



July 16, 2020

REGULATION OF PORTFOLIO MANAGERS

- A COMPARISON OF THE 1993 & 2020 SEBI
REGULATIONS

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The Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 (“**PMS Regulations 1993**”) came into effect on January 7, 1993. The PMS Regulations 1993, *inter alia*, provided for the registration and operation of portfolio managers. On July 11, 2019, the Securities and Exchange Board of India (“**SEBI**”) issued a consultation paper which sought comments and views from the public on various proposals to amend the PMS Regulations 1993 (“**Consultation Paper**”). The Consultation Paper noted that as on February 29, 2012, the combined assets under management (“**AUM**”) of portfolio managers was Rs. 4,72,520 crore, catering to 82,391 clients. By the end of April 2019, the combined AUM of the portfolio management industry had grown to Rs.18,07,938 crore and the number of clients stood at 1,51,618. The Consultation Paper also highlighted the increasing role played by artificial intelligence or smart algorithms in the portfolio management space where investors are becoming more digitally savvy and demanding single window solutions, seamless investing experience and consolidation of portfolio services. To succeed in this new changing environment, SEBI expects portfolio managers to revisit their business models and re-imagine their value proposition.

Pursuant to the Consultation Paper, SEBI issued the Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020 (“**PMS Regulations 2020**”) to replace the PMS Regulations 1993 with effect from January 16, 2020. Subsequently, SEBI issued circular no. SEBI/HO/IMD/DF1/CIR/P/2020/26 dated February 13, 2020 (“**February 13 Circular**”) in respect of the PMS Regulations 2020 which will be applicable from October 1, 2020.

Following are some of the key differences between the PMS Regulations 2020 (as amended by the February 13 Circular) and the PMS Regulations 1993.

1. Minimum investment amount

- 1.1. Regulation 15(1A) of the PMS Regulations 1993 provided that portfolio managers could not accept funds or securities worth less than Rs. 25,00,000 (Rupees twenty-five lac) from their clients.
- 1.2. Regulation 23(2) of the PMS Regulations 2020 provides that portfolio managers shall not accept funds or securities worth less than Rs. 50,00,000 (Rupees fifty lac) from their clients (“**Minimum Investment Amount**”). However, the proviso to regulation 23(2) of the PMS Regulations 2020 provides that such Minimum Investment Amount requirement per client is applicable only for new clients and fresh investments by existing clients of the portfolio manager. The existing investment of clients as on date of the PMS Regulations 2020 may continue till the maturity of the investment or as may be specified by SEBI in this regard. Therefore, clients having existing investments under the PMS Regulations 1993 are not required to satisfy the Minimum Investment Amount requirement under the PMS Regulations 2020.
- 1.3. If a client had invested Rs. 45,00,000 (Rupees forty five lac) under the PMS Regulations 1993, such client would not be required to invest an additional Rs. 5,00,000 (Rupees five lac) to be in compliance with the PMS Regulations 2020. Would such client then be entitled to invest another Rs. 2,00,000 (Rupees two lac) in his or her portfolio, to bring it up to Rs. 47,00,000 (Rupees forty-seven lac)? If a client had invested Rs. 70,00,000 (Rupees seventy lac) in a portfolio managed by a portfolio management service provider in May 2019, before the PMS Regulations 2020 came into effect and such portfolio had shrunk in value to Rs. 45,00,000 (Rupees forty five lac) on January 16, 2020, the day the PMS Regulations 2020 came into effect, would such client be entitled to invest a further Rs. 2,00,000 (Rupees two lac) in his or her portfolio, taking into account that the initial investment was Rs. 70,00,000 (Rupees seventy lac)? The PMS Regulations 2020 do not provide any clarity on these points.

2. Minimum net worth requirement

- 2.1. Under the PMS Regulations 1993, the minimum net worth required for a portfolio manager was originally Rs. 50,00,000 (Rupees fifty lac). In August 2008, this was revised to Rs. 2,00,00,000 (Rupees two crore).
- 2.2. The Consultation Paper noted that inflation and rising income levels have made it necessary to revise this requirement. An increase in compliance costs, costs related to information technology and cyber security, increase in the minimum number of employees etc. also necessitate a higher investment from portfolio managers. The Consultation Paper also opined that a higher net worth requirement would be a deterrent to non-serious players during new applications and would *“put pressure on fringe players co-existing with serious money managers”*. By this, SEBI presumably meant that increasing the minimum net worth would put pressure on fringe players to exit the business. In line with the recommendation of the Consultation Paper, the PMS Regulations 2020 have further revised the required minimum net worth to Rs. 5,00,00,000 (Rupees five crore).

3. Standardisation of performance calculation

- 3.1. The Consultation Paper highlighted a number of concerns which SEBI had regarding performance calculation and reporting by portfolio managers. Some of the concerns were as follows:
 - (i) portfolio managers showing model returns (rather than actual returns);
 - (ii) portfolio managers cherry picking certain portfolios (which were doing well) and showing only returns of such portfolios;
 - (iii) portfolio managers inflating returns by annualizing partial periods;
 - (iv) portfolio managers comparing the strategy's returns with incorrect benchmark returns;
 - (v) portfolio managers not taking into account the cash component in computing returns (i.e. ignoring the drag that cash exerts on returns);
 - (vi) portfolio managers ignoring withdrawn portfolios (and thus reporting a return which suffered from 'survivorship bias'); and
 - (vii) portfolio managers not disclosing qualitative parameters, such as a change in the identity of the fund manager or a change in the investment strategy.
- 3.2. Regulation 14(2)(b)(iv) of the PMS Regulations 1993 required the calculation of performance of a discretionary portfolio manager using the “weighted average method”, taking each individual category of investments for the immediately preceding 3 (three) years. The main drawback of using the “weighted average method” was that it failed to account for the varying holding periods of each security in a portfolio.
- 3.3. A survey of Indian portfolio managers conducted in 2018 by the CFA Institute found that:
 - (i) 31% (thirty one percent) of portfolio managers do NOT use asset weighted average returns of all client accounts when reporting performance;
 - (ii) 46% (forty six percent) of portfolio managers do NOT use time weighted returns of all client accounts when reporting performance; and

- (iii) Only 39% (thirty nine percent) of portfolio managers display the standard deviation of the portfolio when reporting performance.
- 3.4. The working group which prepared the Consultation Paper therefore recommended that returns may be calculated using time-weighted rate of return (“TWRR”). TWRR measures the performance of the account over the time period invested and excludes extraneous elements not usually under a portfolio manager's control, such as, deposits to and withdrawals from an account, as well as transfers in or out. While calculating returns using TWRR, all cash and all investments in liquid funds i.e. the cash drag, has to be mandatorily included. Further, all performance has to be reported, net of all fees, all expenses and taxes.
- 3.5. Based on the recommendations of the working group, regulation 22(4)(e) of the PMS Regulations 2020 has prescribed that the performance of a discretionary portfolio manager be calculated by using the TWRR for the immediately preceding 3 (three) years.
- 3.6. The PMS Regulations 1993 did not prevent the portfolio manager's performance prior to the immediately preceding 3 (three) years from being disclosed in the portfolio manager's advertisements or displayed on its website. Even though regulation 14(2)(b)(iv) of the PMS Regulations 1993 required the calculation of the portfolio manager's performance on the basis of the immediately preceding 3 (three) years, the regulatory requirement of showing weighted average performance for the immediately preceding 3 (three) years was only restricted to the disclosure document and in reports sent to clients. Regulation 22(10) of the PMS Regulations 2020 provides that each portfolio manager shall report its performance uniformly in disclosures made to SEBI, in its marketing materials, in reports to its clients and on its website. This implies that portfolio managers cannot disclose details of their performance prior to the immediately preceding 3 (three) years on their website or in their advertisements or in reports to clients.

4. Compliance with existing circulars

- 4.1. Paragraph D(10)(ii) of the February 13 Circular requires portfolio managers, with effect from financial year 2019-20 to submit to SEBI, a certificate of compliance with the PMS Regulations 2020 and circulars issued thereunder, duly signed by the principal officer of the portfolio manager, within 60 (sixty) days of end of each financial year. The portfolio manager is also required to submit details of non-compliance along with the corrective actions, if any, which are duly approved by SEBI of the portfolio manager.
- 4.2. Regulation 42 (3) of the PMS Regulations 2020 provides that after the repeal of the PMS Regulations 1993, any reference of the PMS Regulations 1993 in any other regulations made, guidelines or circulars issued thereunder by the SEBI shall be deemed to be a reference to the corresponding provisions of the PMS Regulations 2020. Therefore, all of the circulars issued under PMS Regulations 1993 are still in effect and would be applicable to portfolio managers, other than those specifically repealed by the February 13 Circular. If an entity commences the business of acting as a portfolio manager under the PMS Regulations 2020, it would have to become conversant and compliant with all circulars issued under the PMS Regulations 1993.

5. Appointment of a custodian by the portfolio manager

- 5.1. Regulation 16B of the PMS Regulations 1993 exempted portfolio managers who: (i) had a total AUM of less than Rs. 500,00,00,000 (Rupees five hundred crore); or (ii) performed purely advisory functions; from appointing a custodian in respect of securities managed or administered by it. Every other portfolio manager had to appoint a custodian.

- 5.2. Regulation 26 of the PMS Regulations 2020 requires every portfolio manager to appoint a custodian, irrespective of AUM, except portfolio managers who provide only advisory services.
- 5.3. Therefore, while under the PMS Regulations 1993, only portfolio managers having AUM of more than Rs. 500,00,00,000 (Rupees five hundred crore) had to appoint a custodian, the PMS Regulations 2020 offer no such distinction based on the value of the portfolio manager's AUM, and mandates all portfolio managers, except for those providing only advisory services, to appoint a custodian.
- 5.4. It is interesting to note that the Consultation Paper did not broach the subject of appointment of a custodian by each and every portfolio manager.

6. Monitoring of distributors by the portfolio managers

- 6.1. One of the issues identified by the working group which prepared the Consultation Paper was the in relation to the supervision of distributors of portfolio management services. The Consultation Paper noted with disapproval the fact that any person/entity could refer a client to invest with a portfolio manager. A referral by a person without sufficient knowledge may end in improper guidance to the client. The PMS Regulations 1993 were silent on distribution or solicitation of portfolio management schemes. There were no guidelines or regulations to deal with misinformation or mis-selling by intermediaries soliciting portfolio management services. Since SEBI wasn't regulating the distribution of portfolio management services, there were no prescribed codes of conduct or disclosure norms for the distributors.
- 6.2. Regulation 31(1)(g) of the PMS Regulations 2020 requires portfolio managers to furnish a report to their clients every 3 (three) months or as and when required by the clients, whichever is earlier and such report is required to contain, *inter alia*, details of the commission paid or payable by the portfolio manager to the distributor through whom such client invested. Regulation 23(11) of the PMS Regulations 2020 requires every portfolio manager to ensure that any person or entity involved in the distribution of its services is carrying out the distribution activities in compliance with the PMS Regulations 2020 and the circulars issued thereunder from time to time.
- 6.3. Paragraph G of the February 13 Circular deals with the supervision of distributors. According to Paragraph G of the February 13 Circular, portfolio managers are required to do the following in respect of distributors:
 - (i) Utilize services of only such distributors (whether known as channel partners, agents, referral interfaces or by any other name) who have a valid Association of Mutual Funds in India (AMFI) registration number or have cleared the National Institute of Securities Markets (NISM)-Series-V-A exam.
 - (ii) Pay fees or commission to distributors only on a trail-basis and only from the fees received by portfolio managers.
 - (iii) Ensure that prospective clients are informed about the fees or commission to be earned by the distributors for on-boarding them to specific investment approaches.
 - (iv) Ensure that distributors abide by the code of conduct as specified in annexure C of the February 13 Circular.
 - (v) Have a mechanism to independently verify the compliance of its distributors with the code of conduct as specified in annexure C of the February 13 Circular.

- (vi) Ensure that, within 15 (fifteen) days from the end of every financial year, a self-certification is also received from distributors with regard to compliance with the code of conduct.

7. Sharing the disclosure document with clients

- 7.1. Regulation 14(2) of the PMS Regulations 1993 required every portfolio manager to provide the disclosure document along with a certificate in form C as specified the PMS Regulations 1993 to the client at least 2 (two) days prior to entering into an agreement with the client defining the *inter se* relationship, and setting out their mutual rights, liabilities and obligations relating to management of funds or portfolio of securities that is required to be executed before taking up an assignment of management of funds or portfolio of securities on behalf of a client.
- 7.2. Regulation 22(3) of the PMS Regulations 2020 requires every portfolio manager to provide the disclosure document along with a certificate in form C as specified the PMS Regulations 2020 prior to entering into an agreement with the client defining the *inter se* relationship and setting out their mutual rights, liabilities and obligations relating to management of portfolio that is required to be executed before taking up an assignment of management of funds and portfolio on behalf of a client.
- 7.3. Therefore, the PMS Regulations 2020 only state that the disclosure document has to be shared prior to entering into the agreement. The requirement of sharing the same 2 (two) days prior to entering into the agreement, that was present under the PMS Regulations 1993, has been done away with in the PMS Regulations 2020.

8. Filing disclosure document with SEBI

- 8.1. Regulation 14(2)(d) of the PMS Regulations 1993 required a portfolio manager to file a copy of the disclosure document with SEBI before it was circulated or issued to any person and every 6 (six) months thereafter or whenever any material change was effected therein, whichever was earlier, along with the certificate in form C as specified in the PMS Regulations 1993.
- 8.2. The PMS Regulations 2020 has done away with the requirement to file a copy of the disclosure document with SEBI every 6 (six) months. Instead, regulation 22(7) of the PMS Regulations 2020 requires a portfolio manager to file a copy of the disclosure document with SEBI after grant of a certificate of registration, before circulating it to any client or whenever any material change, including a change in the investment approach is effected. The portfolio manager is required to file the disclosure document with the material change within 7 (seven) working days from the date of the change.
- 8.3. There was no definition of “material change” in the PMS Regulations 1993 or the PMS Regulations 2020. Paragraph F (15) the February 13 Circular introduced a definition of “material change” by stating that “material change”, for the purpose of regulation 22 (7) of PMS Regulations 2020, shall include “change in control” of the portfolio manager, principal officer, fees charged, charges associated with the services offered, investment approaches offered (along with the impact of such change) and such other changes as specified by SEBI from time to time. “Change in control” has been defined in regulation 2(1)(e) of the PMS Regulations 2020 by linking it to the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 in case of listed companies. In all other cases, “change in control” has been defined to mean a change in the controlling interest in the body corporate. The expression “controlling interest” has been defined to mean (i) an interest, whether direct or indirect, to the extent of at least 51% (fifty one percent) of voting rights in

the body corporate; or¹ (ii) the right to appoint a majority of the directors or to control the management directly or indirectly.

9. Reporting to SEBI

- 9.1. As per SEBI's RPM circular No.1(93-94) dated October 20, 1993 read with SEBI's circular IMD/DOF-1/PMS/Cir-1/2010 dated March 15, 2010 ("**Half Yearly Reporting Circulars**"), SEBI prescribed the format in which a half-yearly report containing information on portfolio management activities was to be submitted to SEBI by the registered portfolio manager in terms of regulations 20 and 23 of the PMS Regulations 1993. Such reports were to be filed twice a year as on 31st March and 30th September and had to reach SEBI within 30 (thirty) days of the period for which it related. Failure to submit the said report would render the registered portfolio manager liable for action under regulations 31 and 32 of the PMS Regulations 1993.
- 9.2. As per SEBI circular no. IMD/PMS/CIR/1/21727/03 dated November 18, 2003 ("**Corporate Governance Circular**"), SEBI had stated that portfolio managers would be required to disclose the performance of benchmark indices in the periodical reports to be furnished to the client in terms of regulation 21 of the PMS Regulations 1993. The Corporate Governance Circular further provided that the boards of portfolio managers should review the compliance of regulations in their periodical meetings, should develop a system of getting quarterly reports of compliance of SEBI regulations and guidelines, ensure that due diligence has been exercised by their officials in their operations and that the interests of investors are protected. Such reports could be placed before the boards by the compliance officers. Boards of the portfolio managers should also review redressal of investors' grievances. Any deficiency letters or warning letters issued to the portfolio managers by SEBI should also be placed before the boards of the portfolio managers. The Corporate Governance Circular also provided that there shall be an internal audit by a practicing chartered accountant or company secretary so as to judge the quality of internal procedures being followed by the portfolio manager, the report of the internal audit shall be submitted to the board of the portfolio manager and that the portfolio manager shall exercise due diligence in all their operational activities. Finally, compliance with the Corporate Governance Circular was to be disclosed to SEBI while submitting the half yearly reports.
- 9.3. Paragraph of D (9) the February 13 Circular partially modifies the Corporate Governance Circular and states that compliance with the Corporate Governance Circular is to be disclosed to SEBI annually as against the existing bi-annual submission requirement.
- 9.4. Further, paragraph D (10) of the February 13 Circular supersedes the Half Yearly Reporting Circulars and provides that with effect from financial year 2019-20, portfolio managers shall submit the following information to SEBI on an annual basis:
 - (i) a certificate from a qualified chartered accountant certifying the net-worth as on March 31, based on audited accounts, within 6 (six) months from the end of financial year; and
 - (ii) a certificate of compliance with PMS Regulations 2020 and circulars issued thereunder, duly signed by the principal officer, within 60 (sixty) days of end of each financial year and details of non-compliance along with the corrective actions, if any, duly approved by the board of the portfolio manager.

¹ The word 'or' is missing the PMS Regulations 2020. We assume that this is a typographical error. It is unlikely that SEBI intended to use the word 'and' which would mean that both conditions have to be met to create a "controlling interest".

10. On-boarding customers directly

Paragraph B of the February 13 Circular states that portfolio managers ***shall*** provide an option to clients to be on-boarded directly, without intermediation of persons engaged in distribution services. It further requires portfolio managers to prominently disclose in its disclosure documents, marketing material and on its website, the option of direct on-boarding. No charges other than statutory charges are leviable on clients at the time of direct on-boarding. The PMS Regulations 1993 did not mandate portfolio managers to provide a direct on-boarding option.

Though the motive behind requiring portfolio managers to provide a direct on-boarding option is laudable, the PMS Regulations 2020 bring certain complications in their wake. If a portfolio manager allows direct on-boarding for a particular investment strategy, which is also distributed through distributors who receive a commission, the portfolio manager is bound to collect less fees from the clients who have been directly on-boarded. This would result in 2 (two) categories of clients for a strategy, 1 (one) of whom would have been charged lower fees.

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