SEBI's proposals on advisors and distributors

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The recent consultation paper by SEBI (SEBI, 2016) that proposed restrictions on the use of the term "advisor", as well as on the ability of people to provide an opinion on public platforms has led to an intense debate on regulatory over-reach (Varottil, 2016). The paper, however, raises a larger question - on how should we think of distribution and advice of retail financial products - the answer to which is not obvious.

How extensively should product sale be regulated for achieving consumer protection ultimately depends on how we think of the following factors:

1. Is the product universally good, or is it good only under specific circumstance?
2. Can the customer be reasonably expected to arrive at a decision about the merits (and harms) of the product?
3. If there exists information asymmetry (i.e. the buyer cannot easily determine the quality of the product), what can drive the seller of the product to behave in the interest of the buyer?
4. What is our ability to enforce any regulation that tries to align the incentives of the seller and the buyer?

A medicine analogy

Regulations about distribution and advice connected with medicines help us see some of the issues. One could argue that a Crocin is universally useful, and most individuals should be able to decide on whether to take the medicine when feeling unwell. A simple antibiotic may be universally good (i.e. very limited side effects), but the customer may not be able to take the decision by herself. A complicated cancer drug may neither be universally good (i.e. the side effects may vary dramatically depending on the person) nor can it be expected that the customer is equipped to take the decision herself.

We may need intervention in the sale of a simple antibiotic especially if over-use imposes negative externalities by kicking off antibiotic-resistant bacteria, and definitely need intervention in the sale of a complicated cancer drug. The intervention is in the form of a prescription by someone who knows better. The doctor is expected to behave in the interest of the customer - both because she wants to retain the customer, and because there exist regulations that require a certain professional standard.

A requirement on the prohibition of sale of complex medicines without prescription is successful to the extent that the regulator can enforce it. For example, this requires knowledge of what doctors are doing, and whether they are prescribing medicines after due care. It also requires knowledge of what chemists are doing, and whether they are selling medicines only on prescription.

Thinking about financial products

How should we regulate distribution of financial products? Can we find products that are generally good for everyone? The answer to this depends on how large is the investment in the product relative to the overall portfolio of the customer. If it is a small part, then perhaps, no product is too dangerous. If it is a large part, then perhaps, any product is dangerous. If the regulator doesn't know the investors portfolio, and it is not possible or desirable for the regulator to keep a tab on this, then it becomes difficult to think of simple and complex products.

If there are no simple products, and every product is treated as a drug requiring prescription, then there is no purchase at a chemist without prescription either. This implies that sales can only happen after going through a financial advisor. What are the costs of assuming all products are complex products, and require advice? This is the same problem in making people get prescriptions for a crocin. In an economy where most saving continues to be in gold and physical assets, distributors may play an important role in taking the message of financial products to customers. Advisors may only be viable if they are also able to distribute the product. It is unclear which business model will be the most effective.

Why have we been so uncomfortable about distributors? The evidence has pointed to distributors being influenced by high commissions paid by product providers, and not caring for the customer (Anagol and Kim 2012; Halan, Sane and Thomas, 2014). As a result, regulators, especially SEBI, have taken several steps in reducing the influence of high commissions on distributor behaviour.

However, commissions are just one lever to align incentives, as this can never be achieved through a single instrument. It can be done through the following:

1. **Product regulation:** This involves ensuring that the products available for sale are not toxic in their design. This is not to give regulators unbridled powers to prohibit new products, or ban existing products, but to expect regulators to ensure that products follow basic hygiene principles on costs, investment of customer contributions and disclosures.
2. **Disclosures:** This involves maintaining easy to understand disclosures about the product for the

customer - what the product costs, what return it promises (if guaranteed), what is its past performance (over multiple horizons if the product is market linked), and what are the rules surrounding exists.

3. **Fee structure:** This involves setting up a fee schedule which has low upfront fees relative to a trail if paid by the product manufacturer. Higher fees may be possible when the customer is directly remunerating the seller.
4. **Code of conduct:** This involves providing guidelines on what is expected of the seller of a product. This ranges from requiring sellers to undertake a risk profiling of the customer, to acting in a fiduciary capacity.
5. **A redress system:** Rules on disclosures, fees and code of conduct have meaning only if there is enforcement. This can be brought about only if regulators are able to carry out proactive inspections (through mystery shopping exercises for example), listen to customer complaints through an efficient redress system, and respond both by punitive action and policy action.
6. **Uniformity across products:** Finally, all the rules that govern seller behaviour and the redress system have to be uniform across all providers, such that there is no regulatory arbitrage. In fact, the idea of solving the regulatory arbitrage issue was one of the central recommendations of the Bose Committee Report (2015).

The SEBI proposal

The SEBI proposal addresses one component of the framework required for solving the mis-selling problem. The objective of the proposal is to specify uniform standards across all intermediaries engaged in providing investment advisory services. The distributor can continue to sell products, and obtain a trail commission, but not use the title of an independent financial advisor.

In principle, and keeping aside the specific issue of regulatory over-reach related to people putting up opinions on public platforms (Shah and Zaveri, 2016), this seems to be a reasonable requirement. Customers should be easily able to distinguish "advisors" from "distributors", and then make up their minds about what works in their interest. Where the proposal becomes problematic is in requiring that distributors do not provide incidental or basic investment advice in respect of mutual fund products. If they wish to provide such advice, then they have to register with SEBI as an Investment Advisor and follow the SEBI (Investment Advisers) Regulations, 2013. This is difficult for two reasons.

First, distributors may be providing a valuable service in explaining what a mutual fund is to people who have never invested in a mutual fund. Or when a customer asks a distributor questions about the product she is buying, it may difficult to answer customer queries, without providing advice to the customer. For this the proposal says that the distributor may describe the product specification without recommending any particular product. However, one can think of several situations with descriptions of the product can be construed as product recommendation.

Second, the SEBI proposal is silent on how it will enforce this requirement. The proposal provides no clarity on what recourse a customer has if advice was given by the distributor other than a cursory mention of SCORES (the SEBI redress system), and what recourse the distributor has to justify why the information provided was not advice. We have seen from experience that distributors often get customers to sign disclosure forms, and then use these against the customer when things go wrong. The SEBI proposals do not provide any tools to ensure that such instances will not happen with these new proposals.

If SEBI is serious about segregating distribution from advice, then it needs to do a lot more work in designing guidelines on how it would distinguish between the two, and how it would enforce this distinction. SEBI also needs to put out evidence, gathered through inspections, mystery shopping exercises or analysis of customer complaints, on why advice given by distributors is not working in the interest of the customer, and what should be different about this advice. It should provide examples of what it expects distributors to do in different situations, so this could guide distributors on what exactly the regulator expects of them. It would not be very useful to proceed in the direction proposed by SEBI without such an underlying clarity, and establishment of processes to deal with such ambiguities that will certainly arise over time.

Way forward

As discussed earlier, aligning commissions, establishing advisors, enforcing the distinction between advisors and distributors are some of the requirements for getting closer to consumer protection in retail finance. However, until we enact the draft Indian Financial Code (IFC), we will continue to have sectoral regulators, and continue to grapple with the problem of regulatory arbitrage.

Even if we are able to enact the IFC, and set up the Financial Redress Agency (FRA) to deal with customer complaints, we would have made only established the institutional infrastructure. Sane and Shah (2014) suggest three other elements that are required. The first is a more detailed Consumer Protection Handbook that translates principles-based IFC into a shared contemporary practical understanding. The second is the design of the actual regulations that flow from the IFC. The third is setting up effective enforcement.

As suggested by the authors, Consumer protection would come about when individuals inside financial agencies, and those inside financial firms, have a shared understanding of all four steps: of the law, the regulations, of the kinds of enforcement actions that get taken, and the stance of the judiciary on the standards of proof that are required and on contemporary interpretation of timeless principles from the IFC. To achieve true consumer protection, we need to move towards this direction.

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