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Via e-mail to: susantad@sebi.gov.in and sunilk@sebi.gov.in

Re: ***Proposed Policy for Improvement in Sales Practice by the Members of the Stock Exchanges***

Dear Mr Das

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre")[1] and the Indian Association for Investment Professionals ("IAIP") are pleased to comment on *Proposed Policy for Improvement in Sales Practice by the Members of the Stock Exchanges* ("Proposed Policies"), put forward by the Securities and Exchange Board of India ("SEBI") on 31 March 2008. The CFA Institute Centre represents the views of investment professionals to regulators and standard setters worldwide on issues that affect the practice of financial analysis and investment management, as well as the integrity of global financial markets. The IAIP represents nearly 358 investment professionals in India and the Subcontinent, and is a member society of CFA Institute.

General Comments

We commend the SEBI for addressing the issue of improving the sales practice of member-brokers and strongly support the principles of Proposed Policies, except where discussed below. A fundamental principle of ethical investment practice is that the best interests of the investing client must take precedence over the interests of investment professionals and their employers. Every investment professional must take personal responsibility for ensuring and maintaining independence and objectivity when conducting financial analysis, preparing research reports, making investment recommendations, and taking investment action on behalf of clients. This responsibility and the need for full disclosure of conflicts of interest is clearly stated in the CFA Institute *Code of Ethics* and *Standards of Professional Conduct* (Code and Standards) by which CFA Institute requires all of its individual members to abide.

We address the specific questions in the consultation paper below.

[1] The CFA Institute Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, Virginia, USA, and regional offices in London, Hong Kong, and New York, CFA Institute is a global, non-profit professional association of more than 94,500 financial analysts, portfolio managers, and other investment professionals in 136 countries and territories, of which nearly 79,400 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute membership also includes 135 Member Societies and Chapters in 56 countries and territories.

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1. Strengthening KYC Norms

a) The Exposure/Turnover limit given by the trading members should be commensurate with the financial details of the clients reported in the KYC. The said limit to be specified in the KYC and strictly adhered to or the details in KYC to be suitably modified.

b) Only person with financial standing at least comparable to that of the client he is introducing should be accepted as introducer. The documents such as PAN Card, Income Tax Return / Proof of residence etc to be maintained along with the KYC of the client to whom he is introducing.

While the CFA Institute Centre and IAIP recognize the initiative of SEBI to enhance current regulations governing KYC norms, we believe that the above proposals introduce practical challenges that outweigh their good intentions, for the following reasons:

1. Requiring an introducer to have a comparable financial standing to the potential client unduly limits the circle of individuals he or she may be able to introduce to a broker member, and consequently, to the financial market as a whole.

2. The proposed requirement also creates a situation where both the introducer and the potential client will have to share their personal financial details in order to determine whether they have comparable financial standings. We believe that this is an unnecessary intrusion in the privacy of both individuals; sharing of such financial information, in our view, should occur solely between the client and his broker.

With reference to other jurisdictions, we are aware that in Singapore, the introducer is not required to be of comparable financial standing, and while identification papers and proof of residence are required, Income Tax Return is only optional.

2. Work history & background of the Trading Member

a) Trading Members may be required to inform the clients (upfront at the time of entering into Member-Client agreement) about work history & background of their firm.

b) Actions against the trading member for non-compliance/breach of regulatory requirements, investor grievances & arbitration cases filed, pending etc. may be disclosed.

The CFA Institute Centre and IAIP agree with this proposal. Broker members who have been entrusted with their clients' money have the responsibility to disclose regulatory or disciplinary action taken against them or their personnel related to professional conduct *when asked by the client*. We believe that when *solicited by clients*, managers must fully disclose any significant instances in which any employee or the firm has been found to have violated conduct standards or other standards reflecting on the integrity, ethics or competence of the individuals or organization involved. This helps build mutual trust and openness between the two parties.

3. Sales practices

a) Trading members owe their clients a duty to provide suitable investment advice in the best interest of the clients. The basis of sales efforts should reasonably represent fair treatment for the persons towards whom the sales efforts are directed.

b) While recommending purchase or sale of any security / derivatives contract to a client, trading member shall have reasonable grounds for believing that the recommendation is suitable for such client on the basis of the facts disclosed by such client as to his / her financial position, other security holdings, past investment experience & pattern and investment needs.

c) Prior to the execution of transactions on behalf of a non-institutional client, trading member shall make reasonable efforts to obtain the following information regarding the client

Financial status
Investment objectives
Past investment experience & pattern
Risk appetite of the client.
Such other information considered to be reasonable by the trading member

d) Trading members shall not recommend to any client any transactions unless they have reasonable grounds for believing that the entire recommended transaction is not unsuitable for the client, based on the information provided by the client and after reasonable enquiry by the trading member.

e) Trading members shall ensure that the client is adequately informed of the nature and the implication of the recommended transactions and the facts or circumstances which the client needs to know in order to make informed purchase or sale decision.

f) Trading members shall also assure themselves that the client understands the risks involved in such orders and has sufficient net worth to be able to assume the risks and bear the potential losses if such orders result in trades.

g) Trading members shall not recommend to their clients securities or derivative contracts on such securities in a concentrated manner, which represents a subjective or arbitrary supply of information.

h) Trading members shall also ensure timely execution of such transactions of their clients so as to ensure best available price for the client.

The CFA Institute Centre and IAIP support the principles of the Proposed Policies above, which are in line with the Suitability Standards in CFA Institute's *Standards of Practice Handbook (SOPH)* for Chartered Financial Analysts. The SOPH is a handbook that provides guidance and interpretation to the Code and Standards.

On dealing directly with brokers without the benefit of consulting a professional investment advisor, we believe that non-institutional investors have the responsibility to conduct research before making an investment decision and placing a trade order. For practical considerations and as practiced in other jurisdictions, Proposed Policy 3c above should not be required for every trade, as this should have been established at the point of opening an account. The broking firm, however, should have the discretion to request more information from its clients as it deems necessary. Proposed Policies 3d through 3h are good professional conducts brokers must adhere to; however, they are lacking guidelines on their implementation and enforcement, particularly when a violation of the abovementioned conduct results in a loss to the client. To further safeguard the interests of non-institutional clients, we propose that said Proposed Policies be brought to the fore and specifically stated in the client agreement.

In line with practices in other markets, we further recommend that brokers' conversations with clients on the telephone be taped, and that there be a time stamp on client orders.

In most jurisdictions the Proposed Policies above would be more directly relevant for the asset management business rather than the brokers and sub-brokers. In addition to our Code and Standards we would also like to take this opportunity to introduce to you the CFA Institute's *Asset Manager Code of Professional Conduct,* which outlines the ethical and professional responsibilities of firms that manage assets on behalf of clients. The Code encompasses the principles in the Proposed Policy above, and elaborates on the following six key responsibilities of asset managers to their clients:

- Act in a professional and ethical manner at all times
- Act for the benefit of clients
- Act with independence and objectivity
- Act with skill, competence and diligence
- Communicate with clients in a timely and accurate manner
- Uphold the rules governing capital markets

Developed by CFA Institute for the global asset management industry, the *Asset Manager Code of Professional Conduct* has been presented to regulators, standard setters and relevant industry organizations worldwide, and used as a template for similar codes in various jurisdictions.

4. Excessive trading activity

a) Trading members shall not encourage or induce excessive trading or speculative activity in a client's account which is not in accordance with the objectives, risk appetite and financial situation of the client involved.

As mentioned in our prior comment, were this Proposed Policy to apply between brokers and non-institutional clients, CFA Institute Centre and IAIP believe that while beneficial the proposal needs guidelines on its implementation and enforcement, particularly when a violation of the abovementioned conduct results in a loss to the client.

5. Fair dealing with customers with regard to derivative products or new financial products

a) Trading members shall ensure fair dealing with customers when making recommendations or accepting orders for derivatives contracts and new financial products.

b) As new products are introduced from time to time, it is imperative that trading members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding such products.

c) The clients may be required to have certain minimum amount of net-worth (e.g.5 lacs) for trading in Derivative Segment. A net-worth certificate from a practicing Chartered Accountant or acknowledgement for I.T. return filed should be accepted in this regard.

d) While registering any client for Derivative Segment, apart from signing a Risk Disclosure Document, the trading member also should ensure that adequate training vis-à-vis risk associated (including margin requirement) with Derivative Segment is imparted to the clients.

CFA Institute Centre and IAIP support Proposed Policies 5a and 5b, as they are consistent with the Fair Dealing and Suitability standards of our *Standards of Practice Handbook* for Chartered Financial Analysts. Investment professionals must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities. Likewise, investment professionals must determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.

One important component the CFA Institute Centre and IAIP wish to highlight in this Proposed Policy on new financial products – as suggested in Proposed Policy 5d – is continuing education. As practiced in overseas markets, licensed investment professionals are required to undergo compulsory continuing education, with particular focus on new products. We are aware that Singapore Exchange, for example, holds public investor education workshops on a weekly basis. As an alternative, CFA Institute, as the world's leading professional organization for financial analysts, conducts in-person and makes available online continuing education programs for chartered financial analysts and interested investors worldwide.

Furthermore, we agree with Proposed Policy 5c allowing for broker-members to set a minimum net worth to brokers wishing to participate in the derivatives segment. We believe this is a good suggestion already in practice in other countries. To broaden the options for broker-members, another alternative that SEBI might accommodate is to require clients in the derivatives segment to maintain a minimum account balance instead of a minimum net worth. We believe that the account-balance information is easier to monitor, and always more current and relevant to the broker than a client's net worth.

With further reference to overseas markets, we are aware that in Singapore, a separate agreement/ account opening form is required for derivatives trading; that no minimum net worth requirement is in place to open such account; and that trading representatives need to highlight the higher risks of derivative products.

6. Conflicts of interest

a) Trading members must maintain Chinese wall among its various activities such as proprietary trading, investment banking, research etc.

CFA Institute Centre and IAIP agree with the principles of the items in the above Proposed Policies. We believe that “fire walls” must exist in broker-members’ businesses to maintain the integrity of the capital market. Proposed Policy 5a, however, lacks compliance and implementation guidelines to this vital aspect of broker-members’ business operations.

As outlined in the Integrity of the Capital Markets Standard of CFA Institute’s *Standards of Practice Handbook*, a “fire wall” is the most widely used approach to preventing communication of material non-public information within firms. It restricts the flow of confidential information to those who need to know the information to perform their jobs effectively. For a fire wall to be effective in a multi-service firm, an employee can be allowed to be on only one side of the wall at any given time; i.e., there should be no overlap of personnel between such departments.

A primary objective of an effective firewall procedure is to establish a reporting system in which authorized people review and approve communications between departments. If an employee behind a fire wall believes that he or she needs to share confidential information with someone on the other side of the wall, the employee should consult a designated compliance officer to determine whether sharing the information is necessary and how much information should be shared. If the sharing is necessary, the compliance officer should coordinate the process of “looking over the wall” so that the necessary information will be shared and the integrity of the procedure will be maintained.

CFA Institute’s *Standards of Practice Handbook* further elaborates on recommended procedures for compliance to fire wall best practices, and we wish to provide this document to SEBI and interested member-brokers for their consideration when instituting fire wall provisions.

6. Conflicts of interest (cont.)

b) No trading member may directly or indirectly offer favorable research or a specific price target to a company as consideration or inducement for the receipt of business or compensation.

c) Trading members shall ensure that no research analyst may purchase or sell any security issued by a company that the research analyst follows or derivative of such security, for a period beginning 30 calendar days before and five calendar days after the publication of a research report concerning the company.

d) Trading member shall ensure that no research analyst may purchase or sell any security or derivative of such security in a manner inconsistent with the research analyst’s recommendation as reflected in the most recent research report published by the member.

e) A member must disclose in research reports and a research analyst of the trading member must disclose in public appearances:

(a) if the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and

(b) the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position) any other actual, material conflict of interest of the trading member or research analyst of which the trading member knows or has reason to know at the time of publication of the research report.

CFA Institute Centre and IAIP agree with the principles of the items in the above Proposed Policies. Lack of objectivity and independence of research analysts weaken investor confidence in the financial markets, and taint the reputation of all investment professionals. We believe that the above Policy Proposals are in line with the Personal Investments and Trading Standards, as well as Disclosure Standards, of CFA Institute's *Research Objectivity Standards*. We believe however that the proposed policies above does not cover the relationship between the research analysts and the companies they cover, and the research analysts and their employers. We believe that these relationships have a direct impact on the sales practices of broker members, and offer the following suggestions, taken from CFA Institute's *Research Objectivity Standards:*

Relationships with Subject Companies

Firms must implement policies and procedures that manage the working relationships that research analysts develop with the management of subject companies. Research analysts must be prohibited from:

(a) Sharing with, or communicating to, a subject company, prior to publication, any section of a research report that might communicate the research analyst's proposed recommendation, rating, or price target; and

(b) Directly or indirectly promising a subject company or other corporate issuer a favorable report or a specific price target, or from threatening to change reports, recommendations, or price targets.

Investment Banking

Firms that engage in, or collaborate on, investment banking activities must:

(a) Establish and implement effective policies and procedures that:
- i. Segregate research analysts from the investment banking department; and
- ii. Ensure that investment banking objectives or employees do not have the ability to influence or affect research or recommendations;

(b) Implement reporting structures and review procedures that ensure that research analysts do not report to, and are not supervised or controlled by, investment banking or another department of the firm that could compromise the independence of the analyst; and

(c) Implement procedures that prevent investment banking or corporate finance departments from reviewing, modifying, approving, or rejecting research reports authority.

Research Analyst Compensation

Firms must establish and implement salary, bonus, and other compensation for research analysts that:

(a) Align compensation with the quality of the research and the accuracy of the recommendations over time; and

(b) Do not directly link compensation to investment banking or other corporate finance activities on which the analyst collaborated (either individually or in the aggregate).

CFA Institute Centre and IAIP are happy to provide CFA Institute's *Research Objectivity Standards* to SEBI and interested member-brokers for their consideration when instituting research-objectivity provisions.

7. Record Keeping

a) Trading members shall establish and maintain procedures to ensure that sufficient information is recorded and retained about their business and clients for enabling themselves to justify the risk profiling of their clients and the suitability of any advice given.

CFA Institute Centre and IAIP agree with this proposal.

8. General obligations

a) Fictitious accounts: Trading members shall not allow establishment of fictitious accounts in order to execute transactions which otherwise would be prohibited or to disguise such transactions.

b) Unauthorized transactions: Trading members shall not cause to execute transactions which are not explicitly authorized by the client concerned.

c) Misuse of customers' funds or securities: Trading members shall not use clients' funds and / or securities otherwise than as prescribed in the rules, bye-laws, regulations and circulars issued there under.

d) Front running: Trading members shall not execute transactions for own account in securities ahead of making recommendations to their clients in such securities. Trading members shall also have adequate systems in place to maintain the confidentiality of the information about their dealing by their clients.

e) Trading members or their representatives shall not indulge in any fraudulent activities, such as forgery, non-disclosure or misstatement of material facts, manipulations and various deceptions. Making, directly or indirectly, any false or misleading advertisement or any untrue statement of a material fact, constitutes a fraudulent, deceptive or manipulative act on the part of trading members.

CFA Institute Centre and IAIP support the above Proposed Policies. We suggest that to further prevent the creation of fictitious accounts, as practiced in other markets, the new account holder must be physically present, or the new account be notarized; and to prevent the misuse of customers' funds or securities, client monies should be kept separate from company's funds in a trust account.

We also wish to build on the Proposed Policy against front-running and its implementation. As stated in CFA Institute's *Asset Manager Code of Professional Conduct,* broker-dealers particularly those in asset management should give priority to investments made on behalf of the client over those that benefit their own interests. Managers must not execute their own trades in the same security prior to client transactions. Investment activities that benefit the manager must not adversely affect client interests. Managers must not engage in trading activities that work to the disadvantage of clients.

Managers should develop policies and processes designed to ensure that client transactions take precedence over employee or firm transactions. One possible method would be to create a restricted list and/or watch list of securities that are owned in client accounts or may be bought or sold on behalf of clients in the near future and require employees to seek approval prior to trading in any of these securities. In addition, managers could require employees to provide the compliance officer with copies of trade confirmations each quarter and annual statements of personal holdings.

CFA Institute Centre for Financial Market Integrity and the Indian Association of Investment Professionals appreciate the opportunity to comment on SEBI's *Proposed Policy for Improvement in Sales Practice by the Members of the Stock Exchanges*. If you have questions or seek amplification of our views, and feel that CFA Institute Centre and IAIP may be able to help with the adoption of our *Standards of Practice Handbook, Asset Manager Code of Professional Conduct,* and *Research Objectivity Standards* for the Indian market, please feel free to contact Lee Kha Loon, CFA, by telephone at +852-3103-9303 or by email at khaloon.lee@cfainstitute.org, or Sunil Singhania, CFA, at 022-3021-6758 or sunil.sunils@gmail.com.

Respectfully,

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