinese walls</li> </ul>	<ul style="list-style-type: none"> <li>• The ultimate selection of the financial product by the investor is based on the advice given by the advisor and therefore, the investor may want the advisor to execute the advice. Therefore, the choice should be given to the investor to go with the advise for execution of the product.</li> <li>• However, if the investor exercises the option of going with the non individual investment advisor should agree to keep the information of the investor confidential.</li> </ul>

Sr no	Subject-matter	Suggestion	Rationale
6.	Self-Regulated Organizations	<ul style="list-style-type: none"> <li>• Self-Regulated Organization Regulations, 2004 needs to be amended to give express powers to the SRO to administer and regulate the investment advisors wholly.</li> <li>• The SRO's should be given the express mandate to penalize the defaulting advisors and defaulting investors</li> </ul>	<ul style="list-style-type: none"> <li>• There is no express mandate governing penal provisions in the Concept paper.</li> <li>• Secondly, investors should be made equally liable as the advisors for the defaulting in making payments. Otherwise, this would defeat the purpose of creating an amicable business environment.</li> </ul>
7.	Disclosure Norms	<ul style="list-style-type: none"> <li>• As in suggested in the Draft Investor Advisory Regulations, 2007, the proposed regulations should also have stringent disclosure norms with penalty provisions.</li> </ul>	<ul style="list-style-type: none"> <li>• The Draft regulations contain extant provisions containing disclosure guidelines which would make the operations of investment advisors more transparent.</li> <li>• Failure to comply with the disclosure norm would attract penalty. Stringent disclosure norm would act as a safeguard for the client as well for the market.</li> <li>• Further, disclosure norms together with penalty provisions would deter the investment advisors from acting against the interest of the clients and the financial market.</li> </ul>



## ***Annexure I***

### Regulatory Checks in Singapore:

- No person shall act as a financial advisor in Singapore in respect of any financial advisory service unless he is authorized to do so in respect of that financial advisory service by a financial advisor's licence; or is an exempt financial advisor.
  
- The authority will not grant license to the Advisor on the following grounds:
  - if it is not a corporation,
  - the applicant is unable to meet or continue to meet such minimum financial requirements or such other requirements as the Authority may prescribe,
  
  - the applicant has not furnished the Authority with such information or documents as may be required,
  
  - any information or document that is furnished by the applicant to the Authority is false or misleading,
  
  - the Authority is not satisfied as to the educational qualification or experience of the officers or employees of the applicant who are to perform duties in connection with the holding of the financial advisor's license.
  
- A licensed financial advisor has to maintain a minimum paid up capital, the violation of which would result in cancellation of license.
  
- The licensing provisions are extremely stringent resulting in different categories of offences punishable with pecuniary punishments under section 6, section 8, section 9, section 10, et al. Instance: levy of penalty under the following heads:
  - Failure to maintain minimum financial requirements as required under the licensing provisions or professional indemnity insurance policy ;
  - False statements in relation to application for grant or variation of financial advisor's licence;
  - Holding out as financial advisor without having being authorized to provide financial services.
  
- Accounts to be kept by the licensed advisors which may be required to be submitted to the authority under this Act, contravention of which would result in a penalty.

- The authority under this Act may inspect and investigate the licensed advisors and their representatives.
- Any person guilty of an offence under this Act for which no penalty is expressly provided shall be liable on conviction to a fine not exceeding \$12,500.
- No person shall hold himself out to be a financial advisor unless he is a licensed financial advisor. The contravention of this section would lead to a penalty of a fine not exceeding \$75,000 or to imprisonment for a term not exceeding 3 years or to both.
- No licensed financial advisor shall, with intent to deceive, make a false or misleading statement as to the investment product. Any licensed financial advisor who contravenes this section, notwithstanding that a contract does not come into being, be guilty of an offence and shall be liable on conviction to a fine not exceeding \$50,000 or to imprisonment for a term not exceeding 12 months or to both,

Regulatory Check in USA:

- Any person qualifying within the definition of an investment advisor is to be registered mandatorily with the Securities Commission under the s.203 of the Act.
- No advisor will be registered under s.203 of the Act until it has assets worth USD 25,000,000, unless it is an advisor to an investment company registered under the Investment Company Act, 1940.
- The Commission has been given expansive powers to regulate all investment advisors such as revoking the registration, imposing suspension and pecuniary penalties if it finds that the advisors have made false statements or who have violated any provision of the Act.
- The Commission has power to impose penalty for violations under this Act.
- The Commission requires specific records to be maintained by the investment Advisors, one in the form of accounting records and secondly any additional records which the Commission may believe to be necessary for maintaining fiduciary duty towards the clients.
- The commission is empowered to make three different types of investigation/examination; the routine examination, the sweeping examination and the forceful examination.