FOUNDATION OF INDEPENDENT FINANCIAL ADVISORS

29.12.2016

Mr. U.K. Sinha
Chairman,
Securities & Exchange Board of India,
SEBI Bhavan, Plot No. C4-A,
“G” Block, Bandra Kurla Complex,
Bandra (E), Mumbai – 400 051

Dear Sir,

The Foundation of Independent Advisors (FIFA) thanks SEBI for the invitation extended to us to attend the meeting of the MF advisory committee held on 23rd December, 2016, to deliberate on the ‘Consultation Paper on Amendments/Clarifications to the SEBI (Investment Advisers) Regulations, 2013, published on October 7, 2016 and for a meeting with Mr Piyoosh Gupta on 28th December 2016.

Sir, we have already submitted a detailed representation to SEBI on 4th November,2016 on the above paper. A copy of the detailed representation is enclosed herewith as *Annexure 1* for your ready reference.

We also enclose herewith a copy of the brief presentation on Consultation Paper on Amendments/Clarifications to the SEBI (Investment Advisers) Regulations, 2013, published on October 7, 2016 as *Annexure 2*, submitted to SEBI officials in our meeting on 28th December,2016.

A gist of issues discussed and our views thereon have been summarised below. We request your thoughtful consideration of the issue on hand keeping in mind the impactof the unitended consequences that the proposed regulations will have on the Mutual Fund industry and more pertinently the negative impact on the investors.

<u>Adverse Impact of Proposed Investor Adviser Regulations</u>

We reiterate that the proposed amendments will lead to the following outcomes

- Advise Gap - Leading to only HNI’s / large corporates being serviced to the exclusion of retail investors.
- Existing investors will be orphaned.
- Total cost to investor will increase.
- Not in Investor Interest and are in fact harmful to their interests.
- Will lead to a dramatic fall in number of distributors distributing mutual funds.
- Resulting in lower financial penetration and financial exclusion.

We request all concerned at SEBI under your leadership to give serious consideration to the detailed submissions given in our representations.

Global experience on ban of commission also confirms the likely adverse impact

During the MFAC meeting we were able to draw attention to the following:

A study has been conducted by the Financial Conduct Authority (FCA) of the experience post the banning of commissions since 2013 and shift to a fee based model in the U.K. The final report of this study which we shared with you was released in 2016 is enclosed as *Annexure 3*: The relevant findings are given hereunder.

a) This study confirms the creation of an "Advice Gap"; namely lot of investors being serviced earlier in the commission model are no longer serviced under the fee based model.

b) The minimum investible amount for an investor to be serviced by an adviser has gone up substantially – leaving retail investors unserviced or to fend for themselves.

c) Steep reduction in number of advisers.

d) Increase in total cost to Investor (MF expense + Fees Paid directly) paid now are higher than in the earlier embedded cost structure. In U.K. the pre RDR cost was 1.75% which has increased to 2.25% post RDR. Refer page33 of our representation in Annexure 1.

This is clearly evident in other countries also which have moved towards banning commission or towards a fee based compensation structure for advisors.

Study by Finalmile on Investor Behaviour

During the deliberations we pointed out that FIFA has done a Study of Investor Behaviour, by a reputed independent and leading organisation studying human behaviour based on Behavioural Sciences. The organisation Finalmile has worked with Indian Government and RBI on the Jan Dhan Program, a study which was sponsored by the Melinda and Bill Gates Foundation.

The study states " Evidence has begun to emerge, however, that when regulatory agencies seek to increase transparency by outright prohibiting embedded products from the industry-thus forcing current and potential investors to evaluate and negotiate the terms (scope of fees) of their advisory services- many investors either draw from the market or never enter."

We shared some of the key findings of this study and are given in *Annexure 4* attached herewith.
We would like to make a detailed presentation to SEBI and the MFAC and urge that the finding of this pioneering study be considered before taking any decision on the consultation paper.

Sumit Bose Committee also does not support a complete Ban of Commissions

The Sumit Bose Committee made the following observations on the issue of commission based distribution.

- ***"The Indian Market also suffers from a lack of Market for advice. Retail customers are not accustomed to paying for holistic advice. A body of financial advisors capable on advising on the entire portfolio of products is also not available. It was; therefore, felt that a complete ban on commission in such an environment would be counterproductive." (page no. 56 of the report)***

- **The committee arrived at a view that what was required was rationalisation of commissions and disclosures mandates across all financial products, such that products become comparable and provide reasonable and comparable remuneration.**

Concerns on Mis-selling on account of Conflict of interest are Unfounded:

We highlighted that concerns about conflict of interest and perceptions about mis-selling are completely unfounded.

Sir, a number of steps have been taken by the regulator over the years to regulate the mutual fund industry, including

- Capping the total expense ratio (TER) that can be charged by the scheme. Globally the TER is not generally capped by the regulators.
- Abolishing of entry load. Out of the 25 countries studied by Morning Star in the GFIE report 2015, India is the only country in which entry load is banned.
- Introduction of EUIN for all employees distributing mutual Funds.
- Disclosure of commissions on the AMFI website as well as on the website of individual AMC's for specified distributors; maybe the only country to have such a disclosure.
- On Sebi's behest AMFI has introduced a cap on upfront commissions w.e.f. 1.4.2015.
- Disclosure of schemewise commissions paid along with the TER of the scheme in the periodic CAS statements

It is perceived that there exists large scale mis-selling. However, it will be pertinent to note that no material instances of mis-selling have been reported.

Certain instances of alleged high payouts being made during the NFO's of close ended funds during financial year 2014-2015 have probably lead the regulator to believe that even after taking various steps, mis-selling due to commissions yet exists in any material manner. However, data shows that out of the gross inflows of Rs. 1.74 lac crores in equity funds, a sum of only Rs. 11,500 crores (only 6.7%of total gross equity inflows) were invested in close ended funds during financial year 2014-2015. This definitely is not a material number to suggest probable disruptive regulations. Further, even in cases where a higher upfront was paid, what needs to be seen is whether any further payments were made during the close ended period. The correct way to analyse whether excessive amounts were paid would be to amortise the amount paid over the period of the fund.

Expense Ratios across the world – India amongst the least expensive Countries

FIFA has published a study of expense ratios of 25 countries and submitted to SEBI on 15th June, 2016. A copy of the report was circulated during the MFAC meetings and the same is enclosed herewith for your ready reference as Annexure 5.

A detailed presentation of the study was made to SEBI on the study on 21st July, 2016 and the same is enclosed for your ready reference as Annexure 6.

We once again request that a serious consideration be given to the above study before any action is taken to reduce TER's in India as India remains one of the least expensive country with a relatively low AUM base and penetration. MF penetration (AUM to GDP ratio) in India is at 7% versus 91% in USA and 51% in U.K. (See page 34 of our detailed representation – Annexure 1)

Commission Payouts are low:

During the meeting of the MFAC, SEBI had presented data (reproduced below) relating to commissions paid.

Aggregate Commission Payouts			
Financial Year	**Commission Rs Cr**	**AUM Regular Plan**	**% of Commission to AUM**
2013-14	3,280	575,029	0.57%
2014-15	6,007	749,339	0.80%
2015-16	4,755	804,810	0.59%
2016-17	3,507	1,053,000	0.33%

On perusal of the data above it will be appreciated that the average percentage of commission paid during financial year 2015-16 is only 0.59% (Gross-before levy of service tax). In the current financial year till date a total commission payment of 3507 crores on regular plan AUM of 10.53 lac crores which works out to only 0.33% (Gross-before levy of service tax) for the current financial year.

Instead of making disruptive regulations on a perception of mis-selling, we propose that appropriate action be taken against any distributor found to be resorting to mis-selling.

Low expense ratios and low commission payouts are unliklely to lead to Mis-Selling.

Direct Investors Churn more than Investors through Distributors

Distributors have always worked with investor interests in mind. In a recent CII-Mckinsey meet, Karvy had presented a report, “Key highlights of Indian MF Industry and few important data points” (copy enclosed as Annexure 7).

The report contained data relating to the redemption ageing analysis of equity funds. The data (reproduced in the table below) indicated that direct investors redeemed 81 % of the equity funds within one year.

The churn was significantly higher in case of investors investing via the direct option as compared to investors investing through IFA’s and other distributors.

Channel of investment	Redemption of assets within 1 year	Redemption of assets after 3 years
Period 1 - Stable	**April 2015-March 2016**	
Direct	81%	7%
IFA's	36%	45%
Period 2 - Volatile	**April 2016- Nov 2016**	
Direct	81%	4%
IFA's	28%	39%

The summary on redemption ageing as per the said report has been reproduced below:

• *To analyze the distributor level performance, we chose to analyze the redemptions for two different periods. In both the analyzed periods, the data shows different trends, however, a few factors were considered and a few key items are worth highlighting:*

• *Factors considered:*

- *In the analyzed period 1, markets were quite stable*
- *In analyzed period 2, various news items turned the markets volatile*

• *Key highlights:*

• Under both the scenarios, over 80% of the redemptions were carried out with a holding period of less than one year (In period 2, almost 60% redemptions were in less than 3 months), in case of Direct investments

• The above clearly indicates that as soon as markets turned volatile, Direct investors decided to move out of Mutual Funds while distributors, esp IFAs, could convince their investors to stay invested for benefits of long term investments

• In both the analyzed periods, IFAs have the highest value of investors who have redeemed only after a five year holding period. In fact, approx. 40% of their investors had a holding period of more than two years

• It is clearly evident that Direct investors get worried due to lack of guidance and take a decision to leave the fund as soon as the markets turn choppy. Mutual fund is not a product meant for short term investments

From the above it is evident that the IFA actually provides invaluable guidance and hand holds the investor over the period of investment and protects his interest. This evaluation of the services provided by an IFA is in total contradistinction to the perceived misconception of mis-selling by distributors.

If the proposed regulations are introduced resulting in the unintended harm to the investors in the nature of advice gap etc., it would result in mis-buying by unserviced investors. This will cause great harm to the cause of investor protection.

Impact Analysis:

It is imperative that an impact analysis is done before introducing new regulations having far reaching consequences.

It would be appropriate and of great significance to have more widespread discussions with all stakeholders across the length and breadth of the country and more particularly with investors and distributors before introducing the proposed regulations.

Our Submissions:

Further to the deliberations at the meeting we would once again like to bring to your notice the following submissions that we have to make with regard to the retail investors.

a) Today a distributor collects commission from the manufacturer. Even assuming, the split roles/entities are viable for some of the distributors, expecting an advisor to charge say Rs. 5,000 as advisory fees for the year would make little sense for a small investor who wishes to invest say a monthly SIP plan of Rs. 1,000. The advisory fee would be an astronomical number for such an investor and a rational small investor would abandon such a market altogether.

b) If the regulation is implemented after 3 years for a fee based RIA model, a large number of existing investors will be orphaned, as the small ticket size investors won't be prepared to pay the fees (average ticket size of an SIP is 2,500 per month). The RIA will not find it viable to service these investors.

c) Due to viability only the rich with a large investment surplus will be serviced and Mutual Funds will become a Rich man's product rather than the product for the masses.

d) Once there is an advice gap to the retail investors, they are bound to invest in Ponzy schemes, and other inappropriate products.

e) It's very essential to do an impact analysis from the investor view point rather than come out regulations which will kill the investors.... in the name of investor protection there will be no investors to protect.

f) It is also imperative to analyse the cost or burden of mis-selling under the existing system vis a vis the likely cost of the negative impact on the industry by introduction of the proposed regulation.

g) An apprehension of mis-selling or wrong sales driven by commission is not sufficient reason to completely change the regulations and bar distributors from giving incidental advice and receiving commissions. Wrong doers if any need to be penalised rather than making regulations which will effectively kill the whole distribution system and impact the financial penetration and inclusion leading to more disparity between rich and the poor.

We take this opportunity to seek time for a meeting at your honours convenience to deliberate on these issues.

For Foundation of Independent Financial Advisors

DMehta

Dhruv Mehta

Chairman

List of Annexures