

Proposal for recognition of Performance Validation Agency (PVA)

1. Objective

- 1.1. This memorandum seeks approval of the Board for the proposal to:
 - 1.1.1. recognize a Credit Rating Agency (“CRA”) as Performance Validation Agency (“PVA”);
 - 1.1.2. allow a recognized stock exchange to act as PVA Data Centre (“PDC”);
 - 1.1.3. make amendments to SEBI (Intermediaries) Regulations, 2008, SEBI (Credit Rating Agencies) Regulations, 1999 and Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018;
 - 1.1.4. operationalize PVA by issuing necessary guidelines through circular.

2. Background

- 2.1. Intermediaries/ other entities need to showcase their performance to expand to more clients and grow their business. However, in their bid to acquire more clients, some of these entities may indulge in making inflated claims of their performance, thereby misleading the investors. Given this, SEBI has already put in place prohibitions on certain intermediaries related to claim of their performance.
- 2.2. Investment Advisers (“IAs”) and Research Analysts (“RAs”) are involved in giving investment advice/ research recommendation respectively. In terms of the advertisement code for IAs and RA issued by SEBI, IAs and RAs are currently not allowed to refer to past performance in their advertisements, which includes all forms of communications, issued by or on behalf of IA/RA that may influence investment decisions of any investor or prospective investor.
- 2.3. Stock brokers providing services relating to algorithmic trading may need to demonstrate the performance of the algorithms so that investors are better able to understand the risk and return and deploy it towards their investment objectives. Currently, stock brokers are not allowed to make any reference to the past or

expected future return/ performance of algorithms or associate with any platform providing reference to the past or expected future return/ performance of algorithms.

- 2.4. As of now, Asset Management Companies (“AMCs”) calculate the performance of mutual fund schemes. Similarly, portfolio managers have been permitted to report their performance vis-à-vis certain benchmarks. The claims made by these intermediaries/entities are mostly self-verified and as of now, there is no dedicated agency to validate such claims.
- 2.5. There has been a demand from registered intermediaries to showcase their performance to investors so as to establish/ enhance their credibility in the eyes of investors and to help grow the reach of their services to investors. As against this, there exist a plethora of unregistered entities that not only make claims, but also absurd claims and induce investors away from registered intermediaries merely because certain registered intermediaries cannot demonstrate their performance. This feeds back into the frenzy of investors being scammed. Thus, there is an urgent need to allow registered intermediaries to provide a dashboard of their performance when they are soliciting the investor so that the investor can take an informed decision.
- 2.6. This will protect the investors from being lured away by unregistered entities, as investors will now have the additional information about validated performance when he or she deals with the registered intermediary.
- 2.7. In order to facilitate registered intermediaries to disclose their performance to investors, while at the same time having checks and balances to protect the interest of investors against unverified claims/ performance, it was proposed to create an independent body called Performance Validation Agency (“PVA”) to validate the claims/ performance related to investment advice, research recommendation, mutual fund scheme, portfolio management service, algorithm, etc. by SEBI registered intermediaries/ other entities such as IA, RA, portfolio manager, AMC, stock brokers, etc., in the consultation paper issued on August

31, 2023. Copy of the consultation paper is placed at **Annexure A**. (This has been excised for reasons of confidentiality)

2.8. The consultation paper and the public comments received were discussed in the meeting of Intermediary Advisory Committee (“IAC”) on October 17, 2023. All the members of the IAC expressed their agreement with the proposal of creation of PVA. In terms of the recommendation of IAC, a technical group for PVA was constituted comprising of representatives from Market Infrastructure Institutions (“MIIs”), CRAs, stock brokers, mutual funds, IAs, RAs, PMS and AIFs to propose the operational framework for PVA, including details such as types of performance claims, performance parameters, standard valuation methodology, performance presentation standard, required disclaimers/ disclosures, etc. The technical group submitted its report to SEBI therein specifying the operational frameworks for performance validation in respect of services of IAs/RAs and Algorithmic Trading.

2.9. (This has been excised for reasons of confidentiality)

3. Proposed structure for PVA

3.1. In the consultation paper on creation of PVA, issued on August 31, 2023, it was inter alia proposed that though a PVA might be an entity related to an MII, however, it may associate with knowledge partners such as CRAs for its activities.

3.2. (This has been excised for reasons of confidentiality), it is proposed that a CRA may be considered for recognition as PVA. Considering that the activities of evaluation of securities by CRA is similar to the proposed validation activities of performance/claims by PVA, a CRA appears to be the most suitable entity to take over the role of a PVA. Further, CRA being a regulated entity, is also subject to oversight and regulation by SEBI.

3.3. Performance validation process would entail processing humongous amount of data received from varied sources including intermediaries, MIIs etc. Hence, in order to ensure data protection/ data confidentiality, it is desirable that data should flow through minimal nodes. In view of the same, it is proposed that, since stock exchanges are the main repositories of data, one of the stock exchanges shall

serve as a recipient and repository of all relevant data from varied sources for the purpose of validation. Such stock exchange shall be referred to as PVA Data Centre (“PDC”).

- 3.4. Further, stock exchanges are in possession of technological capabilities, have experience of handling huge amount of data, and have systems/policies to ensure data protection / data confidentiality. Stock exchanges, meet stringent compliance requirements related to data protection under the specified Cybersecurity and Cyber Resilience Framework (CSCRF). Therefore, a stock exchange is suitable for the role of PDC.
- 3.5. In the interest of ensuring data protection/ data confidentiality, it is also proposed that the validation technology shall reside with the PDC, which shall carry out the validation activities as per the methodology specified by PVA. The PDC shall share the validated output to PVA for publishing on its website and onward sharing with the intermediaries/public.
- 3.6. PVA and PDC shall have principal (i.e. PVA-CRA) and Agent (i.e. PDC-Stock Exchange) relationship, with PDC performing work under the supervision of PVA.
- 3.7. In view of the discussions in foregoing paras, the proposed structure for operationalization of PVA is as follows:
 - 3.7.1. CRA/s meeting the eligibility criteria, to be specified by SEBI, shall be recognized as PVA.
 - 3.7.2. PVA shall be responsible for the validation work, which may be carried out by its agent under its supervision. One of the exchanges meeting the eligibility criteria to be specified, shall be eligible to undertake the role of PDC.
 - 3.7.3. PDC shall receive and store all the required data for validation from MIIs (i.e. exchanges, clearing corporations, and depositories), AMFI (NAVs of MF schemes) and intermediaries (e.g. advices/recommendation of IAs/RAs) through API/ file-upload, etc.

- 3.7.4. IAs/RAs will share their advices/recommendations to PDC either at the time of giving advice/recommendations to clients or at the end of the day, depending on the type of recommendations. PDC shall provide a facility for receipt of such data through API/upload etc.
- 3.7.5. While the performance validation system i.e. server, technology etc., shall reside with the PDC, PVA shall specify the validation methodology, required fields for validated output, etc.
- 3.7.6. PVA and PDC shall coordinate during the development process of validation system. PVA shall be involved in development process as well as UAT (User Acceptance Test) to ensure that the validation system is proper and in accordance with specified methodology.
- 3.7.7. Once validation system is developed, PDC shall consume the data and provide the validated output in defined format to the PVA through API.
- 3.7.8. PVA shall display the validated output on its website in specified manner along with adequate and complete disclaimers/disclosures. Intermediaries and investors will have access to validated performance on the website of PVA.
- 3.7.9. Application for recognition as PVA shall be sought from CRAs meeting the specified eligibility criteria, however, the applicant CRA must enter into an agreement with an eligible stock exchange to act as PDC and provide such details in its application to SEBI.
- 3.7.10. Recognition to a CRA shall be given as PVA, however, such recognition shall mention the name of partner stock exchange serving as PDC.
- 3.7.11. Systems and processes of PVA and PDC shall be compliant to specified Cybersecurity and Cyber Resilience Framework (CSCRF) and shall be subject to systems and process audit, as may be specified by SEBI.

4. **(This has been excised for reasons of confidentiality)**

5. **Proposed amendments to the SEBI (Intermediaries) Regulations, 2008 (“Intermediaries Regulations”), SEBI (Credit Rating Agencies) Regulations, 1999 (“CRA Regulations”) and SEBI (Stock Exchanges and Clearing Corporations) Regulations, 2018 (“SECC Regulations”) in order to operationalize PVA:**

(Amendments shall be notified after following the due process)

6. **Criteria for grant of recognition as PVA**

6.1. It is critical to ensure that a CRA undertaking the function of PVA has a stable presence, robust financial standing and systems/processes to handle grievances/disputes, hence, it is proposed that, the following eligibility criteria may be applied for recognition of a CRA as PVA:

Eligibility Criteria	Rationale
Number of years of existence: Minimum 15 years	Signifies stability and evolved operations.
Minimum net worth of INR 100 crores;	A reasonable net worth may reflect ability to make investments in technology/other resources.
No. of issuers which have obtained ratings of listed or proposed to be listed debt securities from the CRA as on the date of application for recognition as a PVA: 250 or more	Experience of handling a reasonable number of clients with listed securities indicates the ability to serve various intermediaries. Further, scalability of the operations of PVA is a factor of investment in technology and resources.
Investor grievance redressal mechanism including Online Dispute Resolution (ODR) Mechanism;	Required in order to handle investors' complaints and disputes against intermediaries availing PVA services

7. Criteria for an Exchange to act as a PDC

7.1. Given the critical role of a PDC in the validation process, it is proposed to adopt the following eligibility criteria for a stock exchange for acting as a PDC:

Eligibility Criterion	Rationale
Number of years of existence: Minimum 15 years	Signifies stability and evolved operations
Stock exchanges having a minimum net worth of INR 200 crores;	A reasonable net worth may reflect ability to make investments in technology/other resources
Stock exchanges having nation-wide terminals	Signifies stability, wider reach and ability to service investors
Investor grievance redressal mechanism including Online Dispute Resolution (ODR) Mechanism;	Required in order to handle investors' complaints and disputes against intermediaries availing PVA services

It is to be noted that the above eligibility criteria is similar to the criteria followed for recognition of a stock exchange as the RAASB/ IAASB for administration and supervision of RAs/IAs.

8. Sharing of information from MIIs, IAASB, RAASB, AMFI etc.:

8.1 Apart from the regular flow of data from intermediaries, PDC, for validation in terms of methodology prescribed by PVA, shall require a number of reports/data from various other entities ranging from MIIs such as depositories, clearing corporations, exchanges, Investment Advisers Administration and Supervisory Body (IAASB), Research Analysts Administration and Supervisory Body (RAASB), Association of Mutual Funds in India (AMFI), etc. It is proposed that the such entities may be directed by way of circular to share accurate, complete

and timely data/information with PDC and make the necessary arrangements in this regard.

9. Implementation of PVA framework

- 9.1 In the first phase, it is proposed to operationalize PVA for IAs/RAs and Algorithmic Trading through stock brokers. This would require changes in the regulatory provisions pertaining to these intermediaries in order to enable them to avail the services of the PVA and utilize details of PVA validated performance in their advertisements/ other communications.
- 9.2 As the functioning of PVA and PDC requires extensive use of technology and multiple data flows from varied entities, it is proposed that PVA be made operational for IAs/RAs and Algorithmic Trading on pilot basis for a period of two months.
- 9.3 During the pilot period, relevant fine-tuning (if required) may be carried out to ensure a stable and smooth technological system and efficient and streamlined processes. PVA shall seek feedback from IAs, RAs and stockbrokers while implementing this process during such period. Further, even though the PVA shall carry out the validation process during such period, the validated performance shall not be available to the public.
- 9.4 After the pilot period, if no major changes are required to the operational framework of PVA, it may be made effective.
- 9.5 In subsequent phases, as PVA is operationalized for other intermediaries such as PMS, Mutual Funds etc., the regulatory provisions governing such intermediaries, if required, shall be taken up for amendment.
- 9.6 The framework is proposed to be operationalized by issuing necessary guidelines through circular.

10. Review of operational framework for performance validation:

10.1 Based on the on-ground experiences of a PVA and feedback from the stakeholders, a review of the prescribed operational framework for performance validation may be required in future. In this regard, the following is proposed:

10.1.1 A CRA recognized as PVA may propose a revision in any aspects of the operational framework such as types of permissible performance claims, performance calculation methodology, performance presentation standards etc. in respect of any intermediary.

10.1.2 Such proposed changes in the operational framework may be introduced by SEBI in consultation with Industry Standards Forum (ISF) for the concerned intermediary and SEBI.

11 Proposals:

11.1 The Board is requested to:

11.1.1 consider and approve the proposals made in paras 3,6,7, 8, 9 and 10 above;

11.1.2 consider and approve the proposed amendment to the SEBI (Intermediaries) Regulations, 2008 (Intermediaries regulations), SEBI (Credit Rating Agencies) Regulations, 1999 and Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018 (SECC Regulations) as stated in para 5 above;

11.1.3 authorize the Chairperson to carry out suitable amendments to the regulatory provisions and to take any other consequential or incidental steps for implementation of the decisions the Board.

Encl:

Annexure A (Consultation paper on Performance Validation Agency)

Annexure B (This has been excised for reasons of confidentiality)

Annexure C (This has been excised for reasons of confidentiality)

Annexure A

(Available on SEBI Website www.sebi.gov.in under the head “REPORTS & STATISTICS”>> “Reports”>> “Reports for Public Comments”)

Annexure B

(This has been excised for reasons of confidentiality)

Annexure C

(This has been excised for reasons of confidentiality)