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# Improving Colombo Stock Exchange Regulation

Supplemented by a Book

**"CONSOLIDATED SRI LANKA SECURITIES REGULATIONS"**

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**A Project Financed by USAID/SRI LANKA**

**for the Colombo Stock Exchange**

U.S. and Overseas Offices

Arlington, Virginia \* Lewes, Delaware \* Dakar, Senegal \* Colombo, Sri Lanka \*  
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## SUMMARY OF RECOMMENDATIONS

1. The primary recommendation of this project is that the Colombo Stock Exchange provide for governance by a Board composed only half of members and the other half representatives of listed companies, institutional and individual investors or their attorney and accounting professional representatives.
2. As a base for improved self-regulation, CSE should publish a manual for members, their employees, agents and customers, organizing by subject relevant parts of Sri Lankan law, securities council rules, and CSE articles and rules now in 20 different documents.
3. Establish a full time exchange staff with investigative accounting and securities experience for member surveillance with initial close attention to review of trading, capital and profitability of each member. Provide competent foreign orientation for this staff.
4. To enhance member profitability after exchange surveillance capacity is developed, there should be regulatory options permitting choice by firms to maximize money management profits, to promote liquidity by regulated firm trading, to charge more than the fixed commission in certain instances, and to use customer credits to finance other customers fully collateralized debits.
5. Exchange rules should require both net capital and security deposits which fluctuate with volume and the risks of each member's business. At times, the new exchange requirements would be less than the present overriding Securities Act, at other times the Exchange capital requirements would be greater than those of the Act.

The security deposits could be met by bank guarantees but the liquid capital requirements should be met by a minimum positive capital equity reduced by assets not readily converted to cash and allowances for market risk in such conversions to cash. Provision is made for members now relying on advances from affiliated companies and bank overdrafts to convert such financing to subordinated debt acceptable for capital purposes.

Priorities are established for use of security deposits, and provision is made for pro-rata charging of other members if a failing member's security deposit is insufficient to cover net losses on close out of open contracts.

6. Deposit problems should be corrected by:
  - invalidating any guarantee with less than two months to run (thus encouraging earlier renewals or extensions and providing a discovery period);
  - clarifying the purpose of the guarantees as stated in CSE Article 18 to (a) completion of exchange open contracts of defaulting Members, (b) debts to the Exchange, and (c) unsatisfied claims of customers;
  - providing that the guaranteeing bank has no right of set off against other member assets it might hold; and
  - removing any question as to whether the guarantee could be used to protect contracts entered on the exchange but not processed through the clearing system.

The September 15, 1989 rules on separate bank accounts for customer funds should be amended (as in 703) to permit customer credit balances to finance other customer fully collateralized debits and then enforced. The proposed rule 703 would also establish legal integrity of the required

customer bank accounts as customer property, improving priority distribution to customers under provisions of the Compensation Fund amendments being prepared by the Securities Council.

8. Clarify the obligation of a broker to his customer when the contra broker does not perform. Provide for borrowing of securities against cash collateral to facilitate timely deliveries.

9. CSE should provide prudent regulation of margin business for its members and their affiliates.

10. Minimize risk of employee fidelity through supervision and control rules. In addition, the exchange should investigate the feasibility of required fidelity insurance for members.

Require audit confirmation of customer accounts and mailing of customer security statements by CDS rather than members

11. Impose qualification requirements for agents similar to those proposed for sales employees of members. Encourage members to protect themselves by a contract with the agent indemnifying the member for any liabilities arising from the agent or its employees.

12. Form a committee to look into further centralization of post trade processing functions, such as a common computer system, a mailing facility for communications of companies to security holders, direct receipt and delivery of securities between the central depository and customers, etc.

13. Form a second committee to plan CSE role in training of sales personnel, media promotion, and centralized educational campaign direction. A full time exchange officer for promotional planning and execution should be a future objective.

14. Review fixed commission levels and Exchange financing.

15. Fill critical gaps in CSE rules by adopting specific rules proposed in Exhibits to this report, summarized as follows:

**Organization and Governance** - executive committee balance between members, listed companies, investors; corner control; liability for use of facilities; nominating committee; chief executive officer powers.

**Listing** - approval criteria, proxy procedures, listing agreement.

**Trading** - change of ownership timing, responsibility to customers for settlement, cross (parcel) exposure, auction and customer order priorities, discretion by traders, cash and delayed delivery transactions, erroneous reports, order records changes and definitions, short selling.

**Settlement** - introduction of accounts between members, qualification for carrying and settling accounts, close outs, good delivery and reclamation, assignments, signature file, delivery against payment, borrowing securities, securities loans, signature guarantees, credit extension (margin), partial deliveries.

**Qualification of members, agents and personnel** - conditions of qualification of members, trading attorneys, employee representatives soliciting customer business, agents and agent representatives, other approved persons; reporting of changes, authority for investigations, authority over employees, investigation of new employees, employee records, acceptability hearings.

**Ethical Conduct** - good business practice, conflicting employment, gratuities, reporting of questionable conduct, sharing in customer accounts, misleading names, rumor circulation, privacy

of regulatory information, standards for communication with public, account transfers, fair corporate financing, free riding and withholding, disclosure of conflicts.

Supervision & Control - supervision structure, duties of supervisors, know your customer rule, numbered accounts, employee accounts, control of public communications, prevention of confusion with associated entities.

Financial & Operational - capital and settlement fund requirements, audits, financial statements to customers, reports to exchange; hypothecation, custody and borrowing of customer securities; buy-ins, securities movements.

Discipline - summary access prohibition for failing member; disciplinary bases, penalties and procedures by hearing panels; appeals, discipline by stipulation and consent, right to counsel, discipline of suspended parties.

Arbitration - controversies arbitrated, arbitration procedures, arbitration agreement.

# **IMPROVING COLOMBO STOCK EXCHANGE REGULATION**

**A Project Financed by AID/SRI LANKA  
Executed by the International Science and Technology Institute**

**by Robert M. Bishop  
retired Senior Vice President,  
Chief Regulatory Officer  
New York Stock Exchange**

## **Background of this Project**

**Under the general heading of "Colombo Stock Exchange (CSE) Surveillance and Enforcement" this project is a short term component of the long term capital markets project being performed by the International Science and Technology Institute (ISTI) under contract with USAID/Sri Lanka.**

**The primary focus of the project is on capital adequacy of requirements for CSE members, and reduction of major risks or exposures. The project is also to focus on conflicts of interest of CSE members, exchange supervision of members and their employees, and identification of any unnecessary duplication between the Securities Council (SC) and CSE in regulating the stock market.**

**The project was accelerated by the consultant's December 1989 project in Colombo assisting the Securities Council in preparing a practical plan for implementation of a Compensation Fund and by rewrite of his computerized book on "Model Rules for a Stock Exchange" already adopted for use in 10 other start-up or developing small exchanges.**

**The report following is in three volumes. It begins by discussing in this first volume the major risks needing attention by the Colombo Stock Exchange and proposing specific rule recommendations. The second volume is a "Cut and Paste" compilation of the securities market regulations now existing in Sri Lanka organized in ten subject areas. Upon return to the U.S., this volume is to be converted to a computerized regulatory manual.**

**The third volume is a detailed commentary on the present rules, plus four indexes by different sorts of the topics of the present and proposed rules.**

## **Profitability Risk**

**The ever-present greatest risk to the viability of broker dealers is that of negative profitability. It is the ultimate cause of most failures of exchange members - sometimes causing a slow death, other times sudden and unexpected.**

**Losses weaken the will of vulnerable humans to remain honest, leading to falsification of records to conceal losses, overtrading of customer accounts to boost income, even theft. Slow losses result from the peaks and valleys of brokerage volume. Sudden losses result from customer reneges, from market breaks, from theft discoveries, from uncovered manipulations, from listed company adversities.**

**A priority feature of exchange surveillance of its members, therefore should be a close watch on profitability. A base for that capability is built into attached rules on capital (701) and clearing**

guarantees (704). But the Exchange will also need a staff to operate a surveillance system on that base.

Sri Lanka brokers face another hazard to profitability. Government and exchange policy inhibits their engaging in two of the most profitable parts of the stock exchange business in other countries: money management and firm trading.

Brokerage commission business is at best a break-even activity in most countries. It demands fixed expenses against variable income. It rarely produces sufficient income to finance growth in professional sales forces, branches and investor education or incentive for expansion.

It does produce a basic business which can support profitable money management through margin accounts, interest on float of funds in transit, short term financing through repurchase brokerage and stock lending, etc. It also produces a skilled group of personnel close to the market who can trade in a regulated environment without commissions, profiting while furnishing market liquidity to short term imbalances in supply and demand.

Even in exchanges which prohibit member trading, as in Sri Lanka, there is inevitably a perception if not a reality, that there is underground firm trading. Regulated firm trading on the exchange floor is relatively transparent and market friendly. Sri Lanka already has in place direct regulation of some elements of firm trading control such as insider trading restrictions. Others such as giving priority to all customer orders over firm orders at the same price and prohibiting short sales in declining markets are easily written and enforced.

Although not usually profitable in the early stages of exchange market development, firm trading as exchanges grow becomes a major part of firm profits in times of low volume as well as high. Regulated short sales are an important component. Exchange rules do not mention short selling - a topic treated differently and with great conviction in different world markets. CSE members appear to agree that, at their present level of trading, short selling is undesirable; it probably also would not be profitable and subject to extreme risk of loss. They also recognize that the Act provides for borrowing of securities which ordinarily is a mechanism to support short selling, and that short selling may be desirable in the future to assist market liquidity, particularly as market making develops. (See proposed 212 for immediate clarification, but reconsideration will be needed as the market grows).

Sri Lanka's flat requirement that all customer moneys be kept in separate bank accounts also limits broker opportunity for profit from temporary use of these funds. For example, the U.S., which strictly prohibits use of customer funds to finance firm positions or operations, does permit customer credit balances to be used to finance fully collateralized debits of other customers. The interest differences are a strong income stream for members. Even when interest is paid by brokers on customer credit balances, there is an interest profit from higher rates on customer debits.

**RECOMMENDATIONS** - The exchange should begin its member surveillance system by close attention to profitability of each member.

To enhance profitability after CSE builds a surveillance capacity, Sri Lankan law should be changed to permit a securities firm to be both a broker and dealer under appropriate Securities Council and Exchange regulation. CSE should change its articles and rules to permit dealer members even before the law is changed.

The provisions for separate bank accounts for customer funds should be modified to permit use of customer credits to finance other customer's fully collateralized debits.

## Regulatory Risk

To a degree experienced by few other types of business, stock exchanges and stock broker/dealers have a substantial regulatory risk which is both financial and personal to those engaged in such business.

The securities business is subject to detailed government regulation and exchange self-regulation as well as communications media attention. Infractions are subject to discipline, arbitration, criminal prosecution, and civil lawsuit. Publicity may accompany most such actions, although exchange self-regulatory enforcement actions are likely to remain private where a not guilty determination is reached or where the infraction is minor.

Enforcement actions have a high potential for member customer business loss, monetary loss, and even viability. Dramatic examples are the U.S. examples of Drexel Burnham and Princeton Newport going out of business.

Runs on members by other broker dealers hastening to close out contracts and refusing to enter new contracts are not unusual when certain types of regulatory actions start. Ivan Boesky and Ronald Li are well known examples of prison sentences for individuals who took extreme regulatory risk.

With growth of the Exchange there appears to have been little activity in rule making and enforcement. Some new rules have never been circulated to the membership or public. Existing regulations are in 20 different documents without any integrating manual or index.

One result is that government through the Security Council is rapidly constructing a body of regulation which over time is likely to be less knowledgeably administered and less flexible to changing securities industry conditions than exchange self-regulation would be. Regulatory risk is thus being increased for members, their employees and agents.

The exchange is presently searching for a staff member to concentrate on self-regulation of members, supplementing the present staff specialist in listed company regulation. Several consultants during the last two years have recommended areas of self-regulation which deserve implementing exchange action. Certainly communication on self-regulation should be improved through publication of regulatory proposals for comment before adoption, and through a manual integrating all securities regulations in an organized manner, and through cooperation with the Securities Council.

**RECOMMENDATIONS:** A framework for a regulation manual is suggested at the beginning of the recommended rules section of this report.

Exchange member surveillance employees being hired should preferably have backgrounds in investigative accounting and securities markets. Their initial attention should be on possible trading abuses and financial surveillance through regular reporting and field examination. Orientation by a foreign surveillance expert in Sri Lanka is likely to be more effective than visits to other exchanges.

Exchange surveillance staff should be insulated from undue influence by Brokers. For this purpose, the Exchange Executive Committee should be composed at least half of non-brokers, exchange employees should not be hired by the Executive Committee but by a strong Chief Executive, and periodic reports by the surveillance staff should be made on significant investigations to the Securities Council.

### Conflict of Interest Risk

An assignment for this project was to develop guidelines where CSE members have affiliated companies involved in quoted companies secretarial services, margin trading, unit trusts, investment management or other services closely involved with stock market activity in general. These guidelines were desired to deal with reporting requirements, separation of business, director/employee disclosure and share (or unit trust) market participation limitations.

Approach to these questions is circumscribed by the Securities Council Act's prohibition at 31 of a broker or any affiliate acting as a dealer.

Two weeks ago in response to widespread perception not formally substantiated that there were practices violating this provision of the Act, the Securities Council issued rules clearly stating that members may not execute any trades, even to execute unsolicited orders, in listed securities in which they "have an interest," that personnel and close families of members may not trade through their own firms, but can through other firms, and that members shall report to the exchange the names of all parties to all margin trading accounts.

These rules are consistent with the Act but are likely to have little practical effect in preventing possible abuses of concern. Our experience is that trading in potential conflict of interest situations is better controlled against abuse by regulated openness than by gross prohibition.

Proposed rule 605 is designed to neutralize the negative effect of requiring member personnel and affiliates to place security orders through other brokers. It requires written permission of an employee to open a securities account with another entity and duplicate account statements to be sent to the employer. It binds the member executing such orders as well as the employer member.

**RECOMMENDATION:** With the regulatory positions already taken, the only effective release for business flexibility appears to be repeal of the restrictive provision in the Act against dual broker/dealer functions. This will doubtless depend on the CSE demonstrating a capacity for surveillance and enforcement of the underlying potential abuses such as frontrunning customer orders, insider trading, and price manipulation.

### Capital Adequacy Risk

Exchange conduct rule 13 requires monthly reports to the CSE and SC of statements of "assets and liabilities, net capital, and aggregate indebtedness" but there are no such reports at either agency and the requirement is not further defined. This rule was adopted by the exchange executive committee on September 15, 1989. As a part of this project a draft questionnaire for this purpose has been prepared for the Exchange which will need amendment as experience is gained with member capability of supplying the information.

There is no Exchange requirement for minimum capital of a member at admission or later.

Securities Council Rule 25 required a member to have issued and paid up capital of not less than Rs 500, 000 but compliance with this rule is not apparent from annual audited financial statements required to be filed by members with the Council. There are no filings for several firms recently reorganized as corporations solely in the brokerage business because they have not been in

business long enough to have a required audit. Rule 25 has been omitted from a revision by a government drafting attorney, perhaps because capital requirements by Securities Council rule are not specifically authorized in the enabling Act.

Further the SC rule would not seem to prevent the erosion of total capital below the Rs 500, 000 figure by negative retained earnings.

Out-of-date statements currently on file show several members with negative net worth - an excess of liabilities over assets. They remained operational by means of unsubordinated loans and advances from affiliated companies and bank overdrafts. These accommodations are apparently callable without notice and some are collateralized by fixed bank accounts and property or guarantees of affiliated parties.

Capital adequacy of each member is a primary protection to exchange members as they are not permitted to make a business decision on trading with other particular members, but must accept contracts for large amounts which are open to market risk for up to three weeks or more. In the past, financial responsibility judgment of the exchange and its members has been abrogated to banks through dependence on bank guarantees as a substitute for capital liquidity. This may be acceptable for backing up completion of open exchange contracts, but not for protection of customers whose property is held by members, or of general creditors.

Under Sri Lankan bankruptcy law, customer property held by members has no priority for return to customers, instead customers would share pro-rata with other creditors such as banks writing security guarantees or granting overdrafts, and affiliated companies making advances. There is no legal certainty that a parent or affiliated company will assist a member in sudden financial trouble. Indeed it may be a fiduciary duty of such parents and affiliates to deny any assistance in exercising their fiduciary obligation to their own shareowners. Members with negative equity and not meeting capital liquidity requirements clearly should not be continued as exchange members.

The CSE Articles of Association 17-18 require two types of deposit with the exchange. The first of Rs. 40,000 by a new member is a guarantee for observance of the Articles, subject to refund by the Executive Committee without definition.

The second is a security deposit which varied until recently from Rs 250,000 to 1 million depending on the date of entrance and full or associate member status. This article was changed on December 19, 1989 to conform to a recommendation of the CSE to SC substantially implemented in a decree by the Minister also requiring a deposit with the exchange pursuant to Part III d of the brokers' registration application. Both requirements may be met by market value of government securities transferred to exchange name, or bank guarantee.

The Minister has decreed and the exchange article now provides that such security shall vary between a minimum of Rs 500,000 and a maximum of Rs 1,500,000 with variation between these figures computed at 0.5% of annual turnover (in contract values). Actual deposits in 1989 were Rs 6.1 million based on 1988 rupee volume of 380 million but protecting transactions in 1989 of Rs 225 million. The average open value of contracts in 1989 is estimated to have been about Rs 23 million. The 1989 volume produced a 1990 deposit requirement totaling Rs 6.3 million but turnover values in 1990 during the first nine months were about Rs 1.4 billion. Thus bank guarantees were protecting open contracts about 7 times as large as the base on which the guarantees were calculated. The 1990 volume will result in a far larger deposit requirement in 1991 which is almost certain to be a lower volume year than 1990.

Obviously a once a year variation in contract value protection in a highly volatile financial business creates excess protection and member cost in slow markets, and insufficient protection in active markets.

**RECOMMENDATION:** The recommended rule exhibits attached (701, 704) suggest exchange rules which would require both net capital and security deposits which would fluctuate with volume and the risks of each member's business. At times, the new exchange requirements would be less than the present overriding Securities Council rules, at other times the Exchange capital requirements would be greater than those of the Council.

The security deposits could be met by bank guarantees but the liquid capital requirements would be met by a minimum positive capital equity reduced by assets not readily converted to cash and allowances for market risk in conversions to cash. Provision is made for members now relying on advances from affiliated companies and bank overdrafts to convert such financing to subordinated debt acceptable for capital purposes.

### Related Bank Guarantee Problems

According to the exchange form of guarantee document, the bank guarantees are callable by the exchange to the extent of liabilities which become due and payable by the member under the by-laws of the exchange. The guarantees are not subordinated to the claims of other creditors. They are acceptable as security up to their expiration date for debts not claimed before the expiration date. There is no renunciation of the right of bank set-off of such guarantee payment against other assets held by the bank for account of the member. Indeed the bank guarantees typically are collateralized by specific assets of the Member or its affiliates or guaranteed by third parties.

Thus the guarantees are evidence of liquidity for a going concern, protecting against market risk in delayed completion of open exchange contracts, but are not insulation against loss resulting from a failing member for customers and other creditors.

CSE Article 18 specifies that the required security is applicable to payment of monies due to the exchange, other members or clients as determined by the exchange executive committee. Use of the guarantee to replace missing securities is not mentioned. The guarantee form required, however, is broad enough to cover replacement if delivery of securities were a rule requirement of the Exchange. Rules of the exchange may be considered by-laws. Trading floor rule 10.3 creates obligations to deliver securities and pay sums due through the clearing house and to pay fines for related lateness. There is no requirement for transactions between two customers of the same broker to be entered into the clearing house. Although SC rule 19g requires share certificates to be sent to buyers, a guaranteeing bank might deny payment to replace missing securities of customers.

Possible third priority use of deposits to assist customers of a failing member should be retained as protection from the proposed Compensation Fund will assist only customers with limited values in accounts.

The primary purpose of these security deposits is for completion of Exchange contracts of a defaulting Member. It would therefore be logical to transfer such security to the Central Depository System (CDS) when it becomes operational. Bank participation in CDS may also motivate transfer of the deposit to a CDS fund.

After such transfer, it might become legally difficult to sustain use of any remainder of the security deposit to meet unsatisfied obligations to the Exchange itself or customers. Further, the Act now

requires that such a deposit be "lodged" with the Exchange. Therefore, while the Act remains as is, the deposits should remain with the Exchange, subject to a contract with CDS when it begins operation giving a priority claim to losses on clearing open contracts of a defaulting Member.

In addition as recommended in my report of December 29, 1989 on implementing a Compensation Fund for Sri Lanka and amendments then drafted for CSE Article 18(i), advice of competent bankruptcy counsel should be obtained on how best to insulate such security deposits from classification as assets of the general estate in bankruptcy, and particularly whether use of the fund for meeting exchange and customer claims should be dropped in order to strengthen maintenance of the security deposit for completion of contracts only.

Provision should also be made in related Exchange rules and a contract with CDS that any deficiency in completing contracts of defaulting Members will be met by assessment of other members pro-rata to their security deposits at the time of default.

**RECOMMENDATION:** The draft rules would correct the deposit problems (704) by invalidating any guarantee with less than two months to run (thus encouraging earlier renewals or extensions), would subordinate claims of the guaranteeing bank to claims of customers, would clarify that the bank has no right of set off against other member assets it might hold other than those specifically pledged and would remove any question as to whether the guarantee could be used to protect contracts entered on the exchange but not processed through the clearing system and would establish priorities for use of called deposits. Net losses on close outs of exchange contracts of failing members would be charged pro-rata to other members based on their security deposit requirements.

Retention of the Security Deposits as an Exchange Fund after the Central Depository System is activated is recommended rather than transferring the fund to the CDS in order to provide breadth in use of deposits and because the Act requires such a Fund to be lodged with the Exchange, providing that bankruptcy counsel supports this approach.

#### Customer Funds Bank Accounts Risk

Business Conduct Rule 11 was formally adopted on September 15, 1989 by the exchange executive committee. It requires deposit of customer moneys in bank accounts separate from those of the firm's operating accounts.

However as noted above, there is no priority in bankruptcy for funds in such a separate account to be returned to customers - instead as presently constituted such funds would be part of the bankrupt's general estate. There is no provision in a contract with the bank protecting such customer funds from diversion into the general estate or set off against other unsatisfied obligations of a defaulting Member to the bank.

Further, there is a very serious cost problem as the rule is presently written. The similar American rule permits moneys of customers with credit balances to be used to finance fully collateralized debits of other customers. The CSE rule does not. Members do not seem to have perceived that their rule in effect prevents their paying from the customer bank account the net money amount of a settlement when some customers have not yet paid for their purchases. Instead the CSE rule mandates the firm financing all customer failures to pay before settlement or extension of credit on margin accounts.

**RECOMMENDATION :** The September 15, 1989 rules should be amended (as in 703) to permit customer credit balances to finance other customer fully collateralized debits and then enforced. The proposed rule 703 would also establish legal integrity of the required customer bank accounts as customer property, improving priority distribution to customers under provisions of the Compensation Fund amendments being prepared by the Securities Council.

### Conditions of Sale Risk

The "Conditions of Sale" bye-law of the exchange creates an obligation of a selling broker to remit proceeds to the seller after delivery of valid documents, under proper circumstances to pay over dividends, rights and the like to beneficial owners. There is no obligation under exchange rules to deliver securities to buyers, but there is under SC rule 19g.

It is not clear under exchange rules that brokers once having made a floor contract on behalf of a customer are obligated to pay proceeds or deliver securities timely to the customer, whether or not the contract is completed and settled with the contra broker.

There is no provision in exchange rules for borrowing securities against cash collateral for the purpose of making timely delivery on shares not timely delivered by selling customers or otherwise.

**RECOMMENDATIONS:** Draft rules attached clarify the obligation of a broker to his customer when the contra broker does not perform (202). Provision is also made for borrowing of securities against cash collateral to facilitate timely deliveries (309, 717).

### Credit Extension (Margin) Risk

CSE and SC have no separate rules for conduct of margin (credit extension) accounts. One member carries margin accounts. The affiliate of another does so.

Credit extension on securities collateral is a major business in many countries for exchange members. It is usually less attractive for banks because of their lesser facility in handling frequent changes in securities ownership, staying current with collateral adequacy, etc. Instead, banks prefer to make loans to brokers collateralized by customer securities but protected also by the capital and margin management expertise of the broker. Brokers loan rates to customers above their rates on borrowings from banks provide an attractive income.

But from a risk standpoint, margin lending should not be permitted to become leverage competitive, i.e. to compete for margin business by the percentage of credit extended on securities collateral. Failure to regulate margin required can lead to severe risks such as that which was a basic cause of the 1929 market crash when credit extended by brokers competitively was 90% of market value. These risks are threats not only to the firms extending credit, but are also sometimes the cause of failures which cause loss to other firms. The major failure of an NYSE member firm in the 1987 market break was from a credit extension.

In the U.S. margin lending is regulated at several levels. The Federal Reserve Bank on behalf of government determines margin which must be posted with brokers, banks and other finance organizations for any new purchase, and further prohibits customer violation of such standards. The exchanges regulate the amount of margin which must be maintained in such accounts by members and affiliated entities if market values decrease. Other countries have similar rules.

**RECOMMENDATION:** Sri Lanka should have prudent regulation of margin business. CSE should provide such regulation (311) for its members and the affiliates. This jurisdiction to affiliates can be provided either by requiring affiliates engaged in any phase of the securities business to be approved by the exchange and in compliance with exchange rules, or requiring members to sever affiliation with any entity engaged in margin lending not meeting exchange rule standards. The former approach is used in the recommend rules attached (403, 405).

### **Risk of Theft, Employee and Agent Fidelity**

Perhaps the most difficult risk to control for a securities firm is that of employee dishonesty. In Sri Lanka as noted above, that risk extends also to agents which in some cases can be indemnified by employers of the sub agents.

The methods of minimizing losses from employee dishonesty are legion. They start with careful employee pre-employment investigation, alert supervision, physical security measures, specialized audit techniques, frequent security counts, money reconciliations, etc.

In many countries employee fidelity insurance is available at reasonable cost. It is usually required by exchange rule as failures arising from employee infidelity can cause losses to the rest of the member community.

**RECOMMENDATIONS:** There are numerous provisions in the attached draft (403, 406, 503, 601, 602, 712, 802) to minimize risk of employee fidelity. In addition, the exchange should investigate the feasibility of required insurance for members (718). A group policy may help reduce cost and increase availability. If insurers become convinced that exchange requirements significantly reduce the possibility of fidelity losses.

**Audit confirmation of customer accounts, perhaps including mailing of customer security statements by CDS rather than members.**

### **Risks Related to "Agents"**

The suggested rule revisions (401ff) adjust to the recent approval of "agents" of members who do not themselves be registered broker/dealers.

The responsibility accepted by CSE members for such agents go far beyond that general in other countries. It appears to run to liability for unsuitable or misleading recommendations of securities, thefts of money or securities never forwarded to the member, forgeries of customer instructions, etc.

No obligation is currently imposed on such agents to be subject to the rules of the Exchange including the conditions of sale.

**RECOMMENDATIONS:** The proposed rule additions would impose qualification requirements (401ff) for agents similar to those proposed for sales employees.

members. The rules would encourage members to protect themselves by a contract with the agent or its employees (403). Agent and employees handling securities orders would be required to sign an agreement to be subject to exchange rules (403).

### **Opportunity Risk in CSE Functions**

Exchanges worldwide recognize that their social function goes beyond mere trading of securities, extending also to promoting standards of good business conduct among members and listed companies, representing their constituencies of brokers, listed companies and investors with government, post trade processing, and both professional training and public education on securities ownership.

Some of these functions appear underdeveloped by the Colombo Stock Exchange and thus constitute opportunity risks.

The growth in volume of CSE trading has not been accompanied by equal attention to promotion of good business conduct, strengthening support for favorable government policy toward the private sector, or a campaign for expansion of securities ownership. There has been progress in current development of post-trade processing.

Indeed there is some indication that the areas of under attention are already generating negative perceptions of and business inhibitions for the exchange and its members.

**RECOMMENDATIONS - Suggestions for minimizing loss of opportunity in these areas are made in the sections below.**

#### **1. CSE Governance**

It is very common for stock exchanges to be viewed as "clubs" acting as cartels in the interest of broker members, stifling competition from new entrants to the brokerage business. Perception that brokers intercede ahead of customer orders is also very widespread whether or not exchange rules prohibit trading by members. Government and institutional owners of securities eventually become counter-forces in curbing broker control through regulation and negotiated commissions.

During the past 20 years, developed exchanges have taken the 1971 advice of William McChesney Martin, first full time chief executive of the New York Stock Exchange and 17-year chairman of the U.S. Federal Reserve Board: that exchange governance should be by a body balanced between listed companies and investors as well as brokers.

Such governance has clarified an exchange voice as a spokesman for securities ownership, and indeed modified the advocacy of exchanges to a clearer expression of public interest rather than broker interest. It has blunted the perception that brokers can take advantage of customers without penalty. It has resulted in favorable working relationships between exchanges and capital markets authorities of governments.

The government of Sri Lanka in legislating its Securities Council has recognized the wisdom of broad business representation in council membership for this agency. The Colombo Stock Exchange economically is highly dependent on listed companies who pay more than half of the exchange operating expense. Members derive nearly 100% of their revenue from investors and listed companies.

**RECOMMENDATION** - A primary recommendation of this project (101) consequently is that the Colombo Stock Exchange provide for governance by a Board composed only half of members, and the other half representatives of listed companies, institutional and individual investors of their attorney and accounting professional representatives. This consultant observed the New York Stock Exchange for 15 years under a broker dominated Board and 20 years under a balanced board. The balanced board clearly was an advantage to the exchange and its members as well as listed companies, investors and the public interest.

## 2. Good Business Practice

Exchange members are peculiarly subject to loss of confidence (and loss of business) in the entire membership arising from abusive practices or financial failure of any member. Examples abound: Singapore's simultaneous failure of 10 firms in 1985, New York's paper work crisis of 1968-70, Paris' scandals of the late 1980's, Hong Kong's response to the 1987 market break.

Further, exchange members may suffer crippling losses or "domino effect" failure from open contracts with another failing member.

Exchange members therefore are usually more aggressive and efficient self-regulators than government. This self-interest is reflected in detailed codes of conduct, capital rules, and enforcement. In comparison with other exchanges, there are large gaps in Colombo's self-regulatory rules and practices.

**RECOMMENDATION** - This project through the attached rule additions suggests filling critical gaps in CSE rules by proposing specific rules which are briefly listed at the end of the Summary to this report.

## 3. Post trade Processing

The Colombo Stock Exchange is developing an advanced trade clearance and depository system which will put it in the forefront of developing stock exchanges in post-trade settlement.

CSE members should also look forward to their own future mushrooming costs of computerization. Development of computerization by the exchange for individual firm usage could substantially reduce future member cost in comparison to each firm developing its own system and the constant change in such systems that growth in volume and variety of future business will necessitate.

**RECOMMENDATION** - The exchange and its members should form a committee to look into further centralization of post trade processing functions, such as a common computer system for processing customer accounts, a data base for securities analysis, a mailing facility, etc.

## 4. Promotion of Shareownership by Sales Force Growth

A reality of the securities business is that savers do not buy securities without education, that "securities are sold not bought." It follows that salesman face-to-face educators must be trained and supported by a variety of media devices.

Centralization of these training and promotional efforts is highly economic in a developing securities industry. Indeed some aspects of such promotional centralization remain highly effective for a developed exchange.

Initiative in this area has been taken by the Securities Council, the effective Westpac training program, and a soon to be launched media campaign, largely financed by USAID and the Asian Development Bank.

The ISTI report on securities education and the continued occasional availability of the head of the Dublin Stock Exchange expert in this field for consultation are available to the exchange for defining its major role in this continuing program.

**RECOMMENDATION - The Exchange should form a committee to plan its role in training of sales personnel, media promotion, and centralized educational campaign direction. A full time exchange officer for promotional planning and execution should be a future objective.**

## 5. Commissions

CSE fixed commissions are somewhat lower than rates for average transactions in many other countries, they are fixed maximums and minimums rather than minimums only as in other countries, and they lack common marketing features.

Commission rates ordinarily vary with the value of the transaction and the number of shares as a reflection of the work involved. For very small transactions, there is usually a minimum which may be below cost as an accommodation. Small trades within the normal range are likely to be about 2% of the value. The percentage of commission ordinarily decreases as the number of round lots and values traded increase. The percentage on institutional size blocks is sometimes as small as a fraction of 1% or a few cents per share.

In unusual cases, such as negotiation of unlisted securities trades or extensive efforts to find contra customers for large block buys or sells, the commission may be permissible in the 2-5% range. Primary or secondary distribution compensation is substantially higher than commission rates.

There are variations for fairness and marketing purposes, such as volume rates for large transactions, very small trade minimum rupee rather than percentage rates, round turn reductions for the second side of trades open only for a short period of time, common sales account rates for employee stock purchases and sales in their own company plan, service fees for such matters as transfer of private transactions, custody of inactive accounts, assistance in claims for lost securities, etc.

Bond transactions are ordinarily in greater dollar amounts per unit than shares and bond commissions consequently are ordinarily less.

Commission rates should be high enough to support the promotion and education which the investing public of the country needs, with adequate incentive to brokers. At the same time, they should be low enough and sufficiently varied by values and work involved to give investors a sense of fairness. As an economy becomes developed, commissions may become negotiated, but fixed commissions are appropriate in communities where policy to encourage the growth of capital is more important than competitive lowering of the cost of investing.

**RECOMMENDATION: CSE should consider a more varied minimum commission schedule and supplement its rule by a clearer prohibition of rebates (211).**

## 6. Exchange Finance

The surveillance, educational and promotional activities desirable as continuing activities of the Exchange represent potential operating costs. Financing of the Exchange has been insufficiently explored in this study but deserves analysis.

The annual fees of listed companies taken alone appear very modest in relation to service to their shareholders and the companies themselves. But in total, these fees were 62% of 1989 Exchange income. Should they nevertheless be increased to help finance improved Exchange regulation and markets?

With the 1990 increase in volume, are broker fees reflecting their improved ability to contribute to Exchange operating cost? A major component of developed exchange financing is a percentage of commissions charged by Members. Should an increase in fixed commission rates be devoted to financing surveillance and education, both by firms directly and through the Exchange?

**RECOMMENDATION: Exchange fees should be increased to support functions vital to market integrity, member compliance with regulation, and market growth.**

## Publication of Sri Lanka Securities Regulations

Securities regulations for Sri Lanka now appear in 20 different documents in different formats with different numbering systems. Some have never been published to all members and the public. Compliance with regulation is thus severely inhibited by exchange members, their employees and agents and listed companies. Education of professionals and customers is also handicapped.

Further, properly presented exchange rules constitute contractual terms between customers, brokers, and contra brokers.

Organization in ten sections by subject matter is recommended, with a consecutive numbering system allowing 100 numbers for each of the ten sections, which would result in unused numbers in each section for future use.

The ten sections would be:

1. Organization and Governance
2. Registration and Listing of Securities
3. Exchange Trading
4. Settlement of Contracts
5. Qualification of Members, Agents and their Personnel
6. Ethical Conduct
7. Supervision of Customer Accounts
8. Financial and Operational Responsibility
9. Discipline
10. Arbitration

The following recommended additions and amendments to regulation are presented in that 10-section organization format. The rule numbers used in the following list of course should be changed in the completed manual to place all regulations within a section in a logical sequence.

Four indexes to the existing 20 different regulatory documents and proposed new rules were presented in Volume 3 of this report as prepared in Sri Lanka.

USAID/Sri Lanka at the conclusion of the on site visit authorized the preparation in the U.S. of such a "Consolidated Sri Lanka Securities Regulations" book. The indices to the finished volume will vary from the original.

## Colombo Stock Exchange, Recommended Rules November 8, 1990

### Section One - Organization and Governance

**P1. Governance** - *(This concept to be substituted as appropriate for differing provisions of Articles 47-50 of CSE Articles of Association)* Governance of the Exchange shall be by a Executive Committee of between 6 and 14 persons elected by majority vote of the membership composed half of Chief Executives of Members, and the other half representatives of listed companies and individual and institutional investors, each category in such proportion as determined from time to time by the Committee, plus a Chief Executive Officer elected by the Committee who shall not be associated with a Member or listed company or other financial institution. The Committee may elect a Chairman and Vice Chairman of the Committee from among its number, but if so these offices shall rotate in alternate years between a representative of Members and a representative of Non members. Each Executive or Nominating Committee Member not associated with a Member shall be deemed to have agreed to uphold the rules of the Exchange.

Other Additions to CSE Articles of Association

**P2. Corners** - Whenever in the opinion of the Committee, a corner has been created in a security, the Committee may postpone the time for delivery or direct

the settlement of such contracts by payment of money at a fair settlement price agreed to by the parties or determined by the Committee after giving an opportunity to all interested parties to be heard.

**P3. Liability for Use of Facilities** - The Exchange shall not be liable for any damages sustained by a Member growing out of the use of or enjoyment by such Member, its employees, representatives, and customers for the use of the facilities afforded by the Exchange to Members for the conduct of their business

**P4. Nominating Committee** - The Executive Committee shall appoint a Nominating Committee for a two year term, representative of the constituencies of the Exchange in the same proportion as that for the Board. Current Executive Committee members shall be ineligible for this committee. The Nominating Committee shall solicit suggestions for nominees to the Executive Committee, and select nominees for the next annual election of the Executive Committee and to fill the unexpired term for any vacancy occurring on the Executive Committee between elections. The Committee insofar as possible shall provide for orderly rotation of one third of Executive Committee members at each election. Nominations may also be made by petition

of 10 or more Members, or 10 or more institutional investors, or 10 or more individual investors for vacancies in those categories of Committee membership.

**P5. Committee Members term of office** - Committee Members shall be elected for two year terms and shall be ineligible to serve as such for more than six consecutive years.

**P6. Chief Executive Officer** - The Chief Executive Officer shall be responsible for the management and administration of the affairs of the exchange and shall be the official representative of the Exchange in all public matters. He may appoint such officers, (other than the Chairman or Vice Chairman of the Executive Committee), other employees of the exchange, counsel and expert or professional advisers as he may determine are required for the efficient management and operation of the exchange and fix their duties, responsibilities, terms and conditions of employment and termination of employment.

## **Section Two Registration and Listing of Securities**

**P101. Approval for Listing** - The Executive Committee shall approve Listing and Delisting of Securities for trading based on their finding that

1. There are or are not sufficient securities outstanding, security values, and security holders to support an auction market in the trading style of the Exchange
2. The issuer enters into a Listing Agreement as prescribed by the Exchange and continues to comply with such agreement.

**P102. Proxies** - Whenever a person soliciting proxies shall furnish a Member with a) copies of all soliciting material which such person is sending to registered holders, and b) satisfactory assurance that he will reimburse the Member for all

out-of-pocket costs incurred, including reasonable clerical costs, such Member shall transmit to each beneficial owner of stock in its possession and control the material furnished.

The Member shall transmit with such material either a) a signed proxy indicating the number of shares held for such beneficial owner, a symbol identifying the proxy with the Member's proxy records, and a letter concerning the importance of being represented at the meeting, or b) a request for voting instructions and an explanation of whether the Member may vote the shares without instructions under the conditions following. After a reasonable time with no response from the beneficial owner, such shares may be voted by the Member if there is no known contest or action to be taken at the meeting or authorization for merger, consolidation or any other matter which may affect substantially the rights or privileges of such stock.

**P103. Listing Agreement** - Listing Agreement: - Any issuer applying for listing of its securities on the Exchange shall enter into an Agreement in the following form, but nothing in the Agreement shall be construed to require the issuer to do any acts in contravention of law or in violation of any regulation of any public authority exercising jurisdiction over the issuer.

Listing Agreement

\_\_\_\_\_ (hereinafter called the issuer), in consideration of the listing of the securities covered by this application, hereby agrees with the Colombo Stock Exchange (hereinafter called the Exchange), as follows:

1. Any notification or report required to be made to the Exchange in this agreement will also promptly be publicly announced.
2. The issuer will promptly notify the Exchange of
  - a) any change in the general character or nature of business.

- b) any changes of principal officers or directors.
- c) any disposal of any property or any stock interest in any of its subsidiary or controlled companies if such disposal will materially affect the financial position of the issuer or the nature or extent of its operations.
- d) any change in, or removal of, collateral deposited under any mortgage or trust indenture under which securities of the issuer listed on the Exchange have been issued.
- e) within ten days after the close of a fiscal quarter, in the event any previously issued shares of any stock of the issuer listed on the Exchange have been reacquired or disposed of, directly or indirectly, for the account of the issuer during such fiscal quarter, such report showing separate totals for acquisitions and dispositions and the number of shares of such stock so held by it at the end of each quarter.
- f) all facts relating to the purchase, direct or indirect, of any of its securities listed on the Exchange at a price in excess of the market price of such security prevailing on the Exchange at the time of such purchase.
- g) any action by it or by others which becomes known to it which will result in the redemption, cancellation or retirement, in whole or in part, of any of its securities listed on the Exchange.
- h) action taken to fix a stockholder's record date, or to close the transfer books, for any purpose (and will take such action at such time as will permit giving the Exchange at least ten business days notice in advance of such record date or closing of the books.
- i) any diminution of the supply of stock available for the market occasioned by deposit of stock under voting trust agreements, if any knowledge of such actual or proposed deposits should come to the official attention of officers or directors of the issuer.
- j) if it changes its independent public accountants regularly auditing the

books and accounts of the issuer, with the reasons for such change.

3. The issuer will furnish to the Exchange on demand such other information concerning the issuer as the Exchange may reasonably require.

4. The issuer will file with the Exchange:

- a) four copies of all material mailed by the issuer to its stockholders with respect to any amendment or proposed amendment to its certificate of incorporation.

- b) a copy of any amendment to its certificate of incorporation, or resolution of directors in the nature of an amendment, certified by competent authority.

- c) a copy of any amendment to its by-laws, certified by a duly authorized officer of the issuer, as soon as such amendment shall have become effective.

5. The issuer will publish at least once a year and submit to its stockholders at least fifteen days in advance of the annual meeting of such stockholders and not later than three months after the close of the last preceding fiscal year of the issuer:

- a) a balance sheet as of the end of such fiscal year, and a surplus and income statement for such fiscal year for the issuer as a separate entity and of each other entity in which it holds directly or indirectly a majority of the equity, or in lieu thereof, eliminating all intercompany transactions, a consolidated balance sheet of the issuer and its subsidiaries as of the end of the last previous fiscal year, and a consolidated surplus statement and a consolidated income statement. If any such consolidated statement shall exclude entities a majority of whose equity stock is owned directly or indirectly by the issuer:

- i) the caption of, or a note to, such statement will show the degree of consolidation.

- ii) the consolidated income account will reflect, either in a footnote or otherwise, the parent company's

proportion of the sum of, or difference between, current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of the report; and

11) the consolidated balance sheet will reflect, either in a footnote or otherwise, the extent to which the equity of the parent in such subsidiaries has been increased or diminished since the date of acquisition as a result to profits, losses and distributions. Appropriate reserves, in according with good accounting practice, will be made against profits arising out of transactions with unconsolidated subsidiaries in either parent statements or consolidated statements. Such statements will reflect the existence of any default in interest, cumulative dividend requirements, sinking fund or redemption fund requirements of the issuer and of any controlled entity, whether consolidated or unconsolidated. Such statements shall be in the same form as the corresponding statements contained in the listing application in connection with which this listing agreement is made, and shall disclose any substantial items of unusual or non-recurrent nature. Issuers shall publish either quarterly or mid-year statements of earnings on the basis of the same degree of consolidation as in the annual report. Such statements will disclose any substantial items of unusual or non-recurrent nature and will show either net income before and after income taxes or net income and the amount of income taxes.

b) the number of its shares of stock issuable under outstanding options at the beginning of the year; separate totals of changes in the number of shares of its stock under option resulting from issuance, exercise, expiration, or cancellation of options; the number of shares issuable under

outstanding options at the close of the year, the number of unoptioned shares available at the beginning and the close of the year for the granting of options under an option plan, and any changes in the exercise price of outstanding options through cancellation and reissuance, or otherwise, except price changes resulting from the normal operation of anti-dilution provisions of the options.

All financial statements contained in annual reports or proxy statements to shareholders will be audited by independent public accountants qualified under the laws of Sri Lanka and in conformance with Sri Lanka generally accepted auditing practice, and will be accompanied by a certificate made by them with respect to their audit of such statements showing the scope of such audit and the qualifications, if any, with respect thereto.

6. The issuer will not select any of its securities listed on the Exchange for redemption otherwise than by lot or pro rata, and will not set a redemption date earlier than 15 business days after the date the issuer action is taken to authorize the redemption.

7. In case securities to be issued are in temporary form, to order permanent engraved securities within thirty days after the date of listing.

8. The issuer will make application to the Exchange for the listing of additional amounts of securities listed on the Exchange sufficiently prior to the issuance thereof to permit action in due course upon such application. The issuer will not make any change in the form or nature of any securities listed on the Exchange, nor the rights and privileges of the holders thereof, without giving twenty days' prior notice to the Exchange of the proposed change, and having made application for the listing of the securities as changed if the Exchange shall so require.

9. The issuer will use its best efforts with any large holders to make reasonable amounts of stock available for loaning purposes on the Exchange if at any time such need should develop.

10. The issuer will not make, or permit any subsidiary controlled by it to make, any substantial charges against capital surplus without notifying the Exchange and if so requested by the Exchange submitting such charges to stockholders for approval or ratification.

11. The issuer will not make any substantial change, nor permit any controlled subsidiary to make, any substantial change in accounting methods, in policies as to depreciation and depletion or in bases of valuation of inventories or other assets, without notifying the Exchange and disclosing the effect of such change in its next succeeding interim and annual report to its stockholders.

12. The issuer will maintain a) at least two members of its Board of Directors or similar governing body who are not officers or controlling persons, and b) an audit committee of its Board with a majority of its members not officers or controlling persons.

13. The issuer will maintain in the City of Colombo in accordance with Exchange requirements:

(A) an office or agency where:

- a) the principal of and interest on all bonds of the issuer listed on the Exchange shall be payable and where any such bonds which are registerable as to principal or interest may be registered
- b) all stock of the issuer listed on the Exchange shall be transferable.
- c) Checks for dividends and other payments with respect to listed stock may be presented for immediate payment
- d) Scrip issued to holders of listed securities and representing a

fractional interest in a listed security will be accepted for such purpose.

e) Listed convertible securities will be accepted for conversion, and

(B) a Registrar where listed stock of the issuer shall be registerable. Such Registrar shall be a bank or Trust Company not acting as Transfer Agent for the same security.

14. The issuer will not appoint a transfer agent, registrar or fiscal agent of, nor a trustee under a mortgage or other instrument relating to, any listed security without prior notice to the Exchange. The issuer will not a) appoint a registrar for its listed securities unless such registrar at the effective date is qualified with the Exchange as a registrar or b) select an officer or director of the issuer as a trustee under a mortgage or other instrument relating to a listed security

15. The issuer will maintain a sufficient supply of certificates to meet the demands for transfer. If stock certificates do not recite the preferences of all classes of its stock, it will furnish to stockholders on request and without charge a printed copy of such preferences.

16. The issuer will not issue any common ownership shares without voting rights and all such shares shall have an equal vote

17. The issuer will solicit proxies for all meetings of shareholders.

18. The issuer will publish immediately to the holders of any listed securities any action taken by it with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of listed securities, and will give prompt notice to the Exchange of any such action; and will afford such holders a proper period within which to record their interests and to exercise their rights, and will issue such rights or benefits in form approved by the Exchange and will make the same

transferable, exercisable, payable and deliverable in the City of Santo Domingo.

19. The issuer will issue new certificates for listed securities replacing lost ones forthwith upon notification of loss and receipt of proper indemnity. In the event of the issuance of any duplicate bond as a replacement and subsequent appearance of the original in the hands of an innocent holder, either the original or the duplicate bond will be taken up and cancelled and the issuer will deliver to such holder another bond theretofore issued and outstanding.

20. The issuer will pay when due any applicable listing fees established from time to time by the Exchange

Agreement to be dated and signed for the issuer by an duly authorized party

### **Section Three – Trading**

**P201. Change of Ownership** – An orally agreed trade between authorized trading attorneys of Members on the Exchange constitutes a binding contract pursuant to the rules of the Exchange. Ownership of the traded securities changes at the time of such agreement, with all the rights and privileges of that security as approved for trading by the Exchange at that time, subject to close out on default by either party.

**P202. Member Responsibility to Customers** - Members are responsible to their customers for completion of open trades whether settled with contra members or not.

**P203. Crosses (Parcels)** - Members holding orders to purchase and sell the same security at the same price (a possible cross or parcel), shall announce their intention to the trading session and shall satisfy offers to buy or sell at better prices before executing the cross.

**P204. Auction Order Priorities** - Customer orders shall always have priority for execution at the same price

over orders of Members, their employees and immediate families.

**P205. Customer Order Priorities** - Each customer order shall be recorded by a Member in writing with the time and date received. Priority of execution shall be given by Members to customer orders in the same security at the same price in accordance with a system approved by the Committee. The presently approved alternative systems are:

(1) Executions at the next trading session shall be in the que order of time received. Limited price orders which become executable shall be entered into the que at their entry time.

(2) All customer orders held by a Member at the time trading opens shall be given parity, sharing in proportion to the size of each order in the total executions of such member in that trading session up to the total of such orders at the average price for such orders executed by the Member. Limited price orders held by the Member as such trading opens shall be included in the allocation to the extent that they would have been individually executable during such trading. Customer orders received after trading opens shall be que by time and executed after the Member completes executions of orders on the same side of the market held at the opening as in (1).

**P206. Discretion by Trading Attorneys** - Member attorneys participating in an auction shall be prohibited from exercising discretion for customers except for time and price. Orders as transmitted to the Auction should not disclose the identity of the Customer.

**P207. Cash or Delayed Delivery Transactions** - All transactions shall be for settlement at the settlement date fixed by the Committee unless made for cash or for a stated delayed delivery date. Cash transactions are for settlement on the same day.

**P208. Erroneous Reports** - The price at which an order was executed and

locked in shall be binding notwithstanding the fact that an erroneous report in respect thereto may have been rendered.

**P209. Records of and Changes in Orders** - Every order shall be recorded in writing at the time received, including the name and amount of the security, the terms of the order, the time when received, the time when transmitted, whether agency or principal, and the time at which any cancellation or execution report is received, and the name or designation of the account for which the order is to be executed. No change in the account name or designation shall be made unless authorized in writing by a principal executive officer of the member who shall be personally informed as to the essential facts relative thereto.

**P210A. Securities Definitions** - The term "security" or "securities" shall have the common meaning of stocks, bonds and similar financial instruments.

The term "stock" includes voting trust certificates, certificates of deposit for stocks, rights, warrants, and other securities of a type classified for trading as stocks by the Exchange.

The term "bond" includes debentures, notes, certificates of deposit for bonds, debentures or notes and other securities of a type classified for trading as bonds on the Exchange.

**P210B. Permissible types of orders** - Cash - a transaction for settlement the same day between brokers directly.

Regular Way - a transaction for settlement on the Settlement Date as established by the Board. Any default in settlement by a broker creates a new contract for a fail-to-deliver vs. a fail-to-receive.

Delayed delivery - a transaction fixed by contract of the parties for settlement

directly between brokers at a date later than regular way settlement.

Market - an order to timely buy or sell a specific quantity of a security at the best price available in the exchange market pursuant to the procedures of the exchange.

Limit - an order to buy or sell all or part of a specified quantity of a security at a stated limit price or better as soon as possible pursuant to the procedures of the exchange.

All or None - An order to buy or sell a specific amount of a security larger than one trading unit simultaneously and not partially - but the total may be to more than one broker.

Not-held - An order to buy or sell all or part of a specific amount of a security using the broker's judgement as to timing, and not holding the broker responsible to acquire or dispose of the maximum quantity for which without timing judgement he might compete in the market.

Long - a sale of a security owned.

Short - A sale of a security not owned but to be delivered by a security borrowed.

**P210C. Not-held prohibition** - A market maker in a security shall not accept a not-held order in the same security in which he is making a market. A dealer shall not execute an order for account of the member or associated or related party while holding a not-held order for a customer in the same security.

**P117. Commissions** - The commission to be charged on brokerage transactions in securities traded on the Exchange shall be not less than the rates established by the Exchange from time to time without any rebate, return, allowance or discount in any shape or manner whatsoever or by any method or arrangement direct or indirect or by any bonus, percentage or portion of a commission, and no

remuneration shall be given, paid or allowed by or on behalf of a Member directly or indirectly to any person for business sought or secured for any Member, except as follows:

- a) to Agents on transactions for their customer accounts but not for own account - up to 50% of the non-member commission.
- b) to employee representatives of the Member for their customer accounts, but not for own account, up to 40% of the non-member commission.
- c) to other Members by whom customer advice, order soliciting or servicing, execution, settlement or carrying of a customer account is performed, such division of commission as is mutually agreed.

Confirmations of qualified transactions to non-members shall be rendered with the full amount of non-member commission and any permissible discount allowed shown separately.

Required Minimum Non-Member Rates - To be established by CSE. See prior discussion under Commissions.

**P212. Short Sales** - Members shall not accept or execute orders to sell securities not beneficially owned by the seller (short sales). (Note- When with growth of the market, this rule is changed to permit short selling, it should be replaced by rules requiring every order to be marked as short or long, prohibiting short sales accelerating a declining market, and requiring margin for short sales. Provisions for borrowing to make delivery are in Rule 721)

#### **Section Four - Settlement of Contracts**

**P301. Introduction of Accounts** - A member who does not wish to have custody of customer funds and securities, to clear and settle exchange contracts, or otherwise carry customer accounts may contract with another member to carry its

customer and proprietary accounts on a disclosed and confidential basis and to settle all transactions entered into on the exchange. Such a member may execute transactions on the exchange or engage the carrying member to do so. Transactions self-executed shall be given up to the carrying member for settlement. The introducing member shall be responsible for investment advice, accuracy of receipt and transmission of orders, other services to its customers and compliance with securities regulations in its servicing of customer accounts.

The carrying member shall receive, deliver and maintain custody of all customer and proprietary securities and cash, shall confirm transactions to each party promptly, shall render statements of account as required by these rules, shall effect transfers, claim dividends and other distributions, and otherwise have responsibility for proper conduct of each account. Where a single customer has transactions introduced by different brokers, separate accounts shall be maintained.

If an introducing member as a convenience to a customer accepts securities or moneys from, or transmits securities or moneys to a customer, such property shall be transmitted to the receiving carrying member or customer on the same day.

The carrying member shall confirm transactions and render statements indicating that the account is introduced and serviced by the introducing member and carried by the carrying member. The respective functions shall be explained to each customer at the opening of the account in a form of letter approved by the Committee which shall explain the respective functions and responsibilities for at least the following: a) opening, approving, and monitoring of accounts, b) extension of credit, c) maintenance of books and records, d) receipt and delivery of funds and securities, e) safeguarding of funds and securities, e) confirmations and statements, f) acceptance of orders and

execution of transactions. g) Investment information and advice.

Introducing members shall be financially responsible to the carrying member for the completion of any contract entered by the introducing member on the Exchange, and for timely payment of monies or delivery of securities by introduced customers, and for any lack of fidelity or other loss caused by its personnel or agents. The carrying member shall be financially responsible to customers for the functions specified for carrying members above and for any lack of fidelity by personnel of the introducing member or its agents in delivering securities or moneys entrusted for delivery to or from the carrying firm.

Each introducing member shall maintain on deposit with the carrying member such sum as mutually agreed as a guarantee against its obligations.

**P302. Self-Carrying of Accounts -** With the approval of the Committee upon showing of appropriate financial and operational capability, a Member may carry its own and introduced customer accounts, and settle exchange transactions.

**P303. Settlement Date -** Transactions made regular way shall be recorded in customer accounts and delivered or recorded as delivered between the Members executing the transaction on a settlement date fixed by the Committee. Settlement date on transactions for cash shall be same day, and for delayed delivery as agreed at the transaction. All contracts in securities falling due while the transfer books of such securities are closed shall be settled on the opening of the books.

Any Member failing to meet its obligations at a settlement in an amount not larger than its deposit in the settlement fund shall be suspended from making any transactions other than liquidating transactions at subsequent trading sessions until such obligation is satisfied for failing to meet its obligations in an

amount larger than its deposit in the settlement fund, a Member shall be deemed insolvent.

**P304. Good Delivery and Reclamation -** The seller of securities is responsible for the genuineness and complete regularity thereof and a security which is not valid or is not in proper negotiable or transferable form shall be replaced forthwith by one which is valid and is in proper negotiable or transferable form.

A security with an irregularity which has been delivered may be returned or reclaimed on a settlement date through the settlement after notice has been given to the other party at least one day prior to the settlement. The party to whom the irregular security is being delivered shall substitute a like security in good delivery form or pay the current market value thereof and be deemed to be failing to deliver. Securities with title called into question, reported to have been lost or stolen, or the transfer of which is prohibited or restricted by law or government action shall also thus be returned to the party originally introducing the certificate to the market. Securities partially called may be returned to the party holding such certificate at the time it ceased to be a good delivery.

**P305. Assignments -** A registered security as a good delivery shall be accompanied by a proper assignment executed either upon the certificate itself or on a separate paper for each such certificate. When the name of a party has been inserted in such an assignment as assignee, a power of substitution shall be signed in blank by such party. When the name of a party has been inserted as substitute in such a power of substitution, a new power of substitution shall be executed in blank by such substitute party.

Any alteration or correction in an assignment, power of substitution or other instrument shall be accompanied by

an explanation of the original instrument, signed by the party executing the same.

The signature on such documents shall be technically correct, i.e. it shall correspond with the name written upon the certificate in every particular without alteration or enlargement or any change whatsoever, except that in the case of a firm "and" or "&" or "Company" or "Co" or "Co." may be written either way.

Certificates shall be good delivery only if in a form and with authorizations as required by Rule 156 and for transfer under the laws of the country of jurisdiction.

*Standard forms used for Assignments and Substitutions are published by the NYSE following its Rules 225 and 259.*

**P306. Signature file** - The Exchange shall maintain an authorized signature file of persons authorized to sign for Members and others frequently delivering securities. Parties registering with the signature file shall submit legal documents authorizing the signature(s) to be used and thereafter shall promptly notify the Exchange of any changes in such authorizations with proper documentation for any replacement signature(s). The Exchange shall make available reproductions of the authorized signatures for Members carrying accounts and others having a legitimate interest for a reasonable fee.

**P307. Delivery Against Payment** - Delivery of securities sold or payment for securities purchased may be delayed until the exchange of money and securities in good delivery form can be made in the instance of accounts prohibited by law or national practice from paying or delivering without receipt of value, but interest shall be charged for related financing.

**P308. Closing of Obligations** - When a Member is found insolvent by the Exchange, other Members holding open

contracts with such insolvent member shall without unnecessary delay close out such contracts unless the Board orders a deferment.

Application may be made to the Exchange for temporary deferment of close-out for unusual circumstances and unsuccessful efforts to borrow and if the Exchange finds that a fair market in which to close the contract is not available but no such deferment will relieve the party in default from any resulting damages.

A Member receiving notice that a contract is to be closed out shall immediately retransmit such notice to any other Member from whom the securities involved are due, and a subsequent close out against the contra Member shall also close out against the retransmitted Member. Any money difference resulting from a contract closing shall be specified in immediate statements to contra and retransmitted Members and shall be paid at the next settlement.

When a loan of money is not paid before the end of the day upon which it becomes due, the borrower shall be considered in default and the lender may, without notice, sell sufficient of the securities pledged therefore to liquidate the loan.

**P309. Borrowing and Lending Securities** - Every reasonable means to borrow securities in order to make delivery on open contracts shall be employed by members. Members shall not lend or borrow any security to or from any non-member except pursuant to a written contract or confirmation providing at least for: terms for the simultaneous transfer of securities against money or equivalent collateral and the reverse thereof on demand or a date certain and liquidation rights to the Member in any event of insolvency by the non-member.

**P310. Signature Guarantee** - Signatures authorizing transfer of securities shall be guaranteed by the

the carrying Member.

**P311. Credit (Margin)** – A Member or Approved Person may extend credit to an account collateralized by readily marketable values in such account pursuant to the rules of the Exchange or such more stringent standards as determined by the Member or Approved Person

Interest shall be charged on any balance unpaid by settlement date in either a regular account or a credit account.

No Member shall permit a customer or employee to make a practice of meeting payment obligations by liquidating the same or other security or delivery obligations by buying the same security

Credit accounts shall have a minimum equity of Rs 20,000 (*An amount sufficient to discourage credit purchases by customers who should not afford risk*)

Minimum equity for a new purchase in a credit account shall be at least 50% of the values to be in the account after the purchase. Whenever values in a credit account decline to a 35% equity, the customer shall be called to restore the equity to at least 40%. Values shall not be allowed in an account for this purpose which exceed for each security that amount which can be readily liquidated at a discount of 10% from the market price.

Whenever a person extended credit on securities fails to meet a call for equity, sufficient securities shall be sold out at the next trading session to bring the account into compliance with the above requirements unless the Exchange on application of the responsible Member finds that a fair market would not be maintained

No Member or Approved Person shall arrange for the extension of credit on securities at better terms than such Member or Approved Person can offer pursuant to Exchange rules

**P312. Partial Deliveries** – In instances where for good cause a Member may be unable to deliver the full amount of shares executed in a transaction on settlement date, partial delivery in round lots shall be accepted. (Also see 309)

## **Section Five – Qualification of Members, Brokers, Dealers, Principal Officers, Employee Representatives, Agents, Agent Representatives, Trading Attorneys, Approved Persons**

**P401. Approvals** – Each Member, principal officer, trading attorney, employee representative, agent, or agent representative of a member, and each other person required to be approved shall meet the qualification standards of the Exchange and be approved in the capacity applied for.

**P402. Members** – The Committee shall not approve a corporation as a Member and a corporation shall not continue as a Member unless:

- a) each director of such corporation, each person who controls such corporation, and every person which engages in a securities or kindred business and is controlled by or under common control with such corporation is an approved person
- b) every principal executive officer, every person who is an employee designated to trade on the Exchange, and every person who solicits and services securities business as an employee representative, agent or agent representative is approved by the Exchange as such.
- c) The Board of Directors of such corporation designates its principal executive officers who shall exercise senior principal responsibility over the various areas of the business of such corporation in such areas as the rules of the Exchange may prescribe, including operation, finance and

credit, compliance with law and rules, sales, underwriting, research and administration.

- d) The corporation, its officers, employees, representatives, agents, agent representatives and approved persons agree to comply with applicable rules of the Exchange as they exist or may be amended in the future.

Control Prevention - Whenever an approved person of a Member fails or ceases to be so approved, the Member shall promptly redeem or convert to a fixed income security such of its outstanding voting stock as to terminate that party's ability, if any, to exercise controlling influence over the management or policies of such Member

For this purpose, each certificate of incorporation of a Member shall contain provision authorizing the Member to redeem or convert to a fixed income security all or part of the outstanding voting stock owned by any person required to be approved by the Exchange who fails or ceases to be approved as may be necessary to reduce such party's ownership of voting stock below that level which enables such party to exercise controlling influence over the management or policies of such Member

If the certificate of incorporation provides that a stockholder may compel redemption, it must provide that without the prior written approval of the Exchange, the redemption may only be effected on a date not less than six months after receipt by the Member and the Exchange of a writeten request for redemption given no sooner than six months after the date of original issuance of such shares or any predecessor shares.

Prohibitions - Without the written approval of the Exchange, no Member shall:

- a) reduce its equity or debt capital other than by loss or amend its charter, certificate of incorporation, or by-

laws. The Exchange may at any time in its discretion require the Member to restore or increase its capital or surplus, or both.

- b) issue any fixed debt in a form qualifying as capital of the Member.  
c) amend, modify or cancel any agreement made by it or any of its stockholders relating to the management of the Member or the issue or transfer of securities of the Member.  
d) redeem or repurchase any shares of its stock on less than six months notice given to the Exchange not less than six months after the original issuance of such shares or any predecessor shares, and shall notify the Exchange if any redemption or repurchase is postponed because prohibited by this rule.  
e) issue stock except for cash or such other consideration as the Exchange determines will not impair the financial responsibility and operational capability of such Member.

**P403. Principal Executives, Officers, Trading Attorneys, Employee Representatives, Agents or Agent Representatives** - The Exchange shall not approve persons as principal executives, officers, trading attorneys, employee representatives, agents, agent representatives or individual Members unless satisfied that:

- a) the applicant has honestly submitted application information as required and is of legal age.  
b) the applicant is of good business reputation and integrity  
c) the applicant meets such other requirements as the Securities Council or Exchange may establish from time to time as to sponsorship, experience in the securities or equivalent business, written or oral examination of knowledge, or otherwise, and  
d) such person in writing agrees to comply with the rules of the Exchange as they exist or may be amended.

The terms "employee representative, agent, agent representative" refer to persons engaged in the solicitation of orders for the purchase or sale of securities or similar instruments for the accounts of customers or members or in the solicitation of management investment service on a fee basis by a member. Members are responsible to customers without limit for the acts of such persons in conduct of securities business, but may be indemnified by contract with agents for any losses arising from the conduct of agents or their agent representatives.

P404. Changes - A Member shall promptly give notice to the Exchange in writing of:

- a) The death, discharge, retirement or other termination of association of any person who required Exchange approval, together with the reasons therefore.
- b) dissolution of the corporation
- c) any material change in the stockholding of any approved person
- d) any proposed change in the directors or principal executives
- e) any proposed change in the charter, by-laws or other documents on file with the Exchange, or
- f) any failure to comply with all the conditions of approval specified in P201

Each approved person shall promptly notify his Member of any material acquisition or disposition of stock of the Member

P405. Approved Persons - The Board shall not approve persons otherwise required to be approved unless they satisfy the conditions of sections a), b) and d) of the first paragraph of P403

P406. Investigation Authorization - Each person required to be approved by the Exchange in any capacity shall authorize in writing the Exchange and any agent to conduct an investigation of my character, credit worthiness, ability, knowledge, business activities, educational background, previous

employment and reason for termination thereof. I authorize and request any of my former employers and any other person to furnish to the Exchange and its agents any information they may have concerning me in those respects and I hereby release each such employer or person from any and all liability of whatsoever nature by reason of furnishing such information to the Exchange and its agents. I recognize that I will be the subject of an investigative report ordered by the Exchange and acknowledge that I have been informed of my right to request information from the Exchange concerning the nature and scope of the investigation requested."

P407. Employees of Members - The Exchange may require any information to be furnished by any employee or registered representative of a Member, or by any Member concerning such a person to permit it to enforce compliance with Exchange rules. The Exchange may discipline any such person or disapprove his/her employment by a Member.

Employee Investigation - Members shall make a thorough inquiry into the previous record and reputation of persons whom they contemplate employing, including at least personal conversations with employers during the prior three years.

Employee Records - Members shall obtain before employment, maintain as changes occur during employment, and preserve for at least three years after termination of employment the following information for each employee and employee representative, agent or agent representative.

- a) name and address.
- b) starting date of employment and dates of promotions or approvals to new responsibilities.
- c) educational institutions attended with dates and whether graduated.
- d) complete consecutive record of business connections for the prior ten years, including reason for leaving each, and whether full or part time.

- e) any denial of approval for membership, registration or otherwise or any disciplinary action or injunction or any finding that he was a cause of a disciplinary action or injunction in any securities, financial or kindred business
- f) any arrest or indictment for any felony or misdemeanor, except minor traffic violations
- g) any other names by which he has been known or has used,
- h) whether any surety bond has ever been denied, revoked or surety paid because of such person
- i) a recent photograph at employment and at ten year intervals thereafter.

**P408. Acceptability Hearings** - The Exchange may disapprove the application of a prospective Member or of any person required to be approved by the Exchange, or any change in status of such a person requiring Exchange approval after being given the opportunity to be heard by an Acceptability Committee pursuant to this rule.

Any applicant being considered for disapproval shall be furnished with a written memorandum setting forth the pertinent information relevant to the applicant's acceptability, including specific grounds for disapproval under consideration, at least 15 calendar days before an Acceptability Committee is to consider the matter. The applicant shall have an opportunity to reply in writing and to appear before the Acceptability Committee and present any relevant information or witnesses.

An Acceptability Committee shall consist of three persons designated by the Chief Executive Officer, not excluding himself, from the officers and executive staff of the Exchange and members of the Executive Committee. Each Acceptability Committee shall designate one from among themselves as Chairman. The decisions of a majority of the members of an Acceptability Committee shall be final, except subject to appeal as otherwise provided.

## **Section 6 - Ethical Conduct**

**P501. Good Business Practice** - Every Member and each employee, agent and agent representative of a Member shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs, and shall act in a manner consistent with enhancing the welfare and reputation of the Exchange.

**P502. Other Employment** - Individual Members, and employees and employee representatives, agents and agent representatives of Members shall not create conflicts of interest with the business of their Member employer by other employment, or potential confusion by customers as to which employer is represented. For this purpose, any other employment by such persons shall be requested in writing and approved in writing: for Principal Executives of Members by the Exchange, and for employees and employee representatives, agents and agent representatives of members by such Member. Similar request and approval shall be required for any non-employee type of engagement in any other business, or compensation by others, or financial interest in any other securities, financial or kindred business.

**P503. Gratuities** - Except with the prior written consent of the employer, no Member, member employee or employee representative, agent or agent representative shall employ or compensate any person or give any gratuity to any principal, officer, or employee of the Exchange, its subsidiaries, the Securities Council, another Member, financial institution, news or financial information media, or non-member broker or dealer in securities, commodities or money instruments.

A gift of any kind is considered a gratuity. Records shall be retained for at least three years of all such gratuities and compensation for inspection by the

Exchange. When close relatives work in different financial organizations, gifts arising from the family relationship are not subject to this rule.

**P504. Reporting of Questionable Conduct** - Each Member shall promptly report to the Exchange whenever such member or any employee or employee representative, agent or agent representative:

- a) has violated any rule of the Exchange or any law or regulation (other than minor traffic violations) or has engaged in conduct which is inconsistent with just and equitable principles of trade or detrimental to the interests and welfare of the Exchange.
- b) is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery
- c) is arrested, arraigned, indicted, or convicted or pleads guilty or no contest to any criminal offense (other than minor traffic violations)
- d) is associated in any way with any financial organization disciplined by any jurisdictional organization or which is convicted of or pleads no contest to any felony or misdemeanor
- e) is the subject of any claim for damages or a defendant or respondent in any civil litigation or arbitration which has been disposed of by judgement, award or settlement for an amount exceeding (a significant amount in national currency).
- f) is disciplined by the Member by suspension, termination, withholding of compensation or fines in excess of (a significant amount) or any other significant limitation of activities for cause.

Each employee or registered representative, agent or agent representative shall promptly report to his/her employer the existence of any of the conditions specified in the prior paragraph

**P505. Guarantees and Sharing in Accounts** - No Member, employee or employee representative, agent or agent representative shall guarantee the payment of a debit balance in another person's account, or guarantee a customer against loss, or represent that the Member will guarantee a customer against loss, or take or receive or agree to take or receive a share in the profits or losses of any customer's account or transaction.

This rule does not prohibit participation in a joint account or investment partnership with the prior written consent of the Member. It does not prohibit the sharing in losses after the Member has established that the loss was caused in whole or in part by the action or inaction of such Member, employee or registered representative.

**P506. Misleading Names** - No Member shall do business under a name found by the Exchange to be misleading. No agent or agent representative shall represent that it is doing a securities business in any name other than that of the member represented.

**P507. Discretion** - No employee or employee representative, agent or agent representative of a Member shall exercise any discretionary power in a customer's account without the written authority of the customer and without first notifying and obtaining the approval of another person delegated by the Member with authority to approve the handling of such accounts. Every order entered on a discretionary basis must be so identified on the order at the time of entry. Such accounts shall receive frequent appropriate supervisory review by a delegated person who is not exercising such discretion pursuant to a written statement of supervisory procedures.

No employee or employee representative, agent or agent representative shall exercise and no Member shall permit the exercise of discretion in any customer's account to effect purchases or sales of securities which are excessive in size or

frequency in view of the financial resources of such customer.

The provisions of this rule shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed.

**P508. Rumor Circulation** - No Member or employee or employee representative, agent or agent representative thereof shall circulate in any manner rumors of a sensational character which might reasonably be expected to effect market conditions on the Exchange generally or in particular securities. Discussion of unsubstantiated information published by a widely circulated public media or the subject of broad inquiry within the financial community is not prohibited when its source and unsubstantiated nature are also disclosed. Report shall be promptly made to the Exchange of any circumstances which give reason to believe that any rumor or unsubstantiated information might have been originated or circulated for the purpose of influencing prices in listed securities.

**P509. Privacy of Regulatory Information** - The Exchange, Members, employees or employee representatives, agents or agent representatives thereof shall maintain the privacy of all financial and other competitive information obtained in their capacity as regulators and servicers of securities business, except in response to process of law or Exchange rule. Matters of such privacy which may merit attention of the Committee shall be first reported by the Exchange Chief Executive Officer to the Chairman or a designated Committee Member who is not representing Members for decision on the extent of such information to be reported to the Committee. Otherwise Committee Members are not entitled to access to private financial and competitive information obtained by the Exchange. This rule does not apply to communication

between Members concerning accounts introduced by one Member to another Member.

**P510. Communications with the Public** - Traditional standards of truthfulness and good taste shall apply to any form of communication by Members, their employees and employee representatives, agents or agent representatives. Specifically prohibited are:

- a) any untrue statement or omission of a material fact or communication which is otherwise false or misleading,
- b) promises of specific results, exaggerated or unwarranted claims,
- c) opinions for which there is no reasonable basis, or
- d) projections or forecast of future events which are not clearly labeled as such

Recommendations (even though not labeled as such) must have a basis which can be substantiated as reasonable. When recommending a purchase or sale or switch of specific securities, supporting information must be provided or offered. The market price at the time of recommendation is made must be indicated.

Disclosure shall be made (excluding extemporary interviews) in recommending purchase or sale of specific securities if the Member usually makes a market in such security or the transaction is to be on a principal basis with the Member, or the Member was manager or co-manager of the most recent public offering of the issuer, or if any director or principal executive of the Member or its employees preparing the communication have positions in securities or options of the issuer or is a director of such issuer.

Performance records or statistics of past recommendations or actual transactions of the Member shall be balanced and

- a) confined to a specific universe that can be fully isolated and circumscribed

and that covers at least the most recent 12-month period.

- b) include the date and price of each initial recommendation or transaction and end of period when liquidation was first recommended or effected. Such detail may be summarized, averaged or offered rather than provided provided that there is included the total number of items recommended or transacted, the number that advanced or declined and an offer of the complete information on request.
- c) disclose relevant costs and all material assumptions used for annualization.
- d) indicate general market conditions during the period covered and any comparison to an overall market indicator such as an index are valid.
- e) that the results presented should not and cannot be viewed as an indicator of future performance, and
- f) documents and working papers on which the record is based are retained for Exchange review for at least three years.

Projections and predictions must contain the bases or assumptions upon which they are made and offer the bases and assumptions of such materials used.

Comparisons with a Member's service, personnel, facilities or charges with those of others must be factually supportable

Dating of reports shall be appropriate with identification of any significant information which is not reasonably current

Sources shall be disclosed of communications not prepared under the direct supervision of the Member

Testimonials concerning the quality of investment advice must make clear that such statement may not be representative of the experience of other clients and is not indicative of future performance or success. If more than a nominal sum is paid for the testimonial, the fact that it is a paid testimonial shall be indicated. If

the testimonial concerns a technical aspect of investing, the person testifying must have knowledge and experience to form a valid opinion.

Exchange review of all or particular communications with the public by Members in advance of or following publication may be required by the Exchange.

**P511. Account Transfers** - Upon notice from a customer of his instruction to transfer his account(s) or the servicing of his accounts from one Member to another, such transfer shall be expedited by any carrying Member. Upon failure of prompt transfer upon application of any party and opportunity to be heard by all parties, the Exchange may direct the establishment of collateralized fails between the carrying parties.

**P512. Fair Corporate Financing** - Members shall not participate in any distribution of securities when the underwriting or other arrangements in connection with or related to the distribution, or the terms and conditions relating thereto, are unfair or unreasonable.

**P513. Free Riding and Withholding** - A Member and its associated persons shall not fail to make a bona-fide public distribution of a public offering which is expected to or does trade at a premium in the secondary market whenever such secondary market begins. Members and associated parties shall

- a) not continue to hold any such securities acquired by underwriting or otherwise in own account(s)
- b) not sell any such security to any person associated with any broker/dealer; or to any senior officer or person trading or brokering securities or influencing securities trading or brokering for any financial institution; or to any finder in respect to the public offering, or to any fiduciary to the managing underwriter

or the issuer such as attorneys, accountants and financial consultants; or any member of the immediate family of any such person to which such person contributes support; or to any broker/dealer, bank or other conduit without assurance that such purchase is not for such prohibited parties.

- c) except that sales are not prohibited to such parties where both the aggregate sold to such parties and the amount to each individual is insubstantial and not disproportionate as compared to sales to members of the public and in accordance with the normal investment practice of the purchasers.

**P514. Disclosure of Conflicting Interest** - Disclosure shall be made in advance of any transaction to any customer where a Member or associated person has a conflicting interest, including but not limited to

- a) instances where compensation is to be paid by the contra party  
b) instances where the broker is distributing or acquiring securities for a fee, or receiving a fee  
c) positions are held by the broker

## **Section Seven - Supervision and Control**

**P601. Business Supervision** - a) Each office, department or business activity of a Member shall be under the supervision and control of the Member establishing it and of the personnel delegated such authority and responsibility. Each person employed as an agent or agent representative and each office and department of an agent conducting any securities business shall be by contract subject to control and inspection of its securities business by the Member or the Exchange

The person in charge of a group of employees or employee representatives, agents and agent representatives shall reasonably discharge his duties and obligations in connection with supervision

and control of the activities of those persons related to the business of the Member and compliance with securities laws and regulations

b) The directors of each Member shall provide for appropriate supervisory control and shall designate a chief executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities law and regulation. This person shall:

- (1) delegate to qualified employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control.  
(2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.

c) The prior consent of the Exchange shall be obtained for each office established by a Member other than the main office, by a showing that proper supervision and financing for the office and business to be produced is available.

d) Qualified persons acceptable to the Exchange shall be in charge of any office of a Member, any regional or other group of offices, any sales department or activity. Any person who is a candidate for acceptability under this rule should have a creditable record as a registered representative or equivalent experience, and is to demonstrate in such other manner as the exchange may determine that he has the knowledge and competency to supervise the proposed activity.

e) the amounts and types of credit extended or guaranteed by a Member shall be supervised by employees qualified by experience for such control in the types of business for which credit is extended.

f) Duties of supervisors of employee representatives, agents and agent representatives ordinarily should include

at least approval of new accounts and review of correspondence of employee representatives, agents and agent representatives, transactions, and customer accounts. Appropriate records should be maintained evidencing the carrying out of supervisory responsibilities such as a written statement of the supervisory procedures currently in effect and initialing of correspondence, transactions, blotters or statements reviewed in the supervisory process.

g) Members shall provide for the supervision and control of each general ledger bookkeeping account and account of like function on the basis specified in P353.

**P602. Offices of Members** - shall be physically located or organized in such a way as to eliminate any confusion by customers as to the entity with which they are doing business.

**P603. Diligence as to Accounts** - Every Member is required through a principal executive or person designated under the provisions of P300 to

- a) Use due diligence to learn the essential facts relative to every customer, every order, every cash or credit account accepted or carried by or for such Member and every person holding power of attorney over any such account.
- b) Supervise diligently all accounts handled by employee representatives, agents and agent representatives of the Member
- c) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer. The person approving the account shall be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate approval in writing on a document which is part of the permanent records of the Member

For a credit (margin) account of a non-member corporation, definite knowledge should be had that the corporation has the right under its Charter and By-laws to engage in credit transactions for its own account and that the persons from whom orders are received are duly authorized to so act by the corporation. Copies of the corporate charter, by-laws and authorizations are advisable, otherwise the Member should file a signed memorandum of reasons for believing that credit transactions are legal and authorized.

For a cash account of a non-member corporation, the Member should assure itself through a principal officer of the corporation that the person entering orders has the authority to do so.

For an agency account, the name of the principal for whom the agent is acting and written evidence of the agent's authority should be obtained.

For estate and trustee accounts, Members should have counsel's advice as to documents to be obtained.

Information as to citizenship of a customer is an essential fact.

**P604. Designation of Accounts** - No Member shall carry or guarantee an account in the name of a person other than that of the customer, except that an account may be designated by a number or symbol provided that the Member has on file a written statement signed by the customer attesting the ownership of the account.

**P605. Employee Accounts** - No Member shall carry or guarantee an account or effect a transaction, without the prior written consent of the employer, in which an employee, agent or agent representative of another Member, or an employee of the Exchange, its subsidiaries or the Securities Council is directly or indirectly interested.

Duplicate reports and statements shall be sent promptly to the employer, attention of a designated principal executive, other than the interested employee.

No Member shall carry or guarantee a credit (margin) account or transaction, without the prior written consent of the employer, in which an employee of a financial institution or business is directly or indirectly interested.

No employee, agent or agent representative of a Member and no employee of the Exchange, or its subsidiaries shall open an account or enter orders for transactions with other Members, non-member broker/dealers or banks without the prior written consent of a principal executive other than himself designated to sign such consents, and shall arrange for duplicate confirmations and statements to be sent to such person.

**P606. Public Communications** - Any communication generally distributed or made available by a Member to customers or the public shall be approved in advance by a principal officer or other delegated person qualified for such supervision. Such communication includes but is not limited to advertisements, market letters, research reports, books, sales literature, electronic communications of like content, communications with or by means of the media, and wires or memoranda to branches, employees or employee representatives, agents and agent representatives which are shown or distributed to customers or the public. Letters containing investment advice or information by employee representatives, agents and agent representatives shall also be reviewed in advance of mailing by a competent delegated person.

Research reports are generally defined as an analysis of individual companies, industries, market conditions, securities or other investment vehicles which provide information reasonably sufficient upon which to base an investment

decision, and shall be prepared and then approved by different individuals competent for such preparation and the supervision thereof. Supervision may be by employees of the Member or part time competent consultants retained for that purpose. When in Sri Lanka securities analysis becomes a developed profession, the Exchange shall establish qualification standards for supervisory analysts and require approval of research reports by such persons. Basic analysis in research reports by a person without technical expertise in some areas of the report shall be co-approved by a product specialist so qualified.

For this purpose approval of the Exchange of specific arrangements shall be required for any office jointly occupied with any other business. Acceptable methods of differentiation of businesses in joint tenancy include ceiling high or partial walls with prominent signage at entrances, wearing of badges by employees, barring of any customers from the space, different telephone numbers, and no stationery or advertising showing both organizations.

## **Section Eight – Financial & Operational Responsibility**

**P701. Capital Required** - A Member introducing all accounts on a disclosed basis to the Settlement Agency shall maintain net worth of Rs 1 million.

A Member carrying customer or proprietary accounts and settling exchange transactions shall at all times maintain minimum net capital equal to the greater of Rs 1 million or 7 percent of aggregate debit items computed with the Formula for Determination of Reserve Requirements for such Members below. The 7% requirement shall be subject to adjustment by the Executive Committee as experience with this requirement is gained.

The term net capital means the net worth of the Member adjusted by

- a) adding or deducting unrealized profits or losses with all long or short security positions marked to their market value.
- b) excluding liabilities subordinated pursuant to a satisfactory subordination agreement approved by the Exchange.
- c) deducting fixed assets and other assets not readily convertible to cash such as real estate, furniture and fixtures, exchange fees not amortized; prepaid items, goodwill; unsecured or partially secured advances, loans, customer and other accounts; fixed bank accounts not callable (usable) within 10 business days, assets doubtful of collection.
- d) deducting the market value of all short security differences unresolved 14 days after discovery, and the market value of any long securities differences sold before adequately resolved less any reserves established therefore.
- e) Deducting for securities or money market instruments in the proprietary or other accounts of the Member 5% of the market value of any security issued or guaranteed by the government of Sri Lanka, 30% of the market value of any listed security up to the quantity which is readily marketable at a 10% discount, and 100% for all other securities (Lesser deductions will be allowed for securities accepted as adequate collateral by a bank at the percentage loaned by the bank, or where a ready market on a foreign Exchange and currency convertibility can be demonstrated).
- f) deducting the amount of cash required in each carried or guaranteed account of a customer, employee or registered representative needed to meet the maintenance requirement of the Exchange for credit extension accounts and outstanding five business days or more.

1. Amount of customers' money balances required to be held in separate bank accounts.

2. Moneys borrowed collateralized by customer securities.

3. Contract values of customer securities purchased by open exchange contract and funds not yet received from buying customer or securities not received in good delivery form from selling customer.

4. Moneys payable against customer securities loaned.

5. Market value of stock dividends, splits and similar distributions receivable outstanding more than 30 days.

6. Market value of securities in transfer more than 40 calendar days and not confirmed as in process by issuer or transfer agent during that time.

7. Unsecured and unsubordinated bank overdrafts and borrowings from banks or others.

8. Drafts or checks not yet reflected in any bank balances.

P703. Customer: Reserve Bank Account (Replacement for CSE Rule of Conduct #11. Separate Bank Accounts - Each Member carrying customer accounts shall maintain with a bank or banks "Special Reserve Bank Account for the Exclusive Benefit of Customers" and shall at all times maintain in such accounts cash or qualified securities totalling the cash held without lien for customers less such customer cash used to finance other customer's fully secured debt in respect to securities transactions.

"Qualified securities" means Sri Lankan government securities with a market value at least 105% of the sum they represent in such reserve bank accounts. "Cash held without lien" means cash held as credit balances in customer cash or

P702. Formula for Computing Aggregate Indebtedness - Add the following:

margin accounts which is payable to brokers for settlement of open contracts or payable to or withdrawable by customers for any reason. "Other customer's fully secured debt" means (a) debits in customer margin accounts secured as required in Exchange rules or such higher requirement as normally required by the member carrying an account, (b) for a maximum period of three days after settlement date, the contract value of securities purchases settled by the member but not yet paid by the purchaser, but excluding from both (a) and (b) debits of any customer whose securities are pledged directly or indirectly as security for any bank loan or otherwise.

Such reserve bank accounts shall be subject to written contracts with the holding bank(s) providing that the cash and/or qualified securities are held by the bank for the exclusive benefit of customers of the depositing entity and shall at no time be used directly or indirectly as a fixed deposit, security for a loan to, overdraft facility for, guarantee in favor of, or any other accommodation to the depositing member by the bank and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. The title of the account in the records of the bank shall indicate that it is a "Special Reserve Account for the Exclusive Benefit of Customers." All debit balances constituting "other customer's fully secured debt" upon collection or liquidation of collateral shall be deemed "Special Reserves for the Exclusive Benefit of Customers" in the event that the Security Council directs the Exchange to take over or appoint others to take over the customer property of a member.

**P704. Security Deposit** - Each member shall maintain on deposit with the exchange the larger of the amount required by either (A) or (B) following:

(A) Such amount as required by Section 17, Part II(e) and Section 18, Part III(d)

of the Securities Council Act No 36 of 1987 and Section 18(11) of the Articles of Association of the Exchange. (Currently 0.5% of the annual turnover of a member during the prior calendar year with a minimum of Rs 500,000 and a maximum of Rs 1,500,000). Annual turnover is the total value of buy and sell side contracts, separately included, executed on the exchange to buy or sell securities.

(B) 5% of the second highest total value of open buy and sell side contracts, separately included, at the close of business on the day prior to any settlement day during the prior three months, as determined at the close of business at each month end and effective as a requirement on the fifth business day of the next month. The 5% figure shall be subject to adjustment by the Executive Committee as experience with this requirement is gained.

Any guarantee from a bank deposited as such security in a form required by the Exchange shall not satisfy the security deposit requirement when it has less than two months to expiration or extended expiration, but shall not be withdrawable until its termination date.

Any bank guarantee qualifying as a security deposit shall be supplemented by a copy of any document collateralizing or guaranteeing any sum called by the exchange. No pledge of a separate bank account for customer funds or excess collateral in a loan secured by customer securities shall be acceptable.

(The present form of guarantee required by the exchange shall be amended to: a) provide that the bank has no right of set off against member assets it may hold other than those specifically pledged, b) subordinate claims of the guaranteeing bank to all claims of customers.)

The priorities for use of any called security deposit shall be to satisfy (a) net losses if any on close out of open exchange contracts, (b) debts to the exchange, (c) unsatisfied obligations to customers, in

that order. If a failing member's security deposit is insufficient to satisfy net losses in any close out of open exchange contracts, then the balance of net losses on close outs shall be charged to other members pro-rata to their then required security fund deposit. When the Central Depository System becomes operational, the exchange shall agree by contract with the Depository that the security deposits held by the exchange will be collateral for losses on close out of open exchange contracts of any defaulting member. (See discussion in report for review of this provision by bankruptcy counsel.)

**P705. Subordinated Capital** - Loans of to a Member may be subordinated to the claims of all creditors through a form supplied by the Exchange of an agreement for cash or secured demand note collateralized by securities, and requiring Exchange approval in order to be credited as capital of the Member. Such subordinations by others than principal executives and approved persons of the Member shall not exceed 70% of total capital allowed as the net worth of the Member in computation of capital for a period of not longer than 90 days or such longer period as the Exchange upon application of the Member determines to be in the public interest or for the protection of investors.

For the purpose of increasing a Member's protection of customers and the Settlement Agency, a Member may enter into subordination agreements which are not allowed as good capital, placing at the risk of the business margin accounts, securities, collateral in excess of face value of secured demand notes, personal accounts, and the like. Such subordinations must be in a form acceptable to and filed with the Exchange and shown separately in financial statements and similar documents.

*NYSE forms of subordination are available for adaptation to the law of Sri Lanka.*

**P706. Capital Withdrawal** - No equity capital may be withdrawn by action of a stockholder or through payment of dividends or other distribution, nor may any loan be made to a stockholder or employee or registered representative if, after giving effect thereto and to any other such withdrawals, advances, loans, and any payment or payment obligations under satisfactory subordination agreements which are scheduled to occur within six months following such time, either its net capital should fail to equal 150% of that required.

**P707. Capital Decline** - A Member shall forthwith notify the Exchange if its net capital after deduction of all capital withdrawals including maturities, if any, scheduled during the next six months falls below 150% of that required by Rule.

**P708. Special Capital Requirement** - The Exchange may at any time or from time to time with respect to a particular Member or all Members, or new Members prescribe greater net capital requirements than those prescribed by Rule, including more stringent treatment of items in computing net capital or net worth.

**P709. Restriction** - The exchange may restrict growth of business or require business reduction by a member whose net capital is less than 150% of its capital requirement by Rule, or for whom the deduction of capital withdrawals including maturities scheduled during the next six months would so result, or whose records of customer accounts and securities transactions are materially deficient in accuracy and currency.

**P710. Loan and Advance Restriction** - No drawing, unsecured or partially secured loans or advances of funds shall be made by a Member to any associated or approved party or parties associated with approved persons, except with prior written approval of the Exchange, when the Member's net capital is less than 150% of its capital requirement or the deduction of capital

scheduled during the next six months would so result, or the Exchange restricts the member organization.

Except with the prior written approval of the Exchange, a Member which has outstanding any such obligations by such parties shall forthwith reduce or eliminate such obligations from such borrowers or otherwise restore its net capital to the point where it is less than 150% of its capital requirement under P355 or the deduction of capital withdrawals including maturities scheduled during the next six months would so result, or the Exchange restricts the member organization.

**P711. Financing Arrangements -** No Member shall consummate a sale or financing arrangement intended to improve its capital computation before submitting related documentation to the Exchange for approval. Such events include sale and leasebacks of any assets, sale or factoring or financing of unsecured accounts receivable, loans by a bank upon collateral otherwise deemed not readily marketable, etc.

**P712. Reports to Exchange -** Members, agents and their employees shall submit to the exchange at such times as may be designated in such form and within such time period as may be prescribed such information as the exchange deems essential for the protection of investors and the public interest.

Each member shall file monthly with the exchange a report in a form prescribed by the exchange on its financial and operational condition, profitability and compliance with the capital and operational requirements of the exchange. Such report for the month of the member's annual audit by independent public accountants shall be audited and any adjustments reported to the exchange. The monthly reports shall be filed not later than the 15th of the following month. A member may be required to provide

financial and operational reports for its affiliated and subsidiary organizations.

A fee of a significant amount shall be paid for every day that any required report is overdue, unless a temporary extension is granted upon application at least three business days before the due date. Any report with material inadequacies will be deemed not filed.

**P713. Audits -** The Exchange may at any time require any Member or the Settlement Agency to cause an audit to be made by an independent public accountant of its accounts in accordance with requirements prescribed by the Exchange.

The annual audit report shall contain a Statement of Financial Condition, a Statement of Income, a Statement of Changes in Stockholder's Equity, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors. Said statements shall be in a format and on a basis which is consistent with such statements filed monthly with the Exchange. If a Statement of Financial Condition is not consolidated, a summary of financial data, including the assets, liabilities, and net worth or stockholder's equity shall be included for subsidiaries not consolidated.

Supporting schedules shall include for all Members a computation of required capital, and for Members carrying accounts and the Settlement Agency a computation for determination of reserve requirements, and information relating to the possession and control requirements and shall be filed with said report. A reconciliation shall be supplied, including appropriate explanations, for any differences in the capital and reserve computations separately filed by the Member or Settlement Agency.

**P714. Audit Requirements -** An audit shall be conducted by a certified public accountant who shall be in fact independent and who shall file an opinion covering the required statements. Attached to the report should be an oath or

affirmation by a duly authorized officer of the Member that the financial statements and schedules are true and correct and that neither the Member nor any officer or director has any proprietary interest in any account classified solely as that of a customer. The oath or affirmation shall be made before a person duly authorized to administer such oaths or affirmations.

The Exchange will recognize as a certified public accountant only persons duly registered as such under the laws of Sri Lanka and in good standing both with accounting professional societies and the Exchange.

**P715. Audit Objectives** - The audit shall be made in accordance with Sri Lankan generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results or operations, changes in financial position, the computation of capital, and, if any, the computation for determination of required security deposits and separate bank accounts and information relating to the adequacy of possession or control of customer securities.

The Scope of audit and review shall be sufficient to provide reasonable assurance of disclosure of any material inadequacies existing at the examination in the accounting system, internal accounting controls, procedures for safeguarding securities, and the practices and procedures followed by the Member (and related records) in making periodic computations of capital, security deposits, separate customer bank accounts, quarterly security counts and recordation of differences, in complying with the requirement for prompt payment for securities, and in obtaining and

maintaining physical possession or control of securities as required.

**P716. Technical requirements** - the accountant's report shall be dated, signed manually, indicate the city and other governmental jurisdiction where issued, and identify without detailed enumeration the statements and schedules covered by the report.

Representations in the audit report shall state whether the audit was made in accordance with Sri Lankan generally accepted auditing standards, whether the accountant reviewed the procedures followed for safeguarding securities, and designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular audit which have been omitted and the reason for the omission. (Permissive omission is not implied of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the required opinions).

Opinion of the accountant shall be clearly expressed in respect to the financial statements and schedules covered by the report and the accounting principles and practice reflected therein and as to the consistency of application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

Exceptions taken by the accountant shall be clearly and specifically identified and to the extent practicable the effect of each such exception on the related financial statements shall be stated.

Accountant's material inadequacy findings shall be filed with the Exchange by the Member simultaneously with the accountant's supplemental report on his review of this area since the prior audit, including corrective action taken or proposed, or stating that the audit did not disclose any material inadequacies.

*(Note - With the limitation of exchange members to brokerage only, it should be practical to shorten the deadline date for audit reports to approximately two months from audit date.*

Audit agreements between each Member and an independent public accountant in a form prescribed by the Exchange and dated no later than December 1 shall be filed with the Exchange no later than December 10 of each year covering the Member's annual audit for the following year.

Retention of all required documents of the audit and all pertinent working papers and memoranda shall be for at least three years, and available for review by representatives of the Exchange at the office of the Member or the Accountant.

**P717. Financial Statements to Customers** - Members and the Settlement Agency shall file with the Exchange and send to each person specified below the following:

Audited statements within 90 days of the required annual audit date including:

- a) a balance sheet with appropriate notes prepared in accordance with Sri Lankan generally accepted accounting principles.
- b) a footnote containing a statement of the amount of the entity's net capital and required net capital computed in accordance with Exchange rules and including summary financial statements of subsidiaries, consolidated when material, and the effect thereof on the capital required of the entity, and
- c) if the independent accountant commented on any material inadequacies, a statement by the Member that a copy of such report and comments is currently available for the customer's inspection.

Unaudited statements containing the similar information as of a date six months from the audit date shall be

furnished not later than 65 days after the as of date.

Persons specified to receive these statements are any person who has a claim for property or funds which is part of the capital of the Member or is subordinated to the claims of creditors of the Member, or with whom the Member has effected a securities transaction or carried or guaranteed a securities or money balance during the month before or after the balance sheet date.

**P718. Insurance** - The Committee may require Members to maintain such policy or policies of insurance as the Committee may consider desirable and available against losses caused by the dishonest acts of Member personnel and against losses caused by handling stolen and forged documents of title or securities or other defective instruments, providing such insurance is available.

**P719. Hypothecation of Customer's Securities** - No Member or employee thereof shall directly or indirectly hypothecate or arrange for or permit the continued hypothecation of any securities carried for customers under any circumstances that will permit:

- a) the commingling of securities carried for the account of any customer with securities carried for the account of any other customer without first obtaining the written consent of each such customer to such hypothecation.
- b) such securities to be commingled with securities carried for all accounts of any person other than a bona fide customer of such Member or Settlement Agency under a lien or loan made to such entity.
- c) securities carried for the account of customers to be hypothecated or subject to any lien or liens or claim or claims of the pledgee or pledgees for a sum which exceeds the aggregate indebtedness of customers on such day, provided that funds or securities in an amount sufficient to eliminate such

excess are paid or placed in transfer to pledgees for the purpose of reducing the liens or claims to which securities carried for the account of customers are subjected as promptly as practicable after such reduction occurs, but before the lapse of one-half hour after the commencement of banking hours on the next banking day at the place where the largest principal amount of such loans are payable and in any event before such entity on such day has obtained or increased any bank loan collateralized by securities carried for the account of customers.

The provisions of the prior paragraph shall not apply to hypothecation of securities carried for a customer in a cash account not yet paid for, provided that at or before the submission of the contract note to such customer, written notice is given or sent to such customer disclosing that such securities are or may be hypothecated under circumstances which will permit the commingling thereof with other securities carried for the account of other customers. *(Obviously this should be provided by legend on the back of the confirmation or contract note)*

**P720. Custody of Customer Securities** - Members shall promptly obtain and shall thereafter maintain physical possession or control of all customers fully-paid securities and all securities subject to lien in credit accounts in excess of 140% of the debit balances in such accounts. Violation shall not be deemed if solely as the result of normal business operations, temporary lags occur between the time when a security is required to be in possession or control and the time that it is placed in such status provided that the Member takes timely steps in good faith to establish such status

Any customer property given to an employee or agent shall be transmitted on the same day to the member carrying the customer account.

**P721. Borrowing Customer Securities** - Further, violation will not be deemed if the Member and a Securities Lender at or before the time of the loan, enter into a written agreement that at a minimum sets forth in a separate schedule or schedules the basis of compensation for any loan and generally the rights and liabilities of the parties as to the borrowed securities, provides that the Lender will be given a schedule of the securities actually borrowed at the time of the borrowing of the securities, and specifies that the borrower will provide the Lender on that day with collateral in cash, government bills or notes, or an irrevocable line of credit issued by a bank which fully secures the loan of securities, and that at the close of each successive business day the loaned securities will be marked to the market and collateral if insufficient restored to at least 100% by the close of the next business day

**P722. Control of securities** - shall be deemed to be effected when such securities are:

- a) in the custody or control of the Member, a custodian bank, or securities exchange, the delivery of which does not require the payment of money or value, and if the books and records of the Member identify the customers entitled to receive specified quantities or units of the securities so held for such customers collectively,
- b) subject of bona fide items of transfer not older than 40 calendar days or confirmed in writing to be in process by the issuer or transfer agent,
- c) held in such other locations as the Exchange shall upon application find and designate to be adequate for the protection of customer securities

**P723. Short Security Differences** - Buy-in shall be made of short security differences not resolved within 45 calendar days after the date of any required examination, count, verification and comparison of securities.

**P724. Securities Movements - Not later than the next business day, a Member shall determine from its books and records as of the close of the prior business day the quantity of securities required to be in possession and control actually and not in such possession and control. (Inactive credit accounts may be not less than twice weekly.) Deficiencies in securities in possession and control shall be corrected by ordering if there are securities of the same issue and class in any of the following non-control locations: from money borrowed collateral accounts movement within two business days, from securities loaned movement within five business days, from securities failed to receive for 30 calendar days a buy-in procedure or otherwise, from security dividend receivable or stock split or similar distribution not received for 45 calendar days a buy-in procedure or otherwise.**

**P725. Customer Security Deliveries on Sale -** If a member executes a sell order of a customer (other than an order disclosed to execute a sale of securities which the seller does not own) and if for any reason whatever the Customer has not deposited the security with the carrying entity within ten business days after the settlement date, the Member shall immediately thereafter close the transaction with the customer.

The Exchange will consider applications for extensions of time for buy-ins under this rule.

## **Section Nine - Discipline**

**P801. Access Prohibition -** Except as hereafter provided, the Exchange shall not prohibit or limit any qualified person from access to services offered by the Exchange or any Member without prior written notification with specific grounds and 15 days opportunity to be heard thereupon.

Summary discipline - The Exchange may summarily suspend a Member who is in

such financial or operational difficulty that the Exchange determines that the Member cannot be permitted to continue to do business as a Member with safety to investors, creditors, other Members, or the Exchange.

The Exchange may summarily limit or prohibit any person from access to services offered by the Exchange or any Member if the Exchange determines that such person does not meet the qualification requirements or other prerequisites for such access and that such person cannot be permitted to continue to have such access with safety to investors, creditors, Members, or the Exchange. Any person subject to such summary action shall be notified in writing of specific grounds for such action and promptly afforded an opportunity to be heard upon those grounds.

Whenever a Member fails to perform its contracts, becomes insolvent, or is in such financial or operating difficulty that it cannot be permitted to continue to do business as a Member with safety to investors, creditors, other Members and the Exchange, such Member shall promptly give written notice to the Exchange.

A party who does not pay any fine within 45 days after payable may after written notice be summarily suspended from association in any capacity with a Member.

Any suspended, limited, or prohibited person shall on request submit such books and records as to which it has access and furnish information or appear or testify or cause any employee to appear and testify before the Exchange. Any such person may be disciplined pursuant to rule for any offense committed before or after suspension, limitation or prohibition in all respects as if not so impaired. A Member suspended shall be deprived during the term of suspension of all rights and privileges of membership. Any suspension of an employee or registered representative shall create a

vacancy in any office or position held by such person. Any such person may be relieved from suspension, limit or prohibition by the Board.

**P802. Disciplinary Bases & Penalties** - If a Member, employee, registered representative, or approved person is adjudged guilty by a Hearing Panel in a proceeding pursuant to this rule of any of the following offenses, the Hearing Panel may impose on such party expulsion; suspension; limitation as to activities, functions and operations; fine; censure; suspension or bar from being associated with any Member; or any other fitting sanction, any of which may be remitted or reduced by the Panel on such terms and conditions as it deems fair and equitable. Offenses are:

- a) violating any provision of a governmental securities law or regulation, any agreement with the Exchange, or any rule of the Exchange.
- b) making a material misstatement to the Exchange.
- c) fraud or fraudulent acts.
- d) conduct or proceeding inconsistent with just and equitable principles of trade.
- e) acts detrimental to the interest and welfare of the Exchange.
- f) making or transmitting a fictitious bid, offer, or transaction or giving an order for the purchase or sale of securities the execution of which would involve no change of ownership (a wash sale) or executing or transmitting any such order with knowledge of its character.
- g) making any purchases or sales or offers of purchases or sale of securities for the purpose of upsetting the equilibrium of the market or bringing about a condition in which prices do not fairly reflect market values or assisting in making such transactions with knowledge of such purpose, or being with such knowledge a party to or assisting in carrying out any plan or scheme for the making of such transactions.
- h) having made a misstatement or omission of fact on an application for membership or approval, or on any

financial statement, report or other submission filed with the Exchange, or  
1) refusing or failing to comply with a request of the Exchange to submit books and records subject to access or control or to furnish information or to appear and testify before the Exchange.

An employee of a Member is liable to discipline and penalties for any act or omission of such Member as for his own personal act or omission.

**P803. Disciplinary Hearings** - Disciplinary consideration shall be by a Hearing Panel composed of a chairman appointed by the Board who is a disinterested director or employee of the Exchange or other qualified person and two disinterested peers of the defendant from a panel appointed by the Board and selected by the Chairman subject to two challenges by each party. The decision of a Hearing Panel by majority shall be final and conclusive unless appealed to the Board by either party.

The Chairman shall resolve any procedural or evidentiary matters without appeal, but shall not authorize the discovery or inspection of internal Exchange documents prepared in connection with the proceeding.

The specific charges against a respondent shall be served in a written Charge Memorandum signed by an authorized employee or other inquirer authorized by the Executive Committee of the Exchange, with service deemed effective upon personal delivery or by leaving at or mailing to the respondent's last business or residence address as reflected on Exchange records.

A written, signed Answer to the Charge shall be filed within 25 days of service or such longer period as approved by the Chairman, and shall indicate specifically which assertions of fact and charges in the Charge Memorandum are denied and which are admitted, with any specific facts in contradiction and any affirmative

defenses. Any assertions of fact not specifically denied may be deemed admitted and failure to file an Answer may be deemed an admission of facts asserted in the Charge.

The Panel Chairman shall determine the specific facts put into issue and with respect to those facts only, the Exchange and the respondent may produce witnesses and any other evidence and may examine and cross examine any witnesses so produced. Any failure by a respondent to Answer as required above shall limit consideration of any witnesses or other evidence to determination of the penalty to be imposed. A respondent who fails to file an Answer but appears at the Hearing shall not be permitted to produce witnesses, evidence or testimony, but the Hearing Panel may determine that the respondent had adequate reason to excuse his failure to file and adjourn the Hearing and direct the respondent to file a proper Answer.

After hearing witnesses and considering evidence, the panel shall consider whether the respondent is guilty of the Charges, and if so fix and impose the penalty or penalties, with written notice to the respondent and the Exchange. The determination and penalty shall become final and conclusive 20 days after notice thereof has been served unless a request to the Executive Committee for review has been filed in which case any penalty shall be stayed pending review.

**P804. Disciplinary Appeals** - The staff or inquirer of the Exchange which brought the Charges, the respondent, or any member of the Executive Committee of the Exchange may require a review by the Executive Committee by filing a written request stating the basis and reasons therefore within 20 days of the notice of determination. All concerned parties shall be notified of such review request. Any reviews by the Executive Committee shall be based on oral argument and written briefs and shall be limited to consideration of the record before the Hearing Panel. The Executive Committee

by majority vote may sustain, modify or reverse any determination of the Hearing Panel and increase, decrease or eliminate any penalty, or impose any penalty permitted by these rules as it deems appropriate.

If either party on review shows to the satisfaction of the Executive Committee that additional evidence is material and there was reasonable ground for failure to produce it before the Hearing Panel, the Executive Committee may remand the matter to the Hearing Panel for further proceedings.

**P805. Stipulation and Consent** - In lieu in part of the above procedures, a Hearing Panel may make a determination and impose penalties on the basis of a written Stipulation and Consent entered into between the respondent and an authorized employee or inquirer of the Exchange. Such document shall contain a stipulation with respect to the facts, or on the basis for findings of fact by the Hearing Panel; a consent to findings of fact by the Hearing Panel, including a finding that a specific offense has been committed; and a consent to the imposition of a specific penalty. The Panel may fix and impose the penalty agreed to or any penalty which is less severe or may remand for further proceedings.

**P806. Counsel** - Respondents have the right to be represented by counsel in any hearing, review or investigation by the Exchange.

**P807 - Suspended or terminated parties** - A suspended party may be proceeded against for any offense other than that for which suspended.

If prior to termination or within one year of termination of any person associated with a Member, such person is served written notice that the Exchange is making inquiry into a matter occurring prior to that termination, the Exchange thereafter may require such party to comply with requests, appear, testify, submit books and records, attend hearings, etc. and such

party shall be subject to charges, determinations and penalties in every respect in the same manner and to the same extent as if such person had remained associated with a Member. A party who refuses to comply may be barred from association with a Member permanently, or for such period of time as may be determined, or until such time as such party has complied and the Exchange has completed its investigation and any resulting Hearing is completed, and any penalties imposed carried out.

**P808. Disciplinary Announcements** - Expulsions, suspensions, and major fines shall be announced to the public.

## **Section Ten - Arbitration**

**P901. Controversies Arbitrated** - Any controversy arising out of the securities business of a Member or its dissolution shall be arbitrated pursuant to these rules which is

- a) between parties who are Members, their employees, registered representatives or approved persons, or
- b) between such persons and any non-member at the instance of the non-member party or as provided by any duly executed and enforceable written agreement.

*Comment - Arbitration is based on the assumption that the laws of the country permit enforcement of arbitration judgements by governmental courts and that appeals to courts are possible only for unlawful conduct of the arbitration. It is also assumed that Members will provide in their written account agreements with customers for arbitration of disputes with customers.*

**P902. Arbitrators** - The Executive Committee shall appoint two standing panels, one consisting of representative executives, employees, registered representatives, attorneys and approved persons of Members or retired such

persons, the other consisting of non-members knowledgeable in securities matters. The Executive Committee shall also appoint an Exchange employee or other person as Arbitration Director to perform the ministerial duties of arbitration.

For each controversy or related group of controversies, the arbitration director shall select seven disinterested persons as potential arbitrators from the appropriate panel(s) and submit their names and backgrounds to the arbitrating parties. Each arbitrating party may request that not more than two of the potential arbitrators be removed from such list. From the remaining list, the arbitration director shall appoint in the case of arbitrations involving non-members, two persons from the non-member panel and one from the membership community panel, and in the case of controversy within the member community, three persons from the member panel. Other persons from the remaining list may be substitute arbitrators in case of death or incapacity of an arbitrator. The arbitration director shall designate one arbitrator as chairman.

**P903. Arbitration Agreement** - Pursuant to these rules, the decision of an Exchange Arbitration shall be binding and final upon any Member, employee, registered representative, attorney or approved person thereof. Any non-member party shall have agreed in writing that the arbitration shall be binding and final either in a separate document or in any existing duly executed and enforceable agreement.

*A copy of the Uniform Submission Agreement used in the U.S. can be supplied for adaptation to the law of Sri Lanka.*

**P453. Arbitration Proceedings** - Appropriate sections of the *Uniform U.S. Securities Arbitration Procedures* can be supplied for adaptation to the law of Sri Lanka.

# DETAILED COMMENT ON PRESENT SRI LANKA SECURITIES REGULATIONS

## Section One - Organization and Governance

### SECURITIES COUNCIL ACT NO. 36 OF 1987

13(c) The authority "to give directions to a licensed stock exchange from time to time" should not be used to compel the stock exchange to write rules in areas in which the Council has no authority to act on its own.

14(a) The Council should not exercise its authority to conduct "regular" inspections of stock brokers and stock dealers but rather should require the Exchange to do so, confining its own inspections to those for cause including special inspections of Exchange adequacy in regular inspections.

### CSE ARTICLES OF ASSOCIATION

6(a) Membership in the exchange should not be restricted to brokers. Participation by dealers will enhance liquidity and general strength of the market, probably not at present but especially as dealing becomes profitable enough to support market making obligations. Efficient dealing, and particularly market making, cannot be carried on from outside the membership subject to commission charges and exempt from exchange regulation.

6(c), (d) These clauses prohibit any consideration of extenuating circumstances in readmitting members suspended or expelled from a stock exchange or having been bankrupt. Indeed they convert a suspended member to a permanently expelled member. They should be amended to delete the reference to suspension, to allow readmission after consideration of the reasons for expulsion or bankruptcy and related rehabilitation.

7. The Committee and the Exchange should never have power of "absolute discretion and without assigning any reason" for depriving or withholding any person from any access to the Exchange. Instead see Proposed Rule 801 for fair procedures which can insulate the Exchange from potential civil damages for arbitrary action.

8, 9. Article 8 can be viewed as monopolistic in that it bars membership to parties not known to or proposed by two exchange members. The provision for secrecy of information provided by the two exchange members is contrary to the fair principle that any person should be informed of any reason that he may not be approved and given an opportunity for a hearing.

11. The undertaking required in this article for members should also be a requirement for employee representatives, agents and agent representatives as in proposed rule 403.

52 and 56 (Par.2). A qualified full time Chief Executive of the Exchange rather than the Executive Committee should have authority and responsibility for hiring, supervision, and termination of staff and all executive powers of the Exchange as soon as Exchange income permits. (Proposed Rule 5)

52. Rules and similar instruments should not require approval of a General Meeting, but only of the Executive Committee subject to review as required by Securities Council regulation.

63. No clear provision is found in the Memorandum or Articles for election of members of the Executive Committee other than this nominating clause which restricts nominations to members of the Exchange. Our recommendation is strongly in favor of balanced governance by an Executive Committee of member, listed company, investor and professional representatives. See discussion on CSE Governance and proposed rule 1.  
Our recommendation on nomination is at proposed rule 4.

Omissions from this section of regulation recommended for correction are Corners, proposed rule 2, and Exchange liability for use of facilities, Rule 3.

## **Section Two - Registration and Listing of Securities**

### **SECURITIES COUNCIL RULES 1990**

18(7)(a) The Council should consider requiring interim listed company financial statements quarterly rather than every half-year.

### **STOCK EXCHANGE RULES**

1.1-2 (2) Exclusions in a) and b) should be expanded to include controlling parties (acting alone or in concert) who may not be parents or directors.

1.1-4 No prospectus should be "approved by the Exchange" or Security Council as that implies recommendation of such security for all investors. Instead such documents should be "accepted by the Council and Exchange as adequately presenting information required by law or rule.

1.2-4 The listing undertaking as specified in Appendix 1 is too generalized and should be more specific as to be supplied for proposed rule 53.

1.3-1 I dislike requirement of a sponsoring member for a new listing, but do not object to as many members as wish to do so endorsing a listing application. Compulsory sponsorship may mandate fee or tie-in business for a Member for services which are just as well performed by the company attorney, accountant or internal staff, and should be reviewed by the Exchange for completeness. Further, it establishes a "favored broker" relationship for corporate financial advice, underwriting, etc.

1.3-3 (i) & (ii) may be too severe in limiting listing of issues subsequent to initial listing. This rule is not at all clear as it does not define basic terms.

1.3-4 Prospectus registration requirements have not been reviewed.

1.2-5 The method of primary distribution of an issue is not clear from the rules. Is it by fixed price offering on the Exchange, by auction on the Exchange, by syndicate underwritten distribution on the Exchange. This obscurity is not clarified by rules in the 2 section. Another project to review and recommend primary distribution regulation is recommended.

1.3-6 See proposed rule 513 for possible limitation on allotments to persons associated.

1.3-8 Provisions for renunciation are not clear. Depending on clarification, why is there no "when issued" trading in securities before their physical distribution.

1.3-9 It seems unfair to current shareholders to suspend trading during the course of distribution of a new issue. Provisions for price stabilization by underwriters may be needed.

1.4-4 Does this constitute delisting? If so it ignores due process and other rules of the Securities Council.

1.4.7 Initial quotation fees should be based on issue price, not on nominal value of shares. The fees seem quite low at US\$125 minimum and US\$1,250 maximum.

1.4-8 Annual listing fees also seem low at a maximum of US\$375. Listed companies should bear a substantial percentage of Exchange operating costs both for direct benefits to the company and on behalf of their shareholders who rarely trade but benefit from the exchange establishing market prices for their use in borrowing and other evaluations and as a stand-by market.

2.1-1 Still no description or definition of distribution methods in this "Steps in the Listing Process."

3.1-1 All references to supplying the Exchange with information likely to materially affect securities price should also state that such information should be simultaneously released to the public. Otherwise, there is a perception that the Exchange is receiving inside information subject to possible abuse by staff and members with access.

3.1-3 Communication of any information to shareholders and Exchange only is inadequate as prospective purchasers also have a right to such information. Such information should be made public. Further, communication to shareholders is slower than communication through public media.

3.1-11 should be supplemented by proposed rule 52 which will become increasingly important as shares are held in the depository system. Although that system provides for the system furnishing companies with information for mailing to beneficial owners there may be some residual shares with brokers, or CDS may need authorization.... Should consider with John Kinnamon before he leaves.

3.6 What is done with missing securities and forgery information? Should it not be described in Exchange rules to limit possible civil suit claiming the Exchange was negligent in not adequately distributing such information?

3.7 No provision is found giving the Exchange power to levy fines against listed company directors for which a penalty amount is stated here. No due process is found for such acts.

3.8 & Appendix 5 Provision for private sales - check consistency with SC procedures

Appendix 1 & 2 missing, no reference if obsolete.

Appendix 3 - Why is "Trading Profit" the only business segment for which p&l disclosure is separately required?

Appendix 3,4 Number of shares issued and outstanding is not disclosed. Thus it is not possible to compute from these documents earnings per share or price-earnings ratio, etc. computations of which, before and after taxes, should probably be included in these Appendices.

4 Item 4. Consider whether this private disclosure of inside information on profit & loss may limit the ability of members participating in this review to advise their customers on investment in

securities of such companies until public disclosure is made. Would it be better simply to require some stated recent P&I data in such circulars?

5.1 Although it is not yet practical for Members to be companies with broad public distribution, why should that future possibility be prohibited here? Securities Council policies requiring members to be engaged only in the securities business and related regulation prevent any non-member company from being stock brokers or dealers.

7.2 There is no apparent reason for the two lines in parentheses.

## Section Three - Trading

### SECURITIES COUNCIL ACT NO. 36 OF 1987

31 This prohibition of a broker being a dealer and a dealer being a broker has great potential for inhibiting the growth of shareownership and liquidity of the securities market. At the same time it has little regulatory purpose which cannot be better accomplished by regulation controlling conflicts in such a dual capacity. See discussion under "Profitability Risk" section of consultants report.

### SECURITIES COUNCIL RULES 1990

21-24 These rules are consistent with Act 31, but have no inherent process for decreasing violation of the perceived primary abuses which led to their adoption. They do not necessarily affect member income but do increase member cost by imposing additional logistics for reciprocal execution of trades between members.

7 (3)-(5) These are listing requirements, not rules for sale of listed securities, and should be separately captioned and numbered.

17 It seems inconsistent with principles of regulatory structure for a decision of the stock exchange manager not to approve a trade exceeding a limit price to be immediately referred to the Director General of the Securities Council, without any consideration by the Exchange Executive Committee. In effect this is an appeal of the manager's decision by-passing the governance of the exchange. Further the Securities Council guideline of 4/20/90 stating that the manager should investigate price movements of 20% is inconsistent with the rule requirement of reporting to the manager of 10% price movements and his approval only after being satisfied that trading conditions justify that movement.

### SECURITIES COUNCIL GUIDELINES

4. Private transactions and gifts - To remove an unnecessary administrative burden on the Exchange and Council, these guidelines should be converted to an Exchange rule exempting the specified private transactions from any approval providing that Members assist in transfer at a nominal charge as now provided in Guideline 6. Such exchange rule would be legal as Act Article 28 permits sale subject to a trading procedure adopted by an exchange, and that principle is repeated in SC90 Rule 7 (1). The present guideline recognizes that broker assistance in transfer constitutes compliance with 7(2) for the specified types of private sale.

### SC GUIDELINES 7, CES RULE 4

The fixed commission rate under these rules is lower than in many countries for average transactions. See discussion in consultant's report and proposed rule 211 to strengthen these rules and add rebate provisions.

## **PROPOSED RULES**

Ten proposed new rules would fill gaps in exchange trading regulation.

### **Section 4 - Settlement**

#### **SECURITIES COUNCIL RULE 14 & CSE CONDITIONS OF SALE**

Both documents are unrealistic in stating desirable practices from a broker's interest as required conditions of purchase or sale ignoring the customer's right to protect himself, and actual practice among members.

Demand of delivery against payment in securities transaction settlement is almost universal around the world between brokers and financial institutions and large investors. CSE settlement rules of both CSE and SC demand this. But the rules of each are stated in language which demands payment before settlement and delivery of certificates before settlement from customers, neither of which a Member can guarantee without receiving them before trade execution.

SCR 90 14 therefore must be viewed as descriptive rather than compulsive, not truly a rule. This view is reinforced by questionable authority of the SC to write such a rule or SCR90 15 pursuant to Section 53 of the Act.

SCR90 14 and 15 in any event insofar as they purport to govern acts of listed companies would be more legally established by the Listing Agreement contract between the Exchange and each listed company.

The CSE Conditions of Sale rules are internally inconsistent as follows:

- a) the proscription that a buyer shall pay for all shares purchased during a period of dealing for the same settlement is silent as to whether offsetting sales proceeds should be deducted,
- b) The interest charge for failure of timely payment may be simply anti-rebative of commissions rather than a penalty as is more apparently the 0.5% a day interest on failures to deliver securities,
- c) a calendar month grace for a broker to resell an unpaid security is too long both for reasonable liability of the customer and for not imposing a market risk capital charge on the member,
- d) The proscription of delivery of scrip sold before order execution is inconsistent with delaying penalty until settlement date,
- e) the provisions for the selling member notifying the buying broker of non-delivery by his seller and the subsequent courses of action by the buyer destroy the normal concept of an exchange transaction which is that a broker is responsible for the completion of every contract whether his customer performs or not,
- f) the Conditions prescribe payment to the seller by the selling broker even if the seller wishes to leave such funds with the selling broker for future securities transactions or those due in the next settlement.

Rules for broker responsibility to complete contracts and a system of borrowing securities to facilitate settlement, amplifying Act 27, as provided in the proposed rules 202 & 309 could correct these problems.

## **MARGIN ACCOUNTS**

**SECURITIES COUNCIL RULES 1990 24** The third sentence on furnishing to the Exchange names of all participants in margin accounts is meant to apply to all margin accounts and should be a separate rule. No regulatory purpose is apparent. The requirement is for name disclosure at each transaction, when periodic lists of participants would be less cumbersome. But why does the Exchange need a listing of participants in margin accounts? Why not also participants in cash accounts? The most likely reason is for detection of possible insider trading, which could be done through either cash or margin accounts. Insider information investigation is initiated by obtaining the account details on all (or large) trades in the period of time being investigated. This would include names of account owners and relationships to the company of interest. Information so gathered will be far less cumbersome and useful than lists of margin account participants filed with the exchange on a trade basis.

**CSE RULE 7** is the only specific current reference to margin required. It would become effective through proposed rule 311.

Proposed Rule 301 introduces a concept new to CSE of Members acting only for customer sales service, engaging another member for custody of customer property, settlement, etc. Several other aids to settlement are also proposed.

### **Section Five - Qualification**

**Agent Guidelines** - See discussion in main report. Much of the present Guideline could be replaced by proposed rules 401, 403, 404, 406, 211.

**CSE Article 6** prohibiting membership by registered stock dealers should be amended to permit the addition of liquidity of such dealers to the market under regulated conditions without the expense of a commission when acting through brokers. See report discussion under Profitability Risk.

**CSE Article 11A** should be repealed when a change in the Act to permit dual broker/dealer status is adopted. See other discussion.

**CSE Trading Floor Rules 1, 2** could be dropped with addition of a broader proposed rule 403 ff.

Omissions from CSE rules for qualification are corrected in proposed additional rules.

### **Section Six - Ethical Conduct**

**Securities Council Guidelines 2f, g and 8** on communication standards are proposed to be amplified and in effect replaced by much more comprehensive proposed rules 510 and 605.

**CSE Code of Business Conduct 1** is proposed for replacement by 501.

**CSE Code 3 and 5** on discretionary accounts and sharing in profits and losses is proposed for replacement by a more comprehensive 505.

CSE Code 6, employee transactions in securities, has been replaced by more detail in SC9/24/90 24, and should itself be replaced by proposed 605 to preserve member control over transactions of their own employees and agents executing personal trades through other brokers.

Other proposed new rules of ethical conduct deal with conflicts of interest, commercial bribery, questionable conduct, discretion, rumors, privacy, and account transfers, fair corporate financing and distribution of oversubscribed issues.

## **Section Seven - Supervision and Control**

CSE Code 2 appears to be the only present regulation of supervision by members of their business, employees and agents. It should be replaced by the far more comprehensive 600 series of proposed rules

## **Section Eight - Financial and Operational Responsibility**

CSE Code of Business Conduct 13 requires monthly financial reports from members, but there is no capital requirement of any kind for members. This deficiency can be remedied by adoption of proposed 701, 702, and 705-712.

Act Schedules II and III are the primary requirements for security deposits and are amplified in CSE Article 18 and related guarantee forms. The problems with these requirements are discussed in the Capital Adequacy Risk section of the main report. They are proposed for resolution by proposed rule 704.

CSE Rule 11 on separate bank accounts poses major cost problems for members and has not been knowledgeably observed. Discussion is in this report's section on Customer Funds Bank Accounts Risk and solutions are presented in proposed rule 703 to replace CSE 11.

CSE 10 on required member records and their retention has not been closely compared with the more comprehensive Rules 351 and 355 in the consultant's book on Model Rules for a Stock Exchange because of the differences between American and Sri Lankan accounting practices. It is recommended that the Model Rule requirements and CSE 10 be compared for improvement in CSE 10 by an accountant familiar with both systems.

SCR90 12 and CSE Code 12 deal with auditing. The CSE rule is proposed for replacement by the far more comprehensive proposed 713-716. The "Model Rules" book provides additional detail for use as it becomes needed with growth. A supplementary requirement that audit results be distributed to customers is at 717.

Other proposed rules in this section deal with custody, control, buy-ins, movements, deliveries, and pledging of customer securities.

## **Section Nine - Discipline**

Act 46 & SCR90 13 - My experience is that the Committee to hear Complaints as stock brokerage activity grows is likely to be heavily burdened by unjustified complaints, primarily seeking financial adjustments. Preliminary reference of most such complaints to the Exchange for investigation is suggested as the U.S. Securities Exchange Commission does routinely. Many will

need only explanation for resolution, others will be adjusted, leaving only a few needing adjudication for which Arbitration will be appropriate for civil resolution. The complaint investigation record will then be at hand for those few which may merit disciplinary consideration by the Exchange or this Committee.

Rule 13 of the Securities Council provides one way of implementation of Act 46, but a better way would be to first request the Exchange to apply the investigative and hearing procedures of recommended rules 802-806 to develop a factual record on which the Council could hear an appeal or call up a decision for review.

CSE disciplinary provisions exist today in four different unrelated documents, producing a confusing array of provisions. They are CSE90 22(ii) and 23-26, 1987 disciplinary bye-law 1, 1988, 1988 investigations bye-law 1, and 1/12/90 amendments to 1988 1.

These rules are recommended to be replaced by proposed 801-807 providing for a more complete and integrated procedure with adequate due process but still a "businessmen's tribunal."

The objectives of CSE Rule 22 as to members default in Exchange bill payment, to members or customers would be preserved in summary action under proposed 801. CSE 23 bases for discipline would be broadened in proposed 802.

CSE 24 is highly objectionable and may subject the Exchange to civil liability as it permits an alternative of resignation by a member in sufficiently serious violation that he otherwise would be expelled. The member would thus in a dangerous condition be permitted to stay in business endangering present and future customers and creditors, without disclosure of his status. Such permission to resign may also frustrate the intended operation of a Compensation Fund.

Proposed 803 provides for the type of inquirer now authorized by 1987 1 but such inquirer would be only an investigator and prosecutor, not a judge. Judgement would be by a Hearing Panel with its decisions subject to appeal to the Executive Committee and then to the Securities Council. Lesser penalties than expulsion would be authorized.

Reversal of rule 12 is recommended which prevents representation in disciplinary actions by attorneys. The consultant for about 10 years participated in NYSE disciplinary actions sometimes as prosecutor and other times as judge without participation of attorneys. He then recommended a policy change and participated in disciplinary actions for about 15 years with attorney representation. Attorney representation was clearly helpful to the Exchange as well as defendants as relevant information was more clearly and completely developed, leading to better justice.

It is not clear how the (a)-(c) paragraphs of the 1/12/90 amendments would fit into the 1988 1 structure, but similar requirements should be retained in the proposed new disciplinary structure.

## **Section Ten - Arbitration**

The only references to Arbitration in current regulation appears to be CSE Article 59 and the provisions for an inquirer as an arbitrator in 1987 1. A more formal and complete plan for arbitration is recommended in proposed 901-904.

**LATE ADDENDA**

The new SC Rule 14 as drafted by the government attorney to replace old SC Rule 19 omits the two lines at the bottom. This is an error as those two lines provide an exemption for trades settled in house where the same Member has both the buying and selling customers.

There is another error stating that confirmations would be sent to the buying customer with the certificate. Confirmations should be sent to the buyer on the day of transaction, not after settlement.

Proposed rule 52 deals with arrangements for proxy and other company communications to shareholders to be forwarded to beneficial owners and voting rights to be exercised by beneficial owners in instances where the member is holding such securities. This was examined as to whether it would be needed after CDS furnishes lists of customer holders to listed companies for mailing purposes. The decision was yes, as the problem will grow with the proliferation of margin accounts.

Securities on which banks or brokers have a lien will need to be held in a CDS account subject to sole control by the lien holder, without any right by the beneficial owner to order the company not to transfer the security. In effect the collateral will be in the name of the lien holder. Rule 52 will still be needed as the lien holder will need to execute proxy instructions on behalf of the beneficial owner, credit dividends and other benefits to the beneficial owner, etc..

COLOMBO STOCK EXCHANGE - MONTHLY FINANCIAL REPORT OF MEMBER

As/of Date

Member Name: \_\_\_\_\_

ASSETS	Liquid	Illiquid	Total
Free cash (1)	_____	_____XXXXXXXXXX_____	_____
Cash in Fixed deposits (2)	_____XXXXXXXXXX_____	_____	_____
Cash Segregated (3)	_____	_____	_____
Receivable from Brokers (4)	_____	_____XXXXXXXXXX_____	_____
Receivable from Customers (5)	_____	_____	_____
Securities (6)	_____	_____	_____
Subordinated Assets (7)	_____	_____	_____
Other Assets (8)	_____	_____	_____
Total Assets	_____	_____	_____

LIABILITIES	A.I.	Non A.I.	Total
Bank loans (9)	_____	_____XXXXXXXXXX_____	_____
Bank overdrafts (10)	_____	_____XXXXXXXXXX_____	_____
Loans and Advances, other (11)	_____	_____XXXXXXXXXX_____	_____
Payable to Brokers (12)	_____	_____XXXXXXXXXX_____	_____
Payable to Customers (13)	_____	_____XXXXXXXXXX_____	_____
Other payables (14)	_____	_____	_____
Subordinated liabilities (15)	_____XXXXXXXXXX_____	_____	_____
Total Liabilities	_____	_____	_____

OWNERSHIP EQUITY

Paid in capital	_____
Retained earnings (losses)	_____
Total Ownership Equity	_____
Total Liabilities & Equity	_____

Profit & Loss

This month: Year to Date

INCOME

Commissions (16)	_____	_____
Securities values (17)	_____	_____
Interest (18)	_____	_____
Other Securities (19)	_____	_____
Other income (20)	_____	_____
Total Income	_____	_____

EXPENSE

Officer Compensation	_____	_____
Representative Compensation	_____	_____
Other employee compensation	_____	_____
Paid other members	_____	_____
Contract management (21)	_____	_____
Errors & bad debts	_____	_____
Other operating cost	_____	_____
Total Expense	_____	_____
Profit or Loss before tax:	_____	_____
Provision for taxes	_____	_____
Extraordinary	_____	_____
Net Income (Loss)	_____	_____
Nett Capital (22)	_____	_____
Capital Required (23)	_____	_____

Surplus or (Deficiency) in Separate Customer Bank Accounts \_\_\_\_\_

Highest value of Total Unsettled Contracts in last two months, each side counted separately.

List by footnote source, description and amount of any collateral for member obligations not included in Assets above.

Describe by footnote any significant delays in processing securities transactions, reconciling bank accounts or securities count differences, security transfers, collecting customer funds or securities sold, or customer reneges, bad debts, and other financial or operating problems of significance.

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Instructions for CSE Monthly Financial Report of Members

This monthly financial report is to be filed as of the date of month-end closing of each member, filed not later than the 10th business day thereafter. Any possible inaccuracy shall be footnoted.

Instructions for line items:

1. Free cash includes cash on hand or in banks subject to immediate withdrawal, other than cash in separate bank accounts for customers. Entry of such cash shall be in the Liquid column.
2. Cash in fixed deposits refers to bank accounts not withdrawable within five business days due to such cash being pledged or held against indebtedness, guarantee, overdraft facility, etc. Entry should be in the illiquid column.
3. Segregated Assets comprises deposits in separate bank accounts for the benefit of customers. Enter in the liquid column 100% of such cash plus 95.75% of the market value of any government securities deposited in such accounts which belong to the member or are reflected as liabilities. Enter in the illiquid column the remaining market value of such government bonds.
4. Receivables from brokers include funds due against securities purchased, commission income to be received from other brokers arising from commission splits, underwriting participations, etc. Enter total in liquid column.
5. Receivable from Customers includes amounts due from customers for open contracts, margin calls not older than 5 business days, or otherwise. Enter in the liquid column such assets which are fully secured by listed or government securities readily marketable at a discount of not more than 10%. Fully secured means such receivables not yet having reached normal settlement date, or against which the member is holding collateral in margin accounts with customer equity of at least 40% or in cash accounts the securities received in settlement not more than 5 business days previously. Enter the remainder of such receivables in the illiquid column.
6. Securities are those owned by the Member. Enter in the liquid column 60% of the market value of listed securities readily marketable at a discount of not more than 10%, plus 95.75% of the market value of government securities. Enter the remainder in the illiquid column.
7. Subordinated assets are values subordinated to the claims of all other creditors of the Member by an agreement approved by the Exchange. The values fully secured as described in 6 above should be entered in the liquid column and any remainder in the illiquid column.
8. Footnote by caption and amount the value of any other asset which comprises more than 5% of total assets. Other assets generally should be

- entered in the illiquid column, but a Member may enter in the liquid column any such asset believed to be liquid with a footnote explanation.
- 9, 10 & 11. Footnote description of any collateral or security. Enter in the Aggregate Indebtedness column (A.I.).
12. Principally payable to brokers for securities purchased not yet settled. Also commissions payable due to splits, fees arising from underwritings, etc. Enter in A.I. column.
13. Principally customer funds held in separate bank accounts for benefit of customers, but excluding any moneys held for customer margin accounts with a debit. Enter in A.I. column
14. Identify items over 5% of liabilities by footnote. Generally enter such payables as A.I. liabilities, but a Member may enter in the non-A.I. column any such item believed to not be part of Aggregate Indebtedness with a footnote explanation.
15. Enter in non-A.I. column.
16. Net amounts retained by the member after adding or deducting splits with other members.
17. Capital gains or losses in market value of securities owned during the reporting period.
18. Gross interest income
19. Miscellaneous other income from the securities business, such as underwriting or account management fees, custody fees, etc.
20. Miscellaneous non-securities business income
21. Amounts paid to parents, affiliates or others for supplying management or operating services to the member.
22. The sum of the Liquid Assets column above. This amount may be reduced by the Exchange to reflect significant errors in records, operating problems, delayed settlements and the like.
23. 10% of the total A.I. liabilities as computed above or Rs 500,000 of nett capital, whichever is larger. This percentage or rupee minimum amount may be changed by the Exchange as experience is gained with this questionnaire.