

Consultation Paper on Self Regulatory Organizations in Securities Market

1. Objective

- 1.1. This Memorandum proposes to seek the approval of the Board for initiation of public consultation process on the proposal to amend the SEBI (Self Regulatory Organizations) Regulations, 2004 (“**SRO Regulations**”) to simplify the process of recognition of and to strengthen the role of Self Regulatory Organizations (“**SRO**”) in the securities market.

2. Background

- 2.1. SEBI notified the SRO Regulations on February 19, 2004. SEBI Board, in its meeting held on August 16, 2012, approved the proposal to set up a Self Regulatory Organization (SRO) to regulate the distributors of securities such as mutual fund products, portfolio management products, etc. In order to implement the Board decision, the SRO Regulations were amended and brought into force on January 8, 2013, vide a Notification, in relation to distributors engaged by asset management companies of mutual funds and distributors engaged by portfolio managers.
- 2.2. Subsequent to the aforesaid notification, a public notice was issued on March 21, 2013 on the SEBI website inviting applications from entities desirous of being recognized as an SRO for distributors of mutual fund products.
- 2.3. The SEBI Board in its meeting held on June 25, 2013 after taking into account the difficulties envisaged in multiple SRO system and also the advantages of having a single SRO system decided to have a single SRO for distributors engaged by asset management companies. Further, it was decided to shortlist a suitable entity from the applications received, for grant of in-principle approval and provide a reasonable time period to comply with

all requirements (including capital infusion, setting up infrastructure, etc.) for obtaining the recognition as an SRO.

2.4. Accordingly, another public notice was issued on June 27, 2013 inviting applications from entities for being recognized as an SRO for distributors engaged by asset management companies latest by July 31, 2013.

2.5. The following three applications were received as on July 31, 2013 from-

2.5.1. Institution for Mutual Fund Intermediaries (IMFI), promoted by Association of Mutual Funds in India (AMFI)

2.5.2. Financial Planning Supervisory Foundation (FPSF), promoted by Financial Planning Standards Board India (FPSB)

2.5.3. Organization of Financial Distributors (OFD), promoted by Financial Intermediaries Association of India (FIAI)

2.6. After examining all the applications and upon due consideration of several factors, the Committee of Executive Directors (CoED) recommended that IMFI be granted an in-principle approval for recognition as an SRO for distributors engaged by asset management companies. Accordingly, in-principle approval was granted to IMFI on February 06, 2014 and the decision was communicated to all the applicants.

2.7. Aggrieved by this decision, FPSF filed an appeal before the Hon'ble Securities Appellate Tribunal ("**SAT**") on March 27, 2014. The main contentions of the appellant were as under:

- 2.7.1. IMFI did not have a certificate of incorporation as on the date of its application for being considered as an SRO by SEBI. [in terms of Reg. 3(1) of the SRO Regulations].
- 2.7.2. Rejection of the application of FPSF without an opportunity of being heard. (in terms of Reg. 10(1)).
- 2.7.3. SEBI was biased in favour of IMFI even before inviting the applications.
- 2.8. The Hon'ble SAT, after hearing the matter, restricted itself to two issues in the matter viz. Points 2.7.1 and 2.7.2. and in its judgment dated September 30, 2015, observed the following:
- “...since respondent no. 2 (IMFI) held license under Section 25(1) of the 1956 Act on the date of submitting the application under regulation 3 of the SRO Regulations, respondent no. 2 was eligible to apply and therefore SEBI was justified in entertaining the application submitted by respondent no. 2.”*
- “...since SEBI has failed to comply with the requirements of regulation 10, we quash and set aside the impugned decision of SEBI dated 06.02.2014 and direct SEBI to select an applicant afresh for grant of certificate of recognition in respect of distributors of mutual fund products.”*
- 2.9. FPSF appealed against the aforesaid Order of the Hon'ble SAT before the Hon'ble Supreme Court of India on January 11, 2016 for setting-aside the SAT's Order to the extent that it held that IMFI was eligible to apply for recognition as an SRO.

2.10. SEBI filed an Interlocutory Application (I.A.) before the Hon'ble Supreme Court on July 27, 2017 praying that SEBI would like to proceed in the matter afresh in view of the period of time that has elapsed. It was also submitted that in the meantime (three years) many other entities may have become eligible and that SEBI may be permitted to issue notice inviting applications afresh for recognition as an SRO.

2.11. While disposing off the appeal, the Hon'ble Supreme Court in its Order dated October 13, 2017, observed the following:

“4. In paragraph 16 of the application, it has been stated that the selection process had started in March, 2013 and with the passage of time many more persons/entities have become eligible and the respondent No.1-SEBI, who had initiated the selection process, is confident that if it is permitted to start the process afresh more applications will be received, thereby broadening the choice of selection.

5. Having regard to the above statement in paragraph 16 of the application and the public interest involved, we allow prayer (a) as made in the application extracted above.”

2.12. After the disposal of the said matter, based on regulatory experience the provisions in SRO Regulations were thoroughly examined. The present regulations allow applications to be made by entities and the Board is, therefore, obliged to examine such applications against the criteria specified in the SRO Regulations. These regulations also stipulate that the applicant may be granted opportunity of hearing before rejecting its application. This may lead to a situation wherein many applicants may satisfy the criteria and fulfill the requirements of the regulations and yet many of them would have to be rejected as the number of SROs would be limited. This may lead to unintended complications. The larger issue is that, since the SRO would

be first level regulator, SEBI should have adequate faith and confidence in the capabilities of such SRO for regulating the entities it is supposed to regulate. Therefore, such nomination should be done only after conducting due diligence and getting satisfied of the capabilities of such an organization.

Considering these issues and the associated concerns, SEBI is proposing to amend the SRO Regulations with respect to the manner of recognizing an SRO, subject to the compliance/satisfaction with criteria specified by the Board. As per the proposed process, SEBI would recognize an entity as an SRO on nomination basis, after conducting due diligence, instead of inviting applications for the same.

- 2.13. Accordingly, SEBI filed a Miscellaneous Application (M.A.) before the Hon'ble Supreme Court on October 06, 2018 to seek leave to go ahead with the aforesaid broad approach and to make necessary amendments to the SRO Regulations for the purposes of recognizing an SRO in accordance with amended regulations. The Hon'ble Supreme Court in its Order dated November 12, 2018 while allowing SEBI's application observed the following:

“Prayer to amend the Self Regulatory Organization (SRO) Regulations and to consider the pending cases in the light of the amended Regulations is allowed. We make it clear that we have expressed no opinion on the validity of the amendment(s) proposed.”

- 2.14. With the leave of Hon'ble Supreme Court in place, SEBI intends to undertake the process to review the provisions of the extant SRO Regulations to rationalize the process of recognition and to strengthen the role of an SRO in the securities market. For this purpose, it was proposed to initiate a public consultation process.

2.15. (This para has been excised for reasons of confidentiality)

2.16. (This para has been excised for reasons of confidentiality)

2.17. On examination, in the global scenario, it was noted that Securities Exchange Act, 1934 (of the United States of America) defines the term “Self Regulatory Organization” as follows:

“The term “self-regulatory organization” means any national securities exchange, registered securities association, or registered clearing agency, or (solely for purposes of sections 19(b), 19(c), and 23(b) of this title) the Municipal Securities Rulemaking Board established by section 15B of this title.”

2.18. Further, it was also deliberated whether an SRO could be defined as a “professionally managed entity” and additionally enumerate certain eligibility criteria, like having direct or indirect experience in member registration, training, certification, formulation of code of conduct, inspection, member supervision, investor grievance resolution, arbitration, etc.

2.19. (This para has been excised for reasons of confidentiality)

2.20. (This portion has been excised for reasons of confidentiality) the need for an effective solution to regulate the intermediaries, such as distributors engaged by asset management companies and investment advisers, is urgent. Hence, it is felt that SRO Regulations may be suitably modified to enable SEBI to nominate a body to regulate market participants like distributors engaged by asset management companies and investment advisers.

- 2.21. This purpose may perhaps be achieved by amending, inter alia, the definition of “Self Regulatory Organization” under regulation 2(1)(k) of SRO Regulations as follows:

“Self Regulatory Organization” means, an organization of intermediaries or an entity promoted by a stock exchange, as may be recognized by the Board.”

3. SRO in the Securities Market

- 3.1. Given the development of the securities market, size of Mutual Funds industry and the further scope of expansion, it is proposed to have SRO(s) to regulate the distributors engaged by asset management companies, investment advisers and such other intermediaries/other market participants as may be notified by SEBI from time to time.

3.2. SRO for Distributors of Mutual Fund Products in India

- 3.2.1. In recent years the securities market in general and the Mutual Funds industry in particular has grown manifold. AUM has increased from INR 1.4 Lakh Crores in 2004 to INR 5.87 Lakh Crores in 2012, and thereafter to INR 21.36 Lakh Crore as on March 31, 2018. The number of folios has grown from 1.46 Crores in 2004 to 4.65 Crores in 2012 to 7.13 Crores as on March 31, 2018. The number of distributors of the Mutual Fund products has also increased from 18,285 in 2004 to 47,845 in 2012 to 1,07,302 as on March 31, 2018.

- 3.2.2. As on February 28, 2019, the AUM of the Mutual Funds industry has grown to INR 23.16 Lakh Crores and number of folios has increased to 8.18 Crores.

- 3.2.3. To sustain this growth and to promote deeper penetration of the Mutual Fund products into all areas of the country, the distributors are expected to play an important role.
- 3.2.4. At present, distributors of Mutual Fund products are registered with Association of Mutual Funds in India (AMFI) which assigns an AMFI Registration Number (ARN) to them. They are paid commission by the Asset management Companies (AMCs) for their services in bringing investments. The distributors are empanelled, by way of agreements, with single / multiple AMCs, for marketing their products. Hence, Mutual Funds / AMCs have the primary responsibility for the conduct of the distributors empanelled by it.
- 3.2.5. However, it is observed that there are diverse practices in the industry regarding the relationships between the AMC and the distributor. Further, a distributor is empanelled with multiple AMCs. Thus there is a need to bring a certain level of consistency in the practices of the distributors. Hence, there is a need to have an SRO for the distributors of Mutual Fund products to ensure consistency of the practices, enforcement of code of conduct and to take disciplinary action, if required, particularly in respect of alleged malpractices like misselling of products, churning of portfolio etc. and to deal with investor grievances, in order to safeguard the interests of the investors.

3.3. SRO for Investment Advisers

- 3.3.1. Section 11(2)(b) of SEBI Act inter alia empowers SEBI to register and regulate the working of Investment Advisers. Under the said mandate, SEBI issued a Concept Paper on Regulation of Investment Advisers on September 26, 2011 to seek public comments.

3.3.2. The Concept Paper, inter alia, stated that the aforesaid regulations would be implemented through an SRO. Post receipt of public comments, draft regulations on Investment Advisers were put up to the Board for consideration and approval of the same. The memorandum to the board with regard to the draft regulations, inter alia, proposed as follows:

10.1. At the initial stages till recognition of a SRO, SEBI will directly register and regulate Investment Advisers.

10.2. SEBI may appoint an SRO for the purpose of regulating Investment Advisers, representatives or fund managers.

10.3. SEBI may specify that no person shall act as an investment advisor unless he is a member of a recognized SRO

The Board, in its meeting held on August 16, 2012 approved the draft SEBI (Investment Advisers) Regulations.

3.3.3. SEBI (Investment Advisers) Regulations, 2013 (“IA Regulations”) were notified on January 21, 2013 and came into effect from April 21, 2013. Regulation 14(1) of IA regulations, inter alia, state that the Board may recognize any body or body corporate for the purpose of delegating administration and supervision of Investment Advisers to such a body on such terms and conditions as may be specified by the Board.

3.3.4. As on March 19, 2019, a total of 1136 Investment Advisers are registered with SEBI. The category wise details of SEBI registered Investment Advisers are as follows:

Category	No. of Investment Advisers
Body Corporates	290
Limited Liability Partnership	46
Individuals and Partnership Firms	800
Total	1136

- 3.3.5. SEBI has been registering and regulating Investment Advisers since 2013 by providing necessary criterion for registration and seeking compliances in terms of risk profiling, suitability, maintenance of records etc. Further, the complaints received against registered investment advisers are also taken up for redressal.
- 3.3.6. Since the last five years, the number of registered investment advisers has shown an increase, particularly individuals, and there has been a corresponding increase in number of complaints against them.
- 3.3.7. SEBI is in receipt of a large number of complaints alleging charging of exorbitant fees, assurance of returns, misconduct etc. by Investment Advisers.
- 3.3.8. Given the growth in this segment of the market, it is felt that the time is appropriate to initiate the formation of an SRO. Thus it is proposed that in line with the earlier Board memorandum, an SRO may be formed and recognized for regulating investment advisers.

4. Salient Features of proposed amendments to the SRO Regulations:

- 4.1. Broadly speaking and conceptually, SRO is an organization representing a particular segment of entities, which, as a first level regulator, regulates the members of that segment. The proposed SRO(s), as per Para 3 above, would be entrusted with several important tasks, inter alia including registration / grant of membership, supervision, training and education of its members, and redressal of investors' grievances. SEBI would be assisted in its regulatory functions by such an SRO. Therefore, it is of utmost importance as to which body/institution is allowed to be recognized as an SRO by SEBI.

- 4.2. In the past when applications for SRO of distributors of Mutual Fund products were invited by SEBI, multiple applicants staked their claims. This led to prolonged litigation and complications, thereby, causing unreasonable delay in the process of recognition of an SRO.
- 4.3. Given that SROs are the first level regulators which perform the crucial task of regulating a particular segment of securities market on behalf of the regulator, it is desirable that SEBI, after considering the experience and capability of an entity, grants recognition to it as an SRO on a nomination basis.
- 4.4. Considering the aforesaid issues, SEBI proposes to review the extant SRO Regulations.
- 4.5. In view of the above, a detailed Consultation Paper is placed at **Annexure A**. The salient features of proposed regulations are summarized below:

S. No.	Feature	Proposal	Rationale
4.5.1	Definition of SRO	To amend the definition as follows: <i>“Self Regulatory Organization” means, an organization of intermediaries or an entity promoted by a stock exchange, as may be recognized by the Board.”</i>	It is important that the SRO is promoted by an entity(ies) having expertise in handling various regulatory / supervisory aspects of securities market.
4.5.2	Who may be an SRO	An SRO may be an organization of intermediaries or an entity	In line with the proposed definition of SRO

S. No.	Feature	Proposal	Rationale
		<p>promoted by a stock exchange which has adequate experience in regulation, supervision and dispute resolution. Such organization or entity shall be registered under section 8 of Companies Act 2013.</p>	
4.5.3	<p>Nomination Process</p>	<p>Nomination Committee: It is proposed to constitute a Nomination Committee comprising of external experts, preferably headed by a retired Judge of a High Court or Supreme Court, to consider and give its recommendation(s) to SEBI regarding the suitability of an organisation or entity to be recognised as an SRO.</p> <p>The said committee may also consider the pending cases, as directed by the Hon'ble Supreme Court in its Order dated November</p>	<p>An SRO is the first level regulator that performs the crucial task of regulating intermediaries representing a particular segment of securities market on behalf of the regulator.</p> <p>An SRO would be seen as an extension of the regulatory authority of SEBI and would perform the tasks delegated to it by SEBI.</p> <p>The role of an SRO is developmental, regulatory, related to grievance redressal and</p>

S. No.	Feature	Proposal	Rationale
		<p>12, 2018, as stated in Para 2.13.</p> <p>SEBI, after considering the recommendation of the Nomination Committee and experience and capability of an entity and/or its promoter(s) or promoting entity/entities, may grant recognition to the entity as an SRO subject to such conditions as may be deemed appropriate.</p>	<p>dispute resolution as well as taking disciplinary actions.</p> <p>Therefore, it is crucial that SEBI, after due diligence, recognises such entity/entities which is/are capable of carrying out responsibilities of an SRO.</p>
4.5.4	Governing Board and Committees	<p>The Governing Board may consist of elected representatives of members of SRO (i.e. regulatees e.g. Distributors of MF products and/or Investment Advisers), SEBI nominated Public Interest Directors (PIDs) and shareholder directors (i.e. representatives of the promoters or promoting entities).</p>	<p>Since it is a Self Regulatory Organization, it is proposed to have representation from amongst its regulatees, with majority directors being Public Interest Directors (PIDs) since the principal objective of the SRO is the protection of investors.</p>

S. No.	Feature	Proposal	Rationale
		<p>The Chairman of the Governing Board shall have the casting vote.</p> <p>The Chairman of the Governing Board shall be elected by the Governing Board from amongst the PIDs.</p> <p>The CEO / Managing Director shall be deemed to be a Shareholder Director.</p> <p>The functioning and composition of the Governing Board and the creation, composition and functions of the committees of the Governing Board may be as specified by SEBI from time to time.</p> <p>The appointment and removal of all directors including CEO/Managing Director shall be with prior approval of SEBI.</p>	<p>For the SRO(s) of distributors of MF products and Investment Advisers, it is proposed that the Governing Board shall comprise of not more than 25% Shareholder Directors, not more than 25% Elected Representatives and not less than 50% of PIDs. As an SRO is assisting SEBI in discharging certain regulatory functions, it should have more representation of Public Interest Directors nominated by SEBI.</p>
4.5.5	Arbitration & Dispute Resolution	The SRO shall provide for a dispute resolution mechanism including	Presently there is no effective mechanism to handle disputes between

S. No.	Feature	Proposal	Rationale
		arbitration to settle disputes between investors and its members and disputes between its members.	investors and distributors. Hence, SRO can provide such a mechanism under Arbitration and Conciliation Act.
4.5.6	Tenure of Recognition of SRO	SRO may be granted recognition on a permanent basis subject to it satisfactorily carrying out its role in compliance with regulations etc. to the satisfaction of SEBI and effectively carrying out such other related mandate as specified by SEBI from time to time.	SEBI has gradually moved towards the approach of permanent registration and/or recognition to intermediaries, subject to satisfactory compliance with the regulations, payment of fees and effectively carrying out of its mandate to satisfaction of SEBI.

5. Proposal

- 5.1. The Board is requested to consider and approve the proposal to float a Consultation Paper for seeking public comments.
- 5.2. The Board is also requested to authorize the Chairman to make necessary incidental modifications, if required, to the proposed Consultation Paper.

Annexure A

Consultation Paper

Self Regulatory Organizations in Securities Market

(Uploaded on SEBI website on April 01, 2019 for Public Comments)