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1993 SECURITIES REGULATION IN SRI LANKA

FINANCIAL MARKETS PROJECT, SRI LANKA
(USAID Contract No. 383-0100-C-00-3063-00)

By
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New York Stock Exchange

November 1993



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Financial Markets Project (FMP), funded by the United States Agency for International Development, is designed to improve the reliability of capital market information, increase the availability of financial instruments and assist the development of new forms of financial intermediation in Sri Lanka. It began activities in the field and will continue till the end of 1995. The project will assist in the development of the Securities and Exchange Commission (SEC), Colombo Stock Exchange (CSE), Institute of Chartered Accountants, the Central Bank and emerging financial institutions and will institute the Chartered Financial Analysts training program and assist with the development of a secondary debt market for government and corporate obligations.

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3. *1993 Securities Regulation in Sri Lanka*. Robert Bishop, retired Chief Regulatory Officer New York Stock Exchange. The report examines the progress made by the SEC and CSE in implementing regulatory changes, many which were proposed by Mr. Bishop during an assignment for ISTI in 1990. Provides commentary on progress since 1990 with discussion and recommendations on 18 areas for current attention. November, 1993.

Forthcoming

Stock Option Plan Study, Khursheed Choksy with Robert Bishop. This study examines issues related to developing stock options and compensation for senior corporate executives. January, 1994.

2. *Recommendations and Activity Report Training Courses for Financial Journalists and Seminars for Policy and Opinion Makers*. Hannan Ezekiel, Senior Economist, ISTI. October 1993.

4. *Legislative Review and Training*, Jeswald Salacuse, Dean and Henry J. Braker Professor, and Joel Trachtman, Associate Professor, Fletcher School of Law and Diplomacy, Tufts University. The report analyzes Sri Lanka's legislative and training needs with respect to securities and financial markets. December, 1993.

Second-Tier Market Research Study, Khursheed Choksy, Research and Operations Manager FMP, and Bradford Warner, Vice President, Private Sector and Economics at ISTI. This study examines the motives and constraints under which Sri Lankan companies decide to raise equity through public share offerings and the potential for a second-tier market. January 1994.

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Introduction

In late 1990 after a month of review, I produced a report on "Improving Colombo Stock Exchange Regulation" summarized in 15 recommendations. During the intervening three years very satisfactory progress has been made in implementing some of these regulations by the Colombo Stock Exchange (CSE) and the Securities & Exchange Commission (SEC) while others have had little attention.

The Exchange has grown during that period to the point where there are four trading locations for differing segments of the market as compared to one during my 1989 visit, and three during my 1990 review. Member firms have increased from 9 to 14 and have generally become profitable. Post trade settlement and a depository function have been developed and computerized in an impressive system for an Exchange of this size. Executive managements of both CSE and SEC have changed. The two organizations are now in different physical locations.

SUMMARY OF PRINCIPAL OBSERVATIONS AND RECOMMENDATION

(Where applicable, reference numbers [0] are inserted in this summary indicating sections of the report discussing that item in more depth)

As a general observation, the Exchange has broadened its functional view, recognizing its public responsibility for promoting and enforcing high standards of business conduct not only on its trading floor but by member firms in their entire breadth of service to investors.

There have been three very important improvements: 1) Broadening of the CSE Board of Directors to include equal representation of listed companies and investors as well as members, 2) Monthly financial reports by members to the CSE (passed on the SEC), and 3) the hiring of staff of both CSE and SEC for surveillance, field examination and enforcement of regulation.

The most serious deficiency is that a supplementary 1990 USAID supported project to organize chaotic CSE and SEC rules applicable to CSE members into an orderly single publication has not been followed up by maintenance of that publication with subsequent changes. Consequently review of the detail of change has not been possible in this short term project. And the Sri Lankan securities industry remains without a road map of what is expected of it by the two regulatory bodies. [1]

A second aspect of this serious deficiency is that there is no orderly and disciplined standard process for developing full background information and an industry consensus supporting rule-making at either CSE or SEC. The result is regulation of limited efficiency, sometimes even counter-productive. {1A}

Discussion in attempting to determine current status of my 1990 recommendations has highlighted perception of four problem areas:

1. There seems to be retrogression toward a fragmented structure of the securities industry rather than advancement in broadening the role of CSE Member firms in adding depth and liquidity to the market and creating internal financial strength. [3]
2. It is probable that restudy of the different functions of a Settlement Fund and Capital Requirements might result in (a) lowering immobilization of liquid capital in security deposits and (b) improved capital adequacy based on liquid capital adjusted to historic experience on various types of business risk. This probability is suggested as the result of phasing out of bank guarantees of security deposits, financial data on Members now available, growing market volume and shortening of holding time of customer property by Members as a result of the depository system. [4]
3. The two regulators have been unable to resolve differing views within the community concerning entities acceptable as agents of Members and the extent to which Member financial and regulatory responsibility for such agents would be the same as for employees. Discussion below uses this deadlock as an example of the need for an improved rule development process. [2]
- 4 Generally accepted principles of securities industry ethics and business supervision should be formally expressed in rules as previously recommended. [5]
- 5 There is belief in the CSE community that there is indirect rebating of fixed commissions in ways not detectable by CSE examiners. If CSE industry directors recognize this possibility as a reality, action might include: 1) discussion among members of their self-interest in maintaining fixed commissions; 2) consider change to negotiated commissions, 3) reconsider required commission schedule - it is likely that rebates are for trades and customers producing large volume which may merit a lower scale than at present.
- 6 Late in my visit, I began to hear of disciplinary authority limitations of CSE and SEC - not confirmed but worth research. Alleged weaknesses included limitation on the length of suspensions by CSE, continued membership in CSE without trading privileges for firms which lose their SEC license, no authority for CSE to require production of personal records by Member personnel.

SUMMARY OF OTHER DISCUSSION IN TEXT

Regulation of Lenders on Securities Collateral has merit for protecting interests of borrowing retail customers, and avoiding potential adverse market effect of panic selling of collateral. The diversity of such lending by banks, finance companies, factors and others would require broad control for example by Central Bank administered regulation. SEC regulation of the few organizations engaged only in margin lending would not achieve such public purpose. [7]

The short time of this visit has not permitted sufficient depth of research to amend my 1989 recommendations on implementing a compensation fund to reflect the growth of the market, financial data now available, and the Central Depository System (CDS) developed since that time. [8]

The system of annual updating of information on Exchange Members for the SEC can benefit by review of the US SEC system by staff members shortly to visit Washington. [9]

Methods for improving regulatory control of trading by directors, officers, and employees of members and CSE are suggested. [10]

Quotations in Red - Similar executions by NYSE members in shares of affiliated corporations is not prohibited, but members may not recommend such securities. [11]

A time-identified audit trail of orders and trading with careful reconstruction and explanation of every customer complaint is recommended to offset public perception of front running and reallocation of favorable price orders by member brokers. [12]

The regulatory compliance role of a Chief Executive and line managers is differentiated from the follow-up staff function of "Compliance Officers" in larger US securities firms. [13]

Enforcement of Listing Agreements - The only penalty which seems available to CSE and SEC for non-compliance by issuers with listing agreements appears to be suspension of trading or delisting. For many infractions, such penalty seems harmful to share owners. Two methods of persuading compliance are suggested. The first is publicity. The second is reference to the Attorney General as, to a greater extent than in most countries, listing conditions and related disclosure are specified by law and SEC rule in Sri Lanka. The possibility of criminal prosecution should be persuasive to corporate non-compliers. [14]

Requested advice is given on CSE standards for Member advertising and other communications with the public. [15]

A plan is suggested to develop for publication a consensus on functions and responsibilities of professional participants in New Securities Issues and the words used for such functions. Ideas for helpful rules might also result. [6], [16]

DISCUSSION OF OBSERVATIONS

1. Regulatory Manual - USAID in 1990 authorized a supplementary project for this consultant to prepare a regulatory manual consolidating numerous documents then expressing CSE and SEC rules governing Exchange Members. It was completed in the US with recommended new rules also included. Printed copies were provided in quantity to CSE and SEC. A computer disk was also supplied with the intention that it would provide the base for continuous updating as rules are added or amended. This disk was lost without present Exchange management knowing that it was prepared. A new copy has been provided and its use explained to present Exchange management who are considering updating it with changes since 1990 and maintaining currency.

Exchange publication of certain sections of its rules such as "Listing" and "Conditions of Sale" is excellent. But the lack of a consolidated published source of all securities regulations to which CSE members are subject is a major weakness.

1A. Rule Development Procedure - No evidence has been seen of an organized system for bringing industry practitioners and their knowledge into the rule-making process.

Consideration of new rules or amendments should begin with preparation in writing of (a) description of the perceived problem; (b) definition of the key words used, and any possible alternatives in such definitions; (c) all current law, rules, and practices related to the matter; (d) alternative possible rule variations; and (e) the current view of the proposing entity as to the best regulatory approach to the problem with reasoning for that view and draft rule language. Members seeking consideration by CSE or SEC of a regulatory problem should submit their views in this type of written presentation, as should the CSE and SEC themselves.

The consideration paper should be circulated to all concerned parties for written comment. Depending on the subject, it may be desirable to assemble a committee of practitioners to help prepare the consideration paper, or to help resolve conflicts among commentators. The membership of CSE is small enough for discussion of some subjects at an informal meeting of all members or their

employees most knowledgeable in the subject area. Sometimes publication of revised consideration papers are desirable after practitioner views result in new information and changes in opinion on the best course of action.

The objective should be substantial industry consensus before the Boards of CSE and/or SEC act on a rule proposal. There should also be a similar written method of appeal to a Board by a member or listed company to interpretations given by staff or individual board members.

All US government regulation is created or amended by this type of process.

2. The Agent Problem - An illustration of the rule development procedural problem is that CSE has had trouble developing a consensus on what type of entities should be authorized as agents of Members and the degree of responsibility Members should have for such agents. A related fact is that all registered securities brokers by law must be members of an Exchange.

The problem revolves around whether a Member should accept the same degree of financial and regulatory responsibility for Agents as for Employees performing similar services. Agents often would be employees or principals in other business and professional activities, usually engaged only part-time in the securities business. A member could not in fact exercise the same level of supervision and control over such Agents as over Employees. However, the same degree of competence on advising on and processing securities customers is desired in both Agents and Employee customer brokers; therefore equal qualification in business reputation and knowledge is wanted.

Initially I thought a structural answer to the present division of opinion would be to introduce to Sri Lanka the concept of two different types of Exchange members who are also registered broker dealers.

The present type are full-service brokers, advising customers, processing orders, executing orders, clearing and settling transactions, receiving and paying customer funds and securities, being a customer broker of record on CDS files. Present customer representatives and floor brokers of Members are principally full-time employees under the direct observation of qualified supervisors.

A proposed second type of CSE member would have only the pre-trade functions of developing customer relationships, advising customers, processing customer orders. By contract, such a member would engage a full-service member to perform execution and post-trade functions for its customers with customer name

and essential facts disclosed to the full service broker which would be described as "carrying customer accounts on a disclosed basis for an introducing broker."

Separation of the sales, execution and post trade processing functions is logical, representing the different skills and interests of securities professionals.

Each type of firm would have its own legal, financial and regulatory responsibilities as agreed in their contract and explained to customers by letter when a new account is opened. An estimated more than 90 percent of American registered broker dealers introduce their customer accounts on a disclosed basis to probably less than 500 broker dealers carrying customer accounts.

The second type of entity might be called an Associate Member, or Introducing Member of CSE and would require registration with the SEC. I favor that type of relationship of introducing and carrying firms whether it is for the purpose of structuring an agency relationship or simply because for some sales organization is economic and convenient. For carrying firms, it uses marginal processing capacity and adds to efficiency of scale.

However, at a dinner with members I found that they are quite willing to accept financial and regulatory responsibility for agents. They view agents as equivalent to an employee without the restrictions imposed by law on employment practices. I was surprised to learn that law requires payment of employees by salary, not by commission (a serious impediment to sales incentive). An impediment to engaging with that type of agent is restriction by CSE of splitting commissions with agents.

The controversy concerning agents is a perfect example of a situation where a written consideration paper, informal discussion meetings on such a paper and written comments have promise of developing a regulatory consensus.

3. Functional Fragmenting of the securities industry structure as compared to permitting all regulated functions by any Exchange member organization is likely to weaken distributive capacity, financial protection and operational depth of service to customers. It will increase the exposure of fragmented firms to financial failure in market fluctuations as compared to firms able to generate income from certain lines of business in periods when other lines are in recession.

CSE members should have optional choice to maximize money market profits, and to promote liquidity by regulated firm trading. Instead there seems current retrogression in plans for the SEC to regulate separate organizations in the

business of extending credit collateralized by securities, and eventually to encourage separate organizations for dealing in listed securities, and for underwriting new public issues.

4. Reconsideration of Capital and Security Deposits - A major step forward was accomplished by requiring monthly balance sheets, profit and loss, and cash flow statements to be filed with the CSE and copies transmitted to SEC. These statements are being reviewed by staff to monitor profitability and compliance with existing capital requirements.

Substantial detail is presented in these financial reports. For ease of review by regulatory staff, key figures should be computerized or organized on manual spread sheets for easier observance of trends in each firm as shown by the succession of monthly reports. A valuable management tool for members could also be constructed from these data. For example publication of the percentage ranges and averages of each income and expense category for member firms (without any identification of individual firms) would provide a yardstick for comparison by each firm of its business with that of firms as a whole.

There does not seem to be a widespread understanding of the functions and differences of Clearing Funds and Capital Requirements, respectively. The primary purpose of a Clearing Fund is protection of participant broker members from losses on open contracts at the time of failure of another member. Each participant is required to place on deposit in the Clearing fund values perceived as adequate to cover net profits and losses on that member's open contracts in case regulators order close out of positions if that member fails. As a back-up to that level of protection, if net profits and losses on close out were greater than a firm's clearing deposit, the deficiency would be borne pro-rata from deposits of other participants. A clearing fund deposit is considered a liquid asset.

Capital requirements are in addition (even primarily) for protection of customers and other creditors. They are designed to anticipate the liquidity needs of a broker in times of financial crisis - a run by customers to withdraw their credit balances, a flood of deliveries of securities on open contracts by other brokers when there is publicity or rumor that a firm is in financial difficulty, when firms also hold proprietary positions or do margin lending their loss risk in a market break or collapse of price in a particular security, a large theft by an employee.

In Sri Lanka, the security deposits required by law with the related bank guarantee system provide the type of protection to open Exchange contracts usual in a Clearing Fund, as compared to a capital requirement. I am firmly convinced by experience that any values meeting a clearing fund or capital requirement

should be irrevocably in control of the clearing fund or Exchange member. But the bank guarantee system was not challenged in 1990 as it seemed then a reasonable tool for small firms with little securities business and strong parents. Meanwhile the fragility of a guarantee has been demonstrated by a court injunction restraining the CSE from calling the guarantee of one firm.

As a result the CSE Board recently required each member to post Rs1 million of the Rs5 million minimum security deposit in cash or government securities, and to add each month an amount equal to at least 15% of their gross income until the full security deposit of each is comprised of cash or government bonds. Thus the bank guarantee system is being phased out, thereby eliminating the guarantee deficiencies pointed out in 1990.

Required capital continues to be expressed as share value rather than as liquid assets reduced by allowances for fluctuating business risks and in ratio with selected liabilities. The difference is not ordinarily material with member business presently restricted to brokerage activity with defined customer payment and delivery periods. But there could be serious risk in times of widespread customer renege in market breaks or security suspension. It will be of great importance and benefit if the lines of business permitted for members are broadened.

With the minimum requirement for share capital at Rs 2.5 million and the minimum requirement for security deposit of Rs5 million moving to cash and cash equivalent form rather than guarantee, the security deposit will become the primary determinant of capital adequacy. Will a firm with only Rs2.5 million of net worth be able to finance both a security deposit of Rs5 million and operating funds? Especially with customer funds segregated in separate bank accounts as required?

My instinct is that the security deposit requirement may be too high in relation to realistic risk and may therefore immobilize an undue amount of member operating funds. On the other hand, the present security deposit may be in the right ball park as a liquid capital requirement. Knowledgeable study of these requirements is possible with presently available member financial data, turnover values, and market movement history.

A methodology to determine a reasonable security deposit is as follow:

a) from CSE computerized records select a sample of 7 days of trades, including broker identification on each side, contract price per share, number of shares, and extended contract value. This sample would represent total trades open at

any time. If the sample is available for a period of unusual market volatility, this would be a plus. But any seven day period can be useful.

b) Apply to each trade in the sample the closing price of all listed securities on the seventh day, and compute the profit or loss on each for both sides of each trade.

c) Sort the profits or loss on each trade for each participant member. Sum for each member its net profits and losses. This sum is a proxy for the net profit or loss of each surviving member if a failing member were suspended on the seventh day with close-outs executed promptly.

d) Construct for each firm, a ratio of its net profit or loss to its average daily turnover value.

e) Assume that clearing fund rules would provide that the fund would pay any net close-out loss to brokers with net losses, and would collect any net profit of brokers with net profits. Compute the net profit or loss to the clearing fund.

f) Very conservative inspection of the figures produced will indicate a desirable clearing fund deposit ratio to longer term average turnover values of each firm.

5. Supervision and control rules as recommended in 1990 express for brokers management principles broadly accepted by business everywhere, including CSE members generally. The CSE Board apparently has not focused on the appropriateness of expressing such principles in rules, both for purposes of public image and as a basis for enforcement in the occasional gross negligence of management practice.

6. Split Authority over Public Issues - One serious new regulatory problem has emerged: The Acts of Parliament only give authority to the SEC over public issues of securities listed or to be listed on the Exchange and not to public issues of unlisted companies. A result is that regulation of issues by government is less comprehensive than in other financial communities resulting in the Stock Exchange now questioning whether it should establish standards of advertising for new issue distribution by members.

7. Regulation of Margin Lenders - The SEC has been considering whether it should propose authority and rules to regulate the business of lending against securities collateral, particularly by firms which do so only to facilitate new securities transactions. The public purposes of such government regulation would be: 1) to limit excessive leveraging of securities ownership, which could result in accelerating price declines in market breaks as in the US. 1929 crash, and 2) to provide parallel protection to customer funds and securities held in security lending collateral accounts as is provided in securities brokers accounts.

We interviewed a manager for a firm engaged in such lending formerly affiliated with a CSE member. We found that there is a broad range of competition in that field from banks and other types of finance companies also lending against securities collateral for a broad spectrum of client business and personal purposes as well as for leveraging of new securities acquisitions.

Our conclusion was that regulation only of lending firms principally or exclusively engaged in lending to leverage new securities positions would not accomplish the public purposes mentioned above. Instead, regulation of securities lending practices and capital of all such lenders would be necessary to control adverse effect on the securities markets and client protection.

Such widespread regulation of lending against securities collateral would be more properly administered by a broad based government regulator such as the Central Bank, as in the United States. The US. Securities Exchange Act of 1934 assigns authority for regulation of securities collateralized credit extension to the Federal Reserve Bank rather than to the SEC. That central bank has three parallel sets of regulations for securities broker/dealers, banks, and other types of lenders. They all require uniform initial lending maximums which for many years have been 50% margins.

Consequently, our recommendation is that the SEC should not seek to regulate a class of lender which could be defined as related to securities brokers and dealers, but rather should support more pervasive regulation of margin lending by the Sri Lankan government.

8. Compensation Fund - In 1989, my first study for Sri Lanka resulted in recommendations for implementing the Compensation Fund which had been authorized and anticipated, but not implemented in Act 36 of 1987.

My 27 page report concluded with specific language for amending the Securities Act and new rules for the then Securities Council and the Colombo Stock Exchange. It outlined a systematic method for collecting data from CSE members to determine an optimum size for the Fund. It pointed out that certain parts of the recommended rules and procedures needed review by bankruptcy counsel.

During this visit almost four years later, I was asked to review a draft memorandum containing rules for administration of a compensation fund substantially drawn from my 1989 study. Only a few hours of my two week visit could be devoted to this request. That memo attempts to convert to SEC rule foundation provisions which I recommended as amendments to the Securities

Acts. This method is not likely to withstand legal challenge by non-customer creditors of a bankrupt broker. The specific law and rule amendments proposed on Pages 17-27 of my 1989 report were crafted as an integrated system. They should not be shortened or amended without well-supported reason.

I find that the method of holding customer securities by brokers has changed radically under the new Depository system. Size of the business has grown very substantially. CSE members have become profitable. The length of time that members hold customer securities and money has shortened considerably. None of the financial data related to possible Compensation Fund size or feasibility of settling open Exchange contracts of a defaulting member has been organized to evaluate feasibility of the 1989 recommended procedures although such data is now available in monthly reports by members to CSE. No changes have been made in law. The government has not demonstrated a willingness to finance a Compensation Fund. A small SEC fee is being levied on securities trades which might be accumulated as compensation fund financing. No study by bankruptcy counsel of potential conflicts with such law is known to have been made. There has been no confirmation that the security deposit system now will assure completion of all open contracts of a defaulting broker.

Today's need is still the open question of 1989 - what is the potential deficiency in identified customer property? Will Compensation Fund resources be adequate for a per-customer distribution which in total will offset the deficiency?

CSE members can not be expected to take over accounts and open contracts unless the security deposit system plus the securities and moneys received equal their obligation to deliver to customers. My proposed CSE Rule 22A limits the obligation of an account receiving firm to perform only "to the extent received or restored by assistance from the Compensation Fund". The draft memo does not reflect this reality as CSE rules were not included.

9. Annual Updating of SEC Data on CSE Members - CSE staff asked my suggestions on improving their form for collecting annual updating of background information on each CSE member firm in a document entitled "Declaration of Brokering Firms to the Securities and Exchange Commission of Sri Lanka."

A great deal of experience in this type of endeavor has been accumulated by the US SEC and expressed in their requirement that each registered broker dealer annually file a similar form and submit amendments during the year to maintain its currency.

My suggestion is that SEC staff about to visit Washington under USAID sponsorship obtain copies of this form and discuss its use with appropriate US SEC personnel. It should be very helpful in amending the Sri Lanka form.

10. Securities Transactions by Directors and Employees of CSE and its Members - CSE management has asked for my advice on rules to enable directors and employees of the Exchange and its Members to buy and sell listed securities for themselves and their families. Where I refer to "employee" below, I mean employees, officers, directors and their controlled accounts and families.

In my 1990 report (Pages 7 & 52), I commented that SEC Rules 21-24 "have no inherent process for decreasing violation of the perceived primary abuses which led to their adoption..." and that "trading in potential conflict of interest situations is better controlled against abuse by regulated openness than by gross prohibition". To ameliorate the supervisory handicap imposed by the rule to require trading through brokers other than an employer, I suggested a rule P605 requirement of an employer's written permission for an employee to open a securities account with others, and sending duplicate account statements to the employer.

As a regulator, I would much prefer to have the trading by personnel of members in accounts only with their member so that oversight of these accounts can be daily. The safeguards should include: Identification in a firm's numbering system of employee related accounts, daily review by a competent executive, placing of orders only through the same channels as other customers (no origination on the exchange floor, no discretion by floor personnel), priority of all customer orders before any employee order at the same price, no trading by employees in a security on which the firm is preparing a research report or within a cooling off period after such publication, no allocation of oversubscribed new issues to employees, no use of privileged information by an employee for his own trades.

Similarly, I have 31 years of experience with a successful system of oversight of securities transactions by NYSE employees. That system requires employees to receive written permission to open any securities account, and if with a non-member, written permission for access to that account by the Exchange. Each employee is required quarterly to report in writing his activity in securities. Initially, such reports were reviewed by each employee's supervising officer - later this function was delegated centrally to Personnel Officers. Employee rules prohibit use of any non-public information acquired as an employee of the Exchange or any trading in securities in preparation for Exchange listing.

Exchange employee orders must be placed in the same way as those of other member customers and treated with the same priority.

Rules recommended in 1990 for some of these areas include: P204, 205, 206, 503, 507, 508, 513, 514, 601, 605.

11. Quotations in Red - This phrase in Sri Lanka refers to the prohibition of a CSE member and its personnel from executing any trades for themselves or customers in securities issued by affiliated companies which may have publicly distributed listed shares. This is a significant problem because most CSE members are units of groups, or subsidiaries of holding companies, engaged in diversified business operations.

Affiliated control in such Sri Lankan groups is similar to that of NYSE member firms which are publicly owned, controlled by publicly owned parents, or have publicly owned affiliates. US rules do not prohibit such NYSE members from executing transactions in securities of associated corporations, but do prohibit recommendation of such securities by such affiliated members. Compliance is easily checked by asking a sampling of customers who have purchased such securities the reason for their purchase.

Insider trading rules control Member personnel who may have unpublished material information concerning such affiliated corporations. Confining all trading of member personnel to their employing Member facilitates supervision in this area.

12. Front Running - The Chairman of the SEC in a September 28, 1993 letter has asked the CSE Board to consider the problem of public perception of floor broker concealed trading ahead of customers (front running), and/or later allocation of best prices to favored accounts.

This type of deception is widely alleged by customers in many exchanges I have visited. In some it is doubtless a reality, in others an illusion which can be dispelled by careful reconstruction of a market and patient written explanation of trade sequences by regulators in response to customer complaints.

Customer complaints about their trades are the most frequent type of inquiries received by the NYSE.

Investigating such inquiries requires a time-identified audit trail of all orders and trades in the questioned time period. NYSE rules consequently require time-

identified paper or computer records at entry of each order and each processing point in a member's order rooms, floor receipt and execution report, and each execution in the trading sequence. Thus, orders competing in the market at a particular period can be substantially reconstructed to explain to a customer why he did not receive an execution when he expected, or at a price he expected on his particular order. Exchange investigation can determine whether a competing order which did get executed in competition with a customer order may have been for a concealed account of a floor broker, or whether an upstairs employee or a floor broker may be running his own concealed order ahead of a customer order and re trading to the customer at a less favorable price.

At NYSE, floor broker trading ahead of customers is extremely rare. Occasionally, customer brokers are found following a customer's trading for own account - which is a serious offense when the broker believes his customer may have access to inside information. Any change in designation of an account for which an order was executed requires supervisory approval. Occasional violation of this curb on post-trade passing of favorable transactions to favored accounts is subject to discipline.

13. Compliance Officers - The SEC Chairman also asked that the Board of Directors of CSE consider requiring every broking firm to have a Compliance Officer whose responsibility would be to ensure that all members of the company comply with CSE and SEC rules. All apparently now do so.

In 1990 I suggested for CSE a rule P601b as follows: 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.

This rule for the NYSE clearly establishes the Chief Executive of a Member as primarily responsible for compliance. In the US., on the other hand, the title of "compliance officer" means the chief executive's designate for the "follow up" function in clause (2) of the above rule, principally in the sales and promotional aspects of each firm's business. An "internal auditor" often has parallel responsibility in the bookkeeping, post trade processing and capital parts of member business. A compliance officer ordinarily is also assigned the ministerial functions of registration of personnel, filing of regulatory reports, etc.

The Chief Executive of an NYSE member delegates compliance responsibility formally in writing to each of his subordinate line managers. The compliance officer and internal auditor have staffs and systems to review that each such line manager is properly performing his compliance function. For example, rules require such a compliance officer to have each branch office of his firm inspected at least once a year in a planned program in which the manager is interviewed on his supervision practices, records kept in the office are reviewed, a sampling of customer brokers are interviewed and their required customer account and portfolio records are reviewed both for the quality of service and written evidence of their periodic review by the manager. In the central office, the compliance officer reviews such matters as trades by employees, complaints by customers, registration of personnel, etc.

There was an attempt several years ago by the US SEC staff to impose on compliance officers the same responsibility as that of a line manager. A registered representative in a Florida branch had committed a serious fraud for which his branch manager was also penalized for inadequate supervision. The SEC staff also brought charges of failure to supervise against the compliance employee (Huff) assigned regular duty to review that area of the firm's business. The Hearing Officer initially found Huff guilty. Several years later, after appeal, the full Securities Exchange Commission reversed the Hearing Officer's decision. Their finding was that such a compliance officer did not have power to supervise and control the branch as did the branch manager - that instead he held a staff relationship to the Chief Executive for the follow-up function.

The SEC law which was written as a follow up to the NYSE rules on supervision contains a clause which in substance says that a Chief Executive or other high level management person will not be held responsible for the supervisory failures of his subordinates if there was in place a reasonably functioning system of such compliance review.

Whether each firm should have a compliance officer of the US type is in practice determined by the size of the firm. In very small firms, the Chief Executive can personally review whether his subordinates are performing their assigned functions. As firms grow, first one compliance officer and later large compliance and internal audit staffs are necessary.

My suggestion is that CSE adopt recommended Rule P601b) and related supervision rules and the compliance concepts it defines.

14. Enforcement of Listing Agreements - CSE hesitates to use the only enforcement penalty available to them in instances of failure to comply with listing agreements by listed companies. The sole penalty, suspension of trading or delisting, seems too harmful to share owners for use in most practical non-compliance situations. Penalty by the SEC is similarly limited in enforcing its own listing rules which are more extensive than in many other countries.

Publicity concerning non-compliance would be both a persuasive tool with listed company managements and a disclosure service to share owners.

Since most listing conditions are the subject of SEC rule or law, reference to the Attorney General for consideration of criminal prosecution should also be persuasive in achieving compliance by listed company managements.

15. Advertising and other Communications with the Public - The CSE staff has also asked for my experience on whether and Exchange should review and regulate member advertising. The NYSE gave intensive attention to member firm advertising, sales literature, research reports, and general communications with the public early in the 1960's. The rules adapted in 1990 for CSE as P501 and P606 were the result as in my 1990 recommendations:

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 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.

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.

P606B - Definitions, Research Reports - 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.

In the early days of these rules, advance Exchange review and approval was required for all member advertising. After the community grew familiar with types of advertising deemed acceptable, advance approval was discontinued in favor of periodic calls by the Exchange to firms to submit all written

promotional materials used in a prior week or month for Exchange review. Such a progression of regulation and practice is recommended for CSE.

16. New Issue Problems - CSE is concerned with clarity of functions and responsibilities of participants in new issues of securities variously described as underwriters, managers, registrars, sponsoring brokers. Initially, this seems to be more an industry educational problem rather than regulatory.

One method of addressing the problem would be to assemble a committee of representatives of members, securities attorneys and accountants, and issuers to prepare a Glossary Booklet defining the terms used in new issues. Ideas for rules or guidelines might also be produced - for example, should there be one or two acceptable methods of allocation in oversubscriptions with that chosen described in the prospectus.

A draft of a Glossary would be helpful in focusing attention of such a committee. A start on such a draft might be as follows:

A Glossary of Functional Words in New Issues of Securities

The functions and responsibilities of various participants in new issues of securities are fixed by contract between parties. The usual meaning of frequently used words are as follows:

Issuer - The corporation or trust raising capital by a share or debt offering to the public.

Underwriter - a financial business entity either buying an entire new issue of a security for resale to the public, or guaranteeing to buy any securities otherwise not sold in a public issue of securities.

Best Efforts Distribution - Marketing of a new securities issue by one or more financial intermediaries who contract with an issuer to use their best efforts to distribute such issue without any obligation to sell all of it or to buy any remainder. Ordinarily, there is provision for at least a minimum sale of the issue which if not accomplished, the sums subscribed are returned to the subscribers. Subscribed moneys in such issues are held in escrow pending completion of the offering.

Issuing Agent - a processor of the physical preparation of share or debt certificates and their distribution to owners. An issuer may be its own issuing agent, or may contract with a bank or other entity engaged in such business.

Transfer Agent - Ordinarily the same party engaged as issuing agent also acts as transfer agent for cancellation of old securities and issuance of new securities following secondary sale in the stock market.

Registrar - In US practice, a bank called the Registrar is required to co-sign each certificate attesting to the validity of its issue within the terms of issue approved by a general meeting of

shareholders. The purpose is to prevent sale of unauthorized shares or "watering". In Sri Lanka, the term is sometimes used in the same way as issuing agent.

Distributor - a financial entity which participates in the marketing of a new issue to the public without any obligation to buy securities not otherwise sold.

Syndicate - a group of underwriters and distributors acting formally pursuant to a written agreement to market a new issue to the public. The issue may be underwritten or best efforts.

Manager - The financial institution acting as overall coordinator of pricing and management of a new issue. For syndicates, there are often two or three co-managers. Managers centralize information on potential demand for a new issue and other relevant information to assist the issuer and underwriters and/or distributors decide on an offering price. Managers determine allocation of percentages of underwriting participation in syndicates, and number of shares allocable to distributors. Managers also supervise the production by attorneys and accountants of required prospectuses, listing applications, registration documents, etc.

Sponsoring Member - A Colombo Stock Exchange member who gives particular assistance to an issuer and the manager of an issue in completing applications and other requirements for CSE listing, assists the Board of the Exchange in identifying and requesting any additional information needed, and offers to the Board its professional evaluation of the quality of the company and the adequacy of the distribution for trading in an orderly way on the Exchange.

Hot Issues - New issues expected to be or actually oversubscribed. Underwriters and distributors are prohibited from retaining for firm account any part of such issues, unless pursuant to prior agreement with the issuer, this type of compensation is disclosed in the prospectus. Directors, Officers and Employees of Underwriters and Distributors, their families, and controlled accounts are limited to participation in such issues to the same ratios as subscribers generally and in relation to the usual participation of such parties in new securities issues which are not oversubscribed.

Offering Period - The agreed time for an organized new issue offering, from initial date to termination. There are two types of offering period:

1. As usual in Sri Lanka, an offering period begins promptly after approval of the offering prospectus by the SEC. Seven days are allowed for dissemination of that information. Subscription with payment is then accepted for a specified period, usually 21 calendar days, without any confirmation of sales during that period. At the conclusion of the offering period if there is oversubscription, a lottery is held to determine actual distribution.
2. In American practice, the offering date is set soon after approval of the prospectus by the SEC. Pricing of the issue is determined by the concerned parties immediately before opening the offering. Firm sales are made and confirmed to customers at the end of each day of the offering - thus there is time priority of allocation except on the first day when oversubscription may require allocation, which is determined by each distributor based on the total allotted to that distributor and "hot issue" regulations. The offer is terminated when the issue is sold, or on a date fixed in the original distribution agreement, whichever is sooner. This termination date has importance in fixing the date at which underwriters may sell left over shares at lower prices if the offering is not entirely successful.

Stabilization - For an additional issue of an already traded security, or for an issue subject to secondary "when issued" trading during the course of an offering, there may be purchases and sales in the secondary market by the underwriters to maintain a reasonable relationship between the offering price and the secondary market price. Such stabilization is subject to regulation.

17. Odd Lots - I answered a query about separate transactions of odd lots, especially odd lots trailing a round lot, by suggesting that this is solely a matter of operational logistics at volume levels of a particular exchange. It would be desirable from a customer standpoint to have odd lots and trailing odd lots traded in the regular auction market. But the volume of exchange trading usually necessitates a standard trading lot. In New York volume necessitates an even further modification of priority in certain situations to order, by size.

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