Technical Assistance Consultant's Report

Project Number: 49365-001
September 2016

Sri Lanka: Capital Market Development Program

Prepared by

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Hong Kong, China

For Ministry of National Policies and Economic Affairs
Ministry of Finance's Department of Development Finance

Asian Development Bank

Final Report

TA-9105 SRI: Capital Market Development

30th August 2016

Transforming Markets

Celebrating 25 years in transforming global financial markets

CONTENTS

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INTRODUCTION

1. This Final Report volume contains the 22 Briefing Notes prepared by ISC for TA-9105 SRI: Capital Market Development.

2. The Briefing Notes have been grouped into 4 topic headings:

   A. Regulation and Regulatory Structure;

   B. Market Structure;

   C. Demand for Investments; and

   D. Supply of Investments.

3. **Regulation and Regulatory Structure** covers legislative changes to strengthen regulators, build capacity, simplify dispute resolution, and improve regulatory infrastructure. It includes the following 6 Briefing Notes.

A. Regulation and Regulatory Structure	
1. Strengthen Auditing Standards	Examines current enforcement of audit standards and proposes strengthening the enforcement activities of the audit supervisory board through adopting a risk-based approach.
2. Institutional Strengthening of SEC	Analyses the structure and governance of the SEC and proposes actions to strengthen the SEC and bring it into line with international best practice, including amendments to the SEC Act to guarantee independence, better internal planning, and better staff management.
3. Institutional Strengthening of IBSL	Analyses the structure and governance of the IBSL and proposes actions to strengthen the IBSL and bring it into line with international best practice through legislative changes to ensure independence and better staff management.
4. Strengthen Risk-Bearing Capacity of CSE Intermediaries	Proposes a system for risk-based capital assessment of intermediaries to monitor risk exposures, in part as a precursor to the introduction of universal brokers.
5. Establish a Capital Markets Tribunal	Proposes a model for a tribunal to adjudicate capital market cases and disputes between participants and the SEC, so bringing greater fairness and reduced costs in dispute resolution.
6. Establish Real-Time Surveillance	Proposes a way forward for the acquisition of a more appropriate surveillance system for the SEC to replace the current system which is no longer fit for purpose, being inflexible and lacking a secure evidence trail.

4. **Market Structure** covers improving the efficiency and the attractiveness of the capital market through changes to market structure, enhanced regulation, more equitable taxation and better organization of the stock exchange. It includes the following 6 Briefing Notes.

B. Market Structure	
1. Facilitate Demutualization of the CSE	Proposes a way forward involving a Demutualization Bill and a Working Group leading to demutualization of the CSE with good governance and an equitable allocation of the exchange assets.
2. Strengthen Trading Platform and Establish a Central Counterparty System	Examines current plans for CCP and proposes enhancements to increase transparency in the government bond market, and notes the high-cost of a CCP system which will bring only limited benefits.
3. Develop Incentive Tax Framework for Capital Market Investments	Identifies tax barriers to development of the capital markets, and identifies the most significant obstacles as those relating to transaction taxes, unit trusts, stamp duties, and the uncertainty surrounding the reintroduction of CGT.
4. Promote Colombo as an International Financial Center	Evaluates prospects and possible development paths for Colombo as an IFC, stressing the need for careful identification of competitive strengths, strong AML/CFT regulations, and co-ordination with the domestic market regulation.
5. Enforce On-going Listing Requirements	Examines the CSE's on-going regulation of listed companies and proposes improvements to raise standards, particularly in relation to price sensitive information and delisting of non-compliant companies.
6. Promote Market Making	Assesses the possibility of introducing market making on the CSE and endorses the CSE plan for a pilot program while stressing the need to develop stock lending/short-selling.

5. **Demand for Investments** is a crucial part of capital development – if there are willing buyers then markets will thrive under most circumstances. This topic covers the issuance of government bonds, the demand for unit trusts, and broadening the investments of the national pension scheme. It includes the following 3 Briefing Notes.

C. Demand for Investments	
1. Reform Primary Dealer System for Government Securities	Identifies weaknesses in the current auction system and proposes actions to avoid abuse of the auction based around greater transparency of the auction, enforcement of capital requirements, and closer adherence to market clearing auction rules.
2. Promote Unit Trusts	Examines the relative failure of the Unit Trust industry to develop, and proposes solutions and identifies biases in the tax system, changes to the corporate structure of unit trusts, and a wider range of distribution channels.

C. Demand for Investments	
3. Enhance Demand from Superannuation Funds	Recognizing the dominant position of the Employees Provident Fund (EPF) with its heavy investment in government bonds and the risks of disruptive change, the Briefing Note proposes modest changes to introduce greater diversity, risk-taking and member choice into EPF.

6. **<u>Supply of Investments</u>** recognizes the limited number and range of products currently available in the capital markets and makes recommendations relating to increasing the supply of IPOs, widening the CSE's product range, introducing derivatives and securitizations, and deepening the yield curve to enhance liquidity in the government bond market. It includes the following 7 Briefing Notes.

D. Supply of Investments	
1. Improve Regulation for IPOs and Listings	Analyses possible barriers to listing, identifying the main problem as not process but the small scale of the market, and recommends efforts to attract large local private companies and also to list SOEs.
2. Establish Alternative Listings Boards	Examines proposals to introduce additional boards on the CSE for SMEs, foreign currency stocks and BoI companies, and recommends that the CSE should push ahead with broadening its product range by strengthening its marketing efforts, and should also improve the regulatory reputation of its existing boards by enforcing minimum requirements.
3. Strengthen Market for Corporate Debt	Assesses the current state of the corporate bond market and makes proposals to increase demand and expand the range by broadening pension investment, and increasing the supply by developing services for private placements.
4. Introduce Securitized Instruments	Proposes work to be done to bring the existing draft Securitization Act (dated 2008) more in line with current international practice and thinking.
5. Deepen Yield Curve for Government Securities	Analyses the inefficient nature of the current government bond issuance and proposes remedies to consolidate around benchmark maturities and so increase liquidity.
6. Establish Derivatives and a Commodities Exchange	Recognizing the limitations imposed by the small size and lack of liquidity of the current market, the Briefing Note recommends the CSE should press ahead with structured warrants and exchange traded funds pending the introduction of a CCP which will facilitate the introduction of exchange-traded derivatives. It also recommends a clearer assessment of the business case for a cash commodities exchange in comparison with a simpler, less expensive commodity derivatives exchange.

D. Supply of Investments	
7. Broaden Equity Market Listings - Insurance Companies	Evaluates the current situation of compliance of insurance companies with the requirements to segment business and list, with recommendations that the state-owned insurance company be required to segment its business, that legal clarity on the listing requirement should be obtained with respect of holding companies, and that enforcement action be taken against companies that fail to comply.

7. The Briefing Notes include a wider range of suggestions than those included in the policy matrix and it is recommended that these be given serious consideration in the light of the clear need to strengthen the Sri Lankan capital market.

A. REGULATION AND REGULATORY STRUCTURE

1. Strengthen Auditing Standards

STRENGTHEN AUDITING STANDARDS

I. Assessment

1. The financial reporting system follows the world standard via the UK model. Specifically:

   a. the directors of a reporting entity are responsible for the quality and compliance of the statutory financial statements of their company;

   b. consolidated financial statements are required of all specified business enterprises (SBEs) which corresponds in all material aspects with the concept of Public Interest Entities used elsewhere. SBEs include some private and unlisted companies and organizations which are also regulated by other statutory bodies (e.g., Central Bank of Sri Lanka (CBSL) and Insurance Board of Sri Lanka (IBSL));

   c. financial reporting by SBEs and the auditing of financial statements of SBEs is regulated by the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB), a statutory body formed under the *Accounting and Auditing Standards Act No. 15 of 1995*;

   d. this Act also mandates use of Sri Lanka Accounting Standards Committee (SLASs) and Sri Lanka Auditing Standards Committee (SLAuSs);

   e. SLASs and SLAuSs are produced by the Sri Lanka Accounting Standards Board and the Sri Lanka Auditing Standards Board respectively;

   f. SLASs and SLAuSs are operated by the Institute of Chartered Accountants of Sri Lanka (ICASL), which is also a statutory body charged with the registration and regulation of chartered accountants in Sri Lanka;

   g. SLASs and SLAuSs are based on International Financial Reporting Standards (IFRS)/International Accounting Standards (IAS) and International Standards on Auditing (ISA) respectively. The SLAuSs are verbatim ISAs and the SLASs are near verbatim, so that compliance with SLAs would mean compliance with IFRS/IAS; although the SLASs and SLAuSs do not contain any reference to their IFRS/IAS or ISA equivalence as assurance to foreign readers of the SLASs or SLAuSs; and

   h. the structure outlined above is essentially the same as that in Hong Kong and as the UK system prior to recent reorganizations of regulatory authority and is comparable with structures in other Commonwealth countries.

2. The SLAASMB reviews the consolidated financial statements of SBEs:

   a. as part of a plan set by legislation (see below);

   b. in response to media comments about a set of consolidated financial statements or an SBE; or

   c. in response to complaints from the public or other interested parties.

3. The total number of SBEs is reported as being roughly 1400, of which almost 300 are listed in the Colombo Stock Exchange (CSE). Every Annual Report of CSE-listed entities is subject to review and, in addition, it appears that SLAASMB has been required to examine the consolidated financial statements of all the other SBEs. This has resulted in the 14 professional staff of SLAASMB being put under severe pressure, raising staff morale issues and concerns about the quality of the reviews. The accepted best practice in other countries is a form of risk-based sample covering the organizations which are most significant to society and which pose the highest risk to the financial system.

4. The statutory size thresholds for entities to qualify as SBEs have remained static since 1999, which is an exacerbating issue. This means that SLAASMB's review population has increased substantially, and with a significant proportion which are small private companies which do not warrant review or which lack the resources to produce Financial Statements of an acceptable quality. In addition, SLAASMB appears to be required to review a sample of 100 audit files separately from its review of financial statements.

5. SLAASMB process is set by its statute and is roughly as follows:

    a. The SBE's consolidated financial statements are examined for potential breaches of SLAs leading to:

        i. the directors of the SBE being issued with a no-action "comfort letter" if no significant issues are found;

        ii. a letter setting out "observations" by SLAASMB staff relating to reporting issues which are not significant may be sent to directors of the SBE;

        iii. for issues which are significant but do not make the financial statements as a whole misleading, the directors being asked to re-issue the consolidated financial statements or to correct the error in the next published report (interim or annual report); or

        iv. if the directors do not agree to a correction/restatement, then SLAASMB can issue a direction to the directors to make the correction/restatement.

    b. For issues which are significant and misleading, SLAASMB can prosecute (via the Attorney General) the directors and officers responsible for the misleading report in a Magistrate's Court which may result in fines of up to LKR 500k and up to 5 years imprisonment. SLAAMB does not have the power to impose administrative sanctions.

    c. The SBE's auditor is informed by SLAASMB of these actions (except in the case of the comfort letter and, until recently, prosecutions[1]).

    d. Once the action against the directors is completed, SLAASMB then moves on to the auditor and can take regulatory action for breaches of SLAuSs derived from an examination of the audit working papers for the relevant consolidated financial statements.

[1] The Court of Appeal had ruled against publication but the Supreme Court has now changed that ruling to allow publication.

6. There appears to have been only one case against directors which has reached the final stage, but has not been moved on to the auditor. This has taken over 10 years, having been delayed by legal challenges to SLAASMB process and powers. The absence of reports of regulatory action does not mean, however, that there is no such action but the lack of interim reports of regulatory action does create the impression that SLAASMB is not active in its duties.

7. There is an annual report of SLAASMB's findings from its reviews, which is general and does not relate to any regulatory action. The report is intended to be an educational guidance for directors and auditors. This does not assist in dispelling the natural but mistaken impression that there is no effective enforcement of the SLASs and SLAuSs.

8. A monitoring system such as that operated by SLAASMB can be greatly assisted by an effective system of Practice Review (PR) or external quality control review of audit firms. The ICASL has been operating an Audit Quality Assurance (AQA) scheme for a number of years. The AQA is voluntary but is seen as preparing the ground for a compulsory AQA which the ICASL is currently considering again. The issues involved in making the AQA/PR compulsory are similar to those in other countries, e.g. staffing and costs of an AQA/PR system and a fear of over-zealous enforcement derived from information which comes to light during the AQA/PR, which is connected to deciding which or what kind of body runs the AQA/PR.

9. Having made the observations above about the issues with the financial reporting system, it is important to appreciate that there has not been any significant financial collapse or scandal involving accounting or auditing failures for a number of years. Where problems have arisen, they have been in the finance company sector, and the indications are that SLAASMB does focus on finance companies.

10. In addition, there is some anecdotal indication of concerns or skepticism about the quality of financial reporting and audits in general. For example, one reported perception was that auditors are pressured by clients to grant favors or tone down qualifications. Confirmation of these perceptions would require a review of a sample of consolidated financial statements.

11. Returning to SLAASMB, part of the concerns about its performance and quality of its reviews is its problems in recruiting sufficient high quality, motivated reviewers. Apparently, SLAASMB operates under the Government and, while it has some flexibility in salaries, it is guided by the Civil Service pay scales. For the quality of professionals needed for the review work, the equivalent pay in the competing private sector companies are multiples of equivalent Civil Service pay scales. This means that SLAASMB has difficulties in recruiting and preventing poaching of its staff by private sector firms.

II. Recommendations and Rationale

12. SLAASMB should introduce risk-based reviews, focusing on SBEs which could pose the greatest threat to the public interest and to the reputation and performance of the capital markets.

13. SLAASMB should prepare and accomplish enactment of revisions to the *Accounting and Auditing Standards Act (1995) and its Regulations* to reduce the scope and population of its reviews. This could be done most simply by a significant increase in the thresholds of the criteria for an entity to qualify as an SBE. However,

consideration should be given to revise the definition of an SBE to bring it closer to what is more generally accepted as the concept of a PIE.

14. The operational difficulties apparent in SLAASMB should be addressed by allowing SLAAMB to fund itself through contributions from listed exchanges, regulatory agencies, and the central Government. It should then be permitted to set its own staff remuneration levels.

15. SLAAMB should be given powers to conduct administrative hearings and impose administrative penalties (subject to appeal) including fines and public censure (for individuals and firms) and requiring the professional institutes to suspend firms.

16. The ICASL should be encouraged by the capital market regulators to introduce a compulsory AQA/PR as soon as possible which should be operated by SLAAMB. Auditors' concerns about over-zealous reviews can be addressed by making the findings from reviews educational only for a 3 or 4 year introductory period so that the reviews cannot lead to disciplinary action for that introductory period.

17. In addition, the process should incorporate liaison covering any regulatory action relating to auditors between SLAASMB and the suggested ICASL AQA/PR.

III. Outcome

18. The outcome would be a more focused inspection regime more accurately reflecting the areas of significant risk. The inspection regime would be strengthened by upgrading of capacity at SLAASMB and focusing its activities more efficiently.

19. Introducing a mandatory AQA system would further strengthen the quality of financial reporting and the perception of reporting reliability, both of which results will enhance the attractiveness of investment and the capital markets.

A. REGULATION AND REGULATORY STRUCTURE

2. Institutional Strengthening of SEC

INSTITUTIONAL STRENGTHENING OF SEC

I. Assessment

A. Governance

1. International Organization of Securities Commissions (IOSCO) Principles stipulate that there should be independence in the day-to-day operations of the regulator, reinforced by mechanisms such as transparent appointment procedures and prohibitions on arbitrary dismissal.

2. The Securities and Exchange Commission (SEC) is established as an independent body by the SEC Act and has its own Chairman and Board, who are appointed by the Minister. The Board consists of six members appointed from the private sector and four ex-officio members (the Deputy Governor of the Central Bank, the Deputy Secretary of the Treasury, the Registrar of Companies and the President of the Institute of Chartered Accountants). There is no transparent appointment procedure. Far from providing protection against arbitrary dismissal, the SEC Act states that the Minister can dismiss any Commissioner for no reason with no right of appeal to the court.

3. There is a market perception that appointments to the Board are based on political affiliations. Two Chairmen of the SEC resigned in succession between 2011 and 2012 for reasons believed in the market to be associated with the degree of independence. Following the election of a new President of Sri Lanka in January 2015, the composition of the entire Board changed (apart from the ex-officio appointments). Market perception is that the SEC's willingness to pursue market abuse prosecutions has been affected by the changes in Chairman.

4. The provision in the SEC Act permitting the Minister to arbitrarily to dismiss any Commissioner is inappropriate. No equivalent provision appears in the legislation in, for example, Malaysia or India. The absence of a transparent appointment procedure and the provision for dismissal in the SEC Act, together with the presence of a representative of the Government (the Deputy Secretary of the Treasury) as an ex officio member of the Commission, mean that the SEC is likely to be found to be non-compliant with the IOSCO independence principle.

B. Internal Governance Practices

5. The Commission has yet to adopt the full range of governance practices that may be expected of a regulatory authority. The Commission does not undertake a regular risk assessment to guide the staff. There has been a Code of Ethics for Commission members and staff since 1997. This includes a requirement for annual disclosures of securities holdings; however, this has only been enforced for staff in the past year and has not been enforced for Commissioners. The Code states that Commissioners must not have an interest in a stock broker but there is no similar requirement in relation to any other licensee. There is statutory provision for dealing with Commission conflicts of interest but no protocol for dealing with decisions about what may constitute a conflict of interest in practice. Not all Board Committees have terms of reference and there is no regular review of Committee structure or terms of reference. There is no statement of delegation to the executive.

6. There could be different expectations about such issues as the matters to be referred to the Commission or what may constitute a conflict of interest. The absence of these protocols could leave the SEC open to charges of impropriety.

C. Technical Capacity

7. The SEC is also criticized in the market for having limited capacity to understand market development. Regulatory authorities are frequently criticized on these grounds and it is clear from the SEC Annual Report that the Commission does respond to market developments by adjusting regulations from time to time. Nevertheless, the perception remains strong.

8. The SEC identifies general qualifications for each level of management and specifies more detailed requirements when posts are advertised.

9. The SEC invests in training. Staff may request training as part of their annual appraisal. The SEC nominates staff for foreign courses. There is also training for the Diploma and Certificate of Capital Markets that is delivered by the SEC itself. An annual seminar offered by the Asia Pacific Forum for Economic Cooperation covers topics normally chosen by the SEC. Other local training is also available; however, training appears to be driven more by the availability of courses, as there are no regular documented Training Needs Analyses nor forward planning for the skills the SEC will require in order to complete its tasks, taking into account anticipated market developments.

D. Budget and Staffing

10. The income of the SEC is sufficient to meet its expenditure. The budget is set by the Commission and forwarded to the Treasury for information only. Staff numbers have to be approved by the Treasury, but in practice this approval is usually forthcoming. There is no external constraint on staff salaries. All senior posts are advertised externally but are also available to internal candidates.

11. Staff are assigned to one of six grades from officer to director, with minimum seniority requirements governing progression through the ranks. The Commission has designated salary scales. Each new or promoted staff member normally starts at the bottom of the scale and moves up annually. Neither the annual increment nor the two bonuses paid to each member of staff are based on performance. The SEC states that it has difficulty in filling posts with candidates with relevant market experience. The market perception is that this results in pay levels that inhibit recruitment from the capital market.

12. The SEC budget and staff requirements are planned annually for each financial year. There is no forward multi-year plan for either budget or staff.

E. Organizational Structure

13. The SEC is structured primarily according to its main functions, with divisions for supervision (of the exchanges and intermediaries), corporate affairs (monitoring obligations of public companies), investigation, legal and enforcement, external relations, finance and administration, capital market education, and capital market development (which includes research into new products and services). A commonly adopted alternative structure would be to arrange the SEC with divisions related to different market players such as brokers, unit trust managers, the exchange, public companies and so on. The advantage of the SEC structure is that it provides for a

concentration of specific skill sets, such as the analysis of periodic returns, the conduct of inspections and the understanding of accounts. The advantage of a market player-based structure is that it may strengthen the SEC's understanding of the business of those players.

14. However, the SEC does not have a risk officer, with responsibility for advising the Board on the risks to its objectives and on the risks of current or anticipated market developments.

15. The SEC's regulations on market intermediaries do not apply to brokers, for whom prudential, conduct of business and other rules are set by the Colombo Stock Exchange (CSE), with the approval of the SEC. Both the CSE and SEC share responsibility for monitoring compliance by brokers through analysis of monthly reports and on-site inspections. Both are also responsible for monitoring compliance with obligations for listed companies. This monitoring is coordinated between the CSE and SEC. There is no consensus yet on the CSE's regulatory role after demutualization.

II. Recommendations and Rationale

A. Governance

16. Appointments to the SEC Board should be made on a professional and non-political basis, allowing the SEC Board to continue in office, regardless of changes in the Government.

17. The SEC Act should be amended to remove the provision that allows the Minister to dismiss any Commission member without reason. Instead, the Act should provide protection against arbitrary dismissal by limiting dismissal to defined circumstances such as gross misconduct, conviction of a criminal offence, inability to fulfill the duties and similar matters. This is the approach adopted in the Malaysia Securities Commission Act, for example. Although a common practice amongst emerging markets, the presence of the Treasury Secretary's representative on the Board of the SEC undermines independence and should be removed in the draft SEC Act.

18. To remove the perception that SEC Board members' appointments are made on political grounds, a new appointments process should be introduced. Sri Lanka already has a mechanism for senior judicial and law enforcement appointments, known as the Constitutional Council. The Government could adopt a similar process for the Chairman and Commissioners of the SEC, by appointing a public body with the power to vet appointments and ensure they are made on purely professional grounds. For each new Commissioner appointment, there should be published criteria, identifying the specific skills required.

19. Appointments to the Board should be "staggered" – so that only two or three members reach the end of their term of office in any one year. The Board can thereby develop continuity and cohesion while still benefitting from regular infusions of new members and fresh thinking.

20. The Commission should review its governance practices. It should undertake a risk assessment that should be reviewed annually. It should develop protocols for the matters to be delegated to the executive, the handling of potential conflicts of interest by Board members, annual disclosures of the holdings of securities by Board members, regular reviews of the structure and terms of reference of Committees and other best governance practices.

B. Technical Capacity

21. The SEC has already decided to arrange a review of its technical capacity. One outcome of this should be an up-to-date specification of all skills required for each senior post. In addition, the SEC needs to implement mechanisms that enable it to maintain strong technical capacity by undertaking the following steps.

    a. The SEC should adopt a forward analysis of staffing needs, anticipating, so far as possible, changes in regulation, market practice and new products or services. This should be supplemented by the introduction of secondments into and out of the SEC so as to enrich the collective experience of SEC staff and bring better understanding of the market to the SEC.

    b. The SEC should adopt a Training Needs Analysis cycle under which the Board approves an analysis of the skills needed by the SEC over a three year period, updated annually. This analysis should then be matched by the HR department, so far as possible, with the development aspirations of staff and the foreign and local courses available, including training delivered by the SEC itself. The three year program should be reviewed and updated every year. The intention would be to create a training program that is driven by a documented assessment of training needs, rather than primarily the supply of courses and the aspirations of staff.

C. Budget and Staffing

22. The SEC should make more use of the discretion it has over pay and staffing to recruit staff (including more staff from the capital market private sector, at all levels in the SEC) with the specific and relevant skills and experience it needs to enhance its market understanding. Internal pay should be based more on performance. The SEC is now contemplating a pilot scheme for performance-related pay and this should go ahead. While there are always difficulties in what may be perceived to be unfairness in staff pay relativities, the SEC should adopt the approach that it should pay the salary necessary to get the staff it needs, including staff with recent private sector capital market experience at a range of levels. The grading structure should be simpler and flexible so that good staff can rise quickly to senior positions.

D. Organizational Structure

23. The current structure is generally appropriate for the SEC. The alternative structure of a market player based structure may become appropriate if the range of products and the degree of complexity of those players increases. Many regulatory authorities maintain a combination of functional and market approaches. Organizational change is disruptive and unless there is a clear gain, it is appropriate to retain the status quo, making incremental changes as the market develops. However, the SEC should assign responsibility to an appropriate department for advising the Board on risks associated with market developments and this should be supported by an associated research function.

24. The SEC should, however, review the regulatory role of the CSE. The SEC has primary responsibility for the regulatory objectives of mitigating systemic risk, protecting investors and ensuring fair markets. It should, therefore, set the prudential, conduct and other standards for brokers and take primary responsibility for monitoring compliance. If it concludes that there is scope for delegating some part of the

monitoring role to the CSE, the responsibilities and accountability should be documented.

III. Outcome

25. The benefits of enhanced continuity and independence of the Board will only be achieved over the medium to longer term as the market comes to believe that the SEC is genuinely independent. The benefit will be greater confidence in, and participation in, the capital market.

26. The strengthening of governance practices, the introduction of a market-related pay system and the initiative to recruit more staff from the market will contribute to enhanced technical capacity to maintain market confidence. This will enable the SEC to respond with greater agility to market developments so as to curtail abusive practices and facilitate new products and services through appropriate regulation.

27. This is best illustrated by the example of the potential introduction of universal brokerage. The annual risk assessment recommended above would prompt the SEC Board to focus on the specific risks posed by this development, particularly the increased risk of conflicts of interest within universal brokers. The proposed forward planning for staffing and training needs would prompt the SEC to ensure it had the necessary staff and skills. The enhanced flexibility in pay would enable the SEC to be confident it could hire any additional staff with relevant market experience. The existing organization structure, which focusses on functions, rather than market players, would mean that the SEC could monitor the risks within the existing structure, rather than having to coordinate the efforts of different divisions.

28. Perhaps of greatest importance, the stronger independence that would flow from a revised appointments procedure, better protection against arbitrary dismissals of Commission members and the development of a Board free of political interference and with coherence and continuity, would give greater confidence that the potential abuses of universal brokerage would be tackled with determination.

A. REGULATION AND REGULATORY STRUCTURE

3. Institutional Strengthening of IBSL

INSTITUTIONAL STRENGTHENING OF THE INSURANCE BOARD OF SRI LANKA

I. Assessment

A. Governance

1. The Insurance Board of Sri Lanka (IBSL) is the supervisor of the insurance industry. The legal framework for the regulation and supervision of insurance companies, reinsurance companies, insurance brokerage companies, insurance agents and loss adjusters is set out in the *Regulation of the Insurance Industry Act No 43 of 2000* (as amended[2]).

2. The Core Principles of the International Association of Insurance Supervisors (ICP) stipulate that the insurance supervisor should be independent of the government and have appointment procedures and protection against arbitrary dismissal.

3. The appointment and dismissal arrangements for the Board of the IBSL are established in the *Insurance Act* but are not fully consistent with the independence principle. The Act specifies three ex-officio appointments (the Deputy Secretary of the Treasury, the Deputy Governor of the Central Bank, and the Registrar of Companies). The power to appoint four other members (one of which would be the Chairman) is given to the Minister of Finance. General criteria relating to qualifications and experience are included in the Act. There are no provisions as to the procedures for appointment.

4. The Act provides protection for Board members in that they can only be dismissed for certain specified reasons. However, the Act also provides that the Chairman can be dismissed at any time for no reason. The presence of the Deputy Secretary to the Treasury on the Board of the IBSL may also undermine confidence in IBSL independence.

5. On the election of a new President in January 2015, the Chairman remained in post, although other Board members, who were not ex-officio, resigned. International best practice would be for such Boards to have continuity notwithstanding changes in Government.

B. Internal Governance Practices

6. The Commission has yet to adopt the full range of governance practices that may be expected of a supervisor. There is a Code of Ethics for Commission members and staff, which requires disclosures of interests in insurance companies. However, the Commission does not undertake a regular risk assessment to guide the staff. There is no protocol for dealing with decisions about what may constitute a conflict of interest by Board members in practice. There is no statement by the Board of the matters that should be delegated to the Executive and the matters that must be reserved to the Board. This would be a matter of the Board to determine but it might consider it right to reserve some matters to itself (such as the decision on whether or not to give licenses to new insurance companies) and might delegate some matters of lesser moment to the executive (such as the recruitment of junior staff). There could be

[2] The Regulation of Insurance Industry (Amendment) Acts, No. 27 of 2007 and No. 03 of 2011.

different expectations about such issues as the matters to be referred to the Commission or what may constitute a conflict of interest. The absence of these protocols could leave the IBSL open to charges of impropriety.

C. Capacity of the IBSL

7. IBSL has shown sufficient capacity to develop a Risk Based Capital Framework with the assistance of the World Bank. The World Bank is to undertake a review of how the framework is working in practice. It is also providing assistance to the IBSL in respect of the implementation of risk based supervision. These reforms are useful and will strengthen the capacity of the IBSL.

8. The IBSL monitors compliance with standards through the use of a combination of supervisory tools. It monitors monthly returns from insurance companies and brokers. In both of the years 2013 and 2014, the IBSL undertook on-site inspections of 7 of the 21 insurance brokers and 8 of the 58 brokers. The IBSL does not consider that this level of inspections is sufficient and states that it is constrained by inadequate staff numbers.

9. Enforcement sanctions are limited by the Act. The IBSL states that they can, and have, directed a company to dismiss a senior officer. The Board can also suspend a license (which means, in practice, the refusal to allow insurance companies to do new business) and cancel a license. There are also potentially criminal sanctions. These sanctions are not sufficient to allow for a full range of proportionate actions and the IBSL is seeking amendments to the Act to provide for an administrative fining power.

10. BSL invests in training. Staff may request training as part of their annual appraisal. The IBSL nominates staff for domestic and foreign courses. However, training appears to be driven more by the availability of courses and the aspirations of staff. Although there are ad hoc decisions to send individuals on training courses, there is no regular documented Training Needs Analysis nor forward planning for the skills the IBSL will need to complete its tasks, taking account of anticipated market developments.

D. Budget and Staffing

11. The IBSL is funded largely by fees received by insurance licensees, supplemented by a transfer from the Policy Holder's Protection Fund (PPF). The Act gives the IBSL the power to use the PPF funds for the general protection of policy holders and for any other specific purpose as may be determined by the Board (Section 103(2) of the Act). It has used this power to make transfers for its own operating expenses. This practice, however, creates the appearance of a conflict of interest, for the IBSL is using funds designed to protect the policy holders against future failures of insurance companies to fund its own operating expenses.

12. The Commission has designated salary scales. Each new or promoted staff member normally starts at the bottom of the scale and moves up annually. The annual increment and the annual bonus paid to each member of staff are based on performance but in practice, most staff receives the increment and the bonus.

13. The IBSL is able to pay its staff annual increments and a cost of living increase on its own authority. However, any more substantive change in salaries would require the approval of the Ministry of Finance. The IBSL is about to embark on a study of market salaries as it considers that its current salaries are not sufficiently competitive to permit a regular flow of staff from the private sector.

14. The IBSL budget and staff requirements are planned annually for each financial year. There is no forward multi-year plan for either budget or staff. The IBSL has decided to employ a consultant to assess the overall staffing needs of the IBSL.

15. Most vacancies are advertised so that staff may be recruited internally and from outside the IBSL. However, some promotions are made internally with strict seniority requirements. For example, an Executive (entry grade) staff member must have five years' experience before advancing to Senior Executive.

E. Organizational Structure

16. The IBSL is organized into four main departments – Supervision, Investigations, Finance & Administration, and Enforcement. The Director of Investigations is also responsible for market development and external relations. An organizational chart is attached.

17. It is reasonable for the Director of Investigations also to take responsibility for external relations, since foreign supervisors will be likely to seek assistance in the form of investigations.

18. However, the combination of investigations with market development is a matter for concern. A development role for a regulatory authority gives rise to pressure for regulatory forbearance in order to avoid losing important market players and to mitigate the collateral reputational damage of any failure. Where a supervisor has a development role, it is important that it should mitigate this risk. Placing the market development role within the investigations department would appear to exacerbate it.

II. Recommendations and Rationale

A. Governance

19. Appointments to the IBSL Board should be made on a professional and non-political basis, allowing the Board to continue in office, regardless of changes in the Government.

20. The *IBSL Act* should be amended to remove the provision that allows the Minister to dismiss the Chairman without reason. Instead, the Act should provide protection against arbitrary dismissal by limiting dismissal of the Chairman to defined circumstances such as gross misconduct, conviction of a criminal offence, inability to fulfill the duties and similar matters. Although a common practice amongst emerging markets, the presence of the Treasury Secretary's representative on the Board of the IBSL is likely to be judged as contrary to IAIS Core Principles, in any review of compliance with the ICPs.

21. A new appointments process should be introduced to ensure professional appointments. Sri Lanka already has a mechanism for senior judicial and law enforcement appointments, known as the Constitutional Council. The Government could adopt a similar process for the Chairman and Commissioners of the IBSL, by appointing a public body with the power to vet appointments and ensure they are made on purely professional grounds. For each new Commissioner appointment, there should be published criteria, identifying the specific skills required.

22. Appointments to the Board should be "staggered" – so that only two or three members reach the end of their term of office in any one year. The Board can,

thereby, develop continuity and cohesion while still benefitting from regular infusions of new members and fresh thinking.

B. Governance Practices

23. The Commission should review its governance practices. It should undertake a risk assessment that should be reviewed annually. It should develop protocols for the matters to be delegated to the executive, the handling of potential conflicts of interest by the Board members, and other best governance practices.

24. The IBSL should review its structure and reallocate market development to a more appropriate division.

C. Capacity

25. The IBSL should adopt a formal Training Needs Analysis cycle under which the Board approves an analysis of the skills needed by the IBSL over a three year period, updated annually. This analysis should then be matched by the HR department, so far as possible, with the development aspirations of staff and the foreign and local courses available, including training delivered by the IBSL itself. The three-year program should be reviewed and updated every year. The intention would be to create a training program that is driven by a documented assessment of training needs, rather than primarily the supply of courses and the aspirations of staff.

26. The IBSL is right to seek to expand the range of sanctions available to it under the Act. In the event of non-compliance, it should be able to fine the company, publish a written warning, require the suspension or removal of a director or specified officer. Failure to comply with a direction should also be punishable by one of these sanctions.

D. Budget and Staffing

27. The IBSL is right to be concerned about the propriety of using a transfer from the Policy Holders Protection Fund to pay for its expenses. Its decision to limit any transfer to 20 per cent of the PPF income is a sensible step. However, it may consider seeking a change in the law that would identify a proportion of the cess that should be paid directly to the IBSL and would therefore be its own income by right. The IBSL could then stop making transfers from the PPF.

28. The IBSL is right to mount an assessment of the staff necessary to implement risk-based supervision, monitor compliance with risk-based capital, business conduct and structural issues and take effective enforcement action. The IBSL should ensure that it has an up-to-date specification of all skills required for each senior post.

29. In addition, the IBSL needs to implement mechanisms that enable it to maintain strong technical capacity. The IBSL should adopt a forward analysis of staffing needs, anticipating, so far as possible, changes in regulation, market practice and new products or services. This should be supplemented by the introduction of secondments into and out of the IBSL so as to enrich the collective experience of IBSL staff and bring better understanding of the market to IBSL.

30. Internal pay should be based on performance. While there are always difficulties in what may be perceived to be unfairness in staff pay relativities, the IBSL should adopt the approach that it should pay the salary necessary to get the staff it needs, including staff with recent private sector insurance experience at a range of levels.

The grading structure should be simpler and flexible so that good staff can rise quickly to senior positions.

31. Recommended policy actions are as follows:

    a. The IBSL should commence the review of staff need and salaries.

    b. The IBSL should review its structure and reconsider the position of the market development function within the investigations department.

    c. The IBSL should seek a change to the *Insurance Act* to give the Chairman the protection against arbitrary dismissal that is already present for other Board members. It should also propose an amendment that would remove the Deputy Secretary of the Treasury from the Board.

    d. In consultation with the Minister of Finance, the IBSL should introduce a more transparent appointments procedure, with staggered appointments, as recommended above, so as to aim for appointments that are based purely on professional grounds.

    e. The IBSL should adopt the internal multiyear staffing, pay and budgeting procedures recommended in this brief.

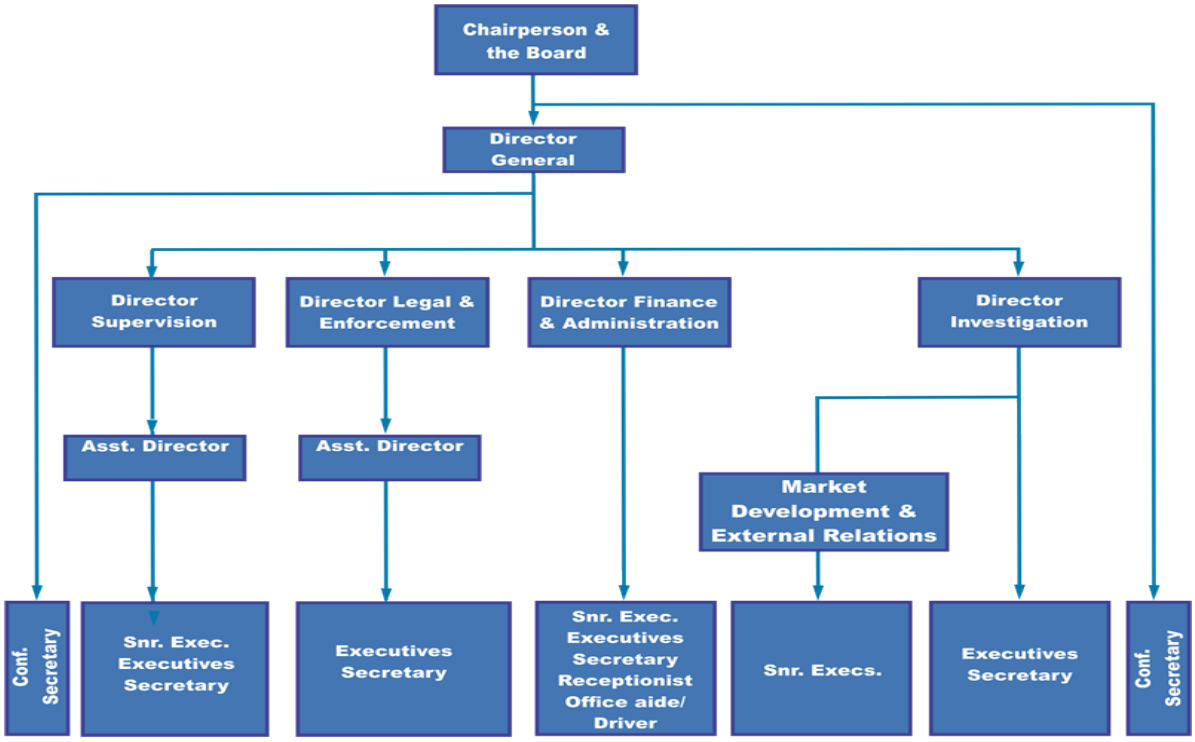
    f. The IBSL should implement a forward planning Training Needs Assessment cycle as recommended in this report.

    g. The IBSL should seek amendments to the Insurance Act that expands the range of sanctions available to it and provides that a percentage of the cess is paid direct to the IBSL as part of its own income.

III. Outcome

32. Greater confidence in independence and greater consistency in effective performance will serve to improve compliance and protect policyholders.

IBSL Organization Chart



A. REGULATION AND REGULATORY STRUCTURE

4. Strengthen Risk-Bearing Capacity of CSE Intermediaries

STRENGTHEN RISK-BEARING CAPACITY OF CSE INTERMEDIARIES

I. Assessment

1. In addition to licensing the Colombo Stock Exchange (CSE) and Central Depository System (CDS), the Securities and Exchange Commission (SEC) licenses various classes of intermediaries.

   a. An intermediary is required to have:

      i. a minimum net capital as stipulated by the SEC from time to time; and

      ii. a minimum liquid capital as stipulated by the SEC from time to time.

   b. If the intermediary is a margin provider, requirements include:

      i. exposure against the aggregate value of loans extended as margin should at no time exceed the value stipulated by the Commission from time to time;

      ii. the maximum margin loan extendable by a margin provider to a single client shall at no time exceed 15% of the maximum margin loan exposure permissible; and

      iii. pledged securities may only be re-pledged by the margin provider to entities licensed by the Central Bank of Sri Lanka (CBSL) and only up to a maximum of 100% of the value of the margin loans portfolio.

   c. If the intermediary is a credit rating agency, it has to maintain a professional indemnity insurance to a certain level.

2. Currently, the licenses in issue and the capital requirements are:

License Type	No.	Minimum Net Capital Requirement	Minimum Liquid Capital Requirement	Notes on proposed CAR for Stock Brokers
Stock Broker	28 Eqty 7 Debt	LKR 35 million	In terms of Stock Broker Rules	Proposed to be replaced by new CAR calculation of Liquid Capital over Total Risk Requirement > 1.2
Stock Dealer	4 Eqty 11 Debt	LKR 35 million	In terms of Stock Broker Rules	Proposed to be same as for stock brokers, but if debt dealer, then required only to meet net capital requirement set jointly by CSE and SEC
Investment Manager	34	LKR 7.5 Million	2.5% of all liabilities	
Margin Provider	32	LKR 30 million	2.5% of all liabilities	
Credit Rating Agency	2	LKR 15 million	2.5% of all liabilities	
Underwriter	9	LKR 50 Million	Determined on a case by case basis by SEC	

License Type	No.	Minimum Net Capital Requirement	Minimum Liquid Capital Requirement	Notes on proposed CAR for Stock Brokers
Managing Companies of Unit Trusts	14 (77 Funds)	LKR 25 Million	NA	

3. The CSE, which is responsible for stockbroker capital monitoring, has proposed that a new risk-based capital adequacy ratio (CAR) is introduced for stock brokers. This will see the ratio of liquid capital to total risk requirements having to be greater than 1.2 times.

4. The 'Total Risk Requirement' will take into consideration the following risks:

   a. 'The Operational Risk';

   b. 'The Counter Party Risk';

   c. 'The Large Exposure Risk'; and

   d. 'Position Risk'.

5. This provides a relatively straight forward CAR process and is appropriate.

6. For non-stockbrokers, the current liquid capital requirement at 2.5% provides an effective 40 times leverage, where most emerging markets set liquid capital at between 5% and 10%. None are as low as 2.5%. The FIRST/World Bank project that recommended the minimum net and liquid capital requirements in the above table had recommended that the minimum liquid capital be 5% of liabilities (20 times leverage) and that liabilities be increased to include off balance sheet liabilities and risks.

7. An issue is that in the stock market settlement process, at present, there is no margining system whilst there is pre-trade confirmation of shares available for sale to ensure settlement. The new broker CAR relies on the calculation of value-at-risk (VAR) of broker positions and this is likely to be the same calculation that is proposed for the implementation of a central counterparty (CCP) risk management process.

8. Once VAR calculations are available it would make sense to require brokers to place margin at the CDS even prior to the introduction of a CCP.

9. It is seen that the bifurcation of risk-based capital (RBC) between CSE and SEC should be addressed and that all RBC requirements for all intermediaries including stockbrokers be on a common basis and undertaken by the SEC. This is increasingly relevant as the market moves to demutualization of the CSE and the introduction of a CCP; then the SEC will need to be more directly involved in monitoring the RBC of all intermediaries.

10. The recent IBSL financial resources rules (FRR) recently enacted, setting out clearly liquidity and solvency requirements, provide a best practice model that the SEC could follow.

11. The FRR should be improved to cater for proposed new products such as derivative warrants, exchange traded funds, futures, options, market making, stock borrowing

and lending, as well as the introduction of commodity derivatives and utilization of a CCP.

12. Finally, most jurisdictions have, in addition to FRR, a set of business conduct rules supported by a code of conduct for different licensed types. Currently, business conduct type rules are comingled with financial requirements in SEC directives. Formal sets of business conduct rules and codes of conduct should be framed, issued for market consultation, and formally gazetted.

II. Recommendations and Rationale

Recommendation	Rationale
Require for non-stock broker licenses the definition of liabilities to include off-balance-sheet liabilities such as running derivative style losses, guarantees, and a provision for operational loss (in line with new stockbroker 25% of expenditure in the proposed CAR).	Harmonize underlying risk principles and requirements across licensees.
Announce an increase in the minimum 2.5% liquid capital requirements to 5% as from 1st January 2017.	Reduce the effective leverage from 40 to 20 times to be more in line with other emerging markets.
The SEC to devise and publish a comprehensive set of financial resources rules for all licensed persons providing a consistent approach across all license types. The CAR methodology should follow best international practice and be consistent across licenses. The FRR should provide for the handling of derivatives, stock borrowing, and lending and commodity futures as envisaged by the capital markets plan.	One set of financial resources rules for licensed securities entities with the oversight of the SEC.
The SEC to develop and issue for consultation a set of “Conduct of Business Rules” as well as for each license type a “Code of Conduct”, and after consultation gazette such rules and codes of conduct. This includes stockbrokers/dealers.	Clear unambiguous business conduct requirements for all market intermediaries.

III. Outcome

13. The outcomes include:

a. harmonized RBC approach;

b. an RBC appropriate to a market utilizing a CCP;

c. provision of a foundation for SEC to be responsible for all licensed persons’ RBC; and

d. clear, unambiguous business conduct rules and codes of conduct that are a foundation for risk-based supervision.

A. REGULATION AND REGULATORY STRUCTURE

5. Establish a Capital Markets Tribunal

ESTABLISH A CAPITAL MARKETS TRIBUNAL

I. Assessment

1. Capital markets legislative frameworks provide three distinct types of legal remedies for contraventions of the law which may (in jurisdictions which are common-law based) all be undertaken in parallel or consecutively. These legal remedies comprise criminal, civil or administrative (disciplinary) proceedings and the consequences of and sanctions for each remedy will be different.

a. **Criminal proceedings** before a Court of Criminal jurisdiction for offences such as market manipulation, insider trading and market abuse are normally referred by the Regulatory Authority to the State Prosecutor who will then commence and conduct the proceedings. It is unusual to find a Regulatory Authority that is vested with specific powers of prosecution of offences under a capital markets law and, even where such power has been vested, the Regulatory Agency normally "hands over" the case to the State Prosecutor (or a specialist financial crimes unit within the State Prosecutors Office[3]) on the basis that such an agency is better equipped to deal with the evidential requirements required by the prevailing Criminal Procedural Rules and or Criminal Evidence Laws.

b. **Civil proceedings** before a Court of Civil jurisdiction are for contraventions of the capital markets law such as trading without a securities license and fraudulently depriving investors' of their money. Here the Regulatory Authority normally commences proceedings and seeks an interim specific remedy from the Court such as an asset freezing order in respect of bank accounts and an injunction to stop further trading. This preserves assets so that the Court can make a final order for restitution of those assets to investors. The Regulatory Authority also normally has a power to wind up a licensed company (usually following interim remedies) on the basis of insolvency. Civil proceedings must comply with the prevailing Civil Procedural Rules and evidential requirements.

c. **Administrative proceedings** which usually encompass the granting, suspension, refusal or withdrawal of a license, public reprimands, and/or censures and imposition of financial penalties for rule breaches. In some jurisdictions, administrative proceedings have been extended to include refusals by the Regulatory Authority for admissions to listing. Administrative proceedings do not, however, include complaints by investors against the licensed firm but such complaints may form the basis for administrative proceedings.

2. The *Securities Exchange Commission Act*[4] incorporates the above three legal remedies. With regard to administrative proceedings, the Act enables the Securities and Exchange Commission's (SEC) administrative decisions to be subject to review

[3] The UK's Financial Conduct Authority is a "prosecuting authority" for the purposes of all the criminal offences under the *Financial Services and Markets Act 2010* however it routinely transfers all such cases to the Serious Fraud Office which inter alia specialises in financial crime.

[4] *Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987* as amended by the Securities Council Amendments Act No. 26 of 1991, the *Securities and Exchange Commission of Sri Lanka (Amendment) Act No. 18 of 2003*, and *the Securities and Exchange Commission of Sri Lanka (Amendment) Act No. 47 of 2009*.

by the Court of Appeal and is, thus, IOSCO compliant in terms of accountability.[5] Accountability in this context means that the Authority is subject to appropriate scrutiny and review, including judicial review of licensing or enforcement related final decisions made by it. Such checks and balances are essential prerequisites of general principles of natural justice.[6] However, there are no specific provisions in the Act for review of certain decisions of the SEC such as Compounding of Offences[7] which may contravene IOSCO accountability requirements.

3. It has been internationally accepted and recognized that domestic legal systems which enable review by the Courts do not necessarily provide the most conducive mechanisms for speedy resolution of capital market disputes. Cases may be the subject of lengthy procedural delays before the actual hearing takes place and domestic legal systems may not have "specialist" benches in their High Courts which contain a cadre of Judges who deal with commercial cases on a daily basis and who have experience and expertise in all aspects of capital markets. Furthermore, not all jurisdictions have "case management rules" where the Judges drive the progress of the case rather than the parties' representatives who may take advantage of technical procedural issues to delay any hearing.

4. Administrative penalties, such as the suspension or withdrawal of a license, effectively mean that the earning capacity of the company has been curtailed. Challenging the merits of such a decision via the Courts may take several years and, were such a challenge to be upheld, the intervening loss of business and reputation may be irreparable and irrecoverable.

5. Independent Panels or Tribunals provide an intermediate stage for review of administrative sanctions imposed by Regulatory Authorities. In 1988, the United Kingdom (UK) was the first jurisdiction to introduce such a stage and this model has been successfully adopted in Singapore, Hong Kong, India and numerous other jurisdictions by means of a specialized Tribunal created by way of primary legislation. Thus, Panels and Tribunals in the context of capital markets have been created to function as part of the regulatory process. The role of the Panel or Tribunal has been judicially described as follows:[8]

   "[it is] independent of the [Regulatory] Authority. [Its] function is to hear and determine references from decisions of the Authority. It conducts a de novo review of the matters referred to it. It may consider evidence whether or not it was available to the Authority at the material time. It may decide points of law, including disputes about the limits of its own jurisdiction and the lawfulness of the decisions and actions of the Authority."

6. A fundamental purpose of any Panel or Tribunal arrangement is to provide a forum for the independent review of regulatory decisions. Whereas the more formal Tribunal arrangements will normally have legal powers such as compulsion of witnesses, Panel arrangements have no such powers. The absence of the specific judicial powers does not present an obstacle to the proper functioning of a Panel. In fact, the

[5] IOSCO Principle 2 which states that "[t]he Regulator should be operationally independent and accountable in the exercise of its functions and powers" and that there should be a system permitting judicial review of licensing, authorising or enforcement related final decisions of the Regulator. However, the Act is not IOSCO compliant with regard to judicial review.

[6] *nemo iudex in causa sua* now widely interpreted as not being investigator, prosecutor and Judge in the same case, and *audi alteram partem* now widely interpreted as the right to a fair hearing.

[7] Section 51A, introduced by amending Act No 26 of 1991.

[8] 3. R. (on the application of Davies) v FSA [2004] 1 WLR 185 per Mummery L.J.

creation of a Panel has an obvious advantage where there are concerns as to possible constitutional impediments to the creation of a more formal legal mechanism associated with Tribunals as has been expressed to be the case in Sri Lanka.

7. Furthermore, the scope of a Panel could be expanded to include consumer complaints against license holders and listed companies. Selecting this policy option could enable all disputes that are currently only capable of resolution through litigation in the Courts to be given the alternative choice of a fast track independent, expert and cost-free "dispute resolution" mechanism. Under the SEC Act, there is already a power to establish a Committee to deal with such complaints. However, this Committee is comprised of members of the Commission and, as such, would appear to be in breach of the doctrine of separation of powers. Enabling this Committee to be constituted as a Panel, which is available to consumers to deal with their complaints, would bring expertise and efficiency to markets and enhance investor confidence

8. Any right of referral to a Panel needs to be specifically enshrined in primary legislation (this is already the case in the current SEC Act by means of a Committee structure) and will generally provide for:

    a. the creation of the Panel;

    b. the formation of a cadre of "expert" persons to serve as members of the Panel as and when nominated to do;

    c. the "expert" Panel to consist of persons with legal qualifications and persons qualified by experience or otherwise to deal with the cases that may be referred to the Panel;

    d. the Panel to be constituted by way of a Legal Chairman and two "experts", usually retired industry practitioners whose experience is directly relevant to the particular subject matter of the reference;

    e. the Panel not to be bound by the strict rules of evidence (such as the rule against hearsay); and

    f. the Panel to regulate its own procedure (this enables the development of flexible procedural rules which provide case management powers to ensure expeditious hearing).

9. The process for selection of Panel members is of paramount importance as the cadre of industry practitioners must be independent and perceived to be independent of the SEC and any external influences and of sufficient gravitas to maintain the integrity and reputation of the Panel. One means of selection is to invite practitioner associations to nominate retired members of their associations to serve on the Panel. Legal members are usually drawn from retired members of the Judiciary and appointed by the Ministry of Justice.

10. The procedural rules for the conduct of cases before the Panel should include an overall six-month time frame for determination of any reference to the Panel, and a requirement to hear the case in private. The combination of these two features minimizes the consequences of potential loss of business and/or reputation were the Panel to change an administrative sanction imposed by the regulator. In addition, Panel rules usually also contain a provision that there will be no charges for referring an administrative decision of a Regulatory Authority to the Panel and that no party

may recover any legal costs whatsoever they incur during the proceedings. This is to encourage parties to conduct the hearings in person.

11. Appeals from a decision by a Panel are usually limited to prevent a "second bite of the cherry" strategy. Generally, a Panel decision is limited to a challenge by either party by way of point of law to the High Court or where a decision on the facts is considered to be "unreasonable or perverse". There has been a suggestion that such a limitation in the Sri Lankan capital markets context may impede or fetter an individual's constitutional rights. In other jurisdictions, such as Singapore and India, such potential constitutional issues have been successfully addressed by means of primary legislation which clearly does not fetter any constitutional rights. There is a precedent for the use of Tribunals/Panels in Sri Lanka, namely the Labour Tribunal which has been in operation since the late 1950's and provides a forum to challenge employment issues such as allegations of unfair dismissal. It may be beneficial to examine and consider the rights of appeal from this body and how they affect (if at all) constitutional rights. An alternative suggestion would be to specifically provide that the use of any Panel procedure would not affect or erode the absolute right of a license holder or consumer who was aggrieved by the decision of the Panel from pursuing the matter through the Courts.

12. With regards to day-to-day running costs, Panels are relatively inexpensive to operate as they are convened on the basis of demand for their services. Panel members do not receive a fixed salary or remuneration but, rather, are only paid a per diem fee as and when they are called upon to deal with a case. Two of the main expenses will be the cost of a venue to hear cases referred to the Panel, and the cost of a part-time secretary to the Panel to deal with administration. Some Panels have reached arrangements with the Ministry of Justice to use Court facilities, others use the premises of a Chartered Institute of Arbitrators or other similar conciliation/median organization, and some simply hire a hotel meeting room.

13. Recent figures for the UK show that some 20 or so cases are disposed of by the UK Financial Services and Markets Tribunal (this Tribunal is now operated by the Ministry of Justice and has been subsumed into the overall Courts structure) each year and, of those numbers, only one matter was successfully appealed to the High Court. The average costs of a Tribunal hearing including Court staff and security have been estimated to be around some USD 5,000 per day as opposed to some USD 10,000 per day in the Commercial Division of the High Court. Neither figure includes legal fees.

II. Recommendations and Rationale

14. The SEC to adopt the policy of creating an independent Capital Markets Panel which is enshrined in primary legislation to determine appeals against administrative penalties imposed by the SEC and or consumer complaints.

15. The SEC to develop its Capital Markets Panel Policy to address:

    a. structure, scope and remit, and procedural operation of the Panel; and

    b. the mechanism for appointment of Panel members.

16. The SEC to engage in industry consultation on its Panel policy and implement the policy.

III. Outcome

17. The outcome is the provision of a speedy, cost effective and expert independent Panel to review decisions of the SEC in line with international best practices and the doctrine of separation of powers.

A. REGULATION AND REGULATORY STRUCTURE

6. Establish Real-Time Surveillance

ESTABLISH REAL-TIME SURVEILLANCE

I. Assessment

1. Following the issue of a Request for Proposals (RFP) in 2010, the Securities and Exchange Commission (SEC) of Sri Lanka acquired, in 2012, an real-time market surveillance system from Millennium Information Technologies (MIT), a Sri Lankan-based company and wholly owned subsidiary of the London Stock Exchange (LSE). The system is called Millennium Surveillance and is part of a suite of systems built over many years by MIT initially targeting emerging markets but in more recent years, and in particular since the company's acquisition by the LSE in 2009, targeting more developed capital markets. Millennium Surveillance provides real-time and offline transaction data analysis, instant market replay and reporting capabilities, alert case management, and an alert investigation system. Millennium Surveillance is used by a number of emerging market stock exchanges around the world. The SEC is the only securities regulator to use Millennium Surveillance.

2. The issue the SEC has with Millennium Surveillance is that although it has some of the necessary functionality needed by the SEC, it was actually designed for stock exchanges and adapted to the needs of a securities regulator. MIT are aware of this and are willing to upgrade the system - at a cost. SEC has had two upgrades since 2012. Major problems with the current system are that all alerts are hard coded and pre-defined and need a system change request simply to alter a parameter setting in an alert. Also, in order to do analysis, the data has to be exported into an Excel spreadsheet and analyzed from there. This could potentially have issues for enforcement because this results in a break in the audit trail where data is exported into a system that can manipulate the data and does not have its own audit trail. It is important when presenting evidence to the courts to show that original data has not been tampered with. The trading data from the Colombo Stock Exchange's trading system, which has its own audit trail, is transmitted to Millennium Surveillance, which again has an internal audit trail, and is then exported, for analysis purposes, to a spreadsheet which has no audit trail. Potentially, the analysis and the evidence of anyone who analyzed the data could be ruled out on the basis that original data "may" have been tampered with during the analysis. However, Millennium Surveillance does provide a "market replay" so the Enforcement Division of the SEC should be able to rely on that rather than the analysis, though market replay is not the best tool for doing detailed analysis. Hence the need to export it to something that can.

3. Before any statement in a document produced by a computer can be admitted in evidence before Civil and Criminal Courts (different standards of proof: civil = balance of probabilities, and criminal = beyond reasonable doubt), there needs to be "corroborative evidence" to support the party seeking to produce the computer record to demonstrate that the computer was working properly at the material time and was not tampered with. The UK has amended its laws with regard to computer records such that there is a basic presumption that the computer producing the evidential record was working properly and not tampered with at the material time so that this record is therefore admissible as "real evidence." But that presumption can be rebutted if evidence to the contrary is adduced.

4. In order to present computer records to the courts or a Capital Markets Tribunal there is therefore a need for the computer records to be supported by contemporaneous records by way of documentation and a system of independent third party controls

that demonstrate that the systems were operating properly and securely; that controls within the system prevent tampering with records and that the information contained in the computer records is accurate.

5. The SEC is in the process of preparing an RFP and has had preliminary discussions with four potential vendors including MIT. The SEC is under the belief that there are very few providers of online market surveillance systems for securities regulators and it is surprising that two of the leaders in this field were not on the list of names known to the SEC. The main problem facing the SEC is the preparation of a functional specification and RFP that will enable them to properly and easily evaluate bids. Under the Sri Lankan public procurement rules, the SEC has requested the Ministry of National Policies and Economic Affairs to establish a Technical Committee to undertake the bid evaluation process.

6. The SEC has already approached the World Bank for assistance in the purchase of a market surveillance system in full or to the extent possible. A figure of USD400,000 has been quoted by one leading vendor but this appears to be for hardware and a software license, including warranty, for one year. The issue with considering a system on the basis of a single year including warranty is that although a bidder might quote the lowest price for one year, subsequent annual maintenance and support costs may result in it being the highest priced system over a 5-year period. Financial bids for a market surveillance system evaluated during a project in Bangladesh for the Bangladesh SEC in 2012 (ADB TA Loan No. 2232-BAN: Improvement of Capital Market and Insurance Governance Project, Subproject 3: Improvement of Capital Markets Governance Project) were between USD476,000 and USD708,000 which included a licensing fee, customization, documentation, and training together with one year's warranty and a further 4 years' support and maintenance.

II. Recommendations and Rationale

A. Policy Action: SEC to retain a consultant to prepare an RFP for online market surveillance system

7. SEC to employ, from its own resources, a consultant to assist with the preparation of an RFP to be issued to qualifying vendors of online market surveillance systems. The consultant should be required to focus in particular on the preparation of the functional and technical specifications for such a system and prepare the RFP in accordance with the Sri Lankan public procurement rules and with international standards for the issuance of such RFPs. It is recommended that the consultant should have considerable previous experience of RFP preparation and vendor selection of systems of this cost, magnitude, and complexity. The employment of a consultant by SEC will simplify and ease the entire selection process. A Technical Committee approved by MoF could be in place in 1-2 months. It is therefore essential that a consultant should be on board as soon as possible and certainly by July/August 2016. The alternative is to rely on existing SEC surveillance staff, who have little experience of RFP preparation and system selection, to prepare and issue the RFP.

B. Policy Action: SEC procures and implements new online market surveillance system

8. A new online market surveillance system is essential because the existing market surveillance system procured by SEC in 2012 is not appropriate for a securities regulator and is not currently being used by any securities regulator. It is a stock exchange surveillance system that is not designed for use by a securities regulator. It

is not possible to do proper analysis without downloading data into an unsecure system (an Excel spreadsheet) which, in matters of enforcement, may not be accepted by the courts because it raises important issues of potential data tampering. Furthermore, the system is inflexible and difficult to use in that any parameter setting change requires the setting to be changed by the system vendor (hard coded). Other systems used by other securities regulators allow surveillance staff to customize parameter settings at will, with the outcome being much more effective data analysis.

9. The SEC intends to implement the new system by 2017. ADB may be able to provide partial grant support for the system's acquisition.

III. Outcome

10. The recruitment by SEC of a consultant to assist in the preparation of an RFP and its review prior to publication by an ADB consultant will help to ensure that the RFP meets both local and international standards and will enable the bidders to respond uniformly to the RFP thereby strengthening the selection process, make it less cumbersome and speed up the process. The evaluation of four technical proposals submitted uniformly under a structured RFP will take of the order of 8 days. The evaluation of four proposals where there is no uniform structure and bidders submit responses to an RFP without a common structure will take 3-4 weeks (consultant experience).

11. The implementation of an online market surveillance system that is designed for a securities regulator and customized to meet the needs and requirements of the Sri Lankan market will greatly strengthen the capabilities of the Surveillance Division of the SEC. It will enable surveillance staff to set alert parameters by themselves and, instead of the 20-30 pre-set alerts built into the existing system, enable staff to set an infinite number of alert parameters. Surveillance staff will be able to produce ad hoc and pre-specified reports tailored to the nature and timescale of the transactions surrounding those alerts, and to carry out detailed analysis of alerts both online and offline without transferring the data to another system. This will enable alerts to be managed more efficiently and effectively and improve the professionalism of the Surveillance Division. Such a system will also be of considerable benefit to enforcement because any analysis that is carried out will be done within the online market surveillance system thereby maintaining a secure audit trail of the data, making the presentation of evidence derived from computer records much more likely to be admitted.

B. MARKET STRUCTURE

1. Facilitate Demutualization of the CSE

FACILITATE DEMUTUALIZATION OF THE CSE

I. Assessment

1. The Colombo Stock Exchange (CSE) is the only major exchange in South Asia that remains a mutual although demutualization has been a top priority of the Securities and Exchange Commission of Sri Lanka (SEC) and CSE on and off since 2002 (*see ADB "Report on the Demutualization of the Colombo Stock Exchange" January 2003 – TA No. 3567-SRI*). Demutualization has also been reported on as a key recommendation in the SEC Capital Market Master Plan (2006), an initiative in the McKinsey Capital Market Master Plan (2012), a key strategy in SEC Capital Market Development Roadmap (2012) and was number 2 in the SEC 2020 Vision (2014). Further studies, focusing primarily on the ownership structure, have been undertaken by SEC (June 2014) and Ernst & Young on behalf of CSE (October 2014); and ABD's *Sri Lanka Capital Market Assessment* (May 2016) correctly identified share allocation as the biggest contentious issue with demutualization.

2. **Share allocation:** SEC wants to follow the model of demutualization implemented by Malaysia in 2004 which it considers a good model because it set a precedent by allocating shares to stakeholders.

    a. The Malaysian model recognized not only the contribution of members of stock exchange and government but a broader spectrum of stakeholders that also included listed companies and investors. In what is known as the "Malaysian Model" of demutualization, brokers and their agents were allocated 40% of the share capital in the new demutualized exchange, whilst government received 30%, and the balance of 30% was allocated to a Capital Markets Development Fund designed specifically to provide funding for the development of the capital market. In Malaysia, consolidation and demutualization of the exchange were identified as key initiatives under the Capital Market Masterplan (CMP) – the country's 10-year strategic blueprint for the development of the capital market. The CMP recommended a sequential path of first consolidating the 5 exchanges in the country to be followed by demutualization with a view to enhancing the competitive position of the country's market institutions. Unfortunately, in Sri Lanka there is no consolidation of exchanges.

    b. SEC's preferred allocation is a maximum 40% to members of CSE and a minimum 30% to Government with the balance either going to a Capital Market Development Fund or held in trust and the proceeds distributed to members via an initial public offering (IPO) or through a sale to a strategic investor. SEC considered it unlikely that the Government would wish, in the longer term, to retain its holding and potentially this could also form part of an IPO. In discussions with the 15 members of CSE, it would appear that consensus could be achieved in terms of the Government receiving an allocation of shares, assuming it sold out at the time of an IPO. Whilst a Capital Market Development Fund was considered positively by some members, this was not the view of the majority. The majority of members also accepted that a proportion of the shares allocated to them would be held in a blocked account until the IPO. This will ensure that members will not have voting control. The members would wish to make a policy decision how their shares were allocated among them; whether it be an equal share or by some other mechanism.

c. SEC calculated member contribution to CSE by reference to members' annual fees and used SEC grants and Government tax concessions as a mechanism for measuring the Government's contribution to the development of CSE. SEC provided summarized figures for broker and SEC/Government contributions for the years 1996 to 2007. These were updated to end in 2016 resulting in a total member fees contribution of LKR337ml and a Government contribution of LKR687ml including funds contributed by the SEC. CSE members would contest some of the contributions from the Government on the basis that the funding did not come from Government but from the Cess fund (money raised from the levy on stock exchange transactions) fund of SEC. In addition, it was said that the tax concession applied to all companies that are limited by the guarantee.

3. **Demutualization Act:** The draft Demutualization Act moves CSE from a company limited by guarantee to a public limited company, allowing the Minister to make regulations with respect to the Act, and ensuring continuation of the former company into the new company. In many respects, the draft Demutualization Act closely follows the Malaysian Demutualization Act in that it also includes the provision for SEC effectively to dictate the allocation of both the proportion and number of shares. However, in Malaysia this was agreed with the brokers in advance.

4. **Governance structure:** The Malaysian model for an exchange board is one-third public interest directors, one-third independent directors, with the remainder shareholder directors. This outcome provided compliance with the governance standards contained in the Malaysian Code of Corporate Governance. However, only Malaysia and Hong Kong have Public Interest Directors that are appointed by the Government on the boards of their respective stock exchanges. CSE members, whilst not objecting to the principal of Public Interest Directors, are concerned that they would be appointed by the Government and therefore any change in Government may lead to a change in the Public Interest Directors. This is not an issue in Malaysia and Hong Kong because both have very stable governments. SEC had proposed following this model but recognizes that other exchanges, e.g. Australia, Singapore, Bangladesh and Pakistan, have appointed majority independent (public) directors to their boards and, in accordance with IOSCO recommendations, required them to act generally in the public interest.

5. **Articles of Association of CSE:** These have been reviewed and are not appropriate for a public limited company and will require an extensive re-write by CSE as part of its approval process to SEC to demutualize.

6. **Separation of business and regulatory roles at CSE:** Both the regulatory areas and the business areas report to the CEO. In a demutualized exchange, this may cause a clear conflict of interest. This can either be addressed by separating out the regulatory functions into a separate legal entity, e.g. Canada and US, or by appointing a Chief Regulatory Officer (or however called) with responsibility for all regulatory functions reporting directly to the Board and separately to SEC (a structure adopted by many other demutualized exchanges). This is the only major change in the way SEC's oversight of CSE will change upon demutualization. Further changes may occur when CSE decides to list on its own market, whereupon SEC will take over responsibility for ensuring the exchange company's compliance with the ongoing disclosure obligations of listing.

7. **Wider share-ownership:** One of the key objectives of demutualization is the achievement of a wider spread of ownership, and in some cases, this has involved seeking strategic investors. They are often difficult to find and those exchanges in the region that have been seeking strategic investors for some years include Pakistan,

Dhaka and Chittagong. As an alternative to allocating an initial amount towards this, additional capital can always be issued by way of a private placement in the event of the subsequent appearance of a strategic investor.

8. **Limits on ownership:** SEC, by placing a 5% limit, is seeking to ensure that no single individual, including concert parties, can acquire a substantial holding in the demutualized CSE without seeking prior SEC written approval. However, the Government and SEC may allow individual ownership limits to be waived in the case of a strategic investor or takeover where these are demonstrated to be in the public interest. This is standard practice in most demutualizations although the percentage limit may vary between 5% and 15%.

9. **Changing the business focus:** One of the objectives of demutualization is streamlining the decision making process of exchanges by having a board that lays down policy and direction and empowers executive management to run the exchange and make fast and sound business decisions. However, in managing the transition to a post-demutualization environment, it is often difficult for exchange management, having previously operated mostly in a regulatory mode, to easily assimilate a commercial mindset or develop the necessary capacity to execute business strategies. This was a particular issue raised by members about CSE management. Most of the world's leading stock exchanges are managed by people with a proven track record in managing businesses and not people with a history of operating stock exchanges.

10. **Profitability and sustainability:** The expenditure of CSE is currently exceeding its earned income and the exchange is heavily reliant on unearned investment income from its substantial reserves. Market volumes are around 50% of break even. International investors were net sellers in 2015 (in common with other countries in the region) and there is little retail investment. SEC identified these concerns. These were confirmed in the ADB *Sri Lanka Capital Market Assessment* (May 2016) which also correctly identified the concerns and impediments of low market size, illiquidity, high transaction costs, too many trading participants, one product exchange, etc. which could have serious implications for a demutualized CSE. These are matters that urgently need to be addressed if CSE is to operate on a for-profit basis and meet the return on investment expected by its future shareholders. CSE has, in its Strategic Plan 2016-18, identified a number of new product initiatives including an SME board, listing of USD denominated securities, REITS, structured warrants and other derivatives together with new indices and Sharia products. However, the opinion of CSE management and members is that market volumes are likely to remain low until Government lists some of the minority stakes in State Owned Enterprises. CSE is seeking, in common with all other exchanges, to diversify its revenue streams and reduce dependency on income from transaction fees which, in 2015, was 56% of total revenue. In contrast, a survey by the World Federation of Exchanges in 2012 showed that transaction fees accounted for 40% of its member exchanges' total revenue.

I. Recommendations and Rationale

A. Policy Action: Demutualization Bill to Parliament

11. Before demutualization can be effected, it will be necessary for CSE to move from a company limited by guarantee to a public limited company. The draft Demutualization Act provides for this. The alternative, not to be considered, would be to wind up the exchange company and to establish a new company as a public limited company. This would raise major issues regarding legality of settlement of transactions as well

as membership and listing issues. ADB should assist SEC in finalizing the draft Demutualization Act which at present includes reference to the appointment of Public Interest Directors, whereas SEC thinking is open to having a majority of independent directors to align with international best practice. The draft Act incorrectly provides for the Minister to publish in the Gazette the names of persons to whom shares will be issued before the Registrar considers the application. S.2(3)(d) of the Act should be amended to reflect approval of the Minister instead of a Gazette notice. Consequential amendment is also needed to s.2(2)(c) of the Act.

B. Policy Action: Establish a Demutualization Working Group with the objective of reaching consensus on the model of demutualization

12. The draft Demutualization Act allows the Minister to make regulations in support of demutualization and includes the provision under s.9(1) of the Act for SEC effectively to dictate the allocation of both the proportion and number of shares which in almost all demutualizations was achieved through consensus building. Currently, there appears to be a relatively small gap that needs to be resolved through consensus building between what SEC is proposing by way of an allocation of shares and what members are seeking.

13. The alternative to consensus building is for SEC to proceed with its plans on the basis of its present model of demutualization and for SEC, via the Minister, to allocate the proportion and number of shares. The danger in doing this without consultation is that it may be challenged via the Courts by existing shareholders on the basis that this empowers SEC to make an allocation without consultation and consent, thus depriving individuals of their rights in property. In India, member objections went all the way to the Supreme Court before the Government prevailed, where the court held that membership was a privilege extended by Government.

14. Additionally, a requirement of the Companies Act is that in order to move from a company limited by guarantee to a public limited company, the Registrar must be provided with the original or a duly certified copy of the resolution passed by members of CSE approving the conversion from a company limited by guarantee to a public limited company. If the existing members do not pass such a resolution, the Registrar cannot make the change and demutualization will fail to happen. It is difficult to see how SEC could instruct CSE members to pass such a resolution without that instruction being challenged in the Courts.

15. In order to assist the consultation process, during project implementation, ADB should assist Government, SEC, CSE and its members, who will comprise a working party, to reach consensus on, in particular, the share allocation of a demutualized CSE. Appendix 1 proposes a framework that could be used as the basis for such a consensus. Other matters such as governance structure, share ownership limits, separation of business and regulatory roles, fitness and properness of directors, handling conflicts of interests etc. should also be addressed but these are unlikely to be contentious and CSE members have largely signed off on them. ADB should provide written and verbal guidance and assistance to the working party during the consultative process by advising on international best practice and inputting experience from other exchange demutualizations.

C. Policy Action: Achieve demutualization of CSE

16. Demutualization will be achieved by SEC setting its requirements for the approval of a license for a demutualized CSE in a regulation. In submitting an application to SEC, CSE will be required to comply with the regulation.

17. ADB should assist SEC in preparing a regulation containing the criteria whereby SEC would approve an application by CSE to demutualize. The criteria will include a detailed description of requirements, in accordance with IOSCO guidance on exchange demutualization, on the separation of business and regulatory roles, compliance with fitness and properness standards of directors, committee structures, handling of conflict of interest, and the organizational and management structure of an exchange. The regulation and criteria will also be used by SEC to consider any future applications for licensing as an exchange from e.g. a derivatives market or any other exchange market (Singapore, Malaysia and Bangladesh have all adopted this approach).

18. ADB should also provide assistance to CSE in the preparation of a new Memorandum and Articles of Association, revision of the Rules, responding to SEC's criteria, and the preparation of a business plan that will include a statement on dividend policy, listing, business plan and regulatory arrangements post demutualization.

19. A description of step-by-step actions is described in Appendix 2.

III. Outcome

20. The benefits of demutualization will be to:

    a. make the CSE less susceptible to members' vested interests;
    b. provide a governance structure that meets good standards of corporate governance;
    c. broaden exchange ownership;
    d. spread ownership risks;
    e. enable members to realize the value of their assets;
    f. provide the exchange with greater access to capital;
    g. improve speed and flexibility in decision making;
    h. enable diversification into other markets and services;
    i. facilitate links with other markets;
    j. accelerate the development of technology-related infrastructure and capabilities;
    k. incentivize management;
    l. bring market discipline to bear upon management; and
    m. ensure management is focused on improving shareholder value.

21. The benefits listed above are well documented and form the cornerstone of any market development.

22. However, in Sri Lanka the true benefits of demutualization will not be felt without a capital markets development strategy with buy-in from all stakeholders including the Government. As recommended in ABD's Sri Lanka Capital Market Assessment (May 2016) "*The most important step for developing capital markets in Sri Lanka is to formulate a national level capital market development program with participation and commitment of all key parties such as [the] Ministry of National Policies and Economic Affairs, Ministry of Finance, Ministry of Public Enterprise Development, Securities and Exchange Commission, Insurance Board of Sri Lanka, Colombo Stock*

Exchange and the Central Bank. Without the highest level buy-in and commitment, the critical pieces of the capital market development puzzle will continue to remain unfinished, and any institutional-level master plan will continue to face implementation challenges".

Appendix 1:
Potential Framework for Reaching Agreement between Gov/SEC and Members of the Colombo Stock Exchange on the Demutualization of the Exchange

1. During discussions with the Director General of SEC and with all 15 members of CSE on the broad principles of demutualization, international experience and local circumstances, it appeared that a consensus may be closer than had originally been thought. There are members that are opposed to any shares being issued to Government but the majority appear to take the view that bringing about demutualization was paramount.

2. The following suggestion on a share allocation is a possible way forward that may be close to what SEC and most members indicated might be acceptable.

3. The board structure, limits on ownership and other matters were largely accepted by all concerned.

A. Share Allocation

4. Government to receive a 30% shareholding which it will commit to disposing off at the first available opportunity via an IPO or private sale to institutions. Government will have full beneficial rights on the shareholding including voting and dividend rights.

5. Members to receive a 70% shareholding, 40% to be issued on demutualization on which they will have full beneficial rights and the balance of 30% will be lodged in a "blocked account." Members will be entitled to dividends but not to voting rights on the shares in the blocked account. Shares in the blocked account will be sold via an IPO and the value distributed to the members.

6. The share allocation amongst the existing members will be decided by the members themselves.

B. Board Structure

7. The board shall comprise a majority of independent directors. The chairman of the board shall be an independent director.

8. Independent directors shall have an over-riding responsibility to act in the public interest as set out in the Demutualization Act.

9. The exchange company, via its articles of association, shall determine the total number of directors.

10. There shall be a Nominating Committee comprising only independent directors. In the case of a vacancy, the nominating committee shall send the names of the intended appointees to SEC who shall determine their suitability based on strict criteria of fitness and properness.

11. All proposed directors, be they shareholder elected or independent directors, shall together with the senior management positions within the exchange, be assessed against the fitness and properness criteria.

12. The board will be responsible for policy and direction. Day to day management of the exchange shall be vested in the Chief Executive Officer.

C. Limits on Ownership

13. No person or persons acting in concert shall own more than 5% of the share capital of the exchange company. Government and SEC may allow individual ownership limits to be waived in the case of a strategic investor or takeover where these are demonstrated to be in the public interest.

D. Other Matters

Separation of Business and Regulatory Roles

14. CSE shall appoint a Chief Regulatory Officer reporting directly to the Board with a separate reporting line to the SEC. The Chief Regulatory Officer shall assume direct responsibility over all staff and responsibilities in all regulatory areas of the exchange including but not limited to listing, surveillance and compliance. The role of the Chief Executive Officer will be to expand the business and increase shareholder value.

Committee Structure

15. In addition to a Nominating Committee, there shall be a Risk Management and Internal Audit Committee comprising a majority of independent directors and a Conflicts Resolution Committee comprising only independent directors to manage all potential conflicts of interest.

16. There will be no Finance Committee; finance is the responsibility of the CEO reporting directly to the board.

17. The board may appoint independent experts.

18. The CEO may call upon advisory committees and/or external experts to assist in the development of new products, rules etc.

Appendix 2:
Step-by-Step Actions for Demutualization

Key Action	Activity During Key Action
1. SEC finalizes draft Demutualization Act and submits to Parliament (by August 2016).	• Gov/SEC/board of CSE (board) to establish Working Party and reach consensus on share allocation, governance structure, ownership limits, etc.; • SEC to prepare draft regulation on criteria for a demutualized exchange; • board to draft new Articles of Association and commence work on scheme of arrangement; and • board to recruit CRO.
2. Demutualization Act promulgated (by May 2017) and SEC immediately issues regulation.	
3. Board completes draft scheme of arrangement comprising: a. new Articles of Association; b. a proposed new board; c. committee terms of reference; d. draft rules; e. names and job descriptions of CEO and CRO; f. new organizational structure; g. proposals for achieving wider share ownership; h. five year business plan and financial forecast; and i. statement on dividend policy.	• Members to determine how the members' shares will be allocated among the membership. CSE Board to notify SEC of this; and • board to issue Notice of Meeting to Members setting out resolutions to (a) convert the company to a public limited company, (b) approve new Articles of Association and (c) approve scheme of arrangement.
4. Members pass resolutions.	
5. Board submits to SEC for approval the scheme of arrangement together with certified copies of resolutions and directors and senior executives declarations with regard to fitness and properness (by October 2017).	
6. SEC reviews and approves scheme of arrangement (by December 2017).	

Key Action	Activity During Key Action
7. Upon approval of SEC, board submits to Registrar, in accordance with the Demutualization Act, an application to convert the company from a company limited by guarantee to a public limited company.	
8. Registrar considers application, registers company as a PLC, and notifies Minister.	
9. Minister immediately issues notice that Colombo Stock Exchange is a PLC and, as required by the Demutualization Act, publishes details of shareholdings (target date January 2018 but must be within 12 months of passage of the Act).	New board is appointed with effect from the publication of this notice.

B. MARKET STRUCTURE

2. Strengthen Trading Platform and Establish a Central Counterparty System

STRENGTHEN TRADING PLATFORM AND ESTABLISH A CENTRAL COUNTERPARTY SYSTEM

I. Assessment

A. Current composition of the Government bond market infrastructure in Sri Lanka, and its development plans

1. Auctions are operated by the Central Bank of Sri Lanka (CBSL) on an in-house developed system which the primary dealers access using a web interface. The current platform runs on legacy hardware (IBM AS/400), hence, the CBSL is currently rolling out an upgrade to this auction platform and this is anticipated to be completed by August 2016.

2. Secondary trading in practice is mostly being done over-the-counter (OTC) by phone between the primary dealers representing their clients. The trades are then captured post trade on to the Central Depository System (CDS). However, a secondary trading platform is currently in place by an initiative undertaken between Bloomberg and the primary dealers on Bloomberg's Fixed Income Trading (FIT) system. Although Bloomberg's FIT is provided at no direct cost to the CBSL or primary dealers, an active subscription is required. All but one primary dealer currently subscribes to Bloomberg. It is understood that some primary dealers subscribe to Bloomberg just for bond trading and do not necessarily require the other service offerings by Bloomberg. Hence, the CBSL has decided to develop or procure a secondary trading platform for which the US Treasury is providing assistance in developing the requirement specifications and some technical assistance for its implementation. The rollout of the new secondary trading platform is anticipated to be completed by late 2016 or early 2017 by the CBSL.

3. The CDS holds Government securities in scripless form and the securities transfer is done on an electronic basis by primary dealers interfacing using SWIFT messages in the Scripless Securities Settlement System (SSSS). Transfers are done by the Real Time Gross Settlement (RTGS) system and instructions are carried out on a trade-by-trade basis with the transfer of securities and the transfer of funds for payment taking place simultaneously. The SSSS transfer instructions are carried out trade-by-trade with the transfer of securities and the transfer of funds for payment taking place simultaneously on a delivery versus payment (DVP) basis. Together, the CDS and SSSS are called LankaSecure by the CBSL. LankaSecure plus RTGS is called LankaSettle. Although the system specifications for LankaSecure's CSD provide functionality for capturing price information for post trade settlement, it is understood that a change request is still required with the vendor to implement this functionality and is something that CBSL intends to undertake and complete by August 2016.

4. The CBSL is considering developing a central counterparty system (CCP) for Government securities and this initiative is currently in the conception stage. The intention is to have LankaSettle supplemented by initiatives for the secondary trading platform and the CCP to form part of a Sri Lankan Bond Clearing House operated by the CBSL. The CBSL do not envisage the CCP initiative to be realized within the next two years.

B. Current Government securities market issues and underlying assessment of technology implications

5. **Price discovery and transparency:** For secondary trading in Government securities, the CBSL does have a trade reporting requirement, however this is understood to be not enforced and, under the current regulatory framework, the CBSL lacks the ability to fine primary dealers and the only disciplinary measure available is to file a legal case. Bloomberg's FIT for secondary trading supports primary dealers or market makers providing indicative quotes, secondary market participants (i.e., non-primary dealers) putting in a request for quote from the primary dealer or market maker and also capturing a voice trade (i.e., trade reporting). Hence, the technology is not the limiting factor, as all best practice mechanisms for secondary trading are already available in the current platform. The FIT platform can be electronically linked to LankaSecure systems to maintain DVP for secondary trading. This approach to secondary trading on Bloomberg's FIT is undertaken in leading markets for government securities such as in the United Kingdom, Hong Kong and Singapore, and in the region for Pakistan, among other markets around the world. Hence, to address price discovery and transparency in the short-term, a more formalized use of FIT should be undertaken by CBSL issuing a new circular or notice. In the long run, if costs for Bloomberg subscriptions for primary dealers, market makers or secondary trading participants are a significant barrier to market development, then CBSL can develop or procure a solution for in-house operation.

6. **Market data and integrity:** By formalizing secondary trading on FIT, market data will be available to stakeholders, thereby improving price transparency. At the same time, the initiative to enable capturing pricing data at LankaSecure should be implemented in the short term. The CDS already supports this functionality and a change request with the supplier of the system to deploy this functionality for CBSL should be a relatively easy and low cost proposition. Thereafter, CBSL will more effectively undertake its supervisory role by having trading and post-trade pricing data at its disposal. FIT's market monitoring surveillance features (referred to as various blotter screens within FIT) should also be used by CBSL to monitor trading and could be also utilized in the future to monitor and receive alerts on the obligations of market makers. When the CBSL deploys its own trading platform, it should ensure that the solution caters for monitoring and surveillance functionality.

7. **Fragmentation of bond market platforms:** There has been discussion between capital market stakeholders on the inefficiencies of having various platforms in the context of the size of the Sri Lankan markets. Although there are successful markets (such as Malaysia) where government securities are traded on exchange, for most markets, government and corporate bonds are auctioned and traded on separate platforms. If the CBSL deploys its own trading platform, then costs to secondary trading participants will no longer be a barrier. If Bloomberg is continued for secondary trading in the long-run, then secondary trading participants (such as universal brokers) can still phone or connect to the order management systems of a primary dealer or market maker. Therefore, although some inefficiencies or risks are introduced from fragmentation of the bond markets platforms, they are not significant enough to warrant a major initiative to consolidate these platforms.

8. **Central counterparty for Government securities:** The introduction of a CCP by the CBSL is currently in its embryonic stages. For the current cash market, given settlement is on DVP and immediate using RTGS, there is no pressing priority for the introduction of a CCP for this market. If derivatives of Government securities are to be introduced, then they will need to be traded at the Colombo Stock Exchange (CSE) (which can support derivative trading) and also piggy-back on the CCP initiative of the CSE. The CBSL attempting to embark on housing its own trading and CCP systems for Government securities derivatives will involve significant investment and, unlike the fragmentation of trading platforms, will represent significant inefficiencies and

duplication as both derivatives trading and derivative CCPs are multi-million dollar systems. Furthermore, there is a strong case for derivatives risk management and margining being done in a consolidated CCP for it to be effective, as risk can be spread across multiple derivatives which may span across various underlying instruments. A CSE-housed derivatives trading and CCP system can easily be linked with LankaSecure for settlement for delivery of any Government securities derivative so the cash leg of the transactions would continue to use the market infrastructure of the CBSL.

II. Recommendations and Rationale

9. The CBSL to issue a new circular or notice to primary dealers mandating any secondary market trade in Government securities to be reported on FIT within 15 minutes of trade being agreed between the counterparties, to improve market transparency.

10. The CBSL to issue a new circular or notice to encourage primary dealers to use FIT for requesting quotes and secondary trading in Government securities, to facilitate better price discovery and improve market transparency.

11. The CBSL to implement the capturing of price information for post trade settlement at LankaSecure for Government securities, to enable better supervision thereby improving market integrity and enabling improved market data.

12. The CBSL to undertake an assessment of Bloomberg's offerings for auction, trading and market surveillance which includes a cost benefit analysis to participants in secondary trading versus costs to be borne by CBSL given Bloomberg costs are paid collectively by the market as subscription fees whereas in-house systems are primarily to be borne by the CBSL. If the outcome of the assessment to be undertaken justifies the hosting of the secondary trading platform including market surveillance and market maker functionality in-house, then CBSL should implement and rollout the secondary trading platform with these features.

III. Outcome

13. The outcome from the above policy action recommendations facilitates market infrastructure, enabling the development of the Government secondary market by:

    a. providing better mechanisms for price discovery by leveraging current electronic platforms;

    b. improving market transparency by providing pricing data for secondary market trading; and

    c. enhancing market integrity by enabling more effective supervision by the regulator from the additional trading and post trade market data.

B. MARKET STRUCTURE

3. Develop Incentive Tax Framework for Capital Market Investments

DEVELOP INCENTIVE TAX FRAMEWORK FOR CAPITAL MARKET INVESTMENTS

I. Assessment

1. The study identified a number of potential tax distortions/impediments to the long term development of the capital markets and Sri Lanka as an international finance center from the following two perspectives:

    a. the potential tax distortions/impediments which impact on Sri Lanka's ability to compete for foreign investment with other regional capital markets such as Australia, Hong Kong, Malaysia, and Singapore; and

    b. the potential tax distortions/impediments which impact on Sri Lanka's ability to develop its capital market including bringing new products to market.

2. It is important that Sri Lanka's tax laws facilitate and encourage the long term development of the capital markets and Sri Lanka as an international finance center. If this is not possible, the tax laws should, at the very least, not be an impediment to this development. The tax laws that need to be amended are:

    a. the laws imposing stamp duty on the transfer of immovable property, motor vehicles and certain legal documents under separate statues legislated for by the provincial councils based under the powers devolved to these councils under the 13th Amendment to the Constitution;

    b. the *Finance Act* which imposes a share transaction levy;

    c. the income and capital gains tax laws contained in the *Inland Revenue Act No 10 of 2006*; and

    d. the value added tax laws contained in the V*alue Added Tax Act No 14 of 2002*.

A. Tax Distortions/Impediments from the Perspective of Investors

(1) Assessment	A foreign unit trust/mutual fund is at a tax disadvantage relative to its domestic competitors (a domestic Securities and Exchange Commission (SEC) approved unit trust/mutual fund) which is investing in the same population of Colombo Stock Exchange (CSE) listed companies. A CSE listed company is not required to withhold tax (10%) on dividends paid to a domestic SEC approved unit trust/mutual fund but is required to withhold if the recipient is a foreign unit trust/mutual fund.
Recommendations and Rationale	The tax obligations imposed on a foreign unit trust/mutual fund investing in CSE listed companies should be the same as those imposed on its domestic SEC approved competitors who are investing in the same market. Both should either be exempted or subject to withholding tax on dividends paid by a CSE listed company.
Outcome	The tax distortion which disadvantages a foreign unit trusts/investment fund coming into the market and competing with its domestic peers will be removed.

(2) Assessment	The indirect tax cost paid by investors to invest on the CSE is high compared to other regional stock exchanges. Whilst the on-market purchase and sale of shares on the CSE is not subject to stamp duty, both the buy and sell side of the transaction are subject to a share transaction levy of 0.3% or 0.6% in total which is essentially a stamp duty in all but name. This transaction levy of 0.3% or 0.6% in total is high by regional capital market standards.
Recommendations and Rationale	The transaction levy should be reduced to a level which is in line with the stamp duty imposed in regional capital markets such as Australia (nil), Hong Kong and Malaysia (0.1% on both sides of the transaction, i.e. 0.2% in total), or Singapore (0.2% on both sides of the transaction, i.e. 0.4% in total).
Outcome	The equivalent of the stamp duty cost of investing in the CSE will be competitive with other regional stock exchanges.

(3) Assessment	The announced re-introduction of a capital gains tax (CGT) in Sri Lanka will distort the market from the perspective of foreign investors.
Recommendations and Rationale	Domestic and foreign investors in shares listed on the stock exchanges in Hong Kong, Malaysia and Singapore are not subject to CGT. Only domestic, and not foreign investors in shares listed on the Australian stock exchange, are subject to CGT. It is unclear if the CGT in Sri Lanka will apply to domestic and foreign investments in CSE listed companies. If it does, CSE will be at a disadvantage relative to its regional competitors. We recommend that all investors, or at least foreign investors (the Australian model), be exempted from CGT in relation to their investments in CSE listed companies.
Outcome	The CSE will be regionally competitive as far as CGT is concerned.

(4) Assessment	The tax law creates a distortion in the market for foreign investors investing in either loans to, or bonds and other debt securities issued by Sri Lankan companies, or in Sri Lankan Government treasury bills and bonds
Recommendations and Rationale	Interest paid to foreigners on loans to, and bonds and other debt securities issued by Sri Lankan companies is currently not subject to interest withholding tax (but see Item (9) below). Interest paid to foreigners on Sri Lankan Government bonds and treasury bills is, on the other hand, generally subject to interest withholding tax. We recommend that the withholding tax obligations in relation to interest paid on Sri Lankan Government treasury bills and bonds should be the same as the withholding tax obligations on interest on loans to, or bonds and other debt securities issued by Sri Lankan companies.
Outcome	The distortion between the markets for corporate bonds and other debt securities vis-à-vis Government treasury bills and bonds will be removed.

B. Tax Distortions/Impediments from the Perspective of the Sell Side

(5) Assessment	There are tax impediments to creating companies of sufficient size and scale to be listed on the CSE. Whilst the company law in Sri Lanka provides the legal framework for mergers and amalgamations (where the rights and the privileges and the liabilities and obligations of the companies amalgamating simply flow into the blended company rather than the extinguishment of the old companies and the creation of a new one), these legal consequences are not mirrored in the tax law. As a consequence, the Inland Revenue Department (IRD) takes the position that, from a tax perspective, an amalgamation does result in the transfer of assets and the business, and the extinguishment of the old companies and the creation of a new one. This in turn means that there may be tax to be paid on the transfer of assets for tax purposes to the "new" company and the loss of certain tax credits, etc.
Recommendations and Rationale	The legal consequences of mergers and amalgamations as provided for in the company law should be mirrored in the tax law.
Outcome	An increase in amalgamations and the population of companies of sufficient scale and size that are able to be listed on the CSE.

(6) Assessment	There are tax impediments to the development of asset- based products. These tax impediments can include stamp duty, VAT, etc. It is unlikely that these products will be developed and brought to the market if these tax impediments are not significantly reduced or eliminated.
Recommendations and Rationale	The tax impediment in the case of a real estate investment trust (REIT) is the (4%) stamp duty cost which is payable to the Provincial Councils rather than the National Government when transferring real estate to the special purpose vehicle (SPV) when forming the REIT. Stamp duty is also the tax impediment to bringing Islamic Bonds (Sukuks) to the market. An attempt to securitize motor vehicle leases and bring that product to the market also failed because of the stamp duty and VAT cost. We recommend that these impediments/tax costs be removed by, for example, exempting the transfer of assets into the SPV from stamp duty and VAT when creating these products. We recognize, in making this recommendation, that in Sri Lanka, the cost of reducing the stamp duty cost will fall on the Provincial Councils rather than the National Government which is an issue that will need to be addressed.
Outcome	The creation of new products that can be brought to the market.

(7) Assessment	The current tax laws (and often just a look of tax certainty on some issues) are an impediment to developing derivatives to be brought to the market.
Recommendations and Rationale	Taking stock borrowing and lending contracts as an example, it will be necessary to exempt such transactions from stamp duty if stock borrowing and lending is to be brought to the market. This will require legislation. It will also be necessary to clarify, either through legislation or a ruling from the IRD, that the manufactured payments under a stock borrowing and lending contract to compensate the lender for any dividends that might be paid during the stock lending period will be taxed as a dividend.
Outcome	Eliminating taxes (which would not in any event be collected if such derivatives are not brought to the market) and providing certainty in relation to potential tax impediments will better enable derivatives to be developed and brought to the market.

(8) Assessment	There is a tax impediment which in theory can prevent CSE listed companies from fully investing in and growing their businesses. The impediment is that all listed and unlisted companies in Sri Lanka are required to distribute at least 10% of their distributable profits as defined in any one year as a dividend. Failure to meet this minimum distribution requirement will result in a deemed distribution of 33.3% of the distributable profits as defined, with that deemed distribution being subject to tax at a 15% rate. The IRD also has the power to deem a dividend distribution (subject to tax at a 15% rate) even if the minimum distribution requirement has been met, if an assessor or assistant commissioner is satisfied that the company has not distributed a sufficient part of its profits to shareholders.
Recommendations and Rationale	The minimum distribution requirement in the tax law should not apply to publicly listed companies. The board and management of publicly listed companies should have the discretion whether or not, and to what extent, to re-invest their profits and grow the business. We recommend that this minimum distribution requirement be removed for CSE listed companies. We would also note that the cost to the revenue from the removal of this minimum distribution requirement will not be large, as we understand that most CSE listed companies meet the requirement because of market dividend expectations.
Outcome	The removal of this tax impediment to greater business investment by CSE listed companies may help grow these businesses and enhance shareholder value for investors.

(9) Assessment	Are there any tax impediments to the raising of foreign loans or foreigners investing in bonds and other debt securities issued by Sri Lankan companies? The simple answer is "no, but!" It is "no", because under the current tax law such foreign loans and foreign investments in debt securities are exempt from Sri Lankan tax. This means that the 20% interest withholding tax or a reduced double tax treaty (DTA) rate, if available, does not apply. The answer is also "but" because the Government announced in the last budget that it would restrict this exemption to foreign loans from financial institutions. The Government's announcement has not yet been legislated.
Recommendations and Rationale	This re-introduction of a 20% interest withholding tax will be a tax impediment to a CSE listed company raising loan funding from foreign investors who are not financial institutions and should not be legislated. An alternative would be to restrict the exemption, but to significantly reduce the interest withholding tax rate that will apply to foreign creditors or investors who are not financial institutions.
Outcome	A significant tax impediment to the raising of foreign loans by Sri Lankan companies will be avoided.

(10) Assessment	Amendments to existing tax law and/or the imposition of new taxes have sometimes created significant impediments to the development of the capital market in Sri Lanka.
Recommendations and Rationale	The process when amending existing law or legislating new tax laws must formally consider the impact of those laws on the capital market in Sri Lanka. The process for this could be by consulting with professional bodies with the expertise such as the Institute of Chartered Accountants in Sri Lanka. One example of the potential problems that can arise is described in Item (8) above. Another example is the recent announcement that capital gains tax (CGT) will be re-introduced in Sri Lanka, raising a number of questions relevant to the capital markets, including: (i) will the re-introduced CGT apply to GSE listed shares owned by foreigners/non-residents of Sri Lanka; (ii) if CGT will be imposed, will shares held by foreigners prior to the announcement be grandfathered; and (iii) if not, will the CGT cost base be the original purchase price or the market value of the shares on the date CGT is introduced; etc. If the re-introduced CGT will apply to listed shares, it will put CSE at a competitive disadvantage vis-à-vis Hong Kong, Malaysia and Singapore stock markets where those countries do not levy a CGT, and even Australia which does not subject foreigners/non-Australian tax residents to CGT in relation to their investments in shares in companies listed on the Australian Securities Exchange (ASX).
Outcome	Any unintended adverse impacts of the capital market in Sri Lanka are more likely to be avoided.

II. Recommendations and Rationale

3. The priority recommendations can be summarized as follows:

   a. The following distortions in relation to Sri Lanka's regional competitive position needs to be addressed.

      i. It is currently unclear if CGT will apply to investments in CSE listed shares. If it does, we recommend that the law be changed so at the very least it does not apply to foreign investments in CSE listed shares as is the case on other regional exchanges with which the CSE competes (for detailed explanation, see Item (3) above).

      ii. The share transaction levy on the purchase and sale of CSE listed shares should be reduced so that it is at least in line with the much lower stamp duty cost on the purchase and sale of listed shares on other regional competitor exchanges (for detailed explanation, see Item (2) above); and

      iii. The withholding tax advantage provided to a domestic SEC approved unit trust/mutual fund over its foreign peers should be removed (for detailed explanation, see Item (1) above).

   b. The tax impediments to the development of new products to be brought to the market needs to be removed.

      i. In the case of asset based products (REITS, Islamic Bonds, securitized loans etc.), the stamp duty, VAT and other tax costs can make the creation of these products uneconomic. These tax impediments need to be removed (for detailed explanation, see Item (6) above);

      ii. In the case of derivatives (e.g. stock borrowing and lending) the stamp duty cost which makes the creation of these products uneconomic, and the uncertainty around how the cash flows under the derivative contracts will be treated for tax, need to be removed (for detailed explanation, see Item (7) above).

   c. The tax law needs to amended so that the legal consequences of a corporate merger or amalgamation is mirrored in the tax law so that a corporate merger or amalgamation does not have adverse tax consequences (for detailed explanation, see Item (5) above).

4. The lower priority recommendations can be summarized as follows:

   a. Future tax law changes need to take into account the impact these laws potentially have on the capital markets in Sri Lanka by consulting with professional organizations such as the Institute of Chartered Accountants in Sri Lanka (for detailed explanation, see Item (10) above).

   b. The law which imposes a tax if a company fails to meet a minimum dividend distribution requirement should be amended so that it does not apply to companies listed on the CSE (for detailed explanation, see item (8) above).

c. The distortion between the market for corporate debt (no interest withholding tax), and Government treasury bills and bonds (withholding tax) should be removed (for detailed explanation, see Item (4) above).

III. Outcome

5. Removing distortions would enable the capital market to develop more broadly and rapidly. In particular:

a. lowering transaction costs would aid market liquidity;

b. modifying stamp duty would support the development of new products such as securitization; and

c. modifying taxation of merged companies would permit larger companies to develop, which are more likely to use the capital market.

B. MARKET STRUCTURE

4. Promote Colombo as an International Financial Center

PROMOTE COLOMBO AS AN INTERNATIONAL FINANCIAL CENTER

I. Assessment

1. The Minister of Finance has decided to create an International Financial Center (IFC) in Sri Lanka. This is to be modelled on the Dubai International Financial Center (DIFC) and to be known as the Colombo International Financial Center (CIFC).

A. International Financial Centers

2. IFCs can be divided into three broad categories:

   a. major financial centers offering the full range of financial services with a global reach (such as London and New York), or with a more regional focus (such as Hong Kong, Singapore and Dubai);

   b. offshore centers with a global reach but offering niche services to a global market such as Switzerland or Jersey (primarily private wealth management), Cayman Islands or Guernsey (fund domicile and associated services); British Virgin Islands or Seychelles (offshore international business companies), Bermuda (captive insurance), or Dublin and Isle of Man (fund and company administration); and

   c. offshore centers with a focus on a single country market such as Mauritius (focusing on the India market), Labuan (Malaysia), San Marino (Italy), and Cape Verde (Portugal, Angola and Brazil).

3. The first group almost all arose because of specific historical, cultural or regulatory factors and have, for the most part, taken several decades to reach the status of a global or even regional financial center. It has been very rare for any new financial center to achieve this status.

4. The most significant exception has been Dubai, where the DIFC has been developed by means of very substantial investment and as part of a further even more substantial investment in real estate, tourism and other business services. Dubai also benefitted from particular features such as the presence of substantial liquid funds in the region which were available for investment but where regional investment opportunities were constrained by legal and judicial systems that were perceived as providing insufficient certainty for financial services contracts. Dubai addressed this problem by creating an enclave where United Kingdom (UK) common law prevailed, unless overridden by statute law specifically drafted for business and financial services. It was subject to a specially created judicial system that did not involve any appeal to domestic courts.

5. A number of jurisdictions have developed financial centers in the second group. In each case, there has been a specific regulatory or tax-related competitive advantage that has enabled them to exploit a niche market and then develop from there. The “first mover advantage” has meant that, once they were established, and had developed the legal infrastructure and associated supporting legal and accountancy and expert support services, they were able to maintain their position. New potential centers found it difficult (although not impossible) to enter these markets. Where centers have been successful, it has been by identifying and focusing on a particular competitive advantage. Many of the financial centers in this group are dependencies of the UK. The existence of a body of common law and judicial precedent, backed, if

necessary by the ability to appeal to the UK Privy Council (now Supreme Court) has been a major factor attracting investments to such jurisdictions because it mitigates the substantial legal risk involved in investing offshore in a small jurisdiction.

6. The third group have remained focused on particular cultural or linguistic ties with another country, although some have aspirations to broaden their base.

7. This description suggests that potential offshore centers need to be very focused on their specific competitive advantage if they are to develop a niche market. If they wish to develop a full scope regional financial center, they need to be prepared to invest very substantial sums and exploit unique legal, cultural and regional factors.

B. The Colombo International Financial Center

8. The Sri Lankan aspiration is to emulate Dubai. The key characteristics of the CIFC would be the creation of a physical enclave in the World Trade Center with its own laws and commercial court. Unlike the case in Dubai, however, there would be scope for appeal in certain limited circumstances (not precisely defined as yet) to the Sri Lankan Supreme Court.

9. Businesses within the CIFC would benefit from a separate regulatory regime (overseen by a bespoke regulator with its own regulatory laws). There would be tax advantages and no foreign exchange restrictions. Companies established in the CIFC would not be able to undertake any transactions with businesses in Sri Lanka.

10. The precise relationship between companies established in the CIFC and those in the Sri Lanka economy is not yet fully determined, although it has been decided that banks in the CIFC would have to be part of major groups with a foreign lender of last resort so as to reduce the systemic risk within Sri Lanka.

11. The CIFC project team has listed virtually all forms of financial service as potentially suitable for the CIFC, including private wealth management, fund management, private banking, Islamic finance, capital markets activity, insurance, reinsurance, Treasury operations and back office processing operations.

12. The CIFC has identified a number of attractive features associated with Sri Lanka. Its time zone makes it convenient for the large populations in South East Asia. There is a cultural empathy between Sri Lanka and different neighboring countries in the region that makes Sri Lanka acceptable to many countries which have mutual antipathy. In addition, the CIFC project team point to high levels of intellectual capacity, in the form of skilled legal and accounting and other professionals, and low cost staff as its competitive advantage. The attractions of Sri Lanka as a residential location for key professionals in the CIFC is also part of the project team's analysis.

13. The CIFC project team has drafted a number of the necessary laws and has undertaken a number of marketing exercises that have resulted in some expressions of interest.

14. The project team is aware that they will not have the funds that were available to the Dubai authorities when the DIFC was established and do not expect to break even within the first five years. The team is aware that substantial sums will need to be spent on developing the legal and physical infrastructure as well as on marketing the center.

15. A key feature of any IFC is its regulatory regime. CIFC is committed to recruiting highly qualified international regulators. An additional step will be to ensure that the work of the CIFC's regulator is coordinated with the work of the domestic regulatory agencies (central bank, SEC, insurance board) to address any cross-jurisdictional issues that eventually arise, ensure that domestic financial institutions do not use offshore subsidiaries as a means to avoid domestic regulation, and discourage regulatory arbitrage.

16. A particular regulatory concern for all financial centers, whether domestic or international, is money laundering and terrorism financing. IFCs with no easily identifiable legitimate economic advantage are particularly vulnerable as there is pressure to justify the investment in the center by attracting new businesses on the basis that regulatory barriers and bureaucracy will be kept to a minimum. Moreover, the nature of an IFC with most customers being located abroad, creates risks that those wishing to use the center for illegitimate purposes will be able to hide behind complex structures that obscure the true identity of the beneficial owner.

17. It will be important to mitigate this risk by applying firm, effective anti-money laundering (AML) measures, and measures to combat the financing of terrorism (CFT).

18. Sri Lanka was subject to a mutual evaluation by the Asia Pacific Group of the Financial Action Task Force in 2014, with the report published in 2015. Sri Lanka was graded as having a substantial level of effectiveness in investigating and prosecuting terrorist financing, and a moderate level of effectiveness in risk, policy and national coordination. For the remaining nine immediate outcomes, Sri Lanka was rated as having a low level of effectiveness.

19. Within the IFC, the imposition of appropriate preventive measures (such as obligations to conduct customer due diligence, monitor customer activity and report suspicious activities) will be particularly important. The mutual evaluation report judged Sri Lanka to be compliant with the recommendation on reporting, and largely compliant with the recommendations on financial secrecy and record keeping, but either non-compliant or partially compliant with the remainder of the preventive measures (Recommendations 9 to 23). Sri Lanka was also rated as non-compliant with the recommendations on the transparency and beneficial ownership of legal persons and arrangements.

II. Recommendations and Rationale

20. The CIFC is a substantial, long term, commitment for the Government of Sri Lanka in financial and other resources. Experience elsewhere is that it is very challenging to develop a successful financial center on the model proposed and the previous examples of such success are few. This is not to suggest that success is impossible but that it is rare and that it is essential to be absolutely clear as to the specific competitive advantages that are going to provide that success. A new center will have to convince potential investors that regulatory, tax, legal, judicial or other advantages can be relied upon over the long term.

21. It will be important to ensure that the regulatory framework is coordinated with domestic regulators and, in particular, that AML/CFT measures are effective and that deficiencies identified in the mutual evaluation report are addressed.

22. Assuming the Parliament's passage of the CIFC Act and the establishment of a regulatory function, it is essential to:

a. develop a regulatory framework that coordinates the work of CIFC and domestic regulatory agencies; and

b. prepare and adopt regulations for anti-money laundering and countering financing of terrorism that is aligned with international best practice.

III. Outcome

23. The introduction of effective AML/CFT measures will help to mitigate the risk that the new CIFC will be abused by money launderers and terrorist financiers.

B. MARKET STRUCTURE

5. Enforce Ongoing Listing Requirements

ENFORCE ON-GOING LISTING REQUIREMENTS

I. Assessment

1. This Briefing Note deals with the regulation of Listed Companies (LCs) post-IPO and admission. There are several sets of continuing obligations in the regulatory system. The primary sets are:

a. periodic reporting in the form of Quarterly and Annual Reports as required of LCs as Specified Business Enterprises (SBEs) and which is regulated by the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) for compliance with Sri Lanka Accounting Standards (SLASs) and Sri Lanka Auditing Standards (SLAuSs) (dealt with in the Briefing Note: Strengthen Auditing Standards). The timing of filings of the periodic reports is regulated by the Colombo Stock Exchange (CSE) as part of its "front-line" regulator status with an oversight role by the Securities and Exchange Commission (SEC);

b. a form of continuous disclosure of "price sensitive information" (PSI), regulated by the CSE again as front-line regulator, again with SEC oversight; and

c. a minimum public float of 25% with 1,000 for the Main Board, and 10% with 200 shareholders for the Diri Savi Board.

2. The CSE and SEC have a range of regulatory actions available to require compliance with the continuing obligations. These actions are similar in type and escalation as those in other exchanges such as the Stock Exchange of Hong Kong (SEHK) and the Australian Securities Exchange (ASX) and include:

a. suspension of trading; temporary "trading halts" (approx. 3-5 days) or longer term suspensions (which may be for many years). Although an LC can request a halt or suspension, the decision lies with the CSE;

b. placing an LC on a "Default Board" which is most commonly imposed because of late filing or CSE concerns about proper continuous disclosure or PSI issues; and

c. by progression from the actions above, a delisting.

3. For Periodic Reporting, the annual reports of all LCs are reviewed by the CSE and the SEC, with each taking roughly 50% of LCs. The focus of the reviews are compliance with the LRs and the SLASs and, given this connection, the SEC also consults SLAASMB on technical issues. This review process is excellent in form but there are problems with the substance of the process, in terms of follow up and enforcement which relies largely on a referral to SLAASMB which, as described in the Briefing Note: Strengthen Auditing Standards, is quasi-judicial and takes many years to obtain a regulatory result. The SEC has managed to get 3 LCs to re-issue cash flow statements which contained misleading misclassifications. It is not clear what regulatory results the CSE has achieved but pursuit of non-compliances appears to be done through the CSE's legalistic and slow disciplinary system.

4. As regards policing of compliance with the filing deadlines, the five months allowed by law for publication is already long by world standards. An LC which is late in filing is always allowed to continue trading, despite the PSI implications of late filings. Also, it is routine for LCs to be allowed to negotiate extensions in filing deadlines.

5. LCs which are late in filing are normally, often after a delay, placed on the Default Board but their shares are allowed to continue to be traded and they may be allowed to remain on this list for extended periods, even years, with no further regulatory action, such as delisting.

6. The best practice for late filings is immediate suspension of trading which continues until the full, proper filing is made (e.g. SEHK, ASX). The basis of this is that late filing is an indication of problems in the LC which are likely to be PSI and this situation may give rise to insider trading and a false market. Placing an LC with extended delays in filing onto a Default Board is acceptable provided that it is a stage in progress to a delisting (e.g., Bursa Malaysia).

7. The SEC Corporate Affairs Department monitors media and market commentaries and LC's Periodic Reports for possible undisclosed PSI and pursues directors if this is suspected. Unfortunately, this has to be done by reference to the Enforcement and Legal Unit for a legalistic evaluation which takes significant time. This arrangement means that the undisclosed PSI continues, and insider dealing and false markets are increasingly likely.

8. Best practice is for the CSE to require directors to make an immediate announcement about the suspected PSI event or to suspend trading immediately until the directors can clarify the circumstances. In addition, the Commission should be empowered to require the CSE or Directors to suspend trading until the PSI issue is clarified. Just placing an LC onto a Default Board with continuing trading does not protect against insider trading or false markets, and investors would be trading on uneven levels of knowledge and information. LCs that have long delayed Periodic Report filings or have not been able to satisfactorily clarify PSI issues are suspended and subject to a process which leads to delisting as time or performance milestones are missed by the Default Board LC.

9. In Sri Lanka, there does not seem to be any transparent process for an LC to proceed to delisting in continuing situations where it is not able to comply with the requirements of the Listing Rules or Law (e.g., filings, SLAS breaches, PSI issues or free-float minima). This situation applies to LCs which are very late with filings or PSI clarification.

10. The CSE Monthly Report for April 2016 details:

Situation	Number of companies	Earliest company on list	Reason
Default Board	8	Miramar Beach, June 2008	No annual report is the most common.
Dealing Suspended	7	Vanik Inc, Oct 2008	Winding up order, otherwise at request of company most common.
Trading suspended	5	Miramar Beach, Feb 2015	SEC directive, Jan 2015, otherwise SEC rules or no annual report.
Trading Halt	2	Entrust Secs, Jan 2016	Pending clarification (actually defaulting primary dealer). Other one is failure to disclose current status.

11. Companies on the default board continue to trade.

12. This also applies to LCs that are unable to meet the minimum free float/shareholder requirements but which are not normally on the Default Board. The CSE is rightly concerned about the large number of LCs (about 60 they report) which are in breach

of these float requirements and has been exploring ways (such as a 3rd Board) to deal with these LCs.

13. The best practice, as outlined above, would be a more appropriate and less distortive solution to this float non-compliance problem, i.e., for the CSE to establish a transparent series of steps leading to resolution of an LC's non-compliance or, failing that, for its orderly path to delisting.

14. An orderly, transparent delisting process enhances the chances of a "white knight" rescuing the non-compliant LC and prevents the accumulation of large numbers of non-compliant LCs.

II. Recommendations and Rationale

15. The CSE and SEC should suspend trading of LCs where there are reasonable grounds to believe there is breach of the Listing Rules or law which is likely to cause false markets or misinformed trading (e.g., failure to meet filing deadlines; reasonable evidence of undisclosed or inadequately disclosed PSI). The decision to suspend trading should be given to a senior executive (e.g., Head of Listing at the CSE) who can exercise the suspension powers directly without submitting it to an extended legal or top-tier approval process. The CSE Listing Rules give the CSE adequate powers (Section 7), require LCs to meet continuous disclosure requirements, and make immediate disclosure of price sensitive information. Section 10 Enforcement gives the CSE the right to impose trading halts and suspensions on LCs for breaches.

16. The CSE should establish and enforce a clear set of Listing Rules and transparent procedures leading to delisting of a LC which is unable to comply with the requirements of the CSE Listing Rules or the law. This should include companies that no longer comply with the listing requirements because they no longer meet the public float criteria or other entry requirements. Section 7 of the CSE Listing Rules requires companies to maintain a minimum public quote (25% for Main Board and 10% for Diri Savi Board - Sub-section 7.13.1). Section 10 Enforcement defines a process:

    a. transfer to Default Board and/or suspension of trading after informing the company;

    b. after one month, CSE (in consultation with SEC) can issue a press notice detailing the violation; and

    c. after three months, the CSE may refer the case to the SEC for necessary action.

III. Outcome

17. The processes recommended will go towards clearly establishing best-practice regulatory practices and instill greater discipline and accountability in LCs and their directors, enhancing their standing and credibility in the eyes of investors, especially foreign investors.

18. The orderly delisting from CSE's Boards of LC's which are unable to comply with the requirements of the Listing Rules and laws will enhance the overall quality of CSE Listed Companies and will make the CSE's investment proposition clearer, less cluttered and more attractive to domestic and foreign investors and to listing applicants.

B. MARKET STRUCTURE

6. Promote Market Making

PROMOTE MARKET MAKING

I. Assessment

1. ADB's *Sri Lanka Capital Market Assessment* (May 2016) identified the lack of market making as an inhibitor to trading activity and liquidity on the Colombo Stock Exchange (CSE). The CSE has considered introducing liquidity providers into the equity market starting with some of the more liquid securities and gradually expanding into the less liquid. There are 297 companies listed on the CSE, of which it is estimated by brokers that only 20 to 30 are sufficiently liquid enough to support market making. However, recognizing the newness of the concept, the CSE has decided to pilot two new instruments. In its paper on "Proposed Liquidity Provider Model for New Products" the CSE identified "liquidity as being an important aspect of these new products" (exchange traded funds and structured warrants) that could only be provided by liquidity providers "making continuous bid-ask spreads". The CSE saw the role of liquidity providers being undertaken by those who would register as stock dealers or by Investment Managers registered with the Securities and Exchange Commission (SEC) as Market Intermediaries. It is our view that this is a sound approach to introduce the market to a new concept and the give the CSE/SEC experience in supporting and regulating market makers.

2. Market makers (also known in some markets as liquidity providers) are not defined in the Securities Act. The CSE is planning to extend the definition of stock dealer. "Stock dealer" means any individual or body corporate engaged in the business of buying or selling of securities or in the dealing or jobbing or trading of securities ("jobbing" is the old London Stock Exchange term for market making). There are already 15 licensed stock dealers. These are separate entities that may be owned by entities that also own stockbroking companies or may just be a vehicle for principal trading. The stock dealers already have direct access to the market - they can put orders into the trading system - but their current activities do not include formal market making. The definition of their activities in the SEC Act suggests they would not carry out trades as agents for clients because they are not stockbrokers nor can they sell to clients from their own book as those trades would be off exchange. However, discussions with the stock dealers suggest that those which are part of conglomerates do a mix of broking and principal business.

3. Differentiating market makers from stock dealers would make the introduction of market making easier but at the same time raises risks as the CSE/SEC would need to differentiate between those stock dealers whose activities are unrelated to market making. This is necessary because the (coming) risk-based capital adequacy requirements of a market maker will be greater than those of stock dealers not engaged in that activity.

4. Introducing market makers will require the CSE to make decisions, and some of these have already been made, as to the nature of the system including:

    a. Will the entities be single capacity - only able to deal with brokers - or dual capacity able to deal with clients? The current stock dealer regulation appears to allow dual capacity.

    b. Will there be single or competing market makers? CSE is yet to decide but believes there is enough interest to have multiple market makers if they so choose.

c. Will the trading system be only open to market maker quotes or will brokers be able to submit orders? The CSE is likely to choose the hybrid option.

d. Will the current trading system be able to cope with the new demands to display two-way quotes? These can be displayed as orders but this would require market makers to refresh their quote each time an order is executed

e. Will there be incentives to firms acting as market makers - to offset the obligation to make firm quotes at all times? They will get certain licensing exemptions but the main attraction will be the waiver of trading fees.

f. Will market makers be able to sell short and borrow stock to cover short positions - this is really essential if market makers are to quote continuous bid prices? This is not yet clear. (It might be less of a concern for structured warrants and exchange traded funds as these have unit trust-like features whereby the sponsor can increase and reduce the supply - though market makers would probably need to short intra-day.)

g. What will be the capital requirements on market makers and how will they be regulated? Currently, CSE does regulate the capital of brokers, but the need with market makers is more demanding since it must reflect an RBC approach.

5. Stock exchanges normally require market makers to continuously quote two-way bid and offer prices with a minimum volume size, gauged either by the number or the value of shares, and within a maximum price range or spread.

6. In all exchanges that have market makers, they are obliged to comply with the requirements laid down in the exchange's rules or contained in a market maker agreement with the exchange. Apart from specifying the privileges of market making, the rules or agreement cover the maximum spread that a market maker can make between the bid and offer quotes, and the minimum quantity in which a market maker can quote.

7. It would be unwise, however, to expect that the introduction of market makers, even if extended to the whole market, will result in a substantial increase in liquidity. Market makers are only intermediaries and the lack of liquidity in the Sri Lankan market is a consequence of lack of supply of investable assets and a lack of competing investors as discussed in other Briefing Notes. The likelihood is that market makers will provide continuous but fairly wide quotes in fairly small sizes which will provide a "backstop" trading option for investors who need to trade immediately and are not especially troubled by a wide spread. Other investors will continue to try and seek out counterparties and trade inside the market makers' spread.[9](Attempts to force market makers to offer excessively narrow spreads or excessively large size ones will just result in market makers withdrawing.) In other illiquid markets, the business sustainability of market making depends less on them attracting business to their quotes than to them becoming the "trading post" for the stock - they know where there is interest and anyone wanting to trade goes to the market maker to negotiate business.

II. Recommendations and Rationale

[9] If the structure allows a hybrid market then other participants will submit orders inside the quote. If the market maker has a monopoly position (i.e., no competing orders) then other participants will negotiate trades and arrange to "put through" trades within the spread possibly giving the market maker a small turn.

8. CSE will introduce market making in exchange traded funds, structured warrants and possibly equities by March 2018. To do this it will need, as well as developing market maker rules, to:

    a. develop regulatory structures and technology to support short-selling and stock borrowing/lending;

    b. develop rules to monitor and supervise exposures of the market makers as part of the risk-based capital structure (which should not be too difficult since RBC will cover principal exposures); and

    c. ensure the trading system is consistent with the needs of market makers to move two quotations in lockstep.

III. Outcome

9. Market makers or liquidity providers in exchange traded funds and in structured warrants (to be launched by end 2016) will help to assure the success of these new products and so aid the CSE's objectives of diversification from a reliance on equity trading.

10. By slowly introducing market making into the equity market by first quarter 2017, and progressively adding more securities throughout 2017 and 2018, CSE and market makers will gain in experience that will be hugely beneficial to them and enable ultimately for market making to be introduced in more liquid securities thereby improving liquidity throughout the market.

11. However, the addition of market makers will not, of itself, lead to an increase in liquidity - market makers are only intermediaries and the lack of liquidity in the Sri Lankan market is a consequence of lack of supply of investable assets and a lack of competing investors.

C. DEMAND FOR INVESTMENTS

1. Reform Primary Dealing System for Government Securities

REFORM PRIMARY DEALING SYSTEM FOR GOVERNMENT SECURITIES

I. Assessment

1. There have been a number of issues related to the primary dealer (PD) system that has given rise to concern, particularly as to the appropriateness of current institutional arrangements. There has been the default of a primary dealer (i.e., Entrust Securities) and the license was transferred to State Bank. There has been notable volatility in auction issuance acceptances with spikes in yield paid against the prevailing trend in rates (one instance in late March 2016 is the subject of an inquiry by the Attorney General's Department). Current licensing requirements are straight forward, requiring fit and proper vetting, minimum capital, proper systems, staff and technology to fulfil the requirements of a PD.

2. There has been dissatisfaction amongst PDs that there is lack of a longer term Auction Calendar, that bids have been rejected or that amounts raised via acceptance of so-called "dummy bids" entered to meet the PD's 10% of auction issue minimum at rates outside perceived acceptable market rates. This volatility has seen both winners and losers and soured many PD's view of the efficiency of the process. The failure of a non-bank PD has made clients more inclined to buy issues through bank-aligned PDs.

3. With 15 PDs each required to submit bids for 10% of the issue in every auction, the total bids in each auction should be for 150% of issue. There is no reason to suspect that the auction bidding process is not competitive and there is no evidence of widespread collusion. However, current international practice has less onerous obligations, ranging from Malaysia where PDs are obliged to bid for 1/x of the auction amount, where x is the number of PDs, to India where bids are required for 50% of the auction amount, so with 17 PDs, the individual level is 3%. In Europe, it ranges from 2% to 4% and so the total obligatory PD bids will be less than 100% of the auction amounts. In general, there are no problems in selling the targeted amounts of debt on offer as PDs will bid for more if the stock is attractive to their clients, and non-competitive bids will take up some of the slack. In the most developed markets there is no obligation, or a very small formal numerical obligation. In the UK, for example, PDs are expected to play an active role in the issuance, distribution and marketing of UK Government debt, they should aim to purchase at least 2.0% of issuance by sector - conventional and index-linked - on a 6-month rolling average basis, and they are expected to participate in every operation for which they are a designated market maker.

4. In India, when accepted bids are greater than 4%, a commission is paid as an incentive. Some countries require PDs to take up a total amount equal to at least 70% of their proportional market share of all auctions over a rolling six-month period. Some countries require bids to be within a spread range to discourage dummy bids. A reduction in bid requirement to 5% of the amount on offer, with incentives like those in India, may make more sense to reduce dummy bids. India has moved from a much more demanding regime in the early 2000s which forced PDs to bid for the whole auction amount to the current more liberal requirement - and is still able to meet its substantial debt sale requirements.

5. The current situation in Sri Lanka encourages "spoof bidding", as the Central Bank of Sri Lanka (CBSL) recognizes. PDs may not be in a position to buy more stock - they may, for example, be still holding substantial amounts on their books from previous issues and may not have the balance-sheet space to take more (the problem may be

compounded by the dominance of Employees Provident Fund (EPF) as a buyer of Government stock; if EPF is not a buyer then the PDs cannot sell the stock quickly after the auction. Quick sale ”flipping” is fundamental to the PD business model as they are not set up to be long-term holders of stock.) The spoof bids are intended as a way of meeting the PD obligation but without taking any stock. In recent times particularly, the Primary Debt Department (PDD), on instruction from the Ministry of Finance (MoF), has seen the inevitable overbidding as an opportunity to raise more money than was stated in the original auction announcement and has at times issued more debt than originally indicated. The consequence has been that debt has been sold at considerably higher yields.

6. As noted, the CBSL recognizes the situation but is cautious about reducing the PD obligation given its agency obligation to sell the Government’s new debt. Other countries have faced a similar dilemma and it is worth noting that with very few exceptions, governments have had little problem selling their new debt. Many (such as India) have managed a transition from more onerous to more liberal obligations. Reducing the obligation actually improves the business incentives for PDs since they can spread their purchase in a way that more closely meets their client’s cashflow/investment needs. If, at the same time, the scope for non-competitive bids is widened the market is potentially broadened.

7. However, whatever the rightness of the arguments and the attractiveness of the long-term goal, there remains the short-term risk that issues will be undersubscribed. A prudent and cautious approach for Sri Lanka would involve a transition period with two strands:

   a. reducing the PD percentage obligation in a number of steps so that the transition can, if necessary, be slowed or stopped; and

   b. moving to a system of assessing PDs compliance with the obligations over a period, perhaps initially 6 months, which would enable PDs to better manage their bidding with their clients likely demand.

8. The absence of an Auction Calendar restricts participants from planning their cashflows and investments to match auction offers, makes auctions and interest rates less predictable and undermines the credibility of the primary market. The rejection of auction bids also undermines the credibility of the market and acts as a deterrent to participation - participants tend to feel they only get stock when they do not want it, so they are facing a one-way option. This increases uncertainty of bidding and reduces bid discipline which raises the overall cost of the Government debt.

9. Discussion with the PDD indicated that they have very poor information flows as to the exact auction requirement, and this can change by a wide margin by the actual time of the auction. A review of the current 82 issues indicates past suboptimal scheduling of issuance across the yield curve and subsequent bunching of redemptions. Current issuance is in the range of 2yrs to 10yrs maturity, with the average time to maturity at 5.75 yrs. As issues are reopened at old coupon rates, most issues are now done at a discount. There is a perceived need to lengthen maturity of issues and consolidate issues at key points on the yield curve with a better maturity profile. It is essential that both a credible short and longer term yield curve based on consolidated issues of “on the run” bonds should be a key strategy aim of the PDD.

10. Therefore there is a need to develop a clear debt management strategy based on proper information flow including Ministry of Finance (MoF) budgeting, Government

cash flow management, issuance of foreign debt instruments, as well as development of bond issues and contingent claims arising from guarantees such as those implicit in stated-owned enterprise (SOE) financing. The volatility in PDD information flow leads to excessive volatility in rates, and the lack of instruments or cross-borrowing capacity to handle liability management hampers a well-functioning debt management process.

11. The Briefing Note: Deepen Yield Curve for Government Securities discusses implementing a program to restructure outstanding issues through market operations.

12. The operation of the auction is shared between two committees at the CBSL:

    a. The Domestic Debt Management Committee (DDMC) acts in a strategic role, taking decisions as to what instruments and maturities of stock to offer in the auction in order to meet the MoF cash requirement. It is chaired by the Superintendent of Domestic Debt and meets approximately monthly. A MoF representative sits on the DDMC.

    b. The Auction Tender Board (ATB) has a more operational role and meets soon after the receipt of auction bids. Its role is to take decisions on whether to proceed with the allocation, to meet all bids or to increase the amount offered. Decisions on cancellation of bids or auctions are taken by the ATB. It also, when instructed, will increase the amount of stock sold beyond that stated in the auction announcement. The MoF is represented on the ATB by the Director General of Treasury Operations. Requests for additional funding, i.e. to raise the amount issued beyond the stated amount may come through the MoF representation on the ATB or may be transmitted through the Minister to the Governor and thence to ATB.

    c. The interaction of the two committees is a factor in the lack of strategic decision-making on the structure of the overall debt which is a contributory factor in the fragmentation discussed above.

13. The PDD is responsible for LankaSecure which is comprised of the Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) for Bonds and Treasury Bills. According to the LankaSecure system specifications, PD's positions and repos should be clearly identifiable in LankaSecure, and the CDS records at the price at which trades were made. However, the PDD indicated at interview that when Entrust Securities defaulted there was a large difference in repos entered compared to the then scrip available for pledging in LankaSecure.

14. PDD said they had a program of onsite inspections which entailed inspection of all PDs over an 18 month period, but PDs interviewed said this used to happen but had virtually stopped occurring.

15. On 28th October 2015, the Central Bank of Sri Lanka (CBSL) issued two directives relating to non-bank PD's unimpaired capital requirements. It lifted the required Tier 1 capital from LKR 300 million to LKR 1,000 million, and also required 10% of after tax profits to be deposited into a special risk reserve account. Any shortfall in required capital was to be paid in, with 50% of the required amount by 31st March 2016, and the balance paid in by 31st October 2016. A further directive of the same date required that the minimum risk-weighted capital adequacy ratio (CAR) be increased from 8% of 10% based on both Tier 1 and Tier 2 capital. The CBSL Department of Supervision of non-bank financial institutions reports that all but one of the PDs have complied with both the March and October increase in capital. The exception is

expected to comply by October 2016. There are no published statements to this effect, although such statements might allay the fears of bank PDs relating to dealing with non-bank PD counterparties.

16. There have recently been problems with recording of CDS account blocks on repo'd stock. A recent PD default is associated with multiple repo'ing of stock. As discussed below, there are weaknesses in the IT systems with respect to recording of prices and ownership (including repo status) in the depository. IT solutions are under discussion but are at a fairly early stage (as discussed in Briefing Note: Strengthen Trading Platform and Establish a CCP System). Such a weakness represents a high risk to financial stability. The CBSL Department of Supervision of NBFIs currently receives auditor reports for each PD, but the CBSL recognizes that these are inadequate since they only represent a snapshot on one day. It is the consultants' opinion that the seriousness of this issue, and its potentially corrosive effect on market confidence, justifies the recommendation that a special thematic inspection should be undertaken by PDD, possibly by directing the PDs auditors to make a formal report on the reconciliation of all PD positions and obtaining client confirmations for accounts at a common date.

17. Often in developing markets, PDD or Debt Management Offices are housed in the MoF to ensure close ties with budget and cash flow forecasting as well as remove any conflicts of interest to monetary policy. PDs said that CBSL monetary policy management actions often conflicted with PDD auction strategy. There appears to be a consensus building up in Sri Lanka in favor of such a move, though implementation would require legislative changes to the Central Bank Act. Specifically, the MoF has set up a Cash and Debt Market Committee which could ultimately take on the roles of the DDMC and the ATB. In the meantime, the CDMC could focus on improving the flow of information between the MoF and the CBSL allowing better synchronization of needs and issuance as well as greater predictability for the market.

18. There are some structural issues which must be addressed. For example there is instrument arbitrage (one year Treasury bills are at 10% whilst repo rate is about 6.5%), there are no obligations for PDs to make regular quotations at reasonable spreads across the yield curve, there is no forward yield curve being constructed, and there is a lack of transparency on any over-the-counter (OTC) trading. The lack of a deep secondary market in Government paper hampers the overall liquidity. The market with institutional investors is buy and hold, with the Employees Provident Fund, a unit of CBSL, being the largest holder of paper (see Briefing Note: Enhance Demand from Superannuation Funds).

19. There is no incentive for PDs to undertake market-making activity, as short selling is not allowed and there is no stock borrowing and lending facility to enhance market liquidity. There will be a need to support market-making facilitation by ensuring any tax, stamp duty or VAT imposts, if any, on trading are removed. (See separate paper on "Develop Incentive Tax Framework for Capital Market Investments").

20. Secondary market transparency would be significantly improved if transaction reporting were made mandatory and enforced. A circular to this effect was issued on 1st August 2016 requiring immediate reporting of all trades over LKR 50 million through Bloomberg. While this is encouraging, there is a need to ensure that the circular is enforced and that reporting is timely. There may be a need to develop a central bond reporting agency similar to that in Indonesia, or the Thai Bond Market Association (ThaiBMA) or other similar processes requiring immediate reporting with publication of trade details (possibly with a delay) to ensure that there is transparency of bond pricing. PDs should have a requirement to make quotes across the yield

curve at either set times or on a continuous basis for a certain time frame with reasonably tight spreads. These requirements should be subject to regular auditing by the PDD.

21. Settlement of trades is currently done on gross basis and no netting efficiency is allowed. Enhancing settlement efficiency will assist with building more liquid secondary markets as PDs can undertake a greater volume of trades.

22. There is reluctance in the PDD to see utilization of Colombo Stock Exchange (CSE) platforms, and a concern as to the risks currently inherent in the PD process and the CSE's capacity to manage settlement risk associated with risky PDs. This shows a lack of understanding of how modern straight-through processing between exchange platforms and central securities depositories (CSDs) can enhance the market's plumbing.

23. Although Reuters and Bloomberg are used in the market for indicative quotations, they are not currently utilized for price transparency reporting. PDD is interested in an interim use of Bloomberg for transparency, but is looking to develop a new auction system and eTrading system. Singapore runs its primary and secondary markets with excellent transparency through the use of the Bloomberg platform, and the use of Bloomberg should be further analyzed to improve many of the structural deficiencies noted in Sri Lanka, thus avoiding the expense of a new trading system.

24. Although a longer term enhancement, it would seem that banks and non-bank PDs could contribute to the development of treasury and bond futures and derivatives to create hedging instruments and greatly assist the development of the market. It is likely that bond and treasury derivatives could be developed at a faster pace than equity derivatives, particularly with the development of a central counter party (CCP) for bond instruments.

25. Statistics on outstanding issues, overall Government borrowings, and the yield curve, are poor and quite dated when published. Up-to-date data on Government debt, both domestic and foreign, should be easily accessible and timely.

26. Finally, the appropriate authority (CBSL, MoF or Treasury), with Prime Minister or Cabinet support, needs to publish the auction rules under which the PDD will operate. The Government should, in the long term, legislate for a separate Debt Management Act clearly ensuring the independence of the PDD and laying out its duties and responsibilities. Examples are Australia, Myanmar, Mongolia, Vietnam, Jamaica and Nigeria amongst others.

27. A draft set of rules is attached as Appendix A. These are based on international practice and discussions with market participants in Sri Lanka. They focus on increasing predictability and improving bidding quality, both of which have been shown in other markets to improve the market and lower debt cost. The draft rules would need substantial fine tuning and consultation to adapt them to the precise needs of the Sri Lankan market and are intended to form a basis for that discussion. Suggested further reading on rules for primary dealers is provided in Appendix B.

II. Recommendations and Rationale

Policy Action	Rationale
The CBSL or MoF to publish rules by which the PDD will abide in terms of openness, transparency and predictability to ensure the auction process is efficiently undertaken and is conducted in accordance with the implicit rules of the primary dealing system.	Confidence that the primary dealer and auction systems are serving the needs of the country by raising debt efficiently would be strengthened.
The CBSL should publish the results of its supervisory checks to ensure all PDs are meeting the new capital requirements and are in full compliance with regulatory requirements.	Following the default of one PD, it is incumbent to ensure that the result of inspections relating to capital adequacy and increased capital requirements are made known to participants to prevent erosion of confidence following the recent PD default.
The PDD to commission a special audit of PDs to ensure that client securities have been reconciled and accounted for by audit confirmation.	This audit should be devised to quickly establish that the issues found in the operation of Entrust Securities is not present in other nonbank PDs.
The PDD to undertake a review of the functionality of the PDD, including compliance monitoring of PDs on a risk-based supervisory model, and implement necessary improvements to both the PDD strategy and information gathering systems as well as information linkages to improve PDD's modus operandi.	Modern debt management requires a holistic approach to information systems, particularly to ensure a credible auction program based on likely issuance requirements.
The MoF and CBSL to begin process of housing the PDD as part of Treasury, or MoF to ensure independence of PDD and improve the informational flows by having PDD closer to Budget and cash flow forecasting. The PDD should be rehoused by Q3 2016. Progress to be significant by August 2016.	Independence is important and this will be improved by a 2nd tranche conditionality of developing a debt management law to enshrine independence.
Extend the Auction Calendar to a forward six month period and aim to have a less than a 15% variance to the actual issuance program, demonstrating a desire to reduce volatility in PDD activities.	Seeks to show that the PDD is serious about addressing perceived shortfalls in the auction process.
Begin the consolidation of outstanding issues from approximately 80 to a lesser number across the maturity spectrum, and develop a plan to lengthen the average term to maturity over an 18 month period. Include in the plan measures to enhance the credibility and usefulness of the yield curve.	Demonstrates a commitment to improving the yield curve functionality.

Policy Action	Rationale
Commission the development of a set of rules and amendments to regulations that provide for market-making facilitation, including short selling, SBL and relief from taxation and other unintended imposts on genuine market making. The changes should also address net settlement efficiencies.	Kicks off necessary urgent market reforms in the initial tranche period.
Improve access and publication of accurate and reconciled PDD debt statistics on a timely basis.	An essential requirement for debt management purposes.
Implement the findings and recommendations to emanate from the 1st tranche policy action reports.	Follows through on 1st tranche actions.
Build on the recent circular requiring transactions to be reported through Bloomberg, and strengthen enforcement of timely reporting, by implementing a bond transaction reporting enforcement process where all trades are recorded. Also require that PD two way quotes be made mandatory at specific times or on a continuous basis for a certain period each trading day.	Transaction reporting and mandatory quotations will ensure a published yield curve is available to price corporate bonds and allow accurate valuation of bonds for mark-to-market assessment and bond portfolio valuations.
Replace existing disparate systems with improved straight through processes that address current flaws and build a platform of primary issuance and secondary market trading, with a clear requirement for price transparency built on developing a fully functioning CSD and primary issuance and secondary trading platform benchmarked to markets in Singapore and Malaysia. Specifically look to link and enhance linkages to CSE debt trading platforms.	Facilitates needed system reforms.
Facilitate the development of short-term and medium-term debt derivatives by facilitating the involvement of banks in a derivatives exchange, likely in conjunction with similar efforts at CSE to develop equity derivatives. The CBSL and SEC should work together on the development of this necessary legal and regulatory environment as well as the utilization of a CCP for risk management. This is seen as very important market infrastructure which needs to be in place to support the development of primary and secondary markets.	Provides the necessary instruments to ensure proper asset/liability management and risk management tools for the debt markets.
Draft and implement a Public Debt Management Law.	Ensures a proper independent debt management office and reduces conflicts of interest.

III. Outcome

28. The outcomes are:

a. confidence in the PDD role in primary debt issuance, and monitoring of compliance with capital requirements and risk-based supervision both on-site and off-site;

b. development of appropriate market infrastructure to facilitate primary issuance, market making, price transparency, and secondary market liquidity via modern straight-through processing covering all stages of transactional flow;

c. an improved term structure of interest rates with an appropriate redemption program and issuance calendar that facilitates the issuance of an appropriate yield curve from which reliable forward yields can be estimated, and facilitates the pricing of non-Government corporate debt; and

d. progress to the implementation and trading of debt derivatives to add liquidity to the market.

Appendix A - Draft PDD Rules as basis for further discussion

Part I. General Provisions

I. Introduction

(1) These Rules govern the procedures for the primary sale of Government securities organized by the Central Bank of Sri Lanka (CBSL), through the Public Debt Department (PDD), and apply at the sale of treasury bills (T-Bills) and Government bonds (GBs) issued in Sri Lanka.

(2) The issuer of Government securities is the [Ministry of Finance[10]] (the Issuer).

(3) The Issuer's obligations and duties as set out in these Rules are aimed at providing a transparent framework for their relationship with, and expectations of, its primary dealers (PDs).

(4) The Issuer is not a regulatory authority. Regulatory responsibility for the primary market in GBs is undertaken by the PDD and regulatory responsibility for secondary market trading in GBs is undertaken by Securities and Exchange Commission of Sri Lanka (SEC) and or the Colombo Stock Exchange (CSE) and all PDs must abide by the law and their regulatory obligations at all times.

Part II. Responsibilities and Duties of the PDD

2. General Responsibilities and Duties

(1) The PDD will:

(a) evaluate the eligibility and competence of each PD and or prospective PD;

(b) recommend disciplinary measures in the case of non-compliance by a PD with its obligations under Part III of these Rules;

(c) mediate, facilitate and/or recommend conciliatory settlement of any disputes arising among PDs[11];

(d) ensure that all PD bids in auctions are treated in an open, fair and transparent way and that all allocations are made in accordance with these Rules;

(e) set the Auction Calendar in accordance with these Rules; and

(f) maintain, publish and regularly update statistical data on market operations, prices, volumes including a list of all GBs issued showing the amounts outstanding, the issue and maturity dates, and any other information as may be relevant for the Government debt market. The list of GBs shall be updated within one business day of the completion of the auction.

3. Conditions of Issuance

(1) The Issuer shall determine the terms and conditions of issuance and make such terms and conditions available to all PD's.

4. Organization of Primary Sale

(1) Government securities shall be sold in Sri Lanka in the primary market by auction to PDs.

[10] Please insert the name of the SL Government debt management office.
[11] PDs may wish for independent mediation or determine this suggestion is not necessary.

(2) Other interested parties, whether legal or natural persons resident in Sri Lanka (clients), may participate indirectly in the primary Government securities market through PDs where a PD may include such clients requests in their bids.

(3) The PDD shall, with the agreement of the Issuer, set the auction limit. The Issuer, or PDD with the approval by the Issuer, may change or amend this limit in the case of a particular auction provided reasonable advance of notice of any such amendments are made available to all PDs.

(4) Auctions for PDs shall be organized by the PDD and the auction venue shall be as specified by the PDD.

(5) Primary sales of GB and T-Bills shall be settled on the date of issue.

5. Administrator of the Issue

(1) The paying agent of a Government securities issue (the Administrator) shall arrange on the authority of the Issuer for all the requisite activities associated with the issuance and in particular (but not limited to) the registration of the Government securities at the Central Depository and for settlement in accordance with the results of the auction.

(2) Where the Administrator is the PDD, then the rights and duties of the Administrator of the issue shall be set out in an agreement concluded between the Issuer and the PD; in other cases the agreement will be concluded between the Administrator, the Issuer and the PDD.

6. Denotation of Issues

(1) The ISIN and serial number shall be unique identifiers of Government securities.

Part III. Criteria for Primary Dealer Status

7. Conditions and Obligations of PD Status

(1) The Issuer and PD are the only entities that may participate in Government securities auctions.

(2) To become a PD, the applicant must meet the following criteria:

(a) demonstrate a long term commitment to the Sri Lankan Government bond market;

(b) have a viable business plan to bring added value to the market by meeting existing demand and widening the investor base for Government bonds where appropriate;

(c) demonstrate sufficient balance sheet capability to support activity in the Government bond market [and a credit standing such as to ensure its long term viability in the Government bond market];

(d) have adequate staffing resources at all times;

(e) have relevant technological capabilities such as the ability to settle via Lankasettle; and

(f) have written approval from the SEC and the SSE to undertake the activity as a PD.

(3) A PD must at all times comply with these Rules and with any other conditions of the individual auctions that may be determined and announced by the PDD as well as any obligations imposed on it by the Colombo Securities and Exchange Commission and the Stock Exchange.

(4) A PD must:

(a) accept, to the extent of its limit, investors' bids and take them to the auction;

(b) comply with the terms and conditions set and announced by the Administrator;

(c) give its consent to inclusion in the list of PD's which is published by the PDD; and

(d) ensure that the PDD has up-to-date specimen authority signatures for GB and T-Bills and only the persons named in such specimen signatures shall be entitled to submit or sign auction bids.

Part IV. Auction Rules

8. Auction Calendar

(1) The PDD and/or the Issuer shall announce on a quarterly basis its plans for auctions over the forthcoming quarter one month prior to the commencement of that quarter and make this available to all PDs.

9. Auction Announcement

(1) The PDD and/or the Issuer shall publish an auction announcement through recognized wire services and, as soon as possible thereafter, on the PDD website not later than [one] working day before the auction in case of GB or at the auction day in case of T-Bills.

(2) The auction announcement will generally be released at [10.30 am] however the PDD and the Issuer reserve the right to make such announcements at any time in the case of exceptional circumstances.

(3) The auction announcement shall include:

(a) either the ISIN of the Government securities issue or the T-Bill issue code;

(b) the type of the auction and the manner of submitting bids;

(c) the auction date;

(d) the issue date;

(e) the maturity date;

(f) the total nominal volume offered at the competitive auction (as a fixed figure or as a spread); and

(g) the time window limit for accepting bids.

(4) The PDD and the Issuer are aware that the market's strong preference is likely to be that the auction should be conducted at the scheduled time on the scheduled date, and that the postponement or cancellation of an auction should only be considered in extreme circumstances. However, in the event of a situation where the PDD and the Issuer, or a significant number of PDs are wholly or partially incapacitated for whatever reason, the auction may be postponed until later on the same day, or the following morning, in order that the auction may still be settled on the same day as originally advertised.

(5) The incapacity of a single PD is unlikely to cause the postponement or cancellation of an auction. In the event of an interruption of this nature, the PD should contact the PDD as soon as possible in order that special arrangements for the submission of bids may be made. Use of such

arrangements does not guarantee the allocation of Government securities other than the usual non-competitive allocation.

10. Submission and Acceptance of Bids

(1) PDs shall submit their auction bids through [the Bloomberg] system from the terminal of one of the authorized users who has provided a specimen signature.

(2) PDs may place, change and cancel their orders within the time window provided in Rule 9 (3) (g). PDs may not make any changes to their orders once the prescribed time window has expired.

(3) If it proves impossible to submit the bid pursuant to paragraph 1 above, the PD shall, at the earliest opportunity, notify an authorized member of staff of the PDD and may then within the prescribed time window, email or fax or its bid to the PDD or deliver the same directly to an authorized member of staff of the PDD. A PD is required to verify delivery of the emailed or faxed order with the PDD using the designated contact telephone number. Non-compliance with this requirement may result in the PDs order not being included in the auction.

(4) The names and specimen signatures of the authorized members of staff of the PDD, their contact addresses, telephone numbers, email address and fax numbers shall be sent directly to each PD.

(5) Each PD shall send the PDD by email, fax or hand delivery a list of all investors (both clients and itself) whose bids have been submitted to the auction. The list of investors shall be delivered at the lasted by the day after the auction date.

(6) Competitive bids shall be submitted in a format prescribed by the PDD.

(7) Each PD is responsible for the formal and material correctness of the information contained in the bid and the list of investors.

(8) No bid is deemed to be legally accepted unless or until the auction results are published.

11. Auction Limits

(1) The maximum permitted bid per PD in the non-competitive part of one auction is [percentage] [or such amount as may be from time to time determined by the Issuer].

(2) The maximum permitted bid per PD in the competitive part of any one auction is [percentage] [or such amount as may be from time to time determined by the Issuer].

(3) The Issuer may not increase or decrease the total nominal amount sold in the competitive part of the auction for Government securities save in exceptional circumstances. Where the Issuer determines that such exceptional circumstances arise, it must immediately provide all PDs with the reasons for such exceptional circumstances.

12. Processing of Bids

(1) Auctions are held on a bid price basis with successful bidders paying the price that they bid and with allocation to the PD bidding the highest price. In the event of more than one PD making the highest accepted bids, the issue shall be allocated pro rata according to the size of each bid.

(2) An individual bid submitted by a PD with the highest yield or the lowest price shall not be processed if that bid would cause the auction limit to be exceeded. In the event that by not processing such a bid the volume bid should fall below the stipulated auction limit, the PDD shall reduce the volume of the bid in such a way that the total volume of the bids will equal the auction limit.

(3) The PDD may only refuse or amend a bid in a case of error or irregularity in the bidding process where it has notified the PD of such a proposed refusal or amendment and the reasons therefore.

(4) Notwithstanding paragraph (3) above, any bid which does not fully comply with the auction Rules in this Part shall be deemed invalid and the [Issuer] shall immediately notify the PD of the reasons for non-compliance.

13. Announcement of Auction Results

(1) The PDD shall publish information on the results of auctions through recognized wire services and the PDD website on the date of the auction save where an auction may have been postponed.

(2) The published auction results shall in particular include:

(a) the total requested nominal volume of competitive and non-competitive bids;

(b) the total volume sold, broken down into competitive and non-competitive bids;

(c) either the minimum, average and maximum accepted yield to maturity and the minimum, average and maximum price in case of the GB with fixed coupon or the spread against the SLIBOR for a non-fixed coupon stock;

(d) the average yield and average price in case of T-Bills auction; and

(e) the bid satisfaction coefficient with the maximum accepted yield to maturity or the spread against SLIBOR and the minimum or maximum accepted price.

14. Claims

(1) Where a PD becomes aware of any mistake in the auction results or any other mistake arising during or at the auction, the PD shall immediately inform the PDD.

(2) Within three working days of receiving notification in paragraph (1) above, the PDD shall respond to the PD in relation to the subject matter of the mistake.

(3) If the PD is not satisfied with the way in which the matter is being dealt with, it may send the PDD a formal written complaint. The PDD shall investigate the complaint and shall inform the PD of the results of that investigation and of its conclusions within five working days of receiving the complaint.

Part V. Breach of the Rules

15. Breach of the Rules

(1) Breach of the Rules means:

a) a breach of the conditions for PD status;

b) a breach of the auction Rules; and/or

c) misrepresentation or attempted misrepresentation (whether knowingly or otherwise) of any information provided by the PD in compliance with these Rules.

(2) If at any time the [Issuer and/or the PDD] establishes that a PD no longer satisfies any of the requirements under paragraph 15 (1) above, the Issuer and/or the PDD shall send the PD written notice specifying the non-compliance and affording the PD a period of three months in which to rectify such non-compliance.

(3) If, after the expiration of the three-month notice period, the Issuer and/or the PDD is satisfied that the PD still does not comply with these Rules [it/they] may:

(a) revoke the PD's status as a PD; and/or

(b) refer the matter the SEC for the consideration of enforcement action and or administrative penalties.

(4) Revocation of a PD's status as such shall have no effect on any contracts concluded prior to such revocation taking effect.

Part V. Final Provisions

16. Announcement and Amendments of the Rules

(1) The CBSL through the PDD may issue any regulatory instruction or circular introducing or amending these Rules and any new PDD pronouncements.

(2) The PDD shall publish these Rules and any amendments thereto on their website.

(3) The PDD may at any time amend the Rules with the consent of the Issuer.

(4) Where an amendment to the Rules is proposed the PDD must provide the PD's with adequate time to enable compliance with any such amendments.

17. Implementation

(1) These Rules shall take effect on [date] 2016.

Appendix B - Recommended guidelines and examples on international practice on PDD rules

1. Primary Dealer Handbooks:
    a. World Bank Primary Dealers Handbook
    http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/Primary_Dealer_Systems_Handbook.pdf
    b. European Primary Dealers Handbook
    http://www.afme.eu/EPDA-Handbook/
2. Rules for The Primary Sale of Government Securities organized by the Czech National Bank
    https://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/financial_markets/treasury_securities_market/government_bonds/download/rules_primary_sales.pdf
3. Greece – Operating Rules of the Primary Dealers System
    http://www.bankofgreece.gr/BogDocumentEn/PRIMARY_DEALERS_RULES.pdf
4. United Kingdom Debt Management Office – Operational Rules
    http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/guidebook20150401.pdf&page=operational_rules/Document
5. Singapore – Rules and Market Practices for Singapore Government Securities
    http://www.sgs.gov.sg/~/media/SGS/SGSRulesMktPractices.pdf

C. DEMAND FOR INVESTMENTS

2. Promote Unit Trusts

PROMOTE UNIT TRUSTS

I. Assessment

1. The unit trust industry has not developed well - penetration among investors remains low as does the total net asset value. The data in the Assessment Report shows that the total value of unit trusts is small - LKR 128 billion at end 2015 compared to a total stock market capitalization of LKR 2,938 billion. The number of holders is also small at 37,526 illustrating the low penetration - 0.2% of the population[12]. The majority of the money in unit trusts is in money market funds (56% at the end of 2015) with a further 31% in Government bond and income funds. Balanced and growth funds were only 13% of total net asset value. In contrast, balanced and growth funds represented 79% of the unit holders.

2. There are also a large number of unit trust management companies (14) offering a large number of trust products (72). Many trusts are very small (some are set up as tied funds for commercial companies for tax reasons as described below). Of the 72 funds, 42 have fewer than 100 unit holders and only 3 have anything comparable to a mass-market appeal with over 2,000 unit holders. The number of providers and funds seems large compared to the current market and moreover some commentators have remarked that there are many very similar fund offerings (though this is also true in developed markets where there will be a large number of, say, equity funds) and this reflects the issues described below and the lack of diversity range of investments available to Sri Lankan investors.

3. The key barriers to development of mutual funds in Sri Lanka are identified as the:

    a. taxation system;
    b. distribution network;
    c. financial literacy;
    d. investment choices;
    e. private pensions; and
    f. legal structure.

A. Taxation System

4. The taxation system is heavily biased against unit trusts and is broadly summarized as:

    a. Unit Trusts are taxed at 10% and this 10% is a final tax, i.e. investors are not liable for additional income tax even if their marginal rate on other income is higher. But bank deposits have a 2.5% withholding tax for individuals, which is also a final tax. This anomaly between the taxation of unit trust at 10% and bank deposits at 2.5% for individuals, makes unit trusts an unviable or an unattractive investment option for individuals. Further, individual income tax marginal rates are below 10% on earnings up to LKR 1.6m. This also makes Unit Trusts an unviable option for most Sri Lankans who fall into the lower tax bracket. Even those paying marginal tax rates above 10% will find bank deposits more attractive.

[12] This is not uniquely low – unit trust penetration in Indonesia is around 0.1%.

b. In contrast, where a corporation invests in unit trusts it is liable, not to the 28% Corporation Tax on profits, but to the 10% rate applicable to unit trusts. This is also a final tax. So a corporation can run its treasury operations through a unit trust and make a tax gain of 18% of the profits. Inevitably a number of companies have followed this route (as they have in India where a similar situation prevails). A number of companies have set up tied unit trusts (where they are the only unit holder). This is the factor behind the large number of very similar trusts available. These funds, by their nature, want short-term assets and are predominantly invested in money market assets.

B. Distribution Network

5. There is a need for an overhaul of taxation relating to capital market investments, with the aim of applying equal treatment to equivalent situations. This is being addressed in another brief (Develop Incentive Tax Framework for Capital Market Investments). If this were undertaken, then it would encompass the issues described. However, there is an urgent need to address the strong tax biases against unit trusts and so the changes described below should be enacted before and outside any overall review.

6. There has also been a discussion as to whether there are too many unit trusts. A comprehensive review of taxation of capital market investments would most likely suggest steps to remove the other bias, in this case in favour of unit trusts, which causes companies to start up tied funds. The effect of this would probably be a reduction in the number of trusts and it would seem wise to await that development before taking any direct action (which is in itself questionable) to reduce the number of trusts or force consolidation of management companies.

7. The distribution network is very narrow. Most unit trust companies are subsidiaries of banks. However they are not permitted by the parent bank company to use their parent bank branch distribution networks. Clearly banks fear erosion of their low yielding deposit products by, for example, higher yielding money market funds and it is indicative of a lack of competition in the savings market that banks are able to uphold this. Stockbrokers, who are licensed to distribute unit trusts have a relatively narrow business model focusing on trading and avoiding the wealth management area. Investment banks do offer wealth management but unit trusts do not feature. In the absence of alternatives, unit trusts are mainly sold through press advertising followed up by personal contact from their own sales forces.

8. However, merely permitting the current brokers to have a licence to sell unit trusts would have limited impact. Even if they wanted to sell unit trusts, their current client base is small - probably similar to the current number of unit trust holders, i.e., 30-40,000. The Capital Market Roadmap proposes licensing of universal brokers - essentially investment banks - that operate in a wide range of capital market activities including stockbroking, fund management, wealth management, corporate finance and primary dealers. Current Sri Lankan investment banks cannot own stockbroking firms, and are not subject to regulation on their other activities (except primary dealing). Universal brokers with the appropriate licenses would be likely to act as channels for unit trust sales as part of their wealth management activities. However, the introduction of universal brokers is some way off and their regulation is complex - because of conflicts of interest - and so will require capacity upgrading at the SEC (to be covered in Briefing Note: Institutional Strengthening of SEC). Opening the unit trust market to current brokers would therefore be a useful interim step. It is likely that if unit trusts were to become more widely popular, banks would recognize the opportunity and begin to add them to their product range.

C. Financial Literacy

9. Although there have been recent initiatives to increase financial literacy through the education system, awareness among potential investors is low, and there is a general preference among Sri Lankans for a fixed rate of return. Traditionally, savings have been and continue to be held in bank deposits, which pay low rates to savers. Generally, the idea of asset management is not well understood and asset managers are not widely used. To illustrate, the dominant pension scheme is predominantly invested in Government bonds and is managed in an unsophisticated style. Specific concerns are:

    a. There is a lack of financial education in the national curriculum. Current provision does not offer capital market education to most students - presently only senior students following commerce-related courses receive such education.

    b. There is a need to enhance the skill base among the salesforce of unit trusts. They are able to attract sufficiently qualified analysts to manage the funds but there are no availability of nor regulatory requirement for qualifications for sales staff.

    c. There is a growing group of young professionals in Sri Lanka who have limited financial awareness and who confine themselves to the inappropriate investment/pension package of the Government schemes and bank deposits. There is a need and an opportunity to educate and introduce them to the advantages of collective investment schemes as a means of saving for the long medium or short term.

D. Investment Choices

10. There is a lack of investment choices for the unit trust industry. They are precluded from investing abroad and so constrained to keeping 100% of their portfolios in wholly domestic products which are limited to Government securities, listed corporate debt (the latter all being purchased by banks) and equity.

E. Private Pensions

11. Private pension provision is not well-developed. A small number of companies (38) are allowed to run their own schemes but, other than these schemes, the law does not permit investors to “opt out” from the mandatory Government-run contractual savings schemes, Employees Provident Fund (EPF) and Employees Trust Fund (ETF). This restricts interest in top-up pension schemes which would be a natural source of demand for unit trusts since any individual pension investment in unit trusts would be in the form of additional voluntary contribution i.e. on top of the already quite high pension levy. It also means that fund management skills are less well-developed since a managed pension industry which is a major user of fund management skills does not exit.

F. Legal Structure

12. The legal structure of trusts is unusual and not helpful to development. The current structure of the Unit Trust industry was based on the Trust Law in Sri Lanka to facilitate the variable capital mechanism as the then prevailing Companies Act (now repealed to facilitate variable capital) did not permit redemption of capital. Furthermore, unit trusts despite legally being constituted as a trust arrangement, are nonetheless classified as “companies” under the Companies Law and therefore

attract corporate taxation. The current Unit Trust Code is also restrictive and does not facilitate permit the development of new products such as REITs.

II. Recommendations and Rationale

13. Of the six reasons for slow growth described above, the requirement to invest only in Sri Lanka will be resolved when the proposal to remove exchange control is implemented, and the limited pension market is addressed as described in Policy Brief - Enhance Demand from Superannuation Funds. Therefore, the recommendations focus on awareness, taxation, distribution and legal structure.

14. SEC will enhance the draft SEC Act to:

    a) permit stockbrokers to distribute unit trusts;

    b) include changes to the legal structure of "collective investment schemes" to enable the formation and operation of corporate, partnership, contractual and trust schemes; and

    c) review and amend the Unit Trust Code to provide a greater range of permitted investment products, such as REITs, and concentration to provide greater flexibility to the industry. Specifically, this change would permit unit trusts to structure themselves as pass-throughs thus permitting taxation of profits and/or income to be determined by the unit holders (individual or corporate) on the basis of the tax rate applicable to them.

15. Following the amendment of the SEC Act, the SEC will establish and license universal brokers when the regulatory structure for such brokers is completed. Current Sri Lankan investment banks cannot own stockbroking firms and are not subject to regulation on their other activities (except primary dealing). Universal brokers with the required licenses would be likely to act as channels for unit trust sales as part of their wealth management activities.

16. The SEC will act to improve the distribution system by enhancing the capacity of the current and future sales forces of unit trust companies. They will require staff from institutions with licenses to market unit trusts (whether in unit trusts, in stockbrokers, in universal brokers and eventually in banks) to meet certain certification requirements and to assist the unit trusts in providing such enhanced training for their marketing staff.

III. Outcome

17. Removal of tax biases, through allowing use of legal structures incorporating pass-throughs, would remove a major disincentive to investing in unit trusts. This would allow them to attract more investors and particularly the smaller and younger investors who would benefit from access to a wider range of investment possibilities. Use of the pass-through structure would also remove the bias in favor of corporate investors and likely result in a rationalization of the number of funds, particularly money-market funds. Since the unit trust industry is very small, any tax cost of change would be slight. Indeed, there would very likely be a tax gain as:

    a) corporates would no longer be able to reduce their tax liabilities by setting up unit trusts; and

b) individuals would pay income tax on unit trust gains at their marginal rate which for better-off individuals may well be higher than 10% if an individual has income exceeding LKR1.6 million.

18. Enhanced and stronger distribution channels, in the sense of leveraging the broker's distribution system and having better qualified sales staff, will reduce the prospect of inappropriate or risky products being sold to savers with low risk tolerances. The introduction of universal brokers would further extend this benefit since they have a wider interest in wealth management. Greater popularity of unit trusts would ultimately draw the banks into the market.

19. Requiring a minimum qualification for unit trust sales staff will improve the advice given to potential investors. This will reduce the risk of mis-selling of risky funds to inappropriate investors.

C. DEMAND FOR INVESTMENTS

3. Enhance Demand from Superannuation Funds

ENHANCE DEMAND FROM SUPERANNUATION FUNDS

I. Assessment

1. In order to develop a mature and liquid capital market, it is normally regarded as helpful to have a series of institutions competing for savings from investors. The need to attract investors will prompt institutions to seek to offer a variety of different savings vehicles with different risk/reward characteristics, different time horizons and different asset classes, in different markets all over the world. It will also prompt institutions to carry out research into opportunities in a search for value and growth potential, and to develop areas of expertise, so as to offer a track record that indicates an attractive risk reward ratio. These pressures from institutions will, in turn, push the capital market players into enhancing transparency and disclosure and offering new instruments. As institutions back the results of their research with trading, markets become more liquid and safe for investors to trade in directly. The key driver is multiple institutions, acting in competition.

2. The main potential institutions in this context are pension funds, life insurance, and collective investment funds. Insurance companies and collective investment trusts are discussed in separate policy briefs. This Briefing Note focuses on pension funds.

3. In Sri Lanka, most employers and employees are obliged to contribute to a single fund - the Employees Provident Fund (EPF). In addition, employers (but not the employee) are obliged to contribute to the Employees Trust Fund (ETF). Both funds are defined contribution funds in that the benefits to employees are derived solely from the contributions paid and the investment returns achieved in practice. For the EPF, the employee can receive a lump sum on retirement at age 50 or 55, or can withdraw funds in certain other circumstances, such as marriage, employment in Government service, or the certification of permanent disability. The employee can withdraw funds from the ETF five years after ceasing employment.

4. Investors have no choice as to whether to contribute to EPF or ETF. Within the two funds, investors have no choice as to the nature of the investments that might be made. The two funds therefore have no need to compete for investors' funds. In practice, both funds place over 90 percent of their funds in Sri Lanka Government bonds. Their rationale is that their primary objective is the preservation of the capital.

5. As would be expected from such a structure, returns to investors are very poor. Over a ten-year period, returns to investors for the EPF was at 3.4% (real) which is no better than that for a one year Treasury Bill, even though the investors have no (or limited) access to their funds for up to 40 years. The return achieved by the ETF, which is at 2.4% (real) is lower.

6. It would be expected that, if there were competing pension funds, managed by competing professional investment managers, operating with the freedom to invest in a wide range of asset classes and motivated by the competitive need to attract investors' funds, the returns to investors would be considerably higher than that achieved by the EPF and ETF.

7. Over time, it would also be expected that such competition and freedom would result in greater use, and hence a development, of the capital markets. It would also be expected that, so long as such a large proportion of Sri Lankan savings are invested in monopoly institutions, with a policy of investing primarily in Government bills, the capital markets are unlikely to develop significantly.

8. Complete reform of the pension funds into a more typical multi-pillar approach, using a combination of compulsory state provision and voluntary private provision is beyond the scope of this brief. Moreover, although it would be far preferable for pensions to be managed by a range of competing institutions with differing investment policies, free to diversify through asset classes internationally, a sudden move to such a position from the present arrangements would be likely to have profound and unpredictable effects on both the Government primary debt market and the markets for equities and other assets. A Government policy to develop the capital markets would no doubt encompass such a change but it would have to be managed so as to preserve macroeconomic and systemic stability.

9. The recommendations of this Briefing Note, therefore, are based on the existing structure of pension schemes. However, the further the departure from a fully competitive model, the lower the benefits and the poorer the results for Sri Lankan investors. While it will be prudent to make a modest start, the long term objective should not be lost.

II. Recommendations and Rationale

10. So long as it is compulsory for pension contributions to be paid into the EPF and ETF, it is important to insert as much competition as possible into such a structure. In particular, each investor should have the right to invest up to 20% of the value of the existing fund attributed to them, and new contributions, in one or more of a range of at least five alternative funds, with different risk/return characteristics. To achieve this, the Government should invite licensed private sector fund managers to bid for the right to offer these alternative funds.

11. The EPF should discuss the funds to be offered with the Securities and Exchange Commission (SEC) [and the Colombo Stock Exchange (CSE)]. They could include a bond fund (covering both Government and corporate bonds), two equity funds (one covering the whole CSE market and one restricted to the top fifteen most liquid stocks), two balanced funds (one with a 40:50:10 bond/equity/cash ratio and one with a 60:35:15 ratio), and a money market fund. If a real estate fund were to become available, this could be added to the list. The EPF would continue to offer its existing fund invested primarily in Government securities. Investment fund managers should also be able to suggest additional fund options. For the existing and any new potential funds, there should be a retendering process every five years so that investment managers have a clear incentive to minimize costs and maximize returns. There should be at least two private sector managers so as to maintain competition.

12. To enable investors to make informed choices they should be provided with investment advice. In the first instance, generic advice could be provided in the form of awareness training relating to investment choices and covering such matters as the importance of diversity, the relationship between risk and reward, the factors that may influence the desired risk/reward balance and the relationship between investment choices and financial objectives. There would have to be a rolling program of seminars over a reasonable period.

13. In addition, before making a specific choice, investors should be provided with individual advice. Given the numbers of investors, it will be difficult to provide such advice within a reasonable timescale. One possible way forward would be to place the 20 percent of investors' funds available for choice into a default fund and only allow an investor to reallocate the funds after receiving investment advice.

14. There may need to be some additional constraints on the choices available so long as the range of equity and other investment opportunities are limited.

15. The EPF will need to upgrade its systems so that it has the technical capacity to deal with the outsourcing and the individual choice.

16. The Government should invite proposals from investment managers to manage the alternative funds to be offered to investors. The range of proposed funds should be identified, although investment managers would be invited to suggest alternatives. The managers should be invited to state the fees they would charge the fund and their proposals for offering choice to the investors through a range of different funds.

17. The Government should also invite proposals from investment advisers to offer both generic investment advice to groups of investors and specific investment advice to individual investors in EPF and ETF to enable them to make their choices. The Government should offer to fund a degree of generic investment advice and a specified amount (e.g., two hours) of personal advice for each investor.

18. The EPF should issue a request for proposals to upgrade its systems.

19. The Government should determine the additional funds to be offered to investors and appoint at least two private sector investment managers to be available for investors in addition to the existing managers of the funds of the EPF.

20. The Government should launch a program of generic investment advice for investors.

21. The Government should launch a program of specific investment advice for individual investors.

22. The EPF should complete the upgrade of its systems to cope with outsourcing.

23. The SEC should set the rules for investment managers that would allow a phased introduction of choice for investors. These rules might include the following:

    a) the format for the offer documents issued to investors, if necessary accompanied by a simplified “key features” document); and

    b) the default fund into which investors’ funds would be placed prior to them making a choice.

24. A phased and managed approach would be appropriate

III. Outcome

25. The introduction of competing fund managers accompanied by investor choice should serve to increase returns, develop awareness of investments and develop the capital markets.

D. SUPPLY FOR INVESTMENTS

1. Improve Regulation for IPOs and Listings

IMPROVE REGULATION FOR IPOS AND LISTINGS

I. Assessment

1. This Briefing Note examines, at a high level, the possible impediments to attracting IPOs to the Colombo Stock Exchange (CSE), detailed in the table below.

Factor	Potential Impediments
Scale	The minimum size requirements are appropriate to the capacity of the local capital market and to the size of prospective listing candidates.
Reporting requirements	Reporting requirements relating to the IPO Prospectus, and the periodic reporting requirements post-listing, which should not be a problem for a Sri Lanka company because it is likely that it is already a Specified Business Enterprise (SBE). This means it would already be reporting and being audited in accordance with the legally mandated accounting standards of Sri Lanka Accounting Standards Committee (SLAS) and auditing standards of the Sri Lanka Auditing Standards Committee (SLAuS), and subject to monitoring by the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB). Quarterly reporting may be new to some potential applicants but this requirement should not be a significant deterrence. The reporting deadline of five months (45/60 days for Quarterlies) after period end should not be a problem, if only because these deadlines are not strictly enforced by CSE.
Pre-vetting of prospectuses	Prospectuses are pre-vetted by the CSE and the Corporate Affairs Department of the Securities and Exchange Commission (SEC). Reportedly, the pre-vetting is technical in nature, primarily focusing on compliance with the Listing Rules and the SLAS and SLAuS as opposed to focusing on the financial merits of investing in the underlying investment. The pre-vetting reviews do, reportedly, result in revisions to the Prospectus, mainly in the financial disclosures. Whilst these regulatory procedures would delay and add cost to the IPO process, it is difficult to see them as a significant disincentive.

Factor	Potential Impediments
Private sector applicants	As regards private sector potential applicants, the other continuing obligations (e.g., monitoring and reporting of price sensitive information; related party reporting and substantial shareholding reporting) are likely to be a significant deterrence to some private family companies despite the apparent light-touch regulation of these reports. These requirements are essential for an orderly and properly informed market and so cannot be waived - they are simply a cost of the privilege and benefits of a company's access to the public capital markets. That being said, apart from these extra reporting obligations, the fact that a listing means that outsiders (i.e., investors and regulators) become involved or, at least, have an interest in the business and how it is operated is well recognized as a significant disincentive to private, family or other entrepreneurial companies. For many of the companies with these concerns, the benefits of a listing do not outweigh these concerns about control or interference because they are able to access sufficient funds without an equity offering.
Minimum public float	The ten per cent minimum public float, and the associated issue of minimum number of shareholders, are already identified as a problem in the CSE and already identified as a challenge in the Briefing Note - Enforce Ongoing Listing Requirements..
Costs of an IPO	The costs of an IPO are reportedly around 3-4% of funds raised. This is low by world standards for companies of the typical size of a CSE issuer. Consequently, cost should not be a significant deterrence to an IPO.

Factor	Potential Impediments
Market capacity	Market capacity is a disincentive to larger potential IPO applicants, both public and private sector. For example, there are apparently several apparel manufacturers with potential Market Caps of over USD1Billion which are understood to be interested in raising additional funds for expansion and to fund stronger international operations and a self-design ability. It is reported that these companies are considering an IPO in the Singapore Exchange (SGX), in part because of doubts about whether there is sufficient fund-raising capacity in CSE to handle an IPO of their size and to provide enough liquidity for efficient secondary trading. A potential solution could be for the CSE to develop a dual-primary listing with tranches listing in CSE and in SGX or the Stock Exchange of Hong Kong (SEHK). One PRC-based company has recently restructured from an SGX sole listing to an SGX/SEHK dual primary listing (reportedly because of liquidity capacity in SGX) and others are reported to be in that process. Currently, only local subsidiaries of foreign companies can be listed. There is no current provision for listing or dual-listing of foreign companies. However, the proposal for a Dollar Board envisages dual-listing of foreign companies and a Memorandum of Understanding (MoU) has been signed with the Maldives Stock Exchange to allow for Maldivian companies to be listed on the CSE.

2. Apart from market capacity, none of the issues examined above should be a significant deterrence for stated-owned enterprises (SOEs) listing on CSE. The problems relating to listing of SOEs are reported to be essentially political in character and not materially related to regulatory issues.

II. Recommendations

3. The analysis demonstrates that the problem is not in process, but the principal problem is the limited capacity and liquidity created by the size of the national capital market and the CSE. This a common feature of developing capital markets. To address this:

   a) the CSE should develop and adapt its marketing and listing channels to cultivate and support listings by large domestic, private companies; and

   b) the CSE should develop the Dollar Board, when implemented, to attract dual-listings from other markets, including those of Sri Lankan companies that want to tap foreign markets as well as the local Sri Lankan market. This would require MoUs with other exchanges (who would need to be persuaded).

4. The most common and most successful solution to the scale problem has been the introduction to the market of stakes in SOEs and other public assets. This route has been applied successfully in a wide range of markets, most notably the United Kingdom, SGX, Australian Securities Exchange (ASX) and China via SEHK and the Shanghai Stock Exchange (SSE). Sri Lanka's 2016 budget speech offered that some

of the profitable state-owned enterprises would list shares. In keeping with this announcement at least 3 state owned enterprises should be listed by June 2018.

III. Outcome

5. Expanding the CSE's market to include significant dual listings may bring new, vibrant companies to the CSE which lacks large, attractive companies. It would also provide additional capital (foreign and local) to develop companies and investable assets for large institutions and so supports the initiative to gain greater market involvement of pension investments.

6. Listing of shares of profitable state-owned enterprises will increase market capitalization and liquidity.

D. SUPPLY FOR INVESTMENTS

2. Establish Alternative Listings Boards

ESTABLISH ALTERNATIVE LISTINGS BOARDS

I. Assessment

1. The market capitalization and liquidity of the Colombo Stock Exchange (CSE) remains one of the major challenges affecting its development. At the end of 2015, market capitalization of the CSE stood at LKR 2,938 billion while market capitalization as a percentage of gross domestic product (GDP) was 30.0%, liquidity measured by turnover as a percentage of market capitalization was 8.6%, and turnover as a percentage of GDP was 2.6%. On a comparative basis, Sri Lanka lags behind India, Pakistan and Bangladesh in respect of both size to GDP and turnover to market capitalization.

2. The infrastructure of the CSE includes an Automated Trading System (ATS) and a Central Depository System (CDS). The ATS and the CDS have the capacity to trade, clear and settle equity securities and debt securities but remain largely underutilized at present due to the low level of liquidity and the concentration of liquidity on equity. The implementation of a clearing house and a central counter party (CCP) has been planned.

3. The CSE intends to adopt a number of strategies to improve market capitalization and grow liquidity. The *Sri Lanka Capital Markets Assessment Report* of May 2016 carried out by Professor Lalith Samarakoon on behalf of the ADB has identified a number of products that can fall in line with the CSEs strategy of introducing alternative listing boards.

4. The CSE has already commenced work on the implementation of the small and medium-sized enterprises (SME) Board and the Dollar Board. The rules for the SME Board have been drafted and a concept paper prepared for the Dollar Board.

A. SME Board

5. The SME Board as envisaged by the CSE is being implemented to attract smaller companies to list equity with the objective of boosting market capitalization and liquidity in the CSE. As a matter of history and in the SEC point of view, the SME Board has been viewed as primarily a board for SMEs to list debt with an attendant Government guarantee. The idea of this is to make interest rates on funding more attractive for SMEs. Such a scheme would represent an unacceptable drain on already scarce Government resources and will encourage companies to depend on subsidized finance to sustain themselves. The CSE has moved on from this view and the SME Board is viewed as, primarily, an equity board.

6. The CSE already has two Boards, i.e., the Main Board and the Diri Savi Board. The comparative listing requirements on the two Boards are as follows:

Criteria	Main Board	Diri Savi Board
Stated Capital	LKR 500 million	LKR100 million
Track Record	3 Years	1 Year
Net Profit after Tax	Immediately Past 3 years	Not Applicable
Positive Net Assets	Immediately Past 2 years	Immediately Past 1 year
Public Float	25%	10%
Minimum Number of Public Shareholders	1000	200

7. The Diri Savi Board was designed to be the CSE's SME Board when it was introduced over a decade ago. However, while the Diri Savi Board has been successful in attracting companies including SMEs that did not want to meet the Main Board requirement for 20% public float, it has also, over time, become a de-facto home for companies that cannot conform to the Main Board minimum requirements (i.e., either through size or the requirement for a 20% public float). Rather than take action to delist such companies, the CSE has "relegated" some to the Diri Savi Board (even if they cannot comply with the lower Diri Savi Board requirements) and some are permitted to remain on the Main Board. This has somewhat tainted the Diri Savi "brand" (and that of the Main Board) as a market for growth companies (though the market currently draws little distinction between the two boards). There are approximately 60 companies on the CSE's boards which do not comply with the minimum requirements. This number has built up over the years when the CSE has not taken enforcement action to delist these companies.

8. Many other markets have alternative listing boards. The Alternative Investment Market (AIM) in London, the Growth Enterprise Market (GEM) in Hong Kong, Catalist in Singapore, and GEMS in Kenya are examples of such alternative listing boards. These have been set up to cater to companies that do not meet the stringent requirements of the main market segment. A key feature of all these, and other successful second boards, is that the disclosure and governance requirements are not fundamentally different from the main board. The difference is in the initial requirements - usually size, public float and track record. This also applies to the Diri Savi Board and to the proposed new SME Board.

9. In other secondary boards, the compromise made in initial requirements is offset by requiring the companies to appoint and retain a nominated advisor or sponsor who is tasked with closely supervising the company to ensure that it meets with the exchange listing requirements.

10. The proposed SME Board would be for companies smaller than those on the Diri Savi Board. Draft rules in this regard have been prepared and are awaiting CSE Board approval prior to being submitted to the Securities and Exchange Commission (SEC). The criteria suggested for the proposed SME Board include a stated capital of LKR 25 million, an operating history of 2 years, a public float requirement of 5%, with no condition being placed on the minimum number of shareholders required and only one independent board director (two for Main and Diri Savi Boards). Investment would only be open to qualified investors (essentially corporate entities).The CSE's rules do not address the appointment and retention of sponsors.

11. There is a point at which the small size of companies makes it uneconomical for such companies to seek a listing (costs of obtaining a listing including the costs of enhanced governance, accounting systems and “fixed costs” of professional and other fees are high). Listing costs are said to be very low in Sri Lanka. Even so, fixed fees are somewhere in excess of LKR 1 million and other compliance-related fees will add up to much more. It seems unlikely that companies with as small as LKR 25 million capital will find it worthwhile to seek a listing. The Diri Savi Board minimum of LKR 100 million is already quite low and could be lowered further if there is demand by SMEs for listing. Small companies, as envisaged in the SME rules, are likely better suited to venture capital/private equity investors who would use the Diri Savi Board as an exit.

12. It is the view of the consultants that an alternative to the introduction of a separate SME Board would be to improve compliance on the Main and Diri Savi Boards either by delisting the companies that no longer comply with requirements, or transferring the non-compliant companies to a special board created for this purpose. The Diri Savi Board could then be branded as the market catering to smaller companies.

13. The CSE is reluctant to delist the non-compliant companies but this is not a sustainable long term strategy (discussed in the Briefing Note: Enforce On-going Listing Requirements).

14. If the Diri Savi Board was to be the SME board, the CSE could play a role in enabling the smaller SMEs (i.e., those too small for the Diri Savi Board) to be nurtured and mentored in the medium term. This could be done through a developmental relationship (which is part of the marketing strategy) such as the Stock Exchange of Thailand, among others, offers. Or more formally, a trading facility (for qualified investors) could be offered for unlisted companies. (Currently this would not be possible but if the amended SEC Act permits trading in the securities of unlisted companies then the CSE might also offer a limited trading facility for these companies.) The companies could be admitted to the trading facility provided they comply with basic disclosure requirements (trading would be very infrequent as most investors would not be interested in companies with such a low level of disclosure other than venture capitalists and similar institutions). Mauritius has developed something along this line in which unlisted companies can be traded “on exchange”, though not as listed companies, if they comply with basic disclosure requirements. Such schemes would ensure that potential listed companies are made ready and tracked by the CSE long before they are ready to list. In effect it would build up a pipeline of potential companies for listing. It could also be tied in with the activities of venture capitalists and private equity investors. As the companies would not be listed, they would not have to be regulated by the CSE and SEC.

15. However, the consultants recognize that the CSE has expressed strong commitment to establishing a separate SME Board and may be unwilling to reverse course. There are risks in bringing very small companies into the public market - caution is urged. In particular, not addressing the need to appoint and retain a sponsor has material risks - it would be better to make a sponsor a permanent requirement. The market awareness and market readiness of very small companies will be low, so companies will need strong marketing efforts and a great deal of “hand-holding” from the sponsor and the CSE if they are to successfully join the market.

B. Dollar Board

16. The concept paper to implement a Dollar Board has been submitted by CSE to the SEC. The introduction of a Dollar Board is an integral part of the CSEs strategy to diversify its product range by facilitating the listing of dollar or other foreign currency denominated securities issued by foreign companies. The CSE intends to extend this facility to local companies, subject to regulatory approvals, once the Dollar Board has been setup. The CSE has identified several Maldivian companies that may be interested in a listing on the Dollar Board and a Memorandum of Understanding (MoU) covering dual listing has been signed with the Maldives Stock Exchange.

17. Even though there is no example from markets other than Mauritius, the introduction of a Dollar Board has several advantages from the point of view of a country such as Sri Lanka.

18. Transactions on the Dollar Board will be limited to foreign nationals, due to the country's exchange controls. Given that non-resident foreign currency (NRFC) and resident foreign currency (RFC) account holders are free to invest in dollar-denominated Government bonds, it is important for the success of the Dollar Board if such account holders, too, are permitted to invest in dollar-denominated securities listed on the CSE. This will enhance the demand for dollar securities making it worthwhile for issuers to consider listing such securities on the CSE. Further, it will encourage expatriate Sri Lankans to remit foreign exchange to Sri Lanka.

19. Given the functionality in the ATS to trade bonds (the ATS at present does not have functionality for repos), attention should also be given by the Government to listing dollar-denominated Government bonds on the CSE. This will enhance the attractiveness of the CSEs Dollar Board and improve transparency in trading and liquidity of such bonds, which in turn will make price discovery more efficient, making it a win-win situation for both the Government and CSE.

C. Financing Infrastructure Projects

20. There is also a need to develop a market-based infrastructure development model where major infrastructure development projects could be financed through the issue of securities that can be listed on the CSE. Such an initiative will help diversify the range of capital market products on offer at the CSE, and also create a supply of longer duration instruments which will be attractive investments for those seeking longer term maturity products such as the Employees Provident Fund (EPF) and the Employees Trust Fund (ETF).

21. From the Government's perspective, this initiative will release the pressure on Government funds which otherwise would have been allocated to finance infrastructure development.

22. However, securities issued in respect of infrastructure projects can be listed on the existing boards of the CSE and there seems little need for an alternative board to list infrastructure development securities.

D. Listing of Board of Investment (BOI) Companies

23. CSE also intends to set up a BOI Board in 2016. The listing of BOI companies (mainly Sri Lankan subsidiaries of international companies) is an initiative that could expand the market capitalization and liquidity of the CSE. Further, it could be a means of opening this segment of the economy to Sri Lankan investors.

24. In order to safeguard local investors, it is preferable if the parents of local companies are listed in their country of origin to ensure that the Sri Lankan subsidiaries listed on the CSE have sufficient quality.

25. However, such securities can already be listed on the existing boards of the CSE and there seems little need for an alternative board to list BOI Companies.

II. Recommendations and Rationale

26. The CSE should continue its strategy of developing a market for SMEs.

27. The CSE should consider the business viability of the proposed board for very small companies and make it compulsory for such companies to appoint and retain a sponsor. The CSE should also develop its operations to provide strong marketing to attract reluctant SMEs and offer adequate support to applicants.

28. The CSE should draft rules and implement the Dollar Board after obtaining SEC acceptance of the concept paper. The Dollar Board should be structured for both equity and bonds catering to local and foreign companies including BOI companies and opened up to NRFC and RFC account holders. It is strongly recommended that dollar-denominated Government bonds are also listed on the Dollar Board in order to enhance their tradability in a transparent secondary market. Such an initiative would contribute to the success of the Dollar Board. Following the relaxation of exchange controls announced for 2017, exchange traded funds on foreign securities could be a product that can be introduced to further enhance the attractiveness of the Dollar Board and increase the depth of the market.

29. The CSE has run at an operating loss since 2011 and recorded an accounting loss in 2015. One of its weaknesses is that it is functioning as a single product exchange relying only on equity. The CSE cannot afford to continue this way, especially considering its pending demutualization. Action has to be taken to diversify the product range. A key objective of the CSE should be to formulate an integrated marketing strategy in consultation with key market participants to widen the depth and breadth of the Capital Market and, thus, ensure that liquidity is improved. Market participants should establish that the likely demand makes the product viable.

III. Outcome

30. The actions recommended are formulated to ensure that the CSE transforms itself from its present level of development to the next level, and gears itself to function as a ‘for profit’ company. Developing a wider product range on a commercial basis is essential for the success of a demutualized stock exchange. Developing commercially attractive products will also benefit the development of the market by widening the investment and trading opportunities for investors. However, the success of these initiatives will depend on the Central Bank of Sri Lanka, Securities and Exchange Commission, CSE and other stakeholders functioning in a cohesive manner with the sole objective of developing the capital market.

D. SUPPLY FOR INVESTMENTS

3. Strengthen Market for Corporate Debt

STRENGTHEN MARKET FOR CORPORATE DEBT

I. Assessment

1. Until 2013 the corporate bond primary market was essentially moribund. In 2013, a tax concession was granted which exempted investors in corporate debt from income tax and withholding tax on interest from corporate bonds. From then, issuance volumes have risen sharply and in 2015 reached LKR 83 billion from 25 debt IPOs. But to put this in context, it is still relatively small - less than USD 600 million total or USD 24 million average per issue. In contrast, the Government bond market raised LKR 710 million, equivalent to USD 4.9 billion. The market perception is that the strength of the IPO market is solely a result of the tax break which cannot be sustained. The bonds are mainly issued by banks and insurance companies and it is rare to see a bond issued from other sectors.

2. Corporate bonds are an alternative to bank finance for companies. One of their strengths is the certainty that comes from fixed rate borrowing. This is true in normal times, but when interest rates are expected to rise, then this is not the case. The current situation in Sri Lanka shows a growing fiscal deficit, an increasing borrowing requirement and a steady rise in bond yields. In such an environment, corporate bonds will tend to be crowded out by Government bonds and corporate issuers will not enter the market. In Sri Lanka, the corporate issues are mainly banks and other financial institutions which tend to be hedged against interest rate rises. It is difficult in the short term to anticipate growth of the corporate bond market and its extension into non-financial sectors until the future interest rate picture in Sri Lanka becomes clearer.

3. Corporate bonds, like government bonds, are attractive investments for long-term funds with long-term liabilities. Normally pension funds and life insurance funds hold bonds as part of their asset portfolio. Life insurance companies are permitted to hold listed corporate bonds up to 10% of their assets. Sri Lankan pension provision is totally dominated by two schemes, Employees Provident Fund (EPF) and Employees Trust Fund (ETF). These invest almost all their portfolio in government bonds. EPF is permitted to invest up to 15% of its assets in non-Government securities and currently has less than 5% in corporate debt. The role of EPF/ETF and the prospects for increasing their demand for capital market assets is discussed in the Briefing Note: Enhance Demand from Superannuation Funds, which proposes measures to allow fund members to have more choice in the risk borne by their part of the portfolio through, for example, employee choice or top-up funds.

4. Corporate bond markets function best when there is a strong and reliable yield curve to determine the base risk-free rate. The yield curve in Sri Lanka is not strong because it is largely based on primary dealer quotes, the amount of issuance in longer maturities is not very large (and trading is even less), and trading is split among a large number of bonds.

5. Public issues are only one option for bond issuance in many countries and, often, corporate bonds have little to gain from listing. Since they trade only infrequently, at best, being admitted to a trading venue is of limited value. In many jurisdictions there are regulatory or tax benefits to getting a listing. For example in Europe, bonds listed on a recognized exchange can pay gross interest. In many countries private placement markets is the norm i.e., private issues to a small number of qualified investors. The documentation requirements for private placements are considerably less demanding than for a listing and there are additional benefits in terms of speed

and flexibility allowing issuers to take advantage of market opportunities more rapidly than would be the case if applying for a listing. In terms of financing for companies, private placements are often an attractive option and many countries have developed a regulatory framework for handling them. The US 144a market was the first formalization of private placements but they are no longer alone. In India, private placements are the most common type of issues easily exceeding public offers which are rare. This remains true despite significant changes introduced by the Securities and Exchange Board of India (SEBI) to ease the public bond application process. China has introduced a hybrid bond which is a private placing but issued through, supervised by and listed on a stock exchange. Sri Lanka has no regulatory framework for private placements though clearly private arrangements do take place.

6. The Colombo Stock Exchange (CSE) corporate bond market is very illiquid. Total trading in 2015 was LKR 4.7 billion, equivalent to USD 32m or USD 130,000 per day. The total number of trades in 2015 was 220.

7. Corporate bond markets are inherently illiquid even in developed markets. This is because:

    a. there are large number of issues, each relatively small, so the cost of search to find a counterparty is disproportionately high;

    b. most bond investors adopt a buy-and-hold strategy;

    c. bond yields are a combination of the risk-free rate and the default premium, and within these parameters bonds are close substitutes; and

    d. fund managers are reluctant to release their good quality bonds because of the difficulty of replacing them.

8. Bond fund managers trade mainly in anticipation of changes in interest rates or in anticipation of generalized movements in risk. They do not, as a rule, trade a particular bond because they perceive its risk profile has changed. In general, they will manage their overall risk profile by altering their holdings of government bonds and cash (and government bond derivatives if these are available). Similarly, they will move in and out of government securities in anticipation of interest rate changes.

9. The typical trading profile for a corporate bond over its life-cycle is active trading for a few weeks after the issues, as underwriters sell stock and institutional fund manages buy and the stock is shuffled around, until it finds a home in a buy-and-hold portfolio where it stays until redeemed. A few corporate bonds, which are similar in size to government issues, will see some activity throughout their term but these are rare.

10. It is also important to note that while order exposure systems have become the norm for equity markets, they are rarely, if ever, attractive to bond traders. Bond trading in other markets is usually carried out over-the-counter (OTC), as is the government bond market in Sri Lanka. The reason is that the inherent infrequency of trading makes sellers and buyers unwilling to declare their intentions on a public screen for fear of moving the market and incurring heavy price impact. OTC trading - and those among the electronic systems which have had some success such as the RBI's system in India - employs indicative quoting and negotiation between the parties around the indicative quote. In contrast, electronic order books require firm prices and offer no opportunity for negotiations.

11. Many stock exchanges have tried to extend their order book systems into corporate bonds. Without exception these have failed to attract significant business, an example being the Stock Exchange of Thailand's BES system which transacts negligible business with most bond trading being done OTC and reported through the system of the Thai Bond Market Association. This raises a further point - some electronic order book systems permit transactions to be negotiated OTC and then reported afterwards. This allows the normal OTC trade to continue but ensures there is regulatory reporting and gives bond traders access to the settlement system. The CSE system permits bond traders to achieve a similar outcome.

12. In addition, the issue sizes of the bonds listed on the CSE are very small. Of the 286 bonds listed, 247 have a nominal value below LKR 2 billion, and only 9 exceed LKR 5 billion. They are also quite widely dispersed. This makes the trade size small and uneconomic for bond dealers.

13. Traders do not have any facility for corporate bond repurchase agreements. The CBSL has opted not to accept corporate bonds for repo, but a third-party repo market already exists for government bonds and could develop for corporate bonds. However this is an issue for later discussion when the market is more developed.

II. Recommendations and Rationale

14. Adopt alternatives for EPF to allow greater tailoring of risk to individual member circumstances. Changing the investment policy of EPF/ETF will encourage the funds to invest in a wider range of assets including corporate bonds.

15. Develop regulatory framework to allow and support private placements as an alternative to listing public bonds for qualified investors only. Private placements have been a valuable addition to the pubic bond market allowing greater flexibility, lower costs and protection of investors by restricting to qualified investors only.

16. Permit trades in private placement bonds to be executed on, or reported to, the CSE. A strong private placement primary market will require an efficient secondary market and settlement access.

III. Outcome

17. These recommendations are helpful, but will admittedly have a marginal impact on the development of the bond market. The more pressing issue is the development of the government yield curve, which is a necessary prerequisite to the development of the corporate bond market.

D. SUPPLY FOR INVESTMENTS

4. Introduce Securitized Instruments

INTRODUCE SECURITIZED INSTRUMENTS

I. Assessment

1. The *Sri Lanka Capital Markets Assessment Report* of May 2016 noted that there are currently issuances of asset-backed securities (ABS) type products, in the main undertaken by specialized leasing companies. However, these ABS are a variation of "true" securitization developed to meet market demand. These quasi-securitization products are essentially two types:

   a. a contractual leasing agreement; or

   b. a contractual hire purchase agreement.

2. Neither of the two arrangements involves transfer of the assets to a special purpose vehicle (SPV) nor do they enable the creation of "true" ABS, but are more akin to collateralized borrowing. Furthermore, these mechanisms may not necessarily provide investors (consumers) with sufficient disclosure as to the risks and consequences of default.

3. There is a continuing need to facilitate the introduction of structured products such as mortgage backed securities (MBS) and ABS by establishing a clear and precise regulatory framework through the means of a Securitization Act and underlying regulations.

4. A FIRST Initiative project provided assistance to the Securities and Exchange Commission (SEC) by way of detailed drafting instructions for a Securitization Act for Sri Lanka and recommendations as to the mechanics of its implementation. The draft Securitization Act (the draft Act) delivered to the SEC reflected agreed policy, consultations with stakeholders and had the benefit of domestic external legal advice. A final draft Act was delivered to the SEC in 2008. That draft Act was sent to Parliament in June 2009. However, since that date the draft Act has lain in abeyance in consequence of the sessions of Parliament being prorogued.

5. The draft Act is self-contained and well crafted. It was accompanied by a report which sets out precise and comprehensive recommendations as to consequential amendments to domestic legislation in Sri Lanka that would be required to facilitate a legally cohesive and integrated securitization framework. The report additionally included the principal complimentary actions that were required by other regulatory authorities (namely the Central Bank of Sri Lanka, the Insurance Board of Sri Lanka, The Employees Provident Fund, The Institute of Chartered Accountants of Sri Lanka, and the Stock Exchange) to facilitate the successful implementation of securitization.

6. However, the draft Act and the accompanying report recommendations should now be the subject of a detailed review to ensure that:

   a. there is no legal doubt that the draft Act facilitates a "true sale" of the assets which is capable of recognition and enforcement by the Courts, in view of the common law treatment of notation and assignment as recognised in Sri Lanka so that the Trustees of the SPV are in position to enforce the obligations of the SPV;

   b. with regard to enforcement rights, consideration is given to the introduction of a specialised legal regime that is capable of recovering the underlying asset,

without such being caught up in the general delays experienced in the judicial system;[13]

c. the draft Act is compliant with current international standards. There has been much international spotlight on, and criticisms of, ABS and SPV's mechanisms following their use, in particular, in the USA and their more general role in the global financial crisis of 2008. It is recommended that the draft Act is benchmarked against the *International Organization of Securities Commissions* (IOSCO) *Principles for Ongoing Disclosure for Asset-Backed Securities* (ABS Ongoing Disclosure Principles) of 27th November 2012, which are designed to provide guidance to securities regulators who are developing or reviewing their regulatory regimes for ongoing disclosure requirements for ABS;

d. the matters identified as potential impediments to securitisation, namely taxation, revenue and stamp duty, and their impact on one of the key objectives of securitisation, namely the transfer and isolation of assets from their originator via an SPV which is structured in such a way that it is "bankruptcy remote," are revisited to ensure that these remain impediments and are effectively addressed; and

e. the consequential amendments to some fourteen separate pieces of related legislation are reviewed to ensure that the draft Act achieves the desired legal effect.

II. Recommendations and Rationale

7. The SEC to review the draft Securitization Act.

8. Submit to Parliament a revised Securitization Act ensuring that this is up-to-date with current international developments and the present legal and regulatory framework in Sri Lanka.

9. The SEC to undertake the following tasks as a prerequisite to successful implementation of the Securitization Law framework:

   a. preparation of draft regulations;

   b. preparation of draft guidelines to facilitate understanding of the framework;

   c. staff training for the SEC in practical aspects of assessment of compliance with guidelines, and what to expect in documentation and the types of enquiries to be made;

   d. staff training for the SEC in the practical issues that may emerge in relation to enforcement; and

   e. development of a system for registration of documents by the SEC, and in particular of asset transfers, which can be easily maintained on an ongoing basis and is readily available to the public on the SEC website.

[13] See for example legislation similar to *Recovery of Loans by Banks (Special Provisions) Act no 4 of 1990.*

III. Outcome

10. The Securitization Act and underlying regulations will:

    a. facilitate the development, issuance, investment in, and trading of ABS in accordance with International Standards and Best Practices;

    b. provide for minimum standards of disclosure and investor protection;

    c. enable the regulation of the ABS market to ensure that professional standards are maintained;

    d. provide for the appointment of a Securitisation Regulator;

    e. enable the Securitization Regulator to conduct investigations into alleged breaches or contraventions of the Act or any regulation, guideline, or code made thereunder; and

    f. enable the Securitization Regulator to take enforcement action by way of financial penalties, civil proceeding for failure to comply with the Act, and/or refer matters for the consideration for prosecution of contraventions of the Act.

11. A robust securitization framework produces creditworthy debt instruments which may be suitable for investment by the general public subject to stringent disclosure and reporting requirements. These products also provide greater investment opportunities for the pension and unit trust funds industry, and reduce concentrations of credit in the banking sector.

D. SUPPLY FOR INVESTMENTS

5. Deepen Yield Curve for Government Securities

DEEPEN YIELD CURVE FOR GOVERNMENT SECURITIES

I. Assessment

1. The Sri Lankan yield curve is somewhat poorly defined. The reasons are:

    a. the paucity of liquid benchmark issues at all dates and especially at the longer dates, and the large number of small, very illiquid issues;

    b. the poor quality of prices caused by the low level of secondary trading, and the method of price collection which relies on primary dealer quotes rather than actual trade prices; and

    c. the poor quality of auction prices since the auctions are not necessarily market clearing.

2. In part the fragmentation of issues results in a lumpy yield curve and a lack of liquidity in the market, because issues tend to be small (of course the dominance of EPF and its mainly buy and hold policy is the most likely main cause of illiquidity). It is a consequence of a legacy of small, old issues which is being compounded - despite the PDD's policy of re-opening existing issues - by a lack of strategic decision-making about the overall pattern of issuance (for example the maturity profile is distorted by issuing more than originally announced for an auction).

3. International practice has moved towards reducing the number of bonds and concentrating outstanding bonds in a small number of benchmark bonds. The concentration in larger bonds increases liquidity and reduces the cost of trading. The overall effect of this is to reduce the debt cost since investors are willing to pay a premium (i.e. accept a lower yield in exchange for higher liquidity). The Australian Government has been among the most successful in this regard. Currently Australia has just 19 coupon bonds in issuance (total face value USD 300 million). As discussed below, it has proved difficult to get accurate data on the number of outstanding current Sri Lankan Government bonds but there are reckoned to be well over 80 (with a total face value only a fraction of the Australian market).

4. Australia and other debt managers have achieved greater concentration:

    a. partly by re-opening existing lines of stock (i.e. an auction will be for a further tranche of an already existing stock which is entirely interchangeable with the same stock issued in earlier auctions rather than creating a new line of stock for each auction as used to be the practice in most markets) - so-called passive restructuring; and

    b. also by actively retiring older smaller issues and replacing them with further issues of benchmark issues - so-called active restructuring.

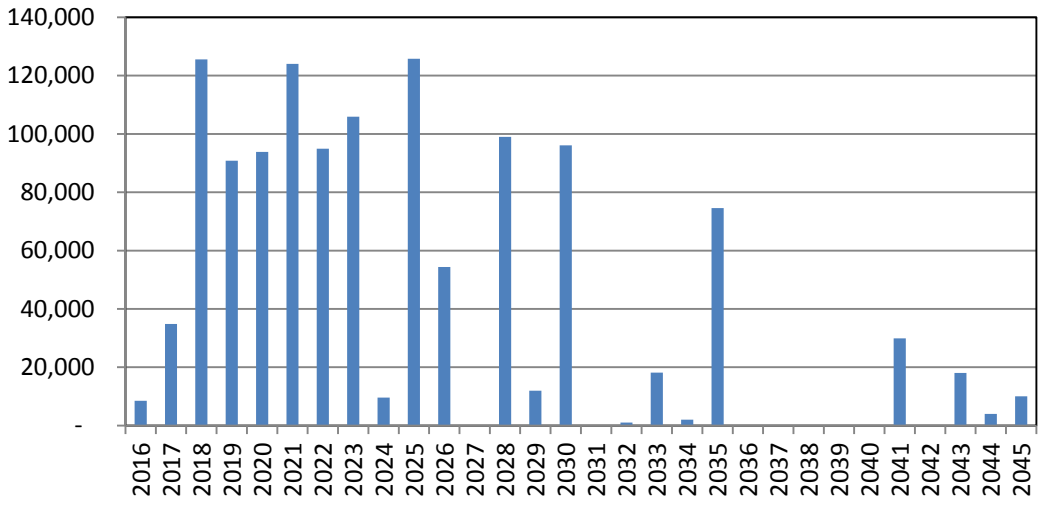
5. Over time, passive restructuring will improve concentration of issues into benchmarks but it is only a partial solution. Proper restructuring will require continuous retirement and replacement of existing benchmarks when, as time passes, they become no longer the market's preferred benchmark maturity.

6. Active restructuring requires implementing a program to restructure outstanding issues through market operations including switch auctions, conversion offers and a buy-back program. These operations essentially involve repurchasing certain series

of bonds and replacing them by reopening issues at selected benchmark maturities on the yield curve. The process replaces the old, illiquid issues with consolidated issues at benchmark maturities - say 5 years, 10 years and 20 years as determined by market preference. Of course, as time passes and the consolidated bonds move away from the benchmark maturities, these will need to be retired and replaced with new issues at the benchmark maturities.

7. The Sri Lankan yield curve, while it reaches out to 2044, is thin at the long end.[14] Figure 1 below shows the amount outstanding for each future year. (The Central Bank of Sri Lanka (CBSL) website contains auction data only up to early April 2016 - there have been issues since then and these have not been included in the analysis).

Figure 1: Outstanding government bonds - LKR million

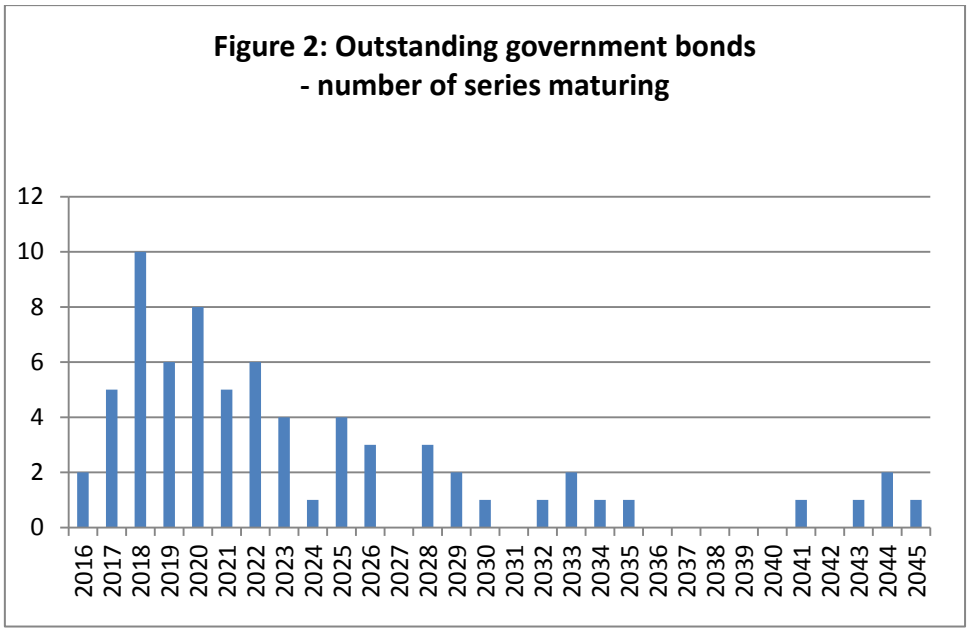


Source: CBSL http://www.cbsl.gov.lk/htm/english/08_stat/s_4.html

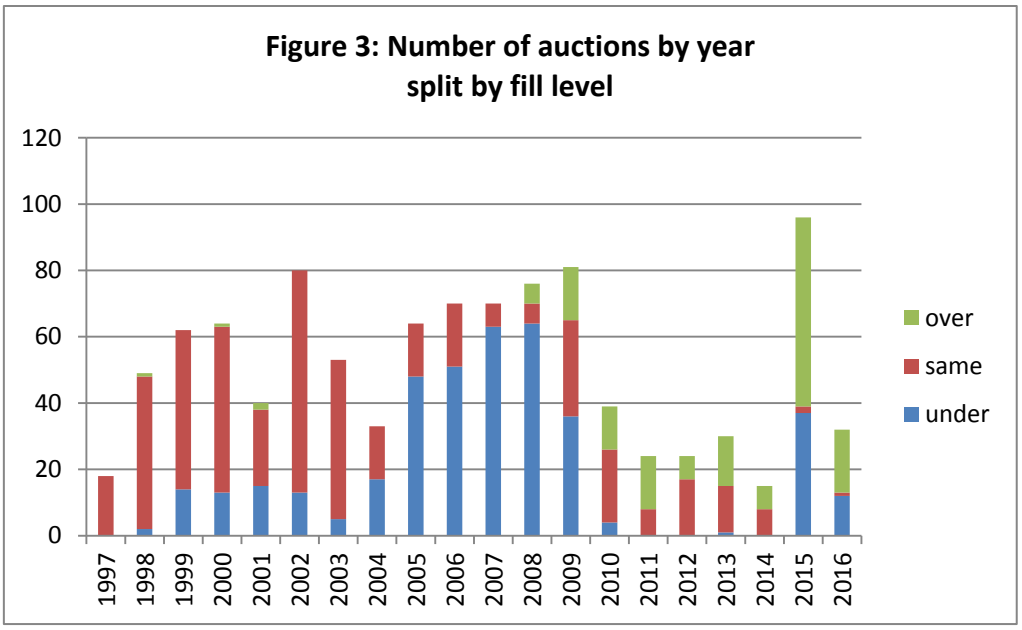
8. There is a good density of outstanding government bonds out to 2023 and then it starts to thin out. After 2030, there are only seven individual years which are populated.

9. Within each maturity year the issuances are fragmented into a number, often a large number, of issues (see Figure 2). 2018 has ten issues maturing, while 2019 has six and 2020 has eight. Multiple issues at the same maturity restrict secondary market trading below what it would be if there were a smaller number of larger size issues at each year.

[14] It has not proved possible to obtain a comprehensive list of outstanding bonds. This is normally on the central bank website but is not on the CBSL site. The data presented here is based on an analysis of bond auction results from 1997 to 1st April 2016 which is on the CBSL website. Historically, auctions have only been a part of the bond issuance strategy – which relied heavily on tap issues and private placements. Over the period, auctions accounted for about a third of all new debt issuance so the data here are incomplete, but we have no reason to believe they are not indicative of the complete picture.



10. One approach to strengthening secondary market pricing would be to improve the quality of the auctions. Currently, auctions are very frequent and, in the recent past, it has been common for the auction amount to be amended upwards or downwards from the announced auction size. Figure 3 illustrates the annual number of auctions (sometimes two stocks are auctioned on one day and this would count as two auctions in Figure 3) and the number of auctions where the amount allocated was "over", "same," or "under" the amount advertised.



11. Sri Lanka does pursue passive restructuring. The public debt department (PDD) of the CBSL states that it does re-open securities rather than create new securities and this is the case: the 129 separate auctions since the start of 2015 to 1st April 2016 involved 42 different series, showing that there were a significant number of re-openings (including the 11% of 2021 which featured in ten separate auctions).

12. However there are barriers to active restructuring. The current fiscal situation places pressure on the CBSL just to raise money and it is unlikely that much resource is

available to consider how to actively restructure. It is not clear whether the current auction IT system and more generally, capacity at the CBSL, could handle reverse auctions and switch auctions. Finally there is a legal barrier in that, possibly accidentally, the law sets the annual borrowing requirement for government bonds in gross terms rather than net so that, for example, a switch auction which would be neutral in its impact on total outstanding debt (retiring one old bond and issuing an equal amount of a benchmark bond) would count as an addition to borrowing in relation to the total borrowing requirement. As the current borrowing requirement is under pressure from high fiscal demands there is no headroom for restructuring.

13. Trading volumes are low with a small number of transactions per day (based on primary dealer comments as no statistics are published). Secondary market trading may be constrained by technical factors but the main barrier to a liquid secondary market is the small number of investors who are mainly buy-and-hold. For example, the Employees Provident Fund (EPF) holds over 45% of outstanding bonds. A reappraisal of the pension schemes to introduce more competition, improvement of the unit trust market, and similar developments, would certainly improve the level of secondary market trading.

14. Primary dealers make reports to the CBSL on transactions as part of the settlement process but these do not contain price information and so cannot be used in yield curve determination. Trade reporting is required but the CBSL believes reporting is substantially incomplete. The CBSL canvasses two-way quotes from primary dealers and these are published to the market. Yield curves are therefore based on quotes which are at best, indicative. This reduces the accuracy of the yield curve estimates.

II. Recommendations and Rationale

15. CBSL/PDD will introduce and enforce a policy of reporting of trades within a fixed time of the trade occurring, as recommended the Briefing Note: Reform Primary Dealer System for Government Securities. We understand that a circular to this effect has been issued on 1st August 2016 requiring immediate reporting of all trades over LKR 50 million through Bloomberg. This will also require enforcement measures to be effective as discussed in the Briefing Note.

16. CBSL/PDD will initiate a program to lengthen the yield curve, concentrate on key benchmarks and reduce the number of individual stocks so as to increase secondary market trading and allow a more accurate yield curve to be estimated. The aim is to consolidate current outstanding bonds into larger bonds by a process of:

    a. reopening existing bonds (a strategy which the PDD already follows);

    b. focusing issuance on key benchmark positions in the yield curve;

    c. early redemption of existing bonds and issuance of new bonds to replace them. (The cost of the process can be minimized by using redemption auctions as well as the normal auctions for new stock); and

    d. continuing its policy of selling longer-dated stock as conditions allow (which they may not be in the current environment of rising yields).

17. PDD auctions should adhere to the stated amount as described in the Briefing Note: Reform Primary Dealer System for Government Securities.

18. CBSL will accomplish a change in the law relating to the way the Parliament-determined annual borrowing limit for bonds is measured. There is currently a legal obstacle caused by the borrowing limit for bonds, as bonds are defined in gross terms (meaning that replacing one bond with another counts as an addition within the borrowing limit). With current high levels of issuance, the PDD feels there is unlikely to be sufficient headroom within the borrowing limit.

19. CBSL to develop capacity for yield curve management in the PDD. The PDD staff are also inexperienced in these sort of techniques relating to managing the yield curve.

III. Outcome

20. The outcome would, over time, be a deepening of the yield curve brought about by increased secondary market trading as fewer bonds make trading easier and as trading is more focused on key benchmark points. This will lead to lower borrowing costs for the Government and provide a stronger price benchmark to support development of the corporate bond market and other interest-related products. The greater transparency will enhance the ability to supervise the market, raise user confidence and improve pricing efficiency.

D. SUPPLY FOR INVESTMENTS

6. Establish Derivatives and a Commodities Exchange

ESTABLISH DERIVATIVES AND A COMMODITIES EXCHANGE

I. Assessment

1. There has been interest in developing both derivatives and commodity markets in Sri Lanka for some time. In 2012, the Securities and Exchange Commission (SEC) called for expressions of interest in the development of a commodity and derivatives exchange and after considering submissions, as well as the requirements for cash commodities including developing warehousing facilities and a warehousing receipt system, the conclusion was that the SEC would not take the matter forward.

2. Further, with the development of a new SEC Act, which includes provision for a derivatives exchange, it was realized that the definition of commodity futures could be incorporated into the proposed new SEC Act as a derivative product. This approach will avoid duplicating regulation and infrastructure whilst still enabling derivatives on key commodities such as tea.

3. Currently tea indices are compiled representing three different sectors of tea production and it should be possible to design appropriate cash-settled futures contracts for the tea market.

4. The Colombo Stock Exchange (CSE) has developed a blueprint for the development of derivatives and such development is linked very closely with the development of a requisite central counter party (CCP) infrastructure which is necessary to handle the risk management of exchange-traded derivative contracts.

5. Some derivatives are being considered that do not require a CCP. These are exchange traded funds and derivative warrants issued by a bank which acts in place of a CCP and takes the role of risk manager. There is a question of the size of bank capital that should be required to be a warrant issuer. In Singapore it is USD500 million and Thailand USD28 million plus a top four credit rating from an international rating agency. Attracting banks to be warrant Issuers based on current shallow liquidity may prove difficult.

6. In addition, both derivative warrants and exchange traded funds require market makers which will require development of short selling and securities borrowing and lending (SBL) rules as well as an appropriate taxation regime for market makers. The draft of the new SEC Act should have a section added providing for a prohibition on naked short selling and for covered short selling through stock borrowing and lending to be in terms of regulations issued by the SEC, including the list of approved shares.

7. Derivative warrants and exchange traded funds can be traded on the existing CSE trading platform and can be settled just like existing share transactions. The risks are borne by the issuing bank.

8. For exchange-traded derivatives, such as individual stock futures and options, as well as index stock and interest rate futures (T-Bill and T-Bond futures), a CCP is necessary, as is, a modern derivatives trading platform and CCP mechanism.

9. Discussion with primary dealers (PDs) indicated a desire to develop interest rate derivatives.

10. One complication is that there is a need to transfer the existing clearing risk management into the CCP to reduce the clearing and settlement risk that currently

exists. This means that the phasing of derivative initiatives is limited by the roll-out of underlying infrastructure. Exchange derivatives will also require short selling and SBL. (Refer to the separate Briefing Note: Strengthen Trading Platform and Establish a Central Counterparty System).

11. The Bank for International Settlements (BIS) principles of financial markets infrastructure recommend that central bank money is utilized in the finality of settlement by the CCP and that is still to be agreed with the Central Bank of Sri Lanka (CBSL).

12. The CSE, since late 2014, has been working on a project to launch a CCP. The CSE engaged international consultants directly to develop the business case and requirements for the CCP. In June 2016 it released an RFP to six potential suppliers for CCP systems. The current trading system at CSE already supports exchange-trade derivatives as per the rules and contract specifications to be developed for Sri Lanka. The CSE estimates the capital costs to establish the required trading and CCP systems is in the order of USD5 million and annual running costs around USD2 million. The cost of a CCP system, however, appears to have been underestimated and, hence, may increase the overall budget for the CCP program. Currently, the CSE is marginally profitable and the overlay of the costs of a derivatives market and CCP could be crippling without increased market turnover.

13. The Central Bank of Sri Lanka (CBSL) is considering developing a separate debt CCP. When initial studies were commenced into a CCP for CSE equities and derivatives, it was envisaged that this would be a jointly-owned and jointly-operated venture for the CSE and CBSL. However, CBSL has withdrawn from the joint proposal and CSE is progressing on its own. It is unknown if SEC will take a shareholding in the CCP but this would present a large conflict of interest as the SEC is required to license clearing and settlement facilities.

14. In the CCP, it will be necessary to ring-fence the risks from equities and derivatives. Many Asian markets have developed separate CCPs for their cash and derivative markets. The current cash settlement risk management process has the backing of LKR604 million securities guarantee fund and it is unclear as to the conditions under which this will be transferred to the new CCP as eventually the aim is to return the LKR604 million to the Government, SEC and CSE who originally funded the guarantee fund. Replacement of these funds will present a drain on the scarce capital available in the market. It is recommended to initially enhance current clearing and settlement by continuing to utilize the guarantee fund and introduce margin requirements for stockbrokers based on the new value-at-risk (VAR) system that has been designed.

15. Derivative warrants and exchange traded funds can still be pursued in the short term and this provides a much lower risk strategy than a big bang derivatives approach.

II. Recommendations and Rationale

Recommendation	Rationale
SEC and CSE to reassess the approach to derivatives and look to introduce enhanced clearing utilizing VAR techniques for assessing and collecting margin from brokers.	Lower risk strategy.
SEC and CSE to finalize derivative warrants, exchange traded funds issuer requirements, trading and settlement rules.	Necessary rules to commence first derivative products.
SEC to develop short selling and SBL rules, and CSE to propose for approval of market making rules for derivative warrants and exchange traded funds and incorporate a short selling provision in the new SEC Act.	Necessary rules to commence derivative products.
Once enhanced clearing has been successfully implemented, SEC and CSE to reactivate plans for exchange derivatives and a CCP.	Lower risk strategy.
SEC and CSE to develop rules for derivative warrants covering trading settlement and market making (liquidity providers).	Necessary rules to commence structured derivative warrant products.
SEC and CSE to clarify the utilization and eventual disbursement of the existing guarantee funds and the establishment of a CCP.	Clarity as to ownership and use of existing GF.
SEC to develop short selling and SBL rules, and CSE to propose for approval market making rules for derivative warrants and exchange traded funds.	Necessary rules to commence derivative products.
Undertake, through an appropriate Technical Assistance program, a comprehensive assessment of the need for a cash commodities exchange, including the extent of warehousing requirements for likely cash agricultural products, as well as the feasibility of establishing a warehousing receipts and financing mechanism.	Study and clarify actual economics and need for the development of a cash commodities exchange and its associated logistical requirements.
Technical Assistance to support the development of derivative rules and regulations for SEC and/or CSE.	Required support to SEC/CSE to prepare for derivatives implementation.

III. Outcome

16. The outcomes are:

a. introduction of enhanced clearing with risk based margining for stockbroker/dealers;

b. commencement of derivative products on staged basis;

c. lower risk entry into a full CCP and exchange-traded derivatives; and

d. proper assessment of the need for and the infrastructure required to establish an economically viable commodities exchange.

D. SUPPLY FOR INVESTMENTS

7. Broaden Equity Market Listings - Insurance Companies

BROADEN EQUITY MARKET LISTINGS - INSURANCE COMPANIES

I. Assessment

1. The Regulation of the Insurance Industry Act No 43 (2000) amendments of 2011 requires that:

   a. all insurance companies that are structured as composite insurers must segregate their long-term (life) and non-life insurance businesses into two separate companies; and

   b. all insurance companies (including the wholly state-owned Sri Lanka Insurance Trust Fund) are required to be listed on the Colombo Stock Exchange (CSE) within five years of the date of the act for companies existing at the time of the act, and within three years of having been granted an insurance license for new companies. An exemption to this requirement for subsidiaries of a group provided the parent of the group is listed, is currently under consideration by the Government. It is estimated by the Insurance Board of Sri Lanka (IBSL) that this will take up to one year to complete.

2. There are clear regulatory reasons for requiring a separation - composite companies can cross-subsidize and move capital between life and general businesses - and this is in line with international trends, for example India and the United Kingdom. The requirement to list was based on a desire for increased transparency and also as a measure to boost the number of listings on the CSE. There is a downside to forcing companies to list against their will, which is that the exchange becomes home to a number of non-compliant or poorly-compliant companies which has a corrosive effect on public confidence, and their persistent non-compliance is a continuing drain on the exchange's resources.

3. The current situation is that there are 29 insurance companies regulated by the IBSL. Of these, 26 are segregated companies - either life or general. The remaining three are companies which are yet to complete the split. One of these is the Sri Lanka Insurance Corporation (SLIC) which functions under the Ministry of Finance and has a market share of around 80%. SLIC has been, and remains, resistant to segregation. The other two, Sasana and Merchant Bank of Sri Lanka (MBSL), have been requested by IBSL to provide capital plans but have failed to do so. The sense of IBSL is that they do not have sufficient capital to set up two separate companies (insurers are required to have a minimum capital of LKR500 million and are now subject to additional risk-based requirements). The IBSL has required both companies to produce capital plans showing how they will meet IBSL requirements, and one has submitted a plan. However, it is thought unlikely that the two will be able to continue, and there needs to be provision made for orderly exits and transfer of business.

4. Of the remaining 26, nine have gained a listing at the CSE (one of these, AIA, has subsequently merged with another local company and is in the process of exiting the market).

5. The split of life and general resulted in nine new companies being created in 2015. One of these has listed and the remaining eight are all still within the three-year grace period for the requirement to list given for new companies. One of these, AIG - a

general company - is in the process of withdrawing from Sri Lanka and is not accepting new business. The IBSL has not approached these companies to ascertain whether they are progressing towards a listing.

6. There are nine companies which (a) have segregated, (b) have not listed and (c) are not in the three year grace period, i.e. which should be listed under the current law. Of these, four have listed parents and could, in future, be exempted if that change to the law is accepted. This leaves five which will not be exempted under the revised proposals and so should be listed. The table below provides a summary:

Status	**Number**
Remain as composites	3
Listed on CSE	9
Still in three year grace period	8
Listed parent so possibly exempt	4
Not listed and unlikely to be exempt	5
Total IBSL	**29**

7. The three remaining composite companies are:

   a. MBSL Insurance Company Ltd. Which trades as a single company (parent is listed);

   a. Seemasahitha Sanasa Rakshana Samagama, which trades as a single company; and

   b. Sri Lanka Insurance Corporation Ltd. which is Government-owned.

8. With the exception of Sri Lanka Insurance Corporation which has dominant market share, the remaining two composite insurers are small with market shares of less than 1%.

9. The five companies that have not listed, are not subject to the grace period, and do not have a listed parent are:

Company	**Business**	**Date licensed**
Continental Insurance Lanka Ltd.	General Insurance	18th December 2009
Cooperative Insurance Company Ltd.	General Insurance	18th September 1998
Life Insurance Corporation (Lanka) Ltd.	Long Term Insurance	18th December 2002
LOLC Life Assurance Limited	Long Term Insurance	30th April 2010
National Insurance Trust Fund	General Insurance	

10. National Insurance Trust Fund (NITF) is a Government-owned specialist reinsurer. The law permits NITF to have up to 50% of the total reinsurance market and the current figure is about 30%.[15] NITF is, thus, an important part of the market

[15] NITF also does a small amount of general business but no life.

infrastructure. The other four companies are small with a total share of industry assets below 2.1%.

11. An exemption from the requirement to list has been sought for both NITF and SLIC.

12. The eight companies which are in the grace period are:

Company	Business	Date licensed
Amana Takaful Life Limited	Long Term Insurance	1st January 2015
Asian Alliance General Insurance Ltd.	General Insurance	1st January 2015
Ceylinco General Insurance Limited	General Insurance	1st June 2015
Cooplife Insurance Limited.	Long Term Insurance	1st January 2015
HNB General Insurance Ltd.	General Insurance	1st January 2015
Janashakthi General Insurance Limited	General Insurance	1st January 2015
LOLC General Insurance Limited	General Insurance	01st October 2015
Union Assurance General Limited	General Insurance	1st January 2015

13. Of the companies in the table above, six have listed parents[16] and so will be subject to the exemption if it is granted. Cooplife and LOLC General do not have listed parents. Their intentions are not known but they will need to act within 18 months to two years to be compliant.

14. If the exemption to the Listing Rules are granted for companies with listed parents then the outstanding problems requiring a solution are:

Company	Segregated?	Listed or possibly exempt	Note
Sri Lanka Insurance Corporation Ltd.	No	No	Listing exemption sought
National Insurance Trust Fund	N/A	No	Listing exemption sought
MBSL Insurance Company Ltd.	No	No	Capital plan requested
Seemasahitha Sanasa Rakshana Samagama	No	No	Capital plan requested
Continental Insurance Lanka Ltd. (Gen)	Yes	No	Not in grace period
Cooperative Insurance Company Ltd. (Gen)	Yes	No	Not in grace period

[16] The Act permits Life companies to own general companies and vice versa – or them to set up holding companies with life and general as subsidiaries.

Company	Segregated?	Listed or possibly exempt	Note
Life Insurance Corporation (Lanka) Ltd. (Life)	Yes	No	Not in grace period
LOLC Life Assurance Limited (Life)	Yes	No	Not in grace period
Cooplife Insurance Limited.	Yes	No	In grace period
LOLC General Insurance Limited	Yes	No	In grace period

15. Apart from SLIC and NITF, the companies in the table above are small, collectively representing less than 4% of total industry assets.

II. Recommendations and Rationale

16. IBSL and its owner, the Ministry of Public Enterprises Finance, will require the Sri Lanka Insurance Corporation (SLIC) to segregate its assets into life and non-life. This is important because SLIC is being taken as a cover by the others to avoid action, and also because its continuing non-compliance undermines IBSL's credibility.

17. IBSL will require the other two remaining companies, that have not segregated because of capital shortfalls, to submit capital plans (if they have not already done so), and IBSL must then accept or reject those plans.

18. IBSL will obtain amendment to the law that requires listing to exempt companies with parent companies listed on the CSE, on foreign exchanges, or which are state owned. It will then require all remaining insurance companies to either list, merge with a listed company, or wind down their businesses. After obtaining the amendment, IBSL will commence enforcement action against those companies (currently six) which have not obtained a listing on the CSE.

III. Outcome

19. Clarification and enforcement action will remove the current element of uncertainty within the insurance industry, which must have a corrosive effect on the attitude to compliance of companies which have followed the law.

20. The effect of eliminating non-compliant companies will strengthen the compliance culture in the remaining companies.

21. The removal of weaker companies and the resulting concentration will strengthen the Sri Lankan insurance industry - though the continued dominance of the state-owned provider will continue to operate as a drag on development.