

LEGISLATIVE REVIEW AND TRAINING CONCERNING SECURITIES AND FINANCIAL MARKETS IN SRI LANKA

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

**By
Jeswald W. Salacuse
Dean and Henry J. Braker Professor of Commercial Law
and
Joel P. Trachtman
Associate Professor of International Law
Fletcher School of Law and Diplomacy, Tufts University**

December 1993



**International Science and Technology Institute, Inc.
1129 Twentieth Street, NW ■ Suite 800 ■ Washington, DC 20036
Telephone: 202-785-0831 ■ Fax: 202-223-3865 ■ Telex: 272785 ISTI UR**

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.

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.

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.

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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SECTION 1

I. Introduction

In connection with the Financial Markets Component of the PSPS Project, the consultants visited Sri Lanka during the period August 16-25, 1993, to conduct training seminars on, and to review selected aspects of the country's laws on companies and securities regulation. The purpose of this report is to: 1) describe the activities undertaken during the visit to Colombo; 2) to review and analyze Sri Lanka's legislative and training needs with respect to securities and financial markets; and 3) to recommend appropriate action to improve its securities and financial regulations and to provide the necessary related training.

Dean Salacuse was primarily responsible for the training aspects of the consultancy, and Professor Trachtman had primary responsibility for a review of selected aspects of Sri Lanka's laws and regulations affecting securities and financial markets. At the specific request of the USAID mission director in Sri Lanka, they are submitting a single report on their assignment. Legal change and legal training are inextricably linked. Indeed, no effective legal change can take place without appropriate and effective legal training.

II. Legal Training for Practitioners, Judges and Government Officials

A. The Need for Training

Although Sri Lanka has a well-established legal tradition and many well-educated lawyers, its practicing bar, judiciary, and government officials generally are not equipped to deal with the legal and regulatory aspects of sophisticated financial transactions in a market economy. Several factors explain this deficiency. First, Sri Lanka's move from a command to a market economy and the development of a legal and regulatory framework to govern securities transactions are phenomena that have occurred only within the past few years. For example, the Securities and Exchange Commission of Sri Lanka Act, which sets down the country's basic framework for regulating the sale of securities, dates only from 1987. Consequently, relatively few lawyers, within or outside the government, have had much experience with this emerging area of law. Second, although the country's two institutions of legal education — the Law College (an independent professional training school) and the Faculty of Law of the University of Colombo — provide adequate training in the basics of Sri Lankan law, both institutions devote relatively little attention to commercial law and give no training at all in the law applicable to financial and securities transactions.

As a result, unlike most American lawyers bound for a corporate practice, Sri Lankan lawyers emerge from their legal training without the knowledge and analytical tools to understand the financial and securities transactions and the legal issues related thereto. And finally, since most judges and government lawyers enter judicial and government service directly after finishing their legal education, they do not have the opportunity to learn through the experience of counseling and representing private enterprise, as is the case in other countries, such as the United States and the United Kingdom, where judges are selected from among the more experienced members of the private bar. Moreover, as they rise in the ranks of the judiciary system, judges' experience in Sri Lanka is confined almost exclusively to criminal, civil and land cases. Only occasionally are they required to decide complex corporate and securities law questions.

Well-trained private lawyers, judges and government officials are essential to the effective functioning of financial and securities markets and their related regulatory systems. First, a market economy depends on individual transactions that are organized and structured according to law. Lawyers play a key role in giving legal and planning advice to private sector participants. Second, since all private transactions are based on the legal device of contract, the courts must be prepared to interpret and enforce those contracts expeditiously when transactions are challenged. If, because of defects in the judicial system, contracts cannot be enforced in accordance with the intent of the parties, then a fundamental pillar of the private enterprise system is destroyed. And third, private enterprise and financial markets require regulation to preserve their soundness and fairness. If private parties are allowed to manipulate those transactions and markets unfairly, then one of the social goals of capital markets — the sound allocation of capital — is thwarted. Moreover, to the extent that certain players in the markets are perceived to violate the rules, other persons may decide to refrain from participating. Consequently, a failure to enforce the rules and regulations of the market can cause it to fail to achieve its second goal — effective capital mobilization. Thus, effective regulation is essential for effective markets. And for there to be effective regulation, a country must have well-trained government officials and judges to apply the law and regulations in a sound and systematic manner.

For all of these reasons, the Chairman and Director-General of the Securities and Exchange Commission of Sri Lanka decided that the SEC should sponsor a program of legal training. They therefore requested the two consultants to come to Sri Lanka during the period August 16-25, 1993, to organize a series of seminars for judges, lawyers, government officials, and stock exchange personnel on selected aspects of securities regulation.

B. The Training Seminars

In organizing seminars for judges, lawyers and government officials, the SEC faced a first and fundamental question: would these legal professionals attend such a seminar, the first of its type to be held in the country? Few judges and lawyers thus far had actually handled securities cases, and one Supreme Court judge said that he did not expect to hear one during his career on the bench. Lack of interest in the subject matter or a belief that it was not relevant to their work, it was feared, might deter lawyers and judges from participating in the seminars. Moreover, some senior legal professionals, such as Supreme Court judges, might consider participation in a seminar as "students" to amount to a loss of status and therefore decline to attend. Fortunately, these concerns were carefully considered and managed by the SEC Chairman, SEC Director-General and ISTI personnel. Thanks to these diligent efforts, the seminars were well attended and, in the opinion of the consultants and the SEC, the participants' interest was high.

During the course of their visits, the consultants conducted a total of six separate seminars. They were as follows:

- i) **August 17 - Seminar for Senior Members of the Judiciary.** A four-hour evening meeting with judges of the Supreme Court (including the Chief Justice) and the court of appeals. Approximately 30 persons attended.
- ii) **August 18 - Public Forum on Financial Markets and Securities.** Open to the public and advertised in the local press, this three-hour session at the Institute of Chartered Accountants was attended by between 55 and 60 persons.

- iii) **August 19 - Seminar For Brokers and Stock Exchange Personnel.** Presided by the Chairman of the Colombo Stock Exchange, this session on securities and market regulation drew approximately 40 participants and lasted two and one-half hours.
- iv) **August 19 - Seminar For the Lawyers in the Attorney-General's Office.** Attended by 55 lawyers who have primary responsibility for securities regulation enforcement in the courts, this session lasted four hours and included the Solicitor General, who was also serving as Acting Attorney General.
- v) **August 21 - All-day Seminar for Members of the Sri Lanka Bar Association.** Relying on the Bar Association to recruit participants, this seminar, held from 9:00 a.m. to 4:00 p.m. on a Saturday, attracted an audience of approximately 20 persons who paid a fee of 500 rupees each to attend.
- vi) **August 21 - Evening Seminar for Lower Court Judges ("the Minor Judiciary").** Held at the specific request of the supreme court judges following the seminar with them on August 17, this four-hour meeting was attended by approximately 15 judges from the district courts of Colombo.

The consultants attempted to tailor each seminar to the perceived needs and interests of the participants. Generally, each seminar began with a discussion of the new policies fostering private enterprise, an open economy and the development of financial markets. It then examined how law and regulations served to implement these policies. In particular, discussion focused on the kind of legal system that best fostered private enterprise. Thereafter, the seminar considered the legal forms of enterprise, with particular reference to company law. This then led to a review of company securities, their nature, and various types, which in turn then introduced the general subject of securities regulation. The discussion of regulation focused essentially on governmental regulation, but self-regulation and regulation through private rights of action were also considered. Each seminar addressed the goals, types, methods of regulating the sale and distribution of securities. It also considered the regulation of securities markets and market professionals. Throughout the program, the consultants drew not only on the American experience in securities regulation, but also on appropriate examples from other emerging economies. Summaries of the consultants' presentations at the seminars are attached as appendices to this report.

With the exception of the all-day seminar for the practicing bar, none of the training sessions lasted more than four hours. This time constraint forced the consultants to focus on selected general topics and did not permit them to give a comprehensive course on securities regulation and corporate transactions. Although the all-day seminar for the bar did not attract as many participants as had been hoped (the bar association had promised 75 persons), it was the most satisfying in terms of the number and depth of the topics covered and the intensity of participation by those in attendance.

In general, the seminars had three positive results. First, they heightened the interest of leading judges, lawyers and government officials to the important role of law and regulation in Sri Lanka's emerging market economy. Second, they gave these same individuals some basic concepts and analytical tools to help them deal with regulatory questions that many of them will inevitably face. And third, the seminars enabled the consultants to assess the training needs of Sri Lanka's legal profession and to gain the knowledge to develop an intensive, comprehensive training program in securities and financial regulation for practicing attorneys, government lawyers and the judiciary.

C. Future Training Efforts

The consultants recommend that USAID support a program of intensive training in the regulation of securities and financial markets, to be conducted under the auspices of Sri Lanka's Securities and Exchange Commission. The program would have three basic elements:

- i. an intensive course of seven to ten days to be conducted annually in Sri Lanka for a period of three years;
- ii. a training course in the United States, with associated internships and/or professional observation visits; and
- iii. one-year fellowships to permit a limited number of young lawyers to pursue an LLM with a specialization in securities regulation or financial law at an accredited American law school.

1. Intensive Course in Sri Lanka

The proposed seven to ten day course would be held in Sri Lanka, outside of Colombo, in May or June of 1994, for approximately 30 to 35 participants from the judiciary, the practicing bar, and the Attorney General's office. Others who might also participate might include stock exchange personnel, accountants, and one or two professors from the law faculty or the Law College. Selection of appropriate persons is a key element in the success of the program. It is therefore recommended that the SEC have responsibility for recruiting and selecting the persons who will attend the seminar.

The seminar would be a highly interactive exercise. Readings, cases, and transaction documents would be sent in advance of the program. Participants would be expected to complete reading assignments in advance of each day's session. The seminar would include the following subjects:

- Sri Lanka's New Economic Policies and Their Impact on the Legal and Regulatory System
- The Nature of Securities and Financial Markets
- Advanced Company Law
- The Nature of Securities
- Securities Offering Regulation
- Market Regulation
- Insider Trading and Other Common Types of Securities Misconduct
- Mergers and Acquisitions
- Elements of Accounting
- Monopolies and Fair Trading Practices
- Direct Foreign Investment

- Portfolio Foreign Investment
- Financial Transactions
- International Contracts and Transactions
- International Commercial Arbitration

It is hoped that the seminar would not only give the participants new knowledge and analytical tools in areas that are crucially important to Sri Lanka's success as an emerging market, but also that it will facilitate communication and dialogue among legal professionals who thus far have little opportunity to talk and work together on important policy matters of common concern.

Depending on the success of the first year's program, the consultants recommend that the same intensive course be offered in 1995 and 1996, thus ultimately providing advanced training to approximately 100 persons during the course of the three-year cycle. A hundred trained legal professionals could significantly strengthen the regulatory and compliance capacity of the country.

The consultants discussed the idea of such a course with the SEC chairman and director general, as well as with USAID personnel. All concerned gave strong preliminary approval to this proposal.

2. Training Course and Observation Visits in the United States

To provide advanced training, the consultants recommend the organization of a special course in the United States for approximately 20 legal and securities professionals from Sri Lanka, possibly in the summer of 1995. The advantages of this course, in addition to that held in Sri Lanka, are two-fold. First, it would allow the organizers to draw on a wide range of American professional expertise, including experts in financing, securities markets and regulation. Second, it would include internships at or observation visits to U.S. organizations, including regional stock exchanges, state securities regulatory bodies, the U.S. Securities and Exchange Commission, investment bankers and underwriters, U.S. courts, and American corporate law firms. The consultants would be prepared to explore holding such a short course at the Fletcher School of Law and Diplomacy, which has had extensive experience in organizing similar programs for professionals from many different countries over the years.

3. LLM Fellowships

A final element in increasing institutional capacity in Sri Lanka might include a limited number of fellowships to allow particularly promising young Sri Lankan professionals to pursue a year of advanced legal education in the United States. For legal professionals, this would entail pursuing a LLM degree at an American law school with particular strength in securities regulation, advanced corporate law, business transactions, law and economics, and corporate finance. Assuming sufficient resources, the consultants recommend that between 3 and 5 such fellowships be awarded beginning in 1995, perhaps to those participants who distinguish themselves at the short courses to be held in Sri Lanka.

III. Legislative Review

In connection with our mission to Sri Lanka from August 16 through August 25, and preparatory and follow-up work in the U.S., we have been requested to consider and report on the following topics:

A. The disclosure regulation applicable to unlisted companies.

Unlisted companies in Sri Lanka are not required to submit prospectuses proposed to be used in connection with public offerings to the SEC for review prior to registration with the Registrar of Companies. Furthermore, the disclosure requirements applicable to these prospectuses remain the requirements of the Companies Act, rather than the additional requirements of the Securities Act. This raises the following issues:

1. Are the disclosure requirements of the Companies Act adequate for these unlisted companies?
2. Are the post-public offering disclosure (continuous disclosure) obligations of these unlisted companies sufficient to support a trading market in their securities?
3. What type of offering or dispersion of share ownership is necessary to give rise to the Companies Act disclosure requirements, or the disclosure requirements under the Proposed Amendments?
4. Is there a private placement exemption from the registration and review provisions; and if not, should there be?
5. Should authority over disclosure in connection with public offerings be concentrated in the SEC?

B. Is sufficient authority to conduct surveillance, investigate and enforce allocated to appropriate agencies?

1. What surveillance, investigation and enforcement powers are allocated to the SEC, the Colombo Stock Exchange, the Registrar of Companies and the Attorney General, respectively?
2. Are these powers sufficient, and are they allocated appropriately?
3. Is there sufficient authority for both criminal enforcement and civil enforcement?
4. What private rights of action exist; are they sufficient to protect investors?

C. What, if any, regulation of underwriters of securities is appropriate?

What regulation of underwriters currently exists in Sri Lanka? How should "underwriter" be defined?

1. Should public offerings be required to be effected using underwriters?
2. If so, should there be a minimum number of underwriters required?
3. What other types of regulation of underwriters are used in the U.S., and why?
4. What types of entities should be permitted to engage in underwriting? Should unit trusts be permitted to do so?
5. What is the liability of underwriters in connection with issues of securities that they underwrite? Are any changes necessary?
6. Are underwriters "dealers" under the Securities Act; should they be required to register as such, and if so, does this raise regulatory problems? (We understand that no "dealers" have been licensed to operate in Sri Lanka.)

D. What is the role of credit rating agencies, and how, if at all, should they be regulated?

1. How can the development of rating agencies be fostered?
2. Should the government license these agencies?

E. Summary of Conclusions and Recommendations

The quality of Sri Lankan securities law is relatively good, given its newness and the fact that it has not seen much use as yet. In addition, the professional abilities of certain SEC and CSE personnel appear exemplary. However, there are certain important gaps in the law, and certain important regulatory resource constraints. Of course, our review was limited in scope, and we have only identified the gaps and constraints that came to our attention in connection with our review.

Disclosure Regulation of Unlisted Companies. While there are some smaller gaps in disclosure regulation of listed companies that should be addressed, the gap in disclosure requirements, and in enforcement of those requirements, in connection with unlisted companies, is unacceptably large. We recommend that this gap be addressed in order to maintain the integrity of the Sri Lanka securities market. In connection with this work, it might be appropriate to further define a small and/or a private offering exemption from the requirements for regulatory supervision, but not from the disclosure requirements or from the application of liability rules in connection with faulty disclosure. Post-offering disclosure, by unlisted as well as by listed companies, should also be examined, and should require a level of disclosure consistent with that required in connection with an offering. This is necessary in order to support a trading market (and therefore, it would be appropriate to exempt privately-offered securities from certain continuous disclosure requirements). Consideration should be given to centralizing this regulatory function in the SEC.

Enforcement powers of the SEC. The SEC lacks a complete statutory framework allocating complete enforcement powers to it. Without a complete set of enforcement powers, the SEC will be hampered in performing its function. Perhaps even more importantly, there are significant gaps in the pattern of statutory prohibitions.

Regulation of underwriters. The most important change in the regulation of underwriters that Sri Lanka could make would be to clarify the definition of underwriter and of the liability of underwriters for misstatements and omissions in prospectuses. We would not recommend a requirement for use of underwriters. However, clarification of the ability of underwriters to engage in stabilization transactions in connection with public offerings, and to extend credit to purchasers, might be appropriate. In addition, Sri Lanka might wish to review the need for greater regulation of compensation to underwriters, and in the ability of underwriters to grant discounts.

Rating agencies. Rating agencies grow with, and foster the growth of debt markets. Sri Lanka may encourage the development of its debt market by fostering the establishment of rating agencies, but little regulatory work is needed. The one regulatory role that might be significant is to make sure that the liability of rating agencies for negligence is clear and not too onerous.

In connection with our work, we have reviewed, *inter alia*, the following materials:

1. The Companies Act of 1982 (as amended by the amendment of 21 August 1991, the "Companies Act").
2. The Securities and Exchange Commission of Sri Lanka Act (as amended through 5 July 1991, the "Securities Act"). We have also considered proposed draft amendments thereto attached as Exhibit A hereto (the "Proposed Amendments"), which we understand will be further revised.
3. The Securities and Exchange Commission of Sri Lanka Rules, 1990 (the "SEC Rules").

4. **The Securities and Exchange Commission of Sri Lanka Regulations, 1990 (the "SEC Regulations").**
5. **The Rules of the Colombo Stock Exchange (the "CSE Rules").**
6. **The Fair Trading Commission Act of 1987 (as amended by the amendment of 28 August 1992, the "FTC Act").**
7. **The September 1991 Draft Final Asian Development Bank Report, "A Study of the Regulation of Securities Markets in Sri Lanka," prepared by The Aries Group, Ltd. in association with Price Waterhouse (the "ADB Report").**

We have had interviews, in person or by telephone, with the persons listed on Exhibit A hereto.

We have also submitted a draft of this report to the staff of the Securities and Exchange Commission of Sri Lanka for their review, prior to finalizing this report. Our analysis follows.

SECTION 2

I. Disclosure Regulation Applicable to Unlisted Companies

This section of the report is structured as follows. First, we summarize the disclosure regulation applicable to companies listed on the Colombo Stock Exchange, in order to place in context the remainder of the discussion. Second, we summarize the disclosure requirements under the Companies Act, as applicable to unlisted companies. Third, we compare the latter requirements with those applicable to listed companies. Fourth, we compare the regime for continuous disclosure under the Companies Act with that applicable to listed companies under the Securities Act, the SEC Rules and the CSE Rules. Fifth, we examine what type of offering or dispersion of share ownership is necessary to give rise to the Companies Act disclosure requirements, or the disclosure requirements under the Securities Act and Proposed Amendments. After this review, we turn to a discussion of the questions listed above.

A. Disclosure Regulation of Listed Companies

The Securities Act itself contains no requirements as to disclosure by public companies.

Section 4 of the SEC Rules requires that companies applying for a listing to a stock exchange meet the listing requirements set forth in Schedule II to the SEC Rules.¹ Section 3 of Schedule II requires such companies to refrain from issuing any prospectus until it is approved by the Exchange. Part IV of Schedule II prescribes the contents of such prospectuses.² In addition to the specific requirements, as described below, Part IV requires that any additional material information be disclosed as well. The Exchange may also require the inclusion of additional specific information. The prescribed disclosure called for by Part IV in *connection with listed companies* may be summarized as follows:³

1. SEC Rules Requirements for Disclosure:

- a. Undertakings of responsibility by the directors and by "the Company managing the issue." These undertakings of responsibility provide assurances of accuracy of information provided, and of no omission of facts the omission of which would make the statements provided misleading.⁴ We comment on these undertakings below.
- b. Descriptions of the securities offered for sale, and the rights appertaining thereto. Descriptions of the method of offering and the underwriters, and all costs of the

¹ Schedule II provides that listing is at the sole discretion of the Executive Committee of the Exchange. Depending upon how this authority is exercised, it may accord too much discretion to the Executive Committee. In addition, some of the criteria for listing should be reviewed to ensure that they are not unnecessarily intrusive.

² The requirements of Part IV are, for all purposes relevant to the following summary, substantially similar to the requirements contained in §7 of the CSE Rules. We note that there seem to be certain limited differences between these otherwise similar sets of requirements.

³ It should be noted that the Companies Act disclosure requirements, described below, would apply in addition to the disclosure requirements described here.

⁴ This is not quite an appropriate formulation. It would be better to refer to any material facts, which is a broader category than those facts needed to make information provided not misleading.

offering, including underwriters' commissions. It is not clear whether a description of the other terms of the underwriting must be described, but they should.

- c. Descriptions of other securities and capital structure of the issuer.
- d. Indication of controlling persons and 10% or more shareholders, and interests of directors.
- e. Estimated proceeds and use thereof.
- f. Material contracts outside the ordinary course of business during the preceding two years⁵ must be summarized; these must also be made available for inspection.
- g. A general description of the business. This seems to call for a relatively superficial description; however, significant depth would be desirable. Description of prospects. Description of any material information, including all trading factors or risks.
- h. Description of properties.
- i. Financial information:
 - (1) Sales for five years, including a reasonable breakdown between more important trading activities.
 - (2) Loans and other indebtedness and lease financing, as well as all guarantees or other material contingent liabilities, outstanding, and all security interests granted.
 - (3) Auditor's report showing a summary of earnings for the last five years, and calculation of net income.
 - (4) A consolidated balance sheet at the end of each of the last five years.
 - (5) Analysis of financial condition and operations, including liquidity trends, capital commitments, unusual events or transactions affecting reported income, known trends or uncertainties.
- j. Management information for directors and chief executives, including names, experience, and certain issues (bankruptcy, convictions for fraud, securities violations, etc.), as well as share options, employment contracts. Aggregate emoluments of directors. Interests of directors in assets acquired or disposed in last two years. Transactions with management in last two years.

⁵ This should be revised to refer to any contracts still in force.

B. Disclosure Regulation of Unlisted Companies

In connection with unlisted companies, the Companies Act requirements alone, and not the additional Securities Act requirements described above, would be applicable.⁶ Section 40 of the Companies Act requires each prospectus to make the disclosures required by Part I of the Third Schedule to the Companies Act. These disclosures are much more oriented to the corporate law and corporate finance issues, giving scant coverage to the issuer's business and prospects.

1. Third Schedule to the Companies Act Requirements for Disclosure

The following clause numbers correspond to the clause numbers in the Third Schedule:

1. The objects and powers of the company.
2. Number of founders' or management or deferred shares, and the interests of the holders thereof in the property and profits of the company.
3. Requirements in articles as to share ownership of directors, and any provision regarding remuneration of directors.
4. Names, descriptions and addresses of directors.
5. For shares offered to the public:
 - (a) Minimum proceeds required for purchase of property, payment of preliminary expenses, repayment of debt, working capital.
 - (b) Other sources of funds for such expenditures.
6. Time of opening and closing of subscription lists.
7. Amount payable on application and allotment.
8. Options on shares or debentures outstanding, and a description of term and exercise price.
9. Issuances of shares and debentures in two preceding years otherwise than for cash, describing consideration.
10. For property to be acquired with proceeds, disclosure of names and addresses of vendors, amount payable in shares or debentures, and other particulars of the transaction, except where the transaction is immaterial or in the ordinary course of business.
11. Cash payable for any property described in clause 10.
12. Commissions to underwriters paid within two preceding years, or payable (excluding commission to subunderwriters).
13. Preliminary expenses and expenses of the issue.
14. Payments paid in two preceding years or proposed to any promoter.
15. Description of material contracts outside the ordinary course of business, other than those entered into more than two years prior to the date of the prospectus.
16. Names and addresses of auditors.
17. Descriptions of the interests of any director in the promotion of or in the property proposed to be acquired by the company.
18. Voting and dividend rights of different classes of stock.
19. Length of time in business, if less than three years.

⁶ Although the Proposed Amendments would insert in the Securities Act a new § 28A that would provide that the prospectuses in relation to all companies must be approved by the SEC prior to registration under the Companies Act, we understand that this feature has been deleted from the Proposed Amendments.

20. Report of auditors as to profits and losses (for past five years), assets and liabilities (at date of last accounts), and rates of dividends. Where the company has subsidiaries, holding company accounts must be provided,⁷ and in addition, the company may provide accounts of its subsidiaries as a group, or of its subsidiaries individually.
21. Where the proceeds are to be used for an acquisition, a report of accountants of the profits and losses of the target for the past five years, and of its assets and liabilities at the date of the last accounts, is required.
22. Where the proceeds are to be used to acquire shares or debentures, resulting in the target becoming a subsidiary, disclosure similar to clause 21 is required. In addition, the company is required to indicate how the acquisition would have affected the company's results in the past.
23. Clauses 3, 4, 13 and 17 are inapplicable to prospectuses issued more than two years after a company is entitled to commence business.

⁷ It is not clear whether the company's accounts are required to be prepared on a consolidated basis. § 147 of the Companies Act would require consolidated accounts in accordance with the Fifth Schedule to the Companies Act.

C. A Comparison of Disclosure Regulation Applicable to Listed Companies with that Applicable to Unlisted Companies.

The above list of disclosure requirements applicable to unlisted companies is remarkable, because it contains very little in the way of disclosure relating to the company's business, other than a requirement for its accounts and for a description of a limited class of material contracts. Below, we compare the disclosure requirements in the following critical areas: (i) disclosure about the company and its properties; (ii) disclosure of accounts; (iii) disclosure regarding management; (iv) disclosure of the company's capital structure; and (v) disclosure regarding the terms of the offering and use of proceeds.³ We use as a baseline for this comparison the very extensive disclosure required under the U.S. master disclosure regulations, Regulations S-K and S-X.

	U.S. Requirements	Sri Lanka SEC Rules	Sri Lanka Companies Act
Company and its properties	Full description of company history and all lines of business, including products, markets and competition. Requirement for description and disclosure as exhibit of material contracts. Full description of all properties, including liens, etc.	General description of business and prospects; description of properties. Description of material contracts during preceding two years.	Objects and powers. Description of material contracts during preceding two years.
Accounts	Balance sheets for last two fiscal years; income statements (profit and loss) for last three fiscal years. Geographic and product segment information. Selected financial data for last five years. Management's discussion and analysis of financial condition and results of operations.	Consolidated balance sheets for last five years; sales broken down by segments; summary of earnings for last five years and calculation of net income. Analysis of financial condition and operations.	Profits and losses for past five years. Assets and liabilities at date of last accounts. Rates of dividends.

³ Although it might be interesting to consider other areas of disclosure in connection with a complete review of the disclosure requirements in the Sri Lankan securities market, these categories include most of the critical business information that investors must have, and therefore constitute an appropriate basis for comparison.

	U.S. Requirements	Sri Lanka SEC Rules	Sri Lanka Companies Act
Management	Names, background, certain legal proceedings of directors, executive officers and significant employees. Compensation to five most highly compensated officers. Security ownership and related party transactions.	Names, background and certain issues of directors. Aggregate emoluments of directors. Share interests of directors. Share options and employment contracts. Related party transactions during last two years.	Names, descriptions and addresses. Description of interests of directors in property proposed to be acquired by company (for new companies only).
Capital structure	Description of all securities, including dividend rights, voting rights, liquidation rights, pre-emption rights, liability, restrictions on transfer. For debt securities, maturity, redemption, etc. and covenants relating to declaration of dividends, incurrence of additional debt, etc.	Description of securities offered, including rights appertaining thereto, and of other securities and capital structure of the issuer.	Voting and dividend rights of different classes of stock. Options on shares and debentures outstanding. Issuances of shares and debentures in two preceding years otherwise than for cash.
Terms of the offering and use of proceeds	Plan of offering. Compensation and other arrangements with underwriters, sub-underwriters, dealers, etc. Use of proceeds and sufficiency of proceeds for uses; other sources.	Descriptions of the method of offering and all costs of offering, including underwriters. Estimated proceeds and use thereof.	Amount payable on application and allotment. Time of opening and closing of subscription lists. Commissions to underwriters. Minimum proceeds for uses; other sources of funds for uses.

D. Continuous Disclosure under the Securities Act and under the Companies Act.

1. SEC Rules.

The SEC Rules, §18, requires issuers of listed securities to file annual reports with the stock exchange, certified by the issuer's auditors. §18 requires continuous disclosure as specified by the stock exchange rules. It requires annual accounts under the Companies Act to be certified as complying with accounting standards set by the Sri Lanka Institute of Chartered Accountants. §18 requires disclosure in the "report" of a listed public company of any event which may materially affect the nature of the business, its objectives, consideration as a going concern, value of assets, assessment of liabilities (including contingent ones) and profits or losses. Finally, §18 requires interim (6 months) reports in such format as prescribed by the stock exchange; these need not be audited.

2. CSE Rules

The CSE Rules specify a number of requirements applicable to listed companies for reporting information (a) to the Exchange, and (b) to the public.

- a. There are a number of requirements for immediate announcement to the Exchange of company news, including:
 - (1) information necessary to avoid establishment of a "false market";
 - (2) material acquisitions or dispositions;
 - (3) proposed changes in the character of business;
 - (4) information regarding closing of books and dividends, or rights or bonus issues;
 - (5) changes in directors, auditors, etc.;
 - (6) change in substantial shareholdings;
 - (7) application for a winding-up or liquidation;
- b. Half-yearly financial statements in summary form.
- c. Annual Director's Report, including annual Accounts, as well as the following information:
 - (1) Principal activities;
 - (2) Significant changes in assets;
 - (3) Issuances of shares or debentures;
 - (4) Shares and debentures offered specially to directors;
 - (5) Directors' interests in shares or debentures;
 - (6) Segment information regarding turnover, operating profit and asset allocation.

3. Companies Act

The Companies Act also imposes certain requirements for continuous disclosure, in addition to those under the securities laws that may be applicable.

Each company having a share capital must file with the Registrar of Companies an "annual return" under § 120 of the Companies Act. Section 124 of the Companies Act requires that the annual return include information on directors, indebtedness on charges registered with the Registrar and a summary of share capital, as well as a list of shareholders. The annual return is also required to have annexed a balance sheet and profit and loss account, certified by a director and secretary, an auditors' report certified by a director and secretary and a directors' report.⁹ The directors' report is required to describe the state of the company's affairs, the recommended dividend and the amount of reserves proposed to be established.

⁹ The balance sheet and profit and loss account must comply with detailed requirements established under the Companies Act. See § 145 of the Companies Act and Part I of the Fifth Schedule to the Companies Act.

E. Type of offering or dispersion of share ownership necessary to give rise to the Companies Act disclosure requirements, or the disclosure requirements under the Securities Act and Proposed Amendments

1. Offering of shares under the Companies Act

The Companies Act regulates prospectuses, defined by § 449 as "any prospectus, notice, circular, advertisement, or other invitation, offering to the public for subscription to or purchase of any shares or debentures of a company. . . ." The key words are "offering to the public" — any document that does so is a prospectus. Section 40 of the Companies Act establishes and incorporates the requirements as to the contents of the prospectus.¹⁰ Section 40 of the Companies Act requires that any application for shares or debentures issued must be accompanied by a prospectus. This requirement is subject to a "private placement" exemption "in relation to shares or debentures which were not offered to the public."¹¹ Section 56 of the Companies Act provides some guidance as to the meaning of "offered to the public." If the offering can be regarded as not calculated to result in persons other than the specific offerees purchasing, it is not required to be treated as an offering to the public. This may be too broad an exemption; it is certainly broader than private placement exemptions under U.S. and English securities law.

2. Offering of Shares under the Securities Act, Securities Rules and CSE Rules

As noted above, the Securities Act itself does not specify disclosure requirements in connection with public offerings. Section 4 of the SEC Rules simply refers to the listing requirements of Schedule II to the SEC Rules. Its applicability is linked to the fact of listing.

The CSE Rules, of course, only apply to companies seeking or holding a listing.

F. Analysis of the disclosure regulation applicable to unlisted companies

We respond below to the questions raised above.

1. Are the disclosure requirements of the Companies Act adequate for these unlisted companies?

The disclosure requirements of the Companies Act are inadequate for unlisted companies that offer their shares to the public. They provide very little in the way of specific requirements for description of the issuer's business, which should be central to the prospectus. In addition, management should be required to analyze and comment upon the financial statements. We recommend that these disclosure

¹⁰ Interestingly, these requirements appear inapplicable unless the prospectus is issued by the company or a person who is or has been engaged or interested in the formation of the company. This leaves a possible gap in regulation with respect to prospectuses issued by other large shareholders, or by underwriters.

¹¹ We discuss the private placement exemption below. The violation of this requirement is merely an offense which may result in a fine up to 5,000 rupees. We discuss the penalties for violation below. In addition, § 40(5) exempts rights offerings from these requirements.

requirements be brought up to the level of those established under the SEC Rules and CSE Rules.¹² We understand that Sri Lanka is considering whether to foster a second-tier market to encourage companies that do not meet the size, earnings history or public flotation requirements of the Colombo Stock Exchange to go public. While this goal is worthy, it should be achieved by relaxing some of the substantive (merit-type) regulation otherwise applicable to listed companies, not by providing a relaxed disclosure regime. Disclosure is just as important in the over-the-counter market as it is for listed securities.

2. Are the post-public offering disclosure (continuous disclosure) obligations of these unlisted companies sufficient to support a trading market in their securities?

The continuous disclosure requirements of the Companies Act, applicable to unlisted companies, are inadequate to support a trading market in their securities. A trading market requires up-to-date and complete information regarding the issuer. In the U.S. and European markets, it is recognized that continuous disclosure should generally match public offering disclosure, as it serves the same purpose. Sri Lanka lacks appropriate continuous disclosure requirements, not only for unlisted companies, but for listed companies as well. This gap in the regulatory regime should be addressed in detail as soon as possible. It will be noted that more extensive continuous disclosure requirements will raise the costs of public offerings and therefore may discourage some companies from effecting public offerings. This is accurate, but adequate disclosure is one of the unavoidable costs of efficient securities markets; without adequate disclosure, securities markets cannot be efficient.

3. Is there a private placement exemption from the registration and review provisions; and if not, should there be?

There is a private placement exemption from the registration, review and liability provisions of the securities laws and CSE Rules, insofar as these are only applicable to listed securities. Furthermore, the Companies Act contains a private placement exemption from its prospectus content and registration requirements. However, the requirements for this private placement exemption should be reviewed. In addition, if the recommendation made above regarding extension of the requirements of the securities law disclosure regime to cover unlisted companies is adopted, it should apply to all public offerings. Again, a revised definition of the private placement exemption is needed. Parameters such as the number of offerees and the level of sophistication of the purchasers are appropriate to be considered. Finally, we would recommend that Sri Lanka consider extending the antifraud and liability provisions of the securities laws and Companies Act (with any enhancements adopted pursuant to the recommendations made below) to privately placed securities.

4. Should authority over disclosure in connection with public offerings be concentrated in the SEC?

We understand that the current limitation of the SEC's authority to listed companies, and to areas of regulation not covered by the Companies Act, reflects historical and political constraints. If these constraints could be overcome, it would be appropriate to provide the SEC with authority over all issues relating to disclosure in the securities market, relating to all unlisted and listed companies whose securities are publicly offered, or are otherwise widely distributed. If this cannot be achieved, a second-best

¹² We would also recommend careful review and supplementation of the SEC Rules and CSE Rules for disclosure in connection with prospectuses, at a later time. With moderate amendments, they can be world class.

solution is to allocate concurrent authority over such disclosure to the SEC, alongside the Registrar of Companies.¹³

II. Is sufficient authority to conduct surveillance, investigate and enforce allocated to appropriate agencies?

A. What surveillance, investigation and enforcement powers are allocated to the SEC, the Colombo Stock Exchange, the Registrar of Companies and the Attorney General?

1. The SEC

Under the Securities Act, the SEC has the objects of maintaining orderly and fair trading (§ 12(a)), protecting the interests of investors (§ 12(b)), and regulating the securities market to ensure professional standards (§ 12(d)). It is allocated the power to license stock exchanges, brokers and dealers and management companies of unit trusts and ensure the proper conduct of its business, including giving directions to them (§ 13(a), (b), (bb), (c)). It also has power to cancel listings or suspend trading for up to three days at a time (§13 (h)). It has power to inquire into the business affairs of, and to carry out inspections of the activities of, a licensed stock exchange, broker, dealer or unit trust, and to publish findings of malfeasance by any broker, dealer, trustee or management company of a unit trust or listed company (§ 13(i), (j); 14(a)). The SEC is authorized to require any person to furnish information or returns requested by the SEC (§ 45).

The Commission also has the power to implement the policies of the government of Sri Lanka with respect to the market in securities (§ 13(k)), and to do all such other acts as may be incidental or conducive to the attainment of its objects or the exercise of its powers (§ 13(n)). It may issue rules thereunder, or under § 53, which provides specific authority for rules regarding listing of securities, disclosures by brokers and dealers regarding share transactions, maintenance of books and audits of brokers or dealers, takeovers and mergers, and certain other matters.

The SEC is authorized to establish a committee to hear shareholder complaints against listed companies, brokers, dealers, stock exchanges or unit trusts, and such committee may examine documents or other evidence in order to determine violations of the Securities Act, and recommend to the SEC action to be taken (§ 46).

Under § 13 of the SEC Rules, the SEC is authorized, upon receipt of a report of the result of an inquiry into a complaint by the shareholders of a public company, or persons who have contracted to buy or sell shares, relating to the conduct of a broker or dealer, to direct the stock exchange (after consultation) to take disciplinary action under its rules.

The SEC also has authority over the rules of a licensed stock exchange.

¹³ We understand that the Registrar does not currently enforce disclosure requirements. Thus, a third-best solution might be to require the Registrar to enforce disclosure requirements, and to provide the Registrar with appropriate resources to do so.

2. The Colombo Stock Exchange

Prospectuses are required to be submitted to the CSE for approval prior to listing. We understand that the CSE does not actively review prospectuses. This approval requirement could serve a useful enforcement purpose, if it were used to engage in surveillance regarding the compliance of prospectuses with law and rules in general, and the quality of disclosure in prospectuses in particular.

The CSE is not granted statutory enforcement powers. However, the CSE has a Market Surveillance Department, which monitors unusual market action, and seeks out causes. Under CSE Rule 8.9, the CSE may call officials of the issuer to determine the cause of unusual market action, and perhaps to request appropriate corrective action.

While the CSE is required by the Securities Act to have rules to discipline, suspend or expel members for inequitable conduct or violations of the Securities Act or the CSE Rules (SEC Act, Schedule, Part I, ¶ (j)(iii)), we did not find such rules contained in the CSE Rules. It appears that the CSE's enforcement apparatus has limited authority, as well as limited resources.

3. The Registrar of Companies

The Companies Act requires that prospectuses be registered with the Registrar on or before the date of publication (§ 43). This registration requirement could serve a useful enforcement purpose, if it were used to engage in surveillance regarding the compliance of prospectuses with law and rules in general, and the quality of disclosure in prospectuses in particular. However, the Companies Act does not require the Registrar to do so. Even if it did, it does not appear that the Registrar's office, at the present time, has the resources needed to carry out a meaningful review of prospectuses.

4. The Attorney-General

The Attorney-General is charged with bringing all [civil and] criminal enforcement actions. We understand that the SEC has a good working relationship with the Attorney-General's office, and that so far, coordination has not been a problem.

B. Are these powers sufficient, and are they allocated appropriately?

1. Issues Regarding Enforcement

There do not seem to be adequate statutory prohibitions of fraud in connection with securities market activity. There do not seem to be adequate statutory prohibitions of fraud in connection with public offerings. While the Companies Act contains certain antifraud provisions,¹⁴ including certain private rights of action, the SEC is not authorized to enforce these provisions. The Securities Act contains no prohibitions of fraud by issuers or investors; § 28(2) merely prohibits brokers and dealers (presumably including thereby underwriters), in connection with the purchase, sale or otherwise of listed securities, from engaging in fraud.

Even if there are adequate statutory (or regulatory) prohibitions, there must also be adequate means for implementation, including especially enforcement, of the law. It is necessary to choose among governmental enforcement, self-regulatory enforcement and private enforcement through private rights

¹⁴ These antifraud provisions may be limited in their applicability, by virtue of the limited scope of the disclosure requirements under the Companies Act.

of action. It is not clear that private rights of action provide a viable method of enforcement in Sri Lanka.¹⁵ Self-regulatory enforcement may be appropriate for certain aspects of broker-dealer regulation, such as requirements to deal fairly with customers, but is not appropriate for disclosure regulation or general antifraud regulation, and is not sufficient to address manipulation in the market. Thus, it is necessary to have governmental enforcement.

2. Recommended Powers of the SEC

The SEC (or, if this is not possible, a substitute agency with adequate resources and expertise and an appropriate mandate) needs full authority to engage in surveillance, investigation and evidence gathering¹⁶ with respect to the following securities market activities:

- a. Disclosure by companies that offer and sell their securities to the public. Surveillance should be supported by a requirement that these documents be registered with the SEC, and "approved"¹⁷ (or not disapproved prior to the expiration of a specified period).
- b. Continuous disclosure by companies that have offered and sold their securities to the public, or that have otherwise developed wide public holdings. This includes disclosure with respect to annual general meetings and extraordinary general meetings.
- c. All dealings by all securities market professionals, including brokers, dealers and unit trust managers, with customers.¹⁸
- d. All dealings by all securities market professionals, including brokers, dealers, unit trust managers, in the market.

C. Is there sufficient authority for both criminal enforcement and civil enforcement by the SEC or the Attorney-General?

The Securities Act prohibits licensed stock exchanges, brokers and dealers from engaging in fraud or deceit, or making any false or misleading statement in relation to a material fact or omitting a material

¹⁵ Private rights of action—authorization for private individuals harmed to sue—can play an important role in enhancing enforcement of, and therefore compliance with, the securities laws. This technique has been actively used in the U.S., partly because of our procedural rules allowing contingency fees to be paid to lawyers, class actions and recovery of legal fees. In addition, we do not have the "English rule" that may require the loser in litigation to pay the winner's legal fees.

¹⁶ We do not here include the other possible components of enforcement: prosecution and adjudication. The SEC will need to be able to rely on the Attorney-General to bring enforcement actions, or will have to be accorded independent authority to do so. In addition, in connection with certain civil sanctions, the U.S. SEC has administrative adjudication powers. Sri Lanka may wish to consider this approach, as it allows certain types of problems to be adjudicated first at the agency level, with a right of appeal in the courts.

¹⁷ The SEC should not take responsibility for disclosure; and issuers should be prohibited from stating that the SEC does so. All that any regulator should be assigned to do is to check that the documents on their face seem to comply with the requirements of law.

¹⁸ Under the Proposed Amendments, market intermediaries including underwriters, margin lenders and investment managers would be subject to registration requirements and surveillance.

fact. It notably does not provide such prohibitions as to the activities of issuers or investors. The SEC Rules (§ 19) prohibit acts "calculated to create a false or misleading appearance of active trading or the market for or the price of any listed securities."¹⁹

Section 51 of the Securities Act provides that any violation of the Securities Act or of any rule or regulation thereunder is an offense. Any person found guilty of such an offence, unless a penalty is specified in the particular provision involved, is liable to up to five years imprisonment or a fine of up to ten million rupees. Section 46 of the Companies Act provides criminal penalties for persons authorizing the issuance of a prospectus containing an untrue statement, subject to a "due diligence" type defense. No prosecutions may be brought under § 46 without the approval of the Attorney-General.

The above does not appear to provide sufficient prohibitions to support an adequate enforcement program. In addition, it is not clear that the SEC or the Attorney General may bring civil (non-criminal) actions. Civil actions may represent a more usable sanction against conduct that does not rise to the level of crime.

D. What private rights of action exist; are they sufficient to protect investors?

The Companies Act provides private rights of action for investors pursuant to misleading prospectuses.

Section 45 of the Companies Act provides private rights of action to all subscribers to shares or debentures "on the faith of" a prospectus for the loss sustained by reason of any untrue statement included in the prospectus. The group of people who may be sued include (i) directors of the issuer, (ii) promoters of the issuer, and (iii) every person who has authorized the issue of the prospectus. The issuer itself is curiously not specifically included, although perhaps it can be considered a person who authorized the issue of the prospectus.²⁰ Another question regarding this section is the extent to which the investor must prove reliance — that he relied on the statement in the prospectus that turned out to be false — and causation — that the falsity of the statement caused his losses. Moreover, this provision only relates to misstatements, and not material omissions.²¹ This provision contains a "due diligence" type defense for persons (presumably including the issuer if the issuer is subject to liability under § 45²²) that had reasonable grounds to believe that the statement at issue was true.

As there appear to be no prohibitions of fraud (by the issuer or by an underwriter, or by anyone else) in connection with public offerings under the Securities Act, there can be no private rights of action to allow defrauded investors to recover.

¹⁹ This only goes to market manipulation, and does not cover fraudulent acts.

²⁰ Another question, discussed below, is whether this provision imposes responsibilities on underwriters.

²¹ Section 48 of the Companies Act provides that a statement "shall be deemed to be untrue if it is misleading in the form and context in which it is included." Thus, it might be argued to cover omissions that have the effect of making other affirmative statements misleading.

²² Under U.S. law, the issuer has no due diligence defense, but is absolutely liable for any material misstatements or omissions.

III. What, if any, regulation of underwriters of securities is appropriate? What regulation of underwriters currently exists in Sri Lanka? How should "underwriter" be defined?

We note here that in Sri Lanka, "underwriter" has the English definition: a person who has agreed to take up all or part of an offering if it cannot be sold to the public. We will use the more general definition applied under U.S. law: an underwriter is any person who helps to market an issuer's securities, including an English style underwriter, but also including someone who purchases the securities for resale, and someone who merely agrees to act as selling agent, without any responsibility to actually purchase the shares.

A. Should public offerings be required to be effected using underwriters?

We would argue against a requirement that public offerings be required to be effected using underwriters. Small companies, or larger companies doing smaller financings, may be able to sell their securities without underwriters. On the other hand, in developed markets, sometimes larger, better established companies decline to use underwriters, especially when they sell their securities to institutional investors. Underwriting should not be required, in order to allow the market to respond flexibly to varied financing needs. On the other hand, the market need for an underwriter can provide a useful protection against fraud in connection with public offerings, assuming that the underwriter has appropriate due diligence responsibilities. While this protection would be the regulatory reason for requiring underwriting, we do not think that it is worth the intrusion of requiring that offerings be underwritten. Another argument for requiring underwriting of offerings is that underwriters can help to publicize and market an offering of securities. Again, we would let the issuer decide whether this activity — and cost — is merited.

B. If so, should there be a minimum number of underwriters required?

If Sri Lanka were to require underwriting of public offerings, the only reason for requiring more than a single underwriter is to enhance the independence of the underwriters in connection with their due diligence and pricing function. In circumstances where there is no special conflict of interest, we would not recommend that more than one underwriter be required, and, as mentioned above, we would not recommend imposing any requirement for underwriting public offerings.²³

C. What other types of regulation of underwriters are used in the U.S., and why?

In the U.S., as in most developed markets, there is no legal or regulatory requirement that offerings be underwritten, although most public offerings are underwritten as a matter of market practice. On the other hand there are other means of regulating the activities of underwriters.

Perhaps the most important means of regulating underwriters, although it is not often thought of as "regulation" *per se*, is the imposition of statutory civil liability on underwriters for material misstatements or omissions in prospectuses under which they sell securities. This liability is qualified by a "due diligence" defense, which allows the underwriter a defense against civil liability if it can show that it checked the prospectus with the care of a reasonable man in the conduct of his own affairs. We consider

²³ Where a company engages in self-underwriting--underwriting of its own securities or those of an affiliate--it might be appropriate to require the use of an independent underwriter to independently approve the pricing and the disclosure in the prospectus. This is the case in the U.S., under the National Association of Securities Dealers' Rules of Fair Practice.

this a type of "regulation" because it imposes a flexibly defined duty on underwriters to check prospectuses that they use. We cannot overemphasize the importance of this liability to the protection of the integrity of the public offering process.

Under U.S. federal securities laws, there are two other types of regulation of underwriters worth mentioning. First, underwriters are not permitted to extend credit in connection with sales of securities that they underwrite.²⁴ Second, in connection with a public offering, while persons connected with the distribution are ordinarily prohibited from making purchases, special exceptions are provided in order to allow limited "stabilization" of the price of the securities offered. This stabilization is viewed as necessary to avoid market disruption and immediate price declines in connection with public offerings. It is regulated by virtue of requirements that it be disclosed and coordinated, and that it can enter bid prices no higher than the last independent bid price — it cannot lead the market up.

Under the U.S. National Association of Securities Dealers' ("NASD") Rules of Fair Practice, there are certain other regulatory constraints on the operations of underwriters. The NASD Rules of Fair Practice contain several restrictions.

1. Restrictions on Underwriting Commissions

The first type of restriction is similar to that under § 54 of the Companies Act of Sri Lanka, which allows payments of commissions to underwriters, or to people who help to market shares, so long as the payment is authorized in the issuer's articles, the commission does not exceed 10%, and the amount of the commission is disclosed in the prospectus. This restriction, known as the "Corporate Financing Rule", is set forth in § 44 of the NASD Rules of Fair Practice. The Corporate Financing Rule establishes the following requirements:

- a. For any public offering, the documents, including underwriting agreements, with the NASD for their review.
- b. The underwriting terms or arrangements, and the terms and conditions related thereto, must be "fair and reasonable." Fairness and reasonableness is subject to the determination of the NASD. Certain arrangements are deemed unfair and unreasonable, including the receipt by the underwriter of compensation greater than 10%.
- c. All items of underwriting compensation must be disclosed in the prospectus.
- d. Where any broker-dealer expects to receive more than 10% of the proceeds (excluding underwriting compensation), the rules relating to self-underwriting must be followed.

2. Fixed Price Offerings

Under § 24 of the NASD Rules of Fair Practice, an underwriter cannot grant or receive discounts or other concessions in connection with a public offering. The purpose of this provision is to ensure that the public offering is effected at the price stated in the prospectus, that a "hot issue" is not sold at higher prices by the underwriter, and that an issue that is difficult to sell is not auctioned down.

²⁴ See § 11(d) of the U.S. Securities Exchange Act of 1934. Section 55 of the Companies Act of Sri Lanka prohibits lending by the issuer in connection with the sale of its shares.

D. What types of entities should be permitted to engage in underwriting? Should unit trusts be permitted to do so?

Underwriting entails a certain amount of risk. The risk takes two forms. Depending on the length of time that is permitted to pass between the time that the underwriter makes its commitment and the time that the underwriter (or issuer) makes firm sales to investors, the underwriter absorbs a degree of market risk²⁵ and risk involving the value of the issuer's securities. The second type of risk involves liability for fraudulent prospectuses. As noted below, we recommend that Sri Lankan law be revised to make clear that people who assist issuers in selling securities, whether as underwriters or as selling agents, should be responsible for any fraudulent misstatements or omissions in the prospectus, subject to a due diligence defense. The risk that investors might successfully assert such liability is an important one for underwriters.

On this basis, we would recommend that specially protected entities not be permitted to engage in underwriting. For example, we understand that unit trusts engage in underwriting in Sri Lanka. Our question is whether the unit holders adequately understand, and have fully consented to, the risks involved in underwriting activities. In the U.S., investment companies and banks are generally barred from the underwriting business, although with respect to banks, this barrier is eroding quickly. One reason for the barrier with respect to banks in the U.S. is the fact that U.S. banks benefit from deposit insurance; it is thought inappropriate to allow banks to use the financial backing of the government through deposit insurance to support these risky activities. Another concern regarding banks with respect to underwriting involves the possibility that banks might underwrite the securities offerings of companies indebted to them and unable otherwise to repay, without independently and carefully checking the prospectus.

E. What is the liability of underwriters in connection with issues of securities that they underwrite? Are any changes necessary?

We have noted above that the Companies Act and the Securities Act do not appear satisfactorily to address the issue of underwriters' liability.

As mentioned above, § 45 of the Companies Act does not specifically include underwriters in the group of people who are responsible for prospectuses. Furthermore, (i) the liability provision of § 45 does not satisfactorily address omissions of material facts, (ii) seems to require that investors rely on the prospectus, (iii) requires a causal link between the misstatement and the investor's loss. Each of these features diminishes the likelihood that an investor could sue successfully. We recommend that these provisions be re-examined in detail.

The Securities Act does not provide sufficient liability for underwriters. Schedule II to the SEC Rules establishes certain requirements for "declarations" in the prospectus of a listed company.²⁶ The directors are required to declare that they take full responsibility for the disclosure, confirming that to the best of their knowledge and belief, there are no material omissions. It is not clear how this would be viewed by a Sri Lankan court, whether it would be viewed as a basis for quasi-contractual responsibility, for liability in tort, or otherwise. Similarly, a statement is required by "the Company managing the issue" (what in U.S. terms would be known as the underwriter) to the effect that "to the best of its knowledge and belief the prospectus constitutes full and true disclosure of all material

²⁵ The risk that the market as a whole experiences some disruption or general decline.

²⁶ These requirements are repeated in the CSE Rules.

facts. . . ." This provision is subject to similar questions regarding its effect in court. Furthermore, it does not establish a particular level of care applicable to the underwriters.

We believe that the pattern of liability of underwriters in Sri Lanka needs significant revision and clarification. In this regard, we believe the U.S. formulation, including the due diligence defense, is worthy of careful consideration.

F. Are underwriters "dealers" under the Securities Act? Should they be required to register as such? If so, does this raise regulatory problems?

The definition of "dealer" contained in § 55 of the Securities Act specifically includes those engaged in the business of underwriting or retailing of securities, as well as those engaged in the business of selling securities. Thus, absent an exemption,²⁷ any underwriter would be a dealer. Section 15 of the Securities Act requires any person carrying out such business to apply for a license as a dealer. Presumably, it is intended that it is illegal to carry on the business of a dealer without possessing a license (we did not find this specifically stated). Therefore, any underwriter that is not licensed as a dealer is acting in violation of the law. This circumstance should be regularized by ensuring that each underwriter is so licensed, even if the license limits the permitted activities to those involved in underwriting.

IV. What is the role of credit rating agencies? How, if at all, should they be regulated?

Rating agencies play an extremely important role in developed debt markets.²⁸ As Sri Lanka's public debt market develops, rating agencies will begin to operate to provide credit risk evaluation services. They will do so because of the potential profits that can be made from providing this service to issuers of securities. Ratings from recognized rating agencies solve a market problem: the difficulty that individual investors have in evaluating the creditworthiness and the terms of each offering of debt securities. They provide a "single scale to compare among this array of different debt instruments."²⁹ In developed markets, these ratings are extremely influential in establishing interest rates and prices of debt securities, and therefore in allocating capital.

A. How can the development of rating agencies be fostered?

We would not recommend extensive government involvement in the activities of rating agencies. These private sector institutions can best be fostered by avoiding unnecessary regulation or other government involvement. On the other hand, it is useful to provide a clear set of legal rules regarding the responsibilities of rating agencies. For example, in the U.S., rating agencies have argued that they are part of the media, and therefore that their activities are protected by rights of free speech under the

²⁷ We understand that the Proposed Amendments have been revised now to exempt underwriters from the definition of "dealer." This must be done carefully, as it is important to ensure that underwriters who engage in dealing activities are regulated as dealers to the extent of their dealing activities.

²⁸ There are also rating agencies active in developing countries, such as India, South Korea and Chile. For a good recent general study of rating agencies, see Carsten Ebenroth & Thomas Dillon, *The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States*, 24 *Law & Pol'y Int'l Bus.* 783 (1993). We have drawn from parts of this study below.

²⁹ Standard & Poor's, *Corporate Finance Criteria 3* (Frank Rizzo et al. eds., 1991).

First Amendment of our Constitution, absent a showing of intentional fraud. The plaintiff would be required to carry the burden of proving scienter — that the defendant knew material facts were misstated. It is also difficult to sue rating agencies when they turn out, as sometimes occurs, to be mistaken, because of requirements for privity of contract between the person suing and the rating agency.

Further, the best way to foster the development of rating agencies is to foster the development of public debt markets. Doing so has much to do with macroeconomic policy, regulation of banks and tax treatment of debt as opposed to equity.

B. Should the government license and/or regulate these agencies?

We would not recommend that the government establish an extensive licensing or regulatory regime relating to rating agencies. The market can regulate these businesses adequately. Where these businesses perform negligently, their ratings will be ignored. Where they perform fraudulently, and perhaps where they are merely negligent, they should be subject to civil liability. It would be appropriate to analyze Sri Lanka's law of negligence and fraud to determine whether a private investor would be able successfully to sue a fraudulent rating agency. In order to limit the possibilities of fraud, it might be appropriate simply to establish a requirement that rating agencies disclose any conflicts of interest they might have when they issue a rating, and to establish the authority of the SEC to investigate the activities of rating agencies.

However, if the government of Sri Lanka were to decide to use ratings as an integral part of its regulatory mechanism, it might also wish to regulate rating agencies, in order to provide assurances of the quality of their work. For example, certain types of institutional investors, such as pension funds or insurance companies, might be prohibited from investing in debt below a certain grade. Alternatively, disclosure standards might be relaxed or otherwise modified for debt above a certain grade.³⁰ If this were to be the case in Sri Lanka, there would be a stronger argument for licensing and regulation of rating agencies.

³⁰ This is the case in France, where issuers that do not obtain a rating must fulfill greater disclosure requirements, and where only the ratings of approved rating agencies are accepted to satisfy this requirement. Decret No. 92-137 du 13 fevrier 1992, art. 6, J.O., Feb. 14, 1992, at 2374.