

**Country Review: Democratic Socialist Republic of  
Sri Lanka**

**IOSCO Objectives and Principles of Securities  
Regulation**

**Detailed Assessment of Implementation**



**OICU-IOSCO**

**THE BOARD  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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## GLOSSARY

Advisory Committee	High Level Advisory Committee to the SEC and CSE
ATS	Automated Trading System
ATS Rules	Automated Trading System Rules
BBO	Broker Back Office
Bribery Act	Bribery Act No 11 of 1954
CAR	Capital Adequacy Ratio
CBSL	Central Bank of Sri Lanka
CCP	Central Counterparty
CDD	Customer Due Diligence
CDS	Central Depository System
CDS Rules	Central Depository System Rules
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CIS	Collective Investment Scheme (in Sri Lanka, typically a Unit Trust/Exchange-Traded Fund)
CMET	Capital Market Education and Training arm of the SEC
COPE	Committee on Public Enterprises
Corporate Governance Code	Code of Corporate Governance 2013
CPD	Continuous Professional Development Programmes
CPSS	Committee on Payment and Settlement Systems
CRA	Credit Rating Agency
CSD	Central Securities Depository
CSE	Colombo Stock Exchange
DEA	Direct Electronic Access
EMMOU	Enhanced MMoU on Enforcement Cooperation (currently in drafting stage)
FIRST initiative	World Bank Financial Sector Reform and Strengthening Initiative
FMI	Financial Market Infrastructure
FSAP	IMF and World Bank Financial Sector Assessment Program Update 2015
ISA	International Standards of Auditing
IASB	International Accounting Standards Board
IBSL	Insurance Board of Sri Lanka
ICASL	Institute of Chartered Accountants of Sri Lanka
IFIAR	International Forum of Independent Audit Regulators
IFRSs	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IOSCO Principles	IOSCO Objectives and Principles of Securities Regulation
IPO	Initial Public Offering

ISSAI	International Standards of Supreme Audit Institutions
IT	Information Technology
KYC	Know Your Customer
Listing Rules	CSE Listing Rules
LKAS	Lanka Accounting Standards
LKR	Sri Lankan Rupees
Minister	(since September 2015) Minister of National Policy and Economic Affairs
MMoU	IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information
MOU	Memorandum of Understanding
NAV	Net Asset Value
NCR	Net Capital Ratio
NSE	National Stock Exchange of India
OMS	Order Management System
PFMIs	IOSCO-CPMI Principles for Financial Market Infrastructures
RMS	Risk Management System
ROSC	World Bank Report on Standards and Codes (Accounting and Auditing) 2015
SEC	Securities and Exchange Commission of Sri Lanka
SLAAS Act	Sri Lanka Accounting and Auditing Standards Act No 15 of 1995
SLAASMB	Sri Lanka Accounting and Auditing Standards Monitoring Board
SLAuSs	Sri Lanka Auditing Standards
SLFRSs	Sri Lanka Accounting Standards
SLSQC	Sri Lanka Standard on Quality Control
SRO	Self-Regulatory Organization
SSSS	Scripless Securities Settlement System
the Act, the SEC Act	Securities and Exchange Commission of Sri Lanka Act No 36 of 1987 as amended by Act No. 26 of 1991, Act No. 18 of 2003 and Act no. 47 of 2009
the Commission	Securities and Exchange Commission of Sri Lanka
the Companies Act	Companies Act No. 17 of 1982
the Exchange	Colombo Stock Exchange
the IOSCO Code	(in relation to CRAs) IOSCO Code of Conduct Fundamentals for Credit Rating Agencies
VAR	Value at Risk
XML	Extensible Markup Language

## I. INTRODUCTION

This Country Review was conducted by the IOSCO Assessment Committee (AC) following a request by the Securities and Exchange Commission of Sri Lanka (SEC), as part of its efforts to assess its capital market regulatory framework as at July 2016 against the IOSCO Objectives and Principles.

After three decades of civil war and political instability, Sri Lanka has embarked on a program of reform intended to enable the country to emerge as an internationally competitive middle level economy.

The Sri Lankan authorities have recognized that the significant post-war economic growth will only be sustained with equally significant structural reforms.

The development of deep and liquid capital markets should be – and has been – recognized by the Sri Lankan authorities as a priority in this reform program. Deep and liquid capital markets are critical to economic growth. They channel savings to meet investment needs. They offer opportunities to build investor wealth and for market participants to manage risk.

The challenge Sri Lanka faces in building deep and liquid capital markets is significant. Its capital market is small, relatively illiquid and somewhat unsophisticated. Market capitalization and the value of market turnover have fluctuated between 25% and 30% of GDP in recent years, significantly less than other jurisdictions in the region.

The key to building deep and liquid capital markets is building investor trust and confidence in those markets. This, too, remains a challenge for Sri Lanka. The World Economic Forum's Global Competitiveness Report for 2015-16 ranked Sri Lanka 51<sup>st</sup> with respect to financial market development based on a series of parameters that addressed efficiency, trustworthiness, and confidence in its financial markets, compared with Malaysia (ranked 9<sup>th</sup>) and Thailand (ranked 39<sup>th</sup>).

The development of a sound and robust regulatory framework for capital markets – both in design and operation – is an essential precondition to building this trust and confidence.

The World Bank, in its recent Market Development Financial Sector Assessment Program (FSAP), highlighted the challenges facing Sri Lanka when recommending modernization reforms. It noted the dominance of banks as a source of finance for Sri Lanka's industries and households<sup>1</sup>, its low stock market capitalization compared to other emerging markets in Asia, and its weak corporate bond and managed investment sectors.

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<sup>1</sup> Recent CSE and CBSL data points to 57% of assets of the Sri Lankan financial sector being held in the banking sector, with listed and unlisted debt and equity securities accounting for 19% at the end of 2015. Banking sector assets were valued at 64% of GDP at the end of 2014 compared with market capitalisation which was valued at 32% of GDP (*Source – SEC data*).

The World Bank made a number of high-level recommendations intended to support a restoration of this trust and confidence, including ensuring that the regulatory framework meets the standards set out in the *IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles)*.

The Sri Lankan authorities note that the World Bank's observations confirmed their assessment about the Sri Lankan market. Some of the World Bank's recommendations have been the subject of policy commitments made by the Sri Lankan authorities with some action already taken, including proposals to amend the relevant legislative framework for capital markets regulation and other market development initiatives.

In the context of these developments, the IOSCO Assessment Committee (AC) has conducted a Country Review of Sri Lanka to assess the Sri Lankan regulatory framework against the IOSCO Principles. This Report contains the outcomes of the AC's detailed assessment, makes recommendations for addressing identified gaps in implementation, and sets out a road map to implement and prioritize those recommendations.

The Review Team (RT) wishes to thank the staff of the SEC for the collaborative and professional approach they brought to the review process, and the large volume of work they completed in preparing the self-assessment and responding to the numerous and, in many cases, complex questions the Review Team posed.

## II. EXECUTIVE SUMMARY

Sri Lanka faces significant – but not insurmountable – challenges in building the capital markets to which it aspires.

This Review has identified significant shortcomings in the Sri Lankan regulatory framework, with almost all assessed IOSCO Principles rated as Broadly (11 Principles), Partly (17 Principles) or Not Implemented (6 Principles).

This Report makes recommendations intended to bring Sri Lanka's regulatory framework in line with international standards. By building trust and confidence in the use of capital markets, implementation of the recommendations will also provide a framework and foundation for capital markets which will allow them to play a more significant and sustainable role in supporting the growth of the Sri Lankan economy in the future.

The shortcomings listed and recommendations included in this Review confirm and build on those identified and made by the World Bank in 2015.

### **Shortcomings**

The shortcomings identified by this Review relate both to the **design** and **operation** of the regulatory framework.

In relation to the **design** of the regulatory framework, the Review notes the following:

- There have been perceptions of a lack of independence of the SEC from political interference in its decisions and day-to-day operations. These perceptions must be addressed through legislative and operational changes before trust and confidence in the Commission and the markets it regulates can be restored. The RT notes that SEC has initiated a wide-ranging reform of its governing legislation towards this end;
- The legislative and regulatory framework is outdated. It has developed in a piecemeal and ad-hoc fashion. It relies on broad, high-level provisions as the source of SEC authority in a number of areas, without concrete and clear guidance to the regulated population about how this authority will be exercised. Revisions to the Securities and Exchange Commission Act (**SEC Act**) to address these concerns are now underway and should continue to be treated as an urgent priority;
- Gaps and inconsistencies are evident in the regulation of key – and potentially risky – parts of the Sri Lankan capital markets:
  - The activities of investment banks, financial planners and advisors, and the activities of employees of market intermediaries, are largely unregulated;
  - The framework for regulating market intermediaries is different to the framework for regulating management companies of unit trusts, which are both different again to the frameworks for regulating stockbrokers and stock dealers;
  - Trustees of unit trusts are subject to minimal regulation and oversight;
  - The issue of unlisted corporate securities and debentures to the public is subject to fewer regulatory requirements than the issue of listed securities.
- Although international audit and accounting standards have been adopted in Sri Lanka, the legal framework in Sri Lanka for setting, supervising and enforcing those standards has relatively limited public interest oversight with the SEC having a limited role falling short of the co-operation or oversight contemplated by the IOSCO Principles;
- The enforcement powers of Sri Lankan authorities are limited. The SEC and the Sri Lanka Accounting and Auditing Standards Monitoring Board (**SLAASMB**) each have powers to initiate criminal action and, along with the Colombo Stock Exchange (**CSE**), have some powers to take administrative actions. None of these authorities can take civil action. Criminal penalties are light by international standards and are not sufficiently dissuasive;
- There are very few formal co-operation arrangements between authorities with a role in regulating capital markets and the financial system, although with some, there is significant informal engagement. The SEC has an MoU in place only with SLAASMB. Formal engagement with the Central Bank of Sri Lanka (**CBSL**), the Registrar of Companies and Institute of Chartered Accountants of Sri Lanka (**ICASL**) is limited to ex officio membership of the Commission. There are no formal arrangements with the Attorney-General's Department or the CSE.



There are also significant shortcomings in the **operation** of the regulatory framework:

- The SEC does not currently employ a risk-based approach to supervision. There is no risk based framework in place to select and prioritize the regulated entities to be inspected nor the frequency or intensity of those inspections. While the SEC undertakes a fair number of supervisory visits annually, these visits (particularly those for managing companies and investment managers) appear to be compliance audits. Although they do cover risks such as credit and operational risks, they are not sufficiently geared toward developing a holistic picture of the firms' weaknesses and risks. The RT notes the SEC advises it is gearing up to address this recommendation.
- Despite steps to improve the quality of the cadre of supervisory staff, who are the public face of the SEC and provide front line contact with the market, scope remains to improve the level of understanding by staff of the entities regulated. There is a need to develop staff in these areas and, where possible, to ensure new hires are drawn directly from the markets.
- There are concerns that although the SEC does follow up on site inspections with a view to identifying deficiencies and issues of non-compliance, it has taken limited regulatory action. The RT notes SEC's advice that it is making a concerted effort to raise standards, while remaining sensitive to the circumstances under which regulatees operate.
- Prosecution of breaches the SEC believes warrant criminal action is severely impeded by slow progress within the Attorney-General's Department in considering references from the SEC. The SEC relies on the issue of cautions and warnings to deal with behavior it believes fall short of the requirements to establish criminal liability. The SEC lacks consistency in the expertise and experience of staff at senior management level, in certain critical areas which are necessary in order to deliver on its core responsibilities. This has meant that talented middle level staff members in these areas lack the direction, mentoring and guidance needed to build a strong and effective cadre of regulatory professionals. These resourcing issues at senior management level also mean that the Director-General, and at times the Commission, play a greater role in operational decision making, limiting the time available to them to provide strategic direction to the SEC and to monitor its progress.
- Communication and consultation with the regulated population about the SEC's strategic direction and its policy positions needs to improve. The regulated population needs, and looks for, clarity and certainty in what the regulator is doing and plans to do.
- The ability of the SEC to identify and assess emerging risks, both within and outside its regulatory perimeter requires further attention. The SEC would benefit from establishing a unit with responsibility for identifying and analyzing emerging risks.
- The SEC's internal audit processes focus on financial – rather than strategic and governance – issues. The SEC would benefit from an audit process which reviews whether and how the SEC is delivering on both its strategies and its mandate.
- Supervision of the auditing profession requires attention by responsible authorities in light of the significant opportunities to improve audit quality.

## Recommendations

The SEC and the Sri Lankan government, to their credit, have recognized many of the above shortcomings, and have proposals in place to address many of the design issues and some operational issues identified in this Report.

However, further action is needed, with priority given to the following recommendations.

The recommendations are not simply about ensuring that the SEC has the powers it needs to regulate and supervise capital markets to engender trust and confidence. Indeed, trust and confidence requires more than simply the regulator having adequate powers. It requires the following – each of which is sought to be addressed by our recommendations:

- confidence that powers are being exercised fairly, objectively and consistently;
- confidence that supervision of markets and market participants is robust; and
- misconduct is not tolerated.

## Framework Design

**The regulatory remit of the SEC and its powers should be extended and augmented as a matter of priority to ensure that the SEC is equipped to effectively regulate capital markets in Sri Lanka. The powers of other authorities participating in the regulation of capital markets should also be augmented.**

1. **Proposed revisions to the SEC Act should be made and implemented as a matter of priority.** Revisions addressing the following are particularly **critical to building trust and confidence** in both the SEC and the markets it regulates. The RT understands from the SEC that these revisions are being drafted:
  - Securing the **independence** of the SEC Commission and Director-General from government, by introducing fit and proper criteria for appointment, limiting removal to removal for cause, and introducing term limits. These revisions should be supplemented by an annual Statement of Expectations setting out the government's expectations of the SEC, and the basis for ministerial interaction and engagement with the SEC;
  - **Augmenting the SEC's powers to remediate and enforce breaches** of the Act, regulations, rules and directives through civil and administrative means. **These revisions are seen as being of particularly high priority;**
  - Bringing investment banking, financial advice and planning activities, investment advisory services and individuals acting on behalf of market intermediaries within the **regulatory remit of the SEC;**

- Introducing a **single licensing framework** setting **consistent and robust requirements** for all **market intermediaries** and empowering the SEC to impose conditions on the grant or renewal of any license; and
  - Providing for the SEC to **approve all public offer documents** whether issued by listed or unlisted issuers.
2. **Further revisions to the SEC Act and Companies Act** are also needed. These include the following which should also be made as a priority:
- Revisions to the **SEC Act** to:
    - raise criminal penalties to an appropriately dissuasive level;
    - clarify the SEC’s role in monitoring, mitigating and managing systemic risk and in reviewing the regulatory perimeter;
    - ensure the SEC is explicitly able to conduct inspections without notice;
    - specify clearly that SEC directions made under the SEC Act have the force of law with a breach of such a direction warranting remedial action – criminal, civil or administrative;
    - ensure the SEC is empowered to share information pertaining to an investigation with foreign regulators without the consent of the person under investigation; and
    - enhance the SEC’s powers in relation to the failure of a market intermediary.
  - Revisions to the **Companies Act and the SEC Act** to ensure the same disclosure requirements apply to issues to the public – whether by a listed or an unlisted issuer.
3. **Regulatory Standards should be remade as either rules or regulations** under the Act.
4. **Revisions and amendments** should be made to **all standards** (along with the CSE Stockbroker Rules and the Unit Trust Code) as a matter of priority to bring them in line with the IOSCO Principles. The introduction of a risk-based capital framework for all classes of intermediaries and further strengthening client asset protection requirements are particularly important, as are revisions to the Unit Trust Code to ensure the regulation of managing companies sets minimum conduct and operational standards in line with the IOSCO Principles. New Standards should also be developed for intermediaries that are being brought within the SEC’s regulatory remit.
5. **Co-operation and information sharing arrangements** and protocols should be entered into between the SEC and each of the other authorities participating in the regulation of activity covered by the IOSCO Principles. This includes arrangements with the CSE, the CBSL, the Attorney-General’s Department and the Registrar of Companies.

6. The SEC should **extend the charter of the Audit Committee** to oversight of processes and governance arrangements to deliver on its regulatory mandate and strategy.

### **Operation of the Framework**

The SEC should also give priority to a number of recommendations intended to ensure the regulatory framework **operates as designed** and increases trust and confidence in Sri Lankan capital markets.

These recommendations are about supporting the **clear and consistent** exercise of the SEC's powers, ensuring **robust supervision** of the regulatory framework, and that by taking timely and decisive enforcement action a message is sent that **misconduct is not tolerated**.

1. Once legislative and regulatory changes are made, the SEC should commit to a **program of providing guidance** on how it interprets the changes made. This will contribute to market confidence that the SEC is applying its powers in a clear and consistent way.
2. The approach to the SEC's supervision of regulated entities should move from the current compliance audit approach, which sees every entity visited each year, to a **truly risk-based approach** that focuses resources on more intense and frequent visits to entities assessed as posing higher risks to investors and market integrity. Reviews should aim to develop a holistic assessment of the overall risks posed by these entities. Supervisory resources should be allocated according to risk posed by regulated entities and not by organizational function. The way the SEC responds to issues identified during surveillance and supervision should be reviewed to ensure timely and decisive action addressing the issue is taken. These initiatives will contribute to market confidence that the SEC is a vigilant and effective regulator.
3. A **human resources strategy** should be developed and implemented to address weaknesses and inconsistencies in staff members' skills and capability – described in this report as bench strength – across the organization. The following initiatives will together contribute to market confidence that the SEC is a vigilant and effective regulator:
  - Priority must be given to recruiting senior staff either from industry or by way of secondment from other jurisdictions, with a longer term strategy to build the middle level of the organization through graduate recruitment and training;
  - SEC resources devoted to investigation must be increased as a matter of priority through hiring or secondment;
  - A training strategy targeted at tailored development of high potential staff should be developed. Training across the organization should focus on improving staff understanding of the businesses they regulate; and
  - Remuneration should also be reviewed.

4. **Co-operation** between the SEC and the Attorney-General's Department should intensify with a view to reducing the time it takes for the Department to consider referrals from the SEC. This will address a key hurdle to the expeditious handling of enforcement action.
5. The Commission should, as a matter of priority, **publish, and regularly update, its strategic plan and direction to 2020**. It is understood that the SEC has developed such a document in the context of a wide-ranging regulatory reform program. The early finalization of this strategy, and its subsequent dissemination among stakeholders, are encouraged, as they will clarify market expectations and set a benchmark against which SEC performance can be assessed. The SEC is also encouraged to publicly disseminate the feedback it receives on its plans.

This Review also makes separate recommendations about accounting and audit standard setting and the monitoring and enforcement of those standards.

In particular, revisions are recommended to the **Sri Lankan Accounting & Auditing Standards Act (SLAAS Act)** to:

- ensure a legal framework is in place to ensure greater public interest oversight in the setting, supervising and enforcing of the audit and accounting standard in Sri Lanka; and
- provide SLAASMB with a range of civil and administrative remedies comparable to those proposed in revisions to the SEC Act for the SEC.

### **III. THE RESPONSE OF THE AUTHORITIES**

The Securities and Exchange Commission of Sri Lanka (SEC), by expressing interest in a Country Review of our implementation of IOSCO Objectives and Principles of Securities Regulation, sought to obtain an independent peer review of the domestic regulatory framework. This review was expected to guide us in benchmarking domestic regulation of the capital market as against IOSCO Principles, in order to build a solid foundation upon which the capital market of Sri Lanka may be better positioned to contribute to the country's economic development.

The present Assessment identifies gaps in our compliance with global standards and best practices, and serves as the basis of the roadmap for implementation that we have since developed.

It is our belief that the findings of this Assessment have significant persuasive value, and support the case in favour of comprehensive capital market regulatory reform in Sri Lanka. The SEC has been acutely aware of the shortcomings in the legal and regulatory framework highlighted by the Assessment Committee, and has made representations for their rectification on a number of occasions prior to the Assessment.

These efforts have resulted in the development of a draft SEC Act updating the 1987 legislation under which the Commission operates at present, a comprehensive review of existing rules for regulatees, and the upcoming formulation of a risk-based supervision framework, as well as the implementation of more effective systemic risk-management

initiatives and the establishment of a delivery-versus-payment (DVP) and central counterparty (CCP) mechanism: all of which are slated to take place in the near future. The SEC Act, the drafting of which was well underway at the time of the Assessment, is due to be submitted to Parliament in 2017, and will address a number of recommendations contained herein.

### **Strategic Plan & Public Consultations**

We have been particularly successful in securing the support of the Government of Sri Lanka in these and other respects which are reflected in the medium-term Capital Market Strategy 2016-2020.

The Capital Market Strategy 2016-2020 was formulated by the SEC as a blueprint for regulatory and developmental measures to be adopted in the medium term, and was approved by the Cabinet of Ministers in October 2016. This Strategy encapsulated the future direction of the Sri Lankan capital market emphasising priority areas to be developed in the 2016-2020 period, and the approval of the Cabinet resulted in initiatives for the development of the capital market being included in the national agenda for policy formulation.

The Strategy addresses capital market stakeholders including issuers, investors, market institutions, and market intermediaries.

The **Regulatory and Governance Strategies** aim to:

- Strengthen regulatory and governance environment
- Increase accountability and market oversight
- Raise the standards and competencies of capital market participants, and
- Manage and mitigate systemic risk

The **Development Strategies** aim to:

- Create an enabling environment for capital formation
- Deepen liquidity and broad-base market participation
- Develop infrastructure and enable new products, and
- Build domestic capabilities

The conduct of the present Country Review, as well as, *inter alia*, the initiatives discussed below, appear in the above Strategy.

The SEC also intends to make the Strategy publicly available and to conduct meaningful stakeholder consultations in the adoption of proposed market reforms: thus enabling stakeholders to keep abreast of developments in the domestic capital market and the

regulation to which it is subject. Concerns of industry stakeholders and matters arising in the implementation of development initiatives will be addressed by formalising periodic stakeholder consultations. The SEC will also conduct quarterly meetings with the Board of CSE. Coordination between the SEC and other regulatory bodies will also be enhanced through regular engagement on relevant matters.

### **Enhancing Compliance with IOSCO Objectives and Principles**

A number of initiatives need to be completed in order to achieve compliance with IOSCO Objectives and Principles, and while a majority will be completed by end-2017, a few others will likely extend beyond.

Several initiatives to enhance the regulatory framework of the SEC were already underway at the time of the Assessment, and further measures have since been adopted.

### **Drafting the new SEC Act**

A new SEC Act which addresses gaps in the enforcement structure and proposes a regulatory framework with provisions in line with IOSCO principles and international governing standards is at present being finalised by the SEC Advisory Committee, and will be deliberated on by the Members of the Commission in January 2017.

The new Act acknowledges a number of recommendations made by the Review Team with respect to broadening the regulatory ambit of the SEC and providing greater flexibility for operations.

Salient features of the proposed SEC Act amendment include:

- (a) Aligning SEC governance with IOSCO standards by introducing transparent criteria for the appointment and removal of Commissioners and the Director General.
- (b) Introduction of the mitigation of systemic risk as an objective
- (c) Recognition of Stock Exchanges, Clearing Houses and Depositories as market institutions
- (d) Provisions for the effective regulation of a central counterparty including the dis-application of insolvency laws to facilitate the mitigation of risk of settlement failure
- (e) Streamlining the licensing process and broadening the range of market intermediaries by the inclusion of categories such as financial planner and corporate finance advisor, thus facilitating tier-based regulation having qualifying thresholds and specifying sales practices.
- (f) Introduction of statutory duties for market intermediaries to enhance investor protection
- (g) Provision for client asset protection

- (h) Provision for the regulation of a demutualised stock exchange with robust oversight powers and the power to regulate derivatives exchanges;
- (i) Expansion of the regulatory ambit of the SEC from the listed market to all public offers.
- (j) Recognition of alternative trading platforms (recognised market operator) to report trades in the unlisted market for the facilitation of a secondary market.
- (k) Broadening enforcement tools by introducing new civil and administrative sanctions to deal with capital market offences in a proportionate and efficient manner and to compensate investors with adequate safeguards
- (l) Codification of statutory defences for serious market misconduct
- (m) Incorporation of provisions on sharing information with other local and foreign regulators.
- (n) Incorporation of provisions on whistleblower protection in respect of capital market offences

The SEC Act also seeks to strengthen regulatory oversight of the audit function by requiring the registration of auditors, and introducing mandatory reporting duties for auditors via the new SEC Act, thus enhancing our ability to adopt pre-emptive measures and to make timely interventions wherever necessary.

### **Facilitation of the Implementation of a Risk Management Mechanism**

A CCP mechanism once implemented with appropriate risk management arrangements will contribute to mitigating and effectively managing settlement and asset commitment risks, and pave way for the introduction of derivative products. In the interim, in order to mitigate systemic risk, the SEC intends to implement DVP and a margining system as a matter of priority.

Subsequent to finalising the Inception Report which provided the road map for CCP implementation by the project consultants, Requests for Proposal (RFP) and Requests For Information (RFI) were developed to call for interested system vendors to supply, implement and support a system for the CCP. Further, legal provisions pertaining to the CCP to be incorporated in to the new SEC Act have been finalised while rules pertaining to the CCP have been drafted and are pending finalisation.

### **Comprehensive Risk Based Supervision framework**

The SEC is presently in the process of formulating a risk-weighted capital adequacy framework for capital market institutions and intermediaries.

As part of the above framework, capital adequacy requirements for all licensed stockbrokers excluding those licensed only to trade in debt securities was approved by the Commission and a Directive issued to the CSE for implementation. Another framework



applicable to those licensed to trade in debt securities has also been developed, and is pending finalisation.

A comprehensive Risk Based Supervision framework based on a rating developed to consider relative systemic importance and risk profiles of regulated entities and a Risk Based Capital Structure for market intermediaries in line with IOSCO recommendations would be implemented upon completion of the establishing phase.

### **Development of the unit trust industry as a channel to broadbase the capital market**

The Unit Trust Code would be reviewed and updated. It would be re-named as the Collective Investments Schemes (CIS) Code. It is also proposed that policies and rules for the introduction of new products, such as Real Estate Investment Trusts (REITs) and Exchange Traded Funds (ETFs) are formulated under the CIS.

To further improve the disclosure standards applicable for Collective Investment Schemes, detailed guidelines pertinent to the contents and form of advertisements in relation to Unit Trusts were finalised and will be published in due course.

### **Strengthening governance of the CSE**

A demutualised Exchange will differentiate ownership from the trading rights of its members, enable management to focus on CSE objectives, and thereby enable the Exchange to better pursue its strategic interests. This would streamline the decision-making process of the Exchange, leading to a more robust organisation.

The proposed CSE Demutualisation Bill is expected to be submitted to Parliament simultaneously with the SEC Act.

In conclusion, the SEC commends the commitment and dedication of the RT in completing a comprehensive Country Review of Sri Lanka, and we take this opportunity to thank all RT members for their efforts. The RT was both accommodative and flexible in its approach to the Review, ensuring that the concerns of all stakeholders were paid due attention, and that ground realities are accurately represented in the outcome document.

The SEC is committed, in our endeavour to propel the Sri Lankan capital market towards advancement and growth, to take all necessary measures to implement the capital market reforms recommended by the RT, with a view to enhancing our compliance with IOSCO Principles.

## **IV. THE REVIEW**

The AC was established by IOSCO in 2012 to organize and structure a program to assess the implementation of IOSCO Principles and Standards across IOSCO's extensive membership. One of the AC's responsibilities is to design and conduct a program of Country Reviews. Specifically, AC Country Reviews:

- Evaluate the status of implementation of IOSCO Principles by the jurisdiction;
- Identify gaps in the implementation of the IOSCO Principles; and

- Recommend, through a road map, how issues of significance and materiality to the implementation of the IOSCO Principles identified by the review might be addressed.

This Country Review is the third to be undertaken by the AC.

It reflects the findings of the Review Team as at the date of the onsite visit - July 2016.

The Review Team would like to reiterate its appreciation to the SEC for its collaborative and professional approach to this Project. It would like, in particular, to thank Chairman Thilak Karunaratne, Commission Members, Director-General Vajira Wijegunawardane and his team, particularly Tushara Jayaratne, Thakshila Francis, Olivi Solangaarachchi, Chathuni Uduwela, and all other members of the SEC staff who contributed to the Review in their areas of expertise for their support and assistance. The SEC team was unfailingly courteous, responsive and helpful throughout the onsite visit, displaying great patience and politeness in responding to our many requests. The AC would also like to thank the five member organizations that volunteered staff members to form the Review Team and others who provided support.

## **V. INFORMATION AND METHODOLOGY USED FOR THE REVIEW**

This Assessment was carried out by a Review Team of five regulators nominated by member organizations from developed and emerging markets, along with a member of the IOSCO Secretariat.

The Review Team members were Raluca Tircoci-Craciun (IOSCO Secretariat), Sharon Kelly (Québec AMF), Niels de Kraker (Netherlands AFM), Alex Lee (Singapore MAS), Rinkal Sanghavi (India SEBI) and Adam Coleman (Australia ASIC). The Review Team leader was Steven Bardy, Chair of the AC and Senior Executive Leader, International Strategy, ASIC. Financial support to conduct the project was received from the Sri Lankan authorities.

The primary source document for the Review Team's Assessment was a self-assessment prepared by a task force set up by the SEC, comprising members from all operational departments relevant to the regulation of securities markets. The Assessment structure followed the methodology developed by IOSCO and used by the IMF and World Bank when conducting assessments under the FSAP.

The first draft of the self-assessment was delivered to IOSCO in March 2016.

In preparing its self-assessment, the SEC relied on numerous sources of information. These included relevant legislation, rules and regulations concerning securities and investment markets.

Throughout the course of the Review, the Review Team developed a deeper understanding of the regulatory framework in Sri Lanka, and the operational capabilities of the SEC, via a process of written questions and answers, supported by documentary evidence such as copies of laws, regulations and guidance.

The Review Team conducted an onsite visit between July 23 and July 29 in Colombo. The visit provided an opportunity to better understand and test the self-assessment. The Review Team met with the Director-General of the SEC, members of the Commission and a broad cross section of SEC staff. Interviews were also conducted on a confidential basis with market participants from each of the sectors regulated by the SEC, industry associations, representatives of the Colombo Stock Exchange (CSE), the Registrar of Companies, the Attorney-General's Department and the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB).

The onsite visit contributed to a richer and deeper understanding of securities markets regulation in Sri Lanka.

The Review Team followed the approach laid down by IOSCO, which requires that the Assessment be based on the regulatory regime current at the Assessment date. For the purposes of this Review this Assessment date was the date of the onsite visit – July 2016.

Envisaged changes were not reflected in the rating for each IOSCO Principle. The Review Team has, however, commented on current and planned initiatives. This includes the legislative reform that has been proposed in Sri Lanka.

The Review Team was also conscious of the IOSCO requirement to not only look at the legal and regulatory framework in place, but also check how it has been implemented in practice. This involves making judgments about supervisory practices and determinations as to whether these practices are sufficiently effective. Among other things, these judgments involved a review of the inspection programs for different types of supervised entities, the cycle, scope and quality of inspections as well as assessing how the SEC follows up on findings, including by taking enforcement action.

The Review Team did not test the preconditions to regulation set out in Appendix One to the Methodology. The Review Team did, however, note the analysis conducted by the World Bank Group in its 2016 Report on *Doing Business in Sri Lanka* which addresses a number of aspects of the preconditions (including Company law, Commercial Code/Contract Law, Taxation Laws, Bankruptcy and Insolvency Laws and the Dispute Resolution System). Where relevant, references to the findings of this World Bank report are made in this Report.

## **VI. THE SRI LANKAN REGULATORY FRAMEWORK**

Regulation of Sri Lanka's financial sector is primarily shared between three authorities: the SEC, the Central Bank of Sri Lanka (CBSL) and the Insurance Board of Sri Lanka (IBSL).

### ***1. SEC***

#### **Overview**

The SEC was established in 1987, under the Securities and Exchange Commission of Sri Lanka Act, No. 36 of 1987 (SEC Act).

The SEC Act sets out the following objectives:

- The creation and maintenance of a market in which securities can be issued and traded in an orderly and fair manner;
- The protection of the interests of investors;
- The operation of a Compensation Fund to protect investors from financial loss arising as a result of any licensed stockbroker or licensed stock dealer being found incapable of meeting their contractual obligations; and
- The regulation of the securities market, including ensuring that professional standards are maintained in that market.

The powers, duties and functions of the SEC are geared towards four objectives: regulating market activity, protecting investors, government policy advice and implementation and upholding domestic securities laws. Each objective is supported by activities set out in the following Table:

**Table 1 – SEC powers, duties and functions**

<b>Objective</b>	<b>Activities</b>
Regulating market activity	<ul style="list-style-type: none"> <li>• Licensing stock exchanges, stockbrokers and dealers and the managing companies of unit trusts;</li> <li>• Registration of Market Intermediaries covering Investment Managers, Margin Providers, Underwriters, Credit Rating Agencies and the Clearing House;</li> <li>• Requiring regulated individuals and firms to file with the SEC their annual balance sheets and income statements, certified by a qualified auditor and, in the case of unit trusts, requiring further reports on their activities twice yearly;</li> <li>• Regulating, inspecting, inquiring into and investigating the conduct of each licensee and registered intermediary and publishing any findings of malfeasance relating to them;</li> <li>• Regulating the listing and issue of securities in the licensed stock exchange, including the rejection of applications, cancelling or suspending the listing or trading of listed securities, and the issuing of directives to listed public companies;</li> <li>• Regulating take-overs and mergers where at least one of the parties is a listed company; and</li> <li>• Charging and levying from both purchasers and sellers a cess (levy) on every purchase and sale of securities recorded in a licensed stock exchange or notified to it.</li> </ul>

<b>Objective</b>	<b>Activities</b>
Protecting investors	<ul style="list-style-type: none"> <li>• Granting compensation to investors who suffer pecuniary loss as a result of any licensed stockbroker or licensed stock dealer being incapable of meeting contractual obligations.</li> </ul>
Policy advisory and implementation	<ul style="list-style-type: none"> <li>• Advising the government on the development of the securities market; and</li> <li>• Implementing its policies and programs with respect to the market in securities.</li> </ul>
Upholding domestic securities laws	<ul style="list-style-type: none"> <li>• Conducting investigations into alleged violations and contraventions of the provisions of the SEC Act; and</li> <li>• Performing all such other acts as may be incidental or conducive to the attainment of the objects of the Commission or the exercise of its powers under the SEC Act.</li> </ul>

The SEC is headed by the Chairman and the Commission, which is the primary strategic policy making division of the SEC. The Commission comprises ten non-executive members. The Commission is supported by the SEC Secretariat (which is led by the Director-General of the SEC).

### **Operational divisions**

The SEC is organized into eight operational divisions. A brief summary of the roles and responsibilities of each division and the number of staff currently employed in each is included in Table 2 below:

**Table 2 – Roles and responsibilities of SEC operational divisions<sup>2</sup>**

<b>Division</b>	<b>Roles and responsibilities</b>	<b># of staff</b>
Legal and Enforcement	The Legal and Enforcement division is responsible for the enforcement of violations of the SEC Act and related instruments.	7

<sup>2</sup> Other divisions not described in this table include Litigation (with one staff member), the Chairman's office (with 1 staff member), Director-General's Office (with one staff member) and the Deputy Director-General's Office (with two staff members). At the time of the self-assessment 5 Director level positions were vacant (Directors of Supervision, Capital Markets Development, Investigations, Human Resources and Capital Market Education and Training).

Division	Roles and responsibilities	# of staff
	<p>The division is also responsible for capital market policy initiatives including provision of legal advice on all legal matters to the SEC Commission and Secretariat, the issuance of directives to regulated firms and listed public companies, the administration of the Takeovers and Mergers Code, and the granting of approvals for global and regional funds investing in listed securities.</p> <p>The division also has responsibility for reviewing and proposing amendments to the SEC Act.</p>	
Corporate Affairs	<p>The Corporate Affairs team is responsible for undertaking a proactive financial reporting surveillance program, as well as inquiring into complaints made about listed public entities by investors.</p> <p>Other functions of the division include:</p> <ul style="list-style-type: none"> <li>• Verifying the accuracy of the notices/announcements published by issuers and public listed companies;</li> <li>• Granting approvals under Section 28A, 29A, SEC Act reviewing proposals relating to Listing Rule 5.4, De-listing applications, and with offers made under the TOM code;</li> <li>• Reviewing applications to raise funds via Initial Public Offerings (Equity and Debt) and applications to further raise finance;</li> <li>• Processing and approving off-the-floor transfers of securities; and</li> <li>• Approving issues of unlisted securities by listed entities.</li> </ul>	8
Supervision	<p>The Supervision Division's core/primary functions are to License/Register and Supervise Capital Market Intermediaries (CMI). CMI's include Stockbrokers, Stock Dealers, Unit Trust Managing Companies, Investment Managers, Margin Providers, Underwriters, Credit Rating agencies and the Clearing House.</p> <p>The Supervisory efforts are directed at achieving the following:</p> <ul style="list-style-type: none"> <li>• Monitoring financial and operational viability through off-site and on-site mechanisms;</li> </ul>	13

Division	Roles and responsibilities	# of staff
	<ul style="list-style-type: none"> <li>• Enhanced market oversight;</li> <li>• Investor protection with a view to building confidence in the capital market;</li> <li>• Developing electronic filing and maintaining databases for off-site analysis;</li> <li>• Promoting a culture of self-regulation amongst licensees/ regulatees;</li> <li>• Regular dialogues with external parties such as External Auditors to achieve a higher degree of compliance.</li> </ul> <p>A variety of tools are also being used by the division to address the above.</p>	
Investigations	<p>The Investigations Division conducts investigations into matters it receives from the Investigations and Surveillance Committee which may be based on internal and external referrals relating to suspected instances of market misconducts to determine whether sufficient evidence of contraventions of the SEC Act (or Rules or Regulations made under the SEC Act) exist to support a criminal prosecution or other enforcement action.</p> <p>Based on the investigation findings the Division recommends appropriate enforcement action in relation to the same, thus fostering high standards of professional conduct and corporate behavior in the market, and deterring future transgressions in the market.</p>	4
<p>The External Relations and Surveillance Divisions are two divisions, which have been temporarily amalgamated under one Director, due to the lack of appropriate senior personnel. The functions of the two divisions are independent of each other.</p>		
External Relations	<p>The External Relations Division has responsibility for providing financial education to existing and potential investors. It does this through engaging with students, teachers and the general public through a variety of media, including printed material and seminars.</p>	4

<b>Division</b>	<b>Roles and responsibilities</b>	<b># of staff</b>
Surveillance	The Surveillance Division undertakes market surveillance activities. It monitors trading activities to detect and prevent violations of the SEC Act, examines complaints and referrals received from the CSE and the complaints received from other stakeholders or the general public and conducts preliminary investigations.	5
Capital markets, education, training and research	The Capital Market Education and Training division provides professional education and training in order to enhance the knowledge and skill levels of market professionals, investors, issuers and market institutions. It does this by administering three main qualifications: the Certificate in Capital Market, the Registered Investment Advisor qualification and the Diploma in Capital Market.	7
Capital market development	<p>The Capital Market Development Division was established in 2007 to carry out a number of policy initiatives under the Capital Market Master Plan 2007 – 2015.</p> <p>The main tasks of the division include proposing and facilitating the implementation of policy initiatives to develop the capital market such as:</p> <ul style="list-style-type: none"> <li>• Broadening and widening the issuer and investor bases;</li> <li>• Advocating improvements to the market infrastructure;</li> <li>• Enhancing liquidity and efficiency in the market; and</li> <li>• Introducing new products.</li> </ul> <p>The Division jointly works with external regulatory agencies and missions to champion focused initiatives on the development of the securities market.</p>	2
Finance and Administration	The Finance and Administration division has responsibilities which include financial control and budgeting, recruitment and personnel management, management of the SEC's funds, supervision of the general maintenance and upkeep of the Secretariat, internal risk management, procurement and management of office facilities and supplies.	9



The professional background of staff below the Director-General based on information provided by the SEC includes experience in accounting firms (30%), regulatory authorities (20%), law firms (18%) and financial markets (14%). Accounting degrees and professional qualifications in accounting are the most prevalent academic qualification (42%) followed by staff holding business management, commerce and economics qualifications (30%) and legal qualifications (20%).

## **Legislation**

The primary source of regulation of capital markets in Sri Lanka is the SEC Act and Rules and Regulations made under the Act.

The Act provides for the establishment of the SEC for the purposes of regulating the securities market in Sri Lanka; granting licenses to stock exchanges, managing companies in respect of each unit trust, stockbrokers and stock dealers; registering market intermediaries; setting up a compensation fund, and for other matters connected with these purposes.

The Act is structured as follows:

- Part I: The establishment and constitution of the Securities and Exchange Commission of Sri Lanka;
- Part II: Objects, powers and functions;
- Part III: Grant of a license to a stock exchange, a stockbroker or a stock dealer and the registration of market intermediaries;
- Part IIIA: Grant of licenses to operate Unit Trusts;
- Part IV: Insider dealing;
- Part V: Finance; and
- Part VI: General.

The Schedule to the Act also consists of several parts:

- Part I: Requirements and conditions to be satisfied for the purpose of granting a license as a stock exchange to a body corporate and a renewal of such a license;
- Part II: Terms and conditions to be complied with for the purpose of granting a license as a stockbroker or stock dealer to a body corporate and the renewal of such a license;
- Part III: Terms and conditions to be complied with for the purpose of granting a license as a stockbroker or a stock dealer to an individual and the renewal of such a license;
- Part IV: Terms and conditions to be complied with for the purposes of the grant of a license to a managing company to operate a unit trust; and

- Part V: Terms and conditions to be complied with for the purpose of granting registration as a market intermediary to an investment manager, margin provider or underwriter, which is a body corporate and the renewal of such a registration.

## **2. CBSL**

The Central Bank of Sri Lanka (CBSL) was established under the Monetary Law Act No. 58 of 1949. The CBSL is charged with two core functions – maintaining economic and price stability, and maintaining financial system stability.

Ancillary to the above, the CBSL also engages in currency issuance and management.

The CBSL also has a number of agency functions, which it performs on behalf of the Government of Sri Lanka (**GOSL**). These functions include:

- The management of the Employee's Provident Fund;
- The management of foreign exchange;
- The management of public debt;
- Regional development;
- Financial intelligence; and
- Provincial office monitoring.

The CBSL directly regulates a series of financial institutions, including licensed commercial banks, licensed specialized banks, licensed financial companies, primary dealers and specialized leasing companies.

There are 24 licensed commercial banks, and 9 licensed specialized banks in Sri Lanka.

These institutions account for 98.2% of deposits and 66.6% of financial system assets in Sri Lanka.

## **3. IBSL**

The third financial sector regulator in Sri Lanka is the Insurance Board of Sri Lanka (IBSL). The IBSL seeks to safeguard insurance policy holders through supervisory control of insurance companies. The IBSL's functions include the registration of insurers carrying on business in Sri Lanka, and the registration of persons as insurance brokers.

The IBSL administers the Regulation of Insurance Industry Act, No. 43 of 2000 as amended by Act, No. 27 of 2007 and Act, No. 03 of 2011.

#### ***4. Other regulatory authorities***

##### **Registrar of Companies**

The Department of the Registrar of Companies has a range of responsibilities, including the registration of companies and prospectuses in Sri Lanka.

The Department also oversees the registration of societies (through the Societies Ordinance No 16 of 1891) and the “cheetu” system (through the Cheetus Ordinance No 61 of 1935). A cheetu, or a rotating savings and credit association, is an informal community-based organization which exists to both save and lend money to rural communities in Sri Lanka.

##### **Institute of Chartered Accountants of Sri Lanka (ICASL)**

ICASL (sometimes abbreviated CA Sri Lanka) was established in 1959 by an Act of Parliament (No. 23 of 1959), to act both as the examining body for certifying chartered accountant qualifications in Sri Lanka and as the licensing authority for its members engaged in public auditing practice.

Under the Accounting and Auditing Standards Act (No 15 of 1995), it also has responsibility for adopting accounting and auditing standards based on recommendations from Accounting Standards and Auditing Standards Committees.

The President of ICASL is an ex-officio member of the Commission of the SEC.

ICASL, through its governing body, the Council, is responsible for:

- Conducting qualifying examinations and prescribing courses of study;
- Supervising student education and training (including encouraging research in accountancy and related subjects); and
- Maintaining professional standards.

ICASL notes it has stepped forward to perform a wider national role to support and strengthen the business regulatory framework in Sri Lanka.

##### **Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB)**

SLAASMB was established under the Sri Lanka Accounting and Auditing Standards Act, No. 15 of 1995 (**SLAAS Act**). The SLAASMB Act identifies certain enterprises as ‘Specified Business Enterprises’ and requires them to send their Annual Audited Financial Statements to the SLAASMB. The Director-General of the SEC is an ex-officio member of the SLAASMB.

The function of the Board is to monitor the compliance of Specified Business Enterprises and their auditors with the Accounting and Auditing Standards adopted by ICASL. Respectively, for this purpose, such enterprises must submit their Annual Reports to the Board, and the Board may, where it deems necessary, carry out investigations or hold inquiries regarding these reports.

## VII. CAPITAL MARKETS OVERVIEW

### Market Infrastructure

The CSE and the Central Depository System Pvt Limited (**CDS**) provide the market infrastructure for Sri Lanka.

#### 1. *The CSE*

The CSE is the sole stock exchange in Sri Lanka. It is a mutual exchange, having 15 full members, 13 Trading Members licensed to trade both equity and debt securities, and 8 members which are licensed to trade in debt securities only.

The CSE is licensed by the SEC and, although not recognized by law to operate as a Self-Regulatory Organization (SRO), undertakes functions that are self-regulatory in character. The CSE undertakes a number of market operator functions, and sets rules which govern participant conduct and automated trading. These rules are subject to SEC oversight. Therefore, the CSE is not entirely self-regulatory, although it does demonstrate some characteristics of an SRO.

#### Size of the domestic capital market

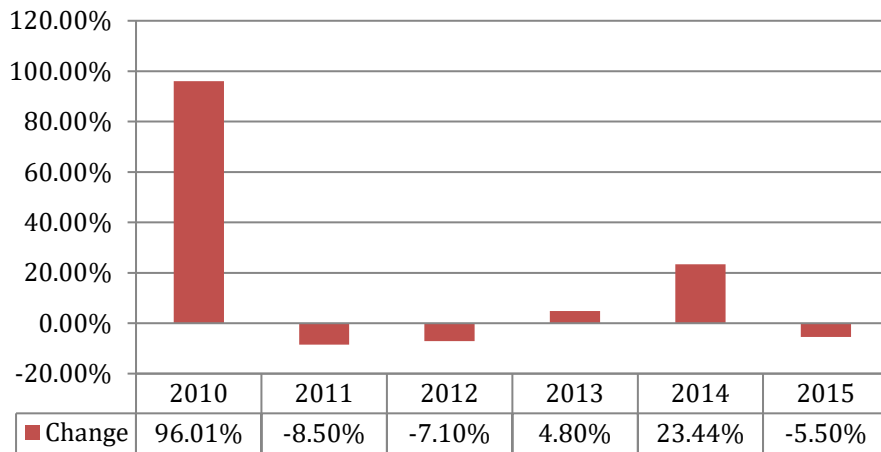
As at 31 December 2015, a total of 294 companies were listed on the CSE. Of these, the securities of 278 were traded in the equity market, and the securities of 40 were traded in the listed debt market. The total market capitalization of the CSE was LKR 2,938 billion, or 30% of GDP.

The bulk of trading in the CSE is in equities. In 2015, in total, LKR 253.25 billion worth of equities were traded on the CSE. This is a decrease from LKR 340.9 billion in 2014 (a 25% decrease). Also in 2015, LKR 4.714 billion of debt securities were traded. Further information on debt securities is provided below.

The CSE has two main price indices, the All Share Price Index (**ASPI**) and the S&P Sri Lanka 20 Index (**S&P SL 20**). The ASPI ended the 2015 calendar year at 6894.5 points, down from 7299.0 points at 31 December 2014 (a 5.5% decrease).

The most significant change in the ASPI was at the end of the Sri Lankan Civil War in 2009. In 2010, the ASPI rapidly rose by 96.01%. The year-on-year percentage change from 2010 to 2015 in the ASPI is reflected below in Figure 1.

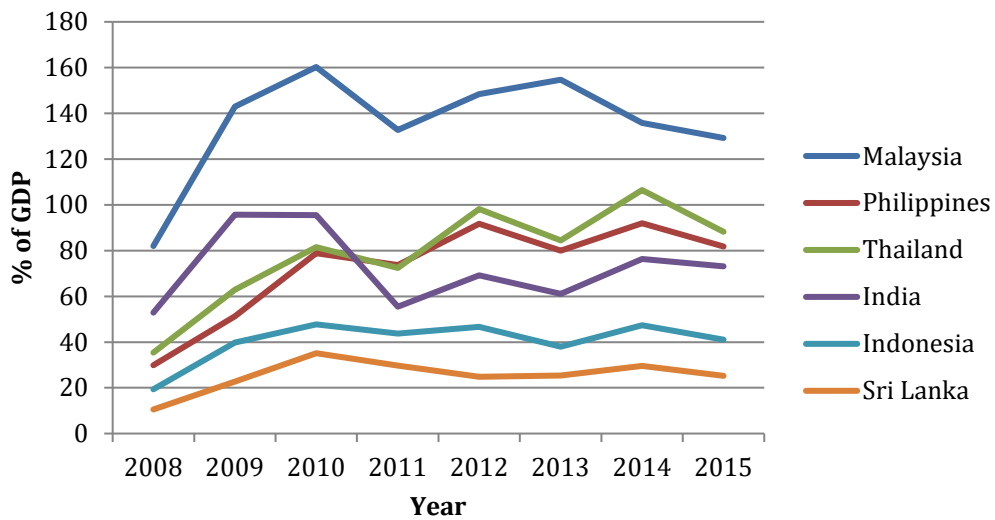
**Figure 1 – ASPI: Year-on-year percentage change**



Source: Sri Lanka: Self-assessment of Securities Regulation, March 2016

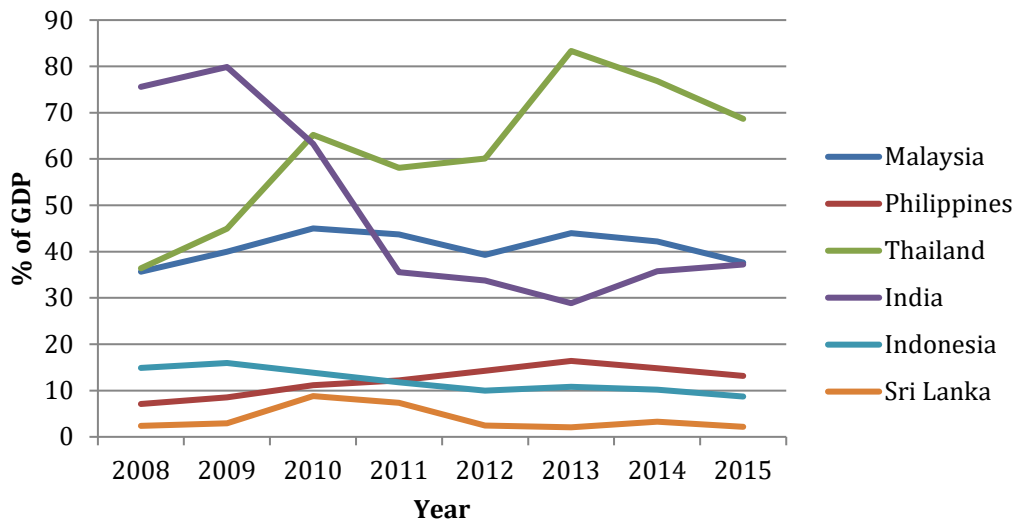
The total market capitalization and the level of trading activity in Sri Lanka are very small compared to other jurisdictions in the Asian region as set out in Figures 2 and 3 below.

**Figure 2 – Market Capitalization of Listed Domestic Companies (% of GDP)**



Source: World Bank, Data Bank (extracted 15 July 2016)

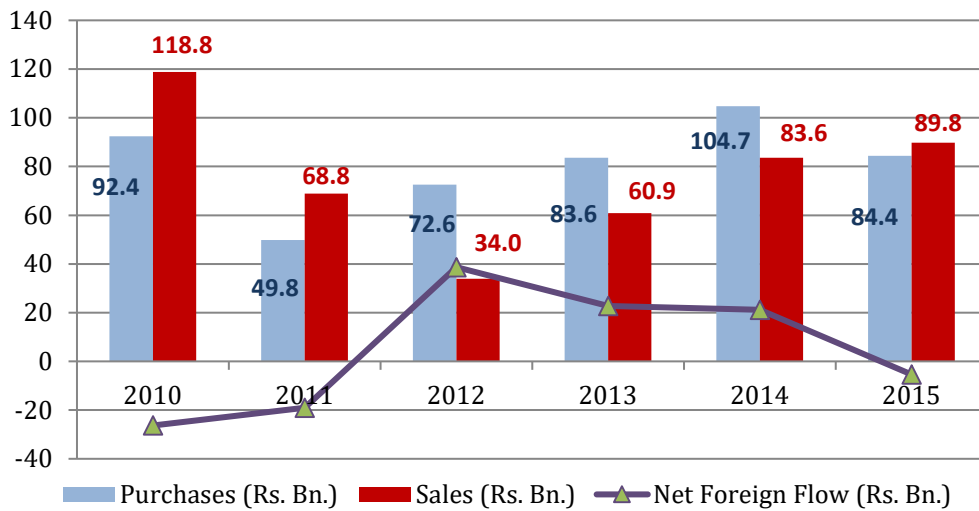
**Figure 3 – Stocks traded, Total value (% of GDP)**



Source: World Bank, Data Bank (extracted 15 July 2016)

Foreign activity in the Sri Lankan market has seen a general upward trend since 2012. Although – consistent with the experience of many emerging markets – the Sri Lankan market saw a net outflow in 2015 of LKR 5.370 billion, as set out in Figure 4.

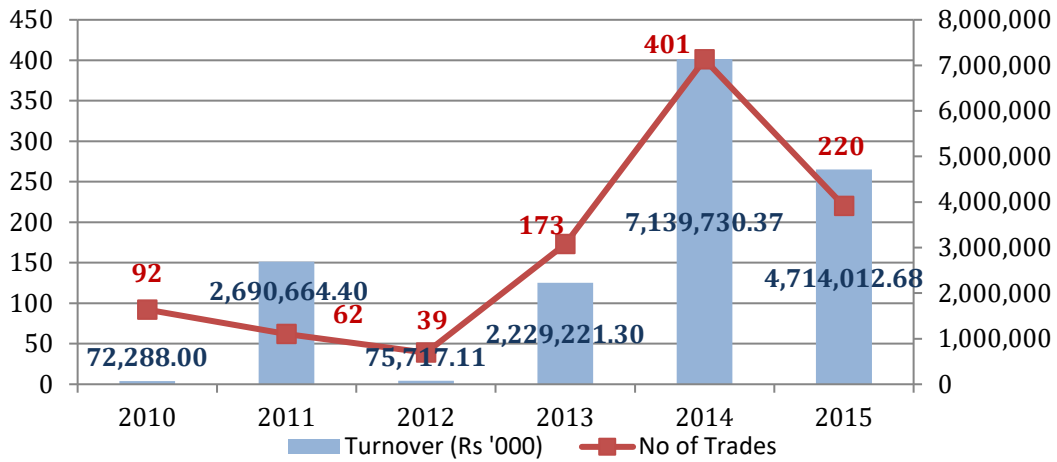
**Figure 4 – Foreign participation in listed equity securities in Sri Lanka, 2010 - 2015**



Source: Sri Lanka: Self-assessment of Securities Regulation, March 2016

As mentioned above, the CSE also offers a secondary market for debt securities. The turnover for the corporate debt market in Sri Lanka, as traded on the CSE, decreased between 2014 and 2015. In 2014, the turnover for debt securities on the CSE was LKR 7.139 billion. In comparison, the 2015 equivalent turnover figure is LKR 4.714 billion (a decrease of 33%).

Figure 5– Corporate Debt, 2010 - 2015



Source: Sri Lanka: Self-assessment of Securities Regulation, March 2016

## 2. CDS

The CDS was incorporated in August 1991 for the purpose of acting as a depository in respect of securities traded on the CSE, and to facilitate the settlement of traded securities. The CDS is also a registered market intermediary in the category of a clearing house.

All share transactions conducted on the CSE occur through a securities account of the CDS. The securities accounts are operated through participant organizations. There are two types of participant organizations, stockbrokers and custodian banks. The stockbrokers are licensed by the SEC who are also members of the CSE, and the custodian banks are registered under the Banking Act of Sri Lanka.

The services provided to account holders by the CDS include:

- Opening of client accounts for residents and non-residents;
- Maintenance of client accounts;
- De-materialization (the process by which physical certificates of a CDS account holder are converted to an equivalent number of securities in electronic form and credited in the CDS account) and re-materialization of securities certificates;
- Transfer of shares; and
- Transmissions and nominations of securities held by a deceased account holder to a nominated party.

All participants are required to produce a bank guarantee for an amount specified by the CDS for the purpose of satisfying its losses or liabilities at the outset, and furnish quarterly (unaudited) financial statements and an annual audited statement to the CDS. The CDS

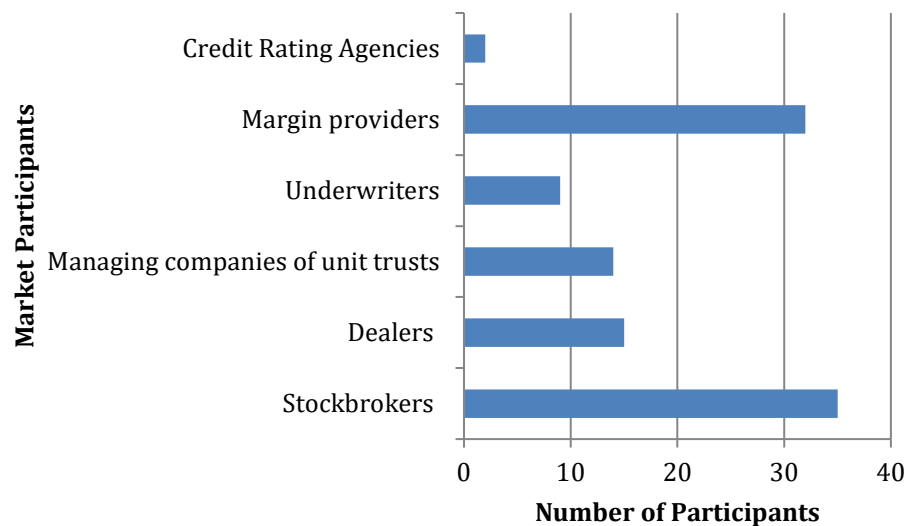
Rules also specify margins, collateral requirements, procedures relating to settlement failure and default, and disciplinary actions available against participants.

Sri Lanka proposes to introduce a central counterparty in 2017.

### Market Participants

Key Market Participants in Sri Lanka are Stockbrokers and Dealers, Underwriters, Investment Managers, Credit Ratings Agencies and the management companies and trustees of Unit Trusts. The following chart demonstrates the number of participants that make up the Sri Lankan market. Further information on each participant's regulatory environment is detailed below.

Figure 6 – Market Participants in Sri Lanka (at 31 December 2015)



Source: Sri Lanka: Self-assessment of Securities Regulation, March 2016

### Stockbrokers and Dealers

The SEC Act defines stockbrokers and stock dealers as follows:

**“Stockbroker”** means any individual or body corporate engaged in the business of buying or selling of securities on behalf of investors in return for a commission’

**“Stock dealer”** means any individual or body corporate engaged in the business of buying or selling of securities or in the dealing or trading of securities, or the underwriting or retailing of securities but shall not include an underwriter who is a registered market intermediary’.

The SEC Act sets out licensing requirements for stockbrokers and stock dealers and, requirements for the renewal of their licenses. Licensed stockbrokers and dealers are also required to comply with the provisions of the SEC Act and the rules and regulations promulgated thereunder.



Further, stockbrokers are also subject to the Stockbroker Rules 2012, issued by the CSE. These rules govern operational requirements, trading practices and conduct, dealings with clients' money, capital requirements, rules for agents, other business activities, minimum standards, supervisory rules and client-stockbroker dispute resolution, disciplinary procedures which are applicable to stockbrokers and stock dealers.

### **Underwriters<sup>3</sup>**

Underwriters are regulated by the SEC, under the SEC Act. The SEC Act definition of market intermediaries specifically includes underwriters. The definition is as follows:

**“Underwriter”** means any person who in connection with a public issue of securities of a listed public company or a company which has applied for a listing guarantees to purchase unsubscribed securities of such company for a fee or commission or who negotiates with such company to purchase such securities in the event of the offer being not fully subscribed and includes any person who purchases such issue from the company specifically view a view to offering such securities to the public.

Part V of the Schedule to the SEC Act addresses the terms and conditions that are to be complied with for the purpose of granting registration as a market intermediary to an underwriter. It also addresses the circumstances for the renewal of registration.

Underwriters are also subject to the terms of the Standards for Underwriters. This instrument contains, generally, provisions that address the fit and proper criteria for directors and persons (particularly where that person deals with clients), requirements as to reporting, regulatory compliance and controls including record-keeping and confidentiality, governance, disclosure and advertising. The instrument also includes special provisions on Material information and Contract, mandating that underwriters execute written contracts prior to carrying out any business for and on behalf of a client.

SEC approval is provided on a case-by-case basis for any underwriting obligation, with assessments made, for instance, about the adequacy of liquidity to meet those underwriting obligations.

### **Investment managers**

Investment managers are classified as market intermediaries by the SEC Act. Specifically, the SEC Act defines an investment manager as follows:

**“Investment manager”** means a person who for a fee or commission engages in the business of managing a portfolio of listed securities on behalf of an investor or advises any person on the merits of investing, purchasing or selling listed securities, but shall not include the licensed managing company of a unit trust.

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<sup>3</sup> The regulation of Underwriters is not addressed in this Review.

Investment Managers are subject also to the terms of the “Standards for Investment Managers”. Amongst more general requirements pertaining to qualifications and experience, competence, disclosure, reporting, governance and advertisements, specific requirements exist for investment managers. These include requirements to segregate client funds, conform to standards for valuation criteria on operational standards, corporate governance, regulatory compliance and internal controls, provide an investment manager services guide and have written contracts.

### **Credit Rating Agencies**

Credit rating agencies are also classified as market intermediaries by the SEC Act.

There are two credit rating agencies operating in Sri Lanka, Fitch Ratings Lanka Ltd and ICRA Lanka Ltd

Similar to underwriters and investment managers above, credit rating agencies are also mandated to comply with their own standards. These are known as the “Standard for Credit Rating Agency”. The standards mandate a number of key competence and reporting criteria, as above with other market intermediaries. Specific to credit rating agencies, however, are requirements to apply a minimum number of persons as analysts. Credit rating agencies must also publicize their rating process and criteria and are subject to independence, avoidance of conflict of interest and standard of care requirements.

### **Unit Trusts**

Unit Trusts are separately addressed in Part IIIA of the SEC Act, and are defined as follows:

**“Unit Trust”** means any arrangement made for the purpose, or of having the effect, of providing for the participation by persons as beneficiaries under a trust, in profits or income and capital gains arising from the acquisition, holding, management or disposal of securities or any other property vested in the trustee or such trust’.

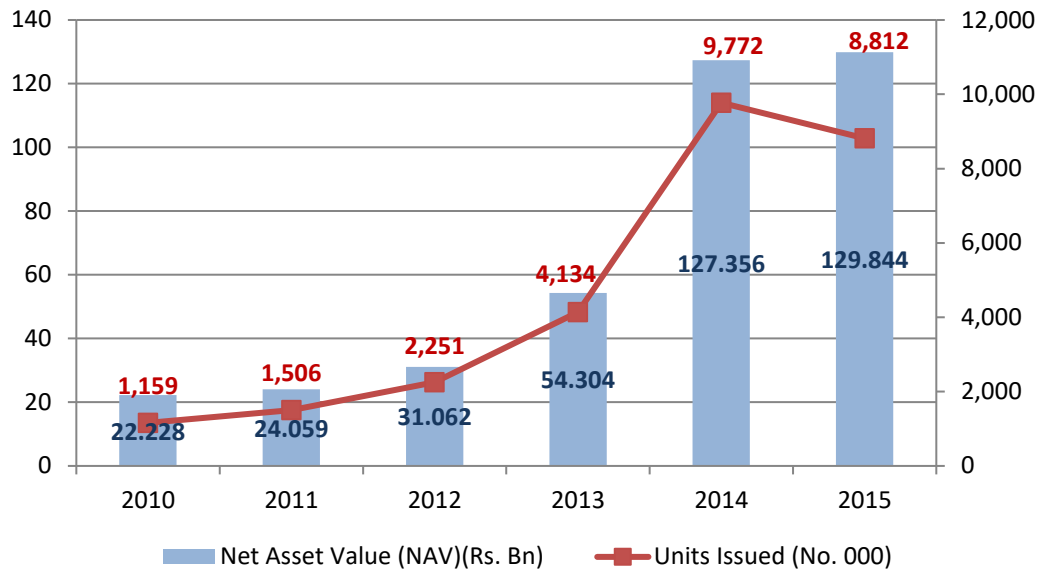
Unit Trusts are required to appoint a trustee and a managing company. Managing companies intending to operate a unit trust are also required to obtain a license from the SEC and to obtain the service of a trustee. The regulatory regime requires the Trustee and Managing Company to be separate, and also addresses the honesty and integrity of the Managing Company, the adequacy of its resources, and its powers and duties. Requirements are set out in Part IIIA and Part IV of the Schedule to the SEC Act.

The growth in the net asset value of the unit trust industry is shown in Figure 7. From 2010 to 2015, the net asset value NAV has grown significantly from LKR 22.228 billion, to 129.844 billion. The units issued have also significantly increased from 2010 to 2014, with a slight fall in 2015. It is understood that this increase is primarily in Money Market Funds, which, at December 31, 2015, accounted for 46% of the Net Asset Value of Unit Trusts in Sri Lanka invested by 11% of number of unit holders (understood to be primarily corporate investors). 63% of the number of unit holders are invested in balanced funds (with a further 11% invested in growth funds).<sup>4</sup>

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<sup>4</sup> ADB Estimates, December 31, 2015.

**Figure 7 – Unit Trust Value and Issuance, 2010 – 2015**



Source: Sri Lanka: Self-assessment of Securities Regulation, March 2016

Further, as at December 31, 2015, the largest five Unit Trusts accounted for nearly 70% of total industry AUM as set out in the following Table.

**The Largest 5 Unit Trusts in Sri Lanka  
(by NAV)**

Fund Manager	NAV (Rs. '000)	Share of total NAV
National Asset Management Limited	13,368,137	10.34%
NDB Aviva Wealth Management Limited	32,249,033	24.93%
Capital Alliance Investments Ltd	19,262,703	14.89%
J B Financial (Pvt) Ltd	13,633,054	10.54%
Assetline Capital (Pvt) Limited	11,291,594	8.73%

Source: Data provided by the SEC

## VIII. PLANNED REFORMS

The World Bank in their recent FSAP identified three key areas for improvement in the SEC Act: ensure operational independence of the SEC, facilitate the introduction of new products and services, and ensure that the CSE is demutualized and operates within a strong public interest framework.

The SEC has proposed amendments to the SEC Act to address these recommendations. A draft sighted by the Review Team includes amendments intended to:

- Align SEC governance with IOSCO standards;
- Extend the jurisdiction of the SEC to all public offers of securities including the unlisted securities market;
- Incorporate legal provisions to regulate a demutualized stock exchange, govern a clearing house and dis-apply insolvency laws;
- Expand the categories of market intermediaries
- Impose mandatory reporting duties on auditors if they detect financial irregularities in their audits of companies within the purview of the SEC;
- Introduce civil and administrative sanctions; and
- Introduce provisions on the protection of whistleblowers and sharing of information.

Other initiatives include the following:

## **Stock exchange**

### Demutualization of the CSE

A bill has been prepared to demutualize the CSE. The draft Demutualization Bill will be submitted to Parliament upon making necessary amendments as per the finalized business model and it is anticipated to submit the same simultaneously with the amended SEC Act. The bill, if passed, will convert the CSE from a company limited by guarantee to a company limited by shares.

The current plan is for demutualization to be completed in 2017. The SEC reports that the demutualization of the CSE has been on the legislative agenda in Sri Lanka for some time. Consistent with the recommendations made in the FSAP, it is expected that the demutualization could improve the governance and operation of the CSE by segregating ownership and trading rights, and commercial and regulatory functions from one another.

## **Stockbrokers and Stock dealers**

### Corporate Governance Rules for Stockbroker Firms

In order to enhance their internal controls, the CSE is in the process of introducing corporate governance requirements for Stockbroker Firms covering, as a minimum, the responsibilities and composition of Boards of Directors and Risk and Audit Committees, and new requirements relating to investor grievance and redress mechanisms.

### Rules on serious loss of capital

The CSE has proposed guidelines/rules for stockbroker firms facing a serious loss of capital in line with the requirements of Section 220 of the Companies Act No 07 of 2007.

The SEC is also reviewing proposed guidelines/rules on Liquidity/Solvency applicable to Stockbroker Firms.

## **Market intermediaries**

### Fit and Proper Standards for Directors of Market Intermediaries and Listed Companies

The SEC has proposed to introduce fit and proper standards for directors of market intermediaries, market institutions, and listed companies, so that each type of firm is subject to similar requirements.

## **Listed companies**

### Revision of CSE Listing Rules

A revision of the CSE Listing Rules is being jointly spearheaded by the CSE and SEC, which seeks to strengthen immediate corporate disclosure requirements; standardize the delisting process; improve disclosures; and introduce a trading black-out period for connected parties in respect of listed companies.

### Amendments to the Takeovers and Mergers Code

The SEC is in the process of amending the Takeovers and Mergers Code to extend its applicability, such that exit options relating to mandatory offers remain even where an indirect takeover occurs; to provide for the Chain Principle to arrive at the price for mandatory offers; to introduce a Takeover Panel to advise the Commission on complications that may arise in a takeover and to issue rulings, practice statements and guidelines that will become binding once approved; and to facilitate the recognition and appointment of compliance auditors who will ensure that both the offeror and offeree in a takeover bid will comply with the Code.

### Capital Market Strategy

At the time of the onsite visit, the SEC was developing a Capital Market Strategy 2016 to 2020 as a blueprint for regulatory and developmental measures to be adopted in the medium term. The Strategy was approved by the Cabinet of Ministers in October 2016 after the date of this Assessment. Details of the Strategy are outlined above in the SECs Formal response.

## **IX. PRINCIPLE-BY-PRINCIPLE ASSESSMENT OF IMPLEMENTATION: MAIN FINDINGS AND RECOMMENDATIONS FOR ACTION**

The purpose of the Assessment is primarily to ascertain whether the legal and regulatory securities markets requirements of the country and the operations of the securities regulatory authorities in implementing and enforcing these requirements in practice meet the standards set out in the IOSCO Principles.

The Assessment is a means of identifying potential gaps, inconsistencies, weaknesses and areas where further powers and/or better implementation of the existing framework may be necessary, to be used as a basis for establishing priorities for improvements to the current regulatory scheme.

The Assessment of the country’s observance of each individual IOSCO Principle is made by assigning to it one of the following assessment categories: fully implemented, broadly implemented, partly implemented, not implemented and not applicable. The IOSCO Assessment Methodology provides a set of assessment criteria to be met in respect of each IOSCO Principle to achieve the designated benchmarks. The methodology recognizes that the means of implementation may vary depending on the domestic context, structure, and stage of development of the country’s capital market, and acknowledges that regulatory authorities may implement the IOSCO Principles in many different ways.

- An IOSCO Principle is considered **fully implemented** (or FI) when all assessment criteria specified for that Principle are generally met without any significant deficiencies.
- An IOSCO Principle is considered **broadly implemented** (or BI) when the exceptions to meeting the assessment criteria specified for that Principle are limited to those specified under the broadly implemented benchmark for that Principle and do not substantially affect the overall adequacy of the regulation that the Principle is intended to address.
- An IOSCO Principle is considered **partly implemented** (or PI) when the assessment criteria specified under the partly implemented benchmark for that Principle are generally met without any significant deficiencies.
- An IOSCO Principle is considered **not implemented** (or NI) when major shortcomings (as specified in the not implemented benchmark for that Principle) are found in adhering to the assessment criteria specified for that Principle.
- An IOSCO Principle is considered not applicable (or NA) when it does not apply because of the nature of the country’s securities market and relevant structural, legal and institutional considerations.

**Table 3 – Summary – Implementation of the IOSCO Principles: Main Findings**

Principle	Rating	Findings
Principle 1. The responsibilities of the Regulator should be clear and objectively stated	PI	<p>The SEC’s responsibilities, powers and authority are set out in the SEC Act and are enforceable.</p> <p>They are generally clearly defined and objectively set out although, in some cases, the <i>powers</i> the SEC has are referred to at a high level only and are based on broadly expressed provisions in the Act.</p> <p>The SEC has not generally clarified its interpretation of these broadly expressed powers in clear regulatory guidance to industry and the public.</p>

Principle	Rating	Findings
		<p>The SEC should be mindful that the use of the omnibus provision, in particular, without such guidance may undermine market participant trust and confidence in the regulator and the regulatory framework. In the absence of legislative reform to deal with new situations, guidance could provide the clarity and certainty that market participant trust and confidence requires.</p> <p>The RT understands that the SEC has drafted legislative amendments which the SEC advises are intended to reduce regulatory reliance on the omnibus provision. The SEC has also advised that it is also open to publishing guidance for interpretation should future circumstances require reliance on the omnibus provision.</p> <p>All actions and directions of the SEC are amenable to judicial review by either the Court of Appeal or the Supreme Court by virtue of the SEC's status as a public body and the inherent jurisdiction conferred on those Courts in respect of such bodies under the Constitution.</p> <p>There are also provisions under the SEC Act which provide for persons aggrieved by SEC decisions to grant licenses to stock exchanges, brokers or dealers, to register market intermediaries, and grants of licenses to unit trusts to appeal such decisions before the Court of Appeal.</p> <p>The SEC's interpretation of its authority is subject to review. There is limited guidance provided on how that discretion is exercised.</p> <p>There is a small – and, possibly, growing – unlisted corporate bond market in Sri Lanka, which is not regulated by the SEC and is subject only to the prospectus registration requirements of the Registrar of Companies. The size of this market is unclear. This is a matter of some concern given the potential risks to investors posed by this market.</p> <p>Some investment banking activities and the activities of financial planners and employees of market intermediaries are also not regulated. Registered auditors registered only under the Companies Act are also not subject to the same intensity of regulation and supervision as auditor members of ICASL.</p>

Principle	Rating	Findings
		<p>Co-operation between the regulators responsible for securities regulation is limited, with the only formal MoU in place being with SLAASMB. There is no formal co-operation agreement or documented protocols with the CSE and no co-operation agreements with the RoC, the CBSL, ICASL or the Attorney-General's Departments, each of which play a role in the regulation of activities the subject of the IOSCO Principles. A more formalized arrangement for information sharing and cooperation with each of these authorities and agencies is needed.</p>
<p>Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and power</p>	<p>NI</p>	<p>The SEC has a stable and adequate source of funding sufficient to meet its regulatory and operational needs. SEC management, Commission members and staff are adequately protected from personal liability for action taken in discharging their functions and powers. Aggrieved persons can seek reviews of certain Commission decisions and can be heard, as required by this Principle.</p> <p>There are, however, a number of significant gaps in the implementation of this Principle, as follows:</p> <ul style="list-style-type: none"> <li>• Although the Review Team did not encounter any concrete evidence of interference or influence in the day-to-day operations of the SEC, there are opportunities for such interference. This includes the Minister's power to remove a Commissioner without cause and without review, the absence of fit and proper criteria in appointing Commission members and the practice of Commission members resigning when there is a change of government. Significantly, there is also a public perception of such interference and lack of SEC independence in day-to-day matters from Government. Revisions to the SEC Act sighted by the Review Team are intended to address these opportunities for influence.</li> <li>• There is no formal consultation process between Commission members and the Government, although consultation appears to occur on a regular basis. Formal consultation processes would contribute to a reduction in market concern about government interference in the operations of the SEC.</li> <li>• There are no provisions that preclude informal communication of confidential material between the Minister and Commissioners.</li> </ul> <p>Although the SEC is accountable to the government and Parliament on an ongoing basis and is subject to audit and review on the use of funds, transparency about the use of resources is limited to retrospective reporting in annual reports.</p>



Principle	Rating	Findings
<p>Principle 3. The Regulator should have adequate power, proper resources and the capacity to perform its functions and exercise its power</p>	<p>PI</p>	<p>The SEC’s funding is adequate to permit it to fulfil its responsibilities, taking into account the size, complexity and types of functions subject to its regulation, supervision and oversight. The SEC also has autonomy in allocating resources once funded.</p> <p>The SEC plays an active role in promoting education in the interests of protecting investors. This covers both investor education and the education of industry professionals.</p> <p>However, significant shortcomings remain in the implementation of this IOSCO Principle. Addressing these shortcomings is critical to building trust and confidence in the regulator and in the Sri Lankan capital markets more generally.</p> <ul style="list-style-type: none"> <li>• The SEC’s powers are not sufficient to meet its current responsibilities, particularly in relation to supervision and enforcement. Furthermore, the SEC does not have an appropriately wide range of sanctions available to it in addressing breaches of the Act, regulations and rules.</li> <li>• Although there is some “bench strength” – or depth of professional capability – at middle levels of the organization, the SEC is experiencing difficulty in filling strategic senior-level positions with appropriately skilled and experienced staff. The absence of enough appropriately skilled staff at senior levels is leading to the escalation of decisions to the Director-General and Commission which should be made at more junior levels. This could, as a result impact the ability of the Director General and Commission to perform strategic functions.</li> <li>• The efficiency with which resources are used warrants some improvement. The need to visit every regulated entity irrespective of the risk they pose should be reconsidered. Consideration should be given, for instance, to decoupling supervisory visits from license and registration renewals and freeing supervisory staff to focus on more intensive supervision and follow up in activities and areas identified as high risk.</li> <li>• There is evidence of a lack of communication between the SEC and industry about the SEC’s recent actions, current thinking and vision for the market. Given the perception in some quarters that the SEC is not effectively fulfilling its mandate as a securities regulator there is a strong need for the SEC to communicate its strategic direction to industry and to ensure that there are internal mechanisms to assess whether the strategic direction is being successfully implemented. The RT notes the SEC’s advice that after the on-site visit that this was noted and is being acted on.</li> </ul>

Principle	Rating	Findings
		<ul style="list-style-type: none"> <li>• While the SEC has a solid staff training program, consideration needs to be given to developing processes under which training is targeted at those who would most benefit from it.</li> </ul> <p>The SEC’s audit function is currently being outsourced and only covers the financial reporting process of the SEC’s operations. A formalized internal audit function that encompasses corporate governance processes would assist in reviewing the SEC’s performance of its own obligations and duties on a continuous basis.</p> <p>Such an internal audit process would help the SEC accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. This in turn will serve to improve the efficiency of the organization as a whole.</p> <p>The RT notes the Commission, in response to this and other developments, has made a decision to hold industry consultations on at least a bi-annual basis, and to conduct quarterly meetings with the Board of the CSE.</p> <p>The Review Team also notes resource and staffing challenges faced by SLAASMB described in the assessment of Principles 18 and 19.</p>
Principle 4. The Regulator should adopt clear and consistent regulatory processes	PI	<p>The SEC is subject to procedural rules and regulations. The SEC’s decisions are required to be made, and are made, applying procedural fairness.</p> <p>However, significant shortcomings remain in the implementation of this IOSCO Principle. Addressing these shortcomings is important to ensuring trust and confidence in the SEC’s regulatory processes. In particular:</p> <ul style="list-style-type: none"> <li>• The SEC does not provide any guidance to its regulated population or to the public as to how it interprets its authority, nor does it publicly disclose its policies in important operational areas. In essence, guidance to market participants from the SEC on regulatory requirements is provided on a case-by-case basis, if at all. As a result, there is a significant risk of inconsistent interpretation of the provisions of the Act.</li> <li>• The SEC’s review procedures lack transparency. This may lead to a lack of public and market confidence in the SEC’s authority and independence.</li> </ul>

Principle	Rating	Findings
		<p>Although consultation processes are well established, and the SEC has consulted with stakeholders about its reform plans there is some concern in the market that the SEC has not communicated outcomes, particularly with respect to its strategic vision for the regulation of the Sri Lankan capital markets. Some industry groups also indicated they would like to meet with the Commission and the Director General on a regular basis.</p> <p>The SEC advises that such outcomes will be communicated once finalised, and that meaningful industry consultations would continue to take place, and increase in frequency thereafter.</p> <p>For consistency and transparency purposes, the SEC should consider publishing specific guidelines on how it interprets its authority. This will also ensure that the SEC's interpretation of its authority and decisions are applied internally in a consistent and fair manner.</p> <p>Regular meetings with industry are also recommended.</p>
<p>Principle 5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality</p>	<p>FI</p>	<p>The SEC staff, management and Commissioners appear to adhere to a strict Code of Ethics and professional conduct in terms of honesty and integrity; procedural fairness; prevention of conflict of interest; and confidentiality.</p> <p>However, in terms of confidentiality of information, there are no provisions that preclude informal communication of confidential matters between Commission members and the Minister. Although Commission members sign a Code of Ethics upon being appointed to the SEC Board, it does not apply to disclosing information to the Government.</p> <p>The Establishment Code and Administrative Manual are outdated and are in need of thorough revision.</p> <p>However, these deficiencies are minor and – while they should be addressed – do not warrant departure from a Fully Implemented rating.</p>
<p>Principle 6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate</p>	<p>NI</p>	<p>The SEC has no process – either formal or informal – to monitor, mitigate and appropriately manage systemic risk.</p> <p>The expertise of the SEC in relation to risk measurements and analysis relevant to systemic risk assessment should be addressed as a matter of urgency. This could be done by applying or adopting measurements and tools developed by other regulators.</p> <p>Although there is some communication between the SEC and other financial sector regulators, such as the CBSL, it is of a general nature and does not specifically pertain to efforts to reduce systemic risks.</p>

Principle	Rating	Findings
		<p>The SEC's initiative to facilitate the setting up of a Central Counterparty (CCP) mechanism at the CSE is a good first step in addressing systemic risk. It is important that the regulatory framework for this CCP, including the CCP's own rules, allow for the mitigation and management of the systemic risks that may be posed by the CCP.</p> <p>The Review Team notes revisions to the SEC Act it has seen make reference to the object of sections of the Act dealing with markets and market institutions, being the reduction of systemic risk associated with capital markets. Consideration should be given to including similar provisions dealing with other areas of the SEC's regulatory responsibilities.</p>
<p>Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly</p>	<p>NI</p>	<p>The SEC has not developed any formal processes for the identification, measurement and analysis of risks.</p> <p>Regular reviews of products, markets, market participants and activities to identify and assess possible risks are not systematic in Sri Lanka. Instead, there have been ad-hoc initiatives in response to issues that have come to light.</p> <p>The SEC acknowledges that it currently has no formalized process to review unregulated products, markets, market participants and activities.</p> <p>The absence of processes to review the perimeter of regulation is a significant weakness, particularly as key participants in securities markets are not the subject of direct SEC oversight.</p> <p>There is, therefore, a need to develop robust arrangements to conduct comprehensive analyses of potential risks emerging from unregulated products and entities in the Sri Lankan securities market.</p> <p>The SEC should, however, be commended for undertaking the significant overhaul of its current regulatory framework: a move also recommended by the 2015 FSAP.</p>
<p>Principle 8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed</p>	<p>BI</p>	<p>In Sri Lanka, what constitutes a conflict of interest in securities markets is specified in relation to each market intermediary and other participants.</p> <p>The regulatory framework places emphasis on preventing and eliminating conflicts of interest, and sets out precautions and remedial measures for market participants such as stock exchanges, stockbrokers and dealers, Unit Trust Managing Companies, and market intermediaries.</p> <p>However, there is no general obligation placed on the operator of a licensed stock exchange to manage or avoid conflicts.</p>

Principle	Rating	Findings
		<p>The SEC has processes in place to address conflicts of interest and misalignment of incentives, including imposing enhanced disclosure requirements and undertaking compliance and oversight functions.</p> <p>While the SEC’s regulatory framework places primary responsibility for avoiding conflicts of interest with regulated entities, the SEC engages in supervisory activity such that, where conflicts do arise, they are detected and addressed through its intervention.</p> <p>When reviewing issuers’ reporting obligations, the SEC seeks to identify potential misalignment of incentives and addresses them mainly through enhanced disclosure. Further, the SEC conducts on-site inspections to monitor regulatory compliance by regulated entities.</p> <p>References to regulatory approaches to conflicts of interest are set out in the assessment of a number of Principles, including Principles 9, 20, 22, 23, 24 and 31.</p>
<p>Principle 9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising power and delegated responsibilities.</p>	<p>BI</p>	<p>In Sri Lanka, the CSE undertakes certain self-regulatory functions, under the overall supervision of the SEC. These self-regulatory functions are generally based on clear rules.</p> <p>However, there are no explicit requirements for the CSE to operate fairly and consistently, to maintain confidentiality when undertaking self-regulatory activities, or to manage or avoid conflicts of interest.</p> <p>However, the CSE, on its own initiative, has confidentiality arrangements in place, which impose a duty of confidentiality on the employees of the CSE and are legally enforceable.</p>
<p>Principle 10. The Regulator should have comprehensive inspection, investigation and surveillance power</p>	<p>BI</p>	<p>The SEC’s powers of inspection, investigation and surveillance are based on high-level, general provisions with no additional guidance provided to regulated entities on how the provisions should be interpreted. This is also the case in relation to provisions dealing with record-keeping.</p> <p>One example is the SEC’s power to conduct ‘inspections without prior notice’, which is implied, rather than specific. Normal practice is to give one-day prior notice to regulated entities before a regular inspection takes place. Although, the power of the SEC to conduct inspections without such prior notice has not been contested, the Review Team is of the view that the SEC should have an explicit power allowing for inspections to be conducted without prior notice.</p> <p>Specific reference in the SEC Act to the detailed powers set out in this IOSCO Principle would provide greater certainty to all stakeholders, and would enhance investor confidence in the regulator and in the markets and</p>

Principle	Rating	Findings
		<p>activities it regulates. This is recognized in revisions to the SEC Act sighted by the Review Team.</p> <p>The SEC's powers are also limited to the activity of regulated entities. They do not extend to the activities of investment banks, investment advisers and individuals working for market intermediaries which fall outside the SEC's current regulatory purview.</p> <p>Again, these limitations are being addressed by draft legislation sighted by the Review Team.</p> <p>SLAASMB has appropriately broad powers of investigation to support the performance of its responsibilities.</p>
Principle 11. The Regulator should have comprehensive enforcement power	PI	<p>The SEC has broad powers to require and obtain information from regulated entities, third parties or any individuals as contemplated by the IOSCO Principle.</p> <p>The SEC has the power to institute criminal proceedings in relation to a range of misconduct offences under the SEC Act and the rules made under that Act.</p> <p>The SEC, however, lacks the power to initiate civil proceedings or impose an appropriately dissuasive set of administrative sanctions. These are significant and serious shortcomings.</p> <p>These shortcomings are being addressed in revisions to the SEC Act, drafts of which were sighted by the Review Team.</p> <p>The Review Team considers that a lower Court may not be the appropriate venue to hear criminal cases that may involve technical and complex matters dealing with the securities sector.</p> <p>SLAASMB is also limited to taking criminal action in relation to breaches of the SLAAS Act. More appropriate civil and administrative remedies are not available to it.</p>
Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement power and implementation of an effective compliance program	PI	<p>Although the Sri Lankan authorities have a supervisory framework in place which ensures most regulated entities receive an onsite visit each year and despite some recent enhancements in supervisory processes and plans for further enhancement, there is scope for significant improvement in the use of inspection, investigation, surveillance and enforcement powers.</p> <p>While the supervisory framework has identified suspicious trading and compliance weaknesses, there is little evidence that these findings have led to timely enforcement outcomes, or to prompt changes in firm behavior.</p> <p>The SEC has advised the RT that it is committed to addressing this and advises that in recognition of this concern it had restructured its Investigations Division</p>

Principle	Rating	Findings
		<p>shortly before the onsite visit.</p> <p>The relative lack of concrete outcomes of surveillance activities and related investigations is strongly related to market confidence and needs to be addressed as a matter of priority.</p> <p>Use of cautions and warnings and supervisory action in following surveillance findings in relation to licenses reinforce, to some extent, the credibility of the enforcement framework, but lack the impact of criminal prosecutions.</p> <p>The following are noted:</p> <ul style="list-style-type: none"> <li>• The SEC does not currently employ a risk-based approach to supervision. There is no risk based framework in place to select and prioritize the regulated entities to be inspected nor the frequency or intensity of those inspections. While the SEC undertakes a fair number of supervisory visits annually, these visits (particularly those for managing companies and investment managers) appear to be compliance audits. Although they do cover risks such as credit and operational risks, they are not sufficiently geared toward developing a holistic picture of the firms' weaknesses and risks. This is being addressed by the SEC through the development of a risk based approach to the conduct of supervisory visits.</li> <li>• Concerns remain that significant weaknesses identified through inspections of stockbroker compliance with key and basic client protection requirements have not always been adequately addressed in a timely and effective way. These weaknesses include lapses in segregation of client monies, co-mingling of clients' monies with house monies, retaining the proceeds of security sales without clients' permission, extending credit to clients beyond regulatory limits and extending credit without an appropriate written agreement. Given the significance and potential pervasiveness of the weaknesses identified, delays in rectification risk client losses and consequent erosion in the credibility of the regulatory framework for stockbrokers.</li> <li>• Despite steps to improve the quality of the cadre of supervisory staff, scope remains to improve the level of understanding by staff of the entities regulated.</li> <li>• There is also insufficient supervision of trustees of unit trusts.</li> </ul>

Principle	Rating	Findings
		<ul style="list-style-type: none"> <li>• In the area of surveillance, the Review Team notes the relatively small number of referrals which have led to the initiation of investigations. The SEC has limited investigation resources which impedes its ability to respond to referrals.</li> <li>• Even where investigations have been undertaken, there have been limited enforcement outcomes. There have been very few criminal prosecutions brought, a small number of administrative actions (including license suspensions or removal of the certification of relevant individuals to deal with clients) and a number of cautions and warnings.</li> <li>• The SEC is effectively limited to criminal sanctions in addressing all breaches of the Act, irrespective of how egregious that breach might be. The SEC does not have the flexibility offered by civil or a full suite of administrative sanctions. Penalties set in 1987, and not revised since, are seen as too low and are insufficiently dissuasive. Use is also made of compounding as essentially a settlement mechanism, which both reduces the maximum financial penalty payable and does not require an admission of guilt by wrongdoers. While administrative and civil sanctions will be included in new legislation, fine levels should also be reviewed to ensure they are consistent and high enough to be effective deterrents.</li> <li>• Slow prosecution processes – including decisions by the Attorney-General’s Department on referrals from the SEC and slow Court processes – contribute to an environment in which acting promptly and decisively is challenging. The relatively greater use of warnings, cautions and compounding supports the perception of the enforcement regime lacking credibility.</li> </ul>
Principle 13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts	PI	<p>The SEC has broad authority to share both public and non-public information with both domestic and foreign counterparts. There are, however, some significant limitations with regard to sharing information which is connected to investigations with foreign counterparts. In these cases, the SEC is required to obtain the consent of the person under investigation.</p> <p>The RT notes the SEC’s advice that the specificity of these provisions is being addressed in proposed amendments to the SEC Act.</p>
Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts	FI	<p>The SEC has been a signatory to the IOSCO Multilateral MoU (MMoU) since 2004 and has successfully used it several times.</p> <p>Domestically, the SEC has signed an MoU with SLAASMB. This Review recommends the SEC also sign equivalent agreements with other authorities engaged in</p>



Principle	Rating	Findings
		regulating the securities markets, or which might affect – or be affected by – these markets.
Principle 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their power	FI	<p>The SEC has the framework to provide extensive assistance to foreign regulatory authorities in carrying out their responsibilities.</p> <p>The SEC does not require the permission of any outside authority to share information and an independent interest or “dual illegality” is not required as a precondition to cooperation.</p> <p>Enhancements to SEC’s authority to share information with foreign counterparties are contemplated in the proposed amendments to the SEC Act.</p>
Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investor’s decisions	BI	<p>For issuers listed on the CSE, the CSE Listing Rules generally meet the requirements set out in this IOSCO Principle about the information to be provided to</p> <p>Although there is no general provision requiring all material information to be disclosed as required by this Principle, there are provisions requiring information to be complete and not misleading and provisions which refer to an extensive (but non-exhaustive) list of the types of information which should be disclosed. For instance, section 8 of the CSE Listing Rules requires all listed companies to release any price sensitive information to the market immediately while under section 3 of the CSE Listing Rules the CSE has the absolute right to require disclosure of any additional information as it considers appropriate in any particular case.</p> <p>The CSE and the SEC have some power to address non-compliance with these requirements, including not approving a listing and, once listed, imposing trading halts and suspensions and invoking the Default Board procedures.</p> <p>The Regulation of issues by <b>unlisted companies</b> does not meet the requirements of the IOSCO Principle. The Companies Act does not, for instance, provide for disclosure of material risks in prospectuses, although it does provide for these disclosures in annual reports. Nor does it impose continuous disclosure obligations, other than setting out annual reporting requirements.</p> <p>The prospectus registration requirements are also not subject to the same scrutiny set by the CSE, with the Registrar of Companies role limited to registration of documents and taking civil and criminal action in the event information contained in the prospectus is misleading. Given the potentially significant number of these issues these shortcomings are a matter of concern.</p>

Principle	Rating	Findings
		<p>Foreign issuers wishing to issue in Sri Lanka are required to meet local listing requirements, without allowance made for meeting listing requirements in other jurisdictions.</p> <p>While the current CSE listing rules ensure that directors are liable for the content of disclosures made, liability does not extend to other relevant persons involved in the issuing process (underwriters, authoring officers, promoters, experts, advisers, etc.). The Companies Act, however, does provide for promoters, experts and others to be liable for the content of disclosure documents. It is unclear whether revisions to the SEC Act will extend liability for the content of disclosure documents to others.</p> <p>Supervision of these requirements by the SEC is sound. Joint cooperation between the CSE and the SEC is satisfactory.</p>
Principle 17. Holder of securities in a company should be treated in a fair and equitable manner	BI	<p>The basic rights of equity shareholders in listed companies set out in the CSE Listing Rules, the Companies Act and the SEC Code on Takeovers and Mergers generally meet the requirements of this IOSCO Principle.</p> <p>There are some shortcomings in relation to both listed and unlisted companies.</p> <p>The RT notes the SEC's advice that shortcomings with respect to listed companies are expected to be addressed in proposed revisions to the SEC Act and that foreign listings will also be covered.</p>
Principle 18. Accounting standards used by issuer to prepare financial statements should be of a high and internationally acceptable quality	BI	<p>Issuers are required to include audited financial statements with the content set out in this IOSCO Principle.</p> <p>Financial statements for listed companies are, in turn, required to be prepared in accordance with the SLFRS's, which are a comprehensive body of accounting standards of an internationally acceptable quality.</p> <p>Unaudited financial statements used in interim reports by listed companies are also required to be prepared in accordance with the SLFRS's – although there are no general requirements for unlisted companies to do so (with some specific exceptions).</p> <p>Requirements about the establishment and timely interpretation of accounting standards are met. Standard setting processes are considered to be open and transparent.</p> <p>A formal system of supervising and enforcing compliance with accounting standards is in place, with SLAASMB responsible for supervision and enforcement.</p> <p>However, there are a number of shortcomings including the approach to compliance with accounting standards,</p>

Principle	Rating	Findings
		<p>limited interaction between the SEC and SLAASMB in monitoring compliance, the fact SLAASMB has limited remediation and enforcement powers and faces resourcing issues.</p> <p>Although as a matter of practice, Sri Lanka has adopted international accounting standards, the legal framework in Sri Lanka for setting those standards also has relatively limited public interest oversight.</p> <p>The fact the SEC is one of 12 members of the Accounting Standards Committee falls short of the co-operation or oversight contemplated by this Principle.</p>
Principle 19. Auditor should be subject to adequate levels of oversight	PI	<p>Elements of an oversight framework for overseeing the quality and implementation of auditing, independence and ethical standards are in place.</p> <p>However, there are a number of significant shortcomings including resource limitations at SLAASMB, limitations to the reviews SLAASMB conducts (including the fact reviews do not cover audit processes or the quality control environment in which auditors operate), an apparent lack of understanding of what audit quality means, and limited enforcement powers and the domination of the SLAASMB Board by members of the profession. The relatively large number of registered auditors not subject to the requirements of the SLAAS Act is also a matter of concern.</p> <p>There are also concerns about the dominance of members of the profession on the SLAASMB Board.</p> <p>The RT notes advice from ICASL that amendments are proposed to the SLAAS Act to establish a Quality Assurance Board to strengthen the auditing profession.</p>
Principle 20. Auditor should be independent of the issuing entity that they audit	PI	<p>The regulatory framework for ensuring independence of auditors is weak.</p> <p>The most extensive provisions for the appointment of auditors of listed companies are in the SEC Guidelines, but the Guidelines do not have the force of law and are limited to listed companies.</p> <p>While the CSE Listing Rules and Companies Act do have the force of law, requirements, to the extent they exist, are high-level and imposed on Audit Committees to be taken into account in appointing auditors. These requirements do not address the requirements set out in this IOSCO Principle.</p> <p>ICASL has indicated that it has recently started quality assurance programs to implement the SLSQC 1 which includes addressing the issue of auditor independence. It notes that auditors are generally understood to have and</p>

Principle	Rating	Findings
		<p>maintain internal systems, governance arrangements and processes for addressing threats to independence.</p> <p>Reviews undertaken by the SEC and SLAASMB are understood to address issues of auditor independence but, as noted in the comments on Principle 19, it is unclear how these issues are, in fact, addressed. Further, remedial and enforcement action undertaken by SLAASMB, as noted in the comments on Principle 19, warrant improvement.</p>
<p>Principle 21. Auditing standards should be of a high and internationally acceptable quality</p>	<p>BI</p>	<p>A regulatory framework is in place in Sri Lanka requiring public issuers' financial statements to be audited in accordance with a comprehensive set of auditing standards.</p> <p>The Sri Lanka Auditing Standards (SLAuSs) are considered to be of high and internationally acceptable quality, adopting International standards.</p> <p>However, the legal framework for setting standards has relatively limited public interest oversight.</p>
<p>Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.</p>	<p>BI</p>	<p>Some – but not all – of the required elements for the regulatory framework for CRA's are in place in Sri Lanka.</p> <p>Requirements are set out in Regulatory Standards which have been made by the SEC as Directives under the SEC Act.</p> <p>A number of shortcomings are evident in the Regulatory Standards applied to CRA's which could be addressed by more granular guidance.</p> <p>Supervision of CRA's focuses primarily on governance and operational processes in the context of the renewal of license applications. Issues about the management of conflicts of interest appear to be well addressed.</p>
<p>Principle 23. Other entities that offer investor analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them</p>	<p>NI</p>	<p>The requirements of this IOSCO Principle are not implemented.</p> <p>Reviews of the activities of information service providers are not conducted as contemplated by this Principle.</p> <p>The provision of research by sell-side analysts and research services is not directly regulated.</p> <p>The Stockbroker Rules, which regulate the activities of the firms understood to provide these services in Sri Lanka, focus on the activities of traders and firms in relation to trading activities and not on the activities of research analysts.</p>

Principle	Rating	Findings
		<p>The Ethical Framework and Best Practices in Professional Conduct, which is said to cover investment analysts, does not have the force of law and only sets high level expectations about addressing conflicts of interest through disclosure of the conflict.</p> <p>Proposed revisions to the SEC Act are understood to contemplate delegating rule-making powers concerning the definitions of types of market intermediary and the SEC has advised that it will consider further how to frame different categories identified in the law. This may lead to an extension of the definition of market intermediaries to cover “investment analysts” and possibly providers of information services to the public.</p>
<p>Principle 24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme</p>	<p>PI</p>	<p>There is a legislative and regulatory framework for collective investments in Sri Lanka, including licensing requirements, some conduct and operational standards for managing companies and ongoing supervision and monitoring by the SEC.</p> <p>However, there are significant shortcomings in both the design and supervision of the framework.</p> <p>Shortcomings in the design of the regulatory framework include shortcomings in eligibility criteria for licensing (including no explicit requirement of risk management frameworks, internal controls and compliance arrangements to be in place), the fact employees and agents of managing companies engaged in selling interests in Unit Trusts schemes to clients are not directly regulated, the absence of key conduct and organizational standards for management companies or Unit Trusts, the fact managing companies are not required to file periodic compliance reports, and the absence of guidance on the delegation of a managing company’s responsibilities and functions.</p> <p>The RT notes the SEC’s advice that these shortcomings are expected to be addressed by revisions to the SEC Act and the Market Intermediary Rules</p> <p>The regulatory framework for managing companies also differs in important respects from other market intermediaries (as set out in Principle 29).</p> <p>The SEC has powers to conduct inspections and investigations of managing companies and trustees and to take disciplinary action. While the SEC proactively conducts on-site inspections and offsite monitoring of managing companies and funds under management, the activity is more in the nature of check list compliance audits which address key operational risks. The SEC should work to ensure that in all cases inspections are approached with a view to providing a holistic enterprise wide assessment of the risks posed to unit holders.</p>

Principle	Rating	Findings
		<p>The RT Notes the SEC’s advice that the proposed risk based supervision framework, the development of which is currently underway, is intended to ensure this.</p> <p>Limited regulatory action has resulted from the detected instances of non-compliance.</p> <p>There are also significant gaps in trustee oversight, including infrequent and relatively light inspections. Given the role trustees play in the oversight of managing companies and Unit Trusts, and the fact one entity acts as trustee for 80% of unit trusts in Sri Lanka, the relatively low level of regulatory oversight is a matter of some concern.</p>
<p>Principle 25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets</p>	<p>PI</p>	<p>The regulatory framework for collective investments in Sri Lanka sets out requirements about the structure of Unit Trusts, investor rights, investment restriction and the orderly winding up of CIS businesses.</p> <p>Trustees are responsible for safekeeping of assets; however there are significant shortcomings in requirements concerning the segregation of unit trust assets. There is also no regulatory guidance in relation to the use of custodian to hold assets of unit trusts. These shortcomings are a matter of concern, given the lack of oversight of the activities of trustees (noted in Principle 24). The Review Team notes the SEC’s advice that proposed revisions to the SEC ACT are intended to address these concerns.</p>
<p>Principle 26. Regulation should require disclosure, as set forth under the principles for issuer, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor’s interest in the scheme</p>	<p>BI</p>	<p>The regulatory framework for collective investments in Sri Lanka generally sets out requirements about the disclosure of material information to investors in offering documents, periodic reports and advertisements.</p> <p>There are a number of shortcomings, including the absence of standard format requirements for offering documents, a lack of detailed advertising guidelines, and no provisions prohibiting or dealing with the issue of inaccurate, false or misleading advertisements.</p> <p>The RT notes the SEC’s advice that preparation of guidance on the form and content of advertising was prepared after the onsite visit and is awaiting input from industry stakeholders. The RT also notes the SEC’s advice that a standard format for offering documents is also being prepared.</p>
<p>Principle 27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme</p>	<p>PI</p>	<p>A regulatory framework is in place covering valuation, pricing and redemption of units in a collective investment scheme in Sri Lanka.</p> <p>However, there are a number of shortcomings, including in relation to the valuation of unlisted, non-traded or thinly traded equity securities, the valuation of Money Market Funds, audit requirements, and the treatment of pricing errors.</p>

Principle	Rating	Findings
		<p>The RT notes the SEC advice that the value-at-risk framework the CSE plans to adopt is intended to address shortcomings in relation to non-traded and thinly-traded securities.</p>
<p>Principle 28. Regulation should ensure that hedge funds and/or hedge funds managers/advisor are subject to appropriate oversight</p>	<p>NI</p>	<p>Hedge funds do not operate in Sri Lanka.</p> <p>There are no provisions prohibiting the launch of hedge funds or marketing of foreign hedge funds in Sri Lanka.</p> <p>There is also no explicit provision for hedge funds to be registered, nor regulatory guidance about the basis on which they might be registered.</p> <p>The RT notes the SEC advice that these shortcomings are intended to be addressed by revisions to the CIS Code currently being developed by the SEC, which will expressly provide for the operation and regulation of hedge funds.</p>
<p>Principle 29. Regulation should provide for minimum entry standards for market intermediaries</p>	<p>PI</p>	<p>Although the fundamentals required in relation to the authorisation standards and on-going requirements for intermediaries are covered by the current regulatory framework, the Review Team has identified a number of concerns.</p> <p>The SEC currently operates the licensing regime and registration regimes in parallel. Although the two regimes are designed to operate in a similar manner, there is a lack of consistency and uniformity in terms of the requirements that are applied on similarly situated intermediaries under the two regimes.</p> <p>There are a number of significant gaps in the regulatory framework, including the following:</p> <ul style="list-style-type: none"> <li>• There are gaps in the licensing/registration requirements and in the process the SEC follows in considering these applications. These gaps may impinge on the SEC's ability to effectively and comprehensively assess the suitability of an applicant. For example, the fit and proper criterion does not apply to the controllers of an applicant. The SEC's reviews focus mainly on the applicants' compliance with prudential requirements, with little emphasis on assessing the adequacy of the applicants' internal organization, risk management, supervisory systems and compliance arrangements. The SEC does not conduct pre-licensing visits to check that the applicants are properly set-up.</li> <li>• The SEC lacks the express power to impose conditions on licenses and registrations. The circumstances under which the SEC may refuse, suspend or cancel licenses or registrations are limited. The RT notes the SEC advice that proposed</li> </ul>

Principle	Rating	Findings
		<p>revisions to the SEC Act are intended to address these shortcomings,</p> <ul style="list-style-type: none"> <li>• Although the SEC has the powers to bar a person from functioning as a director or dealing with clients in respect of market intermediaries, such powers do not extend to other types of intermediaries, such as stock brokers and dealers and management companies. Individuals who conduct regulated activities on behalf of intermediaries are not regulated nor are they subject to any conduct requirements. These limitations hamper the SEC's ability to take effective steps to prevent the employment, or seek the removal, of persons who have committed securities violations or who are otherwise unsuitable to engage in regulated activities.</li> <li>• Investment banks and financial planners and advisers in Sri Lanka are currently not subject to any regulation, which is a serious gap that requires urgent rectification. The RT notes the SEC advice that proposed revisions to the SEC Act are intended to address this shortcoming,</li> </ul>
<p>Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake</p>	<p>PI</p>	<p>Stockbrokers and market intermediaries are required to meet minimum net capital and liquidity requirements at admission and on an ongoing basis. Record keeping requirements for these intermediaries are in place and enable capital levels to be determined at any time. These intermediaries are also required to prepare audited financial statements.</p> <p>There are, however, significant shortcomings in the regulatory and supervisory regimes. Specifically:</p> <ul style="list-style-type: none"> <li>• Capital requirements for all intermediaries do not address the range of risks to be taken into account under this Principle.</li> <li>• Capital requirements are not dynamic. The amount of capital required does not vary according to the nature or quantum of risks assumed, or other significant market developments;</li> <li>• While the existing framework enables intermediaries to absorb some losses, it does not provide assurance that intermediaries set aside sufficient financial resources based on the different types of risks that they face;</li> <li>• There is no early warning mechanism available to the SEC in relation to breaches of capital requirements (e.g. requirement for intermediaries to notify the SEC whenever their capital falls below a certain level). This limits the SEC's ability to make timely</li> </ul>



Principle	Rating	Findings
		<p>intervention and take pre-emptive measures to safeguard investors' interests;</p> <p>A number of stockbrokers are currently not adequately capitalized. This is a significant weakness that warrants further scrutiny, particularly given that stockbrokers are currently operating in a challenging market environment (i.e. low levels of market liquidity and fundraising activities).</p> <p>The RT understands that the SEC together with CSE is to implement a risk based capital adequacy ratio (CAR) which would ensure that stock brokers retain an appropriate level of liquid capital in relation to the risks set out in this Principle. The CAR would replace the present net capital requirements of Stock Broking Firms.</p>
<p>Principle 31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters</p>	<p>PI</p>	<p>The regulatory framework addresses some but not all of the requirements contemplated by IOSCO Principle 31.</p> <p>Shortcomings in the regulatory framework include the following:</p> <ul style="list-style-type: none"> <li>• Intermediaries are not required to subject their internal and operational controls and risk management processes to an objective, periodic evaluation, i.e. through an internal audit function. While some checks may be conducted during inspections and as part of annual financial audits, these actions do not supplant the need for intermediaries to have an internal audit function that independently and regularly evaluates and tests the effectiveness of their risk, control and governance environment.</li> <li>• There are no requirements for managing companies of unit trusts to have in place appropriate management and organization structure, compliance and risk management functions, internal controls and operational procedures, and complaint handling procedures.</li> <li>• The regulatory framework also does not address the risks posed by outsourcing arrangements, or the provision of direct electronic access facility by stockbrokers/dealers. In relation to outsourcing, the Review Team notes the SEC's advice that no broking firms are currently outsourcing their back office functions and that parties who dispatch contract notes and statements of accounts to clients on behalf of several broking firms have entered into confidentiality agreements with those firms.</li> <li>• The expectation for intermediaries to have a reasonable basis (including taking into account the needs of the clients) when recommending any</li> </ul>

Principle	Rating	Findings
		<p>security or investment to their clients is set out in a Guideline which does not have the force of law.</p> <ul style="list-style-type: none"> <li>• The requirement for stockbrokers to provide statements of account does not apply to all of their clients. Margin providers are also not required to provide statements of account.</li> </ul> <p>Significant gaps are also evident in client assets protection requirements:</p> <ul style="list-style-type: none"> <li>• There are no requirements for intermediaries to conduct due diligence on the suitability of the banks and custodians with whom they intend to deposit clients' monies and assets, and to carry out regular reconciliation of client monies and assets.</li> <li>• The requirements for stockbrokers to, before depositing client monies into a bank account, give written notice to (and obtain acknowledgement from) a bank that: (i) the monies are held in trust for the benefit of the client, and (ii) are to be held separately from the stockbrokers' account and not applied to offset the stockbrokers' debt to the bank, do not apply to other intermediaries.</li> <li>• While stockbrokers are obliged to segregate client funds and place these in a bank trust account, there are no specific legal provisions to protect client monies from being subject to creditor claims in intermediary bankruptcy. This presents a significant risk to the clients of stockbrokers, who cannot have complete confidence that their assets are being genuinely protected.</li> <li>• Requirements do not apply to unlisted securities.</li> </ul> <p>The RT notes the SEC's advice that proposed revisions to the Market Intermediary Rules are intended to address these shortcomings.</p> <p>The SEC does not currently employ a risk-based approach to supervision.</p> <p>While the SEC conducts on-site visits of all regulated entities at least annually (with stockbroking firms also visited by the CSE) and there is some focus on how risks are managed, there is room for the SEC to further enhance its inspection approach so that it is able to develop a more holistic picture of the risks each regulated entity poses to its regulatory objectives. In particular, the SEC should work to ensure that inspections of managing companies are approached with a view to providing a holistic assessment of the risks posed to unitholders, as opposed to the current checklist-based compliance audits.</p>

Principle	Rating	Findings
		<p>Where the SEC has identified significant weaknesses – including co-mingling of clients’ monies with house monies, and retaining the proceeds of security sales without clients’ permission – there has been limited follow-up to ensure that the lapses identified are addressed in a prompt and effective manner. The weaknesses identified above may, if they persist, expose clients to losses and lead to an erosion in the credibility of the regulatory framework for stockbrokers.</p>
<p>Principle 32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investor and to contain systemic risk</p>	<p>NI</p>	<p>The SEC has not developed any plans and procedures to deal with the failure or possible failure of a market intermediary.</p> <p>In addition, the following significant shortcomings in the powers and operation of the SEC in this area were observed:</p> <ul style="list-style-type: none"> <li>• While the general obligation to notify of any breach of capital requirements and off-site reviews of periodic financial reports submitted by intermediaries allow the SEC to be apprised of the financial position of intermediaries, enhanced surveillance tools are needed to engender a preventive regime.</li> <li>• The lack of an early warning mechanism limits the SEC’s ability to make timely intervention and take pre-emptive measures to minimize damage and loss to investors.</li> <li>• The SEC does not have express powers to take over an intermediary, request the appointment of a monitor, receiver or administrator, or take possession or control of the assets held by the intermediary (or by a third party on behalf of the intermediary). The RT notes the SEC’s advice that it has not sought these powers given the relatively low systemic risk posed by intermediaries in Sri Lanka. The SEC also advises that revisions are proposed to the SEC Act to give the SEC similar powers in relation to market institutions.</li> </ul> <p>As noted in earlier IOSCO Principles, communication between the SEC and other financial sector regulators is of a general nature and does not specifically pertain to efforts to reduce systemic risks.</p> <p>The RT notes the SEC’s advice that it expects this limitation to be addressed by the recently established Financial Sector Oversight Committee of which the SEC, CBSL and the IBSL are members.</p>
<p>Principle 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight</p>	<p>BI</p>	<p>The establishment of a securities exchange is subject to regulatory authorization and oversight in Sri Lanka.</p>

Principle	Rating	Findings
		<p>There is, however, no framework to regulate and supervise automated trading systems which are not a stock exchange. The RT notes the SEC's advice that these systems are intended to be addressed by proposed revisions to the SEC Act.</p> <p>There are also certain gaps in the assessment criteria, notably around technical system standards.</p> <p>There is also no explicit requirement that the CSE applies its rules fairly and consistently. This is a particular issue in the area of admitting new member brokers. However, the SEC has been prepared to overrule CSE Board decisions on admission of new members in the past.</p> <p>While the CSE operates a dispute resolution scheme, the scheme with a majority of non-broker directors is not fully independent.</p>
<p>Principle 34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants</p>	<p>BI</p>	<p>The CSE is subject to ongoing regulatory supervision by the SEC and maintains rules that generally address market integrity issues.</p> <p>The market is also subject to surveillance and supervisory programs.</p> <p>The SEC has some regulatory mechanisms to address compliance failures by the CSE, but there is a lack of mechanisms to address significant, but not severe, breaches. The RT notes the SEC advice that such breaches are intended to be addressed once revisions to the SEC Act are in place.</p> <p>The parallel systems of surveillance and supervision operated by the SEC and CSE create a need for appropriate levels of coordination between the two organizations, to minimize the compliance burden on firms, and ensure efficiency in the use of regulatory resources.</p> <p>An initiative currently in train to improve coordination between the SEC and CSE in respect of referrals for investigation is noted.</p>
<p>Principle 35. Regulation should promote transparency of trading</p>	<p>PI</p>	<p>The regulatory system in Sri Lanka, via the operation of SEC and CSE Trading Rules, establishes a general transparency requirement, with some limitations.</p> <p>However, significant derogations are permitted in respect of crossings, which are not moderated by pre-trade notification to regulators, nor is there any ability for regulators to consider the appropriateness of the use of a crossing before the crossing takes place.</p>
<p>Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices</p>	<p>PI</p>	<p>Although market misconduct is prohibited by law in Sri Lanka and there are systems in place to identify, investigate and prosecute it, the overall market misconduct framework is insufficiently dissuasive.</p>

Principle	Rating	Findings
		<p>Major gaps remain in the powers available to penalize wrongdoers, with the SEC largely reliant on pursuing criminal remedies.</p> <p>In the area of supervision, there has been limited follow-up action to ensure that identified compliance failures are addressed in a prompt and effective manner.</p> <p>In the area of surveillance, only a comparatively small number of CSE referrals to the SEC have resulted in the initiation of investigations.</p> <p>Furthermore, even where investigations have been undertaken, there have been limited enforcement outcomes, either in the form of prosecution of individuals or, in the case of licensed firms, administrative action beyond relatively infrequent license suspensions or removal of the certification of relevant individuals to deal with clients</p>
<p>Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.</p>	<p>PI</p>	<p>There are certain, limited systems in place at present to manage large exposures in the Sri Lankan market. However, these only implement the Principle to a very limited extent.</p> <p>Tools that are currently used include basic margin requirements for larger trades that have not yet settled through the Central Depository System (CDS), and fortnightly reporting requirements on brokers' credit exposures.</p> <p>There is no active and continuous monitoring, or reporting thresholds that are triggered as a broker approaches relevant exposure limits.</p> <p>There are currently only rudimentary systems to deal with broker default, and client assets are not protected from creditor claims under Sri Lankan law. As such, concerns about the risk of broker failure – and its consequences – are currently a barrier to further market development in Sri Lanka.</p> <p>However, the SEC is currently facilitating the establishment of a CCP mechanism, jointly with the CSE. This provides an opportunity for the further implementation of this Principle.</p>
<p>Principle 38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.</p>	<p>NA</p>	
<p><b>Fully Implemented (FI), Broadly Implemented (BI), Partly Implemented (PI), Not Implemented (NI), Not Applicable (NA)</b></p>		

**Table 4 – Recommended Action Plan to Improve Implementation of the IOSCO Principles**

Principle	Recommended Action
1	<ol style="list-style-type: none"> <li>1. The SEC’s regulatory authority in a number of key areas – particularly those relying on the omnibus provision – should be clarified through legislative amendments to put that regulatory authority beyond any doubt. Examples include the issue of letters of caution or warnings, and imposing conditions on the grant of licenses.</li> <li>2. The SEC should work towards ensuring a greater use of regulatory guidance by publishing specific guidelines on how it interprets its authority.</li> <li>3. Revisions to the SEC Act providing for consistent regulatory treatment of all public offerings – whether listed or unlisted – should be made and implemented as a matter of priority.</li> <li>4. The SEC should consider entering into Memoranda of Understanding (MoUs) or formal protocols with the Colombo Stock Exchange, the Registrar of Companies, the Attorney General’s Department, the Central Bank of Sri Lanka and ICASL to clarify responsibilities, avoid duplication and develop information sharing protocols.</li> </ol>
2	<ol style="list-style-type: none"> <li>1. To address shortcomings in relation to independence, proposed revisions to the SEC Act covering fit and proper criteria for appointment and the removal for cause of Commission members and the Director-General should be made and implemented as a matter of priority.</li> <li>2. Appointments for Commission members should continue for terms beyond the life of the government and for terms longer than 3 years. The Government should also give consideration to term limits to ensure continuity and stability in the Commission.</li> <li>3. The Government should also give consideration to agreeing with the Commission on a Statement of Expectations, to be reviewed and published annually, which sets out the Governments’ high-level expectations of the SEC, and an agreement about interaction between the Minister and the SEC (including an appropriate confidentiality regime). This will provide transparency about the independence from, and accountability of the SEC to, the Minister and address public concerns and perceptions about both issues.</li> <li>4. The Commission should, as a matter of priority, publish its strategic plan and direction for the Commission to the year 2020 and ensure that this strategic plan is regularly updated.</li> <li>5. More sophisticated processes for setting Cess rates should be considered, with rates being benchmarked against fees set in other jurisdictions.</li> </ol>
3	<ol style="list-style-type: none"> <li>1. Revisions to the SEC Act in relation to the SEC’s powers should be made and implemented as a matter of priority. Amendments in relation to the SEC’s enforcement and remediation powers are urgently needed (as set out in recommendations in relation to Principles 11 and 12 below).</li> <li>2. Measures to build the “bench strength” of the SEC are urgently needed. The design and implementation of a recruitment and staffing strategy with the following elements must be given the highest priority: <ul style="list-style-type: none"> <li>• Recruiting staff with regulatory and industry experience into senior executive positions, either from within Sri Lanka or by way of secondment from counterpart regulatory authorities in other jurisdictions;</li> <li>• Growing the SEC’s longer term middle level capability through an aggressive graduate recruitment campaign. The SEC’s recent efforts in this regard are strongly endorsed;</li> </ul> </li> </ol>

Principle	Recommended Action
	<ul style="list-style-type: none"> <li>• Reviewing salaries payable to staff, particularly at the middle and senior levels of the organization, to ensure competitiveness with the private sector. A rigorous performance-based salary structure should also be considered; and</li> <li>• Supporting in-house and external training of SEC staff through mentoring and support by Commission members and by senior staff once hired. Consideration should also be given to developing a talent management strategy which targets high potential staff and supports them with tailored training and development opportunities.</li> </ul> <p>3. The SEC should review the charter of the Audit Committee to enable it to provide regular review and oversight of not only the financial position of the SEC but also its processes and governance arrangements to deliver on its regulatory mandate and strategy. Its objectives could include assisting the SEC’s Chairman to maintain and improve the effectiveness and integrity of the SEC’s governance and internal control frameworks and delivering on its regulatory mandate.</p> <p>The functions and responsibilities of the Audit Committee could also be expanded to include:</p> <ul style="list-style-type: none"> <li>• Reviewing whether the SEC is maintaining effective governance arrangements and an internal control framework, supported by appropriate policies and procedures, which are periodically reviewed and updated;</li> <li>• Reviewing whether appropriate policies and supporting procedures are in place for the management and exercise of delegations; and</li> <li>• Determining whether a sound and effective approach has been followed in establishing the SEC’s business continuity planning arrangements.</li> </ul> <p>4. Consideration should also be given to reviewing the current organizational structure of the SEC and processes to avoid duplication and inefficient use of resources. Consideration should, for instance, be given to dispensing with supervision driven by the annual renewal of licenses and registrations and replacing it with a truly risk-based approach to supervision, with more intensive and regular visits to demonstrably at risk firms and less frequent engagement with lower risk firms.</p> <p>5. As noted in relation to IOSCO Principle 2, the SEC should also, as a matter of priority, publish its strategic plan and direction for the Commission to the year 2020 and ensure that this strategic plan is regularly updated.</p>
4	<p>1. As noted in the recommendations for IOSCO Principle 1, the SEC should develop and publish written guidance about how it interprets its authority, make greater use of policy guidance in key areas, and consider formalizing more granular guidance regarding the application and exercise of its powers under s. 13(p) of the Act. Guidance should also be provided on its internal review procedures. These measures would provide a basis for ensuring greater consistency in decision making and confidence in that consistency.</p>
5	<p>1. The Statement of Expectations recommended under IOSCO Principle 3 should include an appropriate confidentiality regime in relation to the contact between Commission members and the Minister.</p> <p>2. The SEC is strongly encouraged to complete the revision and updating of its Administrative Manual</p>
6	<p>1. Consideration should be given to defining and formalizing the role and contribution of the SEC to monitoring, mitigating and managing systemic risk in Sri Lanka. These arrangements should include a formal MoU between the SEC and the CBSL setting out responsibilities, including in relation to information sharing.</p>

Principle	Recommended Action
	<p>2. Revisions to the SEC Act should reflect that contribution and go beyond references sighted by the Review Team in proposed legislation (limited to clearing houses).</p> <p>3. The SEC should also work toward developing expertise regarding risk measurements in securities markets and analysis relevant to systemic risk.</p>
7	<p>1. The SEC Act should be revised to ensure that provision is made for the SEC to advise on a regular basis about the appropriateness of the regulatory perimeter.</p> <p>2. The SEC should develop robust arrangements to conduct comprehensive analyses of potential risks emerging from unregulated products and entities in the Sri Lankan securities market and to take necessary measures, where appropriate. Processes should also be developed to ensure previous decisions about the application of regulation are kept under review.</p> <p>3. Arrangements to review the perimeter of regulation should:</p> <ul style="list-style-type: none"> <li>• Entail a holistic and systematic analysis of entities, products, markets, market infrastructures and activities across securities markets that could be the source of systemic risk, or that could raise concerns about the regulatory perimeter. The analysis should use a combination of quantitative and qualitative tools;</li> <li>• Involve the systematic and robust analysis of accessible, reliable and good quality data (including micro- and macroeconomic data and market intelligence) either collected by the securities regulator, or sourced from other agencies or parties (including prudential supervisors);</li> <li>• Include mechanisms to assist in understanding the evolving functioning of securities markets;</li> <li>• Involve engagement with market participants to better understand emerging risks, systemic and otherwise. This engagement may take the form of surveys, formal consultations, informal roundtables, individual meetings, etc.;</li> <li>• Include clear documentation of the work performed in assessing potential systemic risks at each stage of the assessment process, and documentation of the status of steps taken to mitigate identified risks;</li> <li>• Allow for periodic reassessment of procedures and outcomes; and</li> <li>• Provide for policy and/or regulatory actions, where appropriate in the context of the regulatory mandate, based on the assessments conducted.</li> </ul> <p>In addition to the general arrangements set out above, the SEC should:</p> <ul style="list-style-type: none"> <li>• Be systematically involved in identifying, prioritizing and determining the scale and scope of emerging risks from different entities, activities, markets and products in financial markets that could serve as the basis for deciding whether and what type of regulatory action or intervention is warranted;</li> <li>• Proactively go beyond existing regulatory boundaries to identify potential risks.</li> </ul> <p>4. To support the effectiveness of the risk arrangements outlined in these recommendations, the SEC should consider establishing a permanent risk identification and assessment unit with appropriately skilled and adequate human and technical resources.</p>
8	<p>1. The SEC should continue to ensure conflicts of interest are a focus of supervisory activity for all market intermediaries and other market participants. Revisions to the SEC Act should be made</p>



Principle	Recommended Action
	to impose an explicit duty on licensed exchanges to manage and, if necessary, avoid conflicts of interest that might arise.
9	<ol style="list-style-type: none"> <li>1. Revisions to the SEC Act should be made to include a general requirement that licensed exchanges apply their rules and processes fairly and consistently. This would provide greater certainty to stakeholders that the CSE does and will conduct itself appropriately in undertaking its functions, particularly its regulatory functions.</li> <li>2. Revisions to the SEC Act should be made to set criteria for admission of exchange participants. The exchange's board should no longer have discretion to reject applicants merely to restrict competition. Instead, the exchange should be required to admit brokers who meet the relevant qualification criteria.</li> <li>3. Revisions to the SEC Act should be made to impose an explicit duty on licensed exchanges to manage and, if necessary, avoid conflicts of interest that might arise.</li> <li>4. Revisions to the SEC Act should be made to require licensed exchanges to maintain confidentiality when exercising self-regulatory functions, such as undertaking supervisory inspections. In the absence of such provisions, the SEC should direct the CSE to maintain confidentiality in these circumstances.</li> </ol>
10	<ol style="list-style-type: none"> <li>1. Revisions to the SEC Act should be made to provide explicitly for the SEC to conduct 'inspections without prior notice'. These revisions should be implemented as a matter of priority.</li> <li>2. The SEC should consider providing more detailed guidance on its interpretation of the current broad provisions in the SEC Act, in line with the requirements of this IOSCO Principle.</li> <li>3. Revisions to the SEC Act should be made to ensure the SEC has appropriate supervision, investigation and surveillance powers in relation to those entities it will have responsibility for regulating for the first time under those revisions (including investment banks and financial planners and advisers).</li> </ol>
11	<ol style="list-style-type: none"> <li>1. Proposed revisions to the SEC Act providing for civil remedies in respects of breaches of the Act should be made and implemented as a matter of priority.</li> <li>2. Proposed revisions to the SEC Act providing for administrative remedies in respect of breaches of the Act should be made and implemented as a matter of high priority.</li> <li>3. Proposed revisions to the SEC Act providing for the SEC to take criminal action in the event of a breach of an SEC directive should be made and implemented as a matter of high priority.</li> <li>4. Revisions to the SLAASMB Act should also be made to ensure it has more appropriate civil and administrative remedies, which are not currently available to it.</li> </ol>
12	<ol style="list-style-type: none"> <li>1. The SEC should move to a risk-based supervisory approach across its regulated population as a matter of high priority. <ul style="list-style-type: none"> <li>• The outcome of this approach should be more frequent and intensive supervision of entities which SEC analysis identifies as posing higher risk to the SEC's core objectives – investors and a fair and orderly market.</li> <li>• The risk-based supervisory approach should be used to identify not only the intensity and frequency of supervisory visits to particular entities, but also the focus of those visits.</li> <li>• The SEC should also move from the current approach, which ensures all entities in each part of the regulatory population are visited at least annually, to a more holistic approach which considers focusing resources on those areas posing greatest risk (and firms within those areas). Consideration should be given to decoupling supervisory visits from license and registration</li> </ul> </li> </ol>

Principle	Recommended Action
	<p>renewals. These visits currently reinforce the audit-style nature of supervision and direct resources away from more intensive supervision and oversight in higher risk areas. This approach should, for instance, ensure Trustees of Unit Trusts are subject to at least annual supervisory visits which are more intensive than those currently undertaken.</p> <ul style="list-style-type: none"> <li>• The risk-based approach should be developed and implemented in consultation with the CSE.</li> <li>• Once agreed, the approach should be documented in inspection manuals and internal policies.</li> </ul> <ol style="list-style-type: none"> <li>2. Consideration should be given to enhancing the supervisory skills and capability of SEC staff responsible for supervision of regulated entities.</li> <li>3. Priority should also be given to strengthening SEC responses to inspections findings and outcomes. Responses should be quick and decisive, setting expectations for action which, if not met within agreed timeframes, lead to further remedial action including – where the deficiencies are severe – suspension or cancellation of relevant licenses or registration.</li> <li>4. Consideration should be given to increasing the complement of staff at the SEC engaged in investigations. The current complement of staff is inadequate to ensure timely responses to cases warranting investigation.</li> <li>5. The level of criminal penalties in the SEC Act should be brought into line with penalties in comparable jurisdictions. The availability of these more dissuasive remedies should lead to a reduction in the use of the less dissuasive compounding.</li> <li>6. The SEC should continue to work with the Attorney-General’s Department to speed up responses to prosecution referrals. This should include engagement with officers of the Department at early stages of investigations about, for instance, evidence collection and engagement once a referral is made.</li> <li>7. Once the proposed amendments to the SEC Act are approved, the SEC should develop, publish and implement a comprehensive enforcement policy setting out its approach to using the enforcement tools available to it. The enforcement policy should present the conditions on which administrative, civil and criminal powers are used and the approach to applying fines and other penalties.</li> </ol>
13	Proposed revisions to the SEC Act to permit the sharing of information without the consent of the person under investigation for a breach of the Act should be made and implemented as a matter of priority. The proposed revisions should allow for sharing of information in similar circumstances with a foreign regulator or authority.
14	As noted in the recommendations for IOSCO Principle 1, the SEC should consider entering into MoUs with, for example, the Attorney General’s Department and the Registrar of Companies to facilitate better coordination of criminal prosecutions.
15	Revisions to the SEC Act should be made to enhance the SEC’s authority to share information with foreign counterparties. These revisions should be implemented as a matter of priority.
16	<ol style="list-style-type: none"> <li>1. Although proposed revisions to the SEC Act contemplate all public offerings of securities requiring Commission approval, a review of, and revisions to, the SEC Act and the Companies Act are needed to ensure disclosure requirements are aligned and consistent with the IOSCO Principles.</li> <li>2. Revisions to the SEC Act to empower the SEC to issue stop orders in the event of non-compliance with prospectus disclosure requirements should be made and implemented as a matter of priority.</li> </ol>

Principle	Recommended Action
	<ol style="list-style-type: none"> <li>3. Authorities should ensure the review of disclosure documents should focus on industry segments or entities identified as posing higher risk and other weaknesses in disclosure identified through desk research and investor complaints and other means.</li> <li>4. A listing regime for offerings by foreign issuers should be developed. Consideration should be given to developing a regime based on recognition of prospectuses to be used in Sri Lanka meeting regulatory requirements in jurisdictions which meet the requirements set out in this Principle. Assistance should be sought from fellow regulators (through IOSCO) about appropriate approaches.</li> <li>5. Revisions to the SEC Act, and if necessary to the Listing Rules, should extend the liability for the content of disclosures to other persons involved in the issuing process (including underwriters, authoring officers, promoters, experts and advisers). Provisions in the Companies Act should be brought into line with these revisions.</li> <li>6. The SEC should continue to monitor closely new developments, such as crowd funding and related investor protection issues, in Sri Lanka.</li> </ol>
17	<ol style="list-style-type: none"> <li>1. The Companies Act should be amended to include a general provision concerning the disclosure of material information and to broaden the scope of provisions relating to change of control transactions.</li> <li>2. Disclosure requirements in the SEC Takeovers Code, where two or more shareholders act in concert, should be transposed into the CSE listing rules and the Companies Act.</li> <li>3. Revisions to the CSE Listing Rules should be made to require timely disclosure of details to material changes of beneficial ownership holdings of voting securities by senior managers.</li> <li>4. As recommended under IOSCO Principle 16, a listing regime for offerings by foreign issuers should be developed. The regime should ensure fair and equitable treatment of shareholders in the case of cross-border listings.</li> </ol>
18	<ol style="list-style-type: none"> <li>1. Consideration should be given to revisions to the legal framework for accounting standard setting set out in the SLAAS Act to provide for greater public interest oversight of the accounting standard setting process.</li> <li>2. The review of audited financial statements should continue to follow a risk based approach, limiting reviews to sectors and issuers deemed to pose higher risk. Co-ordination between the SEC and SLAASMB should also be enhanced through more regular engagement at operational level in discussing the design and outcomes of surveillance activity, through workshops and training sessions.</li> <li>3. Revisions to the SLAAS Act should be made to ensure more appropriate and dissuasive enforcement and remediation powers. Administrative remedies, paralleling those proposed for the SEC in revisions to the SEC Act, should be considered and given high priority.</li> <li>4. The listing regime for cross border offerings recommended in IOSCO Principles 16 and 17 should address requirements about the use of high quality, internationally acceptable accounting standards.</li> </ol>
19	<ol style="list-style-type: none"> <li>1. Consideration should be given to revisions to the SLAAS Act to provide for a greater degree of public interest oversight of compliance with Auditing Standards. Consideration should be given to reducing the role of the profession on the Board of SLAASMB, given its role in the oversight of compliance with auditing standards.</li> <li>2. Revisions to the SLAAS Act should be made to provide for a broadening of SLAASMB's audit oversight responsibilities, including quality control mechanisms.</li> </ol>

Principle	Recommended Action
	<ol style="list-style-type: none"> <li>3. Steps should be taken to ensure SLAASMB is provided with a sustainable funding base to support the execution of its responsibilities. The development of a CESS Fund as the base for funding the SLAASMB, as proposed in revisions to the SLAAS Act sighted by the Review Team, is an important start in achieving this.</li> <li>4. Steps should be taken through training and inward secondments from other audit supervisors to improve SLAASMB and SEC staff level understanding of “audit quality”. Revisions should also be made to the 2001 MoU to cover information sharing in relation to improvements in audit quality.</li> <li>5. The current audit-style approach to the review of audit files of selected SBE’s should be replaced with a risk-based approach. Co-ordination between the SEC and SLAASMB in reviewing audit files should also be enhanced.</li> <li>6. Revisions to the SLAAS Act should be made to ensure more appropriate and dissuasive enforcement and remediation tools. Administrative remedies, paralleling those proposed for the SEC in revisions to the SEC Act, should be considered as part of this and given high priority.</li> <li>7. The relevant Sri Lankan authorities and government should continue following up the 2015 ROSC recommendations, to the extent these are not already specifically mentioned here.</li> </ol>
20	<ol style="list-style-type: none"> <li>1. References in the SEC Guidelines to auditor independence should be transposed in the SEC Act as a matter of priority. Revisions should also be made to requiring auditors to establish and maintain internal systems, governance arrangements and processes for addressing threats to independence.</li> <li>2. SLAASMB and SEC should continue to ensure that its reviews address issues of auditor independence.</li> </ol>
21	<ol style="list-style-type: none"> <li>1. Consideration should be given to revisions to the legal framework for audit standard setting in the SLAAS Act to provide for greater public interest oversight of Audit Standard setting and of the monitoring of compliance with those standards.</li> <li>2. Revisions to the SLAAS Act should be made to provide more appropriate and dissuasive enforcement and remediation tools in relation to auditors. Administrative remedies, paralleling those proposed for the SEC in revisions to the SEC Act should be considered and given high priority.</li> </ol>
22	<ol style="list-style-type: none"> <li>1. Regulatory Standards should be drafted as rules as a matter of priority. This is anticipated to be done under the proposed revisions to the SEC Act and related instruments.</li> <li>2. Revisions to the Regulatory Standards addressing the gaps noted in the comments in this Principle should be made and implemented as a matter of priority.</li> <li>3. Supervision of CRA’s should be redesigned to focus on the holistic risks posed by CRA’s, rather than the current audit style process as a matter of priority. The SEC should work to enhance the capability of its staff in understanding the business of CRA’s.</li> </ol>
23	<ol style="list-style-type: none"> <li>1. The SEC should ensure that the process it establishes under IOSCO Principle 7 to review the regulatory perimeter encompasses reviews about whether firms offering these services which are not regulated warrant regulation and oversight.</li> <li>2. Proposed revisions to the SEC Act to bring investment analysts within the definition of ‘market intermediaries’ should be made and implemented as a matter of priority.</li> <li>3. Regulatory Standards developed for investment analysts should reflect the requirements of this IOSCO Principle.</li> </ol>

Principle	Recommended Action
24	<ol style="list-style-type: none"> <li>1. Proposed revisions to the SEC Act to address the following should be made and implemented as a matter of priority: <ul style="list-style-type: none"> <li>• Bringing managing companies within the definition of market intermediaries and so aligning the regulatory framework applicable to both;</li> <li>• Introducing a registration regime for individuals who act for or on behalf of managing companies when engaging with Unit Trust investors. This should cover both the employees of managing companies, and the employees of managing company agents engaging with investors;</li> <li>• Extending and expanding fit and proper requirements to others engaged in the operation of Unit Trusts (including the CEOs and controllers of managing companies). As noted in the recommendations for IOSCO Principle 29, more detailed guidance should be developed in relation to the factors to be considered in assessing those requirements. In line with recommendations made for IOSCO Principle 29, once legislative changes are made the SEC should enhance the rigor of its review of license applications, including taking active steps to seek documentation and declarations from those affected by these requirements about compliance with those requirements.</li> </ul> </li> <li>2. Revisions to the Unit Trust Code should be made and implemented to do the following: <ul style="list-style-type: none"> <li>• Extend eligibility criteria for managing companies to explicitly require risk management frameworks, internal controls and compliance arrangements to be in place;</li> <li>• Require managing companies to ensure fair treatment of all investors;</li> <li>• Require managing companies to meet standards about best execution, churning, timely allocation, due diligence in the selection of investments and soft commission arrangements; and</li> <li>• Require managing companies to file periodic compliance reports with the SEC. Consideration should also be given to requiring trustees to provide reports about the compliance of those Unit Trusts they oversight to the SEC on a periodic basis.</li> </ul> </li> <li>3. The SEC should consider developing clear principles and communicating guidance about how it exercises its exemption powers under the Unit Trust Code.</li> <li>4. The SEC should develop a clear regulatory framework about the delegation of activities by management companies. The framework should require appropriate disclosure of delegated activities, allow for the investor to identify the company legally responsible for the delegated function and allow for the regulator to effectively access data related to the delegated functions.</li> <li>5. In line with recommendations in IOSCO Principle 31, the SEC should develop a risk-based supervision framework applicable to all intermediaries to replace the current compliance audit process.</li> <li>6. In line with recommendations in IOSCO Principle 31, the SEC should also develop processes to follow through on inspection findings and ensure that remediation measures are properly and effectively implemented.</li> <li>7. In view of the reliance and importance the regulatory framework places on trustees, the SEC should undertake more frequent and intense supervision of trustees.</li> <li>8. Consideration should also be given to revising the definition of Unit Trusts to better reflect their pass-through nature, taking into account the definition of a Collective Investment Scheme (CIS) as provided in the IOSCO 1994 <i>Report on Investment Management</i>.</li> </ol>

Principle	Recommended Action
25	<ol style="list-style-type: none"> <li>1. Revisions to the Unit Trust Code should be made and implemented as a matter of priority to require the segregation of a Unit Trust's assets from the assets of the Trustee and managing company, as well as from the assets of other Unit Trust funds.</li> <li>2. The SEC should also develop guidelines about the appointment and use of custodians.</li> </ol>
26	<ol style="list-style-type: none"> <li>1. The SEC should consider prescribing a standard format for Explanatory Memorandum of Unit Trusts to ensure uniformity of information disclosure and comparability across Unit Trust Funds.</li> <li>2. The SEC should develop and publish guidelines on the contents of advertisements. Consideration should also be given to making and implementing revisions to the SEC Act and relevant rules to prohibit managing companies from issuing inaccurate, false, or misleading advertisements.</li> </ol>
27	<ol style="list-style-type: none"> <li>1. Revisions to the Unit Trust Code should be made and implemented in relation to the following: <ul style="list-style-type: none"> <li>• Requiring the fair valuation of unlisted, non-traded or thinly traded equity securities;</li> <li>• Setting independence requirements for auditors of Unit Trusts and requiring valuation policies and procedures to be regularly reviewed; and</li> <li>• Providing for processes to address pricing errors. Consideration should be given to aligning these processes with IOSCO's 2013 <i>Principles for the Valuation of Collective Investment Schemes</i>.</li> </ul> </li> <li>2. Consideration should also be given to the following (which, although not set out in the current Methodology, warrant attention): <ul style="list-style-type: none"> <li>• Aligning requirements in relation to the use of amortized cost methods for the valuation of money market funds with IOSCO's 2012 <i>Policy Recommendations for Money Market Funds</i>; and</li> <li>• Aligning requirements in relation to the suspension of redemptions with IOSCO's 2012 <i>Principles on Suspension of Redemptions in Collective Investment Schemes</i>.</li> </ul> </li> </ol>
28	<p>The SEC should consider developing a framework for the regulation of hedge funds in line with this IOSCO Principle. Appropriately regulated hedge funds are an important risk management tool which the Sri Lankan authorities are encouraged to allow.</p>
29	<ol style="list-style-type: none"> <li>1. Proposed revisions to the SEC Act addressing the following should be made and implemented as a matter of priority: <ul style="list-style-type: none"> <li>• Introducing a single licensing framework for all market intermediaries; including those engaged in investment banking activity (including corporate finance advisors, derivatives brokers and dealers and investment analysts) and financial advisers in the definition of market intermediaries;</li> <li>• Introducing a registration regime for individuals who act for or on behalf of intermediaries and engage directly with investors. As part of this registration regime, the SEC should place the primary responsibility on the regulated intermediaries to undertake proper due diligence to assess and certify the fitness and propriety of the individuals that they intend to appoint;</li> <li>• Empowering the SEC to impose conditions or restrictions on the grant or renewal of a license or registration; and</li> <li>• Extending fit and proper requirements to controllers. More detailed guidance should also be developed in relation to the factors to be considered in assessing these requirements (including competence, integrity, financial soundness, etc.).</li> </ul> </li> </ol>

Principle	Recommended Action
	<ol style="list-style-type: none"> <li>2. Regulatory Standards for market intermediaries should be promulgated as Rules. This is anticipated to be done under the proposed revisions to the SEC Act and related instruments.</li> <li>3. Regulatory standards should be revised (and in the case of newly regulated intermediaries developed) to ensure the same core requirements are, unless there is a sound policy reason for deviation, applied consistently and uniformly across all classes of intermediaries.</li> <li>4. The SEC should enhance the rigor of its review of license/registration applications, including undertaking a comprehensive assessment of the applicants' internal organization, risk management, supervisory systems and compliance arrangements. The SEC should undertake independent checks on the fitness and propriety of the applicant's controllers and directors (e.g. screenings against an internal database of firms or individuals with past misconduct or adverse records and with overseas regulators where the firms or individuals had previously engaged in regulated activities in other jurisdictions). The SEC should also conduct pre-licensing visits to check that the applicants are properly set-up.</li> <li>5. There should be a centralized portal (as part of the new registration regime) to provide the public with access to accurate and up-to-date information on the regulated intermediaries and their authorized individuals, so that the public can be apprised of the scope of activities that may be conducted by these intermediaries or individuals. This also helps to ensure that the public does not unknowingly deal with unregulated persons.</li> </ol>
30	<ol style="list-style-type: none"> <li>1. The SEC and CSE should give priority to introducing a risk-based capital framework for all classes of intermediaries.</li> <li>2. The SEC should put in place an early warning mechanism, combined with regulatory requirements for intermediaries, to notify the SEC of any adverse development that may have material impact on them. These requirements will enable the SEC to more effectively monitor and ensure that the intermediaries maintain capital that is commensurate with their risk profiles and allows the absorption of losses. The SEC should also consider imposing a limit on the level of indebtedness that can be taken on by intermediaries particularly stockbrokers.</li> <li>3. With the move to a more sophisticated risk-based capital framework, it is essential that the SEC undertake industry engagement to ensure that market participants understand and are able to correctly apply the requirements.</li> <li>4. The SEC should also review its current process for monitoring intermediaries' capital adequacy and compliance with exposure limits, and make enhancements where necessary, e.g. leveraging on regulatory returns to facilitate data analysis and generation of exception reports for staff review.</li> <li>5. The SEC's supervisory activities should include reviewing the risks posed by other unregulated businesses and activities undertaken by licensed and registered firms.</li> </ol>
31	<ol style="list-style-type: none"> <li>1. Proposed revisions to the SEC Act to explicitly ensure that client monies kept in trust accounts are not subject to claims by general creditors in an intermediary's bankruptcy should be made and implemented as a matter of priority.</li> <li>2. Further revisions should be made to the SEC Act, CSE Stockbroker Rules and/or Regulatory Standards to address the following as a matter of priority: <ul style="list-style-type: none"> <li>• Introducing requirements that intermediaries subject their internal and operational controls and risk management processes to an objective, periodic evaluation by way of an internal audit function. This could be supplemented by a requirement for intermediaries to have their more critical controls, such as those relating to client assets protection, validated by an external auditor as part of the annual audit process;</li> </ul> </li> </ol>

Principle	Recommended Action
	<ul style="list-style-type: none"> <li>• Introducing requirements for managing companies of unit trusts to have in place appropriate management and organization structure, compliance and risk management functions, internal controls and operational procedures and complaint handling procedures;</li> <li>• Introducing requirements to address risks posed by intermediaries entering into outsourcing arrangements and the provision of a DEA facility by stockbrokers/dealers to their clients;</li> <li>• Strengthening requirements in relation to client asset protection. Amendments are needed to require all intermediaries to: (i) conduct due diligence on the suitability of banks and custodian with whom they place client monies/assets, (ii) submit periodic reports to the SEC on the amount of client monies/assets held in trust/custody accounts, and (iii) perform regular reconciliation of client monies/assets. Requirements for stockbrokers to give written notice to (and obtain acknowledgement from) banks about the status of client accounts should be extended to other regulated intermediaries that handle client monies. Rules should also be broadened to cover unlisted securities;</li> <li>• Ensuring requirements for intermediaries to make recommendations with respect to any security or investment only with a reasonable basis (including taking into account the needs of the clients) have the force of law; and</li> <li>• Clarifying requirements in relation to the provision of statements of account by stockbrokers and margin providers to their clients.</li> </ul> <p>3. The SEC should finalize the development of a risk-based supervision framework to replace the current audit process. The framework should objectively and comprehensively assess the risks posed by the individual intermediaries and use these risk assessments to drive its supervisory plan (including the frequency of inspections) for each intermediary. The framework should take into account the risk and impact of an intermediary within its sector and across the different sectors. Intermediaries that are assessed to be higher risk/impact should be subject to more intensive supervision and a shorter inspection cycle.</p> <p>4. Inspection manuals and policies should be developed and tailored to each category of intermediaries. Internal capacity of the SEC, including the inspection expertise of its staff, would also need to be enhanced.</p> <p>5. The SEC should develop processes to follow through on inspection findings and ensure that the remediation measures are properly and effectively implemented, e.g. requiring the intermediary to engage an external auditor to validate the effectiveness of the remediation measures where warranted. Serious rule breaches should be met with sufficiently dissuasive sanctions.</p> <p>6. The SEC should consider the use of thematic inspections in relation to topical issues or areas of concern. Common weaknesses and best practices gleaned from these inspections should be published to help raise industry awareness and standards.</p>
32	<p>1. Revisions to the SEC Act should be made to enhance the adequacy of its current suite of powers including providing for explicit powers to: (i) take control of the intermediary, (ii) request for the appointment of a monitor, receiver or administrator, (iii) take possession of assets held by the intermediary (or a third party appointed to hold the assets), and (iv) transfer the clients' assets/positions to another intermediary.</p> <p>2. A cogent set of internal plans and procedures should be developed that would allow the SEC to monitor and take prompt effective actions in the event of a failure or potential failure of an intermediary. The plans should set out the various scenarios that could occur in the local market and the procedures to guide staff in each scenario. In addition, the plans should identify the relevant supervisory powers that may be utilized for each scenario.</p> <p>3. The SEC should also develop a structured monitoring and escalation plan, using a system of early warnings (as recommended in IOSCO Principle 30) and other surveillance tools. System-wide</p>



Principle	Recommended Action
	<p>stress-testing could also be a useful tool for the SEC to validate the CSE's and stockbrokers' preparedness and resilience to serious unexpected events that may affect the local market.</p> <p>4. In parallel with the establishment of a CCP, there is a need to develop a robust set of default management processes and procedures to safeguard the integrity of the clearing and settlement operations against financial shocks caused by extraneous events.</p> <p>5. To protect clients from damages arising from the negligence of intermediaries carrying out regulated activity, the SEC should consider a requirement for intermediaries to obtain professional indemnity insurance that is commensurate with the scale of their business.</p>
33	<p>1. Proposed revisions to the SEC Act to do the following should be made and implemented as a matter of priority:</p> <ul style="list-style-type: none"> <li>• Provide for the registration and supervision of automated trading systems; and</li> <li>• To require exchanges to have adequate technical and system resources.</li> </ul> <p>This would eliminate any possible gap in regulation that could arise in the future in respect of automatic trading systems, and ensure that market operators maintain key systems to enable the efficient operation of the secondary market.</p> <p>2. Revisions to the SEC Act should be made to include a general requirement that licensed exchanges apply their rules and processes fairly and consistently. This would provide greater certainty to stakeholders that the CSE does and will conduct itself appropriately in undertaking its functions, particularly its regulatory functions.</p> <p>3. Revisions to the SEC Act should be made to set criteria for admission of exchange participants. The CSE's board should no longer have discretion to reject applicants merely to restrict competition. Instead, the exchange should be required to admit brokers who meet the relevant qualification criteria.</p> <p>4. The SEC and CSE should consider establishing a fully independent mechanism to resolve disputes between stockbrokers and their clients. Such a mechanism could be operated by a body that is fully independent of the CSE, with the CSE committed to use its powers to enforce its decisions.</p>
34	<p>1. Relevant legislation, rules and regulations should be amended to require licensed markets operators to retain trading data for a suitable amount of time.</p> <p>2. The SEC and CSE should continue to deepen their level of cooperation on surveillance and supervision to reduce duplication and improve the effectiveness of these joint programs. The following are suggested:</p> <ul style="list-style-type: none"> <li>• The SEC and CSE should work jointly to identify key strategic risks and incorporate these into a common set of risk-based priorities for surveillance and supervision;</li> <li>• The SEC and CSE should work to develop common approaches to supervisory and (to the extent possible) surveillance processes, which could include the creation of shared internal manuals;</li> <li>• The SEC and CSE should hold joint workshops among their surveillance and supervisory staff to promote mutual up-skilling, build common regulatory capacity, share intelligence and discuss emerging issues; and</li> </ul>

Principle	Recommended Action
	<ul style="list-style-type: none"> <li>• Building on the recent increase in cooperation between the SEC and CSE on investigation referrals, the SEC should share with the CSE, to the extent possible, its criteria for accepting referrals of suspected market misconduct for investigation and provide feedback to the CSE where it declines to take on cases, including the reasons why the referral was declined.</li> </ul>
35	<ol style="list-style-type: none"> <li>1. The SEC and CSE should arrange to allow for the order book to be displayed during the opening auction. This would remove an exception to the general principle of transparency in Sri Lanka.</li> <li>2. The SEC and CSE should take steps to identify the extent of the use of nominee accounts by brokers and respond accordingly. Quantifying the use of broker accounts could be accomplished by including the issue as part of the regular supervisory reviews of brokers. If the issue is widespread, the SEC and CSE should consider measures to limit the use of such accounts or implement specific disclosure requirements.</li> <li>3. The SEC should make and implement requirements obliging brokers to notify the SEC and CSE of proposed crossings prior to execution and provide the regulators with powers to prescribe alternative trading approaches where that is warranted.</li> <li>4. The SEC could also consider whether the minimum trading size for crossings, particularly the size based on minimum value, is set at the right level, or whether it should be raised.</li> <li>5. The SEC and CSE should work to update the ATS so that it provides the necessary information to enable trading of all types of products listed on the CSE.</li> <li>6. The SEC should take steps to ensure that any expansion in dark liquidity is appropriately regulated and managed. This should include ensuring that: <ul style="list-style-type: none"> <li>• The CSE and SEC have access to adequate information to monitor the development of dark trading and dark orders;</li> <li>• Transparent orders have priority over dark orders; and</li> <li>• Dark pools and transparent markets that offer dark orders provide market participants with sufficient information so that they are able to understand the manner in which their orders are handled and executed.</li> </ul> </li> </ol>
36	<ol style="list-style-type: none"> <li>1. Proposed revisions to the SEC Act to increase the scope of remediation and enforcement powers available to the SEC in relation to market misconduct should be made and implemented as a matter of priority.</li> <li>2. The SEC separately should work toward improving the overall credibility of its market surveillance program through effective enforcement using its existing powers. Specifically: <ul style="list-style-type: none"> <li>• The SEC should ensure more effective and timely follow up on compliance failures by stockbrokers;</li> <li>• The SEC should also consider taking administrative action under the SEC Act, or direct the CSE to do so under the Stockbroker Rules, where market misconduct is committed by licensed firms or their directors, management or staff members. This is particularly important where such a breach raises the risk of client losses or broker failure. Such action could include a direction under s. 21(4) of the SEC Act, the revocation of a license under s21(1) of the SEC Act – in the case of more serious or persistent non-compliance – or a direction to the CSE to take action against the broker under the CSE Stockbroker Rules.</li> <li>• The SEC should consider whether it has enough qualified investigators on staff to enable it to investigate suspected market misconduct cases when these are identified by, or referred to, the SEC.</li> </ul> </li> </ol>

Principle	Recommended Action
37	<ol style="list-style-type: none"> <li>1. Proposed revisions to the SEC Act to provide for the establishment of a clearing house should be made and implemented as a matter of priority: <ul style="list-style-type: none"> <li>• Revisions and rules made under those revisions should provide for appropriate monitoring of large exposures and include general reporting of open positions and credit exposures, as well as trigger-point reporting. Sanctions should be in place for firms that do not provide required reporting; and</li> <li>• The system should also include remedies, where a firm's exposures exceed maximum limits, such as requiring liquidation of these excess exposures.</li> </ul> </li> <li>2. Proposed Revisions to the SEC Act to require clearing house default procedures to take precedence over general insolvency provisions should be made and implemented as a matter of priority. Revisions should ensure the rules provide for: <ul style="list-style-type: none"> <li>• Promptly isolating the problem of a failing firm by addressing its open proprietary positions and positions it holds on behalf of customers; and</li> <li>• Otherwise protecting client funds and assets from an intermediary's default under national law.</li> </ul> </li> <li>3. Revisions to the Stockbroker Rules should be made to allow for an appropriate system of reporting on brokers' margin lending exposures. This should include arrangements for: <ul style="list-style-type: none"> <li>• Regular reporting of brokers' exposures against margin lending limits in a clear and understandable format, more frequently than the current fortnightly requirement;</li> <li>• Exception reporting and escalation, such as reporting to the SEC, when a broker's margin lending exposures approach maximum limits; and</li> <li>• Clear penalties for brokers who fail to meet these reporting requirements.</li> </ul> </li> <li>4. The SEC and CBSL should establish a system to share information concerning corporate groups that include both licensed banks and stockbrokers. This is especially important in the case of exception or trigger-point reporting, where a bank or broking firm is approaching a breach of relevant capital requirements.</li> </ol>

## X. DETAILED ASSESSMENT

**Table 5 – Detailed Assessment of Implementation of the IOSCO Principles**

<b>Principles Relating to the Regulator</b>	
<b>Principle 1.</b>	<b>The responsibilities of the regulator should be clear and objectively stated</b>
Description	<p><b>Responsibilities and Powers</b></p> <p>The Securities and Exchange Commission of Sri Lanka (SEC) was established under the Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987 as amended by Act No. 26 of 1991, Act No. 18 of 2003 and Act No. 47 of 2009 (the “Act”).</p> <p>The primary role of the SEC is to regulate the securities industry and all related matters in Sri Lanka. The breadth of the SEC’s legislative oversight is outlined in Parts I to VI of the Act and the Rules made thereunder and is further described below.</p> <p>The SEC’s <b>objectives, powers, duties and functions</b> are defined and outlined in sections 12 and 13 of the Act.</p> <p>The <b>objectives</b> of the SEC, as set out in Section 12 of the Act, are:</p> <ul style="list-style-type: none"> <li>• The creation and maintenance of a market in which securities can be issued and traded in an orderly and fair manner;</li> <li>• The protection of the interest of investors;</li> <li>• The operation of a Compensation Fund to protect investors from financial loss arising as a result of any licensed stockbroker or licensed stock dealer being found incapable of meeting his contractual obligations;</li> <li>• The regulation of the securities market; and</li> <li>• Ensuring that professional standards are maintained in such markets.</li> </ul> <p>Under Section 13 of the Act, the SEC is <b>competent</b>:</p> <ul style="list-style-type: none"> <li>• To grant a license to a body corporate to operate as a stock exchange and ensure the proper conduct of its business;</li> <li>• To grant a license to any person to operate as a stockbroker or a stock dealer as, the case may be, and ensure the proper conduct of their business;</li> <li>• To grant a license to a managing company to operate a unit trust and to ensure the proper conduct of the business of such unit trust;</li> <li>• To grant a certificate of registration to any person to carry on business as a market intermediary and to ensure the proper conduct of such business;</li> <li>• To give general or specific directions to a licensed stock exchange or a licensed stockbroker or a licensed stock dealer or a licensed managing company or a trustee of a unit trust or a registered market intermediary, from time to time;</li> <li>• To issue general or specific directives to Listed Public Companies from time to time;</li> </ul>

- To grant compensation to any investor who suffers pecuniary loss arising as a result of any licensed stockbroker or licensed stock dealer being found incapable of meeting his contractual obligations;
- To advise the government on the development of the securities market;
- To employ such officers and servants as may be necessary for the purpose of carrying out the work of the Commission;
- To regulate the listing and issue of securities in a licensed stock exchange;
- To direct a licensed stock exchange to reject any application made to it for listing;
- To cancel or suspend the listing of any securities or the trading of any listed securities or to suspend the trading of all listed securities for not more than three days at a time, for the protection of investors;
- To inquire and conduct investigations into any activity of a licensed stock exchange, a licensed stockbroker or licensed stock dealer, a licensed managing company or a trustee of a unit trust, a registered market intermediary or any listed public company;
- To publish findings of malfeasance by any licensed stockbroker or licensed stock dealer or a licensed managing company or a trustee of a unit trust, or a registered market intermediary or any listed public company;
- To implement the policies and programs of the Government with respect to the market in securities;
- To acquire in any manner whatsoever and hold, take or give on lease or hire, mortgage, pledge, sell or otherwise dispose of any immovable or movable property;
- To request the Registrar of Companies, in the exercise of the powers conferred on it by Section 227 of the Companies Act, No. 17 of 1982, to call upon a private limited liability company to become a public limited company;
- To regulate take-overs or mergers where such take-over or merger is between one or more listed companies or where at least one of the parties involved in such take-over or merger is a listed public company;
- To conduct investigations into any alleged violation or contravention of the provisions of this Act or any rule or regulation made thereunder by any person; and
- To do all such other acts as may be incidental or conducive to, the attainment of the objects of the Commission or the exercise of its powers under this Act.

In addition to the above, the SEC has **powers of inspection** under Section 14 of the Act, enabling it to:

- Carry out inspections of the activities of licensed stock exchanges, licensed stockbrokers, licensed stock dealers, licensed managing companies or trustees of unit trusts or registered market intermediaries, in order to determine whether they are operating in conformity with the provisions of this Act or any regulations or rules made thereunder and to charge the costs incurred in carrying out such inspections from the licensed stock exchange, licensed stockbroker, licensed stock dealer, licensed managing company or trustee of a unit trust or registered market intermediary as the case may be, whose activities are being inspected;
- Require licensed stock exchanges, licensed stockbrokers, licensed stock dealers, licensed managing companies of unit trusts and registered market intermediaries to file with the Commission, annual balance sheet and income statements, certified by a qualified auditor in the form and manner specified by the Commission;

- Require the licensed managing company of a unit trust to file with the Commission, in respect of every year, at least two reports of the activities of that unit trust for that year. Every such report shall contain such particulars as may from time to time be determined by the Commission. The first report shall be filed not later than the thirtieth of September of that year and the second report shall be filed not later than the thirty-first of March of the subsequent year.
- Part III of the Act provides for the grant by the SEC of licenses to stock exchanges, stockbrokers and dealers and the registration of market intermediaries and Part IIIA provides for the grant of licenses to manage Unit Trusts.

The SEC has powers that enable it to take steps to remediate and enforce requirements under the Act by pursuing criminal action and the administrative actions described in more detail under IOSCO Principle 11. It does not have the power to impose civil sanctions or penalties – nor are such civil sanctions or penalties able to be sought from the Court in Sri Lanka.

In fulfilling its regulatory functions, the SEC formulates rules and regulations, issues directives and guidelines, and introduces standards and codes affecting its regulated firms and other capital market participants.

#### **Interpretation of Authority**

The SEC's **decision-making authority** with respect to exercising statutory power (including its authority to make decisions) is set out in the Act.

In discharging its functions, the SEC has **the power to interpret its authority** under section 53(1) of the Act. That section further empowers the Commission to formulate rules required from time to time for the purpose of ensuring orderly and fair trading in securities and protection of investors' interest.

These include rules relating to:

- a) Listing and trading of securities in a licensed stock exchange and the subsequent issue of any additional securities by way of rights or bonus or otherwise, by listed public companies (section 53(1)(a));
- b) Disclosures by licensed stockbrokers and licensed stock dealers about security transactions and transactions relating to units in a unit trust by persons who acquired or disposed of securities and by a licensed stock exchange about security transactions (section 53(1)(b));
- c) Proper maintenance of books, records, accounts and audits by a licensed stock exchange, licensed stockbroker, the licensed stock dealer, the licensed managing company of a unit trust or a registered market intermediary and regular reporting by such licensed stock exchange, licensed stockbroker, licensed stock dealer, licensed managing company or registered market intermediary to the Commission of their affairs (section 53(1)(c));
- d) The annual audit of the books, records, accounts and the preparation of financial statements by a licensed stock exchange, licensed stockbroker, licensed stock dealer, the licensed managing company of a unit trust and a registered market intermediary;
- e) Regulation of take-overs or mergers where such take-over or merger is between one or more listed companies or where at least one of the parties involved in such take-over or merger is a listed company;
- f) A code of conduct to be observed by the trustee and the licensed managing company of a unit trust;
- g) Matters in respect of which rules are required by the Act to be made;
- h) The capital requirements, staff qualifications, record keeping and other documentation systems to be followed by licensed stockbrokers, licensed stock dealers, licensed managing companies of a unit trust and registered market intermediaries;

- i) The form and contents of advertisements proposed to be issued by a licensed stock exchange, licensed stockbroker, licensed stock dealer, licensed managing company of a unit trust, a registered market intermediary, a listed public company or a public company which has applied for listing and information to be contained in such advertisements;
- j) The operation of securities in a margin account by a licensed stockbroker, licensed stock dealer or by a registered market intermediary;
- k) The business affairs and activities of registered market intermediaries in relation to listed securities;
- l) Disclosure and reporting and the provision of information by listed public companies;
- m) Rejection of applications for listing made to a licensed stock exchange and the suspension and cancellation of listing by a licensed stock exchange; and
- n) The regulation of the activities of stock lenders and stock borrowers.

The above powers, duties and functions are not exhaustive. Section 13(p) of the SEC Act empowers the SEC to “do all such other acts as may be incidental or conducive to, the attainment of objects of the Commission or the exercise of its powers under this Act”; thereby exercising discretion within the bounds of its objects and powers.

Section 13(p) of the Act has been invoked by the SEC in issuing directives to Public Limited Companies, and in correspondence with regulated firms and other entities, particularly in the absence of specific provisions conferring express jurisdiction to the SEC in particular areas.

**Transparency of the interpretive process** is ensured by the publication of all rules and regulations made by the SEC in the Gazette (pursuant to s. 53 (2) of the Act); the issue of all directives and circulars in writing, and their publication on the SEC website; as well as the publication of all approvals and authorizations on the SEC website. Consultation papers and guidelines are similarly available online, alongside guidance to regulated entities.

All rules made under s. 53(1) are published in the Gazette and come into operation on the date of such publication or on such later date as may be specified therein. These rules are made available to the public via the SEC’s website, thereby ensuring that the rules formulated are well disseminated.

Members, officers or staff of the Commission who undertake any act in good faith are protected from suit or prosecution, per s. 50 (1).

**Judicial Review**

Actions of the SEC are amenable to judicial review by way of appeal to the Court of Appeal, or fundamental rights application to the Supreme Court

All actions and directions of the SEC are amenable to judicial review by either the Court of Appeal or the Supreme Court by virtue of the SEC’s status as a public body and the inherent jurisdiction conferred on those Courts in respect of such bodies under the Constitution.

There are also provisions in the SEC Act which provide for persons aggrieved by SEC decisions to grant licenses to stock exchanges, brokers or dealers, to register market intermediaries, and grants of licenses to unit trusts to appeal such decisions before the Court of Appeal

There is no provision for a review of the SEC’s interpretation of its authority.

	<p><b>Co-operation with other regulators</b></p> <p>The self-assessment describes the SEC as the sole regulator of securities markets in Sri Lanka, with other authorities playing an ancillary role in regulating activities captured by the IOSCO principles.</p> <ul style="list-style-type: none"> <li>• The <b>Colombo Stock Exchange (CSE)</b> plays a role in supervising the activities of stockbrokers and dealers;</li> <li>• The <b>Registrar of Companies (RoC)</b> is responsible for registering prospectuses in relation to the issue of debentures or shares by a company (including both listed and unlisted companies) under s. 40 of the Companies Act (No 7 of 2007). This is described under Principle 16 below;<sup>5</sup></li> <li>• The <b>Sri Lanka Audit and Accounting Standards Monitoring Board (SLAASMB)</b> is responsible for oversight of compliance with Audit and Accounting Standards adopted by the <b>Institute of Chartered Accountants of Sri Lanka (ICASL)</b>. This is described in more detail under Principles 18 to 21 below;</li> <li>• Criminal prosecutions under the Act are proceeded with after referral and endorsement by the <b>Attorney-General’s Department</b>;</li> <li>• The <b>CBSL</b> regulates primary dealers some of whom are also registered by the SEC as market intermediaries.</li> </ul> <p>There are few formal co-operation arrangements, agreements or MoU’s between the SEC and each of these agencies. Specifically:</p> <ul style="list-style-type: none"> <li>• The SEC has a MoU in place with SLAASMB. The MoU, entered into in 2001, sets out responsibilities in relation to the scrutinising of annual reports. It also obliges each party to share relevant information and keep the other informed of a range of matters including non-compliance and enforcement actions. The SEC Director-General is an ex officio member of the Board of SLAASMB.</li> <li>• The Registrar of Companies and the Chair of ICASL are both ex officio members of the SEC Commission. There are no MoU’s in place with either body.</li> <li>• The Deputy Governor of the CBSL with responsibility for financial stability is also an appointed member of the Commission. The SEC advises that this role reflects the fact SEC regulated entities are a part of the total financial system and the fact certain entities regulated by the CBSL have licenses issued by the SEC to operate in other markets. There is no formal MoU in place with the CBSL.</li> <li>• There are no formal arrangements with the Attorney-General’s Department, although the SEC advises regular informal meetings are now taking place at operational level.</li> </ul> <p>The close regulatory interactions between the CSE and SEC are explained in detail in the Assessments of Principle 9, 33 and 34.</p>
Assessment	<b>Partly Implemented</b>

<sup>5</sup> It should be noted that when an *unlisted* company issues shares to the public that will *not* be quoted on a stock exchange, the company must lodge a Prospectus with the Registrar, as noted above. However, this Prospectus may not be subject to the same degree of scrutiny as a Prospectus lodged by a listed company with the SEC.



Comments	<p><b>Regulator’s responsibilities, powers and authority</b></p> <p>The SEC’s responsibilities, powers and authority are set out in the SEC Act and are enforceable. They are generally clearly defined and objectively set out, although in some cases the powers the SEC has are preferable to high level and broadly expressed provisions in that Act.</p> <p>An example is the “Omnibus Provision” in s. 13(p) SEC Act which was cited by the SEC as the basis for taking regulatory action, in the absence of specific provisions elsewhere in the Act.</p> <p>The Provision empowers the SEC to “<i>do all such other acts as may be incidental or conducive to, the attainment of objects of the Commission or the exercise of its powers under this Act</i>”.</p> <p>Use of the provision is not always accompanied by guidance on why and how the provision is being used in particular situations.</p> <p>The SEC should restrict its resort to the omnibus provision, in the absence of specific guidance on the use of the power, to such instances as would not undermine market participant trust and confidence in the regulator and the regulatory framework. In the absence of legislative reform to deal with new situations, guidance may provide the clarity and certainty market participant trust and confidence requires.</p> <p>The RT understands that the SEC has drafted legislative amendments which the SEC advises are intended to reduce regulatory reliance on the omnibus provision. The SEC has also advised that it is also open to publishing guidance for interpretation should future circumstances require reliance on the omnibus provision.</p> <p><b>Interpretation of Authority</b></p> <p>The SEC has discretion to interpret its own authority; however, the interpretative process regarding this authority is not sufficiently transparent or detailed.</p> <p>The SEC does not provide any guidance to regulatees or to the public on how it interprets its authority. For consistency and transparency purposes, the SEC should consider publishing specific guidelines on how it interprets its authority. This will also ensure that the SEC’s authority would be interpreted in a consistent and fair manner.</p> <p><b>Review of Interpretative Process</b></p> <p>All actions and directions of the SEC are amenable to judicial review by either the Court of Appeal or the Supreme Court by virtue of the SEC’s status as a public body and the inherent jurisdiction conferred on those Courts in respect of such bodies under the Constitution.</p> <p>There are also provisions under the SEC Act which provide for persons aggrieved by SEC decisions to grant licenses to stock exchanges, brokers or dealers, to register market intermediaries, and grants of licenses to unit trusts to appeal such decisions before the Court of Appeal.</p> <p>The SEC’s interpretation of its authority is subject to review. There is limited guidance provided on how that discretion is exercised.</p> <p><b>Regulatory Gaps</b></p> <p>The Review Team was made aware that there was a small – and possibly growing – unlisted corporate bond market in Sri Lanka which was not regulated by the SEC and subject only to the registration requirements of the Registrar of Companies. The size of this market is unclear.</p> <p>This is a matter of some concern given the potential risks to investors posed by this market.</p> <p>The apparent gap is proposed to be addressed by revisions to the SEC Act which would see all public offers of securities requiring a prospectus approved by the Commission.</p>
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	<p>The Review Team also notes that some investment banking activities and financial planners are not regulated (as discussed in more detail in Principle 29). Registered auditors registered only under the Companies Act are also not subject to the same intensity of regulation and supervision as auditor members of ICASL (as discussed in more detail in Principle 20).</p> <p><b>Cooperation Arrangements</b></p> <p>Co-operation between regulators responsible for securities regulation is limited, with the only formal MoU in place being with SLAASMB.</p> <p>There is no formal co-operation agreement or documented protocols with the CSE.</p> <p>Co-operation with the RoC and the CBSL is limited to the RoC and the Deputy Governor of the CBSL being ex officio members of the SEC Commission. There is limited and informal engagement at operational level with these authorities.</p> <p>There are no formal co-operation arrangements with ICASL or the Attorney-General’s Department.</p> <p>A more formalized arrangement for information sharing and cooperation with each of these authorities and agencies is needed.</p>
<p><b>Principle 2. The regulator should be operationally independent and accountable in the exercise of its functions and power</b></p>	
<p>Description</p>	<p><b>The Commission</b></p> <p>The SEC is a statutory body, comprising ten Commissioners appointed by the Minister of National Policy and Economic Affairs (the Minister).</p> <p>Sections 3(1)(a) and (b) of the SEC Act empower the Minister to appoint the following members to the Commission:</p> <ul style="list-style-type: none"> <li>• A Deputy Governor of the CBSL nominated by the Governor;</li> <li>• Six persons drawn from the private sector possessing professional expertise, wide experience and proven competency in the fields of law, finance, banking and business. These appointments shall be made to facilitate a Commission with a multi-disciplinary capacity;</li> <li>• The Deputy Secretary to the Treasury (appointed ex officio);</li> <li>• The Registrar of Companies (appointed ex officio); and</li> <li>• The President, Institute of Chartered Accountants, established by the Chartered Accountants Act, No. 23 of 1959 (appointed ex officio).</li> </ul> <p>Members, other than the Deputy Governor of the CBSL and ex-officio members, are appointed for 3-year renewable terms and are eligible for reappointment (s4), except in cases of resignation or removal by the Minister (s 5(1) and (2) respectively).</p> <p>The only criteria in the Act to guide the Minister in the appointments made to the Commission are expertise, experience and proven competency in the fields of law, finance, banking and business (s. 3(1)(a)(ii)).</p> <p>Under section 3(2), the Minister is empowered to nominate, from amongst the members of the Commission, one member to be the Chairman of the Commission.</p> <p>The Minister may, by Order published in the Gazette, remove, an appointed member from office without assigning any reason for so doing. Any such removal is not open to Court challenge. The SEC cited one instance where a Commissioner had been removed for failure to attend 3 consecutive</p>

meetings of the Commission. The Minister cannot remove an ex officio member from the Commission.

Commission members are required to sign the Code of Ethics applicable to staff and Commission members on being appointed to the SEC Commission. The Code obliges members not to divulge to any authorized person or release in advance of authorization of its release, any non-public Commission documents or information contained in any such document.

Under section B1 of the Code, Members are required to avoid any activity which would result in, or might create the appearance of, among other things, not being completely independent or impartial. Section 9 of the SEC Act also obliges Commission members to disclose any direct or indirect interest in a decision to be made by the Commission and provides for members to be recused from participating in any deliberations on that decision.

The Members of the Commission are, together, the policy making arm of the SEC, and provide strategic directions which are operationalized by the Secretariat.

The Commission is required to meet a minimum of once a month, with individual members engaging with the Secretariat from time to time

Acts undertaken in good faith by the members, officers or servants of the SEC in pursuance of the SEC Act or on the direction of the Commission are protected from suit or prosecution (section 50).

### **The Secretariat**

The Director-General of the SEC serves as the CEO of the Secretariat, and is charged with the direction of its affairs and transactions, the exercise, discharge and performance of its powers, functions and duties, and the administration and control of its employees (s42 (2)). The Director-General represents the Secretariat at monthly Commission meetings.

The **appointment and removal** of the Director-General are effected by the Minister on the recommendation of the Commission and the latter cannot be called to question in any court. The considerations on which such a recommendation may be based are not specified in the Act or elsewhere.

The staff of the SEC is similarly governed by decisions of the Commission, as set out in Section 43 of the SEC Act. They are, however, deemed to be public servants within the meaning, and for the purposes of, the Penal Code, and of the Code of Criminal Procedure (s47). These measures serve to ensure that the officers and staff are independent of outside influence.

### **Funding**

The SEC describes itself as self-funding, with its budget decided by the Members of the Commission, based on the recommendations of the Secretariat.

The SEC is funded from three sources:

- The Commission Fund which includes funds voted upon by Parliament for the use of the SEC. The Fund also comprises revenue derived from broker license fees, an administration levy, sales of publications, seminar incomes from educational programs and grants;
- The Cess Fund into which levies are paid on trades on the CSE. The Fund is applied to expenses authorized by the Commission for developing securities markets (s14B SEC Act), to contributions to the Compensation and Commission Funds and for exercising, performing and discharging the powers, duties and functions of the Commission for the purpose of achieving its objects;
- The Compensation Fund includes funds voted by Parliament, funds drawn from the CESS fund and the proceeds of compounding offences under section 51A SEC Act. The Fund is applied to the grant of compensation to investors who suffer pecuniary loss (s38 SEC Act).

Cess rates are set by the Commission and given effect to by the Minister by Order and apply to every purchase and sale of securities on the CSE. During the onsite visit, the Director-General noted the need to adopt a more sophisticated process for setting Cess rates and to benchmark rates against fees set in other jurisdictions. Cess payable on transactions valued at less than 50M LKR is 0.072% and for transactions valued at more than 50M LKR is 0.045%.

Where revenue from the Commission Fund does not cover expenses in a given year, these expenses may additionally be met from the CESS Fund. This facility, as provided in Section 14B(2)(c) SEC Act, is availed annually to meet the Commission's operational expenses. This provision ensures that the SEC's operational allocation of resources is not affected once funded, ensuring that its powers, functions and duties continue to be discharged free from financial constraints.

### **Independence**

Subject to the approval of rules, the SEC is not required to consult with the Minister or any other government minister with respect to the execution of its functions relative to the day-to-day administration of the Act.

The SEC enjoys discretion in its decision making with respect to securities regulation, and no matters of policy that require the approval of, or any consultation with the government or other authority, are provided for in its Act or related documents. Operational decisions do not require consultation with or approval by a government minister or other authority.

Following the appointment of Commission members, the Minister is limited to directing the SEC to furnish such information relating to returns, accounts and other information as he may require (s. 49); or to make regulations in respect of matters required to be prescribed by the SEC Act, or in respect of which regulations are authorized (s. 52(1)).

The SEC advises that the Minister plays no role in the day-to-day operations of the SEC. The SEC sends returns and accounts to the Minister on a quarterly basis and responds from time to time to the Minister's questions.

The Commission may be called upon, if the need arises, to respond to enquiries from the Ministry, other Departments, the Prime Minister and other agencies including the Financial Crimes Investigation Division of the CBSL and the COPE.

### **Accountability**

The SEC is accountable to the Minister, to COPE, and ultimately, to the Parliament of Sri Lanka.

COPE is mandated to ensure compliance and the financial discipline of public corporations and other semi-governmental bodies.

The SEC's Annual Report also contains detailed economic, capital market, and operational reviews, thus encompassing its operations, use of resources, and actions which affect users of the market and regulated entities.

The SEC issues all rules, regulations, directives, notices, and other correspondence in writing. Particularly where decisions affecting specific parties are due, such parties are first called upon to show cause as to why the decision should not be made, failing which the decision is announced in writing, and the underlying reason furnished in the same document.

The SEC Act also provides that persons aggrieved by decisions of the SEC may appeal to the Court of Appeal, in a limited number of contexts provided in Sections 22(1) and 31E(1). The Court, upon such application, reserves, under Sections 22(3) and 31E(3), the right to reverse, modify or set-aside the decision made by the Commission or make such orders as the interests of justice may require. The SEC also advises that decisions of the Commission can be the subject of applications by an aggrieved party to the Supreme Court and the Court of Appeal exercising their inherent jurisdiction in relation to decisions by public officials.

	<p><b>Regulator’s Receipt and Use of Funds Subject to Review or Audit</b></p> <p>The SEC, in complying with Section 37(1), maintains proper books of accounts, detailing its income and expenditure, in keeping with the Sri Lanka Public Sector Accounting Standards. These accounts are subject to article 154 of the Constitution as well, with the implication that they are within the purview of the Auditor-General (s. 37 (2)). The scope and extent of such an audit is at the discretion of the Auditor-General, according to Sections 13 (3) and (4) of the Finance Act No 38 of 1971.</p> <p><b>Official Use of Information</b></p> <p>The SEC’s treatment of confidential and commercially sensitive information is governed by Section 45 of the SEC Act, where it is provided that:</p> <ol style="list-style-type: none"> <li>1) The Commission or a person authorized in that behalf by the Commission may by notice in writing require any person within such period as shall be specified in the notice, to furnish any information or produce any document (other than any information or document which is prohibited from being disclosed or produced under any law which provides for the imposition and recovery of any tax) as shall be specified in such notice and as the Commission may consider necessary for the proper exercise of its powers or the discharge of its functions under this Act.</li> <li>2) It shall be the duty of any person who receives a notice under subsection (1) notwithstanding anything to the contrary in any written law, comply with the requirements of such notice within the period specified therein and where, in compliance with such notice, such person discloses any information or produces any document which he is prohibited from doing under any written law, such disclosure or production shall, notwithstanding anything to the contrary in such written law, not be deemed to be a contravention of the provisions of such written law.</li> <li>3) No information furnished or the contents of a document produced, in compliance with a notice issued under this section, shall be published or communicated by the Commission to any other person, except with the consent of the person furnishing such information, or producing such document, as the case may be or in the course of the discharge of the functions of the Commission.</li> </ol>
Assessment	<b>Not Implemented</b>
Comments	<p>The SEC has a stable and adequate source of funding sufficient to meet its regulatory and operational needs. SEC management, Commission members and staff are adequately protected from personal liability for action taken in discharging their functions and powers. Aggrieved persons can seek reviews of certain Commission decisions and be heard as required by this IOSCO Principle.</p> <p>There are, however, a number of significant gaps in implementation of this IOSCO Principle.</p> <p><b>Independence</b></p> <p>Although the Review Team did not encounter any concrete evidence of interference of influence on the day-to-day operations of the SEC, there are opportunities for such interference.</p> <p>These opportunities arise through the following:</p> <ul style="list-style-type: none"> <li>• When there is a change in government, as a matter of practice all Commission Members resign from their positions and a new Board is appointed. This creates the perception that the political affiliations of Commission members are taken into consideration by the Minister during the nomination process and may influence the decisions Commissioners make in their deliberations on important policy issues.</li> <li>• Under s. 5(2) of the Act, “<i>the Minister may, by Order published in the Gazette, remove an appointed member from office without assigning any reason therefor and such removal shall not be question(ed) in any court</i>”. The fact this power, although not directly exercised, is not reviewable adds to a perception that Commission members may, in making their deliberations, be potentially influenced by the views of the Minister on a given matter.</li> </ul>

	<ul style="list-style-type: none"> <li>• The removal of the Director-General is to be effected by the Minister on the recommendation of the Commission, and the latter cannot be called into question in any court. Since the considerations on which such a recommendation may be based are not specified in the Act or elsewhere, this affords the Commission considerable discretion in this regard and may also impair independence.</li> <li>• The absence of specifications as to fit and proper criteria in appointing Commission members may also affect perceptions of their operational independence.</li> </ul> <p>Significantly, there is also a public perception that such interference and lack of independence between the SEC and the Government exists.</p> <p>Revisions to the SEC Act sighted by the Review Team seek to address a number of these concerns. In particular, criteria are proposed for the Minister in making appointments to the Commission and for the Commission in making recommendations to the Minister about appointment of the Director-General. The Minister would also be limited to removing an appointed member while in office to one of a number of listed grounds. The current provision that any removal is not reviewable by a Court is also removed. The Commission would be similarly limited to the grounds on which it can recommend removal of the Director-General. These revisions are endorsed by the Review Team.</p> <p>There is no evidence the Commission, which draws some members from the markets and market professionals, is not operationally independent from commercial or other sectoral interests. Although the Code of Ethics which applies to Commission members obliges them to avoid activities which would create the appearance of not being completely independent or impartial, consideration should be given to amending the Code to require Commission members to recuse themselves from decisions in which they may have an interest – or may be seen to have an interest.</p> <p><b>Consultation processes</b></p> <p>There is no formal consultation process between Commission members and the Government, although consultation appears to occur on a regular basis. Formal consultation processes would contribute to a reduction in market concern about government interference in the operations of the SEC.</p> <p><b>Confidentiality</b></p> <p>There are no provisions that preclude informal communication of confidential information between the Minister and Commissioners. Although Commission members sign a Code of Ethics upon being appointed to the SEC Board, it does not apply to disclosing information to the Government. Board decisions requiring Government approval need to be approved by the Ministry and are hence communicated to the Minister. More specifically, s. 49 provides the Minister with the power to, from time to time, “<i>direct the Commission to furnish to him in such form as he may require returns, accounts and other information with respect to the work of the Commission and the Commission shall carry out any such direction.</i>” In order to maintain independence, there needs to be a more formal process in place in terms of sharing information between the Commissioners and the Minister.</p> <p><b>Accountability</b></p> <p>Although the SEC is accountable to the government and Parliament on an ongoing basis and is subject to audit and review on the use of funds, transparency about the use of resources is limited to retrospective reporting in annual reports.</p>
<b>Principle 3.</b>	<b>The regulator should have adequate power, proper resources and the capacity to perform its functions and exercise its power</b>
Description	<p><b>Powers</b></p> <p>The SEC has the power to license and register all recognized market participants, engage in capital markets supervision and surveillance with wide-ranging powers of inspection. It also performs investigative and enforcement-related functions.</p> <p>The breadth of the SEC’s oversight is clearly outlined in Parts I to IV of the SEC Act.</p>

The conduct of the SEC's day-to-day functions, such as the registration and licensing of market participants, enforcement, supervision and inspection activities, etc. are all determined by the SEC through established procedures under the Act.

The SEC has extensive powers, duties and functions, as provided in Section 13 of the SEC Act. In addition to these, it has powers of inspection over bodies regulated by it (s. 14), is competent in conducting inquiries and investigations (s46A), and may formulate any rules required from time to time in pursuance of the powers, duties and functions stated in Section 13 (s. 53). These provisions are set out in more detail in the description in IOSCO Principle 1.

The SEC's sanctioning powers are limited to those set out in sections 33A and 51 of the Act and the SEC Rules as set out in more detail in the description in IOSCO Principle 11.

### Delegation of Power

For the purposes of the administration of the Act, under section 42(3), the Director-General of the SEC may, with the approval of the Commission, whenever he considers it necessary to do so, **delegate** to any employee any **power, function or duty** conferred or imposed on or assigned to him by this Act and such employee shall exercise, discharge and perform such power, function or duty subject to the general or special directions of the Director-General.

### Funding

The SEC's funding is set out in the description in IOSCO Principle 2.

As noted, where income in a given year does not cover expenses, as has been the case in recent years, any deficit is funded from the Cess Fund established under Section 14A of the SEC Act. This provision ensures that the SEC's operational allocation of its resources is not affected once funded, ensuring that its powers, functions and duties continue to be discharged free from financial constraints.

The Director-General indicated that the current level of funding was seen as adequate.

A summary of income and expenditure from 2011 to 2015 is set out in the following Table. The Table highlights the heavy reliance the SEC places on the CESS fund in financing the ongoing expenditure of the authority.

SECURITIES & EXCHANGE COMMISSION OF SRI LANKA					
SUMMARY OF INCOME AND EXPENDITURE FOR THE YEAR 2011 TO YEAR 2015					
	2015	2014	2013	2012	2011
	Rs.	Rs.	Rs	Rs	Rs
<b>INCOME</b>					
LICENSE FEES	4,229,573	5,366,368	4,163,816	4,999,634	3,605,563
ADMINISTRATIVE LEVY	2,318,683	2,460,174	3,225,066	1,487,168	3,204,082
SEMINAR COLLECTION - CMET & SEC	5,809,217	4,614,910	7,009,985	14,312,304	22,313,742
OTHER INCOME	21,755	1,822,392	149,824	2,235,587	1,865,098
<b>TOTAL INCOME</b>	<b>12,379,228</b>	<b>14,263,844</b>	<b>14,548,691</b>	<b>23,034,693</b>	<b>30,988,485</b>
<b>EXPENDITURE</b>					
A. PERSONNEL COSTS	178,614,001	166,060,617	159,203,688	140,311,036	114,022,626
B. ADMINISTRATION & ESTABLISHMENT COSTS	115,651,572	108,071,048	110,011,824	78,622,641	72,645,015
C. CAPITAL MARKET DEVELOPMENT	55,265,440	102,721,061	66,228,055	24,478,437	41,098,269
D. FINANCE CHARGES	53,662	83,805	85,112	102,328	160,908
<b>TOTAL REVENUE EXPENDITURE</b>	<b>349,584,675</b>	<b>376,936,531</b>	<b>335,528,679</b>	<b>243,514,442</b>	<b>227,926,818</b>
<b>CAPITAL EXPENDITURE</b>					
MOTOR VEHICLES	7,990,000	6,548,500	103,000	-	6,622,786
FURNITURE, FITTINGS AND FIXTURES	1,315,196	7,394,119	110,880	1,352,222	383,289
OFFICE AUTOMATION	7,651,555	8,330,155	7,219,079	9,754,640	16,413,582
<b>TOTAL CAPITAL EXPENDITURE</b>	<b>16,956,751</b>	<b>22,272,774</b>	<b>7,432,959</b>	<b>11,106,862</b>	<b>23,419,657</b>
<b>NET SURPLUS</b>	<b>(354,162,198)</b>	<b>(384,945,461)</b>	<b>(328,412,947)</b>	<b>(231,586,611)</b>	<b>(220,357,990)</b>
<b>CESS GENERATED DURING THE PERIOD</b>	<b>312,320,570</b>	<b>408,658,830</b>	<b>233,725,415</b>	<b>246,562,437</b>	<b>673,005,097</b>
<b>SURPLUS FOR THE PERIOD</b>	<b>(41,841,628)</b>	<b>23,713,369</b>	<b>(94,687,532)</b>	<b>14,975,826</b>	<b>452,647,107</b>
<b>INTEREST ON INVESTMENTS - CESS FUND</b>	<b>154,415,014</b>	<b>198,752,296</b>	<b>266,747,989</b>	<b>210,657,028</b>	<b>162,980,420</b>
<b>SURPLUS TOWARDS THE CESS FUND</b>	<b>112,573,386</b>	<b>222,465,665</b>	<b>172,060,457</b>	<b>225,632,854</b>	<b>615,627,527</b>

## Staffing

The number of staff – or cadre – that the SEC can employ is subject to Ministerial approval. The Commission decides on how staff numbers are to be allocated across the organizations’ divisions. Personnel costs account for 45% of annual SEC expenditure.

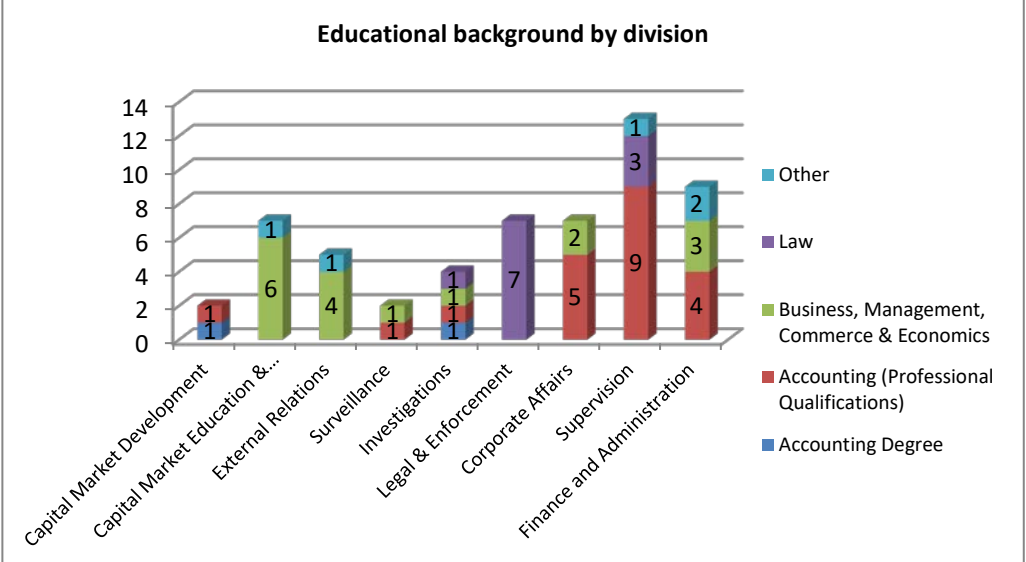
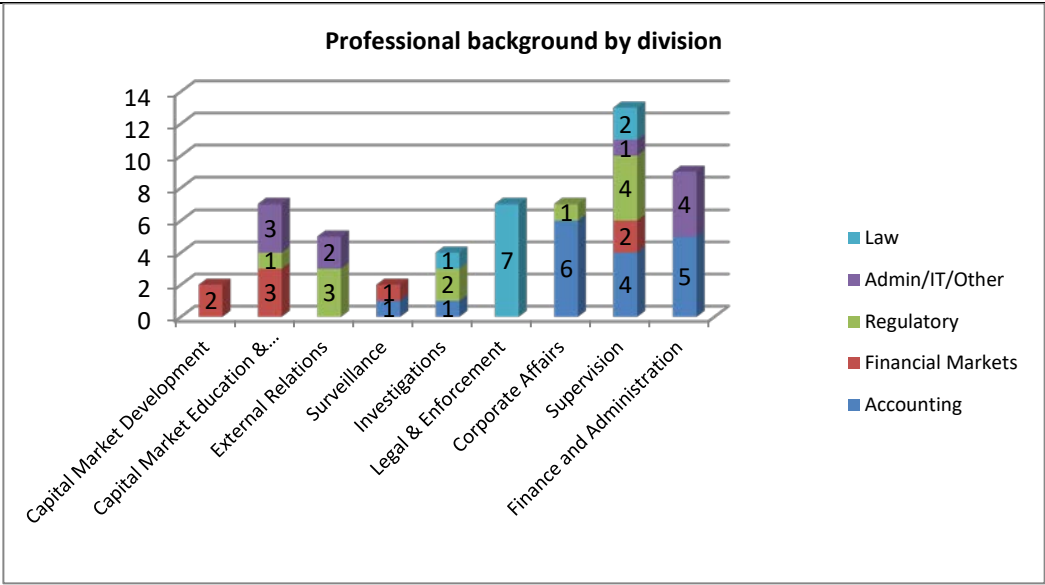
As at July 2016, the SEC has 96 positions, 77 of which are filled.

<b>SEC Cadre Profile as at July 2016</b>				
<b>Categories</b>	<b>Total Approved Cadre</b>	<b>Current Cadre in Employment</b>		<b>Vacancies</b>
		<b>Perma nent</b>	<b>Contr act</b>	<b>To be filled</b>
Director-General	1	1		-
Deputy Director-General	1	1		-
Directors	11	6		4
Assistant Directors	5	2		3
Managers	8	8		-
Senior Assistant Managers	40	14		9
Assistant Managers		17		
Senior Executive Sec.	3	2		-
Executive Secretaries		1		-
Non-Executives	17	17		
Senior Office Assistants	10	6		2
Office Assistants		1		
Office Aide		1		
<b>Total</b>	<b>96</b>	<b>77</b>		<b>19</b>

Staff are currently employed across the divisions as set out in Chapter V in the description of the Sri Lankan Regulatory Framework (see pages 16-18).

The professional background and academic qualifications of staff by division is set out in the following figures. Over 60% of staff were below the age of 45, and over one-third had over 10 years of service in the SEC.





Turnover of staff has been 10% per annum in recent years, which is not inconsistent with experience at other comparable regulators. Staff members are subject to annual performance appraisals.

In 2014, the SEC reviewed its recruitment scheme and salary scales, and a human resources consultant was retained to streamline relevant administrative processes and procedures. The results of this initiative are still being considered.

In addition to its permanent cadre, the SEC receives expert advice and direction from a number of consultants representing the fields of law enforcement, finance, policy-making, and litigation, among others. Further, keeping with its commitment to provide young people with meaningful workplace exposure and to improve their employability, the SEC also conducts an **internship programme** for undergraduates of National Universities.

The SEC recognizes the difficulty of attracting and retaining experienced and skilled staff by offering competitive remuneration packages, and providing for capacity-building measures through recruitment and training. The Director-General acknowledges the need to build the capability of current staff and attract staff with market expertise to fill the currently vacant positions. A management training program is being introduced.

Although salaries are said to be more or less on par with those paid in the CBSL – not taking into account the significant, additional non-salary benefits that CBSL may provide its staff – they are thought to be significantly lower than those paid to industry professionals. The SEC advises that the issue of competitive salaries is being revisited. There is no statutory or other restriction imposed on the salaries that the SEC can offer staff members, beyond the natural constraints imposed by its overall budget and resources.

### **Training**

The SEC places considerable importance on providing specialized and ongoing training to staff to enable them to effectively carry out the SEC's mandate given the increasingly complex nature of the securities markets, both locally and internationally.

In 2014, 10% of personnel costs were devoted to training.

Investment is made each year in overseas training, including programmes conducted by IOSCO, regional bodies, and other capital market regulators. In 2014, SEC staff attended 23 such programmes both within South Asia and in other regions including Japan, USA, UK, Switzerland and South Korea.

In addition, local training in areas of law, statistics, programming and modelling, finance, management, and economics has been provided to personnel. Residential and outdoor training programmes are organized annually, and arrangements made for personnel to attend national conferences, seminars and summits, particularly those relating to their fields of expertise.

SEC staff are awarded scholarships and receive discounts from professional bodies, and sponsorships for higher education.

The SEC's Capital Market Education and Training (CMET) division is dedicated to raising the professional standards of market participants. Its Certificate in Capital Markets entails three series of lectures, on equity, debt, and securities regulation and ethics. CMET also offers a Diploma in Capital Markets in conjunction with the Chartered Institute for Securities and Investment UK, a qualifying examination for Registered Investment Advisors, and tailor-made Continuing Professional Development programmes (CPDs) for existing investment advisors. These in-house courses and programmes are offered in English and Sinhala.

### **Internal Governance**

The SEC has outsourced the internal audit function covering finance operations, regulatory compliance, human resource management and payroll, fixed assets, general administration, marketing operations for CMET and information technology.

The SEC is also subject to a Government audit which analyses accounting deficiencies, financial results, market performance, performance of the Commission, and budgetary control. The findings of the internal and Government audit are reviewed in detail by the Audit Committee and taken up where necessary for necessary actions.

The SEC Audit Committee charter covers:

- Examining the accounting policies of the SEC to determine whether they are appropriate and in accordance with all applicable reporting requirements;
- Ensuring compliance with general and specific laws and regulations;
- Ensuring that truth and fairness is reflected in the preparation and publication of the SEC's financial reports;
- Meeting regularly with the internal and external auditors to ensure the smooth performance of their work;

	<ul style="list-style-type: none"> <li>• Determining the appropriateness of internal audit procedures;</li> <li>• Reviewing the performance of the auditors and providing the auditors with confidential access to the commission;</li> <li>• Referring matters of concern to the Commission, as appropriate, and considering risk management matters;</li> <li>• Establishing procedures to receive and address complaints regarding matters pertaining to accounting, auditing and internal controls;</li> <li>• Approving any non-audit services to be provided by the external auditors in case if the Auditor General appoints a private firm of accountants under section 154 (1) (a) of the constitution of the Democratic Socialistic Republic of Sri Lanka (the constitution) as the auditors of the SEC;</li> <li>• Recommending to the Commission the recruitment of outside experts in different fields of specialization;</li> <li>• Monitoring dealings in particular those of related party transactions; and</li> <li>• Ensuring the competence of the internal auditor’s staff.</li> </ul> <p><b>Investor Education</b></p> <p>Elsewhere in the SEC, the External Relations division undertakes extensive investor education programmes to raise awareness of the benefits and risks associated with investing in the capital market, as well as to equip investors with the requisite skills, knowledge and tools to make informed investment choices. It distributes written materials, conducts seminars and workshops, and engages with print and electronic media in order to do so. In print media, the division published more than 250 articles pertaining to the capital market during the year 2015, while its presence on electronic media was secured by both a live radio chat show with 18 iterations, and a 12-episode reality quiz programme on national television in 2014.</p> <p>6.5% of the SEC’s annual budget is allocated to investor education activities.</p> <p>The SEC’s education initiatives effectively capture all segments of the capital market, from professionals dealing directly in the capital market, those within the corporate structure, and investors, both potential and existing.</p> <p><b>SLAASMB</b></p> <p>The Review Team notes the resourcing and staffing challenges SLAASMB faces. These are described in more detail in the assessment of IOSCO Principles 18 and 19.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>The SEC’s funding is adequate to permit it to fulfil its responsibilities, taking into account the size, complexity and types of functions subject to its regulation, supervision and oversight. The SEC also has autonomy in allocating resources once funded.</p> <p>The SEC also plays an active role in promoting education in the interests of protecting investors. This covers both investor education and the education of industry professionals.</p> <p>However, significant shortcomings remain in implementation of this IOSCO Principle. Addressing these shortcomings is critical to building trust and confidence in the regulator and in Sri Lankan capital markets more generally.</p>

	<ul style="list-style-type: none"> <li>• The SEC’s powers are not sufficient to meet its current responsibilities, particularly in relation to supervision and enforcement. Furthermore, the SEC does not have an appropriately wide range of sanctions available to it in addressing breaches of the Act, regulations and rules.</li> <li>• Although there is some “bench strength” – or depth of professional capability – at middle levels of the organization, the SEC is struggling to fill senior positions with appropriately skilled and experienced staff. This reflects, in part, a dearth of available local candidates. Strict labour laws also make it difficult to hire and retain qualified staff and, in particular, remove staff members who are not suitable for their role. The absence of enough appropriately skilled staff at senior level is contributing to the escalation of decisions which should be made at more junior levels to the Director-General and Commission. This may, over time, impact the focus of the Director-General and Commission on strategic matters</li> <li>• The efficiency with which resources are used warrants some improvement. The need to visit every registered entity irrespective of the risk they pose should be reconsidered. Consideration should be given, for instance, to decoupling supervisory visits from license and registration renewals and freeing supervisory staff to focus on more intensive supervision and follow up in activities and areas identified as high risk.</li> <li>• The SEC’s audit function is currently being outsourced and only covers the financial reporting process of the SEC’s operations. A formalized internal audit function that encompasses corporate governance processes would assist in reviewing the SEC’s performance of its own obligations and duties on a continuous basis. Such an internal audit process would help the SEC accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. This in turn will serve to improve the efficiency of the organization as a whole.</li> <li>• There is evidence of a lack of communication between the SEC and industry about the SEC’s recent actions, current thinking and vision for the market. Although the SEC has consulted with stakeholders about its reform plans there is some concern in the market that the SEC has not communicated outcomes, particularly with respect to its strategic vision for the regulation of the Sri Lankan capital markets. Given the perception in some quarters that the SEC is not effectively fulfilling its mandate as a securities regulator there is a strong need for the SEC to communicate its strategic direction to industry and to ensure that there are internal mechanisms to assess whether the strategic direction is being successfully implemented. The SEC advised the RT after the onsite visit that this has been noted and is being acted on.</li> <li>• While the SEC has a solid training program, consideration needs to be given to developing processes under which training is targeted at those who would most benefit from it.</li> </ul>
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<b>Principle 4.</b>	<b>The regulator should adopt clear and consistent regulatory processes</b>
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Description	<p><b>Procedural Rules and Regulations</b></p> <p>The SEC has extensive procedural rules and regulations, as set out by Parliament in the SEC Act and its amendments, and refined periodically by the Commission, through circulars.</p> <p>The former, for instance, sets out procedures for the grant of licenses to stock exchanges, stockbrokers or stock dealers and the registration of market intermediaries (Part III of the SEC Act); and the grant of licenses to unit trusts (Part IIIA), while the latter serves to address procedural lacunae – or gaps – arising in various contexts.</p> <p>The SEC also has power under s. 53 of the SEC Act to independently formulate rules covering its responsibilities.</p> <p>The CSE may also issue rules that are binding on its members and relevant stakeholders. Examples include the Stock Broker and Listing Rules, the Automated Trading Systems and Central Depository System Rules.</p>
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The Legal division of the SEC also undertakes policy initiatives, whereby amendments to the SEC Act are drafted and changes made to procedures followed by the SEC, the CSE and the market participants.

In addition, internal procedures are described in the Administrative Manual (which the SEC advises is currently under review). Divisional manuals and process charts are maintained and followed. These are not, however, publicly available.

The SEC advises that no periodical reviews or documentation of gaps or shortcomings are undertaken.

#### **Consultation and Transparency**

Both the Act and the circulars are accessible via the SEC website, and any exercise of powers, functions or duties by the SEC cites which rules or regulations apply to the given context. The policy initiatives are embargoed until such time they are approved, and are published upon implementation.

The SEC consults the public and relevant stakeholders on proposed changes to policies, laws and rules. These are done through submissions made by market participants and members of the general public in writing to the SEC, when solicited by the publication of a press notice, followed by the publication of a consultation paper on the SEC website.

Such consultation papers are developed under Regulatory Committee oversight and subject to Commission approval prior to publication. The deadline for written representations is set on a case-by-case basis, but generally permits for a four-week window between publication and receipt. These representations are taken into consideration in drafting/amending Rules, which are then submitted to the Commission for final approval before coming into effect.

The policy formulation process takes into account the efficiency of the regulatory requirements in meeting policy objectives, and the adequacy of regulated firms' budgets to meet such requirements. These are then disclosed, explained and clarified through the SEC website and promotional material, as well as print and electronic media, to facilitate greater public awareness. Changes are disclosed with reasoning underlying them, as well.

All rules and regulations made by the SEC and all instances of their application are documented, and published on the SEC website before they are given effect.

This extends to the context of investigations as well, where discrepancies in market conduct are flagged by sources both internal (other divisions of the SEC) and external (CSE and investor complaints). These are directed to the SEC Surveillance and Investigations Committee comprising the Director-General and two other Directors. This committee examines the surrounding circumstances in order to determine whether it warrants an investigation and, if it is found to warrant further inquiry, directs the Investigations Division to report its findings and recommendations to it. These findings are then considered by the Committee and submitted for the reconsideration of the members of the Commission. The Commission, if satisfied, directs the enforcement action to be undertaken. The subsequent enforcement process is undertaken in consultation with the Attorney General's Department. Where enforcement action is taken, a media release relating to this is published; until this time, no reporting of the findings resulting from investigations may take place.

Costs borne by stakeholders in conforming to and complying with policies and requirements proposed to be adopted by the SEC are taken into consideration during the process of formulation, and concessions and flexible deadlines afforded wherever necessary and appropriate.

The SEC's processes for consulting on decision-making have not been published or otherwise made publicly available. Instead, the processes rely on established internal procedures only.

#### **Procedural Fairness**

The SEC applies principles of natural justice in making decisions. Before taking action, the SEC gives a person the right to be heard and to show cause as to why an adverse decision should not be made. This is done by way of show cause letter issued to the relevant parties. If needed, a meeting is called with the party in question.

	<p>If any cause is found insufficient, the decision is announced, and the underlying reason explained in the same document.</p> <p>Where stockbrokers or dealers are aggrieved by decisions of the SEC, they may appeal against them to the Court of Appeal. The contexts in which such appeal is available are provided in Section 22 (1), and include, but are not limited to, situations where a license for a stockbroker or dealer is:</p> <ul style="list-style-type: none"> <li>• Suspended or cancelled under Section 18A;</li> <li>• Refused under Section 19 or 19A;</li> <li>• Refused to be renewed under Section 20; or</li> <li>• Cancelled or suspended under Sections 21 or 21A.</li> </ul> <p>On application, the Court of Appeal may reverse, modify or set aside the decision made by the Commission or make such order as the interests of justice may require (s22(3)). Similar provisions apply to the managing companies of unit trusts (s31E).</p> <p>However, the Court of Appeal has no power to initiate a review of SEC decisions made at its discretion.</p> <p>The criteria governing the grant, denial or revocation of licenses is therefore publicly available, and any decision made along such criteria entitled to an appeal.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>The SEC is subject to appropriate procedural rules and regulations. The SEC’s decisions are required to be made and are made applying procedural fairness in line with the requirements of this IOSCO Principle.</p> <p>However, significant shortcomings remain in the implementation of this IOSCO Principle. Addressing these shortcomings is important to ensuring trust and confidence in the SEC’s regulatory processes. In particular:</p> <ul style="list-style-type: none"> <li>• The SEC does not provide any guidance to its regulated population or to the public as to how it interprets its authority, nor does it publicly disclose its policies in important operational areas. In essence, guidance to market participants from the SEC on regulatory requirements is provided on a case-by-case basis, if at all. As a result, there is a significant risk of inconsistent interpretation of the provisions of the Act.</li> <li>• The transparency of the SEC’s review procedures warrants improvements in the interests of maintaining public and market confidence in the SEC’s authority and independence.</li> </ul> <p>Although consultation processes are well established, and the SEC has consulted with stakeholders about its reform plans there is some concern in the market that the SEC has not communicated outcomes, particularly with respect to its strategic vision for the regulation of the Sri Lankan capital markets. Some industry groups also indicated they would like to meet with the Commission and the Director General on a regular basis.</p> <p>For consistency and transparency purposes, the SEC should consider publishing specific guidelines on how it interprets its authority. This will also ensure that the SEC’s interpretation of its authority and decisions are applied internally in a consistent and fair manner.</p> <p>Regular meetings with industry are recommended.</p>

<b>Principle 5.</b>	<b>The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality</b>
Description	<p>Commission members, management and staff are subject to an institutional Code of Ethics, in addition to the general rules and regulations commonly applicable to all public officers.</p> <p>Since 1997, Commission members and the staff of the Secretariat have been required to adhere to the SEC's Code of Ethics.</p> <p>The Code of Ethics underlines the importance for members and employees of the Commission to maintain high standards of honesty, integrity, impartiality and general conduct. In doing so, they must be constantly aware of the need to avoid situations which might result either in actual or apparent misconduct or conflicts of interest and to conduct themselves in a manner that commands respect and confidence.</p> <p>The general provisions of the Code of Ethics allow for the avoidance of activities that might result in, or create the appearance of, using public office for private gain, giving preferential treatment to any organization or person, not being completely independent or impartial, or affecting adversely the confidence of the public in the integrity of the Commission.</p> <p>The Code addresses, among other things, conflicts of interest, transparency of securities holdings, and confidentiality, while sanctions for violating the Code or any other rules applicable to public officers are contained in the Establishment Code. These are imposed in keeping with the requirements for due process and fair hearings.</p> <p>There is also a Commission-wide IT User Policy, which prohibits commercial use of SEC IT resources, the undermining of system integrity, unauthorized access or use, uses in violation of law, tampering with resources, search instructions and data downloads, and unauthorized disclosures and transmissions of proprietary or confidential material.</p> <p>Violations of rules and incidents of misconduct are subject to disciplinary procedures detailed in the Establishments Code applicable to all government employees.</p> <p><b>Conflicting employment activities</b></p> <p>Conflicting employment activities addressed in the Code include:</p> <ul style="list-style-type: none"> <li>• Having outside or private employment without the approval of the SEC;</li> <li>• The employment or prospective employment of a spouse or immediate family member by an entity under the jurisdiction of the SEC without informing the SEC;</li> <li>• Acting on behalf of the SEC in any matter affecting a prospective employer; and</li> <li>• Receipt of anything of monetary value from a private source as compensation for services to the Commission.</li> </ul> <p><b>Disclosure of Securities transactions by employees</b></p> <p>There is both an initial and ongoing duty for employees to report to the SEC the securities owned by them, their spouses, or minor children. No transactions in securities for purposes other than bona fide investment, trading in the secondary market or trading in securities of a company under investigation by the SEC, and no financial interests in regulated firms are permitted. Employees may subscribe to IPOs, but require permission to dispose of these securities once purchased.</p> <p><b>Appropriate use of information and Confidentiality</b></p> <p>With respect to the appropriate use of information, confidentiality and secrecy, the general provisions in Section B of the Code of Ethics provide, at 2 and 4 respectively, that:</p>

	<p>2. A member or employee of the Commission shall not engage directly or indirectly in any personal business transaction which arises because of his or her official position or authority, or that is based upon confidential or non-public information which he or she gained by reason of such position or authority.</p> <p>4. A member of employee of the Commission shall not divulge to any unauthorized person, or release in advance of authorization of its release, any non-public Commission documents, or any information contained in any such document or any other confidential information.</p> <p><b>Use of IT resources</b></p> <p>The IT User Policy prohibits commercial uses of SEC IT resources, the undermining of system integrity, unauthorized access or use, uses in violation of law, tampering of resources, massive search instructions and data downloads, and unauthorized disclosures and transmissions of proprietary or confidential material.</p> <p><b>Sanctions for Failure to Adhere to Codes and Policies</b></p> <p>Violations of standards are subject to disciplinary procedures detailed in the Establishments Code applicable to all government employees. The code distinguishes the actions to be taken in the event a public officer is accused of a criminal offence, from those to be taken in response to bribery or other instances of misconduct regulated by a duly authorized statutory authority. These allow for transfer, demotion, dismissal, compulsory retirement, retirement for general inefficiency, or termination of employment of officers guilty of misconduct, following disciplinary hearings. Officers aggrieved by a decision relating to a disciplinary matter may appeal against the same to the Public Service Commission.</p> <p>The relevant disciplinary procedure is begun with a preliminary fact-finding mission, and the issue of a charge sheet in consideration of prima facie evidence. These are submitted for the Commission's consideration along with the response of the employee alleged to have breached a given rule. The Commission, in its capacity as the disciplinary authority of the SEC, may suspend or interdict the employee during the continuance of the inquiry, at the end of which the transfer, demotion, dismissal, compulsory retirement, retirement for general inefficiency, or termination of employment of officers found guilty will result.</p> <p>It should be noted that SEC staff are not strictly governed by the Establishments Code. Section 1.1 of the SEC's Administrative Manual provides guidance to SEC employees with regard to general administration issues. The Establishments Code will apply only in instances where the Administrative Manual is silent and to that extent determined by the Commission.</p>
Assessment	<b>Fully Implemented</b>
Comments	<p>The SEC staff, management and Commissioners appear to adhere to a strict Code of Ethics and professional conduct in terms of honesty and integrity; procedural fairness; prevention of conflict of interest; and confidentiality.</p> <p>However, in terms of confidentiality of information, there are no provisions that preclude informal communication of confidential information between Commission members and the Minister. Although Commission members sign a Code of Ethics upon being appointed to the SEC Board, it does not apply to disclosing information to the Government.</p> <p>The Establishments Code and Administrative Manual are out dated and are in need of a thorough revision.</p> <p>However, these deficiencies are minor and – while they should be addressed – do not warrant departure from a Fully Implemented rating.</p>



<b>Principle 6.</b>	<b>The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate</b>
Description	<p><b>Process to Identify and Monitor Systemic Risk</b></p> <p>The CBSL is responsible for the maintenance of financial system stability in Sri Lanka.</p> <p>The SEC currently has no explicit role in relation to monitoring, mitigating, or otherwise managing systemic risk. Furthermore, there is no definition of systemic risk in the SEC Act or other relevant legislation.</p> <p>The SEC’s self-assessment notes, however, that disclosure and business conduct oversight functions of the SEC contribute to a reduction in systemic risks within the context of the Sri Lanka securities industry.</p> <p>Rules and regulations formulated for each class of intermediary cover risk management and mitigation. They are also the subject of both offsite and onsite inspections where the SEC deems them necessary and warranted as described in more detail in IOSCO Principle 12.</p> <p>Entities licensed or registered by the SEC are additionally subject to minimum liquidity and capital adequacy requirements, buttressed by the stipulated conduct of periodic audit.</p> <p>The rules and regulations apply irrespective of the relative systemic importance of each participant, and overlook the system’s sensitivity to larger (and therefore more influential) participants.</p> <p>The SEC also notes initiatives to establish a Sri Lankan CCP as evidence of its commitment to addressing systemic risk in Sri Lanka and revisions to the SEC Act which will recognise the mitigation of systemic risk as an objective, with requirements imposed on the clearing house to deal with this aspect of its rules.</p> <p><b>Cooperation with other Domestic Regulators</b></p> <p>The SEC advises that it engages from time to time with CBSL, the Insurance Board of Sri Lanka (IBSL) and SLAASMB on issues of common interest including financial stability.</p> <p>More recently the CBSL has also established a Financial Sector Oversight Committee, in which the Director-General participates, which discusses cross sectoral issues including financial stability.</p> <p>These initiatives build on the fact a Deputy Governor of the CBSL is a member of SEC Commission.</p> <p>The SEC has signed a Memorandum of Understanding (MOU) with SLAASMB, but has no formal arrangement with any of the other authorities.</p>
Assessment	<b>Not Implemented</b>
Comments	<p>The SEC has no process – either formal or informal - to monitor, mitigate and appropriately manage systemic risk.</p> <p>The SEC lacks expertise regarding risk measurements and analysis relevant to systemic risk assessment and is unable to apply risk measurements and analysis developed by other regulators. This should be addressed as a matter of urgency. This could be done by applying or adopting measurements and tools developed by other regulators.</p> <p>Appropriate processes and sufficient expertise could, for instance, assist the SEC in monitoring and considering the potential systemic implications of, for instance, the increased role of Money Market Funds in the Sri Lankan capital markets.</p> <p>Although there is some communication between the SEC and other financial sector regulators such as the CBSL, it is of a general nature and does not specifically pertain to efforts to reduce systemic risks.</p>

	<p>The SEC’s initiative to facilitate the setting up of a CCP mechanism at the CSE is a good first step in addressing systemic risk. It is important that the regulatory framework for this CCP, including the CCP’s own rules, allow for the mitigation and management of the systemic risks that may be posed by the CCP.</p> <p>The Review Team notes revisions to the SEC Act it has seen make reference to the object of sections of the Act dealing with markets and market institutions being the reduction of systemic risk associated with capital markets. Consideration should be given to including similar provisions dealing with other areas of the SEC’s regulatory responsibilities.</p>
<p><b>Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly</b></p>	
<p>Description</p>	<p><b>Reviewing the Perimeter of Regulation</b></p> <p>The perimeter of regulation and the adequacy of regulations are not subject to formal or regular review by the SEC. However, where relevant to an operational concern, risks to the objectives of investor protection, fair, efficient, and transparent markets, and reduction of systemic risk, are deliberated upon, on a case-by-case basis.</p> <p>The SEC cites the extensive review of its regulatory framework, and the proposed new SEC Act that arose from it, as evidence of its commitment to reviewing the perimeter of regulation as needed.</p> <p><b>Review of Past Decisions</b></p> <p>A review of past regulatory policy decisions on products, markets, entities, market participants or activities may be undertaken where the need for such changes is underscored by the relevant divisions of the SEC, on the basis of findings submitted by the CSE, or in response to complaints or requests for reviews received from regulated entities and the general public.</p> <p>Further, Commission decisions can be appealed on the basis of evidence relating to new or changed circumstances or be subject to judicial review.</p> <p><b>Review of Unregulated Products, Markets and Activities</b></p> <p>There is no process to periodically review unregulated products, markets, market participants or activities, or to assessing potential for regulatory arbitrage, although the Commission calls for and considers Commission papers and proposals from others, including the CSE, relating to such issues on an ongoing basis.</p> <p>Reviews leading to action have however taken place in the past. The response to the recent World Bank is one example.</p> <p>Another is the response to the CSE identifying, in 2009, with the support of the National Stock Exchange of India (NSE) and an Australian consultancy firm, the need for a CCP which resulted in a proposal being submitted to the SEC<sup>6</sup>.</p> <p>The SEC has also facilitated the project to implement BBO and OMS jointly with the CSE with the objective of improving the trading and settlement efficiency and maintaining uniformity in the BBO</p>

<sup>6</sup> After the completion of initial work in relation to the project, several delays were observed in project implementation. As a result, the SEC decided to fast track the implementation of the project and appointed a high-level committee made up of senior representatives from SEC and CSE to monitor project progress. The Committee served the purpose. However, the project was not completed. In 2014, the SEC, Central Bank of Sri Lanka (CBSL), and CSE jointly initiated the project to set up an integrated CCP mechanism covering all financial transactions. However, the CBSL opted out from the project during the latter part of phase 1 and SEC and CSE are driving the initiative forward. At present, the funding is being secured for the project which at commencement will be rolled out to equity and corporate debt and extended to facilitate other securities.

	<p>systems of Stock Broking Firms. At present, over 95% of Stock Broking Firms have completed OMS &amp; BBO system implementation. The project will be jointly funded by SEC and CSE.</p> <p><b>Regulatory Changes</b></p> <p>The SEC is empowered by legislation to make all such regulatory changes as are required to ensure that risks to investor protection, market fairness, efficiency and transparency are addressed in a timely and effective manner.</p> <p>While rules made by the SEC require publication in the Gazette, other regulatory initiatives, affecting regulated entities and securities issuers, or clarifying internal procedure, are introduced through SEC Directives and SEC Circulars, respectively. These do not require publication in the Gazette.</p> <p>Further, changes to rules affecting trading activity on the Exchange, as suggested by the CSE and submitted for SEC approval, are also approved via the issuance of SEC directives.</p> <p>The SEC has embarked on extensive reforms to all legislation touching on its regulatory responsibilities.</p>
Assessment	<b>Not Implemented</b>
Comments	<p>The SEC has not developed any processes for the identification, measurement and analysis of risks. Regular reviews of products, markets, market participants and activities to identify and assess possible risks are not systematic in Sri Lanka. Instead, there have been ad-hoc initiatives in response to issues that have come to light.</p> <p>The SEC acknowledges that it currently has no formalized process to review unregulated products, markets, market participants and activities. As such, there is a need to develop robust arrangements to conduct comprehensive analyses of potential risks emerging from unregulated products and entities in the Sri Lankan securities market. This is necessary to ensure that its regulation remains appropriate to market developments.</p> <p>The absence of processes to review the perimeter of regulation is a significant weakness, particularly as key participants in securities markets are not the subject of direct SEC oversight, including investment banks and certain other individuals who work for such entities and who are responsible for dealing with their clients. Furthermore, potentially significant unlisted markets in debt and equity securities remain outside the regulatory perimeter of the SEC. The SEC advises that revisions to the SEC Act will extend the perimeter to capture, for instance, all public offers and financial planners and corporate finance advisors in the definition of market intermediaries.</p> <p>There is, therefore, a need to develop robust arrangements to conduct comprehensive analyses of potential risks emerging from unregulated products and entities in the Sri Lankan securities market. The SEC should, however, be commended for undertaking the significant overhaul of its current regulatory framework in response to the 2015 FSAP.</p> <p>The SEC advises that amendments to the Act will provide for the review mechanism required by IOSCO Principle 7.</p>
<b>Principle 8.</b>	<b>The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed</b>
Description	<p><b>Conflicts of Interest</b></p> <p>The regulatory framework in Sri Lanka includes a number of provisions that seek to address conflicts of interest that may arise. The requirements differ depending on the type of intermediary and include the following:</p> <ul style="list-style-type: none"> <li>• Stockbrokers are subject to specific requirements to manage conflicts and act in their clients' interests under s 3.1(3) of the CSE Stockbroker Rules.</li> </ul>

	<ul style="list-style-type: none"> <li>• Unit Trust Managing Companies are only permitted to manage third party portfolios where their management is not in conflict with the Unit Trust (Rule 36(3), and are required to act in the interest of the unit holders and be subject to the oversight and intervention of the Trustee wherever the interests of unit holders so demand. Unit trusts are also subject to requirements in the Unit Trust Code 2011 to address conflicts of interest.</li> <li>• Market intermediaries are subject to the general requirement to ‘always strive to act in the best interests of clients’ under Article 9 of the Code of Conduct for Market Intermediaries. Further specifications made with respect to investment managers, margin providers, credit rating agencies and underwriters.</li> </ul> <p>While the framework places primary responsibility for avoiding conflicts of interest with regulated entities, the SEC engages in supervisory activity which includes detecting and addressing relevant conflicts in respect of each group of intermediaries.</p> <p><b>Addressing Conflicts of Interest</b></p> <p>The SEC, where it identifies a <i>prima facie</i> conflict of interest investigates and enquires into that conflict, recommends a course of action and discloses both the conflict of interest and remedial action taken in response thereto, to the public.</p> <p>For instance, where a conflict of interest arises with respect to credit ratings, the SEC, having afforded a hearing to the ratings agency and the rated issuer, requires that specific measures are adopted. These measures typically include the issue of a press release stating that a conflict of interest has arisen, the securing of a fresh rating from an independent CRA, and suspension of activity until such time as the new rating is obtained.</p> <p><b>Disclosures</b></p> <p>All communications and disclosures required to be made by regulated entities at the direction of the SEC must be either published on a stated number of occasions in a national newspaper having wide circulation, or prominently displayed on that regulated entity’s website.</p> <p>The final directive or correspondence following any hearing conducted by the SEC with respect to matters relating to the conflict of interest of a regulated firm is also published on the SEC website.</p> <p><b>Identifying Potential Misalignment of Incentives</b></p> <p>When reviewing issuers’ reporting obligations, the SEC seeks to identify potential misalignment of incentives and addresses them mainly through enhanced disclosure. This is done through onsite inspections of regulated entities.</p>
Assessment	<b>Broadly Implemented</b>
Comments	<p>In Sri Lanka, what constitutes a conflict of interest in securities markets is specified in relation to each market intermediary and other participants. The regulatory framework places emphasis on preventing and eliminating such conflicts, and sets out precautions and remedial measures for market participants such as: stock exchanges, stockbrokers and dealers, Unit Trust Managing Companies, and market intermediaries, etc.</p> <p>However, there is no general obligation placed on the operator of a licensed stock exchange to manage or avoid conflicts.</p> <p>Conflict of interest issues – and how they are addressed by the regulatory framework in Sri Lanka – are also discussed in more detail in the Assessment of other relevant IOSCO Principles including Principle 22 on Credit Ratings Agencies, Principle 23 on analytical and evaluative information service providers, Principle 24 on CIS’s, and Principle 31 in relation to market intermediaries.</p>

	<p>The SEC has processes in place to address conflicts of interest and misalignment of incentives, including imposing enhanced disclosure requirements and undertaking compliance and oversight functions.</p> <p>While the SEC’s regulatory framework places the primary responsibility of avoiding conflicts of interest on regulated entities, the SEC engages in supervisory activities to detect and address conflicts that have not been appropriately managed by the regulated entity.</p> <p>When reviewing issuers’ reporting obligations, the SEC seeks to identify potential misalignment of incentives and addresses them mainly through enhanced disclosure.</p> <p>The SEC should further develop tools to monitor compliance with obligations of supervised entities regarding conflicts of interest and misalignment of incentives.</p>
<b>Principle for Self-Regulation</b>	
<p><b>Principle 9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities</b></p>	
Description	<p>In Sri Lanka, the CSE – while it does not have delegated regulatory authority – undertakes functions that have a self-regulatory character. These include, among others, the:</p> <ul style="list-style-type: none"> <li>• Admission of members/trading members to the CSE who are licensed as stockbrokers or stock dealers by the SEC;</li> <li>• Supervision of participant brokers;</li> <li>• Resolving disputes between clients and Brokers;</li> <li>• Disciplining participant brokers, including having the power to suspend or cancel their participant status;</li> <li>• Approving listings on the CSE;</li> <li>• Monitoring the compliance of listed companies with the continuing listing requirements;</li> <li>• Monitoring the disclosure of corporate information and imposing trading halts, where necessary; and</li> <li>• Taking certain enforcement actions relating to listed companies permitted under the CSE Listing Rules, such as suspending trading, transferring securities to the ‘Default Board’, delisting and other measures.</li> </ul> <p>More information about the functions of the CSE, including its self-regulatory functions, can be found in the detailed Assessments of Principles 33-35.</p> <p><b>Functions of the CSE</b></p> <p>The primary licensor and overseer of financial firms, including stockbrokers, in Sri Lanka is the SEC, which licenses stockbrokers under s. 19 of the SEC Act. However, the CSE has the power to grant or reject applications for brokers to participate in the CSE securities market as Members or “Trading Members”. This process is set out in Article 6 of the Articles of Association of the CSE.</p> <p><b>Article 7 of the Articles of Association of the CSE allows a right of appeal to the SEC in respect of Board decisions.</b> Indeed, in 2010, the CSE Board was required to change its decision on the final admission of 5 new Trading Members, because the SEC approved appeals made by 2 unsuccessful applicants. This resulted in the CSE admitting 7 Trading Members, rather than 5.</p>

However, the CSE’s power in determining who can be a participant on the CSE is significant as, under s. 6(2) of the SEC Rules 2001: “*No person shall buy or sell securities listed in the official list of a licensed stock exchange, except through a licensed stockbroker or licensed stock dealer who is a member of that stock exchange*”.

The CSE also has the power to make listing rules, which listed companies are required to abide by under s. 3(1) of the SEC Rules 2001. Under s. 4(2) of the SEC Rules 2001, the CSE is also granted the discretion to remove securities from its official list. This power is subject to appeal to the SEC. ION practice the SEC advises that the delisting is carried out jointly.

The CSE is able to make rules that apply to its broker participants. Brokers can be sanctioned by the CSE for breaches of such rules by the CSE under Section 11 of the Stockbroker Rules. The SEC also considers that the Stockbroker Rules have the force of law through the operation of s. 51(1)(a) of the SEC Act, which deems it an offence to breach any requirement imposed under the provisions of this Act or “rule” made under the SEC Act. However, it should be noted that this relies on certain interpretations of that provision and has not been tested in Court.

Under Section 11.3.8(1) of the Stockbroker Rules, the CSE can impose sanctions on stockbrokers including the suspension or cancellation of their membership. It can also require specific performance in respect of clients.

Rules made by the CSE, are subject to approval by the SEC under s. 24(3) of the SEC Act. Under s. 24(1) of the SEC Act, stock exchange rules – once approved by the SEC – cannot be changed without its authorization.

The CSE has also established Automated Trading Rules (ATRs), which were approved by the SEC. These are discussed in greater detail in the detailed Assessment of Principle 33.

#### **Authorization or Delegation Subject to Oversight**

In Sri Lanka, “stock exchanges” are licensed by the SEC under s15 of the SEC Act. It is prohibited, under s. 30(2) of the SEC Act, to carry on business as a stock exchange without the authorization of the SEC.

Stock exchange operating licenses are granted for 5 years under the SEC Act (s. 19(2)(a)) and are subject to assessment and review on re-application. The SEC has conducted reviews of the Colombo Stock Exchange (CSE) in connection with its license renewal.

Part I of the Schedule to the SEC Act sets out the criteria that are applied to the granting or renewal of a stock exchange license. This includes the applicant having rules that concern a number of relevant matters, including the disciplining of members who commit misconduct and addressing investor protection and market integrity. The CSE is also required to submit its rules for approval to the SEC, and the SEC has powers to require that the CSE cooperates with it. See the Assessment of ISOCO Principle 34 for more information about this.

There is no specific requirement that stock exchanges treat their participants, and otherwise act, fairly. The SEC considers that one of its functions is to ensure the CSE does act fairly and consistently and that it acts when the CSE does not do this. However, the SEC’s role in this space is largely a matter of convention and precedent, rather than being based on a specific mandate.

Furthermore, while the prevailing rules – for example, Part 11 of the CSE Stockbroker Rules, which sets out a disciplinary regime for member firms – tend to allow for fair application of CSE requirements and powers, the system for admitting brokers as members of the CSE does not. Instead, it affords the CSE directors, a majority of which are nominated by current broker members, discretion on admitting new participants.

The SEC has also intervened, where it considered the CSE was not making appropriate decisions, such as in 2010, when it instructed the CSE to admit two additional trading members (as noted above).

The proposed new SEC Act, under s. 29(1), would require that a licensed exchange “*ensure, so far as may be reasonably practicable, an orderly and fair market in securities that are traded through its facilities*”.

In terms of cooperation on investigation and enforcement, both the CSE and SEC monitor day-to-day trading in the CSE market through separate market surveillance systems.

The CSE is obliged, under subparagraph (j)(9) of Part 1 of the Schedule to the SEC Act, to have adequate rules: “*with respect to the protection of investors in securities from misrepresentation, misleading information, fraud, deceit and other adverse practices in the issue and trading of securities and from the abuse of certain persons of privileged information not yet made available to the general public*”.

The CSE also operates a supervisory program in respect of participant brokers, in parallel with the SEC’s inspection program. The CSE has a number of inspection powers under Rule 9.1 of the Stockbroker Rules.

See the Assessment of Principle 34 for more information about the CSE’s surveillance and supervision programs.

#### **CSE Rules and enforcement**

As noted above, the CSE is licensed by the SEC but generally does not have regulatory delegations. The SEC has, however, delegated its powers in relation to IPOs and further issuances of shares, under section 29A of the SEC Act, to the CSE.

Nonetheless, the CSE is empowered to make rules, with SEC approval, which it can enforce via Section 11 of the Stockbroker Rules, which allows for sanctions including the suspension or cancellation of membership (Rule 11.3.8).

Other powers of the CSE under its Rules include, among others:

- Rule 10 of the Stockbroker Rules, which permits the CSE to decide on matters relating to client/broker dispute resolution;
- Rule 5.3 of the Stockbroker Rules, which allows for suspension of purchase transactions of a Stockbroker under certain specific circumstances; and
- Rule 10 of the Listing Rules (Enforcement), which provides for a number of remedies pertaining to enforcement of the CSE Listing Rules.

The CSE does not have an MoU with the SEC. Instead the SEC has a number of powers it can use to obtain information from the CSE. (See the Assessment of IOSCO Principle 34.)

In terms of corporate structure, licensed exchanges are required to operate as non-profit mutual organizations under subparagraphs (b) and (c) of Part I of the Schedule.

Subparagraph (g) of Part I of the Schedule to the SEC Act concerns the composition of the board of a licensed exchange, which must be made up of nine members approved by the SEC, out of which not more than five members shall be from among individual stockbrokers or stock dealers elected by the general membership, and not less than four members shall be appointed by the Minister from among persons recommended by the SEC.

That is, a majority of the licensed exchange’s directors are drawn from the broker members. This is significant in light of the CSE board having final say on admission of brokers.

### **Oversight by the Regulator**

As part of the stock exchange license renewal process, the SEC undertakes a detailed review of the CSE, taking into account the licensing requirements set out in Part 1 of the Schedule to the SEC Act. This involves a process similar to the inspections of market participants.

In addition, the SEC has general powers, under sections 14(a) of the SEC Act, to undertake inspections of stock exchanges and other licensees. Under s. 8 of the SEC Rules 2001, it also has specific powers to obtain books and records, which is something the SEC does as a matter of practice.

While the CSE license renewal process happens only every five years, SEC staff members noted that, due to the ongoing interaction between the SEC and CSE on regulatory matters, it is able to, and does, make itself aware of issues and raise them with the CSE where required.

Under the proposed new SEC Act, the licensing regime for stock exchanges will change to a perpetual licensing model. SEC staff members advised that the SEC will then be able to consider altering its general supervisory inspection approach towards the CSE.

Licensed stock exchanges are subject to the same powers of supervision, oversight and sanctioning as market intermediaries in Sri Lanka.

In addition to the remedial powers it has in respect of market intermediaries, the SEC has powers, under s. 23A of the SEC Act, to take over the management of a licensed stock exchange and, if desired, assign the management of the stock exchange to a new operator (s. 23A(2)).

See the Assessment of IOSCO Principle 34 for more information about the SEC's oversight of the CSE.

### **Professional Standards**

As noted previously, the CSE is not subject to a general obligation to operate fairly.

However, the SEC has powers to intervene where it objects to the CSE's acts or omissions in carrying out its self-regulatory functions. The primary tool the SEC uses to do this is the issuance of directives under s. 13(c) of the SEC Act.

Certain other powers are subject to specific right of appeal to the SEC. The primary example of this is the CSE's power to de-list companies, for which s. 4(2) of the SEC Rules 2001 allows a right of appeal to the SEC.

The CSE, similarly to the SEC, requires all employees to adhere to a Code of Ethics and IT policy. These regulate the conduct of employees to ensure confidentiality, among other things.

The CSE has also obtained an ISO 270001 certification with regard to confidentiality and security of trading and other information.

However, there is no general requirement placed on the CSE itself to observe norms of confidentiality when it undertakes its self-regulatory functions. For example, Section 9 of the Stockbroker Rules, which, among other things, gives the CSE the power to obtain books and records from stockbrokers, does not include an obligation on the CSE that these materials are appropriately secured and not provided to third parties.

However, the CSE, on its own initiative, has confidentiality arrangements in place, which impose a duty of confidentiality on the employees of the CSE and are legally enforceable.

The Review Team has been advised that the CSE has entered into Non-Disclosure Agreements with the service/system providers including MIT, EFutures and BTA.



	<p><b>Conflicts of interest</b></p> <p>There is no general requirement placed on the CSE, as a licensed exchange, that it manages conflicts of interest.</p> <p>As noted above, the SEC has adopted a general role of ensuring the CSE acts fairly and consistently, with this SEC role being based primarily on convention and precedent, rather than being based on a specific mandate.</p> <p>However, this has not always operated in practice, as with the admission of members issue mentioned above.</p>
Assessment	<p><b>Broadly Implemented</b></p>
Comment	<p>While the CSE undertakes certain self-regulatory functions, it should be noted that the SEC retains an independent right of action in respect of all regulated firms and is not reliant on the CSE conducting supervisory, surveillance, investigative or enforcement activities. It also retains a general power to direct the CSE.</p> <p>The Review Team has assessed this IOSCO Principle in light of the very limited use of self-regulation in Sri Lanka.</p> <p><b>Functions of the CSE</b></p> <p>There is no general requirement that licensed exchanges apply their rules fairly and consistently. While the Review Team generally accepts that the CSE applies most of its rules fairly and consistently – and that the SEC has adopted a role in ensuring this is the case – a general requirement that exchanges operate fairly would provide a greater degree of certainty in this respect.</p> <p>By contrast, the process through which the CSE chooses to appoint (or not appoint) members is conflicted, as it involves broker-nominated directors exercising discretion as to whether more brokers should be admitted to share a potentially limited pool of brokerage revenue. This has the potential to limit competition in the market place.</p> <p>On the other hand, stakeholders generally agreed that there were too many brokers currently, whose operations are sub-scale and financially marginal. As such, there may be reasons why an expansion of broker numbers is not appropriate at this time. Nonetheless, these decisions should not be placed in the hands of persons who have a commercial interest in restricting competition.</p> <p><b>Professional Standards</b></p> <p>The lack of an explicit duty on the CSE to maintain confidentiality has the potential to undermine the confidence of its regulated population, and reduce their willingness to openly and proactively engage with the CSE.</p> <p>While the CSE currently does maintain general confidentiality as a matter of internal policy, an obligation based on CSE Rules – or, ultimately, legislation – would provide a greater degree of certainty.</p> <p><b>Conflicts of Interest</b></p> <p>The CSE, as a licensed market, is not subject to a general obligation to manage and, if necessary, avoid conflicts of interest that might arise. This includes conflicts that might arise from its mutual structure and board composition.</p> <p>As with the lack of a general obligation to act fairly and consistently, this may undermine the level of confidence investors and market participants have in the market.</p>

## Principles for the Enforcement of Securities Regulation

### Principle 10. The regulator should have comprehensive inspection, investigation and surveillance power

Description	<p><b>Inspection and investigation powers</b></p> <p>The SEC Act vests the SEC with broad powers of inspection over regulated entities, permitting it to determine whether licensed stock exchanges, licensed stockbrokers, licensed stock dealers, licensed managing companies/trustees of unit trusts or registered market intermediaries operate in conformity with the provisions of the SEC Act or any rules or regulations made thereunder.</p> <p>Section 46A (1) provides that:</p> <p><i>“The Commission or any person duly authorized in that behalf by the Commission, may carry out such investigations or hold such inquiries as it or he may consider necessary or expedient for the exercise, performance and discharge of the powers, duties and functions of the Commission under this Act and for such purpose summon and call upon any person to appear before it or him to give evidence or to produce any books or documents in the possession or control of such person, as are required for the purpose of such investigation or inquiry.”</i></p> <p>Under Section 46A(2), any officer authorized by the Commission may inspect and take copies of any records required to be kept under the SEC Act, or any other applicable law.</p> <p>For this purpose, an officer may enter at any reasonable hour of the day, any premises of a licensed stock exchange, licensed stockbroker, licensed stock dealer, listed public company, licensed managing company of any unit trust, or a registered market intermediary.</p> <p>For the purpose of such investigations or inquiries, the SEC may summon and call upon any person, and require them to give evidence or to produce any documents required for such investigation or inquiry. Further, the failure to appear before the Commission when required to do so, refusal to either answer any questions of the Commission or produce any book or document, or knowingly furnishing false answers to questions of the Commission are all offences under Section 46A(4), the liability for which will be a maximum of five years’ imprisonment, a fine of up to one million rupees, or both.</p> <p>Such inspections and requests for further information from regulated entities may be obtained even where no misconduct is suspected, without judicial action. Failure to comply, however, attracts liability, following summary proceedings before a Magistrate. Such inspection must be carried out in relation to a particular investigation, and the oversight of the SEC remains limited to powers set out in s46A(1).</p> <p>In addition to inquiries initiated by the SEC itself, section 46 requires a three-person Committee representing the Members of the Commission to be appointed to hear and determine complaints received in relation to regulated entities.</p> <p>The powers in s. 46A(1) are complemented by powers set out in sections 13 and 14 of the Act, including the powers to:</p> <ul style="list-style-type: none"> <li>• Inquire or conduct investigations into any activity of a licensed stock exchange, a licensed stockbroker or licensed stock dealer a licensed management company or a trustee of a unit trust, a registered market intermediary or any listed public company (s. 13(i));</li> <li>• Conduct investigations into any alleged violation or contravention of the provisions of the Act or any rule or regulation made thereunder by any person (s. 13(o)); and</li> <li>• Carry out inspections of the activities of listed regulated entities (s. 14(a)).</li> </ul> <p>The CSE also has the power to monitor the conduct of stockbrokers and dealers, including the power to carry out inspections, investigation and require the provision of information, under Sections 8 and 9 of the Stock Broker rules.</p>
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	<p>The SEC and CSE are empowered to conduct annual reviews of compliance by listed companies with CSE Listing Rules and Sri Lanka Financial Reporting Standards, as set out in more detail in the description in IOSCO Principle 16.</p> <p>As noted in the description in Principles 18 and 19, SLAASMB is authorized under s26 of the SLAAS Act to conduct investigations and enquiries by notice in writing in relation to its powers under the Act. It has the power to summon and call on officers and auditors of specified business enterprises to appear before it and produce books or records. It exercises these powers to review the annual reports of Specified Business Entities and audit files in relation to those reviews.</p> <p><b>Surveillance</b></p> <p>The SEC conducts continuous surveillance operations independently of the CSE in relation to trades in the CSE. The source of the power to conduct this surveillance is unclear but is assumed to be s. 13(o) of the SEC Act, which empowers the SEC to “conduct investigations into any alleged violation or contravention of the SEC Act”. The CSE conducts surveillance and is empowered to take action in accordance with the Stockbroker Rules.</p> <p>The surveillance division of the SEC monitors the market in real-time to detect abnormal movements and to identify violations of the SEC Act which lead to manipulations. The SEC additionally receives complaints and tips from market participants, as well as surveillance referrals from the CSE. Its surveillance committee, composed of the Director-General and Directors of Supervision and Surveillance, flags suspected cases of malpractice, which are then taken up by the Investigations division. The Commissioners are kept informed of these deliberations and of the findings of investigations.</p> <p><b>Record keeping</b></p> <p>Record keeping requirements for market intermediaries are set out in the General Regulatory Standards for all market intermediaries (set out in more detail in the Assessments of IOSCO Principles 22 and 31 below).</p> <p>In addition, rules made under Section 53(1)(c) of the Act set out requirements about the proper maintenance of books, records, accounts and audits, and regular reporting to the Commission of the affairs of regulated entities.</p> <p>Rule 7(2) requires licensed stockbrokers and dealers to maintain an extensive list of records for a period of five years.</p> <p>These requirements include retention of records in relation to the identity of clients and records that that permit tracing of funds and securities in and out of broker accounts.</p> <p>Access to all information maintained under these requirements must be made available to the SEC, in accordance with the specification that all disclosures, particularly with respect to clients (in which context “know your client requirements apply”, as discussed in the Assessments of IOSCO Principles 29-32), must be made either with the consent of the client to whom the information relates, or where the law requires it (Section 45).</p>
Assessment	<b>Broadly Implemented</b>
Comments	<p>The SEC’s powers of inspection, investigation and surveillance are based on high-level, general provisions with no additional guidance provided to regulated entities on how the provisions should be interpreted. This is also the case in relation to provisions dealing with record-keeping.</p> <p>One example is the SEC’s power to conduct “inspections without prior notice”, which is implied, rather than specific. Normal practice is to give one-day prior notice to regulated entities before a regular inspection takes place. However, there have been no objections by market participants in the few instances where such prior notice was not received. However, the SEC should have an explicit power allowing for inspections to be conducted without prior notice.</p>

	<p>Specific reference in the SEC Act to the detailed powers set out in this Principle would enhance investor confidence in the regulator and in the markets and activities it regulates. This is recognized in revisions to the SEC Act sighted by the Review Team which provide, for example, an express power to conduct surveillance of securities transactions.</p> <p>The SEC's powers are also limited to activity in relation to regulated entities. They do not extend to those intermediaries the SEC does not currently regulate, including some activities of investment banks, investment advisers and individuals (working for market intermediaries).</p> <p>These limitations are being addressed by draft legislation sighted by the Review Team.</p> <p>SLAASMB has appropriately broad powers of investigation to support performance of its responsibilities under the SLAAS Act.</p>
<p><b>Principle 11. The regulator should have comprehensive enforcement powers</b></p>	
<p>Description</p>	<p>The SEC's powers to take action to enforce compliance with laws and regulation relating to securities activity are limited to criminal and some administrative action. It has no power to initiate civil proceedings.</p> <p>Administrative actions available to the SEC include the following:</p> <ul style="list-style-type: none"> <li>• Cancelling or suspending the listing of any securities or the trading of any listed securities or suspending the trading of all listed securities (s. 13(h)); and</li> <li>• Cancelling or suspending the licenses or registrations of market intermediaries, stockbrokers and dealers and management companies of unit trusts (sections 19, 21, 21A, 31C and 31D – described in more detail in the Assessment of Principle 29).</li> </ul> <p>The SEC also has the power to publish findings of malfeasance by any licensed stockbroker or licensed stock dealer or a licensed managing company or a trustee of a unit trust, or a registered market intermediary or any listed public company (s13(j)). It also issues letters of caution or warning under the omnibus power (s. 13(p)).</p> <p>Criminal action may be instituted by the SEC under a number of provisions of the Act and the Rules.</p> <ul style="list-style-type: none"> <li>• Section 51(1) provides a general provision addressing the consequences of non-compliance with any provision of the Act or regulations or rules made under it. Specifically: <ul style="list-style-type: none"> <li><i>Any person who-</i> <ul style="list-style-type: none"> <li><i>(a) contravenes any provision of this Act or any requirement imposed under the provisions of this Act or of any regulation or rules made thereunder;</i></li> <li><i>(b) furnishes or produces, for the purposes of this Act or any requirement imposed under the provisions of this Act or of any regulation or any rule made thereunder, any information which is, or any return, document or statement, the contents of which are, to his knowledge, untrue, incorrect or misleading; or</i></li> <li><i>(c) willfully obstructs any member of the Commission or an officer or servant of the Commission or any person with whom the Commission has entered into an agreement under subsection (2) of Section 23A in the performance of his duties under the provisions of this Act,</i></li> </ul> </li> </ul> </li> </ul> <p><i>shall be guilty of an offence under this Act.</i></p> <p>Offences to which s. 51(1) applies include those listed in rules 12 to 16 of the SEC Rules (including creating a false or misleading impression of active trading or regarding the price of any securities, creating a false market in listed securities, front-running a client, and failure of a listed company to supply with immediate effect any price-sensitive information concerning such company).</p>

- Section 32, under which any person who commits an act of insider dealing as set out in Section 32 shall be guilty of an offence;
- Section 50A, under which any person who threatens or intimidates or makes any derogatory remarks or publishes any statement with a view to bringing disrepute or defaming the reputation of any member of the Commission, the Director-General or any other officer or servant of the Commission in the course of discharging his duties is guilty of an offence; and
- Section 30, under which any body corporate or individual who uses the words “stock exchange”, “stockbroker” or “stock dealer” without first having obtained a license from the SEC shall be guilty of an offence.

It should be noted that section 51(1) does not appear to cover contraventions of directives made by the SEC under the Act, which include the standards applicable to market intermediaries and management companies. The SEC indicates that the breadth of this provision allows it to be interpreted to include directives. This has not been challenged. The SEC also notes that its general approach to contraventions of the SEC’s directives is to suspend or cancel a license or registration.

The maximum penalties for key offences include the following:

- For insider dealing, a fine of not less than 1 million rupees or prison for a term of between 2 and 5 years or both (section 33A); and
- For other offences, a fine of between 50,000 and 10 million rupees or prison for a term of up to 5 years or both (section 51(2)).

Compounding is also available (under s. 51A) and involves the Commission imposing a penalty of 1/3 of the maximum fine imposable for an offence, with the regulated entity not being required to make an admission of guilt. Compounding is available for all offences under the SEC Act. Compounded fines are paid into the Compensation Fund established under section 38. In deciding whether to agree to compound an offence the Commission is given broad discretion having regard ‘to the circumstances in which the offence. were committed’

The SEC also does not have a general power to impose sanctions or take enforcement actions against a director or employee (who engaged in regulated activities) of a regulated intermediary for any contravention of the SEC Act or related instruments. Section 51(3) does, however, provide for directors, managers, secretaries or other similar officers to be held liable for offences against the Act in the circumstances set out in that provision.

Although the SEC has the powers to bar a person (for a specified period of time) from acting as a director or dealing with investors in respect of market intermediaries, such powers do not extend to stockbrokers/dealers and managing companies of unit trusts.

In the case of stockbrokers, the CSE may mete out disciplinary action against an employee of a stockbroker, including suspending or canceling the certification issued to such employee to deal with investors (Rule 11.3.8(2) of the Stockbroker Rules). However, the CSE does not have similar powers in respect of the directors of stockbrokers.

Amendments to the SEC Act propose extending available sanctions to include civil and administrative remedies and extending the range of criminal offences.

The Review Team notes that criminal proceedings under the SEC Act are brought in Magistrates Courts, with criminal cases being directly filed in a higher court only under direct indictment which is the Attorney-General’s prerogative. The SEC advises that under revisions to the SEC Act, the High Court will have jurisdiction in relation to civil matters with criminal matters remaining in the jurisdiction of the Magistrates Courts.

	<p>Failure to prepare financial statements in accordance with Sri Lankan Accounting Standards and failure by auditors to audit financial statements in accordance with Sri Lankan Auditing Standards are criminal offences and, if committed with intent to mislead, is punishable by imprisonment of up to five years (Section 27 SLAAS Act). Compounding is also available (Section 28 SLAAS Act). SLAASMB also has the power to refer violations of the Act to professional associations, the Inland Revenue and other regulators. SLAASMB also has the power to direct that financial statements be revised, re-audited and republished.</p> <p><b>Powers over regulated entities and entities other than regulated entities</b></p> <p>The SEC has broad powers under s. 46A(1) SEC Act to support the conduct of inquiries and investigations. These include the power to summon any person before it to give evidence for the purposes of investigations and enquiries. The subsection also empowers the Commission to call for any books or documents under the control of persons under investigation for the purposes of such investigation.</p> <p>Regulated entities in particular are also required, under Rule 7 of the SEC Rules 2001, and other rules applicable to specific categories of market participants, to maintain books of records, accounts and other documents for a period of five years, which may be examined, alongside receipts and vouchers, whenever the Commission deems necessary. These examinations by the SEC extend to records relating to the name of the account holder, person authorized to transact business, amount purchased or sold, time of transaction, price of transaction, the individual and bank, or broker and brokerage house that handled the transaction and statements or testimony. Examinations are undertaken based on risks posed by regulated entities to the wider capital market.</p> <p>The SEC's investigative powers are not limited to entities regulated by it, and as described above, allow the Commission to summon and call upon any person to give evidence or to produce any book or document required by the Commission, which is in the possession or control of such person.</p> <p>The SEC is also required under the domestic regime for combating money laundering and counter terrorism finance to share information it obtains with the Financial Intelligence Unit of Sri Lanka (FIU)<sup>7</sup>. Sharing information with other authorities which might be taking enforcement or other corrective action can only be done under s. 45(3) SEC Act with the consent of the person furnishing such information (as set out in Principle 13).</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>The SEC has broad powers to require and obtain information from regulated entities and third parties and individuals as contemplated by the Principle.</p> <p>The SEC has the power to institute criminal proceedings in relation to a range of misconduct offences under the SEC Act and the rules made under that Act.</p> <p>The SEC however lacks the power to initiate civil proceedings or impose an appropriately dissuasive set of administrative sanctions. These are significant and serious shortcomings.</p> <p>These shortcomings are being addressed in revisions to the SEC Act, drafts of which were sighted by the Review Team.</p> <p>Private persons also do not have remedies for misconduct under the SEC Act.</p>

<sup>7</sup> This is set out in the Convention on the Suppression of Terrorist Financing Act No. 25 of 2005 (CSTFA), the Prevention of Money Laundering Act No. 05 of 2006 (PMLA), and the Financial Transactions Reporting Act No. 06 of 2006 (FTRA).

	<p>The Review Team considers that a lower Court, such as the Magistrate’s Court, may not be the appropriate venue to hear cases that may involve technical and complex matters dealing with the securities sector.</p> <p>SLAASMB is also limited to taking criminal action in relation to breaches of the SLAAS Act. More appropriate civil and administrative remedies are not available to it.</p>																																													
<p><b>Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program</b></p>																																														
<p>Description</p>	<p>The SEC exercises the inspection, investigative, surveillance and enforcement powers set out in the descriptions to IOSCO Principles 10 and 11 in relation to regulated entities on a regular and ongoing basis.</p> <p>Inspection and supervision of licensed stockbrokers and dealers and assessing compliance with listing requirements and Accounting Standards by listed issuers is also conducted in conjunction with the CSE.</p> <p>SLAASMB exercises its powers set out in IOSCO Principles 10 and 11 in relation to compliance with Accounting and Audit Standards.</p> <p><b>SEC and CSE</b></p> <p>The SEC’s supervisory functions are carried out by the Supervision Division comprising 13 staff with the following roles and responsibilities:</p> <ul style="list-style-type: none"> <li>• Two legally trained staff with responsibility for reviewing new applications and renewals;</li> <li>• Five supervisory staff with responsibility for stockbrokers and dealers and margin providers;</li> <li>• Four supervisory staff with responsibility for investment managers, managing companies of unit trust and CRAs;</li> <li>• One IT specialist and one administrative staff member.</li> </ul> <p>The CSE supervisory team comprises 6 staff responsible for supervising Stockbrokers and Stock dealers</p> <p>The SEC applies a similar approach to supervision of all regulated entities, combining what it describes as onsite inspections and offsite supervision. Onsite visits are conducted annually in the context of the renewal of licenses and registrations and are supplemented by what are described as “for cause” inspections.</p> <p>The number of routine and “for cause” inspections conducted by the SEC over the past 4 years is shown the following tables:</p> <table border="1" data-bbox="427 1487 1449 1872"> <thead> <tr> <th colspan="5" style="background-color: black; color: white;">Routine Inspections</th> </tr> <tr> <th></th> <th>2012</th> <th>2013</th> <th>2014</th> <th>2015</th> </tr> </thead> <tbody> <tr> <td>Stockbrokers</td> <td>27</td> <td>28</td> <td>16</td> <td>11</td> </tr> <tr> <td>Managing Companies of Unit Trusts</td> <td>2</td> <td>13</td> <td>14</td> <td>10</td> </tr> <tr> <td>Margin Providers</td> <td>16</td> <td>25</td> <td>16</td> <td>21</td> </tr> <tr> <td>Investment Managers</td> <td>10</td> <td>23</td> <td>21</td> <td>25</td> </tr> <tr> <td>Underwriters</td> <td>1</td> <td>–</td> <td>–</td> <td>3</td> </tr> <tr> <td>Credit Rating Agencies</td> <td>–</td> <td>3</td> <td>2</td> <td>2</td> </tr> <tr> <td><b>Total</b></td> <td><b>56</b></td> <td><b>95</b></td> <td><b>72</b></td> <td><b>74</b></td> </tr> </tbody> </table>	Routine Inspections						2012	2013	2014	2015	Stockbrokers	27	28	16	11	Managing Companies of Unit Trusts	2	13	14	10	Margin Providers	16	25	16	21	Investment Managers	10	23	21	25	Underwriters	1	–	–	3	Credit Rating Agencies	–	3	2	2	<b>Total</b>	<b>56</b>	<b>95</b>	<b>72</b>	<b>74</b>
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<b>“For Cause” Inspections</b>				
	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Stockbrokers	11	–	7	1
Managing Companies of Unit Trusts	–	–	–	–
Margin Providers	3	5	–	–
Investment Managers	–	1	36	–
Underwriters	–	–	–	–
Credit Rating Agencies	–	–	–	1
<b>Total</b>	<b>14</b>	<b>6</b>	<b>43</b>	<b>2</b>

For cause inspections can be triggered by the following:

- Matters arising from scrutiny of both on site and off site reviews carried out during the year,
- Reviews of compliance with conditions stipulated by the SEC to address on contraventions identified through both earlier on site and off site examinations;
- A regulated entity being assessed as high risk in relation to non-compliance with regulatory requirements;
- Complaints from investors and others received against the entities, whistle blowing and referrals from Surveillance, Corporate and/or investigations Divisions.

The SEC advises that it does not generally review the efficacy of the supervisory function of Trustees of Unit Trust. In fact, in the past 3 years, only 1 inspection of a Trustee has been carried-out with no major deficiencies observed. The SEC also notes that its inspections of investment managers cover areas that are also the subject of Trustee oversight, such as the valuation of securities. They note that this allows them to identify lapses in the supervisory functions performed by the Trustee.

### **On Site Inspections**

The SEC conducts on-site inspections based on what it describes as a “risk-based audit program” that encompasses assessment of prudential, operational, credit, liquidity, internal controls and procedures, governance, information systems and legal risks, as well as compliance-related checks.

In developing the on-site inspection plan, the SEC takes into account the following, and other aspects it considers relevant and of importance:

- Findings from previous on-site and/or off-site reviews and level of compliance to the non-compliances identified previously;
- Governance issues identified;
- Nature of complaints made by the stakeholders against the entity;
- Information provided by the Surveillance and Corporate Affairs Divisions pertaining to contraventions of the regulatory requirements;
- Information identified through electronic/print media in respect to the entity; and
- The license/registration expiration dates.

The SEC also considers the entity’s financial performance, as well as information provided in response to a questionnaire provided by the regulated entity on the entity’s operational/compliance frameworks and internal controls. The size of the on-site inspection team for particular inspections is determined based on the risks identified.



An inspection normally takes about two weeks, including preparation time (about one day), the on-site visit (over a period of two to four days) and drafting the inspection letter. The visit itself generally involves interviews with the CEO and compliance officers. Post-inspection, the SEC will send a draft inspection letter to the intermediary detailing its observations and the intermediary is given 14 days to respond. On receipt of comments from the management of the intermediary, the finalized inspection letter will be issued. Where there are regulatory concerns, these will be escalated to the Director-General for discussion.

The exact timing of inspections is determined by SEC staff on a case-by-case basis based on their assessment of the intermediaries' compliance track record and internal control weaknesses. However, currently there is no formal, risk-based framework in place to select and prioritize which regulated entities will be inspected and how frequently they will be inspected. The factors noted above are used to prepare the Annual Inspection plan for the regulated entities.

In relation to stockbrokers, the SEC and CSE split the inspections, with the SEC inspecting one half of brokers each year and the CSE the other half. SEC staff acknowledged that inspecting all stockbrokers in a single year taxed the SEC's supervisory resources.

The SEC and CSE do not necessarily use the same process for inspections. While the two authorities typically examine similar issues and risks, the level of attention paid to particular matters may vary between the SEC and CSE. Common significant compliance weaknesses among stockbrokers flagged in discussions with industry and SEC staff included:

- Client funds not meeting creditors obligations over T+3;
- Commingling money received on account of clients with its own funds;
- Extending credit to clients beyond approved credit limits;
- Extending credit without an appropriate written agreement;
- Retaining the proceeds of security sales without client permission;
- Failing to properly segregate client assets; and
- Concerns on corporate governance and internal control weaknesses.

The degree of cooperation between the SEC and CSE on supervision of brokers is greater than on surveillance (as set out below). However, it is generally limited to doing the yearly split of brokers and two-way information sharing, through which the SEC and CSE share the findings of their supervisory activities with each other.

While the supervisory processes of the SEC and CSE have identified compliance weaknesses among several stockbrokers, the progress in remediating these identified deficiencies has been slow, and there has been only limited use of existing enforcement remedies to compel brokers to resolve compliance problems. Although enforcement action has been taken during 2016 in relation to compliance weaknesses these were the first actions in some six years.

The SEC advises that for any regulatory non-compliance the SEC first seeks clarification from the regulated entity. In the event the regulated entity accepts the non-compliance and seeks time for rectification the SEC grants time to rectify based on the severity of the alleged non-compliance. In the event the regulated entity fails to provide appropriate justification and non-acceptance of the non-compliance other more severe action will be taken.

The SEC notes, for instance that it requires remediation of non-compliance with the minimum net capital requirement by brokers within thirty days and the issue of directives imposing conditions or restrictions for ongoing non-compliance. The SEC cites one instance of not renewing the license of one Stockbroker entity due to non-compliance with the minimum net capital requirement and irregularities in the management of its affairs.

The SEC also cites a small number other instances of licenses in other sectors not being renewed for ongoing non-compliance with regulatory requirements.

Given the significance of the weaknesses identified through supervision, delays in rectification risk client losses and consequent erosion in the credibility of the regulatory framework for brokers.

### Off-site supervision

Staff of the Supervision Division review regulatory submissions, including the intermediaries' financial statements or reports, compliance reports and debtors' declarations (in the case of stockbrokers). For Unit Trusts, periodic returns, interim and annual reports of the Unit Trusts, annual reports of the Unit Trust Managing Companies and advertisements are also reviewed. As part of these reviews, the staff members assess the financial stability and operational viability of the intermediaries as well as their compliance with the applicable regulatory requirements.

Where necessary, SEC staff will undertake further analysis and obtain further clarifications from the intermediary. If the clarifications are not satisfactory, a letter is sent to the intermediary to require the issue to be rectified.

Significant findings arising from the reviews are reported to the Commission on a quarterly basis, along with the recommended regulatory action in respect of any non-compliance. Regulatory action will be initiated upon the Commission's approval.

The off-site inspection process adopted by the SEC's Supervision Division is set out in the following Table:

PROCESS CHART FOR OFF SITE REVIEW		Remarks	Time Duration
<b>Step 01</b>	<p>Receipt of;</p> <ul style="list-style-type: none"> <li>- Unaudited and Audited Financial Statements of all regulatees*</li> <li>- Compliance Reports of all regulatees*</li> <li>- Advertisements to be published by regulatees</li> <li>- Debtors Declarations of Stock Brokers</li> <li>- Unit Trust Returns</li> <li>- Quarterly/Annually Fund Managers Reports and the Audited/Unaudited Financial Statements of the funds</li> </ul>	<p>*Regulatees includes; Stock Brokers/Dealers, Margin Providers, Investment Managers, UT Managing Companies, Underwriters, Credit Rating Agencies and the Central Depository System (CDS)</p>	<p>Unaudited Financial Statements receive on or before 20<sup>th</sup> of the following month</p>
<b>Step 02</b>	<div style="display: flex; justify-content: space-between;"> <div style="width: 45%;"> <p>Review of Unaudited &amp; Audited Financial Statements of all Regulatees;</p> <ul style="list-style-type: none"> <li>- To assess financial stability and operational viability &amp;</li> <li>- To monitor compliance with regulatory requirements</li> </ul> <p>Detection of Regulatory Non-Compliances and/or Financial &amp; Operational instability</p> <p style="text-align: center;">No</p> <p style="text-align: center;">Yes</p> </div> <div style="width: 45%;"> <ul style="list-style-type: none"> <li>- Review &amp; approve Quarterly/Annually Fund Managers Reports and the Audited/Unaudited Financial Statements of the funds</li> <li>- Review advertisements of regulatees and inform of misleading information to the regulatee if any and obtain amended publications.</li> </ul> </div> </div>	<ul style="list-style-type: none"> <li>- Check the accuracy of the data</li> <li>- Check the compliance on main prudential requirements such as Net Capital, Liquid Capital and other regulatory requirements</li> <li>Ex: CSE Stockbroker Rules &amp; Circulars, Market Intermediary Rules, The SEC Act &amp; Directives, Unit Trust Code</li> <li>- Check the opinion, "Emphasis of Matter" and the notes in Audited Financial Statements</li> <li>- The unaudited financial statements in the E-Filing system are approved if accurate and if any discrepancy persist reject the financial statements and ask the regulatee to resubmit for approval.</li> </ul>	<ul style="list-style-type: none"> <li>- 02 Weeks to review of Unaudited &amp; Audited Financial Statements of all Regulatees &amp; UT Returns</li> <li>- 03 to 05 days to review fund managers report and approve</li> <li>- 01 day to review advertisements</li> </ul>
<b>Step 03</b>	<p>Further analysis and/or obtaining further clarification from the regulatee on the said issue via phone/e-mail. If the clarifications are not satisfactory, letter is sent to the Company strictly advising to rectify the issue. The time granted to rectify the said issue is decided based on the severity.</p> <div style="display: flex; justify-content: space-around;"> <div style="border: 1px solid black; padding: 5px; text-align: center;">Issue rectified</div> <div style="border: 1px solid black; padding: 5px; text-align: center;">Issue not rectified/Continuous non compliances</div> </div>	<ul style="list-style-type: none"> <li>- Requesting further information and supporting documents if necessary to verify the figures in the financial statements if discrepancies identified.</li> <li>- seeking further clarifications for any non-compliances with the regulatory requirements.</li> </ul>	<p>Depend on the severity, complexity and availability of information</p>
<b>Step 04</b>	<p>Preparation of a commission paper to inform the Commission on the issue and/or continuous non compliance and seeking decision of the Commission on the regulatory action need to be taken against the regulatee.</p>		<p>03-05 Days</p>
<b>Step 05</b>	<p>Initiate regulatory action against the regulatee based on the decision given by the commission.</p>		<p>Depend on the decision of the Commission on the action to be initiated</p>

The findings of the Supervision Division are reported to the Commission on a quarterly basis, as follows, for further regulatory action to be undertaken by it:

	PROCESS CHART FOR PREPARATION OF COMMISSION PAPERS ON PERFORMANCE OF THE INDUSTRY	Remarks	Time Duration
<b>Step 01</b>	<div style="border: 1px solid black; padding: 5px; background-color: #f0f0f0;">           Collating Information through E-Filing/hard copies of Unaudited financial statements of Stock Broker, Unit Trust Funds &amp; Managing Companies         </div>	<i>Unaudited Financial Statements receive on or before 20<sup>th</sup> of the following month</i>	<i>2-3 Days</i>
<b>Step 02</b>	<div style="border: 1px solid black; padding: 5px; background-color: #e0e0e0;">           Preparing Commission papers on performance of Stock Broking Industry and Unit Trust Industry and submit to the Commission         </div>	<i>Quarterly submission</i>	<i>2 Days</i>

### Reviews of Listed Issuer Compliance

As noted in the description in IOSCO Principle 16, the SEC and CSE divide reviews of compliance by listed companies with the CSE Listing Rules and the Sri Lanka Accounting Standards. The authorities agree in a given year on which is to review what annual reports and the risks which are to be the focus of the reviews. Every listed company can expect to be reviewed each year.

When reviewing disclosures relating to fund raising (for instance IPO's and rights issues), the CSE focuses on compliance with basic disclosure requirements under the Listing Rules while the SEC assesses market risk and reviews against the SLFR's.

Reviews are undertaken through desk research, onsite visits and other supervisory initiatives and information received from informants.

Compliance failures are generally addressed by letters of comment being sent to listed companies as set out in the following Table.

Description	2013	2014	2015
1) 'Letters of Comments' sent to PLCs based on reviews requiring future disclosure compliance	38	71	64
2) PLCs were informed to comply in relation to matters requiring immediate disclosures			
a) Errata		1	2
b) Immediate/other disclosures as per appendix 8A of CSE Listing Rules/as applicable			8

### Market surveillance

Both the CSE and SEC monitor day-to-day trading in the CSE market through separate market surveillance programs.

The CSE's market surveillance function uses a market monitoring system provided by the National Stock Exchange of India.

There are seven CSE staff members who are involved in market surveillance, but this is not necessarily these staff members' sole function. Two full-time staff are dedicated solely to market surveillance. Where suspicious conduct is identified concerning a broker, the CSE makes additional inquiries directly, and thereafter makes a referral to the SEC. Where the trading concerns a member of the public, the CSE makes a referral to the SEC straight away.

From the beginning of 2014 to September 2016, the CSE made 70 such referrals to the SEC.

The Review Team were advised that the most common forms of suspicious trading observed in the Sri Lankan market are potential market manipulation, followed by possible front-running.

The SEC conducts a parallel system of market surveillance independently of the CSE using a system that generates alerts arising out of unusual market movements. This system stores trading data (including order book data) in-house, enabling the SEC to better analyze data, following trading. Its market replay function can re-enact any trading day scenario going back several months. The system is used effectively to detect trading aberrations, and analyze and identify cases for further investigation. The SEC advised that it is hoping to implement a new market monitoring system, as its current one does not offer functions like automated alerts, website scanning, or analytical tools. It also requires the SEC to do a significant amount of manual computation.

The SEC has four staff members currently devoted to market surveillance, and intends to increase this to five.

The SEC has an internal process to consider whether observed suspicious market trading warrants further investigation, after the SEC has gathered initial information and explanations from relevant brokers or member of the public. In the four years to the end of 2015, the SEC referred 95 instances of suspected securities law violation for further consideration, with 19 resulting in further investigation.

As noted above, the SEC's surveillance activities are supported by referrals from the CSE. In the four years to the end of 2015, the CSE made 70 referrals to the SEC, with 13 resulting in investigations.

However, despite brokers being obliged – under s3.8.2(4) of the CSE Stockbroker Rules – to inform the CSE of any suspicious trading, referrals from brokers are very rarely received.

There are only limited arrangements in place to coordinate the surveillance functions of the SEC and CSE. These arrangements largely comprise information-sharing, which can be one-sided – that is, the CSE providing information to the SEC.

At the time of the onsite visit there was no specific protocol in place, for example, for the SEC to inform the CSE about the status of suspicious trading referrals made to it by the CSE, nor has it been explained to the CSE what criteria the SEC considers in determining whether to accept and investigate surveillance referrals from the CSE.

The SEC advises that from September 2016, the SEC will invite the CSE to the Surveillance and Investigation Committee meetings to discuss CSE referrals. The surveillance referrals will be forwarded to the Surveillance and Investigations Committee. Representatives of the CSE will be allowed to attend and participate in the meetings of the Committee for the duration of time when CSE referrals are deliberated upon. Directions as to which matters warrant full-fledged investigations will be given by the Committee following such deliberations.

While the SEC and CSE consider that the market is significantly less affected by misconduct and manipulation than it was previously, there have been very few prosecutions for market misconduct offences in Sri Lanka. The most recent successful prosecution for such offences took place in the 1990s.

More recently, some prosecutions have been “compounded”, a process by which the case is concluded with the defendant paying a fine of up to one third of the maximum penalty under the SEC Act. Under the general offence provision in s51 of the SEC Act, the maximum compound penalty would be a fine of Rs. 3.33million or about USD\$23,000.

Furthermore, widespread cases of market misconduct – which took place in the boom period following the end of the Sri Lankan civil war in 2009 – are also yet to result in any prosecutions, despite the re-opening of relevant cases by the SEC in 2015.

### **Supervision of Market Operators**

As noted in the description for IOSCO Principle 33, stock exchange licenses are granted for a period of five years and are subject to renewal.

As part of this renewal process, the SEC undertakes a detailed review of the CSE, taking into account the licensing requirements set out in Part 1 of the Schedule to the SEC Act. This involves a process similar to the inspections of market participants. It also includes a separate review of the CSE's IT systems by a specialist consultant and a detailed review of the functions of each Division attached to the CSE.

In addition, the SEC has general powers, under sections 14(a) of the SEC Act, to undertake inspections of stock exchanges and other licensees. Under Rule 8 of the SEC Rules 2001, it also has specific powers to obtain books and records, which is something the SEC does as a matter of practice.

While the CSE license renewal process happens only every five years, SEC staff members noted that, due to the ongoing interaction between the SEC and CSE on regulatory matters, it is able to, and does, make itself aware of issues and raise them with the CSE where required.

Under the proposed new SEC Act, the licensing regime for stock exchanges will change to a perpetual licensing model. SEC staff members advised that the SEC will then be able to consider altering its general supervisory inspection approach towards the CSE.

### **Receipt and responses to intelligence**

Intelligence is received in the form of complaints to the SEC. An SEC committee comprising three members of the Commission considers these complaints.

Complaints received by the SEC may relate to the professional conduct or activities of an entity or person licensed or registered by the SEC, and, per Section 46(1), may be made by any person including stockbrokers and dealers.

On receipt of a written complaint, the relevant committee examines the documents and evidence produced in support of the complaint, and afford the entity an opportunity of being heard, to determine whether the regulated entity has contravened the provisions of the SEC Act or any regulation or rule made under it, including the rules of a licensed stock exchange.

On a positive determination of a contravention, the committee recommends a course of action to the Commission, which in turn may take appropriate action to give effect to this recommendation or may refer the matter for further investigation to an appropriate authority.

The proposed amendment to the SEC Act widens powers relating to the receipt of and response to intelligence, by incorporating specific provisions on whistle-blowing.

### **Supervisory and compliance undertakings by regulated entities**

All regulated entities are required to retain Compliance Officers, report on matters relating to regulatory compliance and operations, and employ and demonstrate safeguards against violations of securities laws. Of these, compliance, in particular, must be reported to the SEC annually, without the need for specific requests to be made. Failure to meet these requirements must be notified to the SEC, and affects the prospects of renewing licenses and registrations. Responsibility for compliance reporting rests with the directors of the regulatee.

## **Investigations**

Investigations are conducted by a small team of 4 staff within the SEC.

Decisions about proceeding with investigations are made by the Surveillance and Investigations Committee of the SEC (comprising the Director-General and the Directors of Supervision, Surveillance, Investigation and Legal and Enforcement). In deciding whether to pursue investigations, the SEC advises that this Committee makes decisions on the basis of a range of factors, including the impact on the market of the relevant activity, loss to investors and the extent of the moral turpitude.

There is a market perception that investigations are taking too long although the SEC argues there has been a recent improvement in the speed with which investigations are being undertaken, reflecting the impact of measures such as the use of the Surveillance and Investigation Committee to approve the start of investigations

Steps have also been taken to engage with the Attorney-General's department through the investigation process on the collection of evidence

### **Action taken by the SEC**

As noted earlier, the Act and SEC Rules set out offences in relation to market and/or price manipulation, insider trading, misrepresentation, and failure to comply with regulatory requirements (which encompass, among others, conduct of business, capital adequacy and disclosure of client assets).

Enforcement action relating to these may involve initiating criminal proceedings under the provisions set out above, compounding, issuing letters of caution or warning or publishing notices of malfeasance.

The maximum penalties for key offences include the following:

- For insider dealing, a fine of not less than 1 million rupees or prison for a term of between 2 and 5 years or both (section 33A);
- For other offences, a fine of between 50,000 and 10 million rupees or prison for a term of up to 5 years or both (section 51(2)).

Compounding (under s. 51A) involves the Commission imposing a penalty of 1/3 of the maximum for an offence, with the entity not being required to make an admission of guilt. Compounding is available for all offences under the SEC Act.

Criminal action is taken after referral to the Attorney-General's Department (**AGD**).

This has proved to be a very slow process, with the decisions by the AGD on referrals from the SEC taking many years.

From publicly available information, in the 4 years to 2015, the SEC reported four referrals to the Attorney-General's Department and three instances of compounding an offence.

The SEC also advised that Court processes in Sri Lanka are very slow. The last successful prosecution was in 1997 (in relation to alleged misconduct in 1996), with that outcome still under appeal at the time of the onsite visit.

Letters of caution or warning and notices of malfeasance are issued under the Commissions' omnibus power (ss. 13(p) and (j) of the Act). From publicly available information in the 4 years to 2015, the SEC reported issuing 15 warnings, 10 cautions and 1 severe caution to regulated entities and particular individuals. The SEC advises that cautions and warnings are used where there is insufficient evidence to launch criminal proceedings. Warnings are made public (with the SEC arguing they have an important deterrent impact). Cautions are not made public.

The SEC also advises that it has, in the 20 months to September 2016, issued 127 telephone warnings to investment advisors and investors in relation to minor transgressions deemed not to have a major impact on the market. The outcome and impact of these warnings is unclear.

As noted earlier, the SEC does not have the power to impose civil sanctions. The only administrative remedies available to it are the cancellation, suspension or non-renewal of licenses and registrations (as set out below in relation to Principles 22, 24 and 29)

#### **Actions taken by the CSE**

As noted, the SEC shares aspects of regulatory enforcement authority over listed entities with the CSE.

Enforcement actions by the CSE are typically undertaken following consultation with and notification to the SEC.

The CSE may undertake one of four measures in response to a finding of non-compliance with its Listing Rules: it may transfer the securities of a non-compliant entity to the 'Default Board', impose a halt on trading, suspend the trading of securities of such an entity or delist the entity from the exchange.

Where securities are transferred to the Default Board, the CSE, on the passing of one month, may issue a press notice informing the public of the violation committed by the entity whose securities have been transferred to the Default Board, following consultations with the SEC.

Three months following the transfer, if no steps have been taken to ensure compliance with the Listing Rules, the CSE may refer the entity to the SEC for further action.

Similarly, while trading halts are issued 'at the discretion' of the CSE, prior to an announcement of price sensitive information, (such as announcements of Corporate actions), to obtain a clarification on a rumor or report, when an unusual movement in price or volume of a security is noted, or if the Exchange deems it necessary for the dissemination of information, Rule 9.3a also provides for a fifth (less restrictive) basis to do so: a direction by the SEC to that effect.

The SEC advises that the CSE has submitted a concept paper to SEC to issue a Trade With Caution Notice where a Listed Company is unable to justify for the Unusual Trading Activity of its Security.

Also, under Rule 9.3b, the SEC may at its sole discretion direct the Exchange to suspend the securities of any listed entity. Typically, all enforcement action undertaken by the CSE is so undertaken following joint deliberations with the SEC, or, at least, following prior notice. Further, the SEC has full access to the separate information maintained by the CSE for the purposes of its enforcement activities.

The SEC periodically reviews and directs the CSE on improvements to its processes, an exercise extended in November 2015 to the enforcement mechanism of the CSE in the event of non-compliance with its Listing Rules. The SEC has received insights into comparable measures undertaken in other jurisdictions, and will be deliberating on a further update to the CSE's relevant mechanism in the coming months.

The SEC advises that it plans to establish a new framework setting out a comprehensive enforcement mechanism in respect of key disclosure requirements.

#### **SLAASMB**

As set out in the description in Principle 18, SLAASMB undertakes annual reviews of approximately 1,200 audited financial statements of Specified Business Enterprises (SBE's). The outcomes of these reviews have led to SLAASMB providing direction to companies, including having financial statements revised, re-audited and republished and to bring professional failures to the attention of other regulatory authorities including the Inland Revenue. Criminal action has been rarely taken.

	<p>As set out in the description in Principle 19, SLAASMB has been undertaking reviews of the audit files associated with the audits of SBE's for a number of years. The samples currently reviewed are in the order of 100 files a year. The sample is based on a pre-determined focus set each year by the SLAASMB Board, with the current year being focused on entities with higher risk profiles "based on market developments".</p> <p>Reviews are conducted by 14 permanent FTE complemented each year by another 20 part time employees supporting the review work.</p> <p>Statistics about financial statement and audit reviews conducted since 2013 are set out in the descriptions for Principles 18 and 19. They point to a significant increase in review activity between 2013 and 2014. For financial statements, the reviews point to a large percentage (between 50 and 60%) of statements reviewed which are compliant with issues – but a very small number (less than 1%) in each year being non-compliant warranting further action. In the last 2 years, audit reviews have seen between 60 and 70% of audits reviewed being compliant with issues.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>Although the Sri Lankan authorities have a supervisory framework in place, which ensures most regulated entities receive an onsite visit each year and despite some recent enhancements in supervisory processes and plans for further enhancement, there is still scope for significant improvement in the use of inspection, investigation, surveillance and enforcement powers.</p> <p>While the supervisory framework has identified suspicious trading and compliance weaknesses, there is little evidence that these findings have led to timely enforcement outcomes or to prompt changes in firm behavior.</p> <p>The SEC has advised the RT it is committed to addressing this and advises that in recognition of this concern it restructured its Investigations Division shortly before the onsite visit. The relative lack of concrete outcomes of surveillance activities and related investigations is undermining market confidence and needs to be addressed as a matter of priority. Use of cautions, warnings and action in relation to licenses has some impact on the credibility of the enforcement framework, but lacks the impact of criminal prosecutions.</p> <p>The following are noted:</p> <ul style="list-style-type: none"> <li>• The SEC does not currently employ a risk-based approach to supervision. There is no formal risk-based framework in place to select and prioritize regulated entities to be inspected, nor the frequency or intensity of those inspections. While the SEC undertakes a fair number of supervisory visits annually, these visits (particularly those for managing companies and investment managers) appear to be compliance audits. Although they do cover risks such as credit and operational risks, they are not sufficiently geared towards identifying a holistic picture of firms' weaknesses and risks. The approach does not encourage regulated entities to look beyond simple regulatory compliance to understanding and assessing the risks they pose to regulatory outcomes. This is being addressed by the SEC through the development of a risk-based approach to the conduct of supervisory visits. In relation to stockbrokers, the coordination between the SEC and CSE during inspections, although strengthened in the last few years, will need further improvements once the risk-based supervision approach (which the SEC is developing) is in place.</li> <li>• Concerns remain that significant weaknesses identified through inspection in stockbroker compliance with key and basic client protection requirements have not always been addressed in a timely and effective way. These weaknesses include lapses in segregation of client monies, comingling of clients' monies with house monies, retaining the proceeds of security sales without clients' permission, extending credit to clients beyond regulatory limits and extending credit without an appropriate written agreement. Given the significance and potential pervasiveness of the weaknesses identified, delays in rectification risk client losses and consequent erosion in the credibility of the regulatory framework for stockbrokers.</li> <li>• There is also insufficient surveillance of trustees of unit trusts.</li> </ul>



	<ul style="list-style-type: none"> <li>• Despite steps to improve the quality of the cadre of supervisory staff, scope remains to improve the level of understanding of the entities regulated.</li> <li>• In the area of surveillance, the Review Team notes the relatively small number of referrals which have resulted in the initiation of investigations. The SEC has limited investigation resources which impedes its ability to respond to referrals.</li> <li>• Furthermore, even where investigations have been undertaken, there have been limited enforcement outcomes, either in the form of prosecution of individuals or, in the case of licensed firms, administrative action such as license suspensions or removal of the certification of relevant individuals to deal with clients (allowed for under s. 11.3.8(2) of the Stockbroker Rules) and a number of cautions and warnings.</li> <li>• The SEC is effectively limited to criminal sanctions in addressing all breaches of the Act, irrespective of how egregious that breach might be. The SEC does not have the flexibility offered by civil sanctions. Penalties set in 1987 are seen as too low and are insufficiently dissuasive. Use is also made of compounding as essentially a settlement mechanism, which both reduces the maximum financial penalty payable and does not require an admission of guilt by wrongdoers. While administrative and civil sanctions will be included in new legislation, fine levels should also be reviewed to ensure they are consistent and high enough to be effective deterrents.</li> <li>• Slow prosecution processes – including decisions by the Attorney-General’s Department on referrals from the SEC and slow Court processes – contribute to an environment in which acting promptly and decisively is challenging. The relatively greater use of warnings, cautions and compounding supports the perception of the enforcement regime lacking credibility.</li> </ul>
<b>Principles for Cooperation in Regulation</b>	
<b>Principle 13. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts</b>	
Description	<p>The SEC has broad powers under sections 45(1) and (2) of the SEC Act to collect both public and non-public information. The power to share this information with third parties – including foreign and domestic counterparts – is implied and subject only to a limitation in section 45(3) of the Act that sharing is contingent on the consent of the party providing the information,</p> <p>Accordingly, the SEC may require all information legally obtainable from any person, whether a regulated firm or otherwise, but in passing on information to other domestic or international bodies it must first obtain the consent of the parties to whom the information relates, or from whom the information was provided, unless such sharing is strictly necessary for the discharge of its functions.</p> <p>No approval by the relevant Minister or attorney is required for sharing information domestically or internationally and, domestically, the SEC may exercise its discretion with regard to complying or refusing a request for information by a given body, unless compelled by a court of competent jurisdiction, the Minister, or other such person or body authorized by the Minister to do so.</p> <p>The width of the provisions in Section 45 permits the SEC to invoke it in any context deemed by itself to be appropriate and necessary, as well as beyond its regulatory perimeter, or (in tandem with the IOSCO MMoU) its jurisdiction.</p> <p>As a result, such inquiries and responses may relate to matters of investigation and enforcement, authorization, licensing, approvals, and surveillance, market conditions and events, client identification, listed and regulated entities or any other type of information relevant to securities regulation.</p>
Assessment	<b>Partly Implemented</b>
Comments	The SEC has broad authority to share both public and non-public information with both domestic and foreign counterparts. There are, however, some significant limitations with regard to sharing

	<p>information which is subject to investigation with foreign counterparts. In these cases, the SEC is required to obtain the consent of the person under investigation.</p> <p>An indiscriminate invocation of Section 45 with minimal restrictions may lead to the exchange of information on an ad hoc basis: a situation sought to be remedied by the SEC through an amendment to its governing Act, specifying the types of information that may be shared and on what basis, the entities with which such sharing is possible, and the conditions attached to the use of such information, if any.</p> <p>The RT notes the SEC’s advice that the specificity of these provisions is being addressed in proposed amendments to the SEC Act.</p>
<p><b>Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts</b></p>	
Description	<p>The SEC derives its authority to receive information from and furnish information to other domestic and foreign regulators from Section 45 of the SEC Act. Future amendments to the Act are proposed to strengthen such information-sharing capabilities, in keeping with the SEC’s international commitments.</p> <p>In practice, the SEC relies on the IOSCO MMoU for cross-jurisdictional information-sharing, and has invoked the instrument on a number of occasions.</p> <p>The SEC has the power, under the SEC Act, to require any person to furnish any information or produce any document as it may consider necessary for the proper exercise of its powers or the discharge of its functions.</p> <p>This provision, which also provides that the SEC may provide such information subject to selected legal and confidentiality-related conditions set out in the SEC Act, is sufficiently wide to allow the SEC to enter into both formal and informal information-sharing agreements with domestic authorities and foreign counterparts alike, and is relied upon to enter into MoUs for the same.</p> <p>Domestically, such MoUs are limited to the 2001 MoU entered with SLAASMB, while the IOSCO MMoU serves as the basis for international engagement. In the light of the IOSCO MMoU, the need for separate bilateral agreements is obviated.</p>
Assessment	<p><b>Fully Implemented</b></p>
Comments	<p>The SEC is a signatory to the IOSCO Multilateral MoU (MMoU) since 2004 and has successfully used it several times.</p> <p>Domestically, the SEC has signed a MoU with SLAASMB. This Review recommends the SEC also sign equivalent agreements with other authorities engaged in regulating the securities markets, or which might affect – or be affected by – these markets.</p>
<p><b>Principle 15. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers</b></p>	
Description	<p>No express provision governing the sharing of information domestically or otherwise exists within the present regulatory framework. However, present administrative practice permits the SEC to offer assistance to foreign regulators on request and at its discretion, provided that parties to whom the information relates, or by whom it is provided, so consent. This extends across all categories of information and all circumstances contemplated by this IOSCO Principle, whether such information originates from the SEC or elsewhere.</p> <p>Further, with specific reference to cross-border information-sharing, Sri Lanka, being a signatory to the IOSCO MMoU is required to provide such assistance as provided for in the MMoU. These obligations will extend further on developing and signing the EMMoU.</p> <p>The SEC notes the use made of the MMoU in 2016 in requesting information in an investigation in relation to alleged insider dealing.</p>

Assessment	<b>Fully Implemented</b>
Comments	<p>The SEC may provide extensive assistance to foreign regulatory authorities in carrying out their responsibilities. The SEC does not require the permission of any outside authority to share information and an independent interest or dual illegality is not required as a precondition to cooperation.</p> <p>Enhancements to SEC’s authority to share information with foreign counterparties are contemplated in the proposed amendments to the SEC Act.</p>
<b>Principles for Issuers</b>	
<b>Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investor’s decisions</b>	
Description	<p><b>Listed Companies</b></p> <p>Companies listed on the CSE are required to meet the CSE Listing Rules with respect to both initial and continuing listings.</p> <p>The Listing Rules:</p> <ul style="list-style-type: none"> <li>• Set out in detail requirements relating to initial and ongoing disclosures (including in relation to the disclosure of price sensitive information, material events and changes, risks and strategy) in prospectuses, annual and other reports and advertisements;</li> <li>• Make provision for timeliness, derogations from disclosures “for bona fides purpose”, the bases for withholding information and corrective measures (including making calls for information, issuing a directive to disclose correct information, the engagement of an auditor), and penalties (including temporary trading suspension and restrictions, sanctions regarding the trading activities of selected persons, or the cancellation of relevant licenses or registrations); and</li> <li>• Require that entities listed on the CSE, and applicants for such listing, furnish documentation including audited financial statements to both the CSE and to the public.</li> </ul> <p>In addition, Rule 15 of the SEC Rules 2001 requires listed companies to clarify rumors or reports that it is aware of, which have the potential to affect investment decisions or prices. This must be done as promptly as possible. Rule 17 of the SEC Rules 2001 make directors of listed companies responsible for the company meeting the Listing Rules.</p> <p>The Companies Act sets out more limited disclosure requirements – applicable to all companies incorporated in Sri Lanka – regarding shareholder voting decisions and director’s holdings.</p> <p>The SEC and CSE exercise concurrent regulatory authority over issuers’ disclosure requirements, with the SEC primarily responsible. The SEC and CSE review compliance with the CSE Listing Rules and the Sri Lanka Accounting Standards (<b>SLFRS</b>). The two authorities divide the reviews.</p> <p>The authorities agree in a given year on which is to review what annual reports (on 50/50 basis) and the risk focus of the reviews. The next year the process is reversed, resulting in 100% coverage for each of the CSE and SEC on a 2 year basis.</p> <p>The SEC and CSE divide reviews of compliance by listed companies with the CSE Listing Rules and the Sri Lanka Financial Reporting Standards. The authorities agree in a given year on which is to review what annual reports and the risks which are to be the focus of the reviews. Every listed company can expect to be reviewed each year.</p> <p>The Review Team was advised that reviews of disclosure documents focus on industry segments or entities identified as posing higher risk and on other weaknesses in disclosure identified through desk research and investor complaints and other means</p>

	<p>When reviewing disclosures relating to fund raising (for instance IPO’s and rights issues), the CSE focuses on compliance with basic disclosure requirements under the Listing Rules to ensure adequate information is available for prospective investors to make informed decisions. The Review Team was also advised that the CSE also carries out a financial review about the company’s financial soundness. The SEC assesses market risk and reviews against the SLFRS’s.</p> <p>Reviews are undertaken through desk research, onsite visits and other supervisory initiatives and information received from informants.</p> <p><b>Other Public Offerings</b></p> <p>The issue of debt and equity by unlisted companies – or the issue of unlisted debt and equity by listed companies – is subject to the requirements of the Companies Act only. Section 40 of the Companies Act requires issuers of securities and debentures to register prospectuses with the Registrar of Companies meeting the information requirements set out in the Fourth Schedule to the Act. The Act also sets out the contents of Annual Reports required of issuers (Fifth Schedule to the Act).</p> <p>The number of public offerings made outside the CSE was, at the time of the onsite visit, unclear, with information sought, but not received, from the Registrar of Companies.</p> <p>According to SEC estimates, the current market of non-listed corporate bonds “publicly offered” by either listed or unlisted companies is considered substantial. According to the SEC, this market has grown from 40bn LKR in 2012 to 80bn LKR in 2014 (or roughly 10% of the capitalization of firms listed on the CSE).</p> <p>These privately placed bonds are becoming increasingly popular with large family owned corporates that don’t want to dilute their shareholdings and want to avoid the transparency requirements that come with listing.</p> <p>The disclosures made in respect of public offerings of unlisted securities do not appear to be subject to the same level of regulatory oversight or scrutiny as those made by listed firms.</p> <p><b>Listings by Foreign Issuers</b></p> <p>Public offerings or listings by foreign issuers are yet to occupy a significant position within the CSE. Disclosure requirements in relation to these issues are not yet in place.</p> <p>Foreign issuers wishing to issue in Sri Lanka are required to meet local listing requirements, without allowance made for meeting listing requirements in other jurisdictions.</p> <p>The Review Team was advised that a framework to list multi-currency securities of companies incorporated outside Sri Lanka has been proposed by CSE which will require co-operation with the home jurisdiction based either the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (“IOSCO MMOU”) or on an appropriate bilateral agreement.</p> <p>The Review Team was advised after the onsite visit that in response to a request made by the Maldivian Securities Exchange, the CSE has prepared proposed listing rules to list Maldivian companies on the CSE. Discussions with the Maldivian authorities continue.</p>
Assessment	<b>Broadly Implemented</b>
Comments	<p>For issuers listed on the CSE, the CSE Listing Rules generally meet the requirements set out in this Principle about the information to be provided to investors.</p> <p>Although there is no general provision requiring all material information to be disclosed there are provisions requiring information to be complete and not misleading and provisions which refer to an extensive (but non-exhaustive) list of the types of information which should be disclosed. For instance, section 8 of the CSE Listing Rules requires all listed companies to release any price sensitive information to the market immediately while under section 3 of the CSE Listing Rules the CSE has</p>

	<p>the absolute right to require disclosure of any additional information as it considers appropriate in any particular case.</p> <p>The CSE and the SEC have some power to address non-compliance with these requirements, including not approving a listing and, once listed, imposing trading halts and suspensions and invoking the Default Board procedures.</p> <p>Regulation of issues by unlisted companies does not meet the requirements of the IOSCO Principle. The Companies Act does not, for instance, provide for disclosure of material risks in prospectuses, although it does provide for these disclosures in annual reports. Nor does it impose continuous disclosure obligations other than setting out annual reporting requirements. The prospectus registration requirements are also not subject to the same scrutiny set by the CSE, with the Registrar of Companies role limited to registration of documents and taking civil and criminal action in the event information contained in the prospectus is misleading. Given the potentially significant number of these issues these shortcomings are a matter of concern.</p> <p>Revisions to the SEC Act seen by the Review Team contemplate all public offerings of securities requiring Commission approval and meeting standards set out in the Companies Act and relevant listing rules. They also vest the SEC with more appropriate powers to address breaches of disclosure requirements (including the issue of stop orders).</p> <p>Foreign issuers wishing to issue in Sri Lanka are required to meet local listing requirements, without allowance made for meeting listing requirements in other jurisdictions.</p> <p>While the current CSE listing rules ensure that directors are liable for the content of disclosures made, liability does not extend to other relevant persons involved in the issuing process (underwriters, authoring officers, promoters, experts, advisers, etc.).</p> <p>The Companies Act, however, does provide for promoters, experts and others to be liable for the content of disclosure documents.</p> <p>The Review Team notes that the CSE does, however, currently require all parties to an issue, to issue a declaration that they have complied with all applicable regulatory requirements relevant to them and that there is no relevant conflict of interest applicable to the issue.</p> <p>It is unclear whether revisions to the SEC Act will extend liability for the content of disclosure documents to others, although the Review Team was advised that the revisions will empower the SEC to issue directives to supplementary service providers – such as valuers and auditors.</p> <p>Supervision of these requirements by the SEC is sound. Staff engaged in this activity are seen by industry as appropriately experienced and competent to discharge their functions. Although the Review Team’s observation is that CSE staff members appear to be quite professional, the SEC has still identified a few weaknesses in the supervisory work of the CSE.</p> <p>Joint cooperation between the CSE and the SEC is satisfactory. Required timelines are observed, and responses to inquiries and requests are made promptly.</p>
<p><b>Principle 17. Holders of securities in a company should be treated in a fair and equitable manner</b></p>	
<p>Description</p>	<p>The rights of shareholders are governed by the Companies Act.</p> <p>This Act includes provisions in respect of distributions (sections 56 and 57); transfer of shares (sections 73-80); minority buy-out rights (sections 93-37); changes to the rights attaching to shares (s99-101); the holding and conduct of meetings and making of resolutions (sections 143-147); annual reports (sections 166-169); and other matters.</p> <p>For listed entities, this regime is supplemented by further requirements in the CSE listing rules and the SEC Takeovers and Mergers Code applying to takeovers and mergers of listed companies.</p> <p>The requirements cover materiality disclosures and disclosures about changes of control.</p>

	<p>The CSE listing rules also contain provisions with respect to disclosure of substantial holdings of voting securities. A threshold for the designation of holdings as being ‘substantial’ is set at 10% or more.</p> <p>The CSE Listing Rules also require immediate disclosure in case of change of control of the (listed) entity (Appendix 8A).</p> <p>The CSE Listing Rules require that information with respect to holdings of voting securities by directors will be disclosed in the prospectus and other listing-related documents (Art 3.1.8). Similarly, a statement of each director’s holding in shares of the entity at the beginning and end of each financial year must be included in the Annual Report of any listed entity.</p> <p>Failure to comply with these requirements could result in enforcement and compliance measures available under the CSE listing rules (section 10).</p> <p>However, the provisions relate only to domestic listings and, in the absence of cross-border activity, there is no specific regulation of foreign listings. Foreign shareholders, meanwhile, and those not resident in Sri Lanka, are subject to the same rules as domestic shareholders.</p> <p>As noted in the description for Principle 16, until now public offerings or listings by foreign issuers have been absent. However, following the announcement in January 2016 that exchange control approval has been granted for the listing of foreign companies in dollar-denominated securities on the CSE, the application of domestic rules and regulations to such listings appears imminent.</p> <p>Unlisted companies making public offerings, and therefore not subject to Listing Rules, are subject only to the requirements of the Companies Act.</p>
Assessment	<b>Broadly Implemented</b>
Comments	<p>The basic rights of equity shareholders in listed companies set out in the CSE Listing Rules, the Companies Act and the SEC Code on Takeovers and Mergers generally meet the requirements of this Principle.</p> <p>The Review Notes that while details of material changes of ownership by directors and the CEO need to be disclosed in a timely manner (as set out in Rule 7.8 of the CSE Listing Rules), there are no such requirements in relation to other senior managers.</p> <p>Where two or more shareholders act in concert, the only disclosure requirements are in the SEC Code on Takeovers and Mergers</p> <p>There are also other shortcomings in relation to unlisted companies to which the provisions of the Companies Act apply. In particular the Act:</p> <ul style="list-style-type: none"> <li>• Contains no provision on disclosure of material information; and</li> <li>• In relation to change of control transactions, provides only for amalgamations (Part VIII).</li> </ul> <p>The RT notes the SEC’s advice that shortcomings with respect to listed companies are expected to be addressed in proposed revisions to the SEC Act and that foreign listings will also be covered.</p>

**Principle 18. Accounting standards used by issuer to prepare financial statements should be of a high and internationally acceptable quality**

Description	<p><b>Financial Statement Requirements</b></p> <p>The CSE listing rules require that entities listed on the CSE, and applicants for listing, furnish audited financial statements to both the CSE and the public conforming to the Sri Lanka Financial Reporting Standards (<b>SLFRS's</b>) as a prerequisite for listing on the CSE (Arts 3.1.12, 3.2.12 and 3.3.7).</p> <p>Section 6 of the Accounting and Auditing Standards Act of 1995 (<b>SLAAS Act</b>) requires Specified Business Enterprises (<b>SBE's</b>) (which include listed companies, banks, insurance companies, factoring companies, finance companies, leasing companies, unit trusts, fund management companies, stockbrokers and stock dealers, and stock exchanges) to prepare accounts in accordance with developed under the provisions of the Act.</p> <p>The CSE listing rules also require issuers to include audited financial statements conforming to SLFRS's in annual reports and interim financial statements.</p> <p>The financial statements are expected to include relevant elements such as a balance sheet, profit and loss and cash flows statements and additional explanatory notes. They are also required to be comprehensive, designed to serve the needs of investors, reflect consistent application of accounting standards and be comparable between accounting periods.</p> <p>Section 151 of the Companies Act sets out requirements about the contents of annual financial statements for other Sri Lankan incorporated companies, including unlisted companies which make public offers. Section 151 requires that financial statements of companies shall comply with (a) any regulations made under the Act in relation to the form and content of financial statements and (b) any requirements which apply to the company's financial statements under any other law. These do not appear to include requirements to meet the SLFRS's.</p> <p><b>Accounting Standard Setting</b></p> <p>SLFRS's set out the minimum financial reporting standards applicable to <b>SBE's</b>. The current standards, adopted in 2016, are said to be fully in line with the 2016 edition of the International Financial Reporting Standards (IFRS's).</p> <p>The Institute of Chartered Accountants of Sri Lanka (<b>ICASL</b>) is responsible, under s2 SLAAS Act, for adopting Accounting Standards in Sri Lanka on recommendations from the Accounting Standards Committee (<b>ASC</b>). The ASC is empowered, under s8 of the SLAAS Act, to make recommendations and otherwise assist ICASL in the adoption of accounting standards.</p> <p>When the International Accounting Standards Board (<b>IASB</b>) issues IFRS's or Interpretation, the ASC reviews the Standard and related technical materials and recommends them to the Council of ICASL for adoption as the SLFRS. These recommendations are then adopted by the Council of ICASL under s2 of the SLAAS Act.</p> <p>The Committee comprises six members of ICASL (including the President), nominated by ICASL, the Registrar of Companies, the Director-General of the SEC, a nominee of the CBSL a nominee of the Sri Lanka Division of the Chartered Institute of Management Accountants (UK), a nominee of the Ceylon Chamber of Commerce and a nominee of the Federation of Chambers of Commerce and Industry of Sri Lanka.</p> <p>The SLFRS's are revisited regularly by the Accounting Standards Committee, and amended, revised or altered whenever necessary to continue alignment with the IFRS's. These amendments, revisions and alterations to the standards are published in the Gazette and disseminated by ICASL to the public.</p> <p><b>Monitoring and enforcing compliance with accounting standards</b></p> <p>SLAASMB's function under s23 of the SLAAS Act is to monitor compliance by SBE's with the SLFRS's.</p>
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SLAASMB was, in fact, one of the first regulatory authorities established in the accounting oversight space worldwide.

The Board of the SLAASMB consist of 3 ex-officio members (the Registrar of Companies, the Commissioner-General of Inland Revenue and the SEC Director-General) and 10 appointed members, of which 4 are from professional bodies (3 from ICASL) and 5 other members also related to the private sector. The Board meets once a month.

SLAASMB has doubled its staff in the last 3 years to 14 permanent FTEs, supplemented by another 20 part-time employees supporting its review work. SLAASMB salary levels are quite low compared to the private sector. The same technical staff members undertake reviews of financial statements and audit files (as set out in the Assessment of Principle 19 below).

Each year, 14 SLAASMB staff (all qualified chartered accountants) review approximately 1200 sets of audited financial statements of SBEs per year.

The results of these reviews for the period 2013 to 2015 are set out in the following Table. The Table points to a significant increase in review activity between 2014 and 2015, with between 40 and 50% of statements reviewed being fully compliant, between 50 and 60% being compliant with issues and a very small number regarded as non-compliant warranting undertakings and direction.

**Table Financial Statement Review Activity 2013 to 2015**

	2013	2014	2015
<b>1. Financial Statements Received</b>			
2. Statements	1,322	1,371	1,430
3. SBE's covered	1,248	1,289	1,345
<b>4. Financial Statements Reviewed</b>			
5. Reviews conducted	751	1,200	1,122
6. SBE's covered	708	1,151	1,068
<b>7. Corrective Action</b>			
<b>8. Compliant</b>			
9. Statements	309	498	553
10. SBE's	280	483	534
<b>11. Compliant with Issues</b>			
Statements	438	697	567
SBE's	424	674	541
<b>Non-Compliant</b>			
Statements	4	5	2
SBE's	4	5	2

Source: Data provided by SLAASMB

Under a 2001 Memorandum of Understanding between SEC and SLAASMB, both bodies agree to inform each other of relevant findings (including non-compliance) in their scrutiny of audited financial statements.

Section 27 of the SLAAS Act provides that failure to comply with Sri Lankan Accounting Standards in preparing financial statements and Sri Lankan Auditing Standards in the audit of financial statements is a criminal offence and, where non-compliance is intended to mislead, persons are liable to a fine not exceeding 500,000 LKR or imprisonment for up to 5 years.

The SEC advises that only one prosecution has been brought under these provisions in recent years.

In the exercise of its general powers under the SLAAS Act, SLAASMB provides directions in relation to financial statements, including directing the revision, re-auditing and republication of financial statements and bringing failure to comply with provisions to the attention of professional bodies, regulators and the Inland Revenue Department (s. 27).



	Additionally, CSE and SEC are entitled under the CSE listing rules to undertake enforcement actions in case of non-compliance with CSE listing rules.
Assessment	<b>Broadly Implemented</b>
Comments	<p>Issuers are required to include audited financial statements with the content set out in this Principle. Financial statements for listed companies are, in turn, required to be prepared in accordance with the SLFRS's, which are a comprehensive body of accounting standards of an internationally acceptable quality.</p> <p>Unaudited financial statements used in interim reports by listed companies are also required to be prepared in accordance with the SLFRS's. There is no general requirement for unlisted companies to do so except where financial statements are required to be prepared for group reporting purposes of for satisfying requirements in relation to financial companies.</p> <p>Requirements about the establishment and timely interpretation of accounting standards are met. The standard setting process is considered to be open and transparent.</p> <p>A formal system of supervising and enforcing compliance with accounting standards is in place, with SLAASMB responsible for supervision and enforcement.</p> <p>However, there are a number of shortcomings:</p> <ul style="list-style-type: none"> <li>• Although as a matter of practice, Sri Lanka has adopted international accounting standards which can be regarded as having taken into account the public interest, the legal framework for setting of accounting standards has relatively limited public interest oversight. Although there are representatives from public authorities on the Accounting Standards Committee, a majority of members are either from the profession or industry. While standard setting formally considers due process, with public consultation, involves co-operation with relevant regulators and involves expertise from the profession, the strong presence of, and influence by, practitioners together with the (perceived) weak level of independent oversight raises question marks as to whether the current arrangements provide sufficient due process and public interest safeguards. The fact the SEC is one of 12 members of the Accounting Standards Committee is insufficient to constitute the co-operation or oversight contemplated by this Principle.</li> <li>• Although the SLAAS Act provides for adequate investigation powers for SLAASMB, the review process is a formal "tick the box" compliance exercise. Although a review of SLAASMB's performance by COPE resulted in a recommendation to strive for 100% coverage of all SBEs, with SLAASMB's current limited resources, a risk-based pro-active approach could be more effective. Annual reviews of the audited financial statements of all SBEs would be very time consuming and is therefore considered sub-optimal.</li> <li>• Interaction between the SEC and SLAASMB in monitoring compliance with the SLFRS's is limited.</li> <li>• SLAASMB's enforcement powers are limited, focusing primarily on providing directions to audited companies to have their financial statements re-audited and – where such financial statements have been published – to re-publish them, and to bring failures to other authorities' and professional bodies' attention, including filing action in court. The SLAAS Act does not provide for sufficiently dissuasive enforcement tools including publicizing compliance failures or imposing administrative sanctions/fines.</li> <li>• SLAASMB is subject to resource constraints in the conduct of its work. This is in part a function of funding limitations and the challenge of attracting staff from the ranks of practitioners as part time employees, given the relatively low salaries SLAASMB can offer.</li> </ul>

**Principles for Auditors Credit Ratings Agencies and other Information Service Providers**

**Principle 19. Auditors should be subject to adequate levels of oversight**

Description

**Oversight Framework**

The requirement for audit, and entities subject to it, are set out in the SLAAS Act and in separate SEC Guidelines with respect to listed companies (see the Assessment of IOSCO Principle 18).

Under s6 of the SLAAS Act, SBEs have a duty to take all necessary measures to ensure that accounts are audited in accordance with the Sri Lanka Auditing Standards (developed as set out in the description in IOSCO Principle 21 as set out below).

SLAASMB is responsible under s23 of the SLAAS Act for monitoring compliance with the Sri Lanka Auditing Standards (SLAuSs) in the preparation, presentation and audit of financial statements of SBEs.

Section 26 of the SLAAS Act provides SLAASMB with a set of supervisory and enforcement powers and responsibilities, including carrying out of investigations and making inquiries, giving directions and filing action in court.

As noted in the description in IOSCO Principle 18, SLAASMB has primarily focused on the conduct of annual compliance reviews of approximately 1,200 sets of financial statements of SBE's active in Sri Lanka.

Sri Lanka was at the forefront of establishing an independent accounting and audit regulator in the early 2000s and commenced reviews of audit files in the mid to late 2000's.

Reviews are based on samples from the annual review of approximately 1,200 financial statements of SBEs. The size of the sample has increased from 30 to currently 100 audit files reviews per year. The sample is based on a pre-determined focus set each year by the SLAASMB Board, the current year focus being on entities with higher risk profiles based on market developments.

The results of audit reviews in the last 3 years, which were mainly risk-based, are set out in the Table below. The Table describes a significant increase in the number of audits reviewed between 2014 and 2015, with the number of audit firms covered reducing between 2014 and 2015. The Table also highlights the very large percentage of reviews identifying issues.

**Audit Reviews conducted by SLAASMB 2013 to 2015**

	2013	2014	2015
Review of Audits			
Audit Reviews	50	100	91
Audit Firms covered	39	41	29
Audit Review Findings			
Compliant Audits	7	32	35
Audits with Issues	43	68	56
	<b>50</b>	<b>100</b>	<b>91</b>

Source: Data provided by SLAASMB

**Auditor Requirements**

Both the SLAAS Act and the SEC guidelines set out the requirements for qualified and competent auditors to Listed companies. The SLAAS Act requires that auditors of entities specified in the Act (specified business entities) shall be members of ICASL. Based on the mandatory CPD requirements, the licenses/certificates to practice are renewed every year by ICASL.

With respect to listed entities, the SEC's Guidelines for Appointment of Auditors to Listed Companies 2007/8 aim to strengthen the effectiveness of audits while enhancing the accuracy, transparency, consistency and reliability of financial reporting. The application of these guidelines is strongly

	<p>encouraged by the SEC and CSE, but is ultimately done on a voluntary basis. The SEC Guidelines in section 2 set out minimum requirements for performing the function of an auditor.</p> <p>The Sri Lankan audit market is dominated by the “Big 4” audit firms (PwC, EY, KPMG and Deloitte Touche Tohmatsu). Of the 1500 SBEs, 90% are audited by one of the Big 4, of which KPMG has the largest market share (40%).</p> <p>The World Bank, in its Report on Standards and Codes (Auditing and Accounting) for 2013/14 (ROSC), identified several shortcomings in relation to monitoring, compliance and enforcement, and recommended that SLAASMB further: enhance methodologies, capacity and information-sharing processes; enhance reviews to adopt more risk-based methods; and implement a mandatory audit quality assurance review process for audit firms to fully implement SLSQC1.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>Elements of an oversight framework for overseeing the quality and implementation of auditing, independence and ethical standards are in place, in particular the existence of an oversight body with monitoring functions and enforcement powers and a licensing regime which sets qualification requirements for auditors.</p> <p>The quality of the accounting and auditing profession and members of ICASL is generally regarded as high with many local practitioners having work experience with the Big 4 abroad.</p> <p>However, there are a number of significant shortcomings:</p> <ul style="list-style-type: none"> <li>• The Board of SLAASMB, which has responsibility for monitoring compliance, is dominated by members of the profession with Public interest oversight limited to the three ex officio members appointed to the Board.</li> <li>• SLAASMB reviews are limited to audit files of SBEs. They do not include regular review of the audit processes and practices of audit firms that audit financial statements.</li> <li>• SLAASMB does not have the power to oversee the quality control environment in which auditors operate. However, following the ROSC recommendations, as a first step ICASL has started an audit quality assurance initiative through the establishment of a Quality Assurance Board composed of retired auditors, to assess the manner in which audits are conducted and to create awareness, all on a voluntary basis. The RT has been advised by ICASL that amendments are proposed to the SLAAS Act to give effect to the establishment of the Quality Assurance Board.</li> <li>• As noted in the assessment of Principle 18, SLAASMB is subject to resource constraints in the conduct of its work. This is in part a function of funding limitations and difficulty in attracting staff from the ranks of practitioners as part time employees, given the relatively low salaries SLAASMB can offer.</li> <li>• SLAASMB staff undertaking reviews are engaged in both the accounting and audit reviews. There is limited experience in reviewing audit files and interaction with audit firms. There also seems to be a limited understanding of what “audit quality” really means in light of international concern about audit quality standards, what it should be and how it could be improved. The RT notes comments from ICASL indicating reliance, in this respect, on the quality control reviews undertaken by international audit firms active in Sri Lanka in relation to methodology and audit approach.</li> <li>• Co-operation between SLAASMB and SEC under the 2001 MoU is limited to accounting oversight and improving financial reporting information.</li> <li>• While the notion of auditor independence is taken into consideration by both SLAASMB and SEC reviews, further explanation or evidence on the assessment of auditor independence (in fact and in appearance) is absent (see further assessment of IOSCO Principle 20).</li> </ul>

	<ul style="list-style-type: none"> <li>• As is the case with accounting standards, SLAASMB has only limited enforcement powers to direct audited companies to have their financial statements re-audited and, where such financial statements have been published, to republish them and bring failures to other authorities' attention, including by filing actions in court. The enforcement toolkit lacks authority to stipulate other remedial measures, to initiate disciplinary proceedings or to impose administrative sanctions, such as fines, on auditors or audit firms.</li> <li>• An apparently significant number of “registered” auditors are not governed by regulations and do not have to meet the requirements set out in the SLAAS Act. They are only registered with the Registrar General of Companies under the Companies Act, and have to meet minimal requirements and qualifications. Their level of expertise and professional competence is variable. They are often retired assessors or former government officials that only audit SMEs. Registered auditors cannot audit public interest entities.</li> </ul>
<b>Principle 20. Auditors should be independent of the issuing entity that they audit</b>	
Description	<p>Requirements about the conduct of audits are set out in the Companies Act, the Listing Rules of the CSE, and the SEC Guidelines for Appointment of Auditors of Listed Companies. The guidelines, as noted earlier, are voluntary.</p> <p>All three make some provision for auditor independence, enforceable by SLAASMB in tandem with other relevant regulators.</p> <p>The Companies Act sets out requirements about the conduct of audits of all incorporated entities, with the Listing Rules and the SEC guidelines setting out more detailed requirements for listed entities. The CSE Listing Rules entrusts the oversight of the preparation, presentation and adequacy of disclosures in financial statements, compliance with regulations and requirements, and internal controls and risk management processes of listed entities to those entities' Audit Committees. These Committees must assess the independence and performance of external auditors and make recommendations pertaining to their appointment, re-appointment and removal, and the terms of engagement applicable to them.</p> <p>The Guidelines are designed to ensure the apparent and actual independence of auditors, as well as to promote and contribute to the monitoring and safeguarding thereof, and sets out the requirements about independence.</p> <p>SLAASMB's enforcement capabilities, as noted earlier, range from the conduct of further inquiries, corrections and reviews, the ordering of re-audits and re-publications and notification to other authorities.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>The regulatory framework for ensuring independence of auditors is weak.</p> <p>The most extensive provisions for the appointment of auditors of listed companies are in the SEC Guidelines, but the Guidelines do not have the force of law and are limited to listed companies.</p> <p>While the CSE Listing Rules and Companies Act do have the force of law, requirements, to the extent they exist, are high-level and imposed on Audit Committees to be taken into account in appointing auditors. These requirements do not address the requirements set out in this IOSCO Principle.</p> <p>ICASL has indicated that it has recently started quality assurance programs to implement the SLSQC1 which includes addressing the issue of auditor independence. It notes that auditors are generally understood to have and maintain internal systems, governance arrangements, and processes for addressing threats to independence.</p> <p>Reviews undertaken by the SEC and SLAASMB are understood to address issues of auditor independence but, as noted in the comments on IOSCO Principle 19, it is unclear how these issues are, in fact, addressed. Further, as noted in the comments on IOSCO Principle 19, remedial and enforcement action undertaken by SLAASMB is inadequate.</p>

<b>Principle 21. Audit standards should be of a high and internationally acceptable quality</b>	
Description	<p>The Sri Lanka Auditing Standards (SLAuS) set the minimum standards for the conduct of audits of listed entities in Sri Lanka. They have been in operation since January 2012. They have been designed to comply with International Auditing Standards set by the International Auditing and Assurance Standards Board (IAASB), which develops and maintains standards, with the intention of applying them on a globally consistent basis.</p> <p>ICASL is responsible for adopting auditing standards under s3 of the SLAAS Act based on recommendations from the Auditing Standards Committee. This Committee is established under s9 of the SLAAS Act and is required to make recommendations and otherwise assist ICASL in adopting these Standards. Membership of the Committee comprises 8 members of which 4 are nominated by the ICASL Council and up to 4 others nominated by the Accounting Standards Committee.</p> <p>ICASL updates Sri Lankan auditing standards to ensure continued alignment with the ISA's, and publishes guides on how they may be complied with, on an annual basis.</p>
Assessment	<b>Broadly Implemented</b>
Comments	<p>A regulatory framework is in place in Sri Lanka requiring public issuers' financial statements to be audited in accordance with a comprehensive set of auditing standards.</p> <p>The SLAuSs are considered to be of high and internationally acceptable quality.</p> <p>Although as a matter of practice, Sri Lanka adopts international auditing standards, the legal framework for setting of auditing standards has relatively limited public interest oversight. While standard setting in Sri Lanka is formally considered to follow due process, including public consultation, similar to the process followed in adopting IAS's, and also co-operation is sought with relevant regulators, the process still includes strong involvement and expertise from the profession.</p> <p>The strong presence of, and influence by, practitioners on the Auditing Standards Committee together with the (perceived) limited level of independent oversight raises question marks as to whether the current arrangements provide sufficient due process and public interest safeguards. Representatives of public authorities are in a small minority and are not members of the Auditing Standards Committee on an ex officio basis.</p>
<b>Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision</b>	
Description	<p>Credit ratings are required for a range of regulatory purposes in Sri Lanka.</p> <p>These include requirements under the CSE Listing Rules and Central Bank requirements (under guidance issued in 2004) that licensed commercial banks and licensed specialized banks obtain credit ratings from 'independent' ratings agencies and disclose these ratings (or the fact they are not rated) in all advertisements soliciting deposits and other debt instruments. Ratings required of banks must be updated annually, with a rating report submitted to the Central Bank</p> <p>Two agencies are currently active and registered in Sri Lanka. Fitch Ratings Lanka is part of a global network and functions as a joint venture between Fitch Ratings Inc., International Finance Corporation, CBSL, and several leading local financial institutions. ICRA Lanka is a fully owned subsidiary of ICRA Limited of India, itself a subsidiary of Moody's Investors Service.</p> <p>Both agencies rate a range of debt instruments and issuances by both public and private Sri Lankan companies. Both apply methodologies developed outside Sri Lanka.</p> <p>The only ratings used for regulatory purposes in Sri Lanka are provided by Sri Lankan registered CRA's.</p>

The SEC Act sets out a framework for the regulation of credit ratings agencies and the ratings they issue. The regime applies to all agencies and ratings whether the ratings are used for regulatory purposes or not.

The framework has the following elements:

### **Definition**

Credit Ratings Agencies are defined by s55 of the SEC Act as follows:

*“a person engaged in the business of assessing and evaluating the credit-worthiness of any issue of listed securities or securities to be listed with particular regard to the issuers’ ability to perform any obligations imposed on the issuer thereon.”*

### **Registration requirements**

CRA’s are required to be registered as market intermediaries (s. 19A). In recent times, only one application has been made to register as a CRA. The application, made by a Pakistani promoter, was not progressed.

Conditions which a CRA is required to satisfy on registration include the following set out in Part V of the Schedule to the Act:

- the applicant must be a company incorporated under the Companies Act;
- its Directors must meet fit and proper requirements (including not having been declared bankrupt, never having had a range of licenses or registrations cancelled or suspended, not having been convicted of a range of offences or contraventions of the SEC Act);
- the applicant is of good financial standing;
- the promoters of the applicant persons are of means and integrity and have special knowledge of matters which the company may have to deal with as a credit rating agency;
- no director of the applicant is a director of a corporate entity or a business firm or a shareholder holding five per cent or more of any corporate entity or business firm or is in any other way interested in such an entity subject to rating by the applicant; and
- it must provide an undertaking that no director, officer or employee of the applicant shall communicate information acquired by him for rating purposes, to any other person except when required under law to do so.

In addition, the General Standards applicable to CRA’s require the promoter of a CRA to be either a domestic bank regulated by CBSL or foreign bank with the approval of CBSL, or a foreign CRA recognized in the country of incorporation, having at least 5 years’ experience in rating securities (Criterion 6).

Rating criteria and the ratings methodology must be forwarded to the Commission together with the application for registration. Upon completion of the registration process, the criteria must be made readily available to the public free of charge and shall be published on the company web-site.

As market intermediaries, CRA’s are required to renew their registration on an annual basis. Renewals are made under s. 20(3) of the SEC Act, where the SEC is satisfied that the CRA has at no time contravened any provision of the Act or regulation or rule made under the Act.

In registering and overseeing the CRA’s it regulates, the SEC has broad and general powers to obtain information from market participants (s. 45(1)). These are supplemented by powers under the General Regulatory Standards applicable to intermediaries (under criteria 15, 16 and 17).

As market intermediaries, CRA's are subject to the general examination and investigation powers available to it under sections 14(a) and (b) and s. 46A(1) of the SEC Act.

The SEC also has the power to suspend or cancel a registration (s. 21A). The grounds for suspension or cancellation include failure to meet the standards expected of CRA's set out in the General Regulatory Standards. Criminal sanctions may also be imposed under s. 51 of the SEC Act. The power to suspend or cancel a registration has been exercised (as set out below).

The SEC also indicated that it has the power to impose conditions on renewal of registrations under s. 13(p) of the SEC Act, a power it has exercised when it required a CRA to employ more staff.

### **Operational and Organizational Standards**

CRA's are required to meet the standards set out in the General Regulatory Standards for both intermediaries and credit ratings agencies. These Standards were promulgated as Directives under the SEC Act and are treated by the SEC as having the status of action under the Act for the purposes of exercising enforcement and supervision powers.

The General Market Intermediary Standards set minimum financial requirements and requirements in relation to the conduct of business (including requirements that market intermediaries *strive* to act in the best interests of clients and to act efficiently, honestly and fairly). They also set requirements about keeping books, furnishing returns and notifications of a list of events including breaches of the Act.

The standards applicable to CRA's, although organized under a different set of headings, touch on the quality and integrity, conflict of interest, transparency and timeliness and confidential information requirements of IOSCO Principle 22.

On **quality and integrity**, the Standards' requirements include requiring a CRA to:

- Have written procedures about the methodologies it uses and any amendments made to them from time to time. A professional ratings Committee of at least 3 people meeting qualification requirements is also required (Criterion 9);
- Ensure a minimum of two ratings analysts are employed (Criterion 3);
- Ensure minimum qualifications for directors and employees involved in providing ratings and that minimum financial requirements are met (Criterion 2);
- Maintain internal records to support its ratings for 6 years, records of clients served and all complaints received in the preceding 6 years (Criterion 15 (a));
- Have adequate financial, human and other resources sufficient to carry out the business of a CRA (Criteria 4 (a));
- Follow internal practice manuals when rating issuers (Criterion 14 (e)); and
- Ensure that staff members act with due diligence and a reasonable degree of care in carrying out their functions (Criterion 11).

On **conflicts of interest**, Criterion 10 of the Standards sets out an obligation in relation to independence and avoidance of conflicts of interests. Obligations generally focus on measures to avoid conflicts and then to address conflicts as they arise. They include requiring CRA's to:

- Engage solely in the business of operating a CRA (Criterion 10(a));
- Ensure they do not carry on any activities which could cause a conflicts of interest to their credit ratings functions (Criterion 10(f));

- Demonstrate its independence from the companies it rates as and when required to do so by the Commission (Criterion 19(d));
- Ensure that rating analysts owning any shares in any corporate entity or business firm refrain from participating in the rating process of such entity or firm (Criterion 10(e));
- Ensure that analysts and members of the Rating Committee refrain from soliciting or obtaining any benefits from anyone with whom the CRA does business (Criterion 14(g));
- Ensure that directors, employees, and members of the Rating Committee do not transact with companies whose securities are rated by it except on an “arm’s length” basis (all such arm’s length transactions and those entered into as a body corporate must be disclosed to the Compliance Officer) (Criterion 10(b));
- Prevent any employee with capacity to influence a rating from participating in or influencing the determination of the rating of any particular entity or obligation (Criterion 10(g));
- Prevent a CRA from rating a security issued by a borrower/subsidiary/associate of its promoter, with which it shares a common chairman, common directors, or common employees (Criterion 10(h));
- Prevent a CRA from rating a security issued by its associate or subsidiary, or an entity with which its rating committee shares a chairman, director or employee (Criterion 10(i)); and
- Refrain from rating any issue of a company in which it or its directors have any interest whatsoever (Criterion 14(i)).

In addition, CRA’s are required to:

- Disclose actual and potential conflicts of interest in a complete, timely, clear, concise and specific manner (Criterion 10(c)); and
- Demonstrate its independence from the companies it rates, if and when required by the Commission (Criterion 10(d)).

On **transparency and timeliness**, the Standards’ requirements include requiring CRA’s to:

- Distribute their ratings and the bases for their ratings decisions (Criterion 14(c));
- Publish ratings criteria on the company web site (Criteria 9(a) and 7(4));
- Disclose ratings which were not initiated at the request of the issuer and the fact the issuer did not participate in the rating process (Criterion 14(h)).

On **confidential information**, the Standards’ requirements include requiring CRA’s to:

- Treat as confidential the information they receive from clients (Criterion 15(c); and
- Employees of CRAs who possess confidential information concerning an issuer of securities are similarly prohibited from transacting in such securities, ensuring that the use of such information is restricted to rating activities alone and those involved in the ratings process.

Other **ongoing obligations** of CRA’s include the following:

- Ongoing fit and proper and qualification and experience requirements for directors and persons involved in the ratings process (Criteria 1 and 2);
- Having and maintaining a Code of Conduct (Criterion 14(j));



- Executing written contracts with clients (Criterion 8);
- Compliance with financial and disclosure requirements relating to capital (Criterion 7(1));
- Maintenance of a professional indemnity policy with an approved insurer (Criterion 7(2));
- Ensuring they have enough staff to monitor compliance and conflicts of interest (Criterion 7(3));
- Publishing completed ratings and lodging them monthly with the SEC (Criterion 7(4));
- Notifying the SEC about liquid capital falling below a designated threshold (Criterion 7(6));
- Keeping the SEC informed of the percentage holding in it by its parent/owning company(s), subsidiary companies, associate companies and partnerships, and of shareholders holding more than 20% or more of its equity (Criterion 5);
- Reporting requirements, including the provision of audited financial reports prepared in accordance with Sri Lankan accounting standards (Criterion 12); and
- Maintaining an internal compliance manual, reporting contraventions and requiring the Compliance Officer to report annually about the extent of compliance with the Act (Criterion 13) and to meet record keeping requirements (Criterion 15). Compliance Reports sighted as part of the review were general organized around the headings of the Regulatory Standards. We were advised there was no standard format for the preparation of these reports.

### **Supervision**

The SEC undertakes ongoing supervision of the two CRA's registered in Sri Lanka. It does so in the exercise of its general powers under sections 14(a) and (b) and 46A(1) of the SEC Act.

CRA's are visited once a year in the context of the renewal of each CRA's registration and generally with advance notice of the visit. There have been instances which the SEC has conducted special on-site inspections on CRA's by giving notice under the day of the said inspection.

In preparing for the visits, supervisory staff review Annual Compliance Reports prepared by each CRA, audited financial statements, ratings lodged with the Commission, previous inspection reports, unaudited financial statements, its operational procedures and information on the CRA's web site.

As is the case with other intermediaries, these visits appear to be largely compliance audits. They are not risk-based, nor do they discuss business risks or necessarily provide a holistic overview of the CRA's risk profile.

Supervisory staff advised the Review Team that visits usually review the qualifications of analysts, assess standard operating procedures, and the application of ratings methodologies. The deliberations of the Rating Committee and the minutes of its deliberations are also reviewed.

Four staff – who also supervise the activities of management companies and investment managers – are responsible for supervision. Supervisory visits – including preparation time – were estimated to take up 2 weeks for each CRA.

Regulated entities report an increase in the value and quality of supervisory visits.

### **Exercise of cancellation powers**

The power to cancel or refuse to review a registration was exercised in mid-2015 when the SEC issued a notice to the public that, pursuant to the lapse of Lanka Ratings Agency's (Agency) registration on 1 July, it was not entitled by law to carry on business as a CRA nor review ratings due to its non-compliance with regulatory requirements.

	<p>The Agency was unable to demonstrate the agreement on collaboration with an international Credit Rating Agency to the SEC. Further the Agency had previously been suspected of permitting “ratings shopping”, with the analysts not meeting experience requirements and finding of a prima facie conflict of interest in the rating of a proposed issue.</p> <p>In the light of conflict of interest issues, the SEC deferred the issue of debentures affected by the rating in respect of which a conflict of interest was detected, requiring a fresh rating to be obtained from an independent CRA. This was done following a hearing involving the directors of both the issuer and the Agency, and was noted by way of a directive to the CSE and a media release. The agency was also restrained from providing ratings until it demonstrated full compliance with the SEC’s regulatory requirements.</p>
Assessment	<b>Broadly Implemented</b>
Comments	<p>Some – but not all – of the required elements for the regulatory framework for CRA’s are in place in Sri Lanka. Requirements are set out in Regulatory Standards which have been made by the SEC as Directives under the SEC Act.</p> <p>The following are shortcomings in the Regulatory Standards applied to CRA’s:</p> <ul style="list-style-type: none"> <li>• Methodologies are not expressly required to be designed to ensure ratings are based on a fair and thorough analysis of all information available to the CRA;</li> <li>• There is no express requirement that CRA’s have sufficient resources to carry out high quality credit assessments;</li> <li>• There is no express requirement that CRA’s update credit ratings as new information becomes available, although it is understood that, as a matter of practice, this is done by the two CRA’s active in Sri Lanka;</li> <li>• CRA’s are not required to disclose actual or potential conflicts arising from compensation arrangements;</li> <li>• CRA’s are not required to publish sufficient information about historical default rates so that interested parties can understand historical performance;</li> <li>• There is no timeliness requirement in relation to disclosures or a requirement that disclosure be on a non -selective basis; and</li> <li>• There is no requirement that the use of non-public information provided to CRA’s should be limited to ratings purposes only.</li> </ul> <p>Supervision of CRA’s focuses primarily on governance and operational processes in the context of the renewal of license applications. Issues about the management of conflicts of interest appear to be well addressed. The rigor and systematic and objective application of ratings methodologies are not assessed or reviewed.</p> <p>The impact of these gaps is arguably mitigated by the fact that CRA’s currently active in Sri Lanka apply methodologies and governance arrangements of the parent companies in the region which are assumed to meet international regulatory standards. Nonetheless, the SEC cannot base its regulatory approach on assumptions about the quality of regulation in other jurisdictions. It should address the gaps identified above and work to develop its own regulatory capability.</p>

<b>Principle 23. Other entities that offer investor analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them</b>	
Description	<p>The SEC does not have a formal process under which it periodically considers whether entities which provide analytical or evaluative services warrant regulation and oversight because of the impact of their activity on the market, or because of the degree to which their services are relied on.</p> <p>Research in Sri Lanka is generally provided by what are described as full service brokers – either directly or through associated companies.</p> <p>The activities of sell side analysts or research providers are not specifically regulated under the SEC Act.</p> <p>Rather, the SEC advises that sell side analysts are employed by firms which are subject to the CSE’s Stockbroker rules. These rules are said to address conflicts of interest, compliance and management responsibility, and integrity and ethical behavior.</p> <p>Specifically, these rules set conduct standards for firms and their employees and, in particular provide for the management of conflicts of interest of stockbroking firms and their employees.</p> <p>Many of the requirements are relevant to addressing conflicts of interest in relation to the <b>trading activities</b> of the firm and the activities of <b>traders</b> (not research analysts). For instance:</p> <ul style="list-style-type: none"> <li>• Rule 3.1 sets out standards expected of firms and their employees <b>acting on behalf of their clients</b>, including requirements that they act fairly (para (2)), in good faith (para (6) and in the best interests of their clients and the integrity of the market (para (7)) while exercising due skill care and diligence (para (5)). These are supported by Rules 3.3 which requires firms and its employees when providing advice to clients to act diligently and carefully.</li> <li>• Rule 3.1 (3) requires that when acting on behalf of clients, a firm and its employees avoid any conflict of interest which might arise. If it does arise, the Firm is required to disclose any conflict of interest, decline to act or take any other measures. The scope of conflicts captured by this rule is broad and undefined. The type of disclosure required is also not prescribed. Rule 3.1 (11) also requires firms and employees to have in place procedures to prevent any conflicts of interest between its clients trading activities and trading on account of employee trades;</li> <li>• Rule 3.3.2 obliges the Firm and its employees when <b>dealing with clients</b> to disclose to the best of their ability all circumstances and risks that could reasonably be expected to affect a client’s decision. Rule 3.3.4 obliges the Firm and its employees not to enter into transactions which may conflict with the client’s interests, unless the client is informed of such conflict and consents to the transaction.</li> <li>• Rule 7.2.7 reinforces obligations in relation to addressing conflicts of interest, including the following: <ul style="list-style-type: none"> <li>○ The stockbroker firm shall avoid any conflict of interest which may arise between trading on own account and trades of the stockbroker firm’s clients.</li> <li>○ The CEO and the compliance officer of the stockbroker firm shall ensure that the trading on own account carried out by the stockbroker firm would not result in any market manipulations, front running of client orders or any other market malpractices.</li> <li>○ A stockbroker firm shall not directly or indirectly deal in any particular listed security or cause any other person to deal in that security, if the stockbroker firm possess information which is not available amongst the investing public.</li> </ul> </li> </ul>

	<p>Other requirements address conflicts issues in the context of the <b>provision of investment advice</b> (which arguably does not cover the publication of equity research for general use or use by the client base). Examples include the following:</p> <ul style="list-style-type: none"> <li>• Rule 2.2.4 requires that the CEO and Compliance Officer ensure that <b>investment advice</b> given to clients by the employee of a stockbroking firm will not result in a conflict of interest with employee trades. Satisfying the requirement is supported by requirements in Rule 2.2 that employees of a stockbroker firm may trade only through the firm which employs them that such trades will be monitored by the firm, and no trades may take place in relation to securities on the Restricted Securities List, comprising securities in respect of which the firm possesses material non-public information.</li> <li>• Rule 3.9 sets out general obligations on firms to implement and maintain appropriate measures and procedures to ensure compliance with a range of rules and regulations, including the CSE’s rules. A Compliance Officer appointed under Rule 8.1.2 is required to carry out checks to ensure compliance and to submit reports to the CSE on a monthly basis.</li> </ul> <p>The SEC advises that providers of research are required to hold a Registered Investment Advisor certification issued by the SEC’s Capital Market Education and Training arm (CMET).</p> <p>The SEC’s <i>Ethical Framework and Best Practices in Professional Conduct</i> also sets out expectations and best practices for market practitioners, including those who conduct investment analysis, make investment recommendations or take investment actions. In addition to setting out best practices about knowledge and compliance with the law and duties to clients and employers, the Framework sets out best practices in relation to the provision of investment advice. This include high level expectation that practitioners:</p> <ul style="list-style-type: none"> <li>• Make reasonable inquiry into a client’s or prospective client’s circumstances and investment experience prior to making any investment recommendation or taking investment action;</li> <li>• Exercise diligence, independence and thoroughness in analyzing investments, making investment recommendations and taking investment actions; and</li> <li>• Have a reasonable and adequate basis, supported by appropriate research and investigation for any investment analysis, recommendation and action.</li> </ul> <p>The Framework does not have the force of law. It was published on 11 July 2009 and has been implemented on a voluntary basis. The SEC advises that proposed revisions to the SEC Act would impose similar requirements to the Framework as a matter of law.</p>
Assessment	<b>Not Implemented</b>
Comments	<p>The requirements of IOSCO Principle 23 are not addressed.</p> <p>Reviews of the activities of information service providers are not conducted as contemplated by this IOSCO Principle.</p> <p>The provision of research by sell side analysts and research services is not directly regulated.</p> <p>These services are provided in Sri Lanka primarily by stockbrokers and stock dealers, with no clear picture who else is providing these services.</p> <p>The Stockbroker Rules focus on the activities of traders and firms in relation to trading activities and not on the activities of research analysts.</p> <p>The Rules as drafted do not, in any event, define conflicts of interest, nor do they set out with any specificity compliance arrangements required to address conflicts. Specific gaps include the following:</p>

	<ul style="list-style-type: none"> <li>• Conflicts are described as actual conflicts and do not appear to include potential conflicts of interest;</li> <li>• Conflicts related to reporting lines do not appear to be addressed;</li> <li>• Disclosures required under Rues 3.1 and 3.3 are not required to be provided in a timely, clear, concise, specific and prominent way;</li> <li>• It is unclear whether the compliance measures contemplated under Rule 3.9 cover written internal procedures and controls, specific procedures around addressing the undue influence of issuers, institutional investors and other outside parties, or requirements about disclosure; and</li> </ul> <p>Research plays a pivotal role in informing investors about the performance and prospects of listed companies. The quality and integrity of that research is critical to investor trust and confidence in investing in the capital market. The absence of direct regulation of research activities is, therefore, a serious gap, which requires urgent rectification.</p> <p>Revisions to the SEC Act are understood to contemplate delegating rule-making powers concerning the definitions of types of market intermediary and the SEC has advised that it will consider further how to frame different categories identified in the law. This may lead to an extension of the definition of market intermediaries to cover “investment analysts” and possibly providers of information services to the public.</p>
<b>Principles for Collective Investment Schemes</b>	
<b>Principle 24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme</b>	
Description	<p><b>Regulatory Framework for Collective Investment Scheme / Unit Trusts in Sri Lanka</b></p> <p>The SEC is responsible for licensing, regulating and supervising Unit Trusts under the SEC Act and SEC (Unit Trust) Regulations, 1991. The operation of Unit Trusts in Sri Lanka is governed by the provisions of the SEC Act, the Unit Trust Code, 2011 (<b>UT Code</b>) and SEC directives issued thereunder.</p> <p>The SEC Act defines a Unit Trust as “any arrangement made for the purpose, or of having the effect, of providing for the participation by persons as beneficiaries under a trust, in profits or income and capital gains arising from the acquisition, holding, management or disposal of securities or any other property vested in the trustee or such trust”(s. 55 interpretation). In practice, a Unit Trust in Sri Lanka is a pass-through vehicle with profit and losses passed to its beneficiaries, even though the definition does not address losses associated with investing in Unit Trusts.</p> <p>At the end of 2015, there were 14 managing companies licensed to operate Unit Trusts managing 72 Unit Trust funds. Total industry AUM was LKR 129 billion with around 37500 investors. Money Market Fund (MMF) schemes and Gilt schemes accounted for 46% and 13% of the total AUM respectively.</p> <p>The AUM of MMF schemes has seen an almost three-fold increase in the last 2 years (increased from LKR 19.2 billion as on year ended 2013, to LKR 60.3 billion as on year ended 2015). This is understood to be explained by legislative changes in 2013 which gave corporate entities a tax advantage when investing in fixed income schemes over directly investing in fixed income securities. Further, as at March 31, 2016, the largest five Unit Trusts accounted for nearly 72% of total industry AUM.</p>

**Eligibility criteria - Marketing Agents of Unit Trust**

SEC Directive dated 7 January 2009 sets out the minimum qualifications and experience that every employee or agent dealing with clients on behalf of the managing company need to possess. Compliance with this Directive is assessed at the time of granting a license to a managing company to operate a Unit Trust Fund and is also monitored at the time of on-site inspections.

In practice, Unit Trusts are generally marketed by employees of managing companies.

There are no specific regulatory requirements for registering employees or agents dealing with clients, with the SEC or any industry body.

**Eligibility criteria - Unit Trust operators**

The SEC Act sets out requirements in relation to the licensing of managing companies in respect of Unit Trusts (which, for the purposes of regulation, are treated as including exchange traded funds).

A managing company intending to operate a unit trust is required to make an application to the SEC, as per the form provided in Schedule I of SEC (Unit Trust) Regulations, along-with the list of documents as set out in Schedule II of the Regulations.

Part IV of the Schedule to the SEC Act sets out the eligibility requirements for the grant of a license to a managing company to operate a Unit Trust. These include:

- The trustee and the managing company of the Unit Trust are separate persons and the trustee is not a connected person of the managing company;
- The managing company has the necessary professional experience and is financially sound;
- The directors of the managing company are fit and proper persons;
- An Explanatory Memorandum has been prepared by the managing company and approved by SEC;
- The trustee must be approved by SEC;
- The trust deed between the managing company and trustee creating the trust must be approved by SEC; and
- The trust deed must contain a set of prescribed provisions relating to the governance and operation of the Unit Trust.

*Honesty and integrity*

The eligibility for grant of a license to a managing company includes a requirement that the directors of the managing company are fit and proper persons (Part IV of the schedules to the SEC Act).

As per SEC Directive dated 7 January 2009, the fit and proper criteria include a disqualification for directors or employees of managing companies and Trustees, where they have a history of convictions for violation of securities or financial business laws or any act of fraud with a regulatory or supervisory body.

However, at the time of providing a license to a managing company to operate a Unit Trust or on an on-going basis, the SEC does not seek any declaration from directors of the applicant that they have not been convicted under any such laws nor does the SEC demand any documents from directors of a managing company or Trustees to ascertain compliance with this “Fit and proper” criterion.

*Sufficient human and technical resources and ability to perform specific duties*

A managing company is required to ensure that at least two persons with academic qualifications and experience prescribed by the SEC are employed by the company in order to conduct its business in accordance with the investment objective and policy as set out in the Unit Trust fund. The SEC also has the authority to direct a managing company to increase the number of qualified personnel on account of the volume in Unit Trust business proposed to be undertaken or being undertaken by them (SEC Directive dated 7 January 2009).

*Financial capacity*

The SEC has the authority to require managing companies to maintain a minimum net capital during the period of its operation (Rule 2(3) of the UT Code). Specifically, under SEC Directive dated 7 January 2009, managing companies are required to maintain minimum net capital requirements of LKR 25 million at all times. The SEC monitors compliance with this requirement by way of on-site inspection and off-site reporting of monthly financial statements of the managing company.

**Risk management and internal controls**

The eligibility criteria for the grant of license to a managing company to operate a Unit Trust do not provide for any specific regulatory requirements on risk management frameworks. However, risk management mechanisms are checked at the time of inspection.

Similarly, there are no requirements for internal controls and compliance arrangements – although as a matter of practice compliance officers are generally appointed. The SEC also advises that these aspects are, as a matter of practice, verified during on-site visits.

The Review Team noted that a single entity acts as Trustee for 80% by number of Unit Trusts in Sri Lanka which together account for over 90% of Unit Trust industry AUM in Sri Lanka.

**Primacy of investor interests**

The regulatory framework provides for the Trustee to oversee the activities of a Unit Trust, in order to ensure management complies with relevant rules and regulations.

Further, to ensure that the Unit Trusts are operated in the interests of investors, the following requirements *inter alia* are in place:

- A managing company shall act only on behalf of its unit holders and Unit Trust in buying and selling securities, shall not trade securities of any firm or company in which it has equity interest without the prior written approval of the SEC. Also, a managing company is prohibited from buying or selling any securities in its own name, (Rule 3(1) and 3(2) of the UT Code).
- A managing company is responsible for any loss suffered by the Unit Trust or by unit holders as a result of any fraud, gross negligence or malfeasance of employees and directors (Rule 4 of the UT Code).
- Any material changes or the addition of a significant new matter in the Explanatory Memorandum is subject to the approval of the SEC (Rule 17 (1) of the UT Code). Further, changes that affect investor rights including changes in managing company's annual charges and change in redemption methods are required to be brought to the notice of the unit holders at least one month prior to taking effect (Rule 11 (3) and Rule 22 (3) of the UT Code).
- The explanatory memorandum and annual reports of funds are required to be accompanied by a declaration by the trustee & management company that they will carry out transaction at an arm's length basis and on terms which are best available for the fund and act at all times in the best interest of the fund's unit holders.
- The services of a managing company can be terminated where deemed desirable by the trustee or requested by 75% of unit holders (Rule 5 of the UT Code).

- It should also be noted that there is a general clause that empowers the SEC to provide exemption to any Unit Trust from applicability of any regulatory norms (Rule 1 (3) of UT Code and SEC directive dated 7 January 2009).

### **International cooperation**

Although at present no Unit Trusts in Sri Lanka are managed by companies or persons in other jurisdictions, persons outside Sri Lanka do invest in units of Unit Trusts in Sri Lanka. Currently around LKR 1.4 billion viz. 1.2% of the total AUM can be attributed to foreign investments in Unit Trusts. The arrangements for cooperation with foreign regulators are described in detail under Principles 13 and 14.

### **Supervision and Ongoing Monitoring**

#### *Responsibility and powers of regulator*

As noted, the SEC has the authority to grant a license to a managing company to operate a Unit Trust, approve a trustee, inspect and carry out investigations into any activity of a licensed managing company or a trustee of a Unit Trust.

Further, the SEC can withdraw the approval given to a trustee or cancel / suspend the license given to a managing company, in cases which include instances of a breach of provisions of the SEC Act or any rules or regulations made thereunder, malpractice or irregularity in management of affairs, among others.

#### *Authorization of a Unit Trust*

Under Section 13(bb) of the SEC Act, the SEC has the power to grant a license to a managing company to operate a Unit Trust and to ensure the proper conduct of the business of such Unit Trust.

Further, no person can use the words “Unit Trust” unless licensed to operate such Unit Trust (s. 31(H) of SEC Act).

No person can issue or publish or cause to be issued or published an Explanatory Memorandum or advertisement inviting the public to invest in units of a Unit Trust, unless such person has been licensed as a managing company of such Unit Trust and has obtained prior approval of the Commission for the contents of such explanatory memorandum or advertisement and for its issue or publication (s. 31(I) of SEC Act).

#### *Inspections and investigation:*

Section 13 of the SEC Act empowers the SEC to inquire and conduct investigations into any activity of a licensed managing company or a trustee of a Unit Trust. The SEC can also carry out inspections of the activities of licensed managing companies or trustees of Unit Trusts under section 14 of the SEC Act in order to determine whether they are operating in conformity with the provisions of this Act or any regulations or rules made thereunder. All accounts, books and records of a Unit Trust, managing company and Trustee can be examined by the SEC at any time (Rule 31 of the UT Code).

In order to ensure compliance with regulatory requirements, in practice, the SEC undertakes on-site inspection and off-site monitoring of Unit Trusts’ portfolio and financial reports of management companies, being submitted on a monthly basis. These inspections are described in more detail in the description to Principle 12. The number of inspections conducted by the SEC of Managing companies of Unit Trust over the past 4 years is shown in the following table:

<b>Routine Inspections of Managing Companies of Unit Trusts</b>			
<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
2	13	14	10



Further, the SEC does not generally review the efficacy of the supervisory function of Trustees of Unit Trust. In fact, in the past 3 years only 1 inspection of a Trustee has been carried-out with no major deficiencies observed.

#### *Remedial action*

The SEC has powers under Section 31(D)(1) of the SEC Act to cancel or suspend the license granted to a managing company in cases including the following:

- The managing company of such Unit Trust acting in breach of any provision of the SEC Act or any rules or regulations made thereunder;
- The managing company of such Unit Trust ceasing to be of good financial standing;
- The managing company of such Unit Trust being guilty of malpractice or irregularity in the management of its affairs.

If the SEC does not consider a violation to be of serious nature, it can direct the managing company to rectify or correct the condition resulting from such contravention or desist from continuing such contravention (Section 31(D)(4) of SEC Act).

The Review Team notes that although the SEC has identified non-compliance with applicable regulatory requirements through inspections and does follow up on on-site inspections with a view to identifying deficiencies and issues of non-compliance, it has taken limited regulatory action.

#### **Record-keeping and reporting**

##### *Record keeping*

The managing company is responsible for keeping the Unit Trust's accounts and preparing and publishing the Unit Trust's reports.

Rule 29 of the Unit Trust Code requires managing companies to keep a daily record of units, which have been acquired and/or held by it or disposed of, and the balance of any acquisitions, holdings and/or dispositions. The managing company is required make such daily record available for inspection by the trustee at all times. Also, all books and records of Unit Trust are subject to examination by SEC at any time (Rule 31 of the UT Code).

Rule 29 of the UT Code also requires managing companies to maintain and preserve books and other documents used in preparation of the financial statements and reports filed with the SEC for a minimum period of five years. Further, the Trustee is also required to maintain and preserve the income account and distribution account of the Unit Trust for a period of 5 years (Rule 30 of the UT Code).

The managing company is also required to publish not less than two reports during each financial year, providing assets and the liabilities of the Unit Trust (Rules 27(1) and 27(3) of UT Code). The annual report is also required to contain the audited revenue accounts of the Unit Trust with the auditor's certificate, among other information. (Rule 27(4) of the UT Code).

##### *Filings with the SEC*

Rule 9(3) of the UT Code requires the managing company to immediately inform the Commission when the total investment made by the managing company, exceeds permitted limits. Managing companies, unlike other intermediaries, are not required to lodge reports with the SEC about compliance with regulatory norms. In practice, the detailed portfolio statements of each Unit Trust fund along-with financial reports of managing companies are filed with SEC on a monthly basis.

Further, while Trustee acts as a first level supervisor of the Unit Trust, the Trustee is not required to file any report to the SEC informing about functioning & performance of Unit Trust Funds and its compliance with relevant regulatory norms.

### **Conduct of business**

Section 53(1)(f) of SEC Act empowers the SEC to formulate a code of conduct to be observed by the trustee and the licensed managing company of a Unit Trust.

While the UT Code, formulated and published under this provision, has standards aimed at ensuring protection of investor's interest (including exercising reasonable care, being responsible for loss suffered as a result of fraud, gross negligence or malfeasance), there is no specific clause requiring managing company to ensure fair treatment to all investors.

Further, there are no direct regulatory requirements in relation to best execution, appropriate trading and timely allocation of transactions, churning, due diligence in the selection of investments and soft commission arrangements.

#### *Underwriting*

The managing company is prohibited from entering, on behalf of the Unit Trust, into an underwriting or sub-underwriting agreement without the prior written consent of the trustee and SEC. Further, if approved, the fees payable to the managing company under such agreement and all investments devolved pursuant to such agreement, shall form part of the deposited property of the Unit Trust (Rule 14 of UT Code).

#### *Fees and expenses*

Rule 11(1) of the UT Code states that the only payment to be made to the managing company by the trustee out of the deposited property by way of remuneration for services rendered, shall be a periodic fee in terms of the provisions in the Trust Deed including any taxes levies or duties imposed from time to time by the Government.

Rule 12 of the UT Code further lists expenses that may be paid by the trustee out of the deposited property, provided that adequate disclosure of such expenses has been provided to unit holders.

Under Rules 11 and 12 of the UT Code, the fees that can be charged to the Unit Trust include:

- (i) Fees towards services provided by managing company;
- (ii) Cost of dealing in the deposited property;
- (iii) Taxation and duties payable;
- (iv) Trustee Fees;
- (v) Audit Fees; and
- (vi) Listing Fees, among others.

However, commissions paid to agents, cannot be paid out of the deposited property.

### **Conflicts of interest**

To minimize conflicts of interests, there are regulatory requirements noted earlier which require a managing company and trustee to be independent from each other.

Further, any transactions between the Unit Trust and the managing company, its associate, joint venture, subsidiary or holding company or any connected person as principal can only be made with the prior written consent of the trustee (Rule 15(1) and 15(2) of the UT Code, 2011).

All such transactions are required to be disclosed in the Unit Trust's annual report (Rule 27 of the UT Code, 2011).

	<p><b>Delegations</b></p> <p>There are no regulatory provisions permitting or limiting the delegation of core responsibilities and functions of a managing company. However, it has been observed that in most instances, registry and accounting functions are outsourced. Similarly, in certain instances, the function of custodian had been outsourced by the Trustee.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
<b>Comments</b>	<p>There is a legislative and regulatory framework for collective investments in Sri Lanka, including licensing requirements, some conduct and operational standards for managing companies and ongoing supervision and monitoring by the SEC.</p> <p>However, there are significant shortcomings in both the design and supervision of that framework.</p> <p>Shortcomings in the <b>design</b> of the regulatory framework include the following:</p> <ul style="list-style-type: none"> <li>• The eligibility criteria for the grant of a license to a managing company to operate a Unit Trust do not provide for risk management frameworks, internal controls or compliance arrangements. The SEC does, however, examine each of these aspects of the companies’ operations during on-site inspections.</li> <li>• In assessing fit and proper requirements, the SEC does not seek any declaration or documentation to ascertain that directors of managing companies have not been convicted under relevant laws nor does it undertake independent checks (e.g. screening against an internal database of individuals with past misconduct or adverse records). The “Fit and proper” criteria also primarily focus on statutory disqualifications with some references to professional competency. However, these requirements do not apply to CEOs and controllers of managing companies.</li> <li>• There are no specific regulatory requirements for the licensing or registration of employees or agents of managing companies dealing with clients and no standards set for their conduct. Given these employees and agents are the primary conduit by which collective investment schemes are marketed in Sri Lanka, this is a matter of some concern.</li> <li>• While the UT code sets standards directed at ensuring protection of investor’s interest, there are no specific requirements for a managing company to ensure fair treatment of all investors. The UT Code also does not set conduct standards in relation to best execution, appropriate trading and timely allocation of transactions, churning, due diligence in the selection of investments and soft commission arrangements.</li> <li>• Managing companies are not required to file periodic reports with the SEC about their compliance with regulatory requirements, as is the case for other intermediaries.</li> <li>• The SEC has not enunciated clear principles nor provided guidance about how it exercises its powers of providing exemption to applicable rules under the Unit Trust Code.</li> <li>• Neither the SEC Act nor the Unit Trust Code addresses the delegation of responsibilities and functions of a managing company.</li> </ul> <p>The RT notes the SEC’s advice that these shortcomings are expected to be addressed by revisions to the SEC Act and the Market Intermediary Rules.</p> <p>The regulatory framework for managing companies is not aligned with the framework for other market intermediaries (as set out in IOSCO Principle 29).</p>

	<p>The SEC has powers under the SEC Act and the UT Code to conduct inspections and investigations of managing companies and trustees and to take disciplinary action. While the SEC proactively conducts on-site inspections and off-site monitoring of managing companies and funds under management, this activity is more in the nature of check list based compliance audits. The SEC should work to ensure that in all cases inspections are approached with a view to providing a holistic enterprise wide assessment of the risks posed to Unit Holders.</p> <p>The RT notes the SEC’s advice that the proposed risk based supervision framework, the development of which is underway, is intended to ensure this.</p> <p>There has been limited remedial or disciplinary action taken in recent times in relation to non-compliance with regulatory requirements. Rather, in cases where non-compliance has been identified, the SEC has given time to the relevant Unit Trust and managing company to comply with the relevant regulatory norm. This has contributed to a perception of light touch regulation in a sector of the market which has grown significantly in recent years and affects many retail investors.</p> <p>There are also gaps in the oversight of Trustees. Given the reliance the regulatory framework places on Trustees for oversight of the operation of Unit Trusts and safekeeping of Unit Trust assets this is a matter of some concern. The SEC does not undertake regular in depth inspections of Trustees, although there has been a recent inspection focused on what the Review Team understands were infrastructure and IT systems issues. Nor are Trustees required to periodically provide reports to the SEC about the operation of Unit Trusts which could enable the SEC to review the efficacy of the Trustees’ oversight activities.</p> <p>The fact that a single entity acts as Trustee for 80% of Unit Trust Funds which together account for over 90% of Unit Trust industry AUM in Sri Lanka further amplifies this concern. Although the Review Team has no direct evidence that this level of concentration is impacting on the quality of that Trustee’s oversight, the SEC should use regular inspections to alleviate any concerns about the Trustee’s ability to effectively oversee these funds.</p> <p>These shortcomings should be addressed as a matter of priority.</p> <p>The Review Team also notes the definition of Unit Trust under the Unit Trust Code envisages an arrangement under which investors would be beneficiaries of the profit, income and capital gains of the trust. It does not provide for the passing through of potential losses associated with such investments.</p>
<b>Principle 25.</b>	<b>The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets</b>
Description	<p><b>Legal Form and investor rights</b></p> <p>Under Section 13(bb) and Section 31 of the SEC Act, the SEC grants licenses to a managing company to operate a Unit Trust. Managing companies are, in turn, formed and registered under the Companies Act, 1982.</p> <p><i>Responsibility and independence of Trustee</i></p> <p>A Trustee, approved by the SEC, is required to be appointed for each Unit Trust fund (Section 31 of SEC Act).</p> <p>The assets of a Unit Trust are required to be held by Trustees on behalf of the Unit Trust (Rule 7(1) of the UT Code). Managing companies are prohibited from buying or selling any securities in its own name (Rule 3(2) of UT Code).</p> <p>Trustees are responsible for ensuring that a Unit Trust is managed by the managing company in accordance with the regulatory provisions and its Explanatory Memorandum (Rule 7(2) of the UT Code).</p>

To ensure independence of the Trustee, Part IV of the Schedule to the SEC Act, requires the Trustee and the managing company of the Unit Trust to be separate legal entities and unrelated to each other.

The SEC Directive dated 7 January 2009 further lays down detailed conditions that would ensure independence of the Trustee from the Unit Trust's managing company, which *inter alia* include:

- a. Neither the Trustee nor the managing company shall be:
  - a holding or subsidiary of the other;
  - an associate of the other unless at least one third of its board of directors comprise of independent directors;
- b. No person shall simultaneously be an Executive Director of the boards or key personnel of the managing company and the Trustee;
- c. The Trustee shall be financially independent, and not reliant on, support from the managing company, except for transactions made in ordinary course of business.

Trustees of Unit Trusts in Sri Lanka are – as a matter of practice - banks licensed by the Central Bank of Sri Lanka. As noted, one entity acts as Trustee to 80% of the number of Unit Trusts funds in Sri Lanka accounting for 90% of the Unit Trust industry AUM in Sri Lanka.

#### **Disclosures**

The group structure of the Unit Trust's managing company and Trustee is required to be disclosed in the Explanatory Memorandum and the annual report of the Unit Trust (SEC Directive dated 7 January 2009).

To ensure that investors are aware of the risk associated with investing in the Unit Trust, each advertisement is required to be accompanied with a statement that “*the price of units and the income (where the Unit Trust pays a dividend) may fluctuate*” (Rule 18(5)(a) of UT Code).

Rule 16(2) of the UT Code requires that the Explanatory Memorandum contain disclosures that are adequate in order to enable the investors to make informed investment decisions.

#### **Responsibility for monitoring compliance with form and structure requirements**

As noted, the SEC has the power to grant a license to a managing company to operate a Unit Trust and to ensure the proper conduct of the business of such Unit Trust (Under Section 13 (bb) of the SEC Act). Part IV of the Schedule to the SEC Act set out terms and conditions to be complied with for granting of license to a managing company.

The SEC also has the power to cancel the license of a managing company in circumstances including those where the managing company of such Unit Trust has acted in breach of any provision of the SEC Act or any rules or regulations made thereunder (Section 31(D) of the SEC Act).

#### **Changes to investor rights**

Any material changes or addition of significant new matters in the Explanatory Memorandum are subject to the approval of SEC (Rule 17(1) of UT Code).

Further, changes that affect investor rights (including changes in managing company's annual charges and change in redemption methods) are required to be brought to the notice of the unit holders at least one month prior to taking effect (Rule 11(3) and Rule 22(3) of UT Code). Any unit holder not satisfied with change in redemption method is entitled to exit the Unit Trust without any exit fee being paid to the managing company (Rule 22(4) of UT Code).

Amendments to the Trust Deed and Explanatory Memorandum can also be made only with prior approval of the SEC, thus preventing discretionary changes by the managing company (s31(F) of SEC Act and Rule 17(1) of UT Code respectively).

### **Investment and borrowing restrictions**

Management companies are restricted from investing Unit Trust's funds in commodities, futures and options, real estate, foreign securities, assets which involve the assumption of unlimited liability, or such other investments as may be designated from time to time by the SEC, without the permission of the SEC.

Further, investments may not be undertaken for the purpose of gaining management control of a company in which the Unit Trust has purchased share capital. Restrictions are also imposed on the amount of leverage that a managing company may undertake (Rule 10(1) of UT Code).

There are also limits on the investments that can be made by a Unit Trust in single issuer's listed or unlisted equity and debt securities, their exposure to single bank rated above investment grade, unrated debt securities, investments in IPOs, offer for sale or rights issue issued by single issuer, among others.

Restrictions have also been placed on investments in quasi equity convertible securities, derivatives & warrants and exposure to banks (SEC directive dated 7 January 2009).

In order to assure ease of redemption, a level of liquidity amounting to at least 3% of the deposited property is required to be maintained in cash or near cash instruments (Rule 9(2) of the UT Code). To ensure that these restrictions are complied with, the SEC is empowered to peruse the interim and other reports of the company, or examine its accounts, books and records invoking its powers under the UT Code and SEC Act (Rules 28 and 31 of the UT Code).

Further, whenever the total investment made by the managing company, exceeds any limit permitted by the provisions of the UT Code or Trust Deed or any of the directives issued by SEC, the managing company is required to immediately inform SEC of such excess amount together with the reasons for the excess, and further inform of the steps that will be taken to reduce such investment to the limits as specified (Rule 9(3) of UT Code).

In practice, the SEC also checks compliance with investment restriction norms mandated for Unit Trusts by way of on-site inspection and off-site monthly portfolio reporting. However, no disciplinary action is observed to be taken by SEC, upon observing such non-compliances.

### **Separation of assets / safekeeping**

Trustees are responsible for the safe-keeping of the assets of the Unit Trust (Part IV of the schedules to the SEC Act and Rule 7(1) of UT Code). Managing companies are also required to maintain proper books of account for each Unit Trust fund.

There are no further regulatory requirements on a Trustee or a managing company to maintain adequate segregation of Unit Trust's assets from the assets of the managing company and its trustees, as well as other Unit Trust funds.

While there are no specific regulatory requirements in relation to the appointment of custodians and their independence, the Review Team noted that there are 6 Unit Trust funds, managed by a single managing company, in which the Trustee has appointed custodians for safekeeping of assets.

### **Winding up**

Rule 35 of the UT Code sets out the procedure for winding up of the business of the Unit Trust.

The Rule requires the Trustee to wind up a Unit Trust as follows:

	<ul style="list-style-type: none"> <li>• The Trustee must realize the deposited property of the Unit Trust, pay all liabilities therefrom, and retain provision for the cost of dissolution.</li> <li>• The Trustee must then distribute the proceeds of realization to unit holders and the managing company (upon production of evidence as to entitlement thereto), in a manner proportionate to their respective interests.</li> <li>• Unclaimed net proceeds or other cash held by the Trustee after the expiration of twelve months from the date on which the same became payable, less expenses incurred by the Trustee, must be paid to the Public Trustee.</li> </ul> <p>This rule also provides for a Unit Trust to be wound up on the direction of SEC, if the value of deposited property falls below an operationally viable level. All funds collected during the period of offer must be refunded, subject to provisions in the last published Explanatory Memorandum.</p> <p>This and other provisions of law generally applicable to winding-up ensure that the process is orderly, fair and equitable.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>The regulatory framework for collective investments in Sri Lanka sets out requirements about the structure of Unit Trusts, investor rights, investment restrictions and the orderly winding up of CIS business.</p> <p>However, the following are shortcomings, the significance of which is amplified by the lack of SEC's oversight on the activities of trustees (noted in IOSCO Principle 24), who are entrusted with safekeeping of Unit Trust's assets.</p> <p><b>Separation of Unit Trust's assets</b></p> <p>There are no regulatory requirements that Trustees or managing companies maintain adequate segregation of Unit Trust assets from the assets of the Trustee and managing company as well as from the assets of other Unit Trust funds.</p> <p><b>Appointment and use of custodians</b></p> <p>There are also no regulatory requirements or regulatory guidance on the use and appointment of custodians and their independence. Given the fact custodians have been appointed to hold assets of the unit trust in some cases, this is a matter of concern.</p>
<b>Principle 26.</b>	<b>Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.</b>
Description	<p><b>Disclosure to investors</b></p> <p><i>Offer document / Explanatory Memorandum</i></p> <p>The managing company of a Unit Trust is required to make a copy of the latest Explanatory Memorandum which has been approved by SEC, available to prospective investors to whom units in Unit Trusts are directly or indirectly being offered (Rule 16(1) of UT Code).</p> <p>The Explanatory Memorandum is required to contain disclosures that are adequate in order to enable an investor to make informed investment decisions (Rule 16(2) of UT Code).</p> <p>The Explanatory Memorandum of the Unit Trust is required to disclose the Unit Trust's group structure, valuation &amp; pricing methodology, fees &amp; expense that can be charged to Unit Trust fund, among other disclosures (Rules 11 and 12 of UT Code and SEC directive dated 7 January 2009 and 17 December 2013).</p>

The Explanatory Memorandum, which is intended to provide adequate disclosures to enable an investor take an informed decision, is required to set out such information in a manner that is easy to understand for investors.

While there are no regulatory norms providing for standard formats of the Explanatory Memorandum nor any guidelines or internal check-list on the minimum contents of offering documents, as a general practice, the Explanatory Memorandum, which is approved by SEC, discloses information regarding date of issuance of Unit Trust, its investment objective, investment policy, risk associated with concerned Unit Trust, rights of investors, investment & redemption procedures, among others.

Further, the Trust Deed is required to provide for the responsibility of Trustees, the method adopted for calculating issue price and redemption price, investment restriction, circumstances in which the redemption can be suspended, among others (Point (i) of Part IV of SEC Act).

The Trust Deed is required to be made available for inspection by the public, free of charge, and copies thereof made available upon payment of a reasonable fee (Rule 34 of the UT Code).

The audited financial information of a Unit Trust is required to be published bi-annually and in the annual report (Rules 27(1), 27(2) and 27(4) of UT code). Guidelines with respect to the contents of annual reports as well as of the Trust Deeds are set out in the UT Code and the SEC Act respectively.

#### *Material changes*

An Explanatory Memorandum must be kept up to date to take account of any material changes affecting the Unit Trust, or any significant new matter that should be stated therein (Rule 17(1) of the UT Code).

An Explanatory Memorandum of the Unit Trust must, however, also be reviewed by the managing company at least every two years (Rule 17(4) of UT Code).

The date on which any amendment was made to an Explanatory Memorandum is also required to be prominently displayed (Rule 17(2) of UT Code).

Any amendments to the Explanatory Memorandum can be made only with prior approval of SEC (Rule 17(1) of UT Code).

Also, upon modification in an Explanatory Memorandum, there is a requirement for the Board of directors of the managing company to provide a declaration that the information it contains is accurate and there are no other facts, which if omitted would make any statements misleading (Rule 17(3) of the UT Code).

#### *Periodic Reports / On-going disclosures*

Under Rule 27(1) of UT Code, the managing company is responsible for preparing and publishing the Unit Trust's reports in respect of each financial year, that includes annual reports, audited financial statements and an interim report for the first half-year. Under SEC directive dated 17 December 2013, the managing company of Unit Trust is required to prepare interim and year-end audited financial statements in compliance with Sri Lanka Accounting Standards (LKAS).

These reports are required to contain statements showing the assets and the liabilities of the Unit Trust, and further show the value of each asset (Rule 27(3) of UT Code). The annual report is also required to contain information regarding audited revenue accounts of the Unit Trust with the auditor's certificate, transactions with associate entities, unclaimed redemption details, among other disclosures.

The annual reports and audited financial statements, approved by Trustees and SEC, are required to be published and distributed by the managing company to unit holders, within three months from the end of the Unit Trust's financial year (Rule 27(2) of UT Code).



Interim reports, approved by Trustees and SEC, are required to be published in at least one leading Sri Lankan newspaper and/or distributed to unit holders within three months of the period they cover (Rule 27(2) of UT Code).

Further, in case a unit holder has elected to reinvest dividends from his/her Unit Trust investments into additional units of Unit Trust, the concerned managing company has to send a statement to such investor, at least once in every year, disclosing the amount of dividends reinvested (Rule 27(5) of UT Code).

#### *Role of the SEC*

No entity can issue or publish an Explanatory Memorandum or advertisement inviting the public to invest in a Unit Trust, unless such person has been licensed as a managing company of such Unit Trust and has obtained prior approval of SEC for the contents of such Explanatory Memorandum or advertisement and for its issue or publication (Section 31(I) of SEC Act).

A managing company can offer or sell units in a Unit Trust to an investor only when a copy of the latest Explanatory Memorandum that has been approved by SEC, is made available to such prospective investor (Rule 16(1) of UT Code). While approving an Explanatory Memorandum, SEC can direct the managing company to carry out modifications in the Explanatory Memorandum as it deems fit, in the interest of investors (Rule 16(3) of UT Code).

Updated Explanatory Memoranda are also required to be approved by the SEC.

Rule 28(1) of the UT Code also mandates that all reports produced by or for the Unit Trust are filed with SEC for approval, two weeks prior to dissemination of such information to unit holders.

The SEC advises that it has not identified any irregularity that the information contained in Explanatory Memorandum is inaccurate, misleading, or false, or does not satisfy the filing/approval requirements or is non-compliant in nature. However, if such irregularity is found, as a practice, SEC would write to the respective management company seeking clarifications on the same.

#### **Advertising**

Unit Trust advertisement is defined by the UT Code to include any invitation appearing in media inviting persons directly or indirectly to subscribe to or purchase units in a Unit Trust (Rule 40 of UT Code).

An advertisement of a Unit Trust can be published by the managing company only after approval of the Trustee, with a copy of the Trustee approved advertisement filed with the SEC five days prior to its publication (Rules 18(1) and 18(2) of UT Code).

A Trustee shall approve an advertisement if it conforms to the advertising guidelines issued by the SEC from time to time (Rule 18(6) of UT Code). Further, the SEC has the right to comment or stop any advertisement so filed from being published (Rule 18(2) of UT Code).

All Unit Trust advertisements are required to be accompanied by a statement that "Price of units and the income (where Unit Trust pays dividend) may fluctuate". Advertisements that quote achieved yield or current yield are required to include a statement that "figures shown are not indicative of future performance" (Rule 18(5) of the Unit Trust Code). Forecasts of the Unit Trust's performance are prohibited from being held out to the public or to unit holders (Rule 18(3) of UT Code).

Advertisements are also required to include a statement that a copy of the Explanatory Memorandum can be obtained on written request and provide instructions on how it can be obtained (Rule 18 (5) of UT Code).

SEC Act (Section 51(1)(b)) provides an overarching rule that a person furnishing information or statement under the SEC Act and rules made there under, whose contents, to his knowledge are untrue, incorrect or misleading, shall be guilty of an offence under this Act. However, there are no specific advertising related rules or guidelines prohibiting or preventing the managing company of Unit Trust

	<p>from publishing inaccurate, false or misleading advertisements. When instances of misleading advertisements have been identified in the past, the SEC has limited its actions by not approving such advertisement and directing managing company to withdraw such advertisements.</p> <p><b>Investment policy or trading strategy</b></p> <p>Managing companies are required to make investment decisions and invest the deposited property of the Unit Trust fund, in accordance with the provisions of the SEC Act, UT Code, directives and also in accordance with the Trust deed, the last published Explanatory Memorandum and the objectives of the Unit Trust fund mentioned therein (Rules 2(1), 2(2) and 9(1) of UT Code).</p> <p>Trustees are also required to take reasonable care to ensure the Unit Trust is managed by the managing company in accordance with regulatory provisions, the Trust Deed and managing company's last published Explanatory Memorandum (Rule 7(2) of UT Code).</p> <p>Further, managing companies are required to inform the SEC, whenever the total investment made by the managing company, exceeds permissible regulatory limits, along-with reasons thereof (Rule 9(3) of UT Code).</p> <p>In the event of non-compliance by a managing company with regulatory guidelines on investments by Unit Trust funds, they shall be guilty of an offence under the Act (Rule 39 of UT Code) and as per Section 31D of SEC Act, SEC has the power to cancel or suspend the license granted to managing company to operate a Unit Trust if it is satisfied that the managing company of such Unit Trust has acted in breach of any regulatory provisions.</p> <p>The SEC seeks to ensure that Unit Trusts are investing in accordance with investment policies, through off-site monitoring of a Unit Trust based on monthly portfolio statement of Unit Trust provided by managing companies to the SEC as well as by conducting on-site inspections.</p> <p>Upon identifying any discrepancy in compliance with investment requirements, the SEC indicates it has sought clarification from the management company and provided a time for the discrepancy to be addressed. Other remedial action has not been taken.</p>
Assessment	<b>Broadly Implemented</b>
Comments	<p>The regulatory framework for collective investments in Sri Lanka generally sets out requirements about the disclosure of material information to investors in offering documents, periodic reports and also advertisements.</p> <p>However, there are a number of shortcomings:</p> <p><b>Standard formats for offering documents:</b></p> <p>While offering documents approved by the SEC are required to contain relevant and up to date material information which would enable an investor make an informed decision, there are no requirements for information be provided in a standard format.</p> <p><b>Regulation of advertising</b></p> <p>Guidelines on advertising are limited to requirements about disclosing risk disclaimers and disclosing the fact that past yield is not indicative of future performance.</p> <p>The SEC has yet to provide detailed guidelines about the content and form of advertisements. This has led, in some cases, to additional expense and unexpected delay in launching marketing campaigns for Unit Trusts.</p> <p>Guidance on the form and content of advertising would give industry more certainty in preparing marketing materials for Unit Trust funds.</p>

	<p>There are no provisions prohibiting or dealing with the publication of advertisements that are inaccurate, false or misleading. The SEC’s only power is directing the withdrawal and revision of such advertisements.</p> <p>The RT notes the SEC’s advice that preparation of guidance on the form and content of advertising was prepared after the onsite visit and is awaiting input from industry stakeholders. The RT also notes the SEC’s advice that a standard format for offering documents is also being prepared.</p>
<b>Principle 27.</b>	<b>Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme</b>
Description	<p><b>Asset valuation</b></p> <p>Valuation of Unit Trust’s portfolio securities is primarily governed by Rule 20 of the UT Code and SEC directive dated 17 December 2013.</p> <p><i>Principles for valuation</i></p> <p>Rule 20 (1) of the UT Code requires Net Asset Value (NAV), which forms the basis for computing issue and redemption price, to be calculated on a daily basis. Further, Rule 20 (2) of the UT Code requires the valuation of unlisted securities to be determined by the managing company of the Unit Trust, on a regular basis.</p> <p>SEC Directive dated 17 December 2013 requires all fixed income securities to be valued on a mark-to-market basis. Money Market Funds’ (MMF) underlying portfolio, repo investments and bank deposits are required to be valued at cost plus accrued interest basis.</p> <p>This SEC Directive also requires all interim and year-end audited financial statements to be prepared in compliance with Sri Lanka Accounting Standards (SLFRS’s).</p> <p>Fair valuation of assets is also provided under SLFRS 13 that defines fair value as “<i>the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date</i>”. SLFRS 13 sets out a framework for measuring fair value of an asset and also requires valuation techniques used to measure fair value of an asset, to be applied on consistent basis.</p> <p><i>Valuation Method</i></p> <p>In order to ensure uniformity and accuracy in valuation of Unit Trust’s portfolio securities, SEC Directive dated 17 December 2013 further provides for daily valuation methods, primarily for valuing fixed income instruments in Unit Trust funds. Specifically:</p> <ul style="list-style-type: none"> <li>• Government securities should be valued on mark to market basis using daily yield curve released by Central Bank of Sri Lanka (CBSL).</li> <li>• Quoted debt securities should be valued at the last traded price. In case there has been no trade in such quoted debt securities for 90 days, valuation will be on mark to market basis.</li> <li>• All other unquoted and unlisted fixed income securities should be valued on mark to market basis using daily yield curve released by CBSL, plus the risk premium attached to the instrument.</li> </ul> <p><i>Money Market Mutual Fund</i></p> <p>MMFs are subject to different rules for valuation of their underlying portfolio.</p> <p>Money Market Funds, that invest only in short term liquid fixed income securities with a maturity period of less than 366 calendar days, are permitted to be valued on cost plus accrual interest method, as per SEC directive dated 17 December 2013.</p>

It is noted that, AUM of MMF schemes has seen an almost three-fold increase in last 2 years (increased from Rs. 19.2 billion as on year ended 2013, to Rs. 60.3 billion).

#### *Auditing requirement*

Financial statements of Unit Trusts are subject to the auditing requirements imposed under Rule 28 of UT Code

The auditor of a Unit Trust is required to prepare a report, for distribution to unit holders, stating that the accounts have been audited in accordance with approved auditing standards, and disclosing whether or not in the auditor's opinion, they give a true and fair view of the financial position of the Unit Trust (Rule 32 (4) of UT Code).

While, as per Rule 32 (2) of UT Code, an auditor of the Unit Trust should not have been the auditor of the managing company or Trustee during the past 2 years, there is no specific regulatory requirement for such an auditor to be independent from the managing company or the Trustee.

#### **Pricing and redemption of interests**

##### *Requirement*

Rule 20 (1) of the UT Code requires issue and redemption prices to be calculated based on the Unit Trust's Net Asset Value divided by the number of units outstanding.

Further, Rule 20(3) of the UT Code requires the issue price of a unit to be the maximum price payable on purchase of units inclusive of any front end fees and the redemption price to be the minimum net price after exit fees if any, receivable upon redemption of units. No further charges are to be paid by the unit holder, apart from stamp duty or other taxes.

##### *Disclosure*

SEC directive Dated 17 December 2013 requires disclosure of the valuation policy in the Explanatory Memorandum in order to inform a prospective unit holder of the daily valuation method. Also, the method adopted for calculating issue price and redemption price, is required to be disclosed in Trust Deed (Point (i)(iv) of Part IV of schedules to SEC Act).

Further, Rule 20(4) of the UT Code requires the latest available offer and redemption prices or the NAV of a Unit Trust to be published, in at least one leading Sri Lankan daily newspaper or on the web site of the managing company.

The financial reports of each Unit Trust are also required to provide disclosure on value and source of valuation of each quoted asset; and description of each unquoted assets along-with its value (Rule 27(3) of UT Code).

##### *Pricing errors*

Pricing errors, when observed, need to be addressed at the earliest possible by way of deferral of dealing in the concerned Unit Trust (Rule 22(1) of UT Code).

If the price of a Unit Trust deviates from the underlying assets by more than 5%, the rule requires the managing company to defer dealing in concerned Unit Trust and calculate a new price of a Unit Trust as soon as possible.

Further, there is a general requirement that requires a managing company to exercise reasonable care in the operations relating to the management of the Unit Trust and places liability on the managing company in case of any loss suffered by the Unit Trust or by unit holders as a result of any fraud, gross negligence or malfeasance of employees and directors (Rule 4 of UT Code).

However, there is no specific regulatory requirement that a managing company compensate affected investors as a result of such pricing error.

	<p><i>Suspension / deferral of redemptions</i></p> <p>Suspension / deferral of redemptions is primarily governed by Rule 23 of the UT Code.</p> <p>Suspension of dealing in Unit Trust is provided for only in exceptional circumstances, having regard to the interest of unit holders. Suspension of redemption requires written approval of the Trustees and the SEC (Rule 23(1) of UT Code). The circumstances in which redemption can be suspended, are required to be disclosed in Trust Deed (Point (i)(v) of Part IV of SEC Act) and the copy of such Trust Deed is to be made available to investors, upon request.</p> <p>When circumstances arise that would require redemptions to be suspended, the managing company is required to immediately notify and seek written approval from the SEC setting out reasons for so doing. Investors are also required to be notified that the Unit Trust has suspended dealing through newspapers, at least once a month during the period of suspension. (Under Rules 23 (1) and 23 (2) of UT Code).</p> <p>Changes in redemption rights, can be made only in exceptional circumstances, having regard to the interests of unit holders and if the possibility of such change in redemption right along-with the circumstances in which it can be changed, has been fully disclosed in the Explanatory Memorandum (Rule 22 (2) of UT Code).</p> <p>Further, to facilitate liquidity management by a Unit Trust, specific circumstances have also been prescribed in the UT Code on deferred dealing and requirement of notice period towards redemption. Under these rules where redemption requests on any dealing day exceed 10% of the total number of units of the fund, redemption of the amount in excess of the 10% can be deferred to the next dealing day, provided the SEC is notified in writing of such deferral (Rule 23(3) of UT Code).</p> <p>Where a unit holder wishes to redeem units which amount to more than 3% of the net asset value of the Unit Trust, the unit holder is required to give at least fourteen days written notice to the managing company (Rule 23(4) of UT Code).</p> <p>In normal circumstances, redemption proceeds are required to be paid to investors within one calendar month from receipt of properly document redemption request. Managing companies are accountable for failure to pay redemption proceeds within stipulated time, and in such case, SEC needs to be notified about such delay along-with reasons thereof (Rule 21 of UT Code). However, it is the practice within the industry to pay the redemption proceeds to the investors within 14 days from receipt of the redemption requests.</p> <p><b>Regulatory authority to monitor compliance</b></p> <p>SEC has the power to examine all accounts, books and records that are required to be maintained by a managing company at any point of time, under Rule 31 of the UT Code. Further, the check list for on-site inspections conducted by SEC includes inspecting valuations of Unit Trusts' underlying assets, creation and redemption prices, interval between redemption requests and redemption payments. The on-site inspections conducted by SEC also take into consideration, for instance valuation and redemption related issues identified during off-site monitoring, complaint received.</p> <p>Violations of regulatory norms law relating to valuation and pricing of Unit Trust are taken note of by SEC, which may, in accordance with SEC's powers and functions, discipline the relevant managing company or enforce the relevant law. Failure to comply with regulatory norms may also lead to cancellation of license of a Unit Trust, which is found guilty of an offence under the SEC Act.</p> <p>While instances of non-compliance with valuation and pricing requirements have been identified by the SEC, no specific regulatory action has been observed to be taken by SEC in this regard.</p>
Assessment	<b>Partly Implemented</b>
Comments	A regulatory framework is in place covering the valuation, pricing and redemption of units in collective investment schemes in Sri Lanka.

	<p>However, there are a number of significant shortcomings. Specifically:</p> <p><b>Securities to which the framework applies</b></p> <p>While the regulatory framework requires fair valuation of fixed income securities and regular valuation of unlisted securities, there are no requirements for fair valuation of unlisted, non-traded or thinly traded equity securities.</p> <p><b>Money Market Funds (MMFs)</b></p> <p>MMFs which invest in securities with a maturity period of less than 366 days, are permitted to be valued on cost plus accrual method. This valuation model for MMFs is not fully in line with IOSCO Policy Recommendations for Money Market Funds under which amortized cost method should only be used in limited circumstances<sup>8</sup>.</p> <p>Given the rise in the number and asset value of MMF's in recent years and the fact that some at least are investing in low quality paper, these valuation issues – although not currently covered directly by Principle 27 - are a matter of concern.</p> <p><b>Auditing requirements</b></p> <p>There is no specific requirement for an auditor to be independent and not associated with the managing company or the Trustee. Further, there is no specific requirement for valuation policies and procedures to be regularly reviewed by an independent auditor, in order to ensure their appropriateness.</p> <p><b>Pricing errors</b></p> <p>The only express requirements in relation to pricing errors are requirements around deferral of dealing. Investors are not required to be compensated. Managing companies are, however, required to exercise reasonable care in all operational matters, are liable in case of any loss suffered by the Unit Trust as a result of any fraud or gross negligence and must defer dealings if the price of a Unit Trust deviates from the value of underlying assets by more than 5%.</p> <p><b>Suspension of redemptions</b></p> <p>There are no regulatory requirements about the maximum period for which redemptions can be suspended.</p> <p>The RT notes the SEC's advice that the value at risk framework the CSE plans to adopt is intended to address shortcomings in relation to non-traded and thinly-traded securities.</p>
<b>Principle 28.</b>	<b>Regulation should ensure that hedge funds and/or hedge funds managers/advisor are subject to appropriate oversight</b>
Description	<p>There are no hedge funds, either domestic or foreign, in operation in Sri Lanka, and no provision is made in the SEC Act for their establishment or prohibiting them.</p> <p>Rule 10 of the UT Code, furthermore, precludes managing companies of unit trust from investing in the types of assets in which hedge funds would invest and their activities (including futures and options and leveraging), unless approval for such investments had been provided by the SEC.</p>

<sup>8</sup> This applies to, for example, maximum residual maturity of a money market instrument that uses amortized cost accounting, which IOSCO recommends to be 90 days for money market funds.

	Neither the Act, nor the UT Code set out the particular requirements contemplated by this Principle, should the SEC choose to permit these investments to be made by a hedge fund.																
Assessment	<b>Not Implemented</b>																
Comments	<p>Sri Lanka currently has no regulatory framework to deal with hedge fund activities.</p> <p>There are no regulatory provisions prohibiting the launch of hedge funds or marketing of foreign hedge funds in Sri Lanka nor are there requirements which expressly contemplate registration of hedge funds being conducted and marketed in Sri Lanka.</p> <p>The RT notes the SEC advice that these shortcomings are intended to be addressed by revisions to the CIS Code currently being developed by the SEC which will expressly provide for the operation and regulation of hedge funds.</p>																
<b>Principles for Market Intermediaries</b>																	
<b>Principle 29.</b>	<b>Regulation should provide for minimum entry standards for market intermediaries</b>																
Description	<p><b>Regulatory Framework</b></p> <p>The SEC currently regulates four types of entities: (i) stock exchanges; (ii) stockbrokers or dealers; (iii) managing companies of unit trusts; and (iv) market intermediaries. Market intermediaries comprise investment managers, margin providers, underwriters, credit rating agencies, and any person who performs the functions of a clearing house.</p> <p>The SEC operates a licensing regime for the entities in categories (i) to (iii), and a registration regime for market intermediaries. An entity that carries on two or more roles (e.g. stockbroker and investment manager) will have to be separately licensed or registered for each of the roles.</p> <p>For the purposes of the Principles for Market Intermediaries, the following entities are considered in scope:</p> <table border="1" style="margin-left: 40px;"> <thead> <tr> <th colspan="2" style="background-color: black; color: white; text-align: center;"><b>Under the Licensing Regime</b></th> </tr> </thead> <tbody> <tr> <td style="width: 30%;">Stockbrokers</td> <td>Undertake agency brokerage business and may carry on proprietary trading up to the limits prescribed in the Stockbroker Rules.</td> </tr> <tr> <td>Stock dealers</td> <td>Undertake proprietary trading.</td> </tr> <tr> <th colspan="2" style="background-color: black; color: white; text-align: center;"><b>Under the Registration Regime</b></th> </tr> <tr> <td>Managing companies of unit trusts</td> <td>Manage pooled funds that are structured in the form of a unit trust.</td> </tr> <tr> <td>Investment managers</td> <td>Undertake discretionary or non-discretionary portfolio management for clients under segregated mandates.</td> </tr> <tr> <td>Margin providers</td> <td>Provide credit to investors to purchase listed securities.</td> </tr> <tr> <td>Underwriters</td> <td>Entering into underwriting agreements to purchase securities which are the subject of a public offer made by a listed company or a listing candidate, in the event the offer is not fully subscribed.</td> </tr> </tbody> </table>	<b>Under the Licensing Regime</b>		Stockbrokers	Undertake agency brokerage business and may carry on proprietary trading up to the limits prescribed in the Stockbroker Rules.	Stock dealers	Undertake proprietary trading.	<b>Under the Registration Regime</b>		Managing companies of unit trusts	Manage pooled funds that are structured in the form of a unit trust.	Investment managers	Undertake discretionary or non-discretionary portfolio management for clients under segregated mandates.	Margin providers	Provide credit to investors to purchase listed securities.	Underwriters	Entering into underwriting agreements to purchase securities which are the subject of a public offer made by a listed company or a listing candidate, in the event the offer is not fully subscribed.
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**Stock exchange, clearing house and credit rating agencies are addressed in other Principles.**

As at 31 July 2016, the total number of licensees and registrants supervised by the SEC was as follows:

<b>Number of Licensees and Registrants</b>	
<b>Licensees:</b>	
Stockbrokers	33
Stock dealers	14
Managing Companies of Unit Trusts	14
<b>Registrants:</b>	
Investment Managers	32
Margin Providers	31
Underwriters	9

**Licensing and Registration Requirements**

Under sections 15 and 31 of the SEC Act, any body corporate which is carrying on or intends to carry on the business of operating a **stock exchange** or any person who is carrying on or who intends to carry on the business of a stockbroker, a stock dealer or a managing company of unit trusts shall make an application to the SEC for the grant of a license. The license for stockbrokers and dealers is valid for a period of one year and must be renewed annually. Managing company licenses are valid for the fund's life.

Under section 19A of the SEC Act, any person who is carrying on or who intends to carry on business as a market intermediary shall register with the SEC for such purpose. The certificate of registration is valid for a period of one year and must be renewed annually.

The grant of a license or registration by the SEC is subject to the applicant's fulfillment of the minimum net capital and liquidity requirements, the requirements pertaining to the its legal status and financial standing as well as the credential and past conduct of its directors and employees who deal with clients.

Proposed revisions to the SEC Act seen by the Review Team contemplate all entities caught by the definition of market intermediaries being licensed.

**Eligibility Criteria**

**Stockbrokers/dealers**

Sections 17 and 18 of the SEC Act provide that no license shall be granted to any body corporate or individual to act as a stockbroker/dealer unless the body corporate or individual complies with the requirements in Part II and Part III of the Schedule to the SEC Act.

Part II of the Schedule to the SEC Act requires a corporate applicant to meet the following requirements:

- The applicant must be a member of a stock exchange licensed under the SEC Act;
- The applicant must be a company incorporated under the Companies Act;
- The directors of the applicant:
  - Have never been declared bankrupt;
  - Have never been themselves, or been directors of a company that has been, denied a license as a stockbroker/dealer; or



- Have never been themselves, or been directors of a company whose license as a stockbroker/dealer had been, removed by the appropriate authority;
- All the applicant's executive directors and employees, who will be dealing with clients on its behalf, have been trained and certified by the licensed stock exchange;
- The applicant has lodged security in such sum as may be determined by the Minister having regard to the value of transactions that are likely to be carried on by the applicant (or an equivalent in bank guarantee) with a licensed stock exchange.

Part III of the Schedule to the SEC Act sets out the eligibility criteria for an applicant who is an individual. Thus far, the SEC has not licensed any individual as a stockbroker/dealer.

Article 4 of the CSE' Articles of Association states that an applicant intending to carry on the business of a stockbroker/dealer is required to obtain a membership of the CSE. Article 5 set out the eligibility criteria for a membership, which are essentially the same as those set out in Parts II and III of the Schedule to the SEC Act.

A stockbroker (being a member of the CSE) must comply with the Stockbroker Rules which require it to have, among other things, an appropriate organizational structure (with adequate human resources, management information reporting system and operating procedures – see details in IOSCO Principle 31). Stock dealers, which trade on their own account, are subject to Rule 7.2 of Stockbroker Rules which sets out requirements on trading procedures, net capital, investments, reporting requirements and conflict of interest.

Under section 29 of the SEC Act, stockbrokers/dealers are not permitted to trade or deal in listed securities outside the licensed stock exchange that it is a member without the prior approval of the SEC.

#### **Managing Companies of Unit Trusts**

Section 31A of the SEC Act provides that no license shall be granted to a managing company to operate a unit trust unless (a) the trustee has been approved by the SEC, and (b) the requirements in Part IV of the Schedule to the SEC Act are met. Part IV of the Schedule to the SEC Act sets out the following requirements:

- The trustee and the managing company of the unit trust are separate persons;
- The trustee is not a connected person of the managing company;
- The managing company is a company formed and registered under the Companies Act or a company duly incorporated or formed under the statute of any foreign country;
- The managing company has the necessary professional experience and is financially sound;
- The directors of the managing company are fit and proper persons;
- An explanatory memorandum has been prepared by the managing company and approved by the SEC;
- The trustee must be approved by the SEC;
- The trust deed between the managing company and trustee creating the trust must be approved by the SEC; and
- The trust deed must contain a set of prescribed provisions relating to the governance and operation of the unit trust (see details in Principle 24).

### **Registered Market Intermediaries**

Section 19A of the SEC Act provides that no person shall be registered as a market intermediary unless the person complies with the requirements in Part V of the Schedule to the SEC Act: The following requirements apply to an applicant which is a body corporate:

- The applicant is a company formed and registered under the Companies Act or a company duly incorporated or formed under the statute of any foreign country;
- The applicant's directors:
  - Have never been declared bankrupt;
  - Have never been persons, or been directors of a Company whose registration as a market intermediary or license as a stockbroker, stock dealer or managing company of a unit trust has been, cancelled or suspended by the SEC;
- All the applicant's directors and employees who will be dealing with clients on behalf of the applicant possess such adequate qualifications and training as may be determined by the SEC from time to time;
- The applicant is in good financial standing; and
- The applicant meets any other criteria that may be imposed by the SEC from time to time.

Part V of the Schedule to the SEC Act also sets out the eligibility criteria for an individual applicant seeking to be registered as an investment manager. Thus far, the SEC has not registered any individual as an investment manager.

Under the Standards for Investment Managers and Margin Providers, every director or employee (who deal with clients) of an investment manager or margin provider must possess either: (i) an academic qualification acceptable to the SEC and at least two years of experience in the financial or securities market, or (ii) at least seven years of experience in the financial or securities market. An investment manager and a margin provider must have at least two such qualified personnel. The SEC may direct an increase in the number of such qualified personnel on account of the firm's volume of business.

Under the Standards for Underwriters, an underwriter must have a minimum of two employees who possess either: (i) an academic qualification acceptable to the SEC and at least two years of experience in underwriting activities, or (ii) at least five years of experience in underwriting activities.

Proposed revisions to the SEC Act seen by the Review Team contemplate a more detailed definition of eligibility criteria and extending the class of individuals required to satisfy those criteria to include, inter alia, 'controllers'.

### **Licensing/Registration Process**

The SEC does not have documented operating procedures for the review of license and registration applications. Such applications are assessed by the staff of the SEC's Supervision Division and approved by Director (Supervision). The assessment comprises (i) a financial review of the applicant, and (ii) a legal review of the qualification, experience, and fitness and propriety of the applicant's directors and employees who deal with clients, as well as the applicant's compliance with the applicable legislations and rules. Applicants seeking to be licensed to be stockbrokers/dealers have to obtain a confirmation from CSE on their membership. The SEC generally takes about 14 days to process a license or registration application.

**Renewal of License or Registration**

The criteria for initial licensing or registration are also applicable to an application for renewal of license or registration. A stockbroker/dealer or registered market intermediary may, three months prior to the expiry of the license or registration, submit a renewal application to the SEC. In deciding whether to grant renewal, the SEC will consider whether the licensee or a registrant has contravened the SEC Act and related instruments.

**Refusal, Cancellation or Suspension of License or Registration**

The SEC has powers under the SEC Act to refuse to (i) grant or renew a license in respect of a stockbroker/dealer (section 19) or a managing company of unit trusts (section 31C), and (ii) grant or renew the registration of a market intermediary (section 19A).

Under sections 21 and 21A of the SEC Act, the SEC may suspend or cancel the license of a stockbroker/dealer or the registration of a market intermediary where:

- The intermediary is in breach of any provisions of the SEC Act or related instruments; or
- The intermediary has ceased to be of good financial standing; or
- The intermediary has since the grant of the license or registration, been disqualified for the grant of such license or registration; or
- The intermediary is guilty of malpractice or irregularity in the management of its affairs.

Under section 31D of the SEC Act, the SEC may suspend or cancel the license of a managing companies of unit trusts where:

- The managing company of such unit trust is in breach of any provisions of the SEC Act or related instruments; or
- The managing company of such unit trust has ceased to be of good financial standing;
- The managing company of such unit trust has been dismissed by the trustee of a unit trust; or
- The approval granted to the trustee of such unit trust has been withdrawn by the SEC under section 31B and a new trustee has not been approved by the SEC.

Prior to the refusal, suspension or cancellation of a license or registration, the intermediary is entitled to show cause as to why its license or registration should not be cancelled or suspended (ss. 21 and 31D of the SEC Act). Any person aggrieved by the SEC's decision to (i) refuse to grant a license or registration (or its renewal), or (ii) suspend or cancel the license and registration, may appeal against such decision to the Court of Appeal within 14 days from the date on which the decision was communicated to the applicant (s 22 of the SEC Act).

Although the SEC has the powers to bar a person (for a specified period of time or permanently) from acting as a director or dealing with investors in respect of market intermediaries, such powers do not extend to stockbrokers/dealers and managing companies of unit trusts. In the case of stockbrokers, the CSE may mete out disciplinary action against an employee of a stockbroker, including suspending or canceling the certification issued to such employee to deal with investors (Rule 11.3.8(2) of the Stockbroker Rules). However, the CSE does not have similar powers in respect of the directors of stockbrokers.

**Ongoing Requirements****Stockbrokers/Dealers**

Stockbrokers/dealers are required to comply with the requirements in the SEC Act (and related instruments) as well as the Stockbroker Rules. The Stockbroker Rules cover operational

requirements, trading practices and conduct, dealings with clients' money, capital requirements, rules for agents other business activities, minimum standards, supervisory rules, client-stockbroker dispute resolution and disciplinary procedures.

### **Managing Companies of Unit Trusts**

Managing companies of unit trusts are required to comply with the requirements under the SEC Act and the Unit Trust Code (see details in Principle 24).

### **Market Intermediaries**

Market Intermediaries are required to comply with the requirements in the SEC Act as well as the General and Specific Regulatory Standards for Registered Market Intermediaries. These Standards were promulgated as Directives under the SEC Act and treated by the SEC as having the status of action under the SEC Act for the purposes of exercising enforcement and supervision powers.

The Standards cover the following:

- Fitness and propriety of directors;
- Minimum qualifications for persons dealing with clients;
- Reporting requirements;
- Minimum net capital and liquidity requirements;
- Regulatory compliance and internal controls;
- Corporate governance;
- Safe custody of clients' monies; and
- Record keeping and confidentiality.

### **Material Changes**

#### **Changes to particulars previously furnished to the SEC**

Under sections 25 and 31G of the SEC Act, stockbrokers/dealers and managing companies of unit trusts which are proposing to alter any material particulars previously furnished to the SEC, or intending to undergo any changes from the state specified in its application for a license, are required to inform the SEC and obtain its prior approval for the alteration or change. Registered market intermediaries are subject to similar notification requirement under section 25(1A) of the SEC Act but are not required to obtain prior approval from the SEC for the alteration or change.

#### **Changes to shareholding structure**

Stockbrokers/dealers are required to obtain prior approval from the SEC and CSE for any change in its shareholding (section 25 of the SEC Act and Rule 2.20 of the Stockbroker Rules). Managing companies are subject to a similar requirement (section 31 G of the SEC Act).

Investment managers (under Rule 16 of Standards for Investment Managers), margin providers (under Rule 7 of the Standards for Margin Providers) or underwriters (under Rule 6 of Standards for Underwriters) are also required to immediately notify the SEC of any changes in shareholdings that would result in a person holding more than 20% shareholding in the entity. However, market intermediaries are not required to obtain prior approval from the SEC for such shareholding changes.

	<p><b>Notification of Material Events</b></p> <p>A market intermediary is required to notify the SEC of the occurrence of the following events under Rule 22 of the General Regulatory Standards for Registered Market Intermediaries:</p> <ul style="list-style-type: none"> <li>• If the market intermediary is in the course of being wound up or otherwise dissolved whether within or outside Sri Lanka or ceases to carry on the business to which the registration relates;</li> <li>• Where the market intermediary has failed to comply with the provisions of the SEC Act, Part V to the Schedule of the SEC Act and the standards stipulated or any other Directive issued by the SEC;</li> <li>• Where any information or document furnished to the SEC is false or misleading; or there is any change in any information or document furnished to the SEC;</li> <li>• Where any execution against the market intermediary in respect of a judgement debt has been returned unsatisfied in whole or in part;</li> <li>• Where a receiver, liquidator or an equivalent person has been appointed in respect of any property of the market intermediary;</li> <li>• Where the market intermediary whether within or outside Sri Lanka has entered into a compromise or scheme of arrangement with its creditors being a compromise or scheme of arrangement that is still in operation;</li> <li>• Where the directors, or the chief executive officer has been convicted of any offence involving fraud or dishonesty or a violation of securities law within or outside of Sri Lanka; or</li> <li>• The market intermediary becomes an undischarged bankrupt.</li> </ul> <p>There are however no comparable requirements for stockbrokers/dealers and managing companies of unit trusts.</p> <p><b>Publicly available information</b></p> <p>The laws administered by the SEC and any changes therein are published in the official Gazette of Sri Lanka, and are readily available on the SEC website for public access. The SEC website sets out a list of intermediaries regulated by the SEC according to their license or registration category. The website does not contain information on the identity of senior management and names of other individuals who are authorized to act in the name of the intermediaries.</p> <p><b>Investment Advisers</b></p> <p>In Sri Lanka, investment managers which undertake discretionary or non-discretionary portfolio management under segregated mandates (pursuant to powers of attorney granted by the clients) are regulated as market intermediaries and subject to the authorization and ongoing requirements as described above.</p> <p>Financial planners and advisers which provide financial advisory services (i.e. engage in the business of analyzing the financial circumstances of another person and providing advice on investment products to meet the person’s needs and objectives) are currently not subject to any regulation.</p>
Assessment	<b>Partly Implemented</b>
Comments	Although the fundamental aspects required in relation to the authorisation standards and on-going requirements for intermediaries are covered by the existing legislative framework, the Review Team has identified the following main areas of concern:

	<ul style="list-style-type: none"> <li>• The SEC currently operates the licensing regime and registration regime in parallel. Although the two regimes are designed to operate in a similar manner, there is a lack of consistency and uniformity in terms of the requirements that are applied on similarly situated intermediaries under the two regimes. For instance, managing companies of unit trusts are not subject to some of the fundamental requirements that are applied on investment managers (e.g. requirements to have in place adequate internal controls and risk management processes, compliance function and effective complaint handling procedures) even though both sets of intermediaries undertake portfolio management. There are also differences in the scope of SEC’s powers in relation to licensees and registrants (see details below). Proposed revisions to the SEC Act are intended to address this concern.</li> <li>• Investment banks (including corporate finance advisers) and financial planners and advisers in Sri Lanka are currently not subject to any regulation. Investment banks provide advice to corporates in respect of fundraising and listing matters – these are areas where there is a strong public interest element. At the other end of the spectrum, financial planners and advisers who normally deal with the general public present significant market conduct risks (e.g. providing poor quality advice, mis-selling, product pushing, etc.). The absence of direct regulation of these entities is a serious gap that requires urgent rectification. Proposed revisions to the SEC Act are intended to address this concern.</li> <li>• Gaps in admission requirements and review process may impinge on the SEC’s ability to effectively and comprehensively assess the suitability of an applicant. For example: <ul style="list-style-type: none"> <li>○ While the SEC requires the directors of an applicant to be fit and proper, this requirement does not apply to the shareholders of the applicant. Proposed revisions to the SEC Act are intended to address this concern.</li> <li>○ The fit and proper criterion is presently a high level concept. There is little guidance on how this criterion is to be applied and assessed in practice. Proposed revisions to the SEC Act are intended to address this concern.</li> <li>○ There are no documented operating procedures to guide SEC staff in the review of license or registration applications. The reviews undertaken by SEC staff focus mainly on the applicants’ compliance with prudential requirements, with little emphasis on assessing the adequacy of the applicants’ internal organization, risk management, supervisory systems and compliance arrangements. The SEC also does not conduct on-site visits prior to licensing or registration to check that the applicants are properly set up and validate representations made by the applicants (such as physical premises, staffing, technical infrastructure, etc.).</li> <li>○ The SEC relies mainly on declarations by the applicants and their directors to assess suitability. The SEC does not carry out any independent checks on the fitness and propriety of the applicants and their directors/shareholders e.g. screening against an internal database of firms or individuals with past misconduct or adverse records and with overseas regulators where the firms or individuals had previously engaged in regulated activities in other jurisdictions. The SEC is unable to screen for past criminal records as there is currently no centralized database in Sri Lanka for criminal offence.</li> </ul> </li> <li>• There are some limitations to the SEC’s powers in relation to its gate-keeping function. For example: <ul style="list-style-type: none"> <li>○ The SEC does not have express power to impose conditions on licenses and registrations e.g. to address issues that may arise from its review of applications or in response to new developments concerning licensees or registrants. The RT notes the SEC’s advice that proposed revisions to the SEC Act are intended to address this shortcoming.</li> <li>○ The circumstances under which the SEC may refuse licensing/registration, or suspend or cancel a license/registration (under sections 17, 18, 19A, 20 and 21 the SEC Act), are narrowly defined and may unduly limit its ability to make such determinations in practice. The SEC should expand the relevant provisions to provide for a broader range of circumstances (e.g. where SEC has reasons to believe that the intermediary or its directors/controller may not act</li> </ul> </li> </ul>
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	<p>in the best interests of customers or conduct its business in a proper manner, or on public interest grounds). The RT notes the SEC’s advice that proposed revisions to the SEC Act are intended to address this shortcoming.</p> <ul style="list-style-type: none"> <li>○ Although the SEC has the powers to bar a person (for a specified period of time or permanently) from functioning as a director or dealing with clients in respect of market intermediaries, such powers do not extend to stockbrokers/dealers and managing companies of unit trusts. Individuals who conduct regulated activities on behalf of intermediaries are not regulated nor are they subject to any conduct requirements. These limitations hamper the SEC’s ability to take effective steps to prevent the employment, or seek the removal, of persons who have committed securities violations or who are otherwise unsuitable to engage in regulated activities. Indeed, SEC staff shared that they have seen many instances where an individual had his/her employment terminated by a particular firm due to misconduct, but subsequently resurfaced at another firm.</li> <li>○ Unlike licensed intermediaries, registered market intermediaries are not required to seek the SEC’s prior approval for a change of control or key appointments (e.g. directors and chief executive officers). This limits the SEC’s ability to respond to such changes.</li> <li>● The SEC’s website provides a list of regulated intermediaries, but does not identify the senior management and authorized individuals of the regulated intermediary. The list also appears to be dated (i.e. last updated in February 2016). The CSE’s website provides details on the firms’ senior management, but only in respect of stockbrokers and dealers.</li> </ul>
<b>Principle 30.</b>	<b>There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake</b>
Description	<p><b>Net Capital and Liquidity Requirements</b></p> <p>Stockbrokers/dealers, managing companies of unit trusts and registered market intermediaries are subject to minimum net capital and liquidity requirements at admission and an ongoing basis.</p> <p><b>Stockbrokers/dealers</b></p> <p>Rule 5.1 of the Stockbroker Rules requires stockbrokers/dealers to maintain a minimum net capital which is determined by the Board of Directors of the CSE or the SEC. As set out on the SEC website, the minimum net capital for stockbrokers/dealers is Rs. 35 million.</p> <p>The net capital requirement is liquidity-adjusted. Net capital is defined as shareholders’ funds less:</p> <ul style="list-style-type: none"> <li>● Unsecured loans given by the stockbroker;</li> <li>● Receivables (other than trade receivables) due from related companies;</li> <li>● Amounts due from clients after settlement date;</li> <li>● All other assets doubtful of collection (less any provision made);</li> <li>● All deferred expenses and intangible assets; and</li> <li>● All contingent liabilities.</li> </ul> <p>In the event the net capital of a stockbroker falls below the minimum requirement, it is required to inform both the CSE and SEC in writing within two market days. The stockbroker is also required to increase its net capital within thirty calendar days of the net capital falling below the minimum requirement.</p> <p>Additionally, section 5.2 of the Stockbroker Rules requires stockbrokers/dealers to maintain a minimum liquidity deposit of Rs. 3.5 million with the CSE, which is progressively increased in blocks of Rs. 500,000 such that it equals 5% of the average daily purchases for custodian settled trades and</p>

three times that amount for trades involving stockbroker firms' settlement. Stockbrokers are required to ensure that at least 50% of the liquidity deposit furnished to the CSE comprises cash and cash equivalents i.e. cash deposits or irrevocable bank guarantee that is acceptable to the CSE. The balance of the liquidity deposit may be in the form of non-cash equivalents as adjusted by the hair-cuts determined by the CSE from time to time.

Liquidity requirements are reviewed by the CSE on a weekly basis. Where CSE increases the minimum liquidity to be maintained, stockbrokers are required to comply within two market days from the date of notification.

It should be noted that under the Stockbroker Rules, a stockbroker is permitted to extend credit to its clients for the sole purpose of purchasing securities traded on the CSE, provided that the total value of the credit extended does not exceed three times its adjusted net capital. Adjusted net capital is defined as net capital less 50% of the written down value of the fixed assets.

The credit extended to a client must be secured by collateral obtained from the client, which shall comprise of securities held in the client's CDS account. The credit extended must not exceed 50% of the market value of the securities pledged by the client (which are marked-to-market at the end of each market day). Where the market value of the securities falls by 25% or more, the stockbroker must inform the client to meet the shortfall by the next market day. In the event the client fails to meet the shortfall on the next market day, the stockbroker is required to immediately sell the securities pledged by the client.

The stockbroker must also ensure that the credit extended to a single client does not exceed 15% of the total value of credit that the stockbroker is permitted to extend under the Stockbroker Rules.

#### **Managing Companies of Unit Trusts**

Rule 2(3) of the Unit Trust Code requires managing companies of unit trusts to maintain the minimum net capital prescribed by the SEC. As stipulated on the SEC website, the minimum net capital for managing companies of unit trusts is Rs. 25 million. Net capital is defined as total assets less total liabilities. There is no requirement for adjustments to be made to the net capital amount to account for illiquid assets, inter-company receivables, doubtful debt, intangible assets or contingent liabilities. Managing companies of unit trusts are however not subject to any liquidity requirement.

#### **Market Intermediaries**

With the exception of underwriters that are regulated as a licensed or registered financial institution by the CBSL, market intermediaries are subject to minimum net capital and liquidity requirements specified by the SEC. Margin providers and investment managers must maintain minimum net capital of Rs. 30 million and Rs. 7.5 million respectively, as well as minimum liquid capital of 2.5% of all liabilities.

Net capital is defined as total assets less total liabilities. There is no requirement for adjustments to be made to the net capital to account for illiquid assets, inter-company receivables, doubtful debt, intangible assets or contingent liabilities.

Liquid capital is defined as cash or investments which can be readily converted to cash, such as bank deposits, re-purchase agreements with maturity of less than three months, commercial papers which are endorsed or guaranteed by a licensed commercial/specialized bank with a term to maturity of less than three months and government securities with a term to maturity of one year or less.

Underwriters are subject to minimum net capital of Rs. 50 million. They are also required to obtain SEC's approval for any underwriting obligation on a case-by-case basis prior to entering into any underwriting agreement. The liquid capital requirement for underwriters will be determined on a case-by-case basis based on the underwriting obligation. In practice, the SEC requires the underwriter to have liquid capital equivalent to the amount that it has agreed to underwrite.



The table below summarizes the minimum net capital and liquid capital requirements for each type of intermediaries:

	<b>Minimum Net Capital Requirement</b>	<b>Minimum Liquidity Requirement</b>
Stockbroker/Dealer	Rs. 35 million	Minimum of Rs. 3.5 million, with progressive increments of Rs. 500,000 (based on average daily purchase)
Managing Companies of Unit Trusts	Rs. 25 million	N.A.
Investment Managers	Rs. 7.5 million	2.5% of all liabilities
Underwriters	Rs. 50 million	Case-by-case basis according to underwriting obligation
Margin Providers	Rs. 30 million	2.5% of all liabilities

#### **Multi-purpose entities**

Intermediaries that function in two or more of roles are considered multi-purpose entities for the purposes of the net capital requirements, and are subject to all standards relevant to each license/registration category to which they belong. For instance, an intermediary that concurrently functions as a stockbroker/stock dealer and underwriter is required to maintain a minimum net capital of Rs. 80 million.

#### **Record Keeping, Periodic Reporting and Audit**

##### **Stockbrokers**

Rule 2.4 of the Stockbroker Rules requires stockbrokers/dealers to maintain complete and accurate records of its books, accounts and other documents for a period of six years.

Rule 2.16 of the Stockbroker Rules requires stockbrokers/dealers to furnish to CSE (i) monthly financial statements within twenty days from the end of the month and (ii) audited annual financial statements within four months from the financial year end. In practice, the financial statements both audited and unaudited are also furnished to the SEC. Rule 8.4.1 requires stockbrokers/dealers to appoint a reputed Chartered Accountant firm with at least three partners as its auditors, with separate partners to act as the engagement partner and the review partner.

##### **Managing Companies of Unit Trusts**

Rule 29 of the Unit Trust Code requires managing companies to maintain and preserve books and other documents forming the basis for financial statements and reports filed with the SEC for a minimum period of five years, and to keep a daily record of units, which have been acquired and/or held by it or disposed of, and the balance of any acquisitions, holdings and/or dispositions. Managing companies are also required to file with the SEC and the Trustee a copy of their annual reports and audited financial statements within three months of the end of its financial year under Rule 28 of the Unit Trust Code.

### **Market Intermediaries**

Under the General Regulatory Standards for Market Intermediaries, market intermediaries are required to maintain accounting records and books to sufficiently explain the transactions and financial position of its business, and enable true and fair financial statements in keeping with the Sri Lanka Accounting Standards to be prepared from time to time, for a period of not less than six years.

All market intermediaries are required to furnish audited annual financial statements to the SEC within six months of their financial year end. The financial statements must be prepared in accordance with the Sri Lanka Accounting Standards.

In addition, investment managers and underwriters are required to furnish quarterly unaudited financial reports while margin providers are required to furnish monthly unaudited financial reports. The financial reports must be prepared in conformity with the Sri Lanka Accounting Standards and signed by a Director and the Chief Executive Officer pursuant to a board resolution. Margin providers are also required to inform the SEC, on a quarterly basis, of the location scrip pledged and re-pledged with adequate details to enable verification by the SEC as well as details on its ten largest clients in value (in terms of margin facilities granted to them).

### **Monitoring Compliance with Capital and Liquidity Requirements**

The SEC relies on on-site inspections and off-site monitoring of the periodic financial reports submitted by intermediaries to monitor their compliance with minimum net capital and liquidity requirements.

Under Rule 5.1.3 of the Stockbroker Rules, stockbrokers are also required to inform the SEC and the CSE of any failure to comply with net capital requirements. Market intermediaries are subject to a similar notification requirement under Rule 22 of the General Regulatory Standards for Market Intermediaries. There is however no comparable requirement for managing companies of unit trusts.

### **Regulatory Action**

Sections 21, 21A and 31D of the SEC Act provides the powers for the SEC to cancel or suspend the license or registration of a stockbroker, stock dealer, managing company of unit trusts and market intermediary where it is satisfied that the firm has contravened any rules or regulations under the SEC Act.

Under Rule 5.3 of the Stockbroker Rules, if a stockbroker fails to increase the net capital within the time period specified (i.e. 30 days) or fails to maintain the minimum liquid capital required, the Chief Executive Officer of the CSE may prohibit the stockbroker from carrying out any purchase of securities on behalf of clients or own account. CSE will have to notify the SEC of such an event. If the stockbroker remains unable to comply with the net capital requirements (at the end of three months from the date of prohibition) or liquid capital requirement (at the end of one month from the date of prohibition), the matter will be escalated to the CSE's Board of Directors for further action.

In relation to contravention of regulatory requirements by a stockbroker, CSE may:

- Reprimand the stockbroker;
- Suspend the membership of the stockbroker;
- Cancel the membership of the stockbroker; or
- Make an order for specific performance towards the clients.

CSE will have to notify the SEC of any actions taken against the stockbrokers. SEC may also take actions against the stockbrokers for any contravention of the Stockbroker Rules.

In 2016, the SEC did not renew a stockbroker license due to, among other things, its failure to comply with the minimum net capital requirement. Apart from this case, the SEC represented that there were

	<p>no other major cases in the past three years where actions were taken in response to intermediaries' failure to meet the minimum net capital requirements.</p> <p><b>Risks arising from outside the Regulated Entity</b></p> <p>Licensed entities and registered market intermediaries are allowed to carry out unregulated activities which are not under the purview of the SEC. They are however required to obtain the approval of the SEC if they intend to carry out any business other than the activity that it is licensed or registered for.</p> <p>Businesses that regulated intermediaries may undertake with SEC's approval include:</p> <ul style="list-style-type: none"> <li>• Any business licensed or registered under the SEC Act;</li> <li>• Any business regulated by the CBSL or the Insurance Board of Sri Lanka;</li> <li>• Any other business recognized by the SEC as being ancillary or associated with securities business.</li> </ul> <p>In the event that a regulated intermediary wishes to invest in a business other than those referred to above, the investment must be less than 20% of the issued shares of the investee company. The regulated intermediary may only make such an investment if it is able to meet the minimum net capital requirement after the deducting the value of the investment.</p> <p>In reviewing an application from a regulated intermediary to carry out or invest in other businesses, the SEC will take into account the reputational risk, financial risk and any conflict of interest that may arise from such businesses.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p>Stockbrokers and market intermediaries are required to meet minimum net capital and liquidity requirements at admission and on an on-going basis. However, the requirements do not address the range of risks to be accounted under this Principle. The capital requirements are also not dynamic in that the amount of capital required does not vary according to the nature and quantum of risks assumed. The capital requirements are also not sensitive to large market movements.</p> <p>While the existing framework enables intermediaries to absorb some losses, it does not provide assurance that intermediaries set aside sufficient financial resources based on the different types of risks that they face. Examples of such risks include: counter-party risk (possibility that a counterparty may default on its obligations), large exposure risk (risk of loss arising from concentrated exposure to a single counterparty), position risk (risk of loss from fluctuations in the market value of financial instruments held by intermediaries) and operational risk (risk of loss due to deficiencies in systems/controls or legal risk). There is also no restriction on the level of indebtedness that may be taken on by the intermediaries. As a result, intermediaries can potentially take on excessive leverage which will expose them to refinancing risk if there is a sudden withdrawal of credit facilities or lines. Stockbrokers also face risks arising from the extension of credit to their clients for the purchase of securities, which may be exacerbated if the exposure limits are not observed (as is the case with several stockbrokers).</p> <p>The Review Team understands that the SEC is working with the CSE to replace the existing net capital requirements with a risk-based capital adequacy ratio (CAR). The proposed CAR is intended to ensure that stockbrokers retain an appropriate level of liquid capital in relation to total risk. The methodology to calculate a risk-based CAR for all stockbrokers will take into account four types of risk factors: operational risk, counterparty risk, large exposure risk, and position risk. The SEC is also looking to introduce risk-based capital requirements for other market intermediaries.</p> <p>The RT notes the SEC's advice that since the onsite visit the CAR rules for equity securities have been issued to stock brokers, while those applicable to debt securities continue to be developed.</p>

	<p>Currently, intermediaries are required to notify the SEC only when they breach the net capital and liquidity requirements. There is no requirement for them to notify the SEC whenever their capital falls below a certain early warning level e.g. below 120% of net capital required. The lack of an early warning mechanism limits the ability SEC to make timely intervention (e.g. in the case of an entity that is showing signs of financial distress but is not yet in breach of the capital requirements) and take pre-emptive measures to safeguard investors' interests.</p> <p>Based on discussions with SEC's and CSE's staff, the Review Team noted that a number of the stockbrokers are currently not adequately capitalized which is in part attributable to the shortcomings of the existing capital requirements. SEC's inspections had also uncovered instances where stockbrokers extended credit to their clients beyond the permissible limits. These weaknesses warrant further scrutiny, particularly given that stockbrokers are currently operating in a challenging market environment (i.e. low levels of market liquidity and fundraising activities).</p> <p>The Review Team notes that record keeping requirements for intermediaries enable capital levels of be determined at any time and that intermediaries are required to prepare audited financial statements.</p>
<p><b>Principle 31. Market intermediaries should be required to establish an internal function that deliver compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters</b></p>	
<p>Description</p>	<p><b>Management and Supervision</b></p> <p><b>Stockbrokers</b></p> <p>The Stockbroker Rules require stockbrokers to have an organizational structure with clearly defined responsibilities and authority for each category of employees. Stockbrokers are also required to appoint certain key officers including:</p> <ul style="list-style-type: none"> <li>• A Chief Executive Officer who is a resident in Sri Lanka and certified by the CSE to deal with investors;</li> <li>• A Compliance Officer who reports directly to the board of directors and is independent of trading and sales operations. The Compliance Officer must be employed at a managerial level;</li> <li>• A Head of Finance who possesses a degree or a professional qualification in finance/accounting with a minimum two years of relevant experience in similar capacity;</li> <li>• A minimum of two Investment Advisers who are certified by the CSE to deal with investors; and</li> <li>• A Documentation Officer who handles account opening for clients, KYC requirements and other CDS-related functions.</li> </ul> <p>In addition, stockbrokers are required to maintain up-to-date systems and procedures covering the following areas, as a minimum:</p> <ul style="list-style-type: none"> <li>• Trading;</li> <li>• Financial management;</li> <li>• Information systems;</li> <li>• Research (if applicable); and</li> <li>• Human Resource Management.</li> </ul>

The Management Information Reporting Systems must include the following features:

- Client Trade Information System – with the ability to generate trade-related information at any given time e.g. individual client account/portfolio statements, debtors/creditors ageing analysis, etc.
- Accounting System – with the ability to generate up-to-date accounting records, balance sheet and income statement at any given time.

The Client Trade Information System should be integrated with the Accounting System. Stockbrokers are also required to have a documented Disaster Recovery Plan (e.g. daily back-up of all accounting and other records maintained off-site).

The SEC has facilitated a project to implement a BBO & OMS jointly with the CSE. The project will also be jointly funded by SEC & CSE to defray the costs of implementing the same by stock broking firms, upon conducting compliance audits on the systems. The Review Team was advised that over 95% of stockbrokers have now implemented such systems.

#### **Managing companies of unit trusts**

Apart from the eligibility criteria spelled out in Part IV of the Schedule to the SEC Act (i.e. having the necessary professional experience and being financially sound), there are no specific requirements for managing companies to have in place appropriate management and organization structure, compliance and risk management functions, internal controls and operational procedures. These requirements are, however, verified as a matter of practice during on-site visits. The questionnaire prepared before the visit also touches on these issues.

#### **Market intermediaries**

Under the specific standards for market intermediaries, market intermediaries are required to:

- Maintain proper systems, processes and human resources suitable and adequate to support the functioning of its business at all times; and
- Have an internal compliance manual applicable to its directors and employees, setting out adequate compliance procedures and practices to ensure that:
  - The directors and employees of the intermediaries do not contravene the SEC Act or related instruments; and
  - Operational and administrative processes are implemented consistently and fairly.

Market intermediaries and their directors are responsible for due compliance with the internal compliance manual. Market intermediaries are required to submit to the SEC an annual compliance report signed by a director and the Chief Executive Officer confirming compliance with the relevant Parts to the Schedule to the SEC Act as well as the standards, rules and directives issued by the SEC within 45 days of the financial year end.

Market intermediaries are also required to have in place suitable information recording and retrieval systems for records relating to its clients. For instance, an investment manager is required to maintain the following records:

- All powers of attorney granted by clients;
- All subsisting agreements entered into by the investment manager;
- All agreements entered into by the investment manager that have been concluded spanning a period of six years from the date of conclusion pertaining to the identity of all clients and all transactions relating to clients including the bases for investment decisions; and

- Records to support investment analysis, recommendations, actions and other investment-related communications with clients and prospective clients (for a minimum period of six years).

### **Requirement for Outsourcing Arrangements**

No stockbrokers currently outsource their back-office functions.

Rule 2.5.2 of the Stockbrokers Rules require stockbrokers to obtain a confidentiality declaration from the service provider in an event the back-office functions are being outsourced.

Several stockbrokers have entered in to confidentiality agreements with parties who have undertaken the operation of dispatching the contract notes and statement of accounts to clients.

The Standards for Investment Managers expressly allows investment managers to enter into outsourcing arrangements as long as they are based on proper written agreements. It is also common for managing companies of unit trusts to outsource certain functions, such as registrar and accounting functions.

Apart from the abovementioned Rule 2.5.2 which deals solely with confidentiality and applies only to stockbrokers, the regulatory framework does not set out any requirement to address the risks posed by outsourcing arrangements. The SEC notes that trust deeds generally provide for the managing company taking responsibility for any outsourced functions.

### **Internal Controls and Risk Management; Periodic Evaluation of such Controls**

#### **Stockbrokers**

Stockbrokers are expected to implement and maintain a Systems & Procedures Manual covering the areas of trading, financial management, information systems, research, human resource management, and disaster recovery (Rule 8.3 of the Stockbroker Rules), and are required to maintain a management information reporting system for client trade information and accounting information. Stockbrokers are also expected to appoint a compliance officer to be responsible to implement appropriate measures and procedures, and conduct periodic checks to ensure compliance with applicable regulatory requirements (Rule 3.9).

The regulatory framework however does not require stockbrokers to be subject to an objective, periodic evaluation of its internal controls and risk management processes, either through an internal audit function or by way of an audit by external auditors.

The SEC advises that these checks are provided through annual audited financial statements which stockbrokers are required to file with the SEC within four months from the end of the financial year and, on-site inspections (which include system audits) performed by the SEC and CSE. CSE. In addition, stockbrokers are subject to off-site supervision by the CSE and SEC on a regular basis.

#### **Managing Companies of Unit Trusts**

The regulatory framework does not require managing companies of unit trusts to have in place adequate internal controls and risk management processes.

#### **Market Intermediaries**

The respective Standards applicable to each type of market intermediary include a section on regulatory compliance and internal controls, which include requirements for the market intermediary to have an internal compliance manual, and to hold the management of the market intermediary responsible for ensuring compliance with the manual.

The regulatory framework does not require market intermediaries to be subject to an objective, periodic evaluation of its internal controls and risk management processes, either through an internal audit function or by way of an audit by external auditors. The SEC advises that they expect audits undertaken by external auditors to cover internal controls and regulatory compliance.

### **Compliance function**

#### **Stockbrokers**

Under Rule 3.9 of the Stockbroker Rules, stockbrokers are required to appoint a compliance officer who will be responsible to implement and maintain appropriate measures and procedures to ensure compliance with applicable regulatory requirements. The compliance officer must possess relevant educational and/or professional qualifications, report directly to the board of directors, be independent of trading and sales functions, and be employed at a managerial level. Compliance officers are also required to submit a Compliance Officer's Report to the CSE on a monthly basis confirming the stockbroker's compliance with applicable regulatory requirements.

#### **Managing Companies of Unit Trusts**

There is no explicit requirement for market intermediaries to have a separate compliance function that reports directly to senior management, independent from the operational divisions. Although there is some oversight by the trustee of the unit trust, such oversight is limited to ensuring that the unit trust is managed by the managing company in accordance with the relevant the SEC Act and relevant instruments as well as the trust deed and explanatory memorandum pertaining to the unit trust. The trustee is not responsible for the managing company's compliance with its own obligations under any law or regulation.

#### **Market Intermediaries**

Market Intermediaries are required under their respective Standards to have an internal compliance manual applicable to its directors and employees setting out adequate compliance procedures and practices to ensure compliance with regulatory requirements, and consistent and fair implementation of its operational procedures and administrative processes. Market intermediaries and their directors are responsible for ensuring compliance with the manual. Market intermediaries are also required to submit an Annual Compliance Report signed by a director and the CEO confirming compliance with the applicable regulatory requirements.

There is however no explicit requirement for market intermediaries to have a separate compliance function that reports directly to senior management, independent from the operational divisions in relation to compliance with the SEC Act and rules and regulations made under the Act. Requirements to establish a compliance management function under the FTRA Act (No 6, 2006) are only in relation to compliance with the provisions of that Act, not the SEC Act or rules and regulations made under it.

### **Conflicts of Interest**

#### **Stockbrokers**

The Stockbroker Rules require a stockbroker and its employees to address conflicts of interest arising from their activities. Examples include:

- Rule 3.1 sets out standards expected of the firm and its employees acting on behalf of their clients, including requirements that they act fairly (paragraph (2)), in good faith (paragraph (6)) and in the best interests of their clients and the integrity of the market (paragraph (7)) while exercising due skill, care and diligence (paragraph (5)). These are supported by Rule 3.3 which requires the firm and its employees when providing advice to clients to act diligently and carefully.
- Rule 3.1(3) requires that when acting on behalf of clients, the firm and its employees avoid any conflict of interest which might arise. If it does arise, the firm is required to disclose any conflict of interest, decline to act or take any other measures. Rule 3.1(11) also requires the firm and its

employees to have in place procedures to prevent any conflicts of interest between its clients trading activities and trading on account of employee trades;

- Rule 3.3.2 obliges the firm and its employees when dealing with clients to disclose to the best of their ability all circumstances and risks that could reasonably be expected to affect a client's decision. Rule 3.3.4 obliges the firm and its employees not to enter into transactions which may conflict with the client's interests, unless the client is informed of such conflict and consents to the transaction.
- Rule 7.2.7 reinforces obligations in relation to addressing conflicts of interest, including the following:
  - The firm shall avoid any conflict of interest which may arise between trading on own account and trades of the firm's clients;
  - The CEO and the compliance officer of the firm shall ensure that the trading on own account carried out by the firm would not result in any market manipulations, front running of client orders or any other market malpractices;
  - The firm shall not directly or indirectly deal in any particular listed security or cause any other person to deal in that security, if the firm possesses information which is not available amongst the investing public.

There are other requirements that address conflicts issues in the context of the provision of investment advice. For example, Rule 2.2.4 requires that the CEO and Compliance Officer ensure that investment advice given to clients by the employee of a stockbroking firm will not result in a conflict of interest with employee trades. In support of this requirement, Rule 2.2 requires that employees of a stockbroker firm may trade only through the firm which employs them such that trades will be monitored by the firm, and no trades may take place in relation to securities on the Restricted Securities List (comprising securities in respect of which the firm possesses material non-public information).

#### **Managing Companies of Unit Trusts**

The Unit Trust Code sets out requirements that aimed at addressing potential conflicts of interest faced by managing companies of unit trusts. See details in Principle 24.

#### **Market intermediaries**

The Standards for Investment Managers, Margin Providers, and Underwriters set out requirements that are aimed at addressing potential conflicts of interest faced by market intermediaries, as follows:

- A market intermediary must always strive to act in the best interests of its client;
- A market intermediary must not ensure that its relationship and activities do not create conflict of interest between itself and its clients. In the event a conflict cannot be avoided, it will have to make full disclosure of such conflict to its clients and to the SEC; and
- An investment manager, in particular, is required to ensure clear segregation of the key duties and functions of the front office and back office to avoid any conflicts of interests.

#### **Direct Electronic Access**

Direct Electronic Access (DEA) was first introduced in Sri Lanka in 2005/06 in the form of direct order routing (a type of mediated access). There are currently 26 stockbroker/dealers which offer such access to their clients. Under this facility, clients may transmit orders electronically to a stockbroker's system and these orders are in turn automatically transmitted to the CSE's Automated Trading System for execution under the stockbroker's ID. There are currently no dedicated regulatory requirements governing such facility. Accordingly, any controls imposed on such access are at the discretion of the relevant stockbrokers/dealers and governed by the contracts which they enter with clients.



## **Protection of client monies and assets**

### **Stockbrokers**

Rule 4 of the Stockbroker Rules require stockbrokers to:

- Treat and deal with all monies received on account of a client as belonging to that client;
- Hold all money received on account of a client in trust for the benefit of the client,
- Shall not commingle monies received on account of a client with their own funds, or use such monies as margin or guarantee for, or to secure any transaction of, or to extend the credit of, any person other than the client; and
- Be able to identify the amount of monies belonging to each client separately at any given point in time.

Stockbrokers are also required to immediately deposit money received on account of its clients in a separate bank account with a commercial bank licensed by the CBSL. Stockbrokers are also required to, before depositing client monies in the bank account, give written notice to and obtain an acknowledgement from the bank that:

- The monies are held in trust by the stockbroker for the customer and that they cannot be used to offset the stockbroker's own debts;
- The account is designated as a clients' account, which must be distinguished and maintained separately from any other account in which the stockbroker deposits its own monies.

Stockbrokers are only permitted to withdraw monies from the clients' accounts for the purposes specified in the Rule 4.5 of Stockbroker Rules, i.e. making a payment to person entitled thereto, making a payment to meet an obligation of a client arising from his/her dealing in securities, defraying brokerage or other charges (e.g. interest on delayed payments) and making a payment authorized by law.

Stockbrokers are permitted to only invest clients' monies in government securities through a primary dealer or CBSL-licensed commercial bank or deposit them in a CBSL-licensed commercial bank. Such investments must be held in trust for the benefit of the clients and titled accordingly.

The SEC advises that stockbrokers' clients would open an account with the CDS to deposit their securities.

### **Managing Companies of Unit Trusts**

Under Rule 7(1) of the Unit Trust Code, the deposited property of a unit trust must be held by a trustee (approved by the SEC) on behalf of the unit trust. See further details in Principle 25.

### **Market Intermediaries**

Rule 11 of the Standards for Investment Managers requires an investment manager to ensure that:

- The monies of each client are maintained in separate bank accounts to enable identification of the same;
- The monies and assets held on behalf of the clients are not pooled;
- All monies and assets held for and on behalf of clients are segregated from monies and assets held by the investment manager; and
- The monies of the clients shall not be utilized except as specifically sanctioned in writing by such clients.

Rule 5(h) of the Standards for Margin Providers requires a margin provider to ensure that monies and securities of clients are maintained in segregated accounts and separate from the monies and securities held by the margin provider on its own account.

Similar to stockbrokers, the SEC explained that the clients of registered market intermediaries would open an account with the CDS to deposit their securities.

### **Investor Complaints**

#### **Stockbrokers**

Rule 2.12 of the Stockbroker Rules requires a stockbroker to have procedures to handle complaints received from clients relating to its business in a timely and appropriate manner. If a client has a complaint against a stockbroker relating to a particular transaction(s), such complaint has to be referred to the Compliance Officer of the stockbroker in writing within three months from the date of the transaction(s). The stockbroker must preserve records pertaining to all complaints and actions taken for a minimum period of 6 years.

Under Rule 10 of the Stockbroker Rules, if a client is not satisfied with the decision taken by the stockbroker or the manner in which the complaint has been dealt with, the client may refer the complaint to the CSE. The complaint will be dealt with by officers appointed by the CSE's Chief Executive Officer. If the stockbroker or the complainant is not satisfied with the decision of the CSE, the party may appeal to the CSE's Dispute Resolution Committee. The Committee will adjudicate upon such complaint and if required, give a hearing to the stockbroker or the complainant. The decision taken by the Committee is ratified by the CSE's Board of Directors, and any failure by the stockbroker to abide by such a decision will lead to disciplinary action being taken by the CSE.

#### **Managing Companies of Unit Trusts**

There is no requirement for managing companies of unit trusts to maintain an efficient and effective mechanism to address investor complaints.

#### **Market Intermediaries**

Market intermediaries are required to maintain an effective complaints handling process. They are also required to maintain a comprehensive written record of all complaints received from clients and action taken by the market intermediaries for a period of six year.

Separately, section 46 of the SEC Act provides an avenue for clients of licensed and registered intermediaries to seek redress for their grievances.

#### **Intermediary's Conduct with Clients**

##### **Know-Your-Customer (KYC) and Customer Due Diligence (CDD)**

Under the Rule 2.3 of the Stockbroker Rules, stockbrokers are required to take all possible steps to establish the true and full identity of its clients, and of each client's financial situation, investment experience and investment objectives. In addition, Rule 3.3 requires stockbrokers and their employees to act diligently and carefully when providing advice to a client, and to disclose all circumstances and risks that could reasonably be expected to affect a client's decision.

Separately, stockbrokers/dealers, market intermediaries and trustees are required to comply with the KYC & CDD Rules for the Securities Industry promulgated by the CBSL's Financial Intelligence Unit in 2007. They are required to (i) identify and verify the identity of the investor and any beneficial owner and (ii) obtain information such as financial background and business objectives in order to develop a business and risk profile of the investor. They would have to monitor that the transactions undertaken by the investor are consistent with the investor's profile. Verification must be conducted using independent and reliable sources, before or during the opening of an account or accepting an investment.

The SEC's *Ethical Framework and Best Practices in Professional Conduct* also sets out expectations and best practices for market practitioners, including those who conduct investment analysis, make investment recommendations or take investment actions. In addition to setting out best practices about knowledge and compliance with the law and duties to clients and employers, the Framework sets out best practices in relation to the provision of investment advice.

This includes high level expectations that practitioners:

- make reasonable inquiry into a client's or prospective client's circumstances and investment experience prior to making any investment recommendation or taking investment action;
- exercise diligence, independence and thoroughness in analyzing investments, making investment recommendations and taking investment actions; and
- have a reasonable and adequate basis, supported by appropriate research and investigation for any investment analysis, recommendation and action.

The Framework does not have the force of law. It was published on 11 July 2009 and has been implemented on a voluntary basis. The SEC advises that the proposed new SEC Act would impose similar requirements to the Framework as a matter of law.

#### **Client information and Account Opening Agreement**

Stockbrokers (under Rule 2.3.5 of the Stockbroker Rules) and market intermediaries (under the Specific Standards) are required to enter into a written agreement with each client before providing services to the client. The agreement must contain all the terms and conditions governing its relationship with the client, including a disclosure of the risks associated with the services provided.

Managing companies of unit trusts are required to have in place a trust deed between the managing company and the trustee creating the trust.

#### **Record keeping**

Stockbrokers/dealers are required under Rule 7 of the SEC Rules 2001 to maintain books of accounts and other documents (e.g. register of transactions, contract books, duplicates of contract notes issued to clients and written consent of clients) for a period of five years. Market intermediaries are required under their respective Standards to maintain complete and accurate records of documents which are sufficient to explain all transactions relating to a particular client either in hard copy or electronic form as well as all complaints received and actions taken, for a minimum period of 6 years.

Further, the Rules on Know Your Customer (KYC) & Customer Due Diligence (CDD) for the Securities Industry require stockbrokers/dealers, market intermediaries and trustees to maintain client identification and verification documents for at least six years after the end of the business relationship.

Under Rule 29 of the Unit Trust Code, managing companies of unit trusts are required to maintain and preserve for a period of five years accounts, books and other documents forming the basis for financial statements and reports filed with the SEC and as necessary to demonstrate compliance with the Unit Trust Code. They are also required to keep a daily record of units which have been acquired and/or held by it or disposed of, and the balance of any acquisitions, holdings and/or dispositions. The managing company shall make such daily record available for inspection by the trustee at all times during ordinary office hours, and supply the trustee with a copy of the record or any part of it on request free of charge.

### **Providing Information to Investors**

Under Rule 3.3 of the Stockbroker Rules, stockbrokers and their employees are required to disclose, to the best of their ability, all circumstances and risks that could reasonably be expected to affect a client's decision. They must also provide all information on a security traded on the CSE upon a client's request.

Stockbrokers are also required to send a contract note confirming the purchase or sale of securities to the client by the end of the trade day (T), and a statement of account to all clients who are debtors over T+3 by the 7<sup>th</sup> day of the following month (Rules 2.4.3 and 2.6 of the Stockbroker Rule). There is however no specific requirement for stockbrokers to furnish periodic statements of account to clients who are not debtors over T+3. Stockbrokers are also required to provide clients with information about applicable fees and charges payable by the client to the stockbroker in the client agreement.

Managing companies of unit trusts are required to provide a copy of the latest explanatory memorandum approved by the SEC, which must contain adequate disclosures to enable investors to make informed decisions (Rule 16 of the Unit Trust Code). They are also required to give unit holders at least one month prior written notice or press notice of any increase in their annual charges, up to the maximum permitted level specified in the trust deed (Rule 11 of the Unit Trust Code).

Under Rule 13 of the Standards for Investment Managers, investment managers must execute a written contract prior to carrying out any business for and on behalf of a client. The contract must spell out the investment objective, the investment strategy and associated risks, the parameters within which investments may be carried out and the fee structure (see and Schedule 3). In addition, investment managers must furnish clients with current and accurate portfolio valuations on a monthly basis (see Rule 15).

Similar to investment managers, margin providers must execute a written contract which spells out the risks associated with margin trading as well as the duties and obligations of each party to the contract (see Rule 8 of the Standards for Margin Providers). There is no however specific requirement for them to furnish a periodic statements of account to clients.

### **Acting with Due Care and Diligence**

The Stockbroker Rules (Rule 3.1) and General Regulatory Standards for Registered Market Intermediaries require stockbrokers and market intermediaries to act in the best interest of clients. Market intermediaries must also not act fraudulently or dishonestly in the performance of the regulated activity and must not engage in any business practices that are deceitful or oppressive or otherwise improper or which reflect discredit on its method of conducting business.

The Unit Trust Code requires managing companies of unit trusts to act with reasonable care in the operations relating to the management of the unit trust, and to bear any loss suffered by the unit trust or by unit holders as a result of any fraud, gross negligence or malfeasance of employees and directors.

### **Supervision of Market Participants**

The SEC undertakes ongoing supervision of stockbrokers/dealers, managing companies of unit trusts and market intermediaries. The SEC has supervisory powers under section 14(a) of the SEC Act. In overseeing licensees and registrants, the SEC can exercise its broad and general powers to obtain information from market participants (section 45(1)). These are supplemented by the specific information-gathering powers under section 8 of the SEC Rules 2001 and the powers under the General Regulatory Standards for Market Intermediaries (i.e. Rules 15, 16 and 17).

The SEC's supervisory function is carried out by the Supervision Division which is headed by Director (Supervision) and organized in the following manner:

- Two legally-trained staff who review new applications and renewals;
- Five supervisory staff who cover stockbrokers/dealers and margin providers;

- Four supervisory staff who cover investment managers, managing companies of unit trusts, and CRAs;
- One IT specialist and one administration staff.

The CSE also monitors the conduct of stockbrokers through a separate supervisory program and has inspection powers under Rule 9.1 of the Stockbroker Rules. The CSE has five supervisory staff who cover stockbrokers and stock dealers.

### **On-site supervision**

As described in Principle 12, the SEC conducts on-site inspections based on a risk-based audit program that encompasses assessment of prudential, operational, credit, liquidity, internal controls and procedures, governance, information systems and legal risks, as well as compliance-related checks.

In developing the on-site inspection plan, the SEC takes into account the following:

- findings from previous on-site and/or off-site reviews;
- governance issues identified;
- nature of complaints made by the stakeholders against the entity;
- information furnished by the Surveillance and Corporate Affairs Divisions pertaining to contraventions with the regulatory requirements;
- information identified through electronic/print media in respect to the entity; and
- the license/registration expiration dates.

The SEC also considers the entity’s financial performance as well as information from the questionnaire on the entity’s operational/compliance framework and internal controls. The size of the on-site inspection team is determined based on the risks identified.

An inspection normally takes about two weeks, including preparation time (about one day), on-site visit (over a period of two to four days) and drafting the inspection letter. Post-inspection, the SEC will send a draft inspection letter to the intermediary detailing its observations and the intermediary is given 14 days to respond. On receipt of comments from the management of the intermediary, the finalized inspection letter will be issued. Where there are regulatory concerns, these will be surfaced to the Director-General for discussion with the intention of initiating appropriate enforcement action.

The number of routine and “for cause” inspections conducted by the SEC over the past 4 years is shown the following tables:

<b>Routine Inspections</b>				
	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Stockbrokers	27	28	16	11
Managing Companies of Unit Trusts	2	13	14	10
Margin Providers	16	25	16	21
Investment Managers	10	23	21	25
Underwriters	1	–	–	3
Credit Rating Agencies	–	3	2	2
<b>Total</b>	<b>56</b>	<b>92</b>	<b>69</b>	<b>72</b>

<b>“For Cause” Inspections</b>				
	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Stockbrokers	11	–	7	1
Managing Companies of Unit Trusts	–	–	–	–
Margin Providers	3	5	–	–
Investment Managers	–	1	36 <sup>[1]</sup>	–
Underwriters	–	–	–	–
Credit Rating Agencies	–	–	–	1
<b>Total</b>	<b>14</b>	<b>6</b>	<b>43</b>	<b>2</b>

<sup>[1]</sup> The description of for cause inspections is set out in IOSCO Principle 12.

The exact timing of inspections is determined by SEC staff on a case-by-case basis based on their assessment of the intermediaries’ compliance track record and internal control weaknesses. However, there is currently no formal, risk-based framework in place to determine which regulated entities will be inspected and how frequently based on the likelihood and impact of the risks they pose.

In relation to stockbrokers, the SEC and CSE split the inspections, with the SEC inspecting one half of brokers each year and the CSE the other half. However, this approach is changing as the SEC seeks to move to a more risk-based approach to identifying targets for supervisory inspections.

The SEC and CSE do not necessarily use the same process for inspections. While the two organizations typically examine similar issues and risks, the level of attention paid to particular matters may vary between the SEC and CSE. Common significant compliance weaknesses among stockbrokers flagged in discussions with industry and SEC staff included:

- Client funds not meeting creditors obligations over T+3;
- Commingling money received on account of clients with its own funds;
- Extending credit to clients beyond approved credit limits;
- Extending credit without an appropriate written agreement;
- Retaining the proceeds of security sales without client permission;
- Failing to properly segregate client assets;
- Concerns on corporate governance and internal control weaknesses.
- Lack of internal controls and minimum standards.

While the supervisory processes of the SEC and CSE have identified compliance weaknesses among several stockbrokers, the progress in remediating these identified deficiencies has been slow, and there has been only limited use of existing enforcement remedies to compel brokers to resolve compliance problems.

#### **Off-site supervision**

Staff of the Supervision Division reviews regulatory submissions, including the financial statements or reports, compliance reports and debtors declarations of stock brokers/dealers. Further, in relation to other market intermediaries the financial reports, annual compliance reports and other reporting requirements as stipulated under rules applicable for market intermediaries are being reviewed.

	<p>In terms of Unit Trusts, the Unit Trust returns, interim and annual reports of the Unit Trusts. Further, annual reports and financial statements of the unit trust managing companies are also reviewed. As part of these reviews, the staff assess the financial stability and operational viability of the intermediaries as well as their compliance with the applicable regulatory requirements.</p> <p>Where necessary, the staff will undertake further analysis and obtain further clarifications from the intermediary. If the clarifications are not satisfactory, a letter is sent to the intermediary to require the issue to be rectified.</p> <p>Significant findings arising from the reviews are reported to the Commission on a quarterly basis, along with the recommended regulatory action in respect of any non-compliance. Regulatory action will be initiated upon the Commission's approval.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p><b>Regulatory Framework</b></p> <p>The regulatory framework addresses some but not all of the requirements contemplated by Principle 31.</p> <p>In relation to <b>management and organizational requirements</b>, the Review Team noted the following significant gaps:</p> <ul style="list-style-type: none"> <li>• No specific requirements for managing companies of unit trusts to have in place appropriate management and organization structure, compliance and risk management functions, internal controls and operational procedures, and complaint handling procedures. The presence of a trustee (acting as an oversight body) does not obviate the need for managing companies to be properly set up with the necessary systems, controls and procedures in place. The SEC advised that these aspects are, as a matter of practice, verified during on-site visits.</li> <li>• No specific requirements for intermediaries to subject their internal and operational controls and risk management processes to an objective, periodic evaluation by way of an internal audit function performed by someone of sufficient autonomy. While some checks may be conducted during inspections and as part of annual financial audits, these actions do not supplant the need for intermediaries to have an internal audit function that independently and regularly evaluates and tests the effectiveness of their risk, control and governance environment.</li> <li>• No specific requirements on outsourcing arrangements (see IOSCO Report on <i>Principles on Outsourcing of Financial Services for Market Intermediaries</i> – February 2005). Given that it is common for investment managers and managing companies of unit trusts to outsource certain functions (e.g. registrar and accounting functions), the regulatory framework should set out clear requirements on the measures that intermediaries should have in place to address the risks posed by outsourcing arrangements and ensure that the regulators' and auditors' access to the books and records of the intermediaries is not impeded.</li> </ul> <p>In relation to <b>client asset protection requirements</b>, the Review Team noted the following significant gaps:</p> <ul style="list-style-type: none"> <li>• No specific requirements for intermediaries to have in place basic measures such as: <ul style="list-style-type: none"> <li>○ Conducting due diligence on the suitability of the banks and custodians with whom they intend to deposit clients' monies and assets, at the point of appointment and on a periodic basis;</li> <li>○ Periodic reporting to the SEC on the amount of monies and assets segregated in trust and custody accounts;</li> <li>○ Regular reconciliation of client monies and assets – this a key control in ensuring that clients' monies and assets are properly accounted for.</li> </ul> </li> </ul>

- A stockbroker is required, before depositing client monies into a bank account, to give written notice to the bank and obtain an acknowledgement from the bank that: (i) the monies deposited in the account are held in trust by the stockbroker for the benefit of its clients and cannot be used to offset any debt owed by the stockbroker to the bank and (ii) the account is designated as a clients' account and be maintained separately from any other account in which the stockbroker firm deposits its own money. This is an important safeguard that should be extended to all other regulated intermediaries that handle client monies.
- There is no provision in Sri Lankan law to explicitly ensure that client monies kept in trust accounts are not subject to claims by general creditors in an intermediary's bankruptcy. SEC staff acknowledged that, legally, the effectiveness of trust accounts as a means to ring-fence client monies against an intermediary's bankruptcy has not been tested. The SEC advised that the proposed revision to the SEC Act will remove this uncertainty.
- The rules should be broadened to cover not just securities that are traded on the CSE but also other asset classes (e.g. non-listed securities).

The RT notes the SEC's advice that proposed revisions to the Market Intermediary Rules are intended to address these shortcomings.

The SEC has published a Guideline on the Ethical Framework and Best Practices in Professional Conduct applicable to those providing investment analysis or recommendations and taking investment actions. While the Guideline is useful in promoting good conduct it does not have the force of law and sets out no more than expectations. The Guideline includes an expectation that intermediaries have a reasonable basis (including taking into account the needs of the clients) when recommending any security or investment to their clients.

In relation to **direct electronic access**, neither the SEC nor CSE has specific requirements in place to address the risks posed by the provision of such facility by stockbrokers/dealers (e.g. trading and credit risks). The IOSCO Report on Principles for Direct Electronic Access to Markets (August 2010) recommended that intermediaries should be required to put in place safeguards to ensure that DEA clients will not pose undue risks to the market and the relevant intermediary (for e.g. requirements on minimum customer standards and automated pre-trade controls).

In relation to **statements of account**, there are no specific requirements for stockbrokers (other than in the case of clients who are debtors over T+3) and margin providers to provide periodic statements of account to clients.

### **Supervisory Approach and Program**

The SEC does not currently employ a risk-based approach to supervision.

While the SEC conducts on-site visits of all regulated entities at least annually (with stockbroking firms also visited by the CSE) and there is some focus on how risks are managed, there is room for the SEC to further enhance its inspection approach so that it is able to develop a more holistic picture of the risks each regulated entity poses to its regulatory objectives. In particular, the SEC should work to ensure that inspections of managing companies are approached with a view to providing a holistic assessment of the risks posed to clients, as opposed to the current checklist-based compliance audits.

The SEC has advised that a risk assessment framework is being developed under which stock broking firms would be assigned to one or more four supervisory buckets according to the risks posed, with supervisory plans for each firm determined according to relative risk. The SEC advises that the risk assessment framework will take into account the overall 'financial stability' of the firm.

In relation to stockbrokers, the coordination between the SEC and CSE during inspections, although strengthened in the last few years, will need further improvements once the risk-based supervision approach (which the SEC is developing) is in place.



	<p>In discussions with industry stakeholders, the Review Team received comments that only a small proportion of stockbrokers could be trusted to ensure that basic client protections were in place, particularly segregation of client monies. Indeed, the SEC’s inspections of stockbrokers had uncovered serious lapses in this and other areas, e.g. co-mingling of monies received on account of clients with the stockbroker’s own monies, failure to properly segregate client assets, retaining the proceeds of security sales without clients’ permission, extending credit to clients beyond regulatory limits and extending credit without an appropriate written agreement.</p> <p>There has been limited follow-up action taken to ensure that these lapses are addressed in a prompt and effective manner. Given the significance and pervasiveness of the weaknesses identified – including failures to stick to margin lending limits and to properly segregate client monies and assets – delays in rectification risk client losses and consequent erosion in the credibility of the regulatory framework for stockbrokers.</p>
<b>Principle 32.</b>	<b>There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investor and to contain systemic risk</b>
Description	<p><b>Plan for Dealing with the Failure of a Market Intermediary</b></p> <p>In relation to the securities market, the current practice where securities traded on the CSE are netted and settled on T+0 while the net funds position is settled on T+3 exposes the CDS and its participants to credit, liquidity, and settlement risk, which in extreme circumstances can lead to systemic risk.</p> <p>The CDS Rules set out some procedures to deal with a settlement default of a stockbroker which entail the following steps:</p> <ul style="list-style-type: none"> <li>• The stockbroker in default will be immediately suspended from making further purchase on behalf of its clients;</li> <li>• The CDS will publish a notice in the local press to highlight the settlement failure of the stockbroker;</li> <li>• The stockbroker may be permitted to continue to carry out the sale of securities on behalf of its clients until the 15th market day from the date of suspension. If it fails to meet all outstanding settlement obligations by the 15th market day, it will be suspended from making further sales;</li> <li>• Clients who hold securities with the stockbroker may change to another stockbroker of their choice;</li> <li>• All sales proceeds must be used to make payments to the respective sellers; and</li> <li>• The stockbroker may obtain funding from the Settlement Guarantee Fund (SGF) to meet settlement obligations. The trustees of the SGF will meet and decide on the necessary course of actions in line with the requirements stipulated in the trust deed of the SGF.</li> </ul> <p>The CDS Rules also set out procedures for the settlement default of a custodian bank.</p> <p>To more fully address clearing and settlement risks, the SEC is facilitating the setting up of a CCP at the CSE. However, a considerable amount of work remains. In parallel with the establishment of a CCP, there is a need to develop a robust set of default management processes and procedures to safeguard the integrity of the clearing and settlement operations against financial shocks caused by extraneous events.</p> <p>At present, other than the procedures in the CDS Rules that deal with the settlement default of a CDS participant, there are no specific plans and procedures to deal with other types of failures and in particular the failures of other larger intermediaries. The default management process will be embedded in the risk management process during the implementation of the CCP.</p>

**Early Warning System or Mechanism**

The SEC monitors the financial health of intermediaries through a combination of on-site visits and off-site reviews of periodic financial reports submitted by the intermediaries, as well as the obligation (on the part of the intermediaries) to notify the SEC of any breach of capital requirements. There is however no system in place which could generate early warnings signals regarding possible default by intermediaries.

**Powers of the Authority**

The SEC has powers under Section 13(c) of the SEC Act to issue general or specific directives to licensees and registrants, e.g. directing an intermediary to implement measures to restrain its trading/business activities. This year, the SEC had, due to certain regulatory concerns, directed a stockbroker to refrain from accepting new clients and carrying out purchases and sales on behalf of clients, as well as to facilitate the prompt transfer of securities of existing clients to other stockbrokers in accordance with clients' request.

However, there are no express powers for the SEC to take over regulated intermediaries. There are also no express powers for the SEC to request the appointment of a monitor, receiver or administrator to take possession or control of the assets held by the intermediary or by a third party on behalf of the intermediary.

According to the SEC, the provisions of the SEC Act are sufficiently wide to allow the SEC to take over an intermediary and to take other actions. In particular, under section 13(p) the SEC Act, the SEC may "do all such other acts as may be incidental or conducive to, the attainment of objects of the Commission or the exercise of its powers under this Act". However, the SEC acknowledged that whether this is practically possible and the adequacy of existing regulation remain to be ascertained, given that there has not been any such intermediary failure in the past.

**Additional Measures (Compensation Fund, Segregation of Client Monies)**

A Compensation Fund has been established under section 38 of the SEC Act for the purpose of granting compensation to any investor who suffers pecuniary loss as a result of any licensed stockbroker or stock dealer being found incapable of meeting its contractual obligations. The Compensation Committee, which comprises three members of the Commission appointed by the Minister, is responsible for assessing and awarding compensation in respect of any application made. The procedures for making a claim against the Compensation Fund are found in section 40 of the SEC Act. The Compensation Fund does not however apply to other intermediaries.

There are some measures in place for the segregation of client monies and assets in relation to stockbrokers, investment managers and margin providers. However, as noted in Principle 31, there are significant weaknesses in terms of the scope of these measures and the standard of compliance by intermediaries (particularly stockbrokers) with these measures.

There is no requirement for the intermediaries (other than CRAs) to obtain professional indemnity insurance.

**Cooperation with Domestic and Foreign Regulators**

Both the SEC and CSE monitor day-to-day trading on the CSE market and undertake supervision of stockbrokers, under their respective surveillance and supervision programs. The degree of cooperation between the SEC and CSE on supervision of stockbrokers is greater than on surveillance. This is generally limited to doing the yearly split of brokers and the sharing of findings of their supervisory activities with each other. If an issue is observed with regard to a stockbroker, the SEC will meet the CSE to discuss and decide on the course of action to be taken. There is no formal protocol for cooperation between the SEC and the CSE.

The SEC engages from time to time with the CBSL, IBSL and SLAASMB, with respect to the receipt and provision of information relating to the regulatory responsibilities of each, in the common interest of ensuring systemic stability. The SEC has signed a MOU with SLAASMB.

	<p>Apart from being a signatory of the IOSCO MMoU, the SEC does not have any other supervisory cooperation arrangements, whether formal or informal, with foreign regulators that deal specifically with financial disruption.</p>
Assessment	<b>Not Implemented</b>
Comments	<p>The SEC has not developed any plans and procedures to deal with the failure or possible failure of a market intermediary.</p> <p>While the general obligation to notify of any breach of capital requirements and off-site reviews of periodic financial reports submitted by intermediaries allow the SEC to be apprised of the financial position of intermediaries, enhanced surveillance tools are needed to engender a preventive regime. In particular, as noted in Principle 30, the lack of an early warning mechanism limits the SEC’s ability to make timely intervention (e.g. in the case of an entity that is showing signs of financial distress but has yet to breach the capital requirements) and take pre-emptive measures to minimize damage and loss to investors.</p> <p>The SEC does not have express powers to take over an intermediary, request the appointment of a monitor, receiver or administrator, or take possession or control of the assets held by the intermediary (or by a third party on behalf of the intermediary). The RT notes the SEC’s advice that it has not sought these powers given the relatively low systemic risk posed by intermediaries in Sri Lanka. The SEC also advises that revisions are proposed to the SEC Act to give the SEC similar powers in relation to market institutions.</p> <p>As noted in Principle 6, communication between the SEC and other financial sector regulators is of a general nature and does not specifically pertain to efforts to reduce systemic risks. The RT notes the SEC’s advice that it expects this limitation to be addressed by the recently established Financial Sector Oversight Committee of which the SEC, CBSL and the IBSL are members.</p>
<b>Principles for the Secondary Markets</b>	
<b>Principle 33.</b>	<b>The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight</b>
Description	<p><b>Exchanges or trading systems subject to regulation</b></p> <p>In Sri Lanka, “stock exchanges” are licensed by the SEC under s15 of the SEC Act. It is prohibited, under s. 30(2) of the SEC Act, to carry on business as a stock exchange without the authorization of the SEC.</p> <p>No equivalent regulatory regime exists for separate trading systems in Sri Lanka. However, no such trading systems are operating, or are presently proposed. The proposed new SEC Act will establish a regime for the regulation of trading systems separately to that of stock exchanges.</p> <p>The SEC Act states at part 16, that: <i>“no licenses shall be granted under this Act to any body corporate as a stock exchange which does not comply with the terms and conditions set out in Part I of the Schedule [to the SEC Act].”</i></p> <p>Section 19(1) of the SEC Act states that: <i>“on receipt of an application made under section 15, the Commission having considered the particulars stated therein and, where it deems necessary, having given the applicant an opportunity of being heard, in person or by a representative, shall by written notice to the applicant, inform the applicant whether he is being granted a license or not.”</i></p> <p>This establishes a process for the SEC to make an assessment or analysis of an application to operate a stock exchange in Sri Lanka.</p> <p>Stock exchange operating licenses are granted for 5 years under the SEC Act (s. 19(2)(a)) and are subject to assessment and review on re-application. The SEC has conducted reviews of the CSE in connection with its license renewal.</p>

Part I of the Schedule to the SEC Act sets out the criteria that are applied to the granting or renewal of a stock exchange license. These include the applicant having rules that concern a number of relevant matters, including for preventing fraudulent behavior (subparagraph j(iii)).

Other rules that a stock exchange licensee applicant must have include:

- Rules for the admission of members (subparagraph (j)(i)) and for the exclusion of members (subparagraph (j)(ii));
- Rules with respect to the conditions under which securities may be listed for trading in the market (subparagraph (j)(v)); and
- Rules with respect to the conditions governing dealings in securities by its members.

Other required rules are described in other parts of the Assessment of this Principle, and others, where they are pertinent to the relevant key implementation question.

Subparagraph (h) of Part I of the Schedule also establishes a general requirement that *“the applicant company’s location and activities will enable the creation of a more orderly market for securities in Sri Lanka”*.

There are no specific requirements in Part I of the Schedule to the SEC Act, which sets out the criteria for the granting and renewing of stock exchange licenses, that a stock exchange demonstrate its operational or other competence to operate a stock exchange. However, as a matter of practice, the SEC does assess this as part of its review of the CSE on license renewal, including a review of its IT systems using a specialized IT consultant. (The proposed new SEC Act requires prospective stock exchange licensees to have adequate resources including, at s. 25(3)(f)(iv): *“automated systems with adequate capacity, security arrangements and facilities to meet emergencies”*.)

As the Sri Lankan market does not have a clearing and settlement system with a central counterparty, the CSE does not assume principal, settlement guarantee or performance risk and is not subject to prudential or other requirements designed to minimize settlement failure. (Though stock exchange licensees are required to be of “satisfactory” financial standing under subparagraph (i) of Part I of the Schedule to the SEC Act.) The new SEC Act will establish a clearing and settlement system to reduce the risk of settlement failure. As noted previously, the SEC is facilitating the establishment of a central counterparty mechanism jointly with the CSE.

There is no specific requirement that stock exchanges treat their participants, and otherwise act, fairly. The SEC considers that one of its functions is to ensure the CSE does act fairly and consistently and that it acts when the CSE does not do this. However, the SEC’s role in this space is largely a matter of convention and precedent, rather than being based on a specific statutory mandate.

Furthermore, while the prevailing rules – for example, Part 11 of the CSE Stockbroker Rules, which sets out a disciplinary regime for member firms – allows for fair application of CSE requirements and powers, the system for admitting brokers as members of the CSE does not. Instead, it affords the CSE directors, a majority of which are nominated by current broker members, discretion on admitting new participants.

Article 7 of the Articles of Association of the CSE allows a right of appeal to the SEC in respect of Board decisions on participation. In 2010 the CSE Board was required to change a decision on the final admission of 5 new Trading Members, because the SEC accepted appeals made by 2 unsuccessful applicants. This resulted in the CSE admitting 7 Trading Members.

The proposed new SEC Act, under s. 29(1), would require that a licensed exchange *“ensure, so far as may be reasonably practicable, an orderly and fair market in securities that are traded through its facilities”*.

The SEC is able to impose ongoing conditions on stock exchange licensees through its power to give general or specific direction to licensees under s13(c) of the SEC Act. The SEC has used this power a number of times in respect of the CSE.

### **Supervision of Market Operators**

Part I of the Schedule to the SEC Act, which sets out the criteria that the SEC must use to assess an application for a stock exchange license, requires that the applicant exchange have rules that “make satisfactory provision”:

- For the expulsion, suspension or disciplining of members for poor conduct of business, or for failure to comply with rules of the stock exchange or the provisions of the Act (subparagraph (iii));
- With respect to the protection of investors in securities from misrepresentation, misleading information, fraud and deceit (subparagraph (ix));
- For ensuring that the customer funds and securities are segregated from other business of brokers and dealers (subparagraph (xiv));
- For the appointment of a disciplinary committee (subparagraph (xv)).

The latter of these serves, among other things and in conjunction with complaints handling requirements in Section 10 of the CSE Stockbroker Rules, as a dispute resolution mechanism in respect of client complaints, for which the SEC serves as a means of appeal for clients. Section 6 of the proposed new Stockbroker Rules, intended to complement the proposed new SEC Act, will establish a dispute resolution mechanism for client complaints, which is separate to the disciplinary committee.

The CSE also maintains an Automated Trading System (**ATS**) and associated Automated Trading Rules (**ATRs**) which govern trading on the CSE and are the only manner in which listed securities can be traded in Sri Lanka. The ATR’s are applicable to all the clients trading through the ATS.

There are no specific rules or regulations in place concerning operational failure or the keeping of records by the exchange itself (though such records are retained automatically by the ATS) nor – as noted previously – in respect of technical systems standards or clearing and settlement.

Part I of the Schedule of the SEC Act also requires that stock exchange licensees have rules that “make satisfactory provision”:

- With respect to conditions under which listing of a particular security may be revoked (subparagraph (vi));
- For the suspension of trading of any given security for the protection of investors or for the conduct of orderly and fair trading (subparagraph (xii)).

The CSE also maintains Listing Rules which, under Part 10, *Enforcement*, allow for the use of trading halts and suspensions to prevent disorderly trading. The CSE oversees these listing Rules under the supervision of the SEC, which is able to direct the CSE to impose trading halts or suspensions. The SEC Rules (2001) also allow for a similar process, and SEC direction, in respect of de-listing.

The CSE does not outsource any of its activities and such outsourcing is not allowed for under the Sri Lankan regulatory regime.

### **Securities and Market Participants**

The prospectus and other documents relating to a proposed new listing on the CSE must be made publicly available (s. 2.4(e) of Section 2 of the CSE Listing Rules) and the SEC can disallow such a listing (s. 13(gg) of the SEC Act). The SEC is actively involved in reviewing new listings.

	<p>In terms of new products listings, currently the CSE lists only equity securities and debentures (debt securities). There is no formal procedure for the consideration of new products, but there is a mutual expectation between the CSE and SEC that the SEC would be consulted on any new product proposals and that the CSE would undertake market analysis to support any proposal. An example of this process is the recent submission to the SEC of concept papers by the CSE to enable the trading of exchange traded funds on the CSE.</p> <p>The proposed new SEC Act is intended to support a range of new products, particularly derivatives such as futures and options. The SEC and CSE are collaborating on preparing appropriate rules to facilitate the introduction of these products.</p> <p>The ATS and ATRs allow for fair access to trading by participants, through consistent trading protocols. The ATRs were subject to approval by the SEC (s. 24(3) of the SEC Act) and cannot be changed without its approval (s. 24(1) of the SEC Act).</p> <p><b>Fairness of Order Execution Procedures</b></p> <p>The CSE publishes the ATRs on its website, which explain how the ATS order routing systems operate. These are in compliance with applicable regulation in Sri Lanka. The trade matching and execution process of the ATS was initially approved based on sample testing by the SEC and this has since been subject to verification during license renewal inspections.</p> <p>All brokers licensed by the SEC in Sri Lanka have equal access to the ATS.</p> <p>While the ATS itself has only limited pre-trade control functionality, such as preventing short-selling, the ATS is compatible with broker order management systems. Over 80% of brokers have now implemented such systems, which allow for a full suite of pre-trade controls.</p> <p>The SEC has facilitated the project to implement a BBO and OMS jointly with the CSE, which is also a pre requisite for a CCP system. At present, over 95% of Stock Broking Firms have completed system implementations. The project is being jointly funded by the SEC and the CSE.</p> <p><b>Operational Information</b></p> <p>CSE Rules and relevant operating procedures are published on the CSE website and are publicly available.</p> <p>As noted above, as a matter of practice, the ATS automatically records transaction information to reconstruct trading activity, however, there is no explicit legal requirement that it do so.</p> <p>The trading system in Sri Lanka is able to, and does, disclose a range of relevant information. (See the Assessment of Principle 35.) In addition, only such trades as are executed by a particular trader are accessible by that trader, maintaining appropriate confidentiality.</p> <p>Market participants are provided with data feeds that provide real-time pre- and post-trade information, with some specific limitations. See the Assessment of Principle 35 for more information about this.</p>
Assessment	<b>Broadly Implemented</b>
Comment	<p><b>Exchanges or trading systems subject to regulation</b></p> <p>The establishment of a stock exchange in Sri Lanka is subject to the approval and oversight of the SEC, based on generally clear criteria.</p> <p>No such framework presently exists to register and supervise an automated trading system that is not a stock exchange. However, in light of the present – and likely future – structure of the Sri Lankan market, the Review Team does not consider this a material gap. However, this could change if the Sri Lankan capital market develops rapidly in future. The Review Team notes the SEC’s advice that these systems are intended to be addressed by proposed revisions to the SEC Act.</p>

	<p>There are certain gaps in the criteria for approval of an exchange.</p> <p>There is no requirement that the exchange have adequate technical and systems capability. The Review Team notes that the proposed new SEC Act will remedy this, and that the SEC nonetheless considers systems capabilities in its supervision of the exchange. However, the lack of specific, current requirements relating to technical systems capacity remains a concern, given the critical nature of such systems to the effective operation of a fair, efficient and transparent market.</p> <p>There is also no general requirement that licensed exchanges apply their rules fairly and consistently. While the Review Team generally accepts that the CSE applies most of its rules fairly and consistently – and that the CSE has adopted a role in ensuring this is the case – a general requirement that exchanges operate fairly would provide a greater degree of certainty in this respect.</p> <p>The mechanism for admitting new members to the CSE, by contrast, is not fairly operated and gives rise to a conflict of interest. This is because the CSE Board, a majority of the members of which are elected by CSE stockbrokers, is able to decide to accept or reject membership applications at their discretion.</p> <p><b>Supervision of Market Operators</b></p> <p>While the CSE operates a dispute resolution scheme, the SEC and CSE should consider the establishment of a fully independent dispute resolution scheme. This would provide a greater degree of confidence in the dispute resolution system.</p>
<p><b>Principle 34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants</b></p>	
<p>Description</p>	<p><b>Market Surveillance</b></p> <p>Both the CSE and SEC monitor day-to-day trading in the CSE market through separate market surveillance programs.</p> <p>The SEC is empowered under s. 13(o) of the SEC Act to: “conduct investigations into any alleged violation or contravention of the provisions of [the SEC Act]”. Likewise, the CSE is required, under subparagraph (j)(xiii) of Part I of the Schedule, to have adequate rules “with respect to the conduct of securities trading of stockbrokers and stock dealers”.</p> <p>Meanwhile, the CSE is obliged, under subparagraph (j)(ix) of Part I of the Schedule to the SEC Act, to have adequate rules: “with respect to the protection of investors in securities from misrepresentation, misleading information, fraud, deceit and other adverse practices in the issue and trading of securities and from the abuse of certain persons of privileged information not yet made available to the general public”.</p> <p>The CSE’s market surveillance function uses a market monitoring system provided by the National Stock Exchange of India. There are two CSE staff members who are involved in market surveillance on a full-time basis. Where suspicious conduct is identified concerning a broker, the CSE makes additional inquiries directly and makes a referral to the SEC. Where the trading concerns a member of the public, the CSE makes a referral to the SEC straight away.</p> <p>From the beginning of 2014 to September 2016, the CSE made 70 such referrals to the SEC. The most common forms of suspicious trading observed in the Sri Lankan market are potential market manipulation, followed by possible front-running.</p> <p>The SEC conducts a parallel system of market surveillance separate from the CSE. The SEC advised that it is hoping to implement a new market monitoring system, as its current one does not offer functions like automated alerts or website scanning. It also requires the SEC to do a significant amount of manual computation.</p>

The SEC has four staff members currently devoted to market surveillance, and intends to increase this to five.

The SEC has an internal process to consider whether observed suspicious market trading warrants further investigation, after the SEC has gathered initial information and explanations from relevant brokers or member of the public. In the four years to the end of 2015, the SEC referred 95 instances of suspected securities law violation for further consideration, with 19 resulting in further investigation.

As noted above, the SEC's surveillance activities are supported by referrals from the CSE. In the four years to the end of 2015, the CSE made 70 referrals to the SEC, with 13 resulting in investigations.

The SEC has an internal process to consider whether observed suspicious market trading warrants further investigation, after the SEC has gathered initial information and explanations from relevant brokers or member of the public.

There are only limited arrangements in place to coordinate the surveillance functions of the SEC and CSE. These largely comprise information-sharing, which can be one-sided. (That is, the CSE providing information to the SEC.) Effective September 2016 the suspicious trading referrals will be considered by the Surveillance and Investigations Committee at meetings attended by representatives of the CSE, and thereafter taken up for investigation.

While the SEC and CSE consider that the CSE market is significantly less affected by misconduct and manipulation than it was previously, there have been very few prosecutions for market misconduct offences in Sri Lanka. The most recent successful prosecution for such offences took place in the 2007.

More recently, some prosecutions have been "compounded", a process by which the case is concluded with the defendant paying a fine of up to one third of the maximum penalty under the SEC Act. Under the general offence provision at s51 of the SEC Act, the maximum compound penalty would be a fine of Rs. 3.33million or about USD\$23,000.

Furthermore, widespread and notorious cases of market misconduct – which took place in the boom period following the end of the Sri Lankan civil war in 2009 – are also yet to result in any prosecutions, despite the re-opening of relevant cases by the SEC in 2015.

### **Supervision of Market Participants**

The CSE and SEC also monitor the conduct of stockbrokers through separate supervisory programs, with both organizations having powers of inspection and oversight in the sector. The SEC has supervisory powers under s. 14(a) of the SEC Act, and specific information-gathering powers under s8 of the SEC Rules 2001. The CSE has inspection powers under section 9.1 of the Stockbroker Rules.

The SEC and CSE each have five supervisory staff members who cover stockbrokers. (In the SEC's case, these staff members also cover margin providers.)

Generally, the SEC and CSE discuss and finalize an audit plan for brokers at the start of each year. This has involved a split of brokers, so that the SEC conducts supervisory inspections of one half of brokers each year and the CSE the other half. However, the SEC advises that this approach is changing as the SEC seeks to move to a more risk-based approach to identifying targets for supervisory inspections.

The SEC and CSE do not necessarily use the same process for supervision. While the two organizations typically examine similar issues and risks, the level of attention paid to particular matters may vary between the SEC and CSE. SEC staff members interviewed during the onsite visit advised that they regard the most common significant compliance weaknesses among stockbrokers as being extending credit to clients beyond approved limits, extending credit without an appropriate written agreement, retaining the proceeds of security sales without client permission and failing to properly segregate client assets.



The degree of cooperation between the SEC and CSE on supervision of brokers is greater than on surveillance. However, it is generally limited to doing the yearly split of brokers and two-way information sharing, through which the SEC and CSE share the findings of their supervisory activities with each other.

While the supervisory processes of the SEC and CSE have identified compliance weaknesses among several stockbrokers, the progress in remediating these identified deficiencies has not always been timely, and there has been only somewhat limited use of existing enforcement remedies to compel brokers to resolve compliance problems.

Given the significance of the weaknesses identified through supervision, including – as noted above – failures to stick to margin lending limits and to properly segregate client assets, delays in rectification risk client losses and consequent erosion in the credibility of the regulatory framework for brokers.

### **Supervision of Market Operators**

As noted in the description for Principle 33, stock exchange licenses are granted for a period of five years and are subject to renewal.

As part of this renewal process, the SEC undertakes a detailed review of the CSE, taking into account the licensing requirements set out in Part 1 of the Schedule to the SEC Act. This involves a process similar to the inspections of market participants. It also, as previously noted, includes a separate review of the CSE's IT systems by a specialist consultant.

In addition, the SEC has general powers, under section 14(a) of the SEC Act, to undertake inspections of stock exchanges and other licensees. Under s. 8 of the SEC Rules 2001, it also has specific powers to obtain books and records, which is something the SEC does as a matter of practice.

While the CSE license renewal process happens only every five years, SEC staff members noted that, due to the ongoing interaction between the SEC and CSE on regulatory matters, it is able to, and does, make itself aware of issues and raise them with the CSE where required.

Under the proposed new SEC Act, the licensing regime for stock exchanges will change to a perpetual licensing model. SEC staff members advised that the SEC will then be able to consider altering its general supervisory inspection approach towards the CSE.

### **Access to pre and post-Trade Information**

The SEC has access to the records of transactions retained by the ATS and uses this information to reconstruct trades, when required, for its market surveillance and investigative activities.

### **Oversight of Stock Exchange Rules**

The SEC, under s. 24(3) of the SEC Act, is given the authority to allow or disallow changes to a licensed stock exchange's rules. Under s. 24(3) of the SEC Act, stock exchange rules – once approved by the SEC – cannot be changed without its authorization.

The CSE has an internal process for developing rule change proposals. Where these are substantive, the CSE seeks SEC input prior to developing final proposals, usually by sharing a "concept paper". More contentious or significant rule changes may also be subject to a process of public consultation.

The SEC also has an internal process for considering proposed CSE rules changes, via its Regulatory Committee (with input from relevant divisions). The final decision on rule changes is made by the Commissioners of the SEC. The SEC expects the CSE to provide a rationale for any rule changes.

The SEC has also initiated rule changes at the CSE by proposing that it amend its rules in response to issues identified by the SEC.

	<p><b>Regulatory Remedies in Respect of Market Operators</b></p> <p>Licensed stock exchanges are subject to the same powers of supervision, oversight and sanctioning as market intermediaries in Sri Lanka.</p> <p>In addition to the remedial powers it has in respect of market intermediaries, the SEC has powers, under s. 23A of the SEC Act, to take over the management of a licensed stock exchange and, if desired, assign the management of the stock exchange to a new operator (s. 23A(2)).</p> <p>As has been noted elsewhere, the SEC Act does not allow for civil penalty actions against individuals or firms that breach their legal obligations. Instead, only criminal actions are possible.</p> <p>However, the SEC does have the power to issue a general or specific direction to a licensee, under s. 13(c) of the SEC Act, which could be used in the context of requiring remediation of a breach. The SEC has also issued private warnings or rebukes to licensees in the past in connection with identified compliance deficiencies.</p> <p>Remedies like fines, or a specific regime for public censure, are not allowed for under the Sri Lankan regulatory regime.</p>
Assessment	<p><b>Broadly Implemented</b></p>
Comments	<p>Overall, the Review Team is satisfied that the SEC acts as a present and effective overseer of the CSE’s compliance and rule-making processes. The CSE, at least as a matter of practice, has access to the required information to carry out its supervisory duties in respect of the CSE and its stockbroker members, and to undertake its market surveillance activities. However, the Review Team also notes the lack of a specific legal requirement for the CSE and ATS to retain key trading data, even though as a matter of practice, the CSE has maintained trading records from the inception of the ATS</p> <p>The Review Team is also satisfied that the secondary market in Sri Lanka is subject to active surveillance, and that participants are subject to active supervision.</p> <p><b>Efficiency of Joint SEC and CSE Surveillance and Supervision</b></p> <p>While it does not necessarily impact the Review Team’s assessment of implementation of this Principle, the Review Team notes that the parallel systems of surveillance and supervision operated by the SEC and CSE risk unnecessary duplication, creating an excessive compliance burden on firms, and inefficiency in the use of regulatory resources. The effectiveness of both surveillance and supervision could be enhanced through greater cooperation between the two organizations, beyond the current information sharing.</p> <p>The Review Team notes that only a comparatively small number of CSE referrals to the SEC have resulted in the initiation of investigations.</p> <p>In this respect, the Reviews Team welcomes the moves towards greater coordination of referrals for investigation that will commence in September 2016.</p> <p>A discussion of the adequacy of the SEC’s investigative resources is included in the Assessment and recommendations in respect of Principle 36.</p> <p><b>Overall effectiveness of Surveillance and Supervision</b></p> <p>Of greater concern is the level of effectiveness of both the surveillance and supervisory regimes in Sri Lanka. While these programs have demonstrably identified suspicious trading (surveillance) and compliance weaknesses (supervision), there is little evidence that these findings are leading to enforcement outcomes or changes in firm behavior.</p> <p>This issue is considered in detail in the comments on Principle 36 and the recommendations made in respect of that Principle.</p>

	<p><b>Remedies in Respect of Compliance Failures of Market Operators</b></p> <p>The SEC possesses sweeping powers to take over the operations of licensed exchanges and, if desired, assign these to another operator.</p> <p>However, as this is such an extreme measure, it is unlikely to be used except in cases of sustained or egregious compliance failure. It may thus not dissuade the CSE from committing less severe breaches or omissions.</p> <p>The SEC does have some other, limited powers to address compliance failures by licensed exchanges, such as the power to issue directives, or the seemingly informal power of privately rebuking the exchange. But these measures are minor in impact and would not be appropriate for infractions which are not severe, but are not merely trivial. As such, the suite of remedies available to the SEC in respect of market operators does have clear gaps.</p> <p>Nonetheless, the Review Team is satisfied that the SEC is an effective supervisor of the CSE and that the CSE itself, if not necessarily some among its members, displays generally effective compliance and engages diligently and appropriately with the SEC on regulatory matters.</p>
<p><b>Principle 35. Regulation should promote transparency of trading</b></p>	
<p>Description</p>	<p><b>Provision of Information to Market Participants</b></p> <p>Generally, transparency of trading is established in Sri Lanka through the operation of the CSE ATRs and the use by brokers of the ATS as the only means by which they can place orders through the CSE market. The SEC Rules 2001 state, at s. 6(1) that: <i>“All transactions relating to listed securities shall take place in compliance with the trading rules of the licensed stock exchange which have been approved by the Commission.”</i></p> <p>The Introduction to the ATRs states that: <i>“Bid and Ask prices are entered into a central electronic order book. During trading hours, orders are matched according to fixed rules and execution prices are set. Price and volume details of all completed transactions are electronically communicated immediately to all the members involved.”</i> The ATRs go on to set out how orders must be entered and flow into the order book displayed on broker terminals.</p> <p>However, there are some exceptions to this general transparency, which are explained below.</p> <p>Brokers and dealers receive detailed information in the form of two intra-day data feeds to their terminals: the Raw Data Feed pertaining to each security traded on the CSE and an XML Ticker pertaining to each transaction on the CSE, both in real time.</p> <p>The Raw Data Feed provides extensive order book information, trade information, statistics and other data; and the XML ticker provides data concerning indices of the CSE, to each securities transaction carried out on the CSE and both total and sector-wide turnover.</p> <p>However, CSE practice and the ATS Rules do not allow for order book information to be displayed during the pre-trade session of the CSE.</p> <p>For debt securities, the ATS is currently unable to display certain important information, notably the yield to maturity.</p> <p>SEC staff members also raised concern about the use by brokers of nominee accounts, which could be used to conceal the beneficial owner of securities bought and sold on-market.</p> <p><b>Publication of Market Data</b></p> <p>The CSE Daily, published on the CSE website, provides a comprehensive report on the daily activity on the CSE, including:</p>

	<ul style="list-style-type: none"> <li>• Indices;</li> <li>• Market turnover and capitalization;</li> <li>• Gainers and losers;</li> <li>• Rights issues;</li> <li>• Dividend announcements;</li> <li>• The default board and suspensions of trading;</li> <li>• Notices of annual and general meetings;</li> <li>• Circulars, directives and disclosures;</li> <li>• Crossings; and</li> <li>• For each security, the closing price, the last traded price, the last traded date, the high/low price, turnover, market cap and the number of securities on issue, held in the Central Depository System (CDS).</li> </ul> <p>The CSE also published similar weekly, monthly and quarterly reports.</p> <p>These reports are published on the CSE website and are free to access.</p> <p><b>Derogations</b></p> <p>The ATRs allow for some derogation from general transparency requirements in the case of two types of orders: “iceberg” orders and crossings.</p> <p>In the case of iceberg orders, conditions are attached to their use. At least 25% of the order must be disclosed up-front, and this quantity, once executed, reduces the priority of the remaining order quantity relative to other, more transparent trades. The total order quantity disclosed to the Exchange.</p> <p>Crossings are subject to price constraints, whereby the price for an equity crossing cannot be more than 5% less than the previous closing price. Crossings must comprise at least 5% of the securities of the relevant issue, or be for an amount greater than Rs. 20,000,000 (around USD\$138,000).</p> <p>Crossings orders do not appear in the order book displayed in the relevant broker market feeds. They are displayed as executed trades, appear on the “crossings boards” and are included in the CSE Daily market reports.</p> <p>Crossings typically make up between 10-50% of the value of daily turnover on the CSE. Some stakeholders claimed that the use of crossings in the illiquid Sri Lankan market had the effect of impeding price discovery.</p> <p>Crossings are not required to be reported to the SEC or CSE in advance and neither organization has an opportunity to assess the need for the use of a crossing and to prescribe alternatives, if that is deemed necessary.</p> <p>Crossings and iceberg orders are the only permitted forms of “dark” (or quasi-dark) trading in Sri Lanka.</p>
Assessment	<b>Partly Implemented</b>
Comments	The Review Team is satisfied that the interaction of the SEC Rules 2001 and the ATRs impose a general requirement for transparency of trading in Sri Lanka.

	<p>However, the Review Team notes both the limitations on this transparency and the derogations from it that are permitted under the ATRs.</p> <p><b>Limitations on Transparency</b></p> <p>The lack of pre-trade transparency in the opening auction process limits the general level of transparency in the Sri Lankan market.</p> <p>The suspected use of nominee accounts by brokers has a similar limiting effect, by potentially concealing from regulators the underlying owner of securities being bought and sold. It is also a concern that there appears to be only anecdotal information available on the extent of the use of such accounts in Sri Lanka.</p> <p><b>Derogations</b></p> <p>It is the view of the Review Team that the facility for iceberg orders is appropriately limited and regulated.</p> <p>However, the lack of pre-execution notification of crossings to regulators – and the consequent lack of opportunity for regulators to consider and prescribe alternative trading approaches – falls short of the expectation of this Principle. The significance of this issue is magnified by the relatively large size of crossings as a proportion of the turnover on the CSE. It should be noted that Crossings were introduced to increase the liquidity of the market and also to encourage foreign investments.</p>
<p><b>Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices</b></p>	
<p>Description</p>	<p><b>Prohibitions on Market Misconduct and Sanctions</b></p> <p>In Sri Lanka, insider trading is specifically prohibited by Part IV of the SEC Act. Other market misconduct, including creating a false or misleading impression of active trading, engaging in fictitious transactions and front running are prohibited under the SEC Rule 2001 (sections 12, 13 and 14, respectively).</p> <p>Under section 28(2) of the SEC Act, regulated (licensed or registered) entities, such as stockbrokers and unit trust managers, are prohibited from providing false or misleading information or other fraudulent or deceitful conduct in relation to listed securities. This prohibition does not apply to members of the general public.</p> <p>The new proposed SEC Act will incorporate market misconduct provisions into the body of the Act, at Part V and include a securities fraud provision that will apply to all persons.</p> <p>Similar prohibitions on market misconduct appear in Part 3.8 of Section 3 of the CSE Stockbroker Rules.</p> <p>Under s. 33A of the SEC Act, insider trading is punishable by a fine of not less than Rs. 1,000,000 (or about USD\$7,000), a jail term of not less than two years and not more than five years, or both.</p> <p>Breaches of other market misconduct provisions are dealt with under the SEC Act’s general offence provision, s. 51(1). Under s. 51(2) of the SEC Act, persons who commit an offence under s. 51(1) can be punished with a term of imprisonment of for a period not exceeding five years, to a fine not less than Rs. 50,000 (about USD\$345) and not exceeding Rs. 10,000,000 (about USD\$69,000) or both.</p> <p>These offences are heard in the Magistrate’s Court, which is a lower court that hears a variety of matters, mostly criminal. Under the proposed new SEC Act, offences – including market misconduct offences – will continue to be criminally prosecuted through the Magistrate’s Court, but civil actions will be heard in the Commercial High Court. The Review Team understands that this is because, under Sri Lankan law, criminal cases can only be heard by higher Courts, at first instance, where there is a direct indictment issued by the Attorney-General, rather than an agency like the SEC itself.</p>

As previously observed, there are no civil penalties available in respect of market misconduct offences in Sri Lanka, with only criminal prosecution possible at present. The proposed new SEC Act will allow for such penalties.

The proposed new SEC Act will also not allow for the “compounding” of market misconduct offences, but will retain it for other breaches of the Act.

#### **Mechanisms Available to Address Market Misconduct**

As noted under Principle 34, the SEC and CSE undertake parallel market surveillance programs to identify potential misconduct.

Section 10.3(a) of the CSE Listing Rules allows the CSE to place trading halts on securities in certain circumstances including, among others, when there is an unusual movement in price or volume of trading in a security, or if the CSE deems it necessary for the purpose of disseminating information. The SEC can also impose trading suspensions under section 13(h).

Under section 10.3(b) the CSE can also suspend the listing of a security when the issuer is in breach of the Listing Rules, as well as for certain other reasons or at the direction of the SEC.

Also as noted under Principle 34, as a matter of practice, the SEC has access to all trading information that is retained by the CSE. It also has access to the books and records of brokers under s8 of the SEC Rules 2001.

Order handling is governed by section 3.1 of the Stockbroker Rules, which requires – among other things – that brokers give priority to client orders, execute orders promptly and on the best available terms and manage any relevant conflicts of interest.

However, there have been only a very limited number of prosecutions for market misconduct offences in Sri Lanka, with the last successful prosecution taking place in the 1990s. While there are fifteen investigations currently ongoing, no charges have been filed in recent years, even in connection with certain notorious instances of alleged misconduct that took place following the end of the Sri Lankan civil war in 2009.

#### **Collection of Information on Trading Activity**

There are arrangements in place to monitor the activities of market participants in Sri Lanka, with the SEC and CSE running parallel programs. (See Principle 34.)

The SEC also has mechanisms in place to consider the further investigation of reports of suspicious trading.

However, brokers themselves, while being obliged to do so under s3.8.2(4) of the Stockbroker Rules, rarely provide referrals of suspicious trading to the CSE – though there have been instances of this happening.

As Sri Lanka has only one secondary market, there are no arrangements for inspection, assistance or information-sharing with respect to cross-market trading. Similarly, no provisions relating to the supervision of a commodity futures market exist, for the same reason, because no such market exists.

There are also no foreign linkages with, substantial foreign participation in, or cross listings on, the CSE. The CSE is currently in the process of finalizing an MoU with the Maldives Exchange to facilitate the cross listing of companies. It is important that this agreement includes appropriate information and other cooperation mechanisms between relevant regulators that address manipulation and abusive trading practices.

Assessment	<b>Partly Implemented</b>
Comments	<p>While there is a regime in place to prohibit market misconduct in Sri Lanka, and an appropriate system of market surveillance to support this prohibition, successful prosecutions have been exceedingly rare. This is in spite of some very high-profile alleged misconduct that took place several years ago, in the boom period following the end of the Sri Lankan civil war.</p> <p>In the case of supervision, as noted in the comments on Principle 31, there has been limited follow-up action taken to ensure that identified compliance failures are addressed in a prompt and effective manner. Indeed, some industry stakeholders indicated to the Review Team that only a small proportion of brokers could be trusted to ensure basic client protections were in place, such as the segregation of client funds</p> <p>The lack of concrete outcomes of investigation activities, and the persistence of compliance weaknesses among supervised brokers, has the potential to undermine investor confidence in the capital market in Sri Lanka.</p> <p>The Review Team notes that only a comparatively small number of surveillances have resulted in the initiation of investigations.</p> <p>Furthermore, where investigations have been undertaken, there have been limited enforcement outcomes, either in the form of prosecution of individuals or, in the case of licensed firms, administrative action such as license suspensions or removal of the certification of relevant individuals to deal with clients (allowed for under section 11.3.8(2) of the Stockbroker Rules).</p> <p>Stakeholder feedback on the effectiveness of the overall market integrity framework was mixed. Stakeholders also differed on their levels of confidence in the integrity of the market at the time of compiling this report.</p> <p>In any event, the lack of prosecutions, or other action, in respect of market misconduct suggests that the regulatory approach to detect and deter such misconduct is not presently sufficiently <i>effective</i> – and nor does it include sufficiently <i>dissuasive</i> sanctions in practice.</p> <p>The Review Team notes and accepts the SEC’s observation that the current SEC Act does not allow for civil penalty actions to be taken against alleged wrongdoers. This leaves criminal prosecutions – with their associated high burden of proof and rules of evidence – as the only means by which the SEC can seek to penalize offenders.</p> <p>The Review Team also accepts that this situation leaves the SEC without a comprehensive suite of dissuasive and effective enforcement powers in respect of market misconduct.</p> <p>However, the Review Team does not believe, in the case of market misconduct offences, that excessive reliance should be placed on the use of civil penalties to punish wrongdoers or deter misconduct. Ultimately, particularly in the case of more serious offences, criminal prosecution – and the associated potential penalties, such as imprisonment – is the only appropriate remedy.</p> <p>The Review Team also notes that administrative action, currently open to the SEC either directly or via direction to the CSE, have not been used sufficiently often in cases where suspected misconduct involves licensed firms or their directors or employees.</p> <p>As such, while the Review Team supports the SEC’s advocacy for reform to the SEC Act, as proposed, it does not see the implementation of civil penalties as a panacea for the observed deficiencies in the enforcement of market integrity. The SEC should aim to use all the tools at its disposal to address misconduct when it is observed. It should also continue to pursue prosecutions where warranted, to ensure serious misconduct is appropriately penalized.</p>

	As noted in the comments on Principle 12, the Review Team queries whether the Magistrate’s Court is the ideal venue for the criminal prosecution of market misconduct offences. The Review Team notes that market misconduct cases can involve the consideration of complex financial matters and detailed evidence. Hearing such cases at the Magistrate’s Court may also be incongruent with the seriousness with which market misconduct offences should be taken, given their potential to undermine investor confidence and damage market integrity.
<b>Principle 37.</b>	<b>Regulation should aim to ensure the proper management of large exposures, default risk and market disruption</b>
Description	<p><b>Monitoring of Large Exposures</b></p> <p>The Sri Lankan market has some limited mechanisms in place to manage the risk of broker default and settlement failure. However, these do not include measures to monitor and evaluate continuously the risk of open positions or credit exposures that are sufficiently large to present a risk to the market or to a firm.</p> <p>Likewise, there are no formal or informal arrangements to enable markets and regulators to share information on large exposures.</p> <p>Under the rules of the Central Depository System (CDS) brokers are required to post margins in respect of larger trades that have not fully settled. However, this is a mechanistic requirement based on the size of the trade, and not an active monitoring system that allows for risk-based evaluations (or actions) at the broker level.</p> <p>Brokers are also subject to capital and liquidity requirements, as described in the assessment of Principle 30.</p> <p>There are specific arrangements in place, under Section 7 of the Stockbroker Rules, which enable stockbrokers to extend credit to their clients. These include limitations on:</p> <ul style="list-style-type: none"> <li>• The amount of credit brokers can lend overall, which is restricted to three times the “Adjusted Net Capital” of the broker (section 7.1.1);</li> <li>• The amount of credit extendable to a single client, which is restricted to 15% of the total value of credit extendable by the stock broking firm (section 7.1.4); and</li> <li>• The initial amount that can be lent as a proportion of the value of the client’s portfolio, which is limited to 50% (section 7.1.3(2)).</li> </ul> <p>The Stockbroker Rules, at 7.1.3(3), also oblige brokers to make a margin call where the market value of the securities falls by 25% with the client expected to meet the shortfall by the next market day.</p> <p>However, there is no provision for specific monitoring of brokers’ margin lending on a continuous basis. (Though there are provisions for fortnightly reporting on credit exposures to the SEC.) There is also no requirement for trigger-point or exception reporting as the broker approaches the set risk limits, for example, as the total amount of margin loans outstanding approach three times Adjusted Net Capital. The credit exposure of the stock broking firms is reviewed during on site and off site supervision. Further the stock broking firms are also required to report on their debtor’s positions fortnightly to the SEC with a declaration made by the CEO.</p> <p><b>Default procedures</b></p> <p>There are inadequate procedures for dealing with broker default at present. While settlement failure is covered under the Section 12 of the CDS Rules, these allow for only limited action by the CDS. See the Assessment of Principle 32 for more information about this.</p> <p>On the CSE, transfer of securities is made same-day and settlement of funds takes place on a T+3 basis. Presently, the SEC is facilitating the establishment of a CCP mechanism jointly with the CSE and until it becomes fully operational, brokers are essentially dealing bilaterally with each other.</p>



	<p>There exists no provision in Sri Lankan law to explicitly ensure that clients' funds are not subject to claims by general creditors in a broker bankruptcy, despite the requirements in Section 4 of the Stockbroker Rules that client assets be segregated and held in a bank trust account.</p> <p>The proposed new SEC Act allows for the default procedures of a clearing house to take precedence over any other proceeding in insolvency or bankruptcy. However, it is, as yet, unknown what the default procedures of any future clearing house would be.</p> <p><b>Short Selling</b></p> <p>Short selling is not permitted in Sri Lanka and such trades are blocked by the ATS.</p>
Assessment	<b>Partly Implemented</b>
Comments	<p><b>Monitoring Large Exposures</b></p> <p>The lack of a system to continuously monitor large exposures presents a significant risk to the integrity of the Sri Lankan market, and to investor confidence. Indeed, some stakeholders nominated the risk of broker default and settlement failure as a key impediment to the further development of the capital market in Sri Lanka. It is, in any event, a clear gap in Sri Lanka's regulatory framework and represents a failure to implement this Principle in anything but a limited fashion.</p> <p>There are insufficient arrangements in place to actively monitor brokers' exposure to client debtors via margin loans. Given the risks posed by the practice, there should be a more frequent process for standard reporting, as well as exception reporting as exposures approach maximum limits.</p> <p>Given that many licensed brokers in Sri Lanka are affiliates of banks regulated by CBSL, the lack of a formal system for two-way information sharing between these organizations gives rise to a risk that contagion emerging from groups' banking operations could imperil the financial soundness of the broking entity.</p> <p><b>Default Procedures</b></p> <p>The lack of clear procedures to deal with a broker default and settlement failure risks creating a disordered market should such an event occur. The lack of a central counterparty magnifies these risks. However, the Review Team notes that the SEC is currently working to facilitate the establishment of a central counterparty mechanism jointly with the CSE.</p> <p>Furthermore, while brokers are obliged to segregate client funds and place these in a bank trust account, there are no specific legal provisions to protect client assets from being subject to creditor claims in insolvency. This presents a significant risk to the clients of brokers, who cannot have complete confidence that their assets are being genuinely protected.</p> <p>Again, these factors demonstrate the limited implementation of this IOSCO Principle.</p>