PERFORMANCE VALIDATION AGENCY FOR REGISTERED ANALYSTS AND INVESTMENT ADVISORS: SEBI CONSULTATION PAPER

Amaan Ali, National Law Institute University, Bhopal

ABSTRACT

With the recent surge in the number of investors in the market[1], Securities and Exchange Board of India (SEBI) has implemented several measures to strengthen the regulatory framework, aiming to cultivate a more robust and secure market environment for both investors and other market players. SEBI released a consultation paper to establish a Performance Validation Agency (PVA)[2]. The primary objectives of the PVA revolve around facilitating SEBI-registered intermediaries in transparently disclosing their performance metrics to investors. This aims to enhance credibility and stimulate growth within the financial sector. Concurrently, the PVA is designed to act as a safeguard, protecting investors' interests from potentially misleading and unverified claims.

[1] https://www.nseindia.com/resources/nse-5cr-unique-investors.

[2] https://www.sebi.gov.in/reports-and-statistics/reports/aug-2023/consultation-paper-on-performance-validation-agency_76220.html.

Introduction

Who is an Advisor?

An advisor, as per the specified criteria, under the SEBI (Investment Advisers) Regulations, 2013[3] is an individual or entity involved in the business of providing advice to others or issuing reports and analyses regarding securities, and who receives compensation for these services.

Any individual or entity that falls under the definition of an investment advisor (**IA**) must register with SEBI. This includes individuals, partnership firms, LLPs, companies, and other entities.

Performance Validation Agency (PVA)

A PVA is proposed to be established as an independent entity with the purpose of validating claims and performance related to investment advice, buy/sell/hold recommendations, algorithms, and other services provided by intermediaries and similar entities such as investment advisors, research analysts, and portfolio managers. Although SEBI has not yet outlined the complete eligibility criteria for the PVA, the proposal suggests that it will function as a wholly-owned subsidiary of market infrastructure institutions (**MII**) or multiple MIIs. This decision is driven by the anticipated necessity for the PVA to manage extensive datasets, an area where MIIs possess the requisite expertise.

Understanding the Rationale behind the proposal.

The SEBI's proposal to establish the PVA addresses many facets of the market one being the consistent demand from various entities, such as IAs, RAs, and stock brokers, seeking the ability to showcase their past performances and enhance their credibility in the eyes of investors[4]. Currently constrained by regulations, IAs and RAs are prohibited from citing past performances when giving advice, even the stock brokers cannot highlight past or anticipated future algorithmic performances. Consumer products, even items like washing powders, are permitted to make efficacy claims. Therefore, the query arises as to why advisors are restricted

[3]https://www.sebi.gov.in/legal/regulations/jan-2013/sebi-investment-advisers-regulations-2013-last-amended-on-december-08-2016-_34619.html.
[4]https://www.sebi.gov.in/reports-and-statistics/reports/aug-2023/consultation-paper-on-performance-validation-agency_76220.html.

from making similar claims. Whatever you don't allow over the table will go under the table. Whatever you don't allow in the sunlight will go into the darkness. Just as happened recently in the case of M.N Ansari observed to be providing recommendations (buy/sell) through social media in the name of "Baap of Chart" ("**BoC**") in the garb of providing educational training related to securities market[5]. Also, For Instance, Algo traders who claim that their products can generate 300 percent returns and so forth by presenting retrofitted data. That is, they present their product as functioning in the most advantageous circumstances, instead of testing it across scenarios including the most challenging ones.

Therefore, these restrictions have spurred the need for an independent and impartial entity like the PVA, which can effectively undertake unbiased verification of investment-related claims made by diverse entities in the financial domain, thereby enhancing transparency and credibility in the market.

Another aspect of this move is to protect investors from these fake, exaggerated claims and to provide a safe investment scenario to the people as there exist a significant gap in the verification of investment-related claims made by entities, owing to the lack of a standardized mechanism. Few companies do provide verified Profit and Loss (**P&L**), i.e., Sensibull[6], however, it's worth noting that relying on verification from a single brokerage firm may present a distorted view of an individual's trading performance across all accounts and despite SEBI's directive[7] for IA/RA to avoid false claims, investors currently lack autonomous means to independently verify the accuracy of these assertions. This gap has led to a surge in entities making exaggerated claims, with Internet Advisers, in particular, actively disseminating recommendations under the guise of educational content in rush of more clients and business. Hence, to enable investors to make an informed choice there was a need to establish an agency to verify such claims. Though this might be a radical change in the industry but there was a need to make that distinction between fact versus fake.

[5]https://www.sebi.gov.in/enforcement/orders/oct-2023/interim-order-cum-scn-in-the-matter-of-unregistered-investment-advisory-activities-of-mohammad-nasiruddin-ansari-baap-of-chart_78333.html

[6] Riskilla Technologies Pvt. Ltd. (an investment management platform for investors in retail) headquartered in Bengaluru.

[7]https://www.sebi.gov.in/legal/circulars/apr-2023/advertisement-code-for-investment-advisers-ia-and-research-analysts-ra-_69798.html

Roles and Responsibility of PVA

Scope of Validation by PVA: the Parameters Within Its Authority?

The PVA is entrusted with the critical task of validating claims made by SEBI-registered intermediaries and other entities concerning the actual profits realized by their clients through advisory services, recommendations, and other offerings. Furthermore, the PVA is mandated to authenticate the performance claims of these SEBI-registered entities and individuals, including the rigorous testing of algorithms over a reasonable prospective period. In adherence to a fundamental principle, the PVA is authorized to validate additional performance claims, ensuring the absence of cherry-picking of favorable events, strategies, clients, or other outcomes.

Emphasizing transparency, any claims put forth must be independently verifiable from sources external to the entity making the claim, reinforcing the overarching objective behind the establishment of this new agency.

The PVA's validation of performance or claims will be guided by defined parameters such as return, risk, and volatility, which will be established through consultation between the industry forum, the PVA, and SEBI. To refine these criteria, the PVA may collaborate with external knowledge partners, including credit rating agencies. A key requirement outlined in the framework is the PVA's obligation to uphold strict confidentiality throughout the validation process. Additionally, the PVA is authorized to charge a reasonable fee for its services, ensuring a balance between operational sustainability and accessibility.

An adviser must have a reasonable and independent basis for its recommendations which plays a pivotal role in the integrity of the financial advice[8]. This requirement ensures that advisers provide recommendations based on technical analysis and unbiased judgment, fostering a more reliable and trustworthy advisory scenario. Importantly, the establishment of a PVA aligns seamlessly with this principle. The PVA, by verifying and validating the claims made by advisers, serves as a deterring mechanism to enforce the requirement for a reasonable basis in

[8] In the Matter of Alfred C. Rizzo, Investment Advisers Act Release No. 897 (Jan 11, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer); In the Matter of Baskin Planning Consultants, Ltd., Investment Advisers Act Release 1297 (Dec. 19, 1991) (adviser failed adequately to investigate recommendations to clients).

recommendations. This verification process acts as an additional layer of scrutiny, reinforcing the credibility of the advice offered to investors.

Disclosure of Validated Claims/Recommendations

Following the completion of validation by the PVA, the confirmed information should be made accessible on either the entity's website or the PVA's website, depending on the nature of the verified claim or performance. SEBI-registered intermediaries, when requesting performance validation for client-specific security portfolio recommendations, are mandated to showcase these recommendations and their PVA validation on their respective websites, limiting access to the concerned clients. In cases where intermediaries seek validation for publicly made recommendations, these endorsements must be simultaneously displayed on both the intermediary's and PVA's websites on the same day itself. Additionally, when seeking validation for a recommended security portfolio, the intermediary's website and PVA will appropriately feature the performance details in a format determined by the consensus among different stakeholders of the industry, with the validation spanning a reasonable period before and after the recommendation date. Similarly, details regarding the performance of all algorithms submitted to the PVA for validation must be disclosed and exhibited on the PVA's website.

What it offers to the Prospective Investors?

The proposal to establish the PVA is a commendable step forward. Historical performance plays a significant role in investment decisions, with investors heavily relying on past data to select suitable opportunities. The PVA aims to introduce standardized criteria for claim verification, transitioning from potentially misleading self-declaratory practices to a more robust and reliable validation process. This initiative stands to benefit both investors and intermediaries. Intermediaries with accurate and genuine claims will gain credibility through PVA validation, while investors will be safeguarded from unverified or potentially deceptive claims made by other entities.

A notable feature of the proposal is that, while the PVA holds the authority to validate claims, it lacks the discretion to selectively choose which claims or performances to verify for the advantage of specific stocks or individuals. For example, verification of actual profits must be conducted comprehensively for all investors associated with a particular intermediary or entity, without selective reporting. If only an individual investor's gains are verified, the resulting report will remain accessible exclusively to that investor.

Looking ahead, the establishment of the PVA holds significant promise for investors, providing a standardized and impartial mechanism for validating performance claims by SEBI-registered intermediaries. The agency's role in scrutinizing actual profits earned by clients, performance claims, and recommended stock/portfolios is poised to foster a more informed investment culture. Investors stand to benefit from verified and reliable performance data, gaining increased confidence in their decision-making processes. Concurrently, credible intermediaries will receive recognition for their transparent and validated claims, contributing to an overall improvement in the integrity and trustworthiness of India's financial markets.

Shortcomings and the needs for further clarification and refinement.

However, amidst the laudable objectives of establishing a Performance Validation Agency (PVA), there are inherent shortcomings that merit careful consideration. Firstly, the effective functioning of the PVA hinges on the capacity of the entity handling the data to undertake the substantial responsibility of gathering, processing, and validating the voluminous amount of data generated by various intermediaries and entities. The sheer scale of this task poses a significant challenge, particularly considering the diverse range of financial products and services offered in the market. This potential strain on the PVA's resources raises concerns about the efficiency and timeliness of the validation process, potentially leading to delays in providing investors with up-to-date and accurate information. This also raises concerns about how the agency would handle sensitive information and ensure data privacy and security, as the data is very sensitive in nature, data breaches or leaks could have significant consequences.

Secondly, while the PVA is empowered to charge a reasonable fee for its validation services, determining what constitutes a "reasonable" fee may be subjective and could vary across different market participants. This introduces a level of ambiguity in the fee structure, which, if not carefully regulated, may create disparities and potentially act as a barrier for smaller intermediaries with limited financial resources. Smaller intermediaries and companies may find these requirements particularly challenging to fulfill due to their limited financial resources and operational capacities compared to larger entities. Meeting the validation standards will involve more than just paying fees—it will also require extensive data collection and reporting, potentially creating an uneven playing field. Ensuring the PVA's financial sustainability through fees while avoiding excessive burdens on market participants will be vital for the mechanism's effectiveness and broad acceptance.

Moreover, as a SEBI-recognized body, the PVA might inadvertently lead investors to develop an undue sense of security by overly relying on claims validated by it. It is essential to highlight that while past performance is an important indicator, it is not a definitive predictor of future investment outcomes. Sound investment decisions require a holistic approach, taking into account a variety of factors beyond historical data.

Thus, addressing these shortcomings is imperative to fortify the PVA's effectiveness and maintain its credibility in the financial ecosystem.

Conclusion

SEBI's proposed establishment of the Performance Validation Agency (PVA) represents a significant step toward enhancing transparency and credibility in India's financial markets. This initiative, detailed in the consultation paper, outlines the PVA's mandate to independently validate claims and performance related to investment advice, buy/sell/hold recommendations, and algorithms offered by intermediaries. While there are acknowledged shortcomings, careful considerations regarding data handling entities and fee structures can effectively overcome these challenges.

To address the identified shortcomings, it is imperative to establish stringent criteria for the entity responsible for handling the substantial amount of data, ensuring its capacity to gather, process, and validate information. Simultaneously, implementing a reasonable fee structure for the PVA's services will ensure financial sustainability without imposing undue burdens on smaller intermediaries. These measures are crucial for the successful functioning of the PVA.

Looking ahead, the establishment of the PVA holds great promise for investors, ushering in a new era of reliability and accountability. The agency's role in scrutinizing actual profits, performance claims, and recommended stock/portfolios will contribute to a more informed investment culture. Investors will benefit from verified and reliable performance data, gaining increased confidence in their decision-making processes. Concurrently, credible intermediaries will receive recognition for their transparent and validated claims, fostering an overall improvement in the integrity and trustworthiness of India's financial markets. The PVA emerges as a pivotal player in shaping a more robust and trustworthy financial ecosystem, reflecting a commendable initiative by SEBI.