

**WP-2011-029**

## **A regulatory approach to financial product advice and distribution**

**M. Sahoo and Renuka Sane**



**Indira Gandhi Institute of Development Research, Mumbai  
December 2011**

<http://www.igidr.ac.in/pdf/publication/WP-2011-029.pdf>

# **A regulatory approach to financial product advice and distribution**

**M. Sahoo and Renuka Sane**

**Indira Gandhi Institute of Development Research (IGIDR)**

**General Arun Kumar Vaidya Marg**

**Goregaon (E), Mumbai- 400065, INDIA**

**Email (corresponding author):** [renuka@saner.org.in](mailto:renuka@saner.org.in)

## **Abstract**

*Financial distribution, where the distributor is the agent of both the product provider and the customer, has been found to inherently work against the interests of customers, in the form of high service fees and perverse incentives in sales practices. This paper proposes segregation of financial advice from financial distribution. It proposes a Financial Advisers Bill, 2012, to promote the development of a market for advice. The Bill suggests that financial advisers be recognised as professionals and be regulated under a new statutory body called the Institute of Financial Advisers of India. The paper suggests that regulation of distributors continue to remain under the purview of product regulators. It outlines alternative models in which the distribution market may be organised. It also points out that the Ministry of Finance and the Financial Stability and Development Council need to play an active role in co-ordinating the setting of common standards for distribution across all product regulators.*

## **Keywords:**

Consumer Protection; distribution regulation; mutual funds; insurance; pensions; investment advice

## **JEL Code:**

G2, G28, D14, D18

## **Acknowledgements:**

# A regulatory approach to financial product advice and distribution

M. S. Sahoo      Renuka Sane\*

15 November 2011

## Abstract

Financial distribution where the distributor is the agent of both the product provider and customer has been found to inherently work against the interests of customers, in the form of high service fees and perverse incentives in sales practices. This paper proposes segregation of financial advice from financial distribution. It proposes a Financial Advisers Bill, 2012, to promote the development of a market for advice. The Bill suggests that financial advisers be recognised as professionals and be regulated under a new statutory body called the Institute of Financial Advisers of India. The paper suggests that regulation of distributors continue to remain under the purview of product regulators. It outlines alternative models in which the distribution market may be organised. It also points out that the Ministry of Finance and the Financial Stability and Development Council need to play a role in co-ordinating the setting of common standards for distribution across all product regulators.

---

\*M. S. Sahoo is a Mumbai-based advocate. Renuka Sane is a Research Economist at the Finance Research Group at the Indira Gandhi Institute of Development Research. Email: [msahoomof@gmail.com](mailto:msahoomof@gmail.com) and [renuka@saner.org.in](mailto:renuka@saner.org.in); URL: <http://www.saner.org.in>. We thank Y. H. Malegam, Uma Shashikant, Susan Thomas, K. N. Vaidyanathan and participants of the IGIDR-FSRR round-table on Financial Product Advice and Distribution held in Mumbai on October 13, 2011 for useful comments.

# Contents

<b>1</b>	<b>Introduction</b>	<b>3</b>
<b>2</b>	<b>Financial product advice and distribution in India</b>	<b>5</b>
2.1	Distribution channels . . . . .	6
2.2	Current measures for consumer protection . . . . .	7
2.2.1	Registration and certification requirements . . . . .	8
2.2.2	Code of conduct requirements . . . . .	9
2.2.3	Commissions and fees . . . . .	10
2.2.4	Grievance redressal systems . . . . .	11
2.3	Critical problems in the current framework . . . . .	12
2.4	Recent policy proposals . . . . .	14
2.4.1	USAID Report, 2007 . . . . .	14
2.4.2	The Committee on Investor Awareness and Protection, 2010 . . . . .	16
<b>3</b>	<b>Way forward</b>	<b>18</b>
3.1	A market for advice . . . . .	20
3.1.1	Registration of advisers . . . . .	22
3.1.2	Professional standards . . . . .	22
3.1.3	Enforcement and grievance redressal . . . . .	23
3.2	Regulating the distribution market . . . . .	23
3.2.1	Organising the distribution market . . . . .	24
3.3	Implementation . . . . .	27
<b>4</b>	<b>Conclusion</b>	<b>28</b>
	<b>Appendix</b>	<b>32</b>
<b>A</b>	<b>Pattern of investments</b>	<b>32</b>
<b>B</b>	<b>International experience</b>	<b>32</b>
B.1	United States . . . . .	33
B.2	United Kingdom . . . . .	35
B.3	Australia . . . . .	36
B.4	European Union . . . . .	38
<b>C</b>	<b>The Financial Advisors Bill, 2012</b>	<b>39</b>

# 1 Introduction

The financial distribution industry has grown significantly in the last decade and stands close to Rs.230 billion at last count. For a sense of scale for the growth in distribution, insurance companies paid their distributors approximately Rs.180 billion in 2009-10, which amounted to almost seven percent of the total premiums collected.<sup>1</sup> Mutual funds are believed to have paid commissions to distributors to the tune of Rs.50 billion.<sup>2</sup>

There are two causes of concern when faced with this kind of growth in financial distribution: firstly, this growth has had little impact on household participation in the financial sector. Only one percent of all households report having investments in mutual funds in the quarter of June 2011 and 26 percent in the case of insurance<sup>3</sup>, despite savings being at 34 percent of GDP.<sup>4</sup>

Secondly, this growth has taken place under a regime of lax monitoring and low regulation. The distribution industry has been subject to several allegations of mis-selling, at the point of sale, or during the product cycle, or sometimes both.<sup>5</sup> Anagol and Kim (2011) document one example of shrouding by Indian mutual funds where they estimate investors lost US\$500 million. Concerns regarding the manner of selling insurance through banks have also surfaced in the last few years (Chapter 8, IRDA (2011)). These concerns have been raised, not just in India, but all over the world, and have accelerated post the 2008 financial crisis.

What raises the seriousness of these concerns is that it cannot be solved by the traditional financial markets solution of competition leading to best-practices. The complicated nature of financial products, and their postponed pay-off make it difficult for customers to evaluate their choices objectively. Gabaix and Laibson (2006) show that in a market with a mix of sophisticated

---

<sup>1</sup>Source: Product Disclosure Reports of Insurance Companies.

<sup>2</sup>The top 500 distributors earned about Rs.18 billion in 2010-11. Source: AMFI.

<sup>3</sup>Consumer Pyramids, CMIE. Table A.1 in the appendix presents the pattern of investments of Indian households.

<sup>4</sup>Table A10, Economic Survey 2010-11.

<sup>5</sup>Typical complaints include customers not been given correct information about products, not shown the full array of products, not told the exact amount of their contributions that will be diverted towards commissions, not made clear about the exact contract that they are signing into, made to churn their portfolios without any apparent benefit to them.

and naive customers, firms choose to shroud information not leading to a low-cost equilibrium. Greater competition therefore does not necessarily ensure better outcomes for the customer. This only underscores the importance of policy that engenders an environment where financial intermediaries are responsive to customer needs and also respectful of customer rights (Khorana, Servaes, and Tufano, 2009).

In the current distribution model, the intermediary sells to the consumer but is remunerated by the manufacturer. Thus, advice (which distributors deliver today) is likely to be biased because the incentive comes not from higher sales driven by customer satisfaction, but from commissions paid by the product provider. These misaligned incentives generate effort in promoting products with no regard to the suitability of the product for the customer.<sup>6</sup>

This is exacerbated through what is typically called the “common agency”<sup>7</sup> problem. An example in India is an agent who can sell products of several mutual funds and an insurance company. Investors can receive very different information about products, which are similar in economic terms, depending on which product provider is paying a higher commission. Stoughton, Wu, and Zechner (2011) find that kick-backs to advisers from product providers are always associated with higher portfolio management fees and negatively impact fund performance, regardless of investor sophistication.

While there is consensus on the problems in the distribution space, the solutions are not so obvious. Regulations may make the market for customers “safer”, but often have unintended consequences of potentially stifling innovation (Inderst, 2009). In India, the difficulty is compounded by the fact that low financial literacy and low household participation demand a significant effort of distribution, requiring regulation to straddle a thin line between establishing safeguards, while not throttling the profession.

In this paper, we propose a two-fold approach. First, we suggest a complete segregation of advice from distribution to solve the incentive-compatibility problem. We suggest that advisers would be the agents of the customer, while distributors would be the agents of the product provider. We propose

---

<sup>6</sup>Bergstresser, Chambers, and Tufano (2009) compare the performance of mutual funds offered through brokers and through direct channels. They find that risk-adjusted returns are lower for funds offered through brokers.

<sup>7</sup>Common agency models are those where multiple principals compete to influence an agent’s decision.

a Financial Advisers Bill, 2012 which provides for the setting up of a professional body called the *Institute of Financial Advisers of India (IFAI)* to develop and regulate the profession of advice.

We then deliberate on various ways in which the present market for distribution may be organised. The options include a *tied-agency* model where the distributor is *tied* to a product provider and is only remunerated by the same. A distributor selling products of multiple product providers is automatically deemed to be an adviser and is regulated more stringently. This model accommodates both advisory firms as well as individual advisers, who can also execute their advice for their client. Regardless of that might be adopted eventually, we recommend that the Financial Stability and Development Council (FSDC) play an important role in influencing the setting up of common standards for distribution in the immediate future.

The paper presents the status of financial product advice and distribution in India and the policy debate on these issues in Section 2. We outline a broad approach in Section 3 which includes segregating advice from distribution. Section 3.1 discusses our proposed solution for regulating advice. The possible models for regulating distribution are explained in Section 3.2, and implementation issues in Section 3.3. Section 4 concludes.

## 2 Financial product advice and distribution in India

The approach to financial regulation in India, like in many markets, is oriented towards product regulation. Thus, among the typical savings and investment products in India, we find:

- Fixed deposits, regulated by the Reserve Bank of India (RBI),<sup>8</sup>
- Small savings products, provided by the Government of India<sup>9</sup>,

---

<sup>8</sup>Other important classes of products are *loans* including home loans, that fall under consumer credit and fall under the purview of the Reserve Bank of India, or the National Housing Bank.

<sup>9</sup>These products offer an administered rate of return which is paid out of the Consolidated Fund of India. These include Postal Savings, National Savings Certificate and the Public Provident Fund.

- Mutual funds and Collective Investment Schemes, regulated by the Securities and Exchange Board of India (SEBI),
- Insurance products, both life and general, regulated by the Insurance Regulatory and Development Authority (IRDA), and
- The New Pension System (NPS), regulated by the Pension Fund Regulatory and Development Authority (PFRDA).

This approach, where each product is separately regulated, in the primary mandate of customer protection misses out a crucial fact that all these products have to be *sold* to the end customer, which includes elements of *financial advice* and *distribution*. These elements of advice and distribution ought to be treated in a common manner for all financial services. However, in the current regulatory approach, the focus ends up being primarily on regulation of the product and the producer with very little focus on the mode of *financial advice* and *distribution*. In addition, each regulator has a different approach to these elements of the business.

In this section, we document how these two elements of financial advice and distribution are practised in India. In the matter of financial distribution, the specific focus is restricted to the distribution of mutual funds, life insurance products and the NPS. On the other hand, the discussion pertaining to financial advisers encompass advising on all products.

## 2.1 Distribution channels

Financial products are sold by an army of distributors. These distributors are employees or agents of the product provider and not of the customer i.e., the remuneration of the distributor comes from commissions paid by the provider. The only exception is the NPS where pension funds are restricted to only managing investments. Customer interface is handled by entities called as “points-of-presence” (PoPs),<sup>10</sup> which are designated bank and other offices authorized to sell the NPS.

The distribution channel includes different kinds of entities. Most typical are Independent Financial Advisers (IFAs) and corporations, which include banks and other entities, and brokers. As of March 2009, the mutual fund

---

<sup>10</sup>See Shah (2006) for a detailed description of the NPS.



industry had 92,499 registered distributors as compared to approximately 2.9 million insurance agents and 2930 corporate agents.<sup>11</sup>

While the industry started out with IFAs, corporate agents, in recent years, have come to play an increasingly important role in distribution. This is especially true in the case of private sector insurance companies, which unlike the Life Insurance Corporation of India (LIC), are increasingly utilising the corporate agent model. Thus, 5 percent of the total insurance premium in 2009-10 came from banks as opposed to 3 percent in 2006-07.<sup>12</sup> Similarly, in the case of mutual funds, banks – and private banks, in particular – have come to dominate distribution with over 30 percent AUM share (KPMG and CII, 2009).

There is variation in the business model across products. Insurance works with a *tied-agency model*, where the distributor is an agent of only one manufacturer. In recent times, there has been some debate on allowing banks to sell products of more than one insurance firm, but a decision is still awaited (IRDA, 2011). Mutual fund distribution is not tied: a distributor may sell products of more than one manufacturer. Small saving agents usually only sell products sold through post-offices, but are not precluded from selling other financial products such as mutual funds and life insurance.

## 2.2 Current measures for consumer protection

In order to implement their key mandate of *protecting the interests of customers* – investors in the SEBI mandate, policyholders under IRDA, pension fund subscribers under the PFRDA – each regulator has put in place mechanisms to regulate the conduct of its own set of intermediaries.

What is missing is co-ordination between regulators. There is no common standard for what is essentially the same function, i.e., distribution of financial products. What follows is a broad overview of the consumer protection mechanisms in place, which include:

- Registration and certification requirements;

---

<sup>11</sup>Table 14: Number of Individual Agents of Life Insurers, Table 15: Number of Corporate Agents of Life Insurers, Handbook on Indian Insurance Statistics 2009-10.

<sup>12</sup>Table 4: Channel Wise Individual New Business Performance Of Life Insurers, Handbook on Indian Insurance Statistics 2009-10.

- Code of conduct;
- Rules on commissions and fees; and
- Grievance redressal procedures.

### 2.2.1 Registration and certification requirements

Distributors in India are required to be registered by their respective regulators, and undergo training to be eligible for registration. Regulators also have the power to revoke the license thereby suspending the intermediary from functioning in the market.

Mutual fund intermediaries need to register with the Association of Mutual Funds of India (AMFI).<sup>13</sup> Besides registration, intermediaries are required to pass a certification program.<sup>14</sup> SEBI also has a separate category of advisers called *Portfolio Managers*, who undertake the management or administration of a portfolio of securities, or funds, on behalf of the client. These are typically managers for high net-worth individuals, and have to meet certain capital adequacy norms in addition to other regulations related to disclosure and governance.<sup>15</sup>

IRDA also requires agents to go through a 100 hours training, typically run by an approved institution before passing an examination.<sup>16</sup> The candidate becomes the agent of one insurance company after having passed the examination.

PFRDA set up a request for proposals for banks and other agencies to obtain a license to operate as a point-of-presence for the NPS.<sup>17</sup> As of September 2011, 35 entities (with a total of 12,226 branches) have been given the license to operate as a PoP and become the touch-point to existing and potential NPS customers. In addition, the PFRDA has allowed for micro-finance (and

---

<sup>13</sup>It is important to note that AMFI is a trade association and not a SRO.

<sup>14</sup>This program was run by AMFI and was called the AMFI Mutual Fund Certification Program, but as of June 1, 2010, the mandate has been given to the National Institute of Securities Markets (NISM).

<sup>15</sup>Schedule IV of the SEBI (Portfolio Managers) Regulations, 1993.

<sup>16</sup>Insurance Regulatory and Development Authority (Licensing of Insurance Agents) Regulations, 2000.

<sup>17</sup>For detailed criteria, please refer to (PFRDA, 2010).

other agencies) to become “aggregators” to distribute the NPS-Lite scheme to lower income households, thereby extending formal finance to those excluded earlier.

### 2.2.2 Code of conduct requirements

SEBI and IRDA have put out a code of conduct for mutual fund distributors and insurance brokers and agents respectively.<sup>18</sup> These broadly involve provisions related to:

- Protecting clients’ interests;
- Disclosing information related to schemes and commissions in case of mutual funds;
- Recommending schemes “appropriate” for clients’ needs and circumstances and other sales practices such as explaining the contract;
- Provisions against mis-selling by asking agents to avoid misrepresentation, exaggeration, selling products solely on the basis of high commissions, encouraging churning of investments so as to earn commissions;
- Training requirements of the agents;
- Practices related to renewal of policies and claims processing in case of insurance.

In addition to the general code of conduct requirements, in August 2011, SEBI increased the responsibility of large distributors, by making it mandatory for Asset Management Companies (AMCs) to conduct due-diligence on distributors who satisfy one of the following criteria: a) have a presence in more than 20 locations, b) have raised AUM over Rs.1 billion in the non-institutional category including high net-worth individuals, c) received commission of over Rs.10 million p.a. across industry and d) received commission of over Rs.5 million from a single mutual fund.<sup>19</sup> AMCs are required to ensure that the distributors satisfy a ‘fit-and-proper’ criteria. All transactions

---

<sup>18</sup>SEBI Circular SEBI / IMD / CIR No. 8 / 174648 / 2009, August 27, 2009. Schedule III, Insurance Regulatory And Development Authority (Insurance Brokers) Regulations, 2002 and Insurance Regulatory and Development Authority (Licensing of Insurance Agents) Regulations, 2000.

<sup>19</sup>SEBI Circular, Cir/ IMD/ DF/13/ 2011, August 22, 2011.

by the distributor are to be categorised either as advisory or execution. If the distributor has an element of advisory function, such advice will be subject to the principle of *appropriateness*. If the transaction is booked as execution only, the distributor will only be paid a flat transaction charge. If the distributor believes that the transaction is not appropriate for the customer, a written communication will still have to be made regarding the unsuitability of the product. The impact of these on the industry and the AUM is yet to be seen.

### 2.2.3 Commissions and fees

Distribution fees usually include entry loads, exit loads and trail commissions. Each regulator stipulates the kind of fee and maximum amount that may be paid to the distributors. The differences in the permissible amounts can be seen from Table 1 which presents the maximum fees stipulated by each of the regulator.

SEBI and PFRDA have strict requirements of what can be charged of customers to pay for distribution. For example, from 1 August 2009, SEBI banned entry loads. Exit loads of 1 percent of redemption proceeds can be charged, and intermediaries can be paid through this amount.<sup>20</sup> As of August 2011, SEBI has allowed the distributor to be paid a flat fee of Rs.100 per subscription of Rs.10,000 and above, and a flat fee of Rs.150 for a first time investor in mutual funds.<sup>21</sup>

In the NPS, there have been no entry or exit loads since inception. Agent compensation is left to the customer. The PoPs do charge an account opening fee of Rs.40 for opening an account and Rs.20 per transaction thereafter.<sup>22</sup>

IRDA on the other hand, is seen to be less demanding in its requirements. There is an overall cap prescribed on total charges during the term of the policy and the entry cap is derived from that depending on the duration of the policy. Since October 2009, the cap on charges for ULIPs is based on the difference between gross and net yields of the product. The net reduction in yield for policies with term less than or equal to 10 years cannot

---

<sup>20</sup>SEBI Circular, SEBI/IMD/CIR No. 4/ 168230/09, June 30, 2009.

<sup>21</sup>SEBI Circular, Cir/ IMD/ DF/13/ 2011, August 22, 2011.

<sup>22</sup>Source: PFRDA.

**Table 1** Maximum fees stipulated by product regulators

	SEBI	IRDA	PFRDA	Small Savings
Entry Load	0	Upto 40% of premium	Rs.40	1%*
Exit load	1% of redemption proceeds	0		
Trail commissions	0.4-0.75%	7.5% in year two 5% thereafter**	0 Rs.20 per transaction	

\* For Recurring Deposit scheme it is 4 percent; For Senior Citizens Scheme it is 0.5 percent

\*\* For ULIPs trail commission is capped at 3 percent

be more than 3 percent at maturity. For policies with term above 10 years, the net reduction in yield at maturity cannot be more than 2.25 percent.<sup>23</sup> While these are lower than before, they still remain higher than those on mutual funds. In the case of insurance, concerns over high front-loading of commissions remain, as these are allowed by The Insurance Act, 1938. The commission for the first year can be a maximum of 40 percent of the premium. In years two and three, the caps are 7.5 percent, and 5 percent thereafter.<sup>24</sup>

#### 2.2.4 Grievance redressal systems

One of the critical elements in any regulatory system is the ability of customers to seek redressal against wrong-doings, and for sellers to be able to make their case. In India, regulators have a mechanism to address customer complaints.

SEBI runs a *Sebi Complaints Redress System* (SCORES) website<sup>25</sup> wherein investors can register complaints against companies and intermediaries listed with SEBI. It also puts out a list of issues investors should be concerned with when investing in products registered under SEBI. This includes a brief

<sup>23</sup>Source: IRDA circular, 20/IRDA/Act1/ULIP/09-10.

<sup>24</sup>Insurance Regulatory And Development Authority (Insurance Brokers) Regulations, 2002.

<sup>25</sup><http://scores.gov.in/Default.aspx>

mention of the list of fees and charges applicable, and product characteristics such as risk factors and asset allocation that an investor should be aware of.

IRDA runs a Grievance Cell<sup>26</sup> that looks into complaints from policyholders. These complaints have to be first routed through the grievance redressal cell at each of the life and non-life companies. If the complaint is a dispute regarding a claim or a policy contract, policyholders are required to approach quasi-judicial or judicial channels, such as the Insurance Ombudsmen<sup>27</sup>, the consumer courts or the civil courts.

PFRDA has put out a note on minimum common standards for financial advisers and financial education<sup>28</sup>, but does not really have clear details for grievance redressal on their website.

It is important to remember that each of the above redressal mechanism is a general mechanism and does not specifically cater to the problems of distribution. Also, more detailed studies need to be undertaken to evaluate the effectiveness of any of the systems.

### 2.3 Critical problems in the current framework

The present regulatory framework still leaves several issues unresolved. These include:

**Conflict of interest** Mutual fund distributors sell products of various product providers, thereby leading to competition amongst providers to achieve maximum sales through higher commissions to a distributor. Similarly several distributors have licenses to sell both mutual fund and insurance products, thereby leading to a situation where similar products but under different regulators get sold according to the commissions they provide. As noted earlier in the paper, this leads to a

---

<sup>26</sup>[http://www.irda.gov.in/ADMINCMS/cms/NormalData\\_Layout.aspx?page=PageNo225&mid=14.2](http://www.irda.gov.in/ADMINCMS/cms/NormalData_Layout.aspx?page=PageNo225&mid=14.2)

<sup>27</sup>The institution of Insurance Ombudsman was created by the Government of India vide its notification dated 11th November, 1998 to handle complaints of aggrieved insured persons. Claimants who could not get their complaints redressed by insurers may get in touch with the Ombudsman relevant to their states.

<sup>28</sup>Committee on Investor Awareness and Protection (2010)

conflict of interest between serving the interest of the manufacturer versus the interest of the customer.

**Fragmented regulation** While product regulators may have similar requirements of distributors selling products under their purview, the details of those requirements often differ, leading to “regulatory arbitrage”. An example of this is the similarity between mutual funds and ULIPs, regulated by the SEBI and IRDA respectively. Another example, are employees of banks who come under the RBI, and not under SEBI and IRDA even when they distribute financial products.

**Weak implementation** SEBI and IRDA have a registration and licensing procedure for distributors, a code of conduct and training requirements, have powers to delicense in case of wrong-doing. Their attention to mis-selling however, has been found to be lacking, and implementation capacity on the ground is seen to be weak.

**No standards for quality of advice** While an objective definition of “good advice” is difficult in the best of circumstances, a basic definition of “who-should-not-be-sold-what” is not in place in India. There is no standard to which distributors can be held responsible for what they sell.

**Underdeveloped market for advice** The popular means of selling financial products is through distributors remunerated through commissions. There is a small fledgling market of professional financial planners, but its penetration and impact is minuscule. The concept of paying for advice has yet to catch up with Indian customers, and continues to pose a big challenge for policy-makers.

**Problems of NPS** While on the one hand, mutual fund and insurance products are primarily driven through sales by agents, the NPS, does not support a distributor led sales effort. This is believed to be one reason for the abysmally low penetration of the scheme.<sup>29</sup> A product like NPS can only work if there is awareness about the product amongst customers such that they can seek the product themselves, or there is a market of financial planners, who for a fee, will recommend the NPS if it suits the customers needs. As both these are missing at the

---

<sup>29</sup>As of September 2011, only about 55,000 customers are said to have signed up for the NPS.

moment, there is tremendous pressure on the PFRDA to drop the NPS design and adopt the agent-led sales model (CRIISP, 2011). However, an important aspect to bear in mind is that there has also not been any effort at educating customers about the NPS by the Government of India, as was envisaged in the design of the NPS. An increase of this effort may prove to be more useful than taking the NPS along the commissions driven sales route.

**A parallel system for low income workers** A disconcerting development in Indian finance is a parallel system for low-income workers. Micro-finance institutions, for example, have become the de-facto distributors of credit and other financial products to poor households. There is an effort towards bringing these under a separate legislation through the Micro Finance Institutions (Development and Regulation) Bill, 2011. As distributors of financial products, they invariably also play the role of advisers and there does not seem to be adequate appreciation of this function in the regulatory debate.

## 2.4 Recent policy proposals

The need for reform in the distribution landscape has been felt for a long time in India. One of the first proposals on this subject was that of the Expert Group on *Protection of Interests of Small Investors and New Avenues for Safe Investment of their Savings* (GoI, 2005). Since then, there have been two main attempts at reviewing and proposing reforms for the distribution market in India. This section presents a brief summary of the latest two reports.

### 2.4.1 USAID Report, 2007

USAID (2007) took a comprehensive look at the investment advice landscape and made recommendations for regulating the same. Their main recommendation was for regulation of investment advice by one regulator across all financial products. The critical idea of the report was that *the regulatory mechanism for investment advice should be robust enough to include all varieties of advice and all types of investment adviser firms and individuals in the business.*



Towards this goal, it suggested that the definition for advice should include the following elements<sup>30</sup>: a) advice should be for compensation; b) adviser should be engaged in the business of providing advice to others; c) this advice may be provided directly or indirectly, through reports or other publications; and d) advice could be as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or as part of a financial plan in connection with providing financial services.

With this definition of advice, the report identified three separate categories of advisers depending on the discretion the adviser has on the funds of the client. These are:

**Investment Advisor** These advise on behalf of the client and generally have discretion and custody of their clients' assets.

**Financial Planner** These typically prepare a financial plan for their clients and advise on multiple products that can become a part of the clients portfolio and generally do not have discretion or custody over clients assets.

**Securities Distributor** These advise customers only about the product they are selling and do not provide broader investment advice like that of the financial planners. They also do not have discretion or custody over their clients assets.

The Report called for registration of all three kinds of advisers as well as firms and individuals. The apex body responsible for registration and regulation should be a Regulatory Organisation (RO) in the form of a private, non-profit corporation authorized by the Government of India, but directed by and subject to SEBI oversight. The Report defined the RO's mission statement as

RO's mission is to be a respected, efficient and efficacious front line regulator of entities and professionals in the India's investment advice system. It should be responsive to the people it regulates and investors and to market changes. It should enforce India's laws, SEBI's regulations, and RO's own rules; with equity and justice, to provide a safe environment for India's investors.

This Report recommended that the organisation should:

---

<sup>30</sup>USAID (2007), page 33.

- Develop principle based regulations with risk based examinations
- Implement regulation of discrete market segments in phases
- Utilize information technology for registration and regulation of firms and individuals.

Market conduct regulations set by the organization should include standards for advertising, performance reporting and presentation, disclosure of fees, conflicts, and conduct, and fair dealing.

The regulations would also subject all investment advisers to a fiduciary duty, suitability guidelines, and protect client assets in the case of investment advisers. While laying stress on regulation, the report pointed out that increasing the competency of investment advisers was also a key role of the regulator. It stressed that regulator should continually raise qualification standards and continuing education requirements for advisers, and to provide for education conferences and meetings, and provide communication about current market issues and other developments.

The report visualised SEBI as the oversight regulator with SEBI having the duty of oversight, approval of rules and budgets for the RO and a review of its performance.

#### **2.4.2 The Committee on Investor Awareness and Protection, 2010**

The Committee on Investor Awareness and Protection was set up by the High-Level Coordination Committee on Financial Markets (HLCCFM) to *strengthen the ongoing efforts for imparting financial education and promoting investor protection* and submitted its report in March 2010.

The Committee was focused on regulating the three million insurance and mutual fund sellers, including IFAs, bank officers (selling non-banking investment and credit products), and pension fund advisers who will also enter the market once the New Pension System gets established.

The Committee's view was that investor protection and investor education need to be brought about together, as neither works in isolation. It pointed out that while the network of agents had helped to create awareness, this had not necessarily amounted to knowledge.

The Report highlighted the low participation of Indian households in market linked products and pointed out that a critical factor that can bring about a change is the building of faith amongst consumers about risk-based financial products. One reason for the lack of faith has been the manner in which products have been distributed. The presence of a *trustworthy, regulated retail intermediation industry, with common minimum standards* will facilitate the transition to greater household participation in financial markets. To ensure regulation in this market for advice, the Committee clubbed all agents, advisers and planners into one category. It also decided that the selling of commissions based products will be treated as advice.<sup>31</sup>

Another aspect that was studied in depth by the Committee was the importance of financial literacy amongst the population. The Report informs about the various measures taken by the regulators, product providers and NGOs in improving knowledge about finance in India, as well as the experience on the same in international markets such as the US, UK, Australia, Canada, New Zealand and the OECD.

Against this background of the need for order and education in the market, the Committee's key recommendation consists of the setting up of the *Financial Well-Being Board of India* (FINWEB). The goal of the organisation, not surprisingly, would be to bring order to the adviser market and building a financially literate community. It will consist of two arms: one SRO arm that will be responsible for bringing advisers under one common standard, and a Financial Literacy arm that will work on promoting financial literacy. In addition the Committee had the following recommendations:

1. All retail financial products to go *no load* by April 2011;
2. All financial advisers to undergo a minimum knowledge-linked training program, and selling of more complicated products to require a higher level of education ;
3. All financial advisers to be governed by a code of ethics that is standard across products and organisations;
4. All products to abide by a disclosure template which will display the most important terms and conditions of the products, and the amount an adviser earns from the sale and maintenance of the product;

---

<sup>31</sup>Section 3.3, Committee on Investor Awareness and Protection (2010).

5. The sales process to be documented, along with customer profiling that took place before a product was sold;
6. A common interface for grievance redressal; and
7. Financial literacy modules for Advisers, School students, Post Class XII students, and other such entities to be developed by the Financial Literacy arm. The Financial Literacy arm to be the focal point for all financial literacy initiatives in the country.

### 3 Way forward

Across the various reports, there has developed a general consensus on what needs to be done to improve distribution of financial products. The key areas of consensus are:

- The need to set up a regulatory body to oversee distribution of financial products. This includes establishing a procedure of registration of intermediaries, setting up of disclosure norms and suitability guidelines.
- The need to promote financial literacy.

In September 2011, SEBI released a concept paper for regulating investment advisers, where it separated the role of an adviser from that of a distributor.<sup>32</sup> SEBI's proposal includes the formation of a SRO which will regulate advisers who will charge clients for advise on various products. These advisers will not be remunerated by product providers. However, SEBI's proposals leave the actions for mis-selling, violation of code of conduct, conflict of interest for products other than securities under the jurisdiction of regulators of other product providers. Such a fragmented regulatory structure is not conducive to the development of a market for advisory services.

The most critical lacunae in the discussions has been a lack of focus on *implementation*. Besides clarity on implementation, three issues remain to be addressed:

- It may not be enough for the regulatory authority to be a SRO, and more importantly for it to be under the oversight of one regulator.

---

<sup>32</sup>For more details, refer to SEBI (2011).

There needs to be uniformity in the standards that apply to distributors of *all* financial products, and the oversight of one regulator might not work well for regulators of other products.

- There is still not a concerted effort towards creating a body of financial planners who will only work for *the customer* and not the product provider.
- There has been a complete lack of focus on credit. A large part of the consumer finance regulation across the world has emerged because of problems in mortgage and other credit markets. In India too, the MFI crisis in Andhra Pradesh in October 2010 was essentially a crisis in the market for micro-credit. However, there has been no concerted effort at acknowledging and resolving the problems of distribution in the credit space.

The international response to the problem of distribution has gravitated towards a complete ban of commissions and volume based payments, and a heavy requirement from advisers to meet suitability standards.<sup>33</sup> However, it is important to point out that in many of these markets, investment is often mandatory through retirement plans, and the penetration of these products is also higher than in India. Agents play an important role in educating the customer about modern finance as well as financial products. To impose a blanket ban on commissions, therefore, may not be the optimal response for a transition economy like India.

The Indian market also suffers from a lack of a market for advice where customers are not accustomed to paying for holistic advice. To ban commissions before a body of financial advisers comes into place may lead to a lower household participation than it already is today. What is required, therefore, is to provide an enabling environment for the development of the profession of advice, while still allowing remuneration of agents by product providers, provided it is made subject to higher standards than at present.

We propose a comprehensive two-fold response to the problem:

- Develop a market for holistic advice.

---

<sup>33</sup>A brief overview of the reform proposals in the US, UK, Australia and EU is presented in the Appendix.

- Develop solutions within the existing frame-work to ensure better distribution practices.

In what follows, we describe the proposed solutions to the problem of regulating distribution intermediaries in the financial markets. The first proposal deals with creating a regulatory framework for advice. The second deals with organising the current market for distribution.

### 3.1 A market for advice

We propose a Financial Advisers Bill, 2012<sup>34</sup> and the setting up a new *statutory body*, called the Institute of Financial Advisers of India (IFAI), with the mandate of *developing and regulating the profession of financial advisers*. The proposed statute prescribes eligibility criteria to become a financial adviser; the process of registration as financial adviser; the conditions of registration; general obligations of a financial adviser; the disciplinary actions that can be taken by the Institute in case of any misconduct of a financial adviser; provisions of appeal; redressal of grievances of clients, etc. This framework aims to ensure a vibrant group of professionals who can render competent financial advice.

A statutory body is important because the profession of financial advice spans across all regulators, and a certain independence is required to not be swayed in the direction of any single provider. It is not possible to house this under any one existing regulator for reasons of political economy, and an independent body with separate legal powers is considered to be more effective in regulating the profession of financial advisers. The body would need to have representation from all the four product regulators viz. SEBI, IRDA, PFRDA and RBI.

A SRO model would face the limitation of not having adequate powers to take rigorous action against misdemeanor that has the force of law. Given the nascent stage of the advisory industry, the regulatory body also needs to play a developmental role in providing an enabling framework for the growth of the advisory industry on the one hand, and spread of financial literacy amongst the general population on the other. An SRO may not have the focus on development.

---

<sup>34</sup>The draft Bill is presented in the Appendix

The law that forms the statutory body would define the two key terms; Financial advice and Financial advisers. The definition of financial advice proposed is:

any explicit or implicit recommendation, either directly or through media i) to acquire, liquidate or continue to hold any product in the portfolio and/or ii) to use, discontinue or continue to use any service.

while a financial adviser is:

any person who, for compensation for any kind, engages in the business of providing financial advice and includes any person who holds himself out as a financial adviser, by whatever name called to others.<sup>35</sup>

This definition of financial adviser will span all firms that service customers, including such as micro-finance institutions, if they are in the business of providing financial advice to low-income customers. A financial adviser needs to only be an *agent of the customer*. The services may include custody of client funds, in which case, more rigorous guidelines will apply.

A distributor who is *an agent of the product provider* would not be eligible to be an adviser till he terminates his contract with the product provider. A sales-agent, who only sells the product (without an element of advice) will not be subject to the authority of the statutory body. In this sense, the functions of an adviser and distributor (tied to a single or multiple product providers) need to be completely separated.

Regulating financial advisers in the business of providing financial advice as defined above would involve three core functions:

- Registration of advisers
- Setting standards for advice
- Resolving disputes

---

<sup>35</sup>There would be some exceptions for persons if the advice is solely incidental to some other business or profession.

### 3.1.1 Registration of advisers

A key function of the statutory body will be to maintain a register of financial advisers, such that only people on the register will be allowed to perform the function of providing financial advice. The body may lay down criteria and conditions that any individual or firm would have to meet to be able to obtain a place in the register. These would include obtaining a minimum level of proficiency that will need to be proved through examinations that the institute will administer, either itself or through an approved agency. The institute will also have the authority to take action against any individual or firm found to be engaging in the business of financial advice without explicit permission from the institute. Sales agents, or distributors who do not have a license from the institute and/or are remunerated by product providers, will not be allowed to provide advice.

### 3.1.2 Professional standards

Financial advisers registered under the IFAI will be required to meet certain professional standards in their knowledge set, and in the manner of providing advice.<sup>36</sup>

Advisers will be required to update themselves about changing market trends and products through continuing education programs, run by the institute or through other approved agencies. This is extremely critical as new products with complex features get introduced in the market, and it is the job of an adviser to stay abreast of the full range of possibilities for their customers.

One approach to setting high standards for delivery of advice is to establish a fiduciary duty of advisers. Fiduciaries are legally bound to act at all times for the sole benefit and interest of a beneficiary, i.e., the customer. A fiduciary standard also implies that agents will have to avoid conflicts of interest. This subsumes more detailed suitability regulations that have been put out by the FSA in the UK and ASIC in Australia. One concern with detailed suitability guidelines is that they can become onerous and leave no room for risk-taking by customers. Risk-taking will be the customers prerogative, and there will

---

<sup>36</sup>An example in this direction is the Financial Planning Standards Board of India (<http://www.fpsbindia.org/>), a public-private enterprise and a professional standards setting body for financial planners in India.



need to be sufficient evidence that the customer was advised of the risks by the adviser and has yet taken the decisions on his own accord.

Another approach is to ensure that all relevant information about the advisers, their links to product providers (if any) are made known to the customer at the time of sale, and through the duration of the relationship between the adviser and the customer. Advisers will have the responsibility to ensure that the customer has all the material available to make an informed decision.

### **3.1.3 Enforcement and grievance redressal**

Recourse to justice is a critical component in engendering trust amongst customers, and in setting incentives to not break the law. There need to be provisions against fraud, manipulative practices including disclosing of confidential information about the customers to outside parties with strict penal action to enforce such rules.

The IFAI will be given adequate powers to:

- Receive complaints against advisers, carry out necessary investigations and enforce penal action on advisers if found guilty;
- Receive complaints against individuals/firms carrying out advisory services without the requisite license and take them to court.

The institute needs to be authorised to enforce a wide range of actions against errant advisers, including revoking or canceling the license to function as an adviser. Only when the threat of punishment is real can it serve as a disincentive to errant behaviour.

## **3.2 Regulating the distribution market**

The development of a market for financial advice is a long-term process and it will be several years before such a market becomes vibrant and is significantly able to penetrate households. Meanwhile, there already exists a huge machinery of product-provider driven agents, who continue to reach out to consumers with various mutual fund and insurance products. It is not optimal to dismantle this machinery before the market for advice has

been established. Given the problems that pervade the sector, it is not unreasonable to not let the status-quo remain either. Any change in the current system is not possible without the co-ordination of the concerned regulators, and a first step would be for these regulators to come together and agree upon a set of actions that will be undertaken, in a co-ordinated fashion, across all products.

There are two things to bear in mind while framing regulations for the current distribution market:

1. Product distribution is a component of product origination. As origination is the domain of the product regulator, so should be distribution.
2. Standards for product origination and distribution should be uniform across all jurisdictions to avoid regulatory arbitrage.

### **3.2.1 Organising the distribution market**

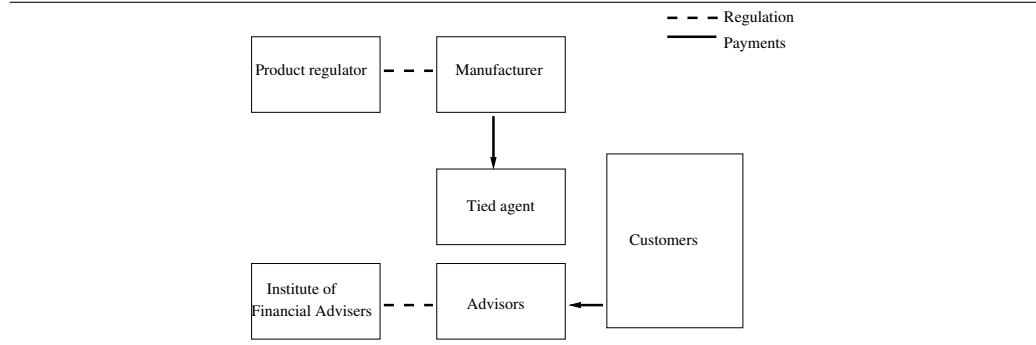
At the outset, effort needs to be made to disentangle the function of advice from that of distribution. While a distributor may provide a big service in bringing various options to the doorstep of the customer, he does not provide a holistic overview of both customers portfolio and the full range of product availability. With the setting up of the IFAI, it may be possible to ensure that a distributor remains a distributor only. It is not clear however, how to organise the market for distributors and advisers in a nascent financial market with customers who are financially unaware. For example, once an adviser gives advice, a customer will need to find distributors to actually implement the advice. At the same time, there may be customers who do not require the services of an adviser and want to access the products directly. These will also need to tap into the network of execution-only agents. We present three ways of organising the distribution market today.

#### **1. Tied-agency model**

In this model, distributors may only be sales agents of a particular product provider and get remunerated by the same. This implies that an agent will have to be *tied* to a product provider to avoid any conflict of interest. For example, if the agent sells mutual funds of a particular mutual fund house, then he may not sell funds from a competing house, or competing products

such as unit-linked plans of insurance companies (See Figure 1).

**Figure 1** Tied-agency model

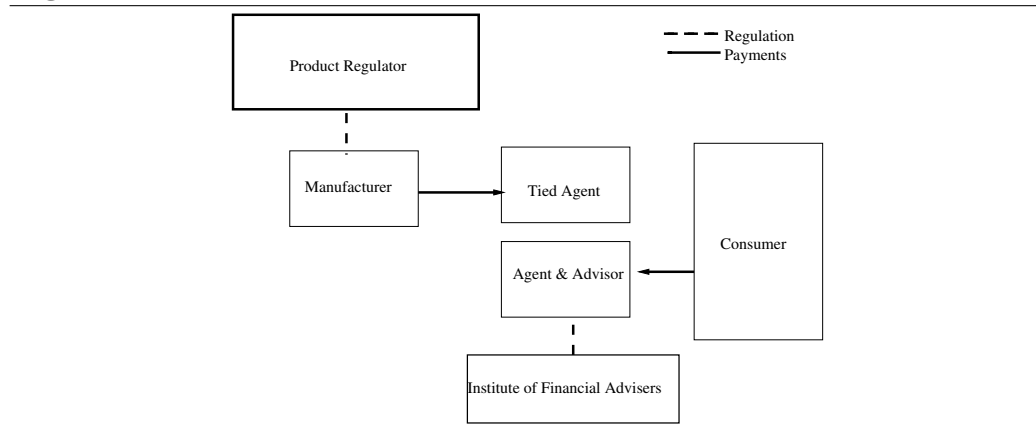


The trade-off with a tied-agency model is that it can become onerous for customers to locate agents for their purchase of financial products. There is great merit in achieving scale economies in distributing various financial products, and relying solely on a tied-agency model to deliver products may not serve the purpose.

## 2. Combined advice-distribution model

Another approach to organising the market for distribution is to allow for the advisory firm to also be able to sell financial products.

**Figure 2** Combined advice-distribution model



This essentially implies there will be two kinds of agents (See Figure 2):

- Tied-agents who will only be able to sell products of one manufacturer.

- Adviser-agents who will be able to sell products of more than one manufacturer.

Tied-agents will get remunerated by the manufacturer and regulated by the product regulator. Any agent who wants to sell more than one product will be deemed to be providing advice and will have to seek certification from the IFAI and meet all the norms required of an adviser. Any sale emanating from an adviser or an advisory firm will automatically be subject to suitability requirements and all the standards set by the IFAI. The adviser-agent will also get remunerated only by the customer.

The present model of distribution by banks falls under this category. Banks which sell more than one product will be deemed adviser-agents in this model and will be prohibited from collecting a commission from the product manufacturer. Employees of banks who sell these products will have to obtain certification from the IFAI and will have to develop a pricing system to be able to charge customers for dispensing advice and selling products.

Consumer protection in this framework might prove to be a challenge. It is not difficult to envisage situations where a firm may charge customers for advice while in reality only pushing products they have the mandate to sell. Also, if the advisory firm can only get remunerated by the customer, it may serve as a disincentive to smaller players to enter into the distribution space, leading to a further fall in household participation in financial markets.

### **3. Grocery-store model**

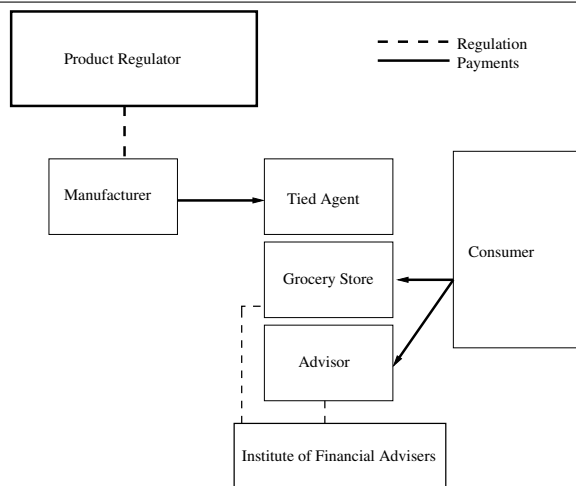
While it is imperative that individual agents who get paid by a product provider are tied to the same, there is a case to be made for developing “stand-alone” shops that will house *all* financial products for sale. The remuneration for these will have to come from the customer and not from the product provider in the form of commissions. The analogy here would be chemist shops which sell over-the-counter medicines for a price (See Figure 3.)

In this model, an adviser may be able to set-up a separate entity that sells the products he recommends. The store will be able buy products directly from the manufacturer and sell them to customers for a price. The adviser will have to disclose his links with the grocery-store, and make it optional for the customer to use his services. The customer will have the choice to go to another distributor to implement the advice. Both the distribution firm and advisory firm will come under the jurisdiction of the IFAI, as both will

---

**Figure 3** The grocery-store model

---



be functioning as agents of the customer.

This model is similar to the adviser-agent model except that the adviser will have to set-up a separate entity that sells products. Chinese walls between two such activities may not be a sufficient safeguard against fraud, and may lead to an increase in costs of operation.

### 3.3 Implementation

A peculiar aspect of Indian finance is the fragmented nature of regulation. The market for financial advice and the proposed reforms in the distribution framework will effect change only if steps are taken to actually implement them.

Regulators and administrators need to take the Financial Advisers Bill, 2012, forward to bring about the establishment of the IFAI and the development of a body of financial advisers.

In order to provide a framework of common standards across the distribution of all financial products, it is imperative that all regulators co-ordinate on the organisation of the distribution market, setting of standards and their enforcement. The Financial Stability and Development Council (FSDC) should facilitate the co-ordination. The Ministry of Finance, through its policy

statements could direct regulators, through the FSDC to develop, monitor and enforce common standards related to financial product distribution. For example, as a first step, regulators could very quickly jointly mandate disclosure on the following:

- The rupee amount that is paid to the distributor at the time of purchase, and the subsequent fees that are deducted over the course of the investment. This is important also because it will enable advisers to select from various products for their customers.
- Minimum amount of contributions required before the product lapses.
- Details on the exit clause.
- Risk characteristics of the product.

In practice disclosure is not seen to be having the intended effects (Beshears, Choi, Laibson, and Madrian, 2009; Choi, Laibson, and Madrian, 2010). It is found that subjects often do not understand loads, overlook them, and do not make the most optimal choices. While improved disclosure will certainly help in providing the much needed information, it is not going to solve the full set of problems related to mis-selling. It is, however, a necessary first step.

## 4 Conclusion

One of the goals of policy is to maximize the financial well-being of customers. This includes providing an environment that enables households to allocate their savings efficiently across various products and safeguards their interests. The current distribution landscape with high commissions and perverse incentives where the distributor is the agent of both the product provider and customer is not conducive to promoting the goal of customer protection.

This paper proposes a complete segregation of advice from that of distribution. Financial advisers should be recognised as professionals and be regulated under a new institute called the Institute of Financial Advisers of India. At the same time, regulation of distributors should continue to remain under

the purview of the product regulators, as product distribution is a component of product origination. Ministry of Finance and the Financial Stability and Development Council need to play a role to co-ordinate the setting of common standards for distribution across all product regulators.

## References

- Anagol, Santosh, and Hugh Kim (2011): “The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market,” *American Economic Review* (forthcoming).
- Bergstresser, Daniel, John M. R. Chambers, and Peter Tufano (2009): “Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry,” *The Review of Financial Studies*, 22(10), 4129–4156.
- Beshears, John, James J. Choi, David Laibson, and Brigitte C. Madrian (2009): “How Does Simplified Disclosure Affect Individuals Mutual Fund Choices.,” in *Explorations in the Economics of Aging*, ed. by D. Wise.
- Choi, James J., David Laibson, and Brigitte C. Madrian (2010): “Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds,” *Review of Financial Studies*, 23(4), 14051432.
- Committee on Investor Awareness and Protection (2010): “Minimum Common Standards for Financial Advisers and Financial Education,” A consultation paper, Government of India, Chaired by D. Swarup, Chairman PFRDA.
- CRIISP (2011): “Report of the Committee to Review Implementation of Informal Sector Pension,” Report, PFRDA, Committee headed by Mr. G. N. Bajpai.
- EU (2009): “Packaged Retail Investment Products: Issues for discussion,” PRIPs Workshop, Brussels.
- Financial Services Authority (2009): “Distribution of retail investments: Delivering the RDR,” Consultation Paper 09/18, The Financial Services Authority.
- (2011): “Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection,” Guidance consultation, The Financial Services Authority.
- Gabaix, Xavier, and David Laibson (2006): “Shrouded Attributes, Consumer Myopia, And Information Suppression In Competitive Markets,” *The Quarterly Journal of Economics*.
- GoI (2005): “Report of the Expert Group on Protection of Interests of Small



- Investors and New Avenues for Safe Investment of their Savings,” Discussion paper, Ministry of Finance, Government of India, Chairman: G. N. Bajpai.
- Inderst, Roman (2009): “Retail Finance: Thoughts on Reshaping Regulation and Consumer Protection after the Financial Crisis,” *European Business Organization Law Review*, 10, 455–464.
- IRDA (2011): “Report of the Committee on Bancassurance,” Committee report, Insurance Regulatory and Development Authority.
- John, Richard S. (2011): “Review of compensation arrangements for consumers of financial services,” Statutory compensation review, future of financial advice, Commonwealth of Australia.
- Khorana, Ajay, Henri Servaes, and Peter Tufano (2009): “Mutual Fund Fees Around the World,” *Review of Financial Studies*, 22(3), 1279–1310.
- KPMG and CII (2009): “Indian Mutual Fund Industry: The Future in a Dynamic Environment Outlook for 2015,” KPMG and CII Report.
- Oxera (2009): “Retail Distribution Review proposals: Impact on market structure and competition,” Prepared for the financial services authority, Oxera.
- PFRDA (2010): “Request for proposal for appointment of additional Points of Presence (PoP) for expansion of National Pension System (NPS) delivery network for all citizens,” Request for proposal (rfp), Pension Fund Regulatory and Development Authority.
- SEBI (2011): “Concept Paper on Regulation of Investment Advisors,” Concept paper, Securities and Exchange Board of India.
- Shah, Ajay (2006): “Indian pension reform: A sustainable and scalable approach,” in *Managing globalisation: Lessons from China and India*, ed. by D. A. Kelly, R. S. Rajan, and G. H. L. Goh. World Scientific.
- Stoughton, Neal M., Youchang Wu, and Josef Zechner (2011): “Intermediated Investment Management,” *The Journal of Finance*, 66(3), 947–980.
- USAID (2007): “Developing a Road Map for Investment Advice Regulation,” Draft report, Indo-US Financial Institutions Reform and Expansion Project - Capital Markets, USAID.

# Appendix

## A Pattern of investments

---

**Table A.1** Pattern of investments

---

Centre for Monitoring Indian Economy (CMIE) runs a system named Consumer Pyramids, which is a household survey database with a panel of 140,000 households measured every quarter. Information about percentage of households that have invested in the various savings instruments in the quarter of July 2011 is reported in this table. Households may have invested in more than one instrument.

---

Savings Instruments	Percent of Households that have invested in
Fixed deposits	25.32
Bonds	0.48
Post office savings	8.86
National Savings Certificates	0.79
Kisan Vikas Patras	1.62
Provident Fund	11.34
Life Insurance	26.34
Mutual funds	1
Listed Shares	0.72
Business	4.65
Gold	66.54
Real estate / housing	75.54
Other financial instruments	6.66

---

Source: Consumer Pyramids, July 2011

---

## B International experience

The complexity of the problem of distribution is faced in all countries, and the demand for better regulation of advice has grown stronger after the 2008 financial crisis. While a large focus of these discussions is the mortgage and credit market, especially in the US, the need for regulating distribution of other financial products is also well accepted.

The underlying model in most countries has been a agent-based model driven by commissions from product providers. However, regulation today is headed

towards another extreme of a complete ban of commissions and volume based payments to advisers as is evident from the reforms underway in the UK and Australia. There is also a move to strengthen legislation that will require advisers to be more diligent in establishing “suitability” checks before any product is sold to the customer.

In this section we briefly describe the policy approach of various countries on financial product distribution.

## B.1 United States

The oldest piece of legislation on this subject is the Investment Advisers Act, 1940 in the United States which sets a fiduciary duty for investment advisers. The Act defines an investment adviser (IA) as:

any person<sup>37</sup> who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities<sup>38</sup> or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

Advisers in the US are regulated at the state and the federal level. If an adviser functions in one state only, then regulations of that particular state apply. However, if the adviser functions in more than one state, or functions in one state but has assets under management of not less than US\$25 million, or is an adviser to a company registered under Title 1 of the Act, then the federal Act applies.<sup>39</sup>

Advisers are required to register with the Commission<sup>40</sup> by submitting particulars such as education, affiliation, net-worth and also information on a) the nature of the business of the adviser including the manner of giving advice and analyses, b) the nature of the authority of the adviser with respect

---

<sup>37</sup>Person means a natural person or company.

<sup>38</sup>Security encompasses a range of financial products including stocks, bonds, debentures, and derivatives among others.

<sup>39</sup>For more details, refer to Section 203A of The Investment Advisers Act of 1940.

<sup>40</sup>The Commission refers to the Securities and Exchange Commission.

to clients' funds and accounts, and c) the basis on which the adviser is compensated. The Commission retains the authority to not grant registration, or place limitations, revoke or cancel the registration of an adviser if doing so is in public interest.<sup>41</sup> The Act prohibits actions by advisers that may defraud any client and provides the Commission with the authority to levy strict monetary (and other) penalties in case of violation of the law.

Despite the prevalence of the Act, it was felt that advisers to hedge funds and private equity funds who were outside its purview<sup>42</sup>, needed to be brought in to close the regulatory gap. The Dodd-Frank Act of 2010 has sought to bridge such gaps by bringing in these advisers under the regulatory fold.

The other lacunae in the US was the lack of a single agency to oversee and regulate *the entire spectrum* of consumer finance products. The latest effort in this regard is the Bureau of Consumer Financial Protection<sup>43</sup> within the Federal Reserve set up under the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 (Dodd-Frank Act) to regulate products such as credit, deposits, on-line banking, property purchases and financial advisory services. The Bureau aims to *educate* customers against defensive practices, *enforce* federal consumer financial laws and restrict unfair, deceptive or abusive practices, and *study* consumers, providers and markets. While the Bureau's first task is to solve the problems in the mortgage market, the Bureau is eventually expected to turn its attention to other consumer finance products.

The thrust of the Bureau seems to be on regulating disclosure and ensuring transparency in the products that are sold to the customer. In addition, the Bureau aims to promote financial literacy to enable customers to make better choices in the financial products space.

---

<sup>41</sup>The Act carefully defines public interest as well as conditions which could bring upon such an action on the adviser. It also requires the Commission to provide for a hearing before any such action is taken.

<sup>42</sup>Advisers to private funds were not required to register with the SEC because of an exemption that applied to advisers with fewer than 15 clients. This exemption counted each fund as a client, as opposed to each investor in a fund. As a result, some advisers remained outside of regulatory oversight even if they were managing large sums of money for the benefit of hundreds of investors.

<sup>43</sup><http://www.consumerfinance.gov/>

## B.2 United Kingdom

The Financial Services and Markets Act, 2000 provides the framework for dealing with financial distribution in the UK. The Financial Services Authority puts out a Code of Business Source-book (COBS) for firms accepting deposits, conducting designated investment business and carrying on long-term insurance business in relation to life policies and also has a Specific Conduct of Business source-books for insurance intermediaries, mortgages and home finance firms, and banking.

The COBS has provisions related to risk categorisation of customers, information dissemination, and suitability reports on recommendations made by firms to clients. However, a review of the investment advice found half of the recommendations to be unsuitable from the point of view of the risk a customer was willing and able to take. The FSA has, therefore, required firms to establish processes to assess risk appetite of customers, and engage customers in a suitability assessment process as well (Financial Services Authority, 2011).

The FSA also launched a Retail Distribution Review (RDR) in June 2006. The RDR focused primarily on looking at how investments were being distributed to retail customers and it was found that competition between advisers was more about recommending a particular provider's products, and less about the usefulness of the product to the customer directly. The report sought to improving the process of financial advice and improving the clarity with which services are described to customers, both through higher standards for advisers and better remuneration practices of advisers. The key proposals include:

- Banning commission-based remuneration system;
- Setting up two kinds of advisers: independent advisers who get remunerated by the client, and restricted advisers who can advice only on their range of products;
- Raising the minimum level of qualification for investment advisers and enhanced standards for continuing professional development;
- Setting up an overarching Code of Ethics;
- Increasing the minimum capital requirement for all personal investment

firms from £10,000 to £20,000. Firms will also be required to hold additional capital as provision against potential liability for any activities excluded by their professional indemnity insurance policies.<sup>44</sup>

These reforms are going to take effect from the end of 2012, and will impact on all regulated firms producing or distributing retail investment products and services, including banks, building societies, insurers, wealth managers and financial advisers (Financial Services Authority, 2009).

It is hoped that with the RDR, the influence of the provider on the adviser will diminish. However, it is also expected that providers will now use alternative routes to market their products, and one possibility could be the integration of providers and advisory firms. There might also be an impact on the market structure, with smaller firms exiting the market or merging with larger firms (Oxera, 2009).

### **B.3 Australia**

Australia was one of the first countries to separate out prudential regulation from distribution regulation and has a dedicated regulator for customer protection, called the Australian Securities Investment Commission (ASIC).<sup>45</sup> The legal framework for the regulation of advisers under ASIC is the Corporation Act, 2001 and the Regulatory Guide 146, 175 of ASIC. This provides detailed definitions of what constitutes a financial product, and financial service. Financial product advice is clearly defined to be a financial service. All personal advice is required to comply with a ‘suitability’ rule or ‘reasonable basis for advice’ rule, which involves the adviser taking the trouble to understand clients personal circumstances, and ensure the appropriateness of the advice.

Financial advisers are required to hold a Australian Financial Services License (AFSL), and comply with the disclosure requirements. These include the giving of a Financial Services Guide to each retail client and a detailed statement of advice which sets out the advice and the basis on which it was given, and all information on remuneration (and other benefits) the adviser

---

<sup>44</sup>This requirement is part of the Review of prudential rules for personal investment firms, 2008.

<sup>45</sup><http://www.asic.gov.au>.

(or a related entity) may receive, and information on any relationship of the adviser that may have influenced the particular advice. Advisers also have to meet certain training and competency requirements.

The curious feature of the Australian market is that there is a combination of remuneration arrangements. There are fee-for-service advisers who get paid directly by the customer, and there continue to exist commissions, bonuses and soft-dollar incentives financed by the product providers. The existence of customer-based and provider-based fees has led to most remuneration still coming from the product provider thereby diluting the development of a customer-focused market for advice. In 2008, Australia was rocked by scandals such as the collapse of Storm Financial<sup>46</sup>, which led to a consensus on the need to review and reform the current state of affairs on financial product distribution.

This has culminated in the *The Future of Financial Advice* (FOFA) package. The FOFA reforms focus on improving the quality of financial advice and expanding the availability of more affordable forms of advice. The key proposals of FOFA include:

- Banning of up-front and trailing commissions;
- Banning of volume based payments;
- Banning of soft-dollar benefits<sup>47</sup>;
- Setting up a statutory best interest duty for financial advisers;
- An opt-in scheme whereby clients will have to agree to paying fees to advisers every two years;
- Providing the option of ‘scaled advice’ instead of ‘holistic advice’;
- A compensation scheme whereby clients will have to be compensated for bad/unsuitable advice.<sup>48</sup>

Australia has moved further ahead than the UK in seeking a complete ban of commissions and other volume based payments. There is no provision to allow for ‘tied-agents’ as allowed for under the RDR.

---

<sup>46</sup>For more details, see [http://en.wikipedia.org/wiki/Storm\\_Financial](http://en.wikipedia.org/wiki/Storm_Financial).

<sup>47</sup>This is defined as any benefit received by a financial planning firm, its representatives or associates, other than basic monetary commissions or direct client advice fees.

<sup>48</sup>For more details see (John, 2011).

## B.4 European Union

The EU set up a group to work on Packaged Retail Investment Products (PRIIPs) in 2009 under its Markets in Financial Instruments Directive (MiFID) Implementing Directive. The focus of this group was on pre-contractual product disclosures and rules on sales practices. The Commission committed itself to developing a new, horizontal legislative approach in these two areas, drawing on the best of existing requirements but applying these to all relevant products and sales channels so as to achieve a consistent and coherent overall approach (EU, 2009). The key proposals include:

- Harmonised requirements for disclosure across retail investment products. This includes requirements for disclosures to be fair, and clear, using plain language and a short format.
- Sales requirements



## **C The Financial Advisors Bill, 2012**

## THE FINANCIAL ADVISERS BILL, 2012

A Bill to provide for the establishment of an Institute to regulate and develop the profession of Financial Advisers and for matter connected therewith or incidental thereto.

Be it enacted by Parliament in the Sixty-Third Year of the Republic of India as follows:—

### **CHAPTER I**

#### PRELIMINARY

Short title, extent and commencement.

**1. (1) This Act may be called The Financial Advisers Act, 2012.**

(2) It extends to the whole of India.

(3) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint in this behalf.

Definitions.

2. (1) In this Act, unless the context otherwise requires,-

(a) "Act" means the Financial Advisers Act, 2012;

(b) "certificate" means certificate of registration granted by the Institute under section 16;

(c) "cognate Acts" mean and include:

a. the Reserve Bank of India Act, 1934 (2 of 1934);

b. the Insurance Act, 1938 (4 of 1938);

c. the Banking Regulation Act, 1949 (10 of 1949);

d. the Securities Contracts (Regulation) Act, 1956 (42 of 1956);

e. the Securities and Exchange Board of India Act, 1992 (15 of 1992);

f. the Depositories Act, 1996 (22 of 1996);

g. the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);

h. the Pension Fund Regulatory and Development Authority Act, 2011 (.. of 2011);

i. any statutory modification or re-enactment thereof;

(d) "Council" means the Council constituted under section 4;

(e) "financial advice" means any explicit or implicit recommendation, either directly or through media, (i) to acquire, liquidate or continue to hold any product in the portfolio and/ or (ii) to use, discontinue or continue to use any service;

(f) "financial adviser" means any person who, for compensation of any kind, engages in the business of providing financial advice and includes any person who holds himself out as a financial adviser, by whatever name called, to others;

Provided that a person shall not be deemed to be engaged in the business of providing financial advice, if the advice is solely incidental to some other business or profession and the advice is given only to clients of the person in the ordinary course of such other business or profession.

Explanation:

1. A lawyer, accountant, or a similar professional who provides financial advice solely incidental to the practice of his profession shall not be deemed to be a financial adviser.

2. A participant or intermediary (for example, broker, stock exchange, bank, fund manager, insurance company), who is registered with IRDA, PFRDA, RBI or SEBI, as the case may be, and provides financial advice solely incidental to the conduct of its business, shall not be deemed to be a financial adviser.
- (g) "Institute" means the Institute of Financial Advisers of India established under section 3;
- (h) "IRDA" means the Insurance Regulatory and Development Authority established under section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);
- (i) "member" means a member of the Council constituted under section 4;
- (j) "PFRDA" means the Pension Fund Regulatory and Development Authority established under section 3 of the Pension Fund Regulatory and Development Authority Act, 2011 Act (.. of 2011);
- (k) "prescribed" means prescribed by regulations made under this Act;
- (l) "product" means and includes any asset or liability, whose origination or dealings therein are regulated by IRDA, PFRDA, RBI or SEBI;
- Provided that an asset or liability created and structured specifically between a product manufacturer(s) and a client shall not constitute product.
- (m) "RBI" means the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934);
- (n) "register" means the register of financial advisers maintained under section 18;
- (o) "regulations" means the regulations made by the Council under section 6(2);
- (p) "SEBI" means the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);
- (q) "service" means and includes any service the provision of which is regulated by IRDA, PFRDA, RBI or SEBI;
- (r) "Tribunal" means the Securities Appellate Tribunal established under section 15K of the Securities and Exchange Board of India Act, 1992 (15 of 1992);
- (2) Words and expressions not defined in this Act, but defined in or under the cognate Acts, shall have the same meanings as have been assigned to them by or under those Acts.

## ***CHAPTER II***

### **ESTABLISHMENT OF THE INSITUTE OF FINANCIAL ADVISERS OF INDIA**

#### **Establishment of Institute.**

3. (1) With effect from such date as the Central Government may, by notification, appoint, there shall be established, for the purposes of this Act, an Institute by the name of the Institute of Financial Advisers of India.
- (2) The Institute shall have perpetual succession and a common seal and shall have power to acquire, hold and dispose of property, movable or immovable, and to contract, and shall by its name sue or be sued.
- (3) The head office of the Institute shall be at Mumbai.
- (4) The Institute may establish offices at other places in India.

#### **Constitution of Council.**

4. (1) The Institute shall have a Council which shall be constituted by the Central Government every three years.
- (2) The Council shall consist of the following members, namely:—
- (a) an officer not below the rank of whole time member of the IRDA;

- (b) an officer not below the rank of a whole time member of the PFRDA;
  - (c) an officer not below the rank of additional secretary of the Ministry of Finance;
  - (d) an officer not below the rank of deputy governor of the RBI;
  - (e) an officer not below the rank of whole time member of the SEBI;
  - (f) four financial advisers elected in the prescribed manner from amongst the financial advisers whose names appear on the register.
- (3) The term of the Council shall be three years.
- (4) The terms of members appointed under sub-section 2 (a) to (e) in the Council shall be co-terminus with their employment with IRDA, PFRDA, Ministry of Finance, RBI or SEBI as the case may be.
- (5) Any vacancy arising in the offices under sub-section 2 (a) to (e) shall be filled up by another eligible officer for the balance period of the term of the Council.
- (6) The members appointed under sub-section 2(f) in the Council shall hold office for a period of three years from the constitution of the Council.
- (7) Any vacancy arising in the offices under sub-section 2(f) shall be filled up by another financial adviser nominated by the Council for the balance period of the term of the Council.
- (8) A member may relinquish his office, at any time before the expiry of the term specified under sub-section 3, by giving to the Central Government notice of not less than three months in writing.
- (9) No act or proceeding of the Council shall be invalid merely by reason of any vacancy in, or any defect in the constitution of the Council.
- (10) The Council at its first meeting shall elect one of its members to be the Chairperson thereof, and so often as the office of the Chairperson falls vacant, the Council shall choose a member to be the Chairperson.
- (11) The Chief Executive Officer appointed under section 8 shall be Secretary to the Council.

### **Meetings of the Council.**

5. (1) The Council shall meet at such times and places, and shall observe such rules of procedure in regard to transaction of business at its meetings as may be prescribed.
- (2) The Chairperson or, if for any reason, (s)he is unable to attend a meeting of the Council, any other member chosen by the members present from amongst themselves at the meeting shall preside at the meeting.
- (3) All questions which come up before any meeting of the Council shall be decided by a majority votes of the members present and voting, and, in the event of an equality of votes, the Chairperson, or in his absence, the member presiding, shall have a second vote.
- (4) Any member, who has any direct or indirect personal interest in a matter coming up for consideration at a meeting of the Council, shall, as soon as possible after relevant circumstances have come to his knowledge, disclose the nature of his interest at such meeting and such disclosure shall be recorded in the proceedings of the Council and the member shall not take part in any deliberation or decision of the Council with respect to that matter.

### **Functions of the Council.**

6. (1) The Institute shall function under the overall control, supervision and guidance of the Council.

(2) In particular, and without prejudice to the generality of the foregoing powers, the Council shall prescribe by regulations—

(a) the academic courses a person should complete to be eligible for registration as a financial adviser;

(b) the standards and procedure for delivery of academic courses;

(c) the continuing professional education programmes for financial advisers and their delivery;

(d) the registration and supervision, including code of conduct, of financial advisers;

(e) the levy of fees from financial advisers, students pursuing academic courses and other persons;

(f) the manner of maintenance of accounts of the Institute;

(g) delegation of powers, except the powers to make regulations, to a sub-committee of Council or officers or groups of officers of the Institute;

(h) the terms and conditions of employment with the Institute;

(i) the rules and procedure for the meetings of the Council;

(j) procedure and manner of enquiry and investigation;

(k) format and contents of annual report, in consultation with the Central Government;

(l) preparation and approval of annual budget;

(m) records to be maintained by a financial adviser;

(n) elections under section 4(2)(f);

(o) any other matter which needs to be determined by regulations under this Act.

(3) The Council shall-

(a) approve the annual budgets for the Institute;

(b) appoint Chief Executive Officer of the Institute;

(c) ensure the functioning of the Institute in accordance with the provisions of this Act;

(d) undertake any other activity as may be necessary to carry out the purposes of this Act.

Functions and powers of Institute.

7. (1) The functions of the Institute shall include—

(a) development of courseware and examinations;

- (b) delivery of academic and continuing professional education programmes;
- (c) administration of examinations;
- (d) the maintenance and publication of a register of financial advisers;
- (e) the removal of names from the register and the restoration to the register of names which have been removed;
- (f) registration and supervision financial advisers;
- (g) collection of fees from financial advisers, students, examinees and other persons;
- (h) the conduct of elections for the members under section 4(2)(f);
- (i) redressal of grievances of clients against financial advisers;
- (j) spreading financial literacy;
- (k) undertaking any other activity as may be necessary to carry out the purposes of this Act.

(2) The Institute shall have powers to call for information and records from, undertake inspection, conduct enquiries and audits of financial advisers.

(3) Notwithstanding anything contained in any other law for the time being in force, while exercising the powers under sub-section 2, the Institute shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908) while trying a suit in respect of the following matters, namely:-

- (i) the discovery and production of records and documents of financial advisers, at such place and such time as may be specified by the Institute;
- (ii) summoning and enforcing attendance of persons and examining them on oath;
- (iii) inspection of any record or document of a financial adviser;
- (iv) issuing commissions for the examination of witnesses or documents.

#### **Officers and employees of the Institute.**

8. (1) The Council shall appoint a Chief Executive Officer of the Institute.

(2) The Institute may appoint other officers and employees as may be necessary to discharge the responsibilities under this Act.

(3) All members of the Council, the Chief Executive Officer, other officers, and employees of the Institute shall be deemed, when acting or purporting to act in pursuance of any of the provisions of this Act or regulations made thereunder, to be public servants within the meaning of section 21 of the Indian Penal Code (45 of 1860).

#### **Finances of the Institute.**

**9. (1) There shall be established a fund under the management and control of the Council into which shall be paid all moneys, including donations and grants, received by the Institute and out of which shall be met all expenses, including donations and grants, made and liabilities properly incurred by the Institute.**

(2) The Institute may invest any money for the time being standing to the credit of the fund in any government security or in any other security approved by the Council.

(3) The Institute shall keep proper accounts of the fund distinguishing capital from revenue in the manner prescribed.

(4) The Institute shall prepare in the manner prescribed and approve, prior to the start of the financial year, an annual budget indicating all its anticipated revenues as well as all proposed expenditures for the forthcoming year.

(5) The annual accounts of the Institute shall be prepared in such manner as may be prescribed and be subject to audit by a Chartered Accountant in practice to be appointed annually by the Council.

(6) The Institute shall forward a copy of the audited accounts together with audit report thereon annually to the Central Government and that Government shall cause the same to be laid before each House of Parliament.

(7) Subject to such directions as the Central Government may, by order in writing, make in this behalf, the Institute may borrow any money for meeting its liabilities on capital account on the security of the fund or on the security of any other assets for the time being belonging to it.

(8) A shortfall, if any, in the revenue account of the Institute in any year shall be made good by grants equally by Central Government, IRDA, PFRDA, RBI and SEBI.

#### **Returns and reports.**

10. (1) The Council shall furnish to the Central Government at such time and in such form and manner such returns and statements as the Central Government may, from time to time, require.

(2) Without prejudice to the provisions of sub-section 1, the Council shall, within 90 days after the end of each financial year, submit to the Central Government an annual report giving a true and full account of its activities, policy and programmes during the previous financial year.

(3) A copy of the report received under sub-section 2 shall be laid, as soon as may be after it is received, before each House of Parliament.

#### **Power of Central Government to issue directions.**

11. (1) The Institute shall, in exercise of its powers or the performance of its functions under this Act, be bound by such directions on questions of policy as the Central Government may give in writing to it from time to time.

Provided that the Council shall, as far as practicable, be given an opportunity to express its views before any direction is given under this sub-section.

(2) The decision of the Central Government whether a question is one of policy or not shall be final.

#### **Exemption from income tax, etc.**

12. Notwithstanding anything contained in any law for the time being in force, the Institute shall not be liable to tax on its wealth, income, expenditure, gift, profits or gains.

#### **Regulations to be laid before Parliament**

13. Every regulation made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days, which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or successive sessions aforesaid, both Houses agree in making any modification in the regulation or both Houses agree that the regulation should not be made, the regulation shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation.

***CHAPTER III***  
**REGISTRATION OF FINANCIAL ADVISERS**

**Certificate of registration.**

14. (1) On and from the commencement of this Act, no person shall act as a financial adviser or hold himself out as a financial adviser unless he has a certificate of registration from the Institute and its name is entered in the register of financial advisers:

Provided that a person acting as a financial adviser immediately before the commencement of this Act may continue to do so for a period of six months from such commencement or, if it has made an application for a certificate under section 16 within the said period of six months, till the disposal of such application.

**Qualifications for financial advisers.**

15. (1) An individual shall be eligible to be registered as a financial adviser if he—

- (a) is at least 21 years of age;
- (b) is a citizen of India;
- (c) has not been adjudged bankrupt;
- (d) has not been convicted of an offence involving fraud or dishonesty;
- (e) is not engaged in any business, profession or activity which may conflict with the profession of financial adviser;
- (f) has passed the qualifying examination prescribed by the Council; and
- (g) is a fit and proper person.

(2) A partnership firm shall be eligible to be registered as a financial adviser if all its employees dealing with clients and its partners are registered as financial advisers.

(3) A company shall be eligible to be registered as a financial adviser if all its employees dealing with clients are registered as financial advisers.

**Application for registration.**

16. (1) An eligible person under section 15 and desirous of acting as financial adviser shall apply to the Institute in the prescribed format seeking grant of a certificate.

(2) The Institute may require the applicant to furnish such further information or clarification as may be necessary for considering the application for grant of certificate.

(3) The Institute, on being satisfied that the applicant is eligible, shall grant a certificate in the prescribed format and enter its name in the register of financial advisers.

(4) Where the Institute is of the prima facie opinion that a certificate ought not be granted to an applicant, it shall afford an opportunity of hearing to the applicant before taking a final decision.

(5) Where an application for a certificate is rejected by the Institute, the order of rejection shall be communicated to the applicant as soon as may be.

(6) A person aggrieved by the order of the Institute under sub-section 5 may prefer an appeal before the Securities Appellate Tribunal.

**Conditions of registration.**

17. A registration granted under section 16 shall be subject to the conditions that the financial adviser:

- (a) remains eligible under section 15;
- (b) pays the prescribed fees in time;
- (c) undertakes prescribed continuing professional education programmes;
- (d) takes adequate steps for redressal of grievances of clients;
- (e) abides by the provisions of this act and the regulations made thereunder.

Register of financial advisers.



18. (1) The Institute shall maintain in the prescribed manner a register of the financial advisers.

(2) The financial advisers entered in the register shall be divided into two classes designated respectively as associate financial advisers and fellow financial advisers.

(3) Any person shall, on his name being entered in the register, be deemed to have become an associate financial adviser and be entitled to use the letters A.F.A. after his name to indicate that he is an associate of the Institute.

(4) A financial adviser, being an associate who has been in continuous practice in India for at least five years, and who completes such continuing professional education programmes as the Council may prescribe, be entered in the register as a fellow financial adviser and shall be entitled to use the letters F.F.A. after his name to indicate that he is a fellow of the Institute.

(5) The Institute may remove from the Register the name of any financial adviser —

- (a) who is dead / wound up;
- (b) from whom a request has been received to that effect;
- (c) who has not paid any prescribed fee required to be paid;
- (d) who fails to meet eligibility requirements specified in section 15; or

(e) whose certificate of registration has been cancelled by an order of Institute.

(6) No name shall be removed from the register under sub-section 5 (c) to (e) without providing an opportunity of hearing to the financial adviser concerned.

(7) If the name of any financial adviser has been removed from the register under clause (c) of sub-section (5), on receipt of an application, his name may be entered again in the register on payment of the arrears of fee and entrance fee, as may be prescribed by the Council.

#### **CHAPTER IV** **GENERAL OBLIGATIONS**

**General obligations.**

19. (1) A financial adviser shall-
- (a) always act in the best interest of its clients;
  - (b) disclose to all its clients concerned the conflicts of interests as and when they arise or seem likely;
  - (c) disclose to clients, at the time of providing financial advice, all commissions, rewards, or incentives by whatever name called, if any, that it may receive if the client chooses to accept its advice;
  - (d) disclose to clients, at the time of providing financial advice, all material information about itself, its business, its disciplinary history, the terms and conditions on which it offers advisory services, its affiliations with product / service providers and such other information as is necessary for the client to take an informed decision;
  - (e) sign an agreement with the client describing its terms of engagement with him;
  - (f) document the financial advice provided to clients;
  - (g) redress the grievances of clients within 15 days of the receipt of the same;
  - (h) maintain the records as may be prescribed;
  - (i) comply with the provisions of this Act and regulations made thereunder.
- (2) A financial adviser shall not-
- (a) provide any product or service either as principal for its own account or as agent;
  - (b) disclose to anybody, either orally or in writing, directly or indirectly, any confidential information about its clients, which has come to its knowledge, without taking prior permission of its clients except where such disclosures are required to be made in compliance with any law for the time being in force;
  - (c) employ any device, scheme, or artifice to defraud any client;
  - (d) engage in any transaction, practice, or course of business which operates as fraud or deceit upon any client;
  - (e) engage in any act, practice or course of business which is fraudulent, deceptive or manipulative.

---

#### **CHAPTER IV**

#### **PROCEDURE FOR ACTION IN CASE OF DEFAULT**

##### **Interim orders.**

20. (1) Where the Institute has reasonable ground to believe that a financial adviser is providing financial advice detrimental to the clients or financial markets, or has violated any provisions of this Act or the regulations made thereunder or directions issued by the Institute, it may direct, by order in writing, an officer of the Institute to investigate the affairs of such financial adviser and to report thereon to the Institute.

(2) The Institute may, by an interim order, for reasons to be recorded in writing, in the interest of clients or financial markets, pending investigation, suspend the certificate of a financial adviser for a period not exceeding three months.

##### **Final orders.**

21. (1) Based on the findings of investigation undertaken under section 20(1), discovery of facts under section 7 (2) or non-redressal of grievances, if the Institute forms a prima facie opinion that a financial adviser is guilty of professional misconduct or contraventions of the provisions of this Act or regulations made thereunder, it shall institute an enquiry.

(2) The enquiry shall be completed in the manner prescribed.

(3) The Institute may, by an order, in the interest of clients or financial markets, award any of the following penalties, on conclusion of the enquiry proceeding, namely-

- (a) reprimand a financial adviser;
- (b) direct a financial adviser to cease and desist from an particular practice;
- (c) suspend the certificate of a financial adviser for a period not exceeding six months;
- (d) cancel the certificate of a financial adviser;
- (e) impose a monetary penalty not exceeding rupees five lakh for an individual financial

adviser and rupees twenty-five lakh for a corporate/partnership financial adviser.  
(4) All sums realized by way of monetary penalties under this Act shall be credited to the Consolidated Fund of India.

### **Offences.**

22. (1) Without prejudice to any award of penalty by the Institute under this Act, if any person contravenes, or attempts to contravene, or abets the contravention of the provisions of this Act or regulations made thereunder, he shall be punishable with imprisonment for a term which may extend to three years, or with fine which may extend to rupees one crore, or with both.

(2) If a person fails to pay the monetary penalty imposed by the Institute or fails to comply with any of its orders or directions, he shall be punishable with imprisonment for a term which may extend to three years, or with fine which may extend to rupees one crore, or with both.

(3) No court shall take cognizance of any offence punishable under this Act or regulations made thereunder, save on a complaint made by the Institute.

(4) No court inferior to that of a Court of Session shall try any offence punishable under this Act.

## **CHAPTER V** **APPEALS**

### **Appeal to Securities Appellate Tribunal.**

23. (1) Any person aggrieved, by an order or decision of the Institute, may prefer an appeal before the Securities Appellate Tribunal.

(2) Every appeal under sub-section 1 shall be filed within a period of forty-five days from the date on which a copy of the order or decision is received by the appellant.

Provided that the Securities Appellate Tribunal may entertain an appeal after the expiry of the said period of forty-five days if it is satisfied that there was sufficient cause for not filing it within that period.

(3) On receipt of an appeal under sub-section 1, the Securities Appellate Tribunal may, after giving the parties to the appeal, an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or setting aside the order appealed against.

(4) The Securities Appellate Tribunal shall send a copy of every order made by it to the parties to the appeal and to the Institute.

(5) The appeal filed before the Securities Appellate Tribunal under sub-section 1 shall be dealt with by it as expeditiously as possible and endeavour shall be made by it to dispose of the appeal finally within six months from the date of receipt of the appeal.

### **Procedure and powers of Securities Appellate Tribunal.**

24. (1) The Securities Appellate Tribunal shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908 (5 of 1908), but shall be guided by the principles of natural justice and, subject to the other provisions of this Act, the Securities Appellate Tribunal shall have powers to regulate their own procedure including the places at which they shall have their sittings.

(2) The Securities Appellate Tribunal shall have, for the purpose of discharging their functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), while trying a suit, in respect of the following matters, namely:—

(a) summoning and enforcing the attendance of any person and examining him on oath;

(b) requiring the discovery and production of documents;

(c) receiving evidence on affidavits;

(d) issuing commissions for the examination of witnesses or documents;

(e) reviewing its decisions;

(f) dismissing an application for default or deciding it ex parte;  
(g) setting aside any order of dismissal of any application for default or any order passed by it ex parte.

(3) Every proceeding before the Securities Appellate Tribunal shall be deemed to be a judicial proceeding within the meaning of sections 193 and 228, and for the purposes of section 196 of the Indian Penal Code (45 of 1860) and the Securities Appellate Tribunal shall be deemed to be a civil court for all the purposes of section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973 (2 of 1974).

**Right to legal representation.**

25. The appellant may either appear in person or authorise one or more chartered accountants or company secretaries or cost accountants or legal practitioners or any of its officers to present his or its case before the Securities Appellate Tribunal.

**Limitation.**

26. The provisions of the Limitation Act, 1963 (36 of 1963) shall, as far as may be, apply to an appeal made to a Securities Appellate Tribunal.

**Civil court not to have jurisdiction.**

27. No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which a Securities Appellate Tribunal is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

**Appeal to Supreme Court.**

28. Any person aggrieved by any decision or order of the Securities Appellate Tribunal may file an appeal to the Supreme Court within sixty days from the date of communication of the decision or order of the Securities Appellate Tribunal to him on any question of law arising out of such order:

Provided that the Supreme Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.

**CHAPTER VI**  
**MISCELLANEOUS**

**Amendments to certain enactments.**

29. On and from the commencement of this Act, the Acts mentioned in the Schedule shall stand amended to the extent mentioned therein.

**Power to remove difficulties.**

30. (1) If any difficulty arises in giving effect to provisions of this Act, the Central Government may, by order, published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as may appear to be necessary for removing the difficulty.

Provided that no order shall be made under this section after the expiry of five years from the commencement of this Act.

(2) Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.

**THE SCHEDULE**  
**AMENDMENTS TO CERTAIN ENACTMENTS**

**A. Amendment to the Securities and Exchange Board of India Act, 1992**

The words 'investment adviser', wherever they occur in section 11 and 12 of the Securities and Exchange Board of India Act, 1992, shall be deleted.