

## Amendment to SEBI (Portfolio Managers) Regulations, 1993

### 1. Objective

- 1.1. This Memorandum proposes to introduce SEBI (Portfolio Managers) Regulations, 2019 in place of SEBI (Portfolio Managers) Regulations, 1993 and seeks the approval of the Board for the same.

### 2. Background

- 2.1. SEBI (Portfolio Managers) Regulations, 1993 were notified on January 07, 1993. The said Regulations, inter alia, provide for registration, operations and governance of Portfolio Managers. The SEBI (Portfolio Managers) Regulations, 1993 were last amended on February 10, 2012.
- 2.2. Over a period, there has been significant increase in number of clients and assets under management (AUM) of the Portfolio Managers. The data on growth of Portfolio Management industry since February 2012 is given below:

<b>Types of Portfolio Management Services (PMS)</b>				
	<b>Discretionary</b>	<b>Non-Discretionary</b>	<b>Advisory</b>	<b>Total</b>
As of February 2012 - No. of Portfolio Managers - 250				
No. of clients	67938	5192	9261	<b>82391</b>
AUM (Rs. Cr.)	380809	17564	74146	<b>472519</b>
As of March 2019- No. of Portfolio Managers – 321				
No. of clients	138829	6853	4038	<b>149720</b>
AUM (Rs. Cr.)	1303141	109031	193,620	<b>1605792</b>

- 2.3. Also, per capita disposable income has increased from Rs. 80,472 in March 2012 to Rs. 1,52,454 March 2019. In view of the increase in per capita disposable income along with the trends seen in PMS industry, further increase in number of clients and investment in PMS industry is expected.
- 2.4. In this context, SEBI, considering the need for a comprehensive review of SEBI (Portfolio Managers) Regulations, 1993, set up a working Group of industry participants, with the following terms of reference:
- (a) To review SEBI (Portfolio Managers) Regulations, 1993 including need for improvement in transparency.
  - (b) To study the role of distributors in Portfolio Management and necessary disclosures.
  - (c) To evaluate the performance disclosures by Portfolio Managers and changes in reporting format.

- (d) Any other matter considered relevant by the working group.
- 2.5. The Working Group held 11 meetings with detailed discussions on various aspects of the SEBI (Portfolio Managers) Regulations, 1993. Following exhaustive discussions, the Working Group submitted their report (“**WG Report**”) on July 11, 2019, along with draft SEBI (Portfolio Managers) Regulations, 2019 [which will replace the existing SEBI (Portfolio Managers) Regulations, 1993] (**Annexure –I & II**).
- 2.6. The major recommendations of the Working Group deal with the following issues:
- (a) Enhancement of Qualifying Criteria for registration of Portfolio Manager
  - (b) Tightening product suitability in PMS
  - (c) Adoption of Nomenclature “Investment Approach” in PMS documents and reporting
  - (d) Supervision of Distributors of PMS
  - (e) Reporting and Disclosure Requirements of Portfolio Managers
  - (f) Rationalization fees and expenses
  - (g) Other issues
- 2.7. Through a Consultation paper floated by SEBI on August 02, 2019 (**Annexure –III**) public comments were sought on the recommendations of the Working Group and the draft SEBI (Portfolio Managers), Regulations 2019. The public comments received on the Consultation Paper have been segregated issue –wise and are placed at **Annexure –IV**.

### **3. Proposed key regulatory changes**

Taking into account the recommendations of the Working Group, the public comments received thereon, issues highlighted in various media reports and experience of SEBI, it is proposed to issue SEBI (Portfolio Managers), Regulations 2019 (“**proposed PMS Regulations**”) which will replace the SEBI (Portfolio Managers) Regulations, 1993 (“**existing PMS Regulations**”).

Part A as given below provides the key proposed regulatory changes which were discussed in the Consultation Paper and placed for public comments. In the course of review of public comments and further internal deliberations, certain additional changes were considered appropriate, even though they were not part of the Consultation Paper. These proposals are dealt with in Part B subsequently.

## **Part A- Key proposed changes discussed in the Consultation Paper**

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### **3.1. Definition of Principal Officer**

3.1.1. The existing PMS Regulations define Principal Officer as follows:

“principal officer” means an employee of the portfolio manager who has been designated as such by the portfolio manager”

3.1.2. The above definition does not clearly assign the roles and responsibilities of the Principal Officer. Therefore, it is proposed in the report of the Working Group to define the role of the Principal Officer in the proposed PMS Regulations as under:

“Principal Officer means an employee of the portfolio manager who has been designated as such by the portfolio manager and is responsible for: -

(A) The decisions made by the portfolio manager for the management or administration of a portfolio of securities or the funds of the client, as the case may be; and

(B) over all supervision of the operations of the portfolio manager.”

3.1.3. All public comments received on this proposal have been favorable. Accordingly, we may accept the recommendation of the Working Group.

#### **Proposal**

3.1.4. The definition of Principal Officer as recommended in the WG Report may be accepted and incorporated suitably in the proposed PMS Regulations.

### **3.2. Eligibility Criteria for Principal Officer of registered Portfolio Manager**

3.2.1. The existing PMS Regulations mandates that the Principal Officer of a Portfolio Manager shall have either relevant experience of 10 years or a professional qualification in finance, law, accountancy, business management or CFA charter from the CFA Institute. Considering the proposal to assign the responsibility for all the activities of a Portfolio Manager to the Principal Officer, it was recommended by the Working Group that the minimum qualification and experience of the Principal Officer may be amended as under:

(i) a professional qualification in finance, law, accountancy or business management from a university or an institution recognized by the Central

Government or any State Government or a foreign university and relevant NISM Certification<sup>1</sup> as prescribed by the Board from time to time AND

- (ii) an experience of at least 5 years in related activities in the securities market including as a portfolio manager, stock broker, Investment Advisor or a fund manager.

[Provided that at least 2 years of relevant experience is in portfolio management or investment advisory services or in the areas related to fund management]

- 3.2.2. Majority of the public comments received on this proposal were in favor of enhancing the minimum eligibility criteria of the Principal Officer, though certain comments suggested that the NISM Certification may not be made mandatory. A small number of comments also suggested that the enhanced eligibility criteria may not be mandated for professionals who have been Principal Officers for at least 5 years at the time of notification of the proposed PMS Regulations. Certain comments have been received suggesting that the qualification criteria may be either professional qualification or work experience, not both. Comments have also been received that more academic/professional qualifications like CFA, Qualification in Mathematics, Economics, Engineering etc. should also be considered for Principal Officer.
- 3.2.3. Considering the increasing trend of participation and AUMs in PMS, the absence of prudential norms to guide the investment decisions of the Portfolio Manager and the roles and responsibilities of the Principal Officer, it is essential that the Principal Officers are well equipped both in terms of academic qualifications as well as work experience to be able to fulfil their responsibilities. It is also therefore necessary that the work experience is related to management of funds, assets, portfolios etc.
- 3.2.4. In view of the above, we may accept the recommendations of the Working Group, with minor changes in the specified qualifications. Considering that acquiring professional qualifications may require at least two years, the existing Portfolio Managers may be granted up to 36 months' time from the date of the notification of proposed PMS Regulations, to comply with the enhanced eligibility criteria.

### **Proposal**

- 3.2.5. Accordingly, it is proposed to mandate the eligibility criteria for the Principal Officer as under:

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<sup>1</sup> As on date, NISM Certification is not available for employees of Portfolio Managers. Certification will be designed by NISM in coordination with SEBI.

- (i) a professional qualification in finance, law, accountancy or business management from a university or an institution recognized by the Central Government or any State Government or a foreign university; or CFA Charter from CFA Institute and
- (ii) relevant NISM Certification as prescribed by SEBI from time to time; and
- (iii) an experience of at least 5 years in related activities in the securities market including in a portfolio manager, Stock Broker, Investment Advisor, Research Analyst or a Fund Manager.

[Provided that at least 2 years of relevant experience is in portfolio management or investment advisory services or in the areas related to fund management]

3.2.6. Portfolio Managers who were granted certificate of registration under the existing PMS Regulations, shall ensure compliance with the enhanced eligibility criteria for the Principal Officer, within 36 months from the date of notification of the proposed PMS Regulations.

3.2.7. As on date, NISM is yet to introduce a Certification Programme for employees of Portfolio Managers. It is proposed that NISM may design the said Certification Programme in coordination with SEBI. Circular in this regard may be issued after introduction of such Certification by NISM.

### **3.3. Minimum number of employees required for a Portfolio Manager**

3.3.1. The existing PMS Regulations mandates that a Portfolio Manager shall have a minimum of two employees who, between them, have at least 5 years' experience in related activities in portfolio management or stock broking or investment management or in the areas related to fund management.

3.3.2. Presently, the above regulatory requirement may be fulfilled by appointment of Principal Officer and Compliance Officer.

3.3.3. The Working Group proposed that in addition to Principal Officer and Compliance Officer, a Portfolio Manager should have at least two employees with the following eligibility criteria:

- (i) a professional qualification in finance, law, accountancy or business management from a university or an institution recognized by the Central Government or any State Government or a foreign university and relevant NISM certification; AND

- (ii) an experience of at least 2 years in related activities in the securities market including as a portfolio manager, stock broker, Investment Advisor or a fund manager.
- 3.3.4. It was further proposed that any employee of the Portfolio Manager who has authority to make investment decisions shall have the same minimum qualifications as the Principal Officer.
- 3.3.5. A few comments have been received suggesting to maintain status quo or to mandate only one additional employee other than the Principal Officer and Compliance Officer. Some suggestions were to not mandate minimum qualification for the additional employees, whereas, some suggestions were to not mandate additional manpower requirement for Portfolio Managers who avail services of a SEBI registered Custodian. Majority of the comments on this proposal have reasoned that many Portfolio Managers rely on system driven and rule based forms of investing and on technology to automate many tasks.
- 3.3.6. Regulation 15 (1) of existing PMS Regulations states that “the discretionary portfolio manager shall individually and independently manage the funds of each client in accordance with the needs of the client in a manner which does not partake character of a Mutual Fund...” However, it is understood that a large number of the Portfolio Managers categorize their client portfolios into a limited number of investment strategies (which requires lesser resources) instead of providing customized portfolios.
- 3.3.7. It is felt that compliance in letter and spirit with the aforesaid regulatory requirement will require the Portfolio Manager to invest in both technology and personnel. Further, as the number of clients and AUM increase, the amount of continuous due diligence required under various applicable laws also increases.
- 3.3.8. Considering the cost of increased manpower and the reasoning given in public comments about usage of technology, it is felt that while the increase in number of employees is desirable, the additional requirement may be reduced to one employee as against two employees recommended by the Working Group. Similarly, the qualification criteria for the employee not involved in investment decisions, may be reduced to Graduation in any discipline, instead of the recommendation of Working Group of having Professional Qualification and relevant NISM Certification.

### **Proposal**

- 3.3.9. Accordingly, it is proposed that apart from the Principal Officer and Compliance Officer, a Portfolio Manager should have at least one additional employee with the following credentials:

- (i) graduation from a university or an institution recognized by the Central Government or any State Government or a foreign university; and
- (ii) an experience of at least 2 years in related activities in the securities market including in a portfolio manager, stock broker, Investment Advisor, Research Analyst or as a fund manager.”

[Provided any employee of the Portfolio Manager who has decision making authority related to fund management shall have the same minimum qualifications and experience as specified for the Principal Officer]

3.3.10. Portfolio Managers who were granted certificate of registration under the SEBI (Portfolio Managers) Regulations, 1993 may need time to recruit one additional employee with graduate qualification and 2 year’s relevant experience.

3.3.11. Portfolio Managers who were granted certificate of registration under the existing PMS Regulations, shall ensure compliance with the enhanced manpower requirement, within 12 months from the date of notification of the proposed PMS Regulations.

#### **3.4. Capital Adequacy requirements for Portfolio Manager**

3.4.1. Considering inflation and rising income levels, enhanced compliances recommended by the Working Group, increase in cost related to information technology and cyber security, recommendation on minimum number of employees etc., as well as with a view to deter ill-equipped and non-serious entrants into the PMS industry, it was recommended that the minimum Net Worth requirement of a Portfolio Manager may be enhanced to Rs. 5 Crore from the present mandate of Rs. 2 Crore. The WG report proposed 1 year time to be granted to existing Portfolio Managers to meet the enhanced net worth requirement.

3.4.2. The net worth requirement for registered Portfolio Managers was last revised in August 2008 to Rs. 2 Crore from Rs. 50 lacs in October 2002, a fourfold increase in 6 years.

3.4.3. Public comments were received on this proposal both against and in favor of increasing the net worth requirement to Rs. 5 Crore. However, majority of comments received are to maintain status quo.

3.4.4. The comments which recommended status quo, have stated that increase in net worth would be detrimental to small players in the industry. Certain respondents suggested to increase the net worth requirement pegged to AUM, Inflation, etc.

whereas certain respondents were in favor of increasing the net worth requirement to Rs. 5 Crore or more, with a longer time frame of up to 3 years for implementation.

- 3.4.5. Some comments have stated that the proposal may be detrimental to the Portfolio Managers who have received registration in the last one year or so with a net worth of Rs. 2 Crore, as they may not be able to upgrade to the revised net worth requirement within one year. Further, a large number of comments objecting to the proposed higher net worth requirement have stated that Portfolio Management being a service industry is not capital intensive and hence there should not be financial detriments to “Young Entrepreneurs and Analysts with rich knowledge and working expertise” to launch start-ups offering personalized service in Portfolio Management.
- 3.4.6. In this regard it is felt that, while it is good to encourage entrepreneurs and start-ups, given the burgeoning AUM handled by Portfolio Managers, it is necessary that there is sufficient investment in personnel, systems, cyber security, risk management etc. to ensure that there is no compromise on the quality of management or administration of the portfolios or governance standards. Further, a higher net worth criteria shall ensure that only well prepared participants enter into the PMS industry, particularly as a Portfolio Manager has no “skin in the game”.
- 3.4.7. Accordingly, it may be considered to agree with the recommendation of the Working Group to increase the net worth requirement. However, considering the number of public comments and reasoning highlighted therein to extend the time to meet the enhanced net worth requirement, existing Portfolio Managers may be granted, time up to 36 months to raise their net worth to Rs. 5 Crores.

#### **Proposal**

- 3.4.8. Accordingly, it is proposed:
  - (i) to increase the minimum net worth requirement for Portfolio Managers to Rs. 5 Crore.
  - (ii) that the existing Portfolio Managers shall raise their net worth to not less than 5 Crore rupees within 36 months from the date of notification of the proposed PMS Regulations.

### **3.5. Minimum investment by investors of Portfolio Management Services**

- 3.5.1. Considering increase in per capita income, improvement in economic indicators and the risks associated with a product like PMS, the Working Group recommended that the minimum capital (funds and securities taken together) to be invested by the

clients of PMS, may be increased from the current threshold of Rs. 25 Lacs to Rs. 50 Lacs.

- 3.5.2. The minimum investment threshold for investors of PMS was last revised in February 2012, whereby the investment threshold was increased to Rs. 25 Lacs from Rs. 5 Lacs in October 2002, a fivefold increase in ten years.
- 3.5.3. Majority of the public comments received on this proposal were in favor of maintaining the investment threshold at Rs. 25 lacs. Certain comments were received in favor of increasing the investment limits while permitting Systematic Investment Plans (SIPs) in PMS instead of mandating one-time capital of Rs. 50 Lacs. Majority of the respondents also suggested that the upward revision in investment threshold may be made applicable only to new clients on-boarded.
- 3.5.4. Certain comments were received stating that increasing the minimum investment size shall discourage participation in the industry, as, Rs. 50 lacs may be too big an amount for one client to park in a single investment instead of diversifying their investments. Certain comments have also suggested that increasing the investment limit for new clients may deny high net worth individuals with savings more than Rs. 25 lacs but less than Rs. 50 lacs, the opportunity to avail personalized investment service.
- 3.5.5. It is felt that as there are no prescribed prudential norms for investments of Portfolio Managers, the PMS investments may become complex and risky, and therefore, largely suitable for investors with high risk-taking capacity. Increase in the minimum investment threshold is felt necessary so that investors with low risk appetite and limited understanding of volatility and risk in securities market are not enticed into deploying their savings into a risky product. On the issue of diversification, the rationale of respondents may not hold true, as a customized portfolio can be well diversified.
- 3.5.6. As regards the suggestions of introduction of SIPs in Portfolio Management, it is felt that the portfolio management for the client would be based on the proposed investment of Rs. 50 lacs and not the portion of capital received. The client may also not bring in the remaining portion of the proposed investment in future, defeating the regulatory mandate of minimum investment.
- 3.5.7. In view of the above, recommendation of the Working Group may be accepted.

## **Proposal**

3.5.8. Accordingly, it is proposed as under:

- (i) Minimum investment threshold for a client of Portfolio Manager may be increased from Rs. 25 Lacs to Rs. 50 Lacs. Such increased investment thresholds shall be applicable for new clients and fresh investments by existing clients.

Explanation: "Fresh Investment by existing clients" means any renewal of portfolio fund on maturity of the initial period.

- (ii) Existing investments of clients, as on date of notification of proposed PMS Regulations, may continue as such till maturity of the investment or as specified by the Board.

### **3.6. Permissible investment instruments for Portfolio Management Services**

3.6.1. Presently, Portfolio Managers may invest in any particular type of investment on behalf of the client as long as the investment is in line with the terms of the agreement between the portfolio manager and the client and in compliance with the provisions of the existing PMS Regulations. As a result, in the Portfolio Management industry, investments are seen in a range of financial instruments, listed or unlisted.

3.6.2. It was proposed in the WG report that Portfolio Managers may be permitted to invest only in listed securities, whether equity, debt or commodity derivatives and units of Mutual Funds on behalf of their clients. It was further proposed that investment by Portfolio Managers in Mutual Funds may only be through "Direct" plans.

3.6.3. Public comments were received both in favor of and against the proposal to limit the permissible investment instruments, particularly to disallow unlisted investments. Some comments suggested that investment in unlisted securities may be restricted to a fraction of the AUM of the Portfolio Manager. A few comments were also received which suggested that Fixed Deposits in Banks, Government Securities, units of REITs & INVITs etc. may also be permitted.

3.6.4. From the examination of the various complaints received by SEBI and media reports in the recent past, it is felt that unlisted securities add significant risk to the client portfolios. In case of Discretionary Portfolio Management, under the existing PMS Regulations, investments may be made in unlisted securities without the client being aware of the investment and the nature of risk associated with the investment.

- 3.6.5. However, in case of Non-Discretionary Portfolio Management, each investment on behalf of the client requires express consent of the client, thereby ensuring that the client has an opportunity to assess the investment independently, if so desired. Similarly, in case of clients of Advisory Portfolio Management, the decision to act upon the investment advice is entirely with the client. Therefore, a certain percentage of the client portfolio (AUM) under non-discretionary and advisory portfolio management may be permitted to be invested in unlisted securities.
- 3.6.6. In view of the above, the recommendations of the Working Group w.r.t. Discretionary Portfolio Management Services may be accepted; however, it may be relaxed in case of non-discretionary and advisory Portfolio Management Services.

### **Proposal**

- 3.6.7. Accordingly, the following is proposed:
- (i) Portfolio Managers offering Discretionary Portfolio Management Services may be permitted to invest in listed securities, money market instruments, units of Mutual Funds and such other securities/ instruments as specified by SEBI from time to time, on behalf of their clients
  - (ii) Portfolio Managers offering Non-discretionary/ Advisory Portfolio Management Services may be permitted to invest/ provide advice up to 25% of their AUM under Non-discretionary/ Advisory Portfolio Management Services in unlisted securities, in addition to the securities permitted for Discretionary Portfolio Management Services.
  - (iii) Investment by Portfolio Managers in units of Mutual Funds shall only be through “Direct Plans” of the Schemes of Mutual Funds.
  - (iv) For the portion of AUM invested in units of Mutual Funds, the Portfolio Manager shall not charge any distribution fees (by whatever name it is called – e.g. distribution commission, referral fees etc.) to the clients.

### **3.7. Outsourcing of core activities of Portfolio Manager**

- 3.7.1. In the past SEBI has received requests under the SEBI (Informal Guidance) Scheme, 2003 seeking clarification on registered Portfolio Managers receiving non-binding, recommendatory advice from other registered Portfolio Managers, Investment Advisors etc. In this regard, ‘Guidelines on Outsourcing Activities by Intermediaries’ issued by SEBI vide Circular No. CIR/ MIRSD/ 24/2011 dated December 15, 2011 states that intermediaries shall not outsource their core

business activities and compliance functions, which in case of Portfolio Managers cover investment related activities.

- 3.7.2. As making investment decisions and advising clients on investments are core functions of a Portfolio Manager, it was proposed in the WG Report that portfolio managers shall not invest client's fund based on the advice of another portfolio manager, investment advisor or any other registered intermediary.
- 3.7.3. Certain public comments have been received on this proposal, with the rationale that a portfolio manager who does not have access to all investment strategies, may want to rely on investment strategies offered by the other specialist portfolio managers. A few comments were received which stated that portfolio managers should be allowed to avail third party research and non-binding investment advice.
- 3.7.4. A Portfolio Manager is expected to manage/ administer the clients' portfolios in a manner that meets the specific requirements and risk profiles of each client. Assessing the clients' requirements and risk profile, and determining suitable investments for them is thus a core function of the Portfolio Manager. While the Portfolio Manager may refer to third party research reports to assess securities, seeking investment advice to create/manage/ administer client portfolios may not be desirable.
- 3.7.5. Considering the above, the recommendation of the Working Group may be accepted. However, the Working Group is silent on advice received from other than registered intermediaries. It is felt that the similar restriction should be extended to advice received from entities other than registered intermediaries.

### **Proposal**

- 3.7.6. Accordingly, it is proposed to mandate as under:
  - (i) The portfolio manager shall invest the clients' funds only in the portfolio managed or administered by himself, and not that of another portfolio manager.
  - (ii) The portfolio manager shall not invest clients' funds based on the advice of any other entity.

### **3.8. Definition of "change in control" of Portfolio Manager**

- 3.8.1. The existing PMS Regulations defines "change in control" for a listed Portfolio Manager, with reference to the definition of control in terms of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. In any other case, the change in control shall be construed as the change in the controlling interest in the

body corporate. However, the definition of “controlling interest” does not include the right to appoint majority directors or to control the management or policy decisions as provided for listed companies.

3.8.2. Therefore, the Working Group recommended that the definition of “controlling interest” may include the right to appoint majority directors or to control the management directly or indirectly.

3.8.3. No public comments have been received on this proposal. Therefore, we may agree with the recommendation of the Working Group.

### **Proposal**

3.8.4. Recommendation of the Working Group with regard to definition of ‘change in control’ may be incorporated in the proposed PMS Regulations.

## **3.9. Adoption of nomenclature “Investment Approach” for regulatory reporting**

3.9.1. Regulation 15 (1) of existing PMS Regulations states that “the discretionary portfolio manager shall individually and independently manage the funds of each client in accordance with the needs of the client in a manner which does not partake character of a Mutual Fund...”

3.9.2. Generally, each Mutual Fund Scheme has a specific investment objective and the investors’ funds are pooled to deploy them in securities on the basis of such pre-defined investment objective. It is the responsibility of the client to choose a particular Scheme of Mutual Fund based on his risk appetite and investment objectives. However, in case of Portfolio Management Services, it is the responsibility of the Portfolio Manager to make investment decisions based on risk profile, investment objective and other requirements of the client.

3.9.3. It was opined by the Working Group that, as the number of clients on-boarded by the Portfolio Manager increases, Portfolio Managers construct clients’ portfolios based on investment approaches. Portfolio Manager identifies various investment approaches and corresponding suitable investment instruments and then market such investment approaches to their prospective clients. Similarly, for the purpose of reporting, all the portfolios under one investment approach are consolidated by the Portfolio Manager to report their performance.

3.9.4. Presently while reporting to SEBI, Portfolio Managers combine the performance of all investment approaches, and therefore, the performance reported does not indicate that portfolios are consolidated under one or more investment approaches.

- 3.9.5. Accordingly, the report of the Working Group has proposed that the nomenclature “Investment Approach” be permitted for use in the regulatory reporting, client reporting, disclosure documents and all marketing material of the Portfolio Managers. As stated in the WG report, Investment Approach means investment into a specific class of securities (specific portfolio) taking into consideration various investor specific and security specific factors such as but not limited to time horizon, market cap, sectoral allocations. The Investment Approach can be different within each asset class or can be a combination of asset classes.
- 3.9.6. Nearly all the public comments received to this proposal were in favor of recognition of “investment approach”. One comment was received wherein it was suggested that SEBI should disallow “Model Portfolio” and mandate compulsory personalization of portfolio.
- 3.9.7. While portfolio managers are required to manage the funds and securities of each client in accordance with the needs of the client, thus providing customized investment portfolios, they may be allowed to report their overall performance in regulatory filings, disclosure documents and marketing material by segregating their portfolios under various investment approaches.
- 3.9.8. In view of the above, the recommendation of the Working Group may be accepted with minor modifications.

### **Proposal**

- 3.9.9. Accordingly, it is proposed that “Investment Approach” may be explained in the Regulations as a broad outlay of the type of securities and permissible instruments to be invested in by the Portfolio Manager for the client, taking into account the various client and securities specific factors.
- 3.9.10. Further, the following may be implemented by way of issuance of Circular:
- (i) Disclosure Documents as well as Periodic reporting by Portfolio Managers to SEBI shall provide overall performance data by segregating their portfolios under various “Investment Approaches”.
  - (ii) Use of nomenclature “Investment Approach” in all marketing material utilized by the Portfolio Managers.

### **3.10. Compliance with regard to Disclosure Document**

- 3.10.1. Regulation 14 (2) (a) of existing PMS Regulations require Portfolio Managers to provide a copy of the Disclosure Document to their prospective clients at least two

days prior to the execution of PMS agreement. The purpose of the Disclosure Document is to provide essential information about the portfolio services in a manner to assist and enable the investors in making informed decision for engaging a portfolio manager.

- 3.10.2. The Working Group has opined that keeping audit trail of each client having received the Disclosure Document at least two days prior to agreement execution is an onerous task and results in gaps in the process of keeping track of the same.
- 3.10.3. Further, Regulation 14 (2) (b) of existing PMS Regulations provide the minimum list of information to be made available in the Disclosure Document. The present Regulations do not specifically mention conflict of interest arising out of transactions with associates/ group companies as an information to be provided in the Disclosure Document. The report of the Working Group proposed that disclosure of Conflict of Interest which are related to services offered by Group Companies of the Portfolio Manager may be compulsorily captured in the Disclosure Document.
- 3.10.4. The report of the Working Group also proposed that the risk associated with each investment approach followed by the Portfolio Manager may be disclosed in detail in the Disclosure Document.
- 3.10.5. Regulation 14 (2) (d) of existing PMS Regulations requires the Portfolio Manager to file a copy of the Disclosure Document with SEBI, before it is circulated or issued to any person and every six months thereafter or whenever any material change is effected therein, whichever is earlier.
- 3.10.6. Considering that major sections in Disclosure Document are static in nature and would not undergo material changes very frequently (Organization history, Background, Key Management Personnel, Strategy details, Risk Chapter, Taxation etc.), the WG Report proposed that the Disclosure Document may be filed with SEBI before it is circulated or issued to any prospective investor, and at the time of any material change in information previously submitted. In case of change in material information, it is proposed that the Disclosure Document is to be filed with SEBI within 5 working days of such change becoming effective.
- 3.10.7. The public comments received on this proposal have been highly favorable. A few respondents have sought more time to file the revised Disclosure Document with SEBI as five days is too short for the same.
- 3.10.8. In view of the above, the recommendations of the Working Group may be accepted with incidental changes.

## **Proposal**

3.10.9. Accordingly, the simplified compliance requirements with regard to Disclosure Documents to be incorporated in the proposed PMS Regulations shall be as under:

- (i) Disclosure Document to be filed with SEBI for the first time upon receipt of Certificate of Registration, and within 7 working days, whenever any material change is effected.
- (ii) Portfolio Managers to provide a copy of the Disclosure Document to their prospective clients prior to the execution of PMS agreement.
- (iii) Latest Disclosure Document of the Portfolio Manager to be available on the website of the Portfolio Manager at all times
- (iv) Disclosure Document to include details of conflicts of interest which are related to services offered by Group Companies of the Portfolio Manager.
- (v) Disclosure Document to include details of risk specific to each investment approach offered by the Portfolio Manager.

### **3.11. Compliance with regard to Client Reports**

3.11.1. Regulation 21 of the existing PMS Regulations provide the list of reports to be furnished to the clients of the Portfolio Manager and such periodic reports have to be provided to the clients at least once in six months and/or as and when requested by the clients. It is understood many Portfolio Managers provide clients reports at greater frequency i.e. monthly or quarterly.

3.11.2. The report of the Working Group proposed that the periodicity of such reports may be increased to at least once in three months instead of six months. The report of the Working Group further proposed that details of commission paid to distributor(s) for each client may be furnished in the report submitted to that particular client.

3.11.3. The comments received for the above mentioned proposals have been favorable though a few respondents have sought that a format for reporting may be provided by SEBI.

## **Proposal**

3.11.4. Accordingly, the compliance requirements with regard to client reporting by Portfolio Managers to be incorporated in proposed PMS Regulations shall be as under:

- (i) Periodicity of client reporting to be at least once in three months and as and when required by the client
- (ii) Client report to inter alia contain details of commission paid to distributor(s) for the particular client

3.11.5. The format of client reporting shall be implemented by SEBI by way of issuance of Circular.

### **3.12. Performance Reporting by Portfolio Managers**

3.12.1. The Portfolio Managers report their performance through various periodic reports to SEBI and existing clients, as well as through Disclosure Documents and other marketing material to their prospective clients. While a reporting format is prescribed for performance reported to SEBI (monthly and half-yearly) there is no specific manner of calculation of performance or presentation of such information mandated under the current regulatory framework.

3.12.2. The WG Report proposed the following:

- (i) Performance reported by the Portfolio Manager to be calculated using time-weighted rate of return (TWRR). TWRR is designed to measure the performance of the account over the time period invested, and to exclude elements not usually under a Portfolio Manager's control – specifically, clients' decisions to deposit, withdraw and transfer in or out from an account.
- (ii) Performance calculated using TWRR to include all cash and all investments in liquid funds.
- (iii) Performance to be reported net of all fees, all expenses and taxes.
- (iv) Format of periodic reporting to SEBI to be revised in the manner provided in the WG Report
- (v) As a change in investment approach may impact the performance of client portfolio, such change to be disclosed to the clients in the marketing material
- (vi) Performance reported in all marketing material and website of the Portfolio Manager to be the same as that reported to SEBI.

- (vii) Performance reporting used in marketing material to mandatorily have the disclaimer that the performance related information is not verified by SEBI.
- (viii) Combined performance of all the portfolios managed by the Portfolio Manager should match with the aggregate performance at the firm level. Such performance shall be audited annually and reported to SEBI.
- (ix) The audited performance data to be self-certified by any of the Directors of the Portfolio Manager or by person(s) authorized by the Board of Directors of the Portfolio Manager.

3.12.3. Majority of the comments received were in favor of the proposal, while also seeking clarification and suggesting changes to the proposed format of performance reporting. Therefore, the recommendations of the Working Group may be accepted with incidental changes based on public comments.

### **Proposal**

3.12.4. Accordingly, a Circular shall be issued by SEBI to implement the recommendations of the Working Group with incidental changes.

## **3.13. Supervision of distributors of PMS**

3.13.1. As on date, any person/entity can refer a client to invest with a Portfolio Manager in lieu of commission. However, there is no regulatory provision that provides for assignment of responsibilities with regard to engagement of distributors to solicit clients for Portfolio Manager. Similarly, there is no Code of Conduct applicable for PMS distributors or guidelines/ regulations to deal with misinformation / mis-selling by PMS distributors.

3.13.2. It is recommended by the Working Group that:

- (i) Common minimum qualification criteria may be mandated, for distributors to solicit clients for portfolio management approaches/ services.
- (ii) Portfolio Managers to only utilize services of such distributors who have cleared NISM Mutual Fund exams or such distributors who have already been provided an AMFI Registration Number (ARN), till a separate certification for the PMS distributors is introduced.
- (iii) Code of Conduct to be mandated for distributors of Portfolio Management Services

- (iv) Distributors to mandatorily disclose their fees/ commission to the prospective clients
- (v) Distributor commission to be paid only on trail- basis and only from the fees charged by the Portfolio Manager.
- (vi) Annual self-declaration by distributors to be submitted to the Portfolio Manager with regard to compliance with code of conduct and to confirm his abstinence from mis-selling to the PMS clients

3.13.3. Varied public comments have been received on this proposal. Some of the comments are on the periodicity of self-declaration by the distributors and on the disclosure of commission received, though overall the comments are favorable to the proposal. Only a few public comments were received wherein it was suggested that the requirement of NISM Certification and/or ARN may be reconsidered.

3.13.4. Considering that the public comments are generally favorable to the proposal, the recommendations of the Working Group may be accepted.

### **Proposal**

3.13.5. Accordingly, Circular may be issued to implement the recommendations of the Working Group.

3.13.6. As on date NISM Certification is not available for distributors of Portfolio Management Services. It is proposed that certification will be designed by NISM in coordination with SEBI. Circular mandating the relevant NISM Certification for distributors of Portfolio Management Services and effective date of implementation, may be issued after introduction of such certification.

## **3.14. Rationalization of fees and charges associated with PMS**

3.14.1. The existing PMS Regulations does not mandate the type, basis, limit etc. of fees and charges levied by Portfolio Managers to their clients. There is a need to ensure transparency in the various fees and charges levied by the Portfolio Managers.

3.14.2. Therefore, it was recommended in the WG Report that:

- (i) Range of fees charged under various heads shall be disclosed in the Disclosure Document
- (ii) "Catch-up" in the context of fees charged by Portfolio Managers is not defined by SEBI, therefore, performance fee shall be charged only on "without catch-up" basis, i.e. only on the amount over and above a hurdle rate.

- (iii) Operating expenses excluding brokerage, which are over and above the annual management fees shall be capped at 0.50% per annum
- (iv) Custody Charges (component of Operating expenses) shall be capped at 10 basis points
- (v) Audit Fees / Notary Charges/ Franking / Miscellaneous (component of Operating expenses) shall be capped at 25 basis points
- (vi) Stock Broking expenses shall be charged to client account as expense, at actuals
- (vii) Transactions (Broking, Demat services, custody etc.) through Associates shall be capped at 20% per associate per calendar quarter. Any charges/fees paid to the associate not to be more than what is paid to the non-associate intermediaries providing the same service.
- (viii) Exit load shall be capped based on duration of client portfolio
- (ix) Illustration of fees and charges provided in the Disclosure Document shall be for sample portfolio of Rs. 25 Lacs (or the minimum investment amount for opening PMS account)
- (x) Requirement for client to provide acknowledgment in his own handwriting about understanding of the fee structure to be done away with.

3.14.3. Many public comments were received for the above proposal. Certain comments have stated that within the overall cap for operating expenses, further limits on individual costs may not be imposed. Few comments have been received on the proposal to limit transactions through associates, suggesting that such limit may not be imposed and instead arms-length dealing may be mandated.

3.14.4. The Working Group suggested that the performance fees shall be calculated without 'Catch-up'. However, it is understood that Portfolio Managers may also use different terminologies, such as 'Carry', 'Additional Returns', etc., for calculation of performance fees, which may not be appropriate. Since, the calculation of performance fees is not uniform, it is felt that there is a need to simplify the manner which Performance Fees is calculated.

3.14.5. The Working Group's proposal at Para 3.14.2.(vii) does not propose any cap on the Transactions executed by the Portfolio Managers' through their own registrations as Stock Brokers, Depository Participants, Custodian, etc. It is felt that a similar cap may be implemented, in this regard.

3.14.6. In view of the above, the proposal of the Working Group may be accepted with certain modifications.

## **Proposal**

3.14.7. Circular to be issued to implement the recommendations of the WG Report except those at Para 3.14.2 (iv), (v) and (x). Also, the recommendations at Para 3.14.2 (ii) and (vii), are to be revised as follows:

- (i) In para 3.14.2 (ii) – Performance fees shall be charged only on the amount over and above the hurdle rate, by following “high watermark principle”. Circular detailing finite set of models of calculating Performance Fees, will be issued by SEBI.
- (ii) In para 3.14.2 (vii) - Transactions through Associates (e.g. Broking, Demat services, custody etc.) to be capped at 20% by value per associate per calendar quarter. Any charges/fees paid to the associate should not be more than what is paid to the non- associate intermediaries providing the same service. The said requirements shall also apply in case where the Portfolio Manager is also registered as a Stock Broker, Depository Participants, Custodian etc. and execute transactions through these registration(s).

## **Part B - Other Key Proposals not part of the Consultation Paper**

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### **3.15. Definition of “change of status or constitution” of Portfolio Manager**

3.15.1. As per the existing PMS Regulations, one of the means for change in status or constitution of the Portfolio Manager, is the change in Managing Director or Whole-Time Director. Some of the public comments received on the draft of the proposed PMS Regulations have stated that change in Managing Director or Whole-Time Director may not be considered as change in status or constitution of Portfolio Manager.

3.15.2. It is noted that other SEBI Regulations governing similar business activities like SEBI (Mutual Funds) Regulation, SEBI (Alternative Investment Funds) Regulation and SEBI (Investment Adviser) Regulation do not consider change in Managing Director or Whole-Time Director as change in status or control of the intermediary. Similarly, the definition of Control in Section 2(27) of Companies Act, 2013, does not refer to Control by Managing Director or Whole-Time Director.

3.15.3. Further, the proposed definition of Principal Officer clearly assigns all responsibility for overall supervision of the operations of the portfolio manager as well as for the

decisions made by the portfolio manager for the management or administration of portfolio of securities or the funds of the client on the Principal Officer. No specific responsibilities with regard to decision making or governance are assigned to the Managing Director or Whole-Time Director. Accordingly, “Change in Managing Director or Whole Time Director” may be omitted from the definition of change in status or constitution.

### **Proposal**

- 3.15.4. Accordingly, it is proposed to delete “change in its managing director or whole-time director;” from the definition of “change of status or constitution” of Portfolio Manager.

### **3.16. Appointment of Custodian**

- 3.16.1. In the existing PMS Regulations, a SEBI Registered Custodian is to be appointed by the Portfolio Manager in case the AUM is more than Rs. 500 crore or the Portfolio Manager deals in commodity derivatives.

- 3.16.2. Considering the growth in the number of clients and AUM, it is felt that having a custodian in charge of the assets of the investors will enable better control mechanisms and also address issues of conflicts of interest. It is believed that the benefits of the proposal will outweigh the increased cost. Therefore, to protect the interest of investors of PMS, it has been felt that the requirement for appointment of a custodian may be made mandatory for all Portfolio Managers.

### **Proposal**

- 3.16.3. Accordingly, it is proposed that appointment of custodian may be made mandatory for Portfolio Managers.

### **3.17. Direct On-boarding of clients by Portfolio Managers**

- 3.17.1. Currently, clients are on-boarded in PMS industry either directly or through channel partners/distributors/agents. However, it is the discretion of the Portfolio Manager whether clients may be on-boarded directly or only through channel partners. Further, the Portfolio Manager may or may not charge such direct clients expenses related to distribution. It is desired that all the Portfolio Managers must offer clients the option to be on-boarded directly without intermediation of channel partners (‘Direct On-boarding’) and that such clients are not charged any expense related to distribution.

## **Proposal**

3.17.2. In view of the above, it is proposed to implement the following by way of issuance of a Circular:

- (i) Portfolio Managers to allow option to clients to be on-boarded directly without intermediation of channel partners/distributors/agents.
- (ii) No distribution charges, called by whatever name shall be levied on clients who are on-boarded directly
- (iii) Portfolio Managers to disclose on their websites, Disclosure Documents etc. about the option for direct on-boarding, and all the details associated with such direct on-boarding

## **3.18. Restrictions on Off Market Transfers**

3.18.1. The existing PMS regulations provide that any transaction of purchase or sale including that between portfolio managers' own accounts and clients' accounts or between two clients' accounts shall be at prevailing market price.

3.18.2. In the ordinary course of business, the off market transfers are carried out for the purpose of settlement and collateral. Off market transfer may also be carried out for buying and selling of unlisted securities. However, not defining the perimeter of off market transfers may result in misuse of clients' securities by Portfolio Managers.

3.18.3. Also, the prevailing market price may not readily be available for certain securities, which may allow discretion to Portfolio Manager in valuation of securities.

## **Proposal**

3.18.4. In view of the above, off market transfers from/to clients' accounts of any type may not be permitted, except:

- (i) for settlement of clients' own trades
- (ii) for providing margins for clients' own positions
- (iii) for dealing in unlisted securities in accordance with the Regulations
- (iv) with the express positive consent of the clients on transaction to transaction basis
- (v) as specified by SEBI from time to time.

#### 4. Proposals for consideration

- 4.1. The proposals at Para 3.1 to 3.11 (except 3.2.7, 3.9.10, 3.11.5), 3.15, 3.16 and 3.18 shall require amendment to the existing PMS Regulations.
- 4.2. The proposals at Para 3.2.7, 3.9.10, 3.11.5, 3.12, 3.13, 3.14 and 3.17 shall require issuance of circulars under the proposed SEBI (Portfolio Managers) Regulations, 2019.
- 4.3. The Board may consider and approve the proposals at Para 4.1 and the draft SEBI (Portfolio Managers) Regulations, 2019 placed at **Annexure V**.
- 4.4. The Board may authorize the Chairman to take steps to implement the proposal by notifying SEBI (Portfolio Managers) Regulations, 2019 and issuance of circulars on operational guidelines, wherever necessary, with consequential and appropriate changes, as may be required, and to take consequent steps as may be deemed appropriate to give effect to the decision.

### **Annexure I, II & III**

Consultation Paper on SEBI (Portfolio Managers) Regulations, 1993, Report of the Working Group and draft of SEBI (Portfolio Managers) Regulations, 2019 submitted by the Working Group are available on SEBI Website.

## **Annexure IV**

This has been excised.

## **Annexure V**

SEBI (Portfolio Managers) Regulations, 2019 shall be notified after following the due process.