Capital Market
PROGRESS REPORT
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“Mahinda Chinthanaya”

ing the way for a robust Capital Market

...In 2005 Sri Lanka entered a new era under the leadership of His Excellency President Mahinda Rajapakse who took oaths as the fifth Executive President of the Democratic Socialist Republic of Sri Lanka. Commitment to ending the near 3 decade long terrorist conflict and bringing about sustainable economic development for the island nation was of paramount importance to H.E. President Rajapakse and action was taken according to the “Mahinda Chinthanaya” strategic framework.

With the successful end to the 27 year old terrorist conflict in 2009, government focus and commitment was given to strategic economic development which would propel Sri Lanka to a medium income nation in the short run and to a high income nation in the medium term. To achieve this economic prosperity the “Hub Strategy” was devised and implemented to harness the potential of locational advantage, resource strengths and global commerce...
SEC Chairman’s Message

It gives me immense pleasure to issue this message on the occasion that the Securities and Exchange Commission of Sri Lanka (SEC) together with the Colombo Stock Exchange (CSE) is jointly hosting the “Capital Market Conference 2014”.

Economic growth hinges on efficient Capital Market that pool savings and mobilizes capital for productive investments. Sri Lanka is in the process of advancing towards an upper middle income country and thereby achieving a per capita income of over US$ 4,000. Hence, the gross investment needs to rise by 33% of GDP to achieve this ambitious target. An increase in investment can only be fuelled by local and foreign investments.

The Stock Market has recorded an implausible growth of over 300% during the post war era. The CSE has become one of the best performing Stock Markets in the world in 2014 by appreciating over 22%. During the post war period the Net Asset Value of Unit Trusts has appreciated from LKR 6.7 Bn to LKR 75.7 Bn (1,029%). In this backdrop the Capital Market can be further utilized as a mode of attracting both local and foreign funds. Therefore, the SEC together with the CSE has been instrumental in conducting many successful investor forums in the recent past both in Sri Lanka and in overseas. The “Capital Market conference 2014” is also aimed at attracting large funds to the Capital Market.

At present the total value of the Stock Market has reached LKR 3 Trillion, which is around 35% of the GDP. The SEC is focused on increasing the market capitalization to 40% of GDP within the next 3-4 years and in order to make the Capital Market a key contributor to our economy the SEC formulated a comprehensive Capital Market Master Plan comprising of 10 key strategies. These strategies include demutualizing the CSE, amending the SEC Act, developing new products, enhancing education and awareness, developing the corporate bond market, implementing a risk management system and attracting new funds etc. This forum will contribute to attracting new funds and thereby steering the Capital Market to greater heights.

The SEC is committed to contributing towards the development agenda of the country and promoting economic growth. I am confident that this forum will give us the opportunity to position Sri Lanka as a lucrative investment destination with tremendous growth potential.

Dr. Nalaka Godahewa
Chairman
Securities & Exchange Commission of Sri Lanka
CSE Chairman’s Message

The Colombo Stock Exchange has commenced a series of initiatives to develop the Stock Market and is investing in developing market infrastructure and transforming the Stock Exchange into a world class organization. Building capacity both within the Stock Exchange and the industry will be a key success factor and the Exchange is committed to investing in skills development and knowledge building.

The Sri Lankan Capital Market is an attractive destination for investment, for foreign institutional investors as it provides an opportunity for diversification of their investments; as the performance of the Sri Lankan Stock Market has been considerably better than most regional markets, and more importantly has low correlation with other markets. This, no doubt, has prompted many foreign investors to look at our market positively.

The Capital Market in Sri Lanka has seen exponential growth during the post war era and we are seeing a sustained improvement in all market indicators during this period. We are extremely happy to note that the market has been outperforming all other forms of investment in the country, building on the country’s political and economic stability and growth.

We have made the necessary improvements to market infrastructure and regulatory framework to enable the Capital Market to play a significant role in the growth trajectory of the economy. The combined synergies between the CSE, the SEC, and market intermediaries has been a key success factor in the development of the Sri Lankan Capital Market.

The Colombo Stock Exchange has initiated a country wide awareness programme to educate the general public, existing and potential investors and students on the fundamentals of the Capital Market. The regional branch network that provide Stock Market services in eight provinces in the country makes the market more accessible to investors in the provinces.

The CSE has made the Stock Market information more accessible to investors using technology by enabling internet based trading and making available timely trading and market information through mobile applications, the use of social media and the internet. We believe that these are tools that will empower our local investors to make timely and wise investment decisions.

We are confident that the Capital Market will establish itself as a catalyst in Sri Lanka’s forward march to a developed economy.

Vajira Kulatilaka
Chairman
Colombo Stock Exchange
Overview of Sri Lanka’s Capital Market
Sri Lanka’s Economy and its Capital Market were reborn thanks to His Excellency President Mahinda Rajapakse and his visionary leadership which successfully ended the three decade old terrorist conflict in May 2009. Thereafter with the liberation of Sri Lanka from terrorism strategic planning to uplift the island nation as one of Asia’s growing economic power-houses took form and developing the Capital Market within the Commercial Hub strategy was given significant importance by H.E. President Rajapakse and his Government.

End of conflict and future expectations of strong economic growth significantly uplifted the sentiment of investors, business community and the public at large since mid-2009 and Sri Lanka’s Capital Market rallied for two consecutive years, with Bloomberg recognizing the Colombo Stock Exchange (CSE) as one of the best performing markets globally, during the years 2010 and 2011. This market revival and strong growth should be credited to none other than the H.E. the President’s commitment to end the prolonged conflict in the North. However having gone through a period of uncertainty and significant political, economic and social hurdles between the years 1983 to 2005, Sri Lanka’s Capital Market participants were not swift enough to adjust for this new found freedom and harness the unprecedented growth prospects which the post 2009 era brought about. Thereby despite two years of strong growth the CSE went through a sharp correction and thereafter a period of stagnation since the market peaked in February 2011 to August 2012.

Up till end 2012 gradualness of the Capital Market and its participants to adjust to the speed of overall economic progress and the Government’s broad strategies somewhat contributed to the sluggishness of the CSE experienced during this period. And recovery seemed to be taking far longer than anticipated. Poor risk and credit control measures at brokering companies, market manipulations by few market participants, unsatisfactory Corporate Governance practices by some listed companies, adverse media coverage and lack of cohesion among the market regulators added further strain on possible Capital Market recovery.

The importance placed on Capital Market by the Head of State was evident when H.E. President Rajapakse personally intervened in addressing the issues and provide strategic direction along with Dr. P.B. Jayasundara Secretary to the Treasury and Mr. Ajith Nivard Cabraal, Governor Central Bank of Sri Lanka. Thereby on 29th August 2012, Dr. Nalaka Godahewa was appointed as the Chairman of the Securities & Exchange Commission of Sri Lanka (SEC) with the responsibility to revive the Capital Market and put it back on track to achieve Sri Lanka’s overall strategy of becoming a commercial hub.

Dr. Godahewa and his team at the SEC commenced implementation of a much thought after strategy of a step by step approach to address the most pressing issues at the time and then to introduce a ten step incremental strategy of developing Sri Lanka’s Capital Market to become in par with any developed nation. Firstly the SEC with the full support of the past CSE Chairman Mr. Krishan Balendra and his team ensured the two regulative bodies namely the SEC and CSE started working cohesively in reviving the market. Negative publicity given by
the print and electronic media on the Capital Market was mitigated by way of active interaction and provision of direct information, which ultimately led to the media outlets reversing its stance and providing considerable support to the SEC in the revival and development of the CSE. Thereafter the SEC relaxed some stringent regulations imposed earlier and enable a measured increase in trading activities.

After successfully addressing the most imperative issues and ending the CSE’s decline in performance, SEC started focusing on short to medium term requirements to develop the Capital Market. Lack of market liquidity was a key obstacle in attracting foreign investors and stakeholders pointed further improvements required in Corporate Governance. Further, public education and awareness on Capital Market were significantly poor and specially awareness of the CSE outside of the main cities were limited. Also for the Capital Market to achieve the 2016 targets significant capacity building was necessary.

As part of the initiatives to increase the liquidity in the market, the SEC under the guidance of Dr. Godahewa introduced a mandatory minimum public float requirement was introduced for listed companies following a practice that has already been adopted by a large number of international and regional jurisdictions. The minimum public float in addition to increasing liquidity in the market, is also expected to facilitate a better price discovery mechanism. Further with the full corporation provided by the now Chairman of the CSE Mr. Vajira Kulatilaka and his team, both institutions collaborated in order to attracted more new listings in both equity and debt instruments, which also contributed in increasing market liquidity.

Steps have been already taken to improve the Corporate Governance aspect of the listed companies by structuring educational programs partnering with established professional bodies and increasing awareness. Thereby a cornerstone of SEC’s new operational plan has been to work together with all stakeholders for the betterment of the industry rather than to work in isolation. Further progress has been made in revising the SEC Act to suit the dynamic economic requirement of modern Sri Lanka.

The SEC has implemented a comprehensive Capital Market Master Plan comprising of 10 key strategies to reposition the market to play an important role in capital formation and development of the economy. These initiatives include Strengthening the Regulatory Framework, Development of the Corporate Bond Market, Education & Awareness, Attracting new funds, Increase Listings, Development of New Products, Development of Unit Trust Industry, Development of IT Infrastructure, Implementation of CCP Mechanism and Demutualization of the CSE. Work relating to realizing all of these strategies and objectives are already in motion and the success of these initiatives are already visible with the current Capital Market revival.
Performance of the Colombo Stock Exchange
Growth story of the Colombo Stock Market

The Colombo Stock Exchange (CSE) recorded a sharp growth in the first 9 months of 2014, with the All Share Price Index (CSEALL) increasing by 22.6% to 7,252.1 points and the Blue chip S&P SL 20 index growing by 23.7% to 4,038.3 points as of 30th September 2014. This continuous growth was on the back of 4.8% growth in CSEALL and 5.8% rise in the S&P SL 20 index during the year 2013.

With this growth CSE is continuing to be the best performing frontier market and also enjoys the pole position among all regional markets.

While the fall in interest rates have helped to boost market activity many initiatives taken by the Securities and Exchange Commission of Sri Lanka (SEC) and the CSE since 2013 were instrumental in increasing daily market liquidity. As of 26th September 2014 total market turnover surpassed the total annual turnover in 2013 of LKR 200.4 Bn and was recorded at LKR 226.4 Bn. Foreign investor participation was at 29.7% while the balance was from local investors, which managed to increase the average daily turnover by 60% to LKR 1,322 Mn during the first nine months of the year.

The initiatives taken by the SEC and CSE together with other market participants to organize overseas investor forums and attract foreign investors have no doubt contributed to the growth of the foreign investor contribution in 2014. Further steps taken by the SEC to increase market liquidity through introducing minimum public holding criteria for the listed companies has also positively affected the market performance.

As of September 2014, a total of LKR 21.3 Bn was raised through the Capital Market with LKR 13.9 Bn raised as equity IPO’s, LKR. 2.7 Bn as debt IPO’s and LKR 4.7 Bn by way of rights issues. The proactive approach taken by the SEC and other market intermediaries in further developing the Capital Market since 2013 has been validated by the market performance and the growth in IPO’s and rights issues witnessed thus far in 2014.

The Unit Trust (UT) industry also had recorded commendable growth increasing the Net Asset Value of all funds from LKR 53.8 Bn in 2013 to LKR 113.2 Bn as of August 2014. The concessions given by the National Budget of 2013 and the steps taken by all stakeholders has no doubt made a significant impact on the growth of the industry.
Colombo Stock Exchange to benefit from the +8% real GDP growth trajectory

As at 30th September 2014, the Colombo bourse had 295 companies covering 20 sectors listed, with a total market capitalization of approximately US$ 23 Bn
The Banking & Financial services, Food, Beverage & Tobacco and the Diversified sectors are the largest sectoral contributors on the exchange respectively representative of 25%, 16% and 16% of the total market capitalization.

Market Performance

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014 YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Capitalization (LKR Bn)</td>
<td>1,092.1</td>
<td>2,210.5</td>
<td>2,213.9</td>
<td>2,167.6</td>
<td>2,459.9</td>
<td>3,067.3</td>
</tr>
<tr>
<td>Daily Average Turnover (LKR Mn)</td>
<td>593.6</td>
<td>2,396.3</td>
<td>2,285.6</td>
<td>883.6</td>
<td>828.4</td>
<td>1,286.8</td>
</tr>
<tr>
<td>Market PE (x)</td>
<td>5.4</td>
<td>11.6</td>
<td>14.0</td>
<td>12.4</td>
<td>10.8</td>
<td>14.9</td>
</tr>
<tr>
<td>Market PBV (x)</td>
<td>1.7</td>
<td>3.0</td>
<td>2.0</td>
<td>2.1</td>
<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>DY (%)</td>
<td>3.0</td>
<td>1.2</td>
<td>1.8</td>
<td>2.4</td>
<td>2.9</td>
<td>2.4</td>
</tr>
<tr>
<td>No.of Listed Companies</td>
<td>231</td>
<td>241</td>
<td>272</td>
<td>287</td>
<td>289</td>
<td>293</td>
</tr>
</tbody>
</table>

Source : Colombo Stock Exchange/ Bloomberg

With the end of terrorism in 2009 the CSE enjoyed a bull run unmatched by most other markets since 2009 to mid-2011 with the benchmark CSEALL peaking at 7,800 points in February 2011. On this backdrop and unprecedented growth levels, Bloomberg named it one of the best-performing Stock Markets in the world for the years 2009 and 2010. However with the euphoria of end-of-war gradually waning and over excited investors stretching the valuations to levels previously unseen, the bourse went through a correction and liquidity levels too thinned in 2012.

With the market valuations again becoming attractive alongside a fall in interest rates and the efforts taken by the Regulator to strengthen the Capital Market since end of 2013, the CSE is on a sharp growth trajectory.
The market rebounded after it bottomed out in May 2012 driven by improved market sentiment, strong market fundamentals and the sustainable decline in both interest rates and inflation. The continued decline in benchmark interest rates helped the market to maintain its growth momentum in 2014, and the CSEALL posted 19% growth during the first nine months of the year with the CSEALL just shy of around 3% to reach the all-time high index level. However this sharp growth in YTD 2014 does not insinuate peaking of the market but the contrary since trailing PE multiples are still at mid-teens while 1 year forward and 2 year forward PE multiples are at low double digit and single digit levels respectively.

CSEALL on average, performed better (during June 2009-August 2014) than global indices and some of the best-performing regional indices, although growth over the immediate post war period eased after mid-2011 due to a market correction.

Regional Indices

The market rebounded after it bottomed out in May 2012 driven by improved market sentiment, strong market fundamentals and the sustainable decline in both interest rates and inflation. The continued decline in benchmark interest rates helped the market to maintain its growth momentum in 2014, and the CSEALL posted 19% growth during the first nine months of the year with the CSEALL just shy of around 3% to reach the all-time high index level. However this sharp growth in YTD 2014 does not insinuate peaking of the market but the contrary since trailing PE multiples are still at mid-teens while 1 year forward and 2 year forward PE multiples are at low double digit and single digit levels respectively.
Further the economy despite enjoying on average 7.5% real GDP growth is now adjusting to a better managed monetary policy framework with low interest rates and inflation which would add impetus to this already bolstered growth rates.

Most sectors in the CSEALL still trading below market and historical valuations bodes well with the upside potential of the market. The Hotels & Travel, Diversified and Beverage, Food & Tobacco sectors have consistently traded at higher P/E multiples than the market over the past five years, thus reflecting their growth trajectory. Nevertheless both the economy and the market having been re-rated subsequent to the paradigm macroeconomic and political shifts since 2009 provides further justifications for these primary growth sectors to attract fatter premiums. However, most other sectors with relatively similar growth potential, such as Manufacturing, Power & Energy, Land & Property and Construction & Engineering, still trade below the market. The P/B valuation shows a similar trend, with most sectors trading below the five-year market average and historical sector valuations, thereby presenting attractive investment opportunities.
The CSE still trades at a discount to regional markets despite strong fundamentals. The CSEALL currently trades at a low P/E valuation compared to most of its regional peers, despite the country being one of the fastest-growing economies in the world. The Colombo bourse which is currently classified as a frontier market has been the best performing market for YTD 2014 amongst the selected universe and is the market with the highest real GDP growth. The CSEALL's current valuation of 14.9x is at a 17% discount to its regional peers. Similarly, the CSEALL's forward valuations also trade at discounts to peers, despite expected growth in market EPS over the next 12 months.

Regional PE comparison

![Regional PE comparison chart]

Source: Bloomberg

Frontier market GDP comparison

![Frontier market GDP comparison chart]

Source: Bloomberg
On average the foreign trading at the CSE has accounted for around 25% of the trading value. In 2009 after surpassing 30% levels with the market rallying with strong local retail strength the overseas trading contribution had waned in 2010 and 2011. However the market witnessed a net positive flow of foreign investments starting from 2012 onwards. This clearly indicates foreign investor confidence in Sri Lanka’s economic prospects. Foreign turnover levels increased to LKR 72 Bn during 2013, significantly higher than the levels seen over 2011-2012. Foreign turnover came in at LKR 59 Bn in 2011, while it reached LKR 53 Bn in 2012. The momentum continued in YTD 2014 with foreign trading activity accounting for nearly 30% of the total market turnover.

**Foreign Fund Movement**

![Foreign Fund Movement Graph](image)

Source: Colombo Stock Exchange

**Market Turnover Split**

![Market Turnover Split Graph](image)

Source: Colombo Stock Exchange
YTD 2014 market capitalization levels and market activity was further boosted by new IPO’s, rights issues, Debt IPO’s and private placements.

**Equity & Debt Capital Raised**

<table>
<thead>
<tr>
<th>(LKR Mn)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014 YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity IPO</td>
<td>4,348</td>
<td>19,156</td>
<td>1,739</td>
<td>494</td>
<td>13,900</td>
</tr>
<tr>
<td>Debt IPO</td>
<td>15,000</td>
<td>1,000</td>
<td>12,500</td>
<td>68,262</td>
<td>2,694</td>
</tr>
<tr>
<td>Rights Issues</td>
<td>24,322</td>
<td>28,020</td>
<td>11,128</td>
<td>25,539</td>
<td>4,659</td>
</tr>
<tr>
<td>Conversion of Warrants</td>
<td>2,675</td>
<td>1,955</td>
<td>1</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Private Placement</td>
<td>433</td>
<td>4,500</td>
<td>2,266</td>
<td>-</td>
<td>1,008</td>
</tr>
</tbody>
</table>

Source: Colombo Stock Exchange

Market capitalization has more than doubled since 2009 and stood at LKR 2,952 Bn (approximately US$ 23 Bn). Nevertheless, there is further growth potential since the CSE’s market capitalization/GDP is still low compared to that of most other emerging markets in the region. The government expects the CSE’s market capitalization to reach LKR 6,500 Bn by 2016E and this target is easily achievable if at least few of the State Owned Enterprises (SOE’s) get listed. However since 2009 to date no SOE’s have been listed apart from People’s Leasing Finance Co. (which is a subsidiary of the state owned Peoples Bank)

The CSE’s market capitalization has doubled since 2009

Market Capitalization to GDP (as of 2012)

Note: Currently Sri Lanka’s Market Capitalization to GDP is at c.35%

Source: Central Bank of Sri Lanka /Colombo Stock Exchange

Source: Bloomberg
Market liquidity contracted during the early part of 2012; however, volumes have picked up since then and are now on par with the five-year historical average. Factors that contributed to this spike include the CSE’s decision to relax some of its rules relating to broker credit. Furthermore, a rebound in both retail investor and local institutional investor sentiment has also contributed to the market’s increased liquidity. One of the key concerns of investors has been the lack of liquidity in the market, which constricts block trades and easy exits.

Even though the CSEALL currently has a free float of around 25%, most companies within the index have less than 5% free float. In a bid to increase liquidity, the Securities and Exchange Commission (SEC) of Sri Lanka issued a directive stating that Main Board-listed companies should have a minimum public free float of 20%.

However despite the limited free float for the market as a whole the most popular, medium to large capitalized listed stocks have significantly higher free float. The S&P 20 Index consists of some medium to large capitalized stocks with high free float percentages.

### S & P 20 Companies Market Capitalization and free float

<table>
<thead>
<tr>
<th>Name</th>
<th>Ticker</th>
<th>Market Cap. (LKR Mn)</th>
<th>Public Holding (%)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aitken Spence Plc</td>
<td>SPEN.N0000</td>
<td>45,187</td>
<td>38.78</td>
</tr>
<tr>
<td>Asian Hotels &amp; Properties Plc</td>
<td>AHPL.N0000</td>
<td>31,039</td>
<td>21.38</td>
</tr>
<tr>
<td>Bukit Darah Plc</td>
<td>BUKI.N0000</td>
<td>73,440</td>
<td>22.84</td>
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<tr>
<td>C T Holdings Plc</td>
<td>CTHR.N0000</td>
<td>29,753</td>
<td>39.26</td>
</tr>
<tr>
<td>Cargills (Ceylon) Plc</td>
<td>CARG.N0000</td>
<td>36,960</td>
<td>20.48</td>
</tr>
<tr>
<td>Carson Cumberbatch Plc</td>
<td>CARS.N0000</td>
<td>88,197</td>
<td>14.30</td>
</tr>
<tr>
<td>Ceylon Tobacco Company Plc</td>
<td>CTC.N0000</td>
<td>215,947</td>
<td>15.87</td>
</tr>
<tr>
<td>Chevron Lubricants Lanka Plc</td>
<td>LLUB.N0000</td>
<td>40,140</td>
<td>49.00</td>
</tr>
<tr>
<td>Commercial Bank Of Ceylon Plc</td>
<td>COMB.N0000</td>
<td>126,318</td>
<td>99.50</td>
</tr>
<tr>
<td>DFCC Bank</td>
<td>DFCC.N0000</td>
<td>52,039</td>
<td>63.30</td>
</tr>
<tr>
<td>Dialog Axiata Plc</td>
<td>DIAL.N0000</td>
<td>92,025</td>
<td>14.73</td>
</tr>
<tr>
<td>Distilleries Company Of Sri Lanka</td>
<td>DIST.N0000</td>
<td>63,450</td>
<td>42.97</td>
</tr>
<tr>
<td>Hatton National Bank Plc</td>
<td>HNB.N0000</td>
<td>58,871</td>
<td>61.00</td>
</tr>
<tr>
<td>Hayleys Plc</td>
<td>HAYL.N0000</td>
<td>27,285</td>
<td>30.95</td>
</tr>
<tr>
<td>John Keells Holdings Plc</td>
<td>JKH.N0000</td>
<td>249,027</td>
<td>98.60</td>
</tr>
<tr>
<td>Lanka Orix Leasing Company Plc</td>
<td>LOLC.N0000</td>
<td>41,200</td>
<td>15.50</td>
</tr>
<tr>
<td>Lion Brewery Ceylon Plc</td>
<td>LION.N0000</td>
<td>49,248</td>
<td>14.61</td>
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<tr>
<td>National Development Bank Plc</td>
<td>NDB.N0000</td>
<td>41,589</td>
<td>87.80</td>
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<tr>
<td>Nestle Lanka Plc</td>
<td>NEST.N0000</td>
<td>112,705</td>
<td>9.20</td>
</tr>
<tr>
<td>Sampath Bank Plc</td>
<td>SAMP.N0000</td>
<td>40,802</td>
<td>83.25</td>
</tr>
</tbody>
</table>

*As per the Public Holding definition of the CSE.  
Source: Colombo Stock Exchange
Development Initiatives of Sri Lanka’s Capital Market
Recent Regulatory Initiatives of the SEC to Develop the Sri Lankan Capital Market

Broker's Net Capital Computation (October 2012)
Introduced a revised policy/formula to address the limitations of the ‘Broker Net Capital’ requirement computations.

Primary dealers to become trading members of CSE (May 2013)
Completed initiatives to enable primary dealers to trade in listed corporate debt. This will facilitate development of secondary market for debt.

Lock-in’ mechanism (August 2013)
Introduced revised provisions on ‘lock-in’ of shares applicable to new listings, to enhance liquidity and regulations streamlined.

Introduction’ mechanism (October 2013)
Re-instated Introduction mechanism as a method of listing equity on the CSE with necessary safeguards to attract new listings to the CSE.

Diri Savi Board criteria (October 2013)
Revised the minimum number of Public shareholders of companies seeking to listing on Diri Savi Board, to enhance liquidity of the CSE.

Introduction - Internal Guidelines for waiving lock-in rule with respect to Public Shareholders (November 2013)
Internal guidelines were developed to waive lock-in rule imposed on public shareholders who have acquired shares during the 12 months prior to the initial listing application in order to comply with the minimum public holding requirement at the time of listing via Introduction. These guidelines are meant to accommodate listings and facilitate ‘Public’ Shareholders to engage in secondary market trading.

Listing BOI Companies (November 2013)
Developed a mechanism to list large BOI Companies to encourage further FDIs into Sri Lanka. This is to be implemented in consultation with BOI & CSE.
Maximum ‘Ticket size’ of Debt (November 2013)
Finalized framework on ‘ticket size’ by setting a maximum upper limit of LKR 10,000 for debt. This is to broad-base the investor base by allowing more accessibility.

Rules for listing of Debt (November 2013)
Developed new rules for the listing of debt as approved by the SEC Commission which were issued to the CSE for implementation.

Related Party Transactions (December 2013)
‘Code of Best Practices’ on Related Party Transactions by listed companies was developed and approved by the SEC Commission to create greater transparency. The compliance with the Code is mandated with effect from 01st January 2016.

Minimum Public Float (December 2013)
Rules on ‘Maintenance of minimum public float as a continuous listing requirement’ were implemented in order to increase market liquidity. These rules are in effect from 01st January 2014.

Immediate Disclosure (December 2013)
Developed new rules on ‘immediate disclosure’ in relation to Directors share dealings to ensure transparency of Directors’ dealings and eliminate subjectivity in interpretations and disclosures. These rules are in effect from 01st April 2014.

Unit Trust Funds (September 2014)
Maintain a minimum number of fifty (50) unit holders for each fund at all times.
Capital Market Development Road Map

- Strengthening the regulatory framework
- Development of the Corporate Bond Market
- Education and awareness
- Attracting new funds
- Increasing listings
- Development of new products
- Development of Unit trust Industry
- Implementation of CCP Mechanism
- Demutualization of the CSE
- Development of IT Infrastructure
The Securities and Exchange Commission of Sri Lanka (SEC) initiated a Capital Market development master plan which focuses on 10 key strategic areas which would enable realizing the Commercial Hub strategy envisaged under the overall development plan for the country. This master plan was carefully formulated in consultation with all the key Capital Market stakeholders comprising of senior representatives from the CSE, SEC and securities industry to provide policy direction. All ten areas of this overall plan is progressing concurrently while the benefits of some initiatives are already visible and others would be fully evident once final implementation takes place.

The SEC in 2013 and year to date 2014 continued the implementation of these initiatives to reposition the Capital Market to play an important role in capital formation and development of the economy in line with the Government's overall strategy.

1. **Strengthening the regulatory framework**

1.1 **SEC Act amendments**

The SEC together with the industry stakeholders conducted a gap analysis to identify necessary changes to the current SEC Act to ensure risk mitigation and Capital Market growth. The SEC obtained technical assistance from FIRST initiative of the World Bank who drafted policy papers for the identification of amendments to the SEC Act (Securities and Exchange Commission of Sri Lanka Act no. 36 of 1987 as Amended by Act no. 26 of 1991, Act no. 18 of 2003 and Act No. 47 of 2009). The drafting of the proposed amendments to the SEC Act has been completed and submitted to the Ministry of Finance and Planning (MoF) before submitting for Cabinet approval. Currently, the amendments are being reviewed by a committee appointed by the MoF. The main objective of the proposed amendments are to enhance the efficiency and the attractiveness of the Capital Market as a financing or investment vehicle and broaden the product range in the Sri Lankan Capital Market through the adoption of an effective legal framework for the Capital Market.

1.2 **Regulations to address liquidity concerns**

As part of initiatives taken by the SEC to increase the liquidity in the market, a mandatory minimum public float requirement was introduced for listed companies following a practice that has already been adopted by a large number of international and regional jurisdictions. The minimum public float in addition to increasing liquidity in the market is also expected to facilitate a better price discovery mechanism.

The Rule requires any Entity listed on the Main Board to have a minimum public holding of 20% in the hands of a minimum 750 public shareholders or a market capitalization of LKR 5 Bn in the hands of a minimum 500 public shareholders while maintaining a minimum public holding of 10%. Meanwhile an entity listed on the Diri Savi Board is to maintain a minimum public holding of 10% in the hands of a
minimum of 200 public shareholders. This rule which was introduced in December 2013 would be progressively implemented while all listed companies would need to be fully compliant by 31st December 2016.

A special mechanism of listing by Introduction with necessary safeguards to protect the integrity of the investors and the Capital Market was re-instated in order to facilitate the efforts by the CSE/SEC to increase the number of listed entities by attracting new companies.

Moreover the SEC is exploring the possibility to allow Board of Investment (BOI) companies to list on a separate Board without having to wait for three years to list on the Main Board of the CSE.

1.3 Regulations on related party transactions

A Code of Best Practices on Related Party Transactions was introduced for listed companies as part of the efforts of the SEC to further enhance Corporate Governance within listed entities and to protect minority interests. This new initiative is expected to significantly increase Sri Lanka’s ranking of “Doing Business Index” under Investor Protection category.

1.4 Revisions to the Code of best practices on corporate governance

A policy directive on the disclosure of dealings by the Directors and the CEO’s was introduced to increase transparency of dealings by directors and CEOs on their relevant interests in shares by mandating timely disclosures.

Directions were provided to Managing Companies and Trustees of Unit Trusts specifying the daily valuation method in order to standardize and adopt a uniform valuation method for fixed income instruments in trust funds.

2. Development of the Corporate Bond Market

2.1 Corporate debt market expands in 2013 and signals further growth potential

The raising of long term capital is an important function of any Capital Market and as such developing the corporate bond market has been a key focus area for the SEC over the last few years. Initially through representations made to the MoF and CBSL withholding tax treatment was brought in line with Government securities and foreigners allowed to invest in corporate debt respectively among other initiatives. However, the real boost to the corporate bond market came by way of the MoF exempting the 10% withholding tax on corporate bond issuances.
and these instruments been made income tax exempt in the hands of the investors after the MoF was convinced of the importance of allowing the market size to grow from its insignificant levels at the time. As a result, debentures worth LKR 68.3 Bn were issued in 2013 (from LKR 12.5 Bn in 2012), with approximately 84% of these issues coming from banks and other financial institutions. Another significant development is that over 50% of the funds raised are in the 5-10 year tenor bonds.

**Funds raised through listed debentures in 2013**

![Circle diagram showing funds raised through listed debentures in 2013](source: Central Bank of Sri Lanka)

<table>
<thead>
<tr>
<th>Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Commercial Banks</td>
<td>49%</td>
</tr>
<tr>
<td>Local State Banks</td>
<td>32%</td>
</tr>
<tr>
<td>Local Finance companies</td>
<td>16%</td>
</tr>
<tr>
<td>Non Financial Institutions</td>
<td>3%</td>
</tr>
</tbody>
</table>

2.2 **In a low interest rate environment, Sri Lankan corporate issuances present attractive investment opportunities**

Corporate debenture issuances in Sri Lanka in 2013 carried rates of 13-15% (the effective annual interest rate), well above the government bond rate of 11%. With government interest rates on a decline and currently at single digit levels and given a low interest rate environment in most economies, local corporate issuances present attractive investment opportunities, providing healthy returns with relatively low risks. Furthermore, in 2013, two of Sri Lanka’s leading savings and development banks leveraged by completing US$ bond issuances. State owned National Savings Bank raised US$ 750 Mn in September and DFCC Bank raised US$ 100 Mn in October, while both issuances were oversubscribed.

2.3 **Sri Lankan Debt Market still dominated by Government Securities**

Government Securities accounted for most of Sri Lanka’s LKR 3 tn debt market. Although much of government debt is denominated in rupees, the government has successfully issued several foreign currency bonds. Thus far, the government has issued seven sovereign bonds; the most recent issuance, a five-year US$ 500 Mn sovereign bond with a 5.125% coupon, was oversubscribed 8.3 times. At the same time, foreign holdings in local government bonds have increased to about 15% in 2013 from less than 2% in 2008.
2.4 Initiatives to further boost the Corporate Bond Market

A policy decision has also been made to allow primary dealers who are engaged in dealing in Government securities to further boost the secondary market in corporate debt through their role of market makers.

Further, as a joint initiative of the CBSL, SEC and CSE upgrades to the CSE trading infrastructure for debt market securities are being finalized to streamline trading, enhance price discovery and transparency.

3. Education and Awareness

The SEC and CSE commenced education and awareness programmes both collectively and separately. This initiative was focused on educating and increasing awareness among all stakeholders.

Therefore, various programmes have been structured targeting industry participants, the public at large and corporate directors.

3.1 Education Programmes – Industry Development

The SEC is conducting a certification programme, Certificate in Capital Market (CCM), which also serves as the pre-requisite for Individual Stock Brokers to obtain the licensed status of Registered Investment Advisor (RIA). The successful completion of the CCM, examinations and a VIVA the RIA’s have to accrue a minimum amount of credits per year under the Continuous Professional Development (CPD) requirement which is been made a mandatory to maintain the RIA status.

Also an educational curriculum for the sales and marketing staff of Unit Trust Companies have been finalized and this certificate programme is expected to commence in the very near future and would become the basis for ensuring the knowledge level of the personnel deployed in the industry.

Further moving beyond the Certificate level, a Diploma in Capital Market was launched by SEC and 4 batches have already completed the programme and the 5th intake was in September 2014.
3.2 Education and Awareness Programmes - Public

During the past few years both the CSE and SEC had worked together in increasing public awareness on Capital Market and to ensure the retail public becomes sufficiently knowledgeable in identifying both the listed equity and debt markets as investment avenues.

The SEC had initiated many Television and Radio programmes (some of which are still on-going) mainly in Sinhalese and Tamil to increase awareness and concurrently educate the public on Capital Market. Further on the print media, knowledge of investing in the Capital Market is being imparted in all three languages abundantly.

The CSE too has been increasing public awareness and education in a much focused manner and attempted to make direct representations. Taking the Capital Market to areas outside Colombo and to ensuring rural Sri Lanka is also made aware of the equity markets has been an objective closely pursued by the CSE.
CSE Branch Network

Source: Colombo Stock Exchange
Sri Lanka's first Capital Market reality show “Danno Dinanno...”

CPD programme for industry stakeholders

Training for independent directors by CMET of SEC

SEC endorsed programme by SLID

Prof. Mervyn King at CDP programme of SEC & CA SL
3.3 Educational and awareness programmes – Corporate Directors

Training for Independent Directors

A seminar for Directors of Listed Companies titled ‘Company Law Obligations of Directors in a Listed Company’ which was conducted by the SEC in April 2013.

Corporate Directors Programme by SEC in collaboration with CA Sri Lanka

SEC together with the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) jointly launched the Corporate Directors Programme on 20th May 2014 to aid corporate directors enhance their existing competencies and gear themselves to grapple with new regulations and challenges. The programme featured a keynote speech by Professor Mervyn King, Chairman of the International Integrated Reporting Council who shared his experience on emerging trends in Corporate Governance.

SEC endorsed Board Leadership Training Programme by Sri Lanka Institute of Directors

A two day Board Leadership Training Programme targeted at new and practicing directors, aspiring and potential directors of listed companies, private companies and state owned enterprises was conducted by Sri Lanka Institute of Directors in February 2014. The programme endorsed by the SEC was built up on the material developed by the International Finance Corporation (IFC) Global Corporate Governance Forum, customised to suit the Sri Lankan business environment.
4. Attracting New Funds

Over the years the CSE, SEC and few stock brokering companies had been conducting overseas investor forums promoting Sri Lankan equities among global fund managers much successfully. However given the country’s overall post-war development, CSE together with the SEC introduce a programme which would cohesively boost the Capital Market Awareness among the international fund managers.

Thereby during the past 24 months the CSE and SEC collectively organized overseas investor forums under the theme of “Invest Sri Lanka” with the participation of many listed Sri Lankan companies and market participants. The take up was commendable with total fund manager registrations usually at full capacity. To date investor forums were held in Mumbai, Dubai, Hong Kong, Singapore, London and the most recent been in New York in September 2014. The CSE also plans to continue this exercise and conduct similar investor forums in other global economic centers.

The present event the “Capital Market Conference - 2014” in which you are participating is another programme which both the SEC and CSE would want to conduct periodically and keep the global fund managers updated on the events taking place in Sri Lanka.
5. Increasing Listings

5.1 Regulatory initiatives to encourage listings

The mechanism of “Listing through Introduction” which was suspended temporarily was reinstated while the SEC and CSE would be focusing on ensuring all listed companies maintain a minimum public float which would assist in maintaining and improving the liquidity in the market.

Also the BOI, SEC and the CSE are collectively working together to amend the BOI and Listing Rules in order for BOI companies to be listed on the CSE. This initiative is viewed favourably with 7 BOI companies already expressing interest on the possibility of being listed. (BOI is a special purpose institution able to attract FDI’s and provides tax benefits for BOI companies meeting specific investment criteria)

5.2 Other initiatives to encourage new listings

Awareness on listing and benefits of the same is been widely publicized using electronic media and print media. A step-by-step guide to listing, a tri-lingual publication was completed to assist in the process while the SEC and CSE have made 141 direct representations to unlisted companies to encourage listing.

The SEC and CSE have both made many representations to State Owned Enterprises (SOE’s) to entice them to list and this exercise would be continued in 2015 as well.

Both SEC and CSE have worked together with many industry and business chambers to see the possibility of creating a separate Small and Medium Sized Enterprise (SME) board which would cajole both entrepreneurs and SME owners to raise capital through listings. Also a collective research is being carried out to understand a firm’s requirement to list and any barriers for such given the Sri Lankan context.

5.3 Future initiatives

A micro level study to understand provincial requirements and to encourage more listings of regional based companies is underway.

Discussions and consultations are taking place to evolve with the changing environment to ensure minority shareholder concerns if any are addressed. Further evaluation is taking place on the necessity of changing or amending the policy framework to encourage more Public and Private companies to list.
6. Development of New Products

6.1 Dollar Bond Funds

The SEC has given conditional approval for the launch of a second Dollar Bond Fund. Already the initial applicant has launched Sri Lanka’s first ever Dollar Bond Fund and marketing of the same has commenced while the second fund is expected to assist further in growing this new product.

6.2 Real Estate Investment Trusts (REIT’s)

Work on developing REIT products and necessary rules, regulations and policy amendments are currently being discussed by the SEC with the CBSL and Ministry of Finance and Planning.

7. Development of Unit Trust Industry

7.1 Performance of the Unit Trust Industry

As of 31 July 2014, Sri Lanka had 54 unit trusts, including income, growth, gilt-edged, money market, balanced, Shariah, equity and IPO funds. Participation in unit trusts has grown by threefold over the past 19 months, with assets under management (AUM) coming in at LKR 80 Bn, or US$ 613 Mn, by July 2014 (compared with AUM of LKR 23 Bn in 2012), with a majority of exposure to fixed income and equity investments. This phenomenal growth is largely due to the incentives given in the 2013 budget, which include tax incentives for participating in unit trusts, and the removal of restrictions on foreign participation, thereby creating another avenue for foreigners to enter the market.

Sri Lanka’s 2013 budget brought down the taxation of Unit Trust management companies to 10% from 28% in order to strengthen the Unit Trust Industry and direct foreign investments were allowed in unit trusts without the requirement to open a Securities Investment Account (SIA).
Over the past three years, a large number of unit trusts have outperformed the overall market.

### 7.2 Development initiatives for the Unit Trust Industry

In an attempt to increase Unit Trust participation and industry growth, the SEC has directed unit trusts to maintain a minimum of 50 unit holders for each fund at all times. If and when this requirement is not met due to redemption by a unit holder or any other supervening circumstances, the managing company of Unit Trust Funds will be required to make best efforts to comply within three months from the date of the first short fall and consult the Commission forthwith. Unit Trusts are also required to obtain a minimum of 50 unit holders during an IPO period and if that is not met Unit Trusts will have to refund the monies collected at the close of the IPO period.
Further Unit Trust management companies, along with the SEC, are presently conducting a major public awareness campaign to boost the industry, with the aim of strengthening its retail investor base.

Through representations made by the SEC, unit trusts were made permissible investment within the maximum 20% exposure limit to the Capital Market by pension funds as per the Department of Inland revenue direction. Gilt Funds were enabled to be recognised as Government securities as per mandatory holdings of licensed commercial and specialized banks through representations made to the CBSL by SEC. Also through representations made by the SEC to the Insurance Board of Sri Lanka (IBSL) is to recognize Gilt Edged funds as government Securities for solvency purpose calculations of insurance companies. All these developments are expected to invariably lead to the expansion of the Unit Trust Industry.

Sales staff of Unit Trust Companies would be trained and certified under an educational curriculum created by the SEC and Unit Trust Association of Sri Lanka, which is expected to broaden the knowledge base of the industry staff and the retail public.

8. Development of IT Infrastructure

As part of the overall Capital Market development exercise, the SEC and CSE decided to ensure that the Broker Back Office (BBO) systems are upgraded to suitable performance standards ensuring accuracy and trade efficacy. Therefore, a dedicated team from the SEC, CSE and industry have short listed certain parties meeting specified criteria having the ability to provide the industry with a suitable BBO system meeting the necessary standards. Implementation is targeted during 2nd half 2015.

9. Implementation of CCP Mechanism

The elimination of counter party risk and asset commitment risk currently prevailing in the Stock Market has been a key priority for the SEC and CSE over time and many initiatives have been considered in this regard with the ultimate objective of establishing a clearing house. However, with the Central Bank (CBSL) too considering the necessity for a Central Counter Party (CCP) mechanism for Government Securities, currently the SEC, CSE and CBSL are in the process of establishing a CCP for all instruments in the domestic financial system. In this regard a consultant cum project manager has been identified and the project implementation is targeted to be end of 2015. The establishment of a CCP is expected to boost foreign portfolio investments into the Capital Market of the country.
10. Demutualization of the CSE

The CSE was established under the Companies Act No. 17 of 1982 and functions under the license of the SEC as a mutual exchange with 15 member firms and 13 trading member firms. The CSE through its fully owned subsidiary Central Depository Systems (Pvt) Ltd. (CDS) functions as a clearing and settlement system facilitator.

Considering the functionality of the global exchanges and the need for the CSE to pursue its strategic interests by running the stock exchange as a ‘for profit’ organisation by separating ownership, management and trading rights, the regulators are pursuing the demutualization of the CSE. The SEC, upon receiving cabinet approval to demutualize the CSE created a comprehensive draft Demutualization Bill with the consultations of the Legal Draftsman, Attorney General’s Department, CSE and the brokerages. A committee consisting of personnel from the SEC and CSE was created to carry out the demutualization process and based on their view a consultant was retained to handle the value allocation and other modalities of the process. The final draft of the Demutualization Bill was forwarded to the Ministry of Finance and Planning by the Legal Draftsman and is currently been translated into Sinhala and Tamil and expected to be presented in Parliament soon.
SEC and CSE
Governing structure

SEC Commission Members

Dr. Nalaka Godahewa (Chairman)
Mr. Lolitha Abeysinghe
Mr. Mohamed Zuraish Hifaz Hashim
Mr. B. D. W. A. Silva
Mr. Priyanka Fernando
Dr. Prathiba Mahanamahewa
Mr. D.N.R. Siriwardena
Dr. B.M.S. Batagoda
Mr. Arjuna Herath

CSE Board of Directors

Chairman
Mr. Vajira Kulatilaka

Elected Directors
Mr. Asanga Seneviratne
Mr. M. R. Prelis
Mr. Ray Abeywardena
Mr. Aravinda Perera

Appointed Directors
Mr. Dakshitha T. W. Thalgodapitiya
Mr. Hiran M C de Alwis
Ms. M.A.D.S. Jeeva Shirajanie Niriella
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