Capital Market Development Workshop 2011

*Let's Make the **Right** Moves Together*

18th & 19th June 2011, Jetwing Blue
Negombo, Sri Lanka

Rapporteurs:

Mrs. Ayanthi Abeyawickrama, *Asst. Director Legal and Enforcement, SEC*
Ms. Himani Weerasekera, *Asst. Direct Supervision, SEC*
Mr. Suneth Perera, *Manager Capital Market Education and Training, SEC*
Miss Madhugayanie Balapitiya, *Manager Investigations, SEC*
Miss Sharmila Panditaratne, *Manager Legal and Enforcement, SEC*
Mrs. Saumi Kodippily, *Senior Executive Supervision, SEC*
Ms. Ruwani Munasinha, *Manager Capital Market Development and Research, SEC* (Lead Rapporteur)

Opening Remarks

Mrs. Indrani Sugathadasa
Chairperson
Securities and Exchange Commission of Sri Lanka

The Chairperson of the Securities and Exchange Commission of Sri Lanka (SEC) opened the sessions by stating that the Capital Market Development Workshop 2011 was organized by the SEC in collaboration with the Colombo Stock Exchange, Colombo Stock Brokers Association and the Unit Trust Association of Sri Lanka. The Chairperson welcomed the Chief Guest, Mr. U. K. Sinha, Chairman of the Securities and Exchange Board of India, who accepted the SEC's invitation to this Workshop.

The SEC Chairperson indicated that representatives from all key players in the Sri Lankan capital market, such as the Colombo Stock Exchange, Broker Firms, Unit Trust Management Companies, Market Intermediaries, the Central Bank of Sri Lanka and some of the top listed companies, have been invited for this workshop.

The SEC Chairperson stated that the economic and political environment in the country has been very positive and conducive for the expansion and development of the capital market in Sri Lanka. However every aspect of the capital market is rapidly changing day by day, not only in Sri Lanka, but everywhere in the world. The shape or the structure of the market, the key market indicators such as turnover, as well as the dominant players in the market, change from time to time. What are the driving forces which take companies or a particular individual to that position? Is it basic principles, the fundamentals or the demand and supply theory, which determines the price of any good, or something else? The SEC Chairperson indicated that it is up to the audience to find answers to these questions during this workshop.

The SEC Chairperson further stated that Sri Lanka has relied predominantly on the banking sector for its corporate financing and investment activities over the years and that position is being changed. *The SEC as the Regulator is very keen to play a facilitatory role in developing the capital market* to complement the banking sector as an alternative source of financing and as required for a robust financial system.

With benchmark interest rates being relatively low, the stock market continues to be an attractive investment alternative which is evidenced by the opening of new CDS accounts which has been encouraged by IPO's coming into the market. The SEC Chairperson however mentioned that despite this, a noteworthy factor is, that out of the 600,000 CDS accounts opened to date, *only 30,000 CDS accounts trade monthly* and are considered as active accounts. What these numbers indicate is that the surge in stock market returns, in the past few years, have been enjoyed by a relatively small fraction of the population on the one hand, and on the other, indicates the opportunities for expanding the business activities of the market.

Following the present Government's policies, the SEC Chairperson stated that the SEC is *keen to extend the benefits of stock market investments, to a wider segment of the population*. Therefore, the SEC aims to broaden the investor base as well as the issuer base. In this regard the SEC has brought in policies to give preferential allocations to the relatively small investors at IPO's and Unit Trusts which the SEC wants to promote as the ideal conduit for unsophisticated investors to access the stock market.

The SEC she said is very encouraged by the marked improvement in companies looking to raise equity finance and already there have been seven IPO's and a number of them lined up for listing during the course of this year. However, not only for the sake of investors, but also for the sake of retaining the growth of the market and its sustainability, the SEC is very keen to encourage fundamentally strong companies with good prospects and those that represent other sectors of the economy to seek listings and raise debt finance.

The SEC Chairperson said that the Central Bank of Sri Lanka has directed all finance companies to list on the Colombo Stock Exchange within a given period and when these companies applied for listing, the Commission realized that the financial status of certain companies has not been stable, at least in the recent past.

Since the present listing requirements do not cover certain important aspects of a company where the long-term stability is concerned, the Commission advised the SEC Secretariat to amend the listing requirements to cover all these areas.

Furthermore, there has been a long overdue requirement to amend the SEC Act since the present Act does not cater to the demands of the present day market. The SEC Chairperson stated that the SEC has been successful in obtaining World Bank assistance to amend the Act. Work will commence shortly to enable the SEC to amend the Act as early as possible, to cover various areas which are not covered by the present Act. The SEC intends to introduce new concepts such as Demutualization and other concepts in time to come.

The SEC also encourages *state-owned enterprises* and *infrastructure projects* to tap the potential of the capital market to promote public-private partnerships in the next phase of economic development of the country.

For all these initiatives, the SEC Chairperson remarked that the *contribution of all market participants is invaluable* in the form of comments, suggestions or even constructive criticism and it is the duty of everyone at this Workshop to discuss and explore alternative ways and identify strategies *to develop the capital market further, to harvest its untapped potential, whilst focusing on international best practices*. The SEC Chairperson concluded by *requesting all market participants to work hand in hand* and by wishing the Workshop great success.

Guest of Honor's Address

Mr. U. K. Sinha
Chairman Securities and Exchange Board of India
Chairman of the Asia Pacific Regional Committee of the
International Organization of Securities Commissions (IOSCO)

Mr. Sinha mentioned that the Securities and Exchange Board of India (SEBI) and the Securities and Exchange Commission of Sri Lanka (SEC) have signed the first MOU in as early as January 2003, and the Chairperson of the SEC has visited India. Sri Lanka was the first country in the entire South Asian Region to host the IOSCO Annual Conference in 2005. The Colombo Stock Exchange was the first in the Region to join the World Federation of Exchanges. Mr. Sinha said he was enthused by the announcement that the Government is contemplating the amendment of the SEC Act, including the *Demutualization and the Corporatization of the Colombo Stock Exchange*.

Mr. Sinha said that GDP growth in the Asian region is in the range of 8.3% at present compared to around 3.6% in 2009. The Market Capitalization of this region is very high, around US Dollars 17 trillion, and the growth in Market Capitalization in the Region has been 20% over the last one year. He also said that what was most relevant was the fact that 43% of the entire capital raised in the world last year, was raised in the Asia Pacific region. The lesson to be learned here is that *the Region is in for massive changes*, and *the Government has to be prepared, the Regulator has to be prepared and all market participants have to be prepared. He stressed the importance of Capital Market Development Workshop in providing an opportunity to all the participants to learn about the developments in other parts of world, as well as locally, and then to take measures for further growth.*

Mr. Sinha remarked that the capital market provides the mirror for the state of the economy. He highlighted the remarks made by the SEC Chairperson that, by and large in the past, Sri Lankan corporates were raising money through the banking system. There are any number of global examples, data and statistics to show that *if you want to go to a higher level of growth, and a higher level of public participation in the growth,* then the securities market, or the capital market in general, can provide a *very efficient intermediation* and *the corporates as well as the investors have to move away from the pure bank driven economy, to a market driven economy.* He said that a well-regulated and a vibrant market provide all the benefits, to a larger number of people who are participating either directly or indirectly in the market. However whatever the measures being taken, these measures have to be taken in a calibrated and gradual way and in a manner that all understand to be in the best interest of the local economy.

Mr. Sinha then narrated some of the developments in the global economy over the last three years, and stressed how the *lack of regulation* allowed subprime mortgages to lead to *a global meltdown.* He took us through an Indian example, where the amount of checks and balances that were provided by way of single party exposure or group exposure or exposure to a particular sector, the way it was being monitored, the way there was a focus on the capital adequacy requirements of Banks, and the way there was a focus on segregating the banking activity from the rest of it, that is what has helped India. Otherwise the contamination would have been direct and immediate. India is suffering because of this, but India's suffering is much lower, compared to some of the countries which were for it. Overall, he cautioned the mentality of innovating and following the crowd. He remarked that we need to change, we need to change *our economy* in a manner that serves the purpose, but we have to move in a calibrated way.

He added that IOSCO has come out with eight additional principles. These principles have come after the global crisis. Some of these principles are, for example, dealing with corporations which are too big to fail or which everyone thought were *too big to fail.* There were corporations which had activities across various regulations.

Every Regulator thought that the other Regulator is looking into it. In the case of AIG for example, they discovered that there was one small Regulator in a US State which was regulating it as one of the unimportant aspects of that particular insurance company, but that turned out to be an activity which was so large in its impact that it took the whole market down. Therefore IOSCO has provided in, among the eight New Principles, that we must look at *corporates which are perceived to be too big to fail.* He highlighted *two Principles.*

So far as the 'too big to fail' is concerned, in India there are issues. If SEBI wants to monitor corporates which have large activities and there are some of Indian corporates which are even in the list of the Financial Stability Board, they will have to amend the SEBI Act, because the current laws had not envisaged that these kinds situations might arise.

Mr. Sinha also highlighted the aspect of *stress testing.* What would be the consequences of a sudden reversal of foreign funds from a country? For example, are the **Risk Management measures of Stock Exchanges monitored carefully?** If a particular floor of money is coming in, and foreign flows have been very significant especially in India and in Sri Lanka as well, what would be the consequences of a sudden reversal of foreign funds into a Country? Are we prepared for it, he asked? Have we visualized that situation? Who are the people who are going to be affected? For example, are there Risk Management measures at Stock Exchanges and are they being monitored carefully? Are there any systems audits or process audits for this? What happens if an event takes place that we haven't anticipated in our statistical modeling? How well prepared are we for that?

At the same time Mr. Sinha mentioned that you cannot plan for extreme situations as planning only for extreme situations would throttle the market. He said that the wisdom of the people here, the talent of the people here will lie in deciding on something that is good for the country and at the same time, keep on challenging yourself and reviewing the situation from time to time to see whether the *Risk Management measures* you have introduced serve the purpose. He said that in India they have introduced a very *robust Risk Management System.* SEBI had worries in the past, for example, on payments and settlements and on systems when there was a market wide crash and the market had to be stopped. When they started building on those scenarios, SEBI realized that the system needs further upgradation, which has been done. But he stressed that the important thing is they will *continue to do it regularly.* As such, out of the eight new IOSCO principles, Mr. Sinha stressed on the *two new* P*rinciples on large corporates* and on *stress testing* and that everyone should review and contribute towards making these developments.

Mr. Sinha briefly commented on the SEBI regulatory developments: The SEBI Act was enacted in 1992 and there was a *major incident of market misconduct in 2001.* It became apparent that *the SEBI Act* was *not serving the purpose.* As a result an amendment to the SEBI Act was made in 2002. Some of the important points in that amendment are:

- Introduction of *multiple, full-time members of SEBI* with *experts on the Board* which provide the opportunity for informed discussions whenever a major issue is being discussed.
- The **significant enhancement of powers of SEBI.** For example, if found guilty in matters such as unfair trade practices, market manipulation, or violation of other serious matters, the *penalty that can be imposed is as high as Indian Rupees 25 crores, or three times the unlawful gain* made by that company or that agency, whichever is higher. This was a major change in the jurisprudence in India and has instilled a fear in the minds of possible manipulators that they can be challenged.
- Provision for Demutualization and Corporatization of Exchanges. The Securities Contracts Regulation Act amendment has **provided for the compulsory Demutualization and Corporatization of Exchanges,** with the main idea being to *separate the trading rights, from the management rights and the ownership rights.* Mr. Sinha remarked that this has done well for India.
- Provision for Dematerialization of shares (occurred in 1996/1997). We have **two large dematerialization companies,** National Securities Depository Limited (NSDL) and CDSL, which compete against each other. Mr. Sinha believed that the ratio of business of NSDL and CDSL is **40:60**.
- SEBI has been empowered by the Parliament to facilitate a forum for appeal.

- **Introduction of new products** such as derivatives (introduced for the first time in 2000). This was started gradually with *Futures on the Index* and then *Futures on single stocks*, and later expanded to *Options on the Index* and then *Options on single stocks*. In three years Currency Derivatives were also completed. Mr. Sinha remarked that new products will be introduced, but at a pace and manner that is good for the Country.
- **Provision for the simplification of the IPO process** was also made recently and this is encouraging new investors to come in. As many as one million new investors have come in through a single IPO.

Mr. Sinha believes that the growth of the *Mutual Fund industry in India* has been satisfactory with the compounded annual growth rate (CAGR) during the last five to six years being **above 20%**, which is rather healthy.

India has been trying in a major way to provide for *financial inclusiveness in the capital market*. There are two ways of doing this: One is to reach out and provide for a very high level of direct participation of the Retail *by making services available to them,* and ensuring that they are informed through the *creation and sustenance of a very informed investor education and financial literacy programme.*

At the same time, Mr. Sinha said that India is working in the area of *Pension Reforms* because our thinking is that if workers savings can come through pension funds, then this *institutional money coming in* will not only provide more money to the workers of the Country, but will provide a wide and significant stability to the capital market. He said that they have a new Pension System which has been introduced and another Bill is pending in Parliament. The idea is that worker should have a *choice,* a cross variation of schemes. They can for examples invest in a scheme which is 100% invested in corporate bonds or invest in a scheme which is 50% invested in equity. This experiment is being tried out.

There are several challenges for everyone in India, out of which, Mr. Sinha highlighted <u>two areas</u>. Whilst focusing on the needs of the local economy, the *concentration on global developments is vital.* IOSCO provides a vey good forum for this. It is important not just for the Regulators, but for market participants and those that have an interest in the capital market, as well for the Stock Exchange, *to keep abreast of the developments in the global economy and global market* and it is also a *good recipe to avoid any shocks.* In India they very strongly believe in this and have *set up mechanisms to access and evaluate global developments,* and also in forums such as IOSCO they obtain worthy ideas.

The second point Mr. Sinha highlighted is the problem of the multiplicity of Regulators in a country. In India, when their crisis happened in 2001/02, they discovered that a *co-operative bank had issued/negotiated a cheque for a very big amount concerning the capital market.* The payments and settlements system of the entire capital market was disturbed by that particular cheque. The co-operative bank was not regulated by the Banking Regulator or the Market Regulator, but by a Local Act of the State Government, which empowers the State Government to regulate Co-operatives. Given these developments, He suggested that Sri Lanka has to watch that, as the Country progresses, as the insurance industry becomes important and as the pension industry becomes significant, *consider whether Sri Lanka needs so many multiple Regulators or can those functions be combined together.* There is no one recipe. In fact until 2008, everyone believed that the FSA model was the best model (i.e. a Super Regulator). In Mr. Sinha's opinion, *all financial activities should be regulated*, but there should be *a forum or mechanism for Regulators to exchange views and share information.* If Sri Lanka can do this, he was of the opinion that it would save the Country from any future shock.

There will always be a demand for new and complex products, but he remarked that we have to evaluate our own systems and then prepare ourselves for it in a gradual way. *Retail participation is very important.* In the USA, the *whole mutual fund industry took off on the strength of the pension reforms bill.* If the pension money had not come, in the early 1980s, to the market, he felt that the mutual fund industry would have been only 1/10th of its size today. Mr. Sinha indicated that pension reforms are important, as well as *directly approaching the Retail and providing them safeguards.*

Closing Remarks

Mr. Malik Cader
Director General
Securities and Exchange Commission of Sri Lanka

On behalf of the Securities and Exchange Commission of Sri Lanka (SEC), the Director General thanked Mr. Sinha for accepting the SEC's invitation to be in Sri Lanka and address the Capital Market Development Workshop 2011. The Director General commented that Mr. Sinha will also share his experience on the success of the Unit Trust industry in India. The Director General stated that the *Unit Trust industry in Sri Lanka has to take off* and the SEC trusts that this is the time to make use of the experience of Mr. Sinha's expertise on how the Unit Trust industry has been developed in India.

On behalf of the Commission, the Director General also thanked Mr. Sinha and the Securities and Exchange Board of India (SEBI) for being very co-operative with the SEC. Currently there is a document with the Department of the Legal Draftsman, which will soon be gazetted and that will *enable Exchange Traded Funds* (ETFs) to be regulated and available in Sri Lanka. The technical assistance for ETFs came to the SEC from India. In fact SEBI sent a team of specialists to Sri Lanka to study and help SEC to develop rules for Exchange Traded Funds (ETFs). The Director General indicated that the SEC is hopeful that within the next two months, the regulatory framework will be ready to enable ETFs to be traded at the Colombo Stock Exchange.

In addition, a high-powered team will visit India in *July 2011*, led by the SEC Chairperson and officials of the SEC, the Colombo Stock Exchange and the Department of the Legal Draftsman, to study and understand the legal framework of the *Central Counter Party System* operating in India. Visits to the Regulator and the National Stock Exchange of India and all other activities are being co-ordinated by SEBI and on behalf of the Commission, the Director General thanked Mr. Sinha for agreeing to do this.

The Director General thanked Mr. Nihal Fonseka, former Chairman of the Colombo Stock Exchange (CSE), and Mr. Kishan Balendra, the present Chairman of the CSE and the CEO of the CSE, for joining hands with the SEC in organizing this Workshop. The Director General also thanked the Colombo Stock Brokers Association and the Unit Trust Association of Sri Lanka.

The Director General reminded the audience that *they are* the movers and shakers of the capital market. *The landscape of the capital market of Sri Lanka is changing* and *everyone needs to adapt to that change*. Two to three years ago, organizations operated necessarily like a one man show and everything was with the CEO. The Director General believed this is changing and proper financial institutions are needed, regulated by the SEC. Change sometimes may not be very pleasant and necessarily we are averse to change. The Director General said that however, *we need to get together and make that change, if we are to take this market to the next level.* He said that Sri Lanka needs a *disciplined market, a market which has integrity and a market in which people have confidence.* Everyone has a role to play in this regard.

He said that the exercise today is for the SEC and the CSE to take stock of the current situation, to see whether there are gaps and we can discuss and debate. The Director General recalled when the SEC had discussions last week with panelists, they were categorically told that they are free to be as open as they can be. He added that if anyone has anything to raise today or tomorrow, they should do so. If this is successful, events such as this can be held on an annual basis to help the market to move forward.

The Director General concluded his remarks wishing that the deliberations in the next two days are *useful, meaningful* and *fruitful*, *for the capital market of Sri Lanka and for the Country.*

Session 1

Shaping the Next Phase of Development for the Capital Market

Keynote Speaker – Mr. Krishan Balendra
Chairman
Colombo Stock Exchange

Keynote Speaker – Mr. Tony Weeresinghe
Director Global Development
London Stock Exchange Group (LSEG)

Session Chairman – Mr. Nihal Fonseka, *CEO DFCC Bank and Director Colombo Stock Exchange*

Discussants – Mr. Ravi Abeysuriya, *Chief Executive Officer Heraymila Securities*
Mr. Sriyan Gurusinghe, *President Colombo Stock Brokers Association*
Mr. Vajira Wijegunawardane, *Director Capital Market Devt. and Research, SEC*

Rapporteurs – Mr. Suneth Perera, *Manager Capital Market Education and Training, SEC*
Miss Madhugayanie Balapitiya, *Manager Investigations, SEC*
Miss Rosheni Wickramaratne, *Executive Legal and Enforcement, SEC*

Keynote Speaker : Mr. Krishan Balendra *Chairman Colombo Stock Exchange*

The address by the Chairman of the Colombo Stock Exchange (CSE) covered the following –

I. Global and Regional Developments in Capital Markets;

II . Recent Developments in the Sri Lankan Capital Market

III. What more needs to be done to develop the Sri Lankan Capital Market?

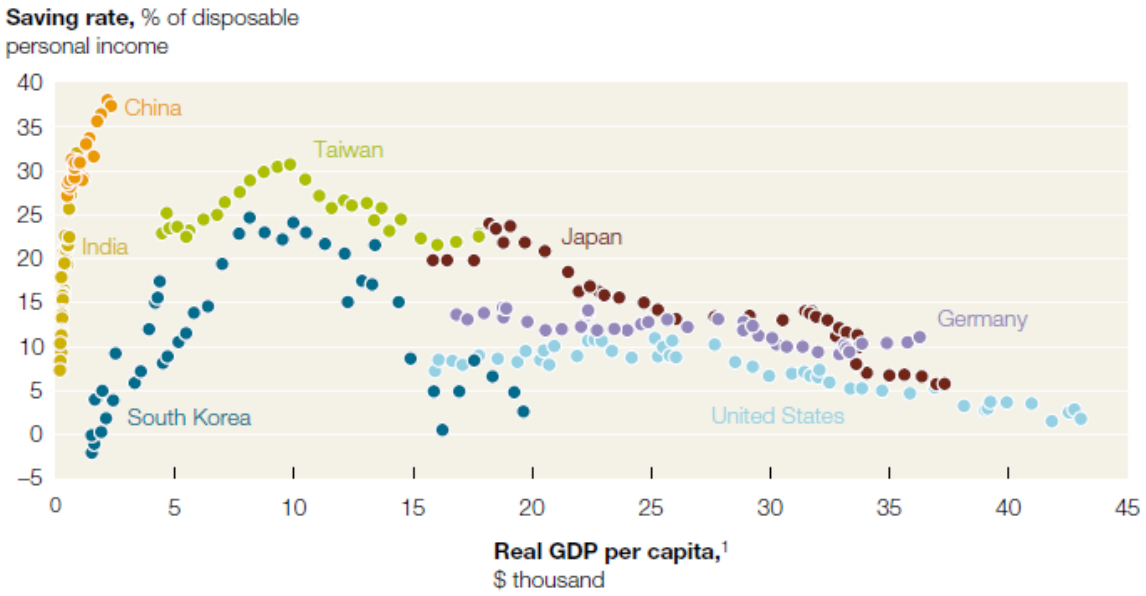
IV . Focus on Corporate Bonds: What needs to be done to develop the Corporate Bond market as the market is very small in Sri Lanka.

I. Global and Regional Developments in Capital Markets

The Chairman of the Colombo Stock Exchange drew the audience's attention to the statement made by the Chairman of the Securities and Exchange Board of India, on the link between the rapidly developing economy and the capital market and the importance of the capital market to economic growth. During the last 30 years, the world's financial assets (equities, private and public debt, and bank deposits) nearly quadrupled in size relative to global GDP. Similarly, since 1990, there has been significant growth in financial depth. In 1990, there were only two countries where the capital stock exceeded 300% of GDP, in 2006 this rose to 26 countries.

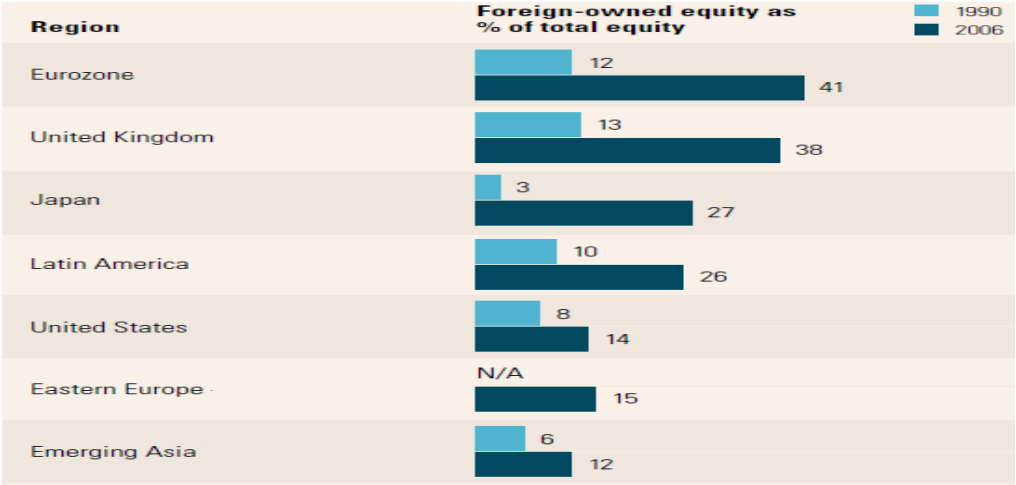
- More Developed Countries

  Mr. Balendra presented a study which showed that the higher the GDP per capita, the lower the savings rate, which means that **capital is being mobilized by capital markets away from savings into financial assets.** Hence the *depth of the financial markets* in these economies is *significant*.



Mr. Balendra also presented another study which showed that the *higher the GDP per capita*, the *greater the depth of the financial markets.* In countries with GDP per capita of USD 25,000 to USD 60,000, you have financial depth *exceeding 500% of GDP* in some cases. Mr. Balendra said that this clearly shows a direct link between economic growth and the size of the capital markets.

He further demonstrated that in terms of the composition of global financial assets, equity and private debt have grown significantly in the recent past, exceeding other forms of financial assets and that the total share of equity has grown significantly, increasing the importance of equity. *Foreign equity ownership has also increased significantly from 1990 to 2006, worldwide.*

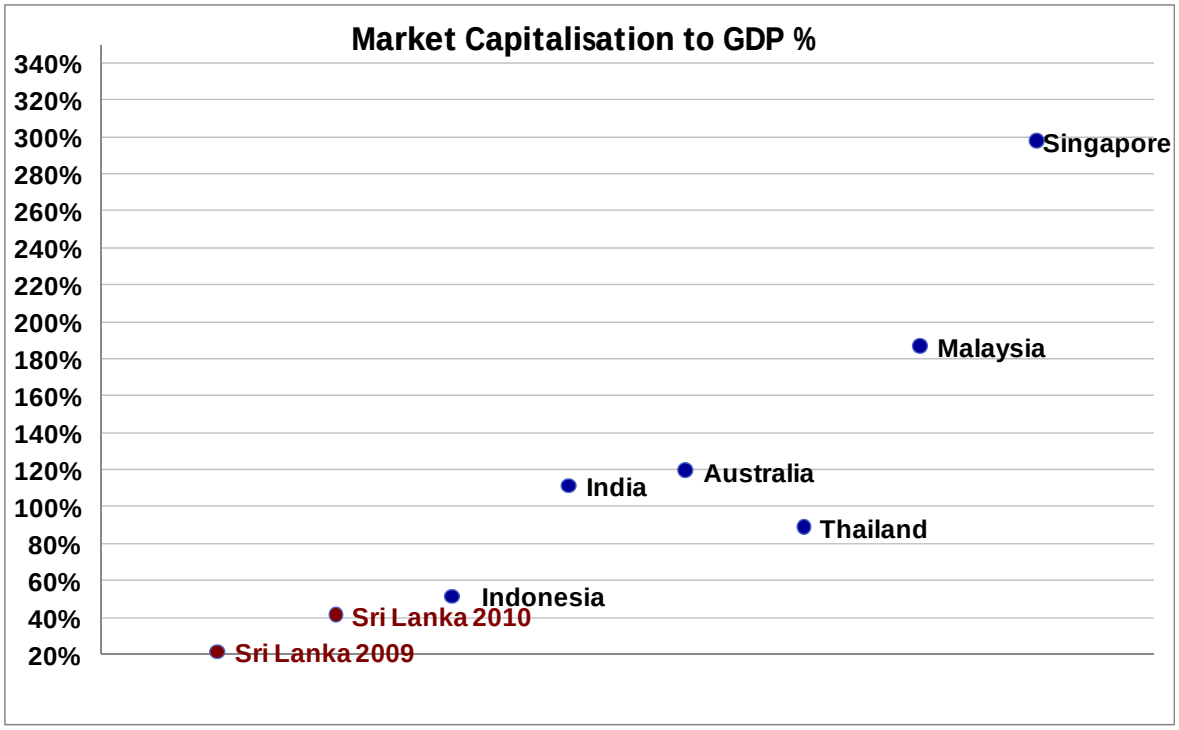


- Emerging Markets

There have been a substantial net capital flows into *Emerging Markets.* The importance of equity and private debt has grown over the years, with equity becoming a significant financial asset in Emerging Markets (China taking the lead). However in terms of the importance of equity and private debt, there is some way to go when compared to the more mature economies.

II. Recent Developments in the Sri Lankan Capital Market

Despite the boom seen over the last two years, the **Market Capitalisation to GDP** in *Sri Lanka* is **only 40%**. In *Malaysia* market capitalization is above *300% of GDP* at the peak, with a similar story in Singapore. Although Sri Lanka's market capitalisation has progressed from 2009, **the country has a long way to go** (*Sri Lanka* is ranked at the *bottom in terms of a Regional comparison* on Market Capitalisation to GDP%).

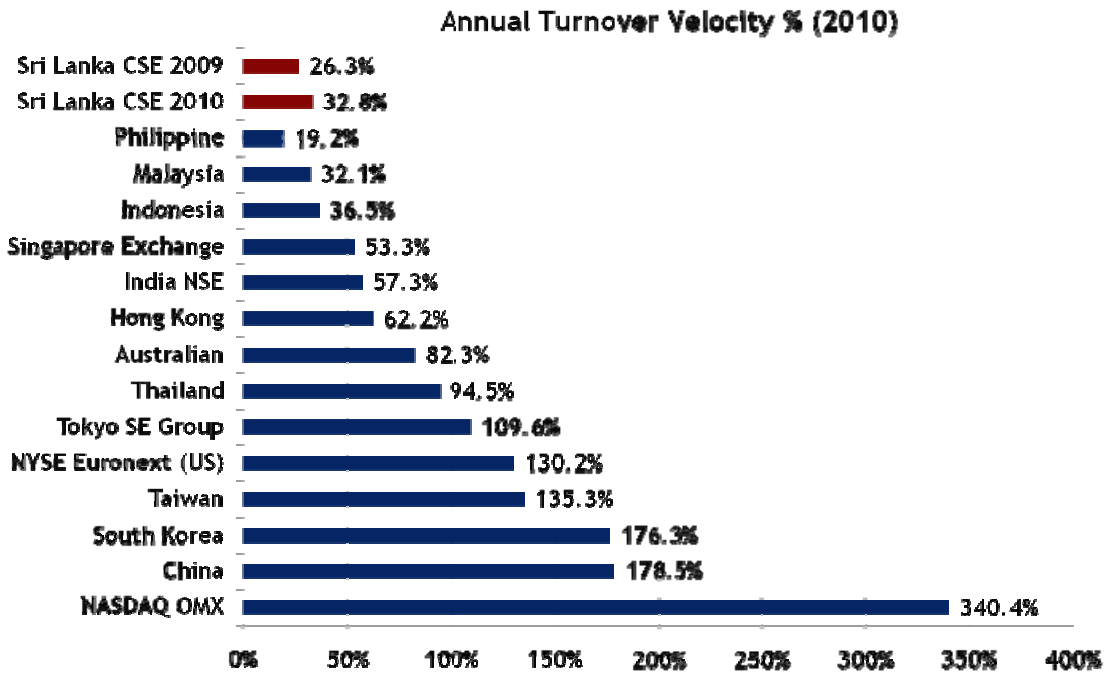


There are views that the Sri Lankan stock market has gone up *too much*. If the Sri Lankan economy and the capital market develop, as they have in other countries in the Region, the Chairman of the CSE illustrated where Sri Lanka could go;

	2010	Future?
GDP (LKR. Bn)	5,610	5,610
Market capitalisation as a % of GDP	39%	250%
Market capitalisation (LKR. Bn)	2,211	14,026

250% of GDP (as achieved by Malaysia), would mean Sri Lanka's *market capitalisation would increase* from LKR. 2.2 trillion to **LKR. 14 trillion**. Mr. Balendra said that this is what could happen and should happen if we all *take the right steps* to develop the capital market.

Based on a comparative study of the 2010 annual turnover velocity in the Region, the Chairman of the CSE indicated that turnover velocity in Sri Lanka is very low, despite increases in turnover over the last two years. Turnover velocity is **178.5% in China** compared to **32.8% in Sri Lanka**. *Hence a lot more growth in this area is possible for Sri Lanka.*



The Chairman of the CSE pointed out that **only 11%** of the investing population **use internet trading**, compared to *India* where it is *50%*.

	2010
Sri Lanka	11%
Thailand	25%
India	50%

With broadband connectivity and internet trading expected to increase in Sri Lanka, this is another big opportunity and something he said the *market players should promote*. **If Broker Firms improve their internet trading platforms and promote internet trading,** this will enable *greater, wider and more active participation across the Country.* 11% internet trading is still *quite insignificant.* Therefore it is necessary that the initiative to deepen information technology in the Country focuses on *promoting internet trading*.

III <u>What more needs to be done to develop the Sri Lankan Capital Market?</u>

Mr. Balendra stated that the SEC has been very proactive in the last two years. He stated the following key measures taken by the SEC during 2010-2011, which are generally common in other markets and are positive developments for the last two years;

- ✓ Increased the number of new license granted to market participants (8 Stock Brokers, 11 Investment Managers, 15 Margin Providers, 3 Under writers, 2 Stock Dealers, 1 Credit Rating Agency and 3 managing companies to manage unit trust funds).
- ✓ A system of dematerialization for all listed securities has been implemented by the SEC.
- ✓ Completed the regulatory framework for Exchange Traded Funds.
- ✓ Revised rules pertaining to ESOPs were drafted by the SEC.
- ✓ Updated the Unit Trust Code.
- ✓ Reduction of tick size to 10 cents.

- ✓ Simplified and reduced transaction costs.
- ✓ There is a consultation ongoing on the minimum public float which is a feature of many markets worldwide.
- ✓ Introduced price bands to arrest volatility in the market.
- ✓ Introduced a policy on credit arrangements to clients of Broker Firms.
- ✓ Procured a state-of-the-art surveillance system.

The SEC is also working on further regulatory changes he said;

- To regulate demutualised exchanges.
- To effectively regulate Central Counter Parties and Depositories.
- To introduce civil and administrative sanctions to deal with capital market offenders.
- To introduce provisions that will provide for restitution for investors.
- To introduce other relevant provisions that will enhance protection to investors.

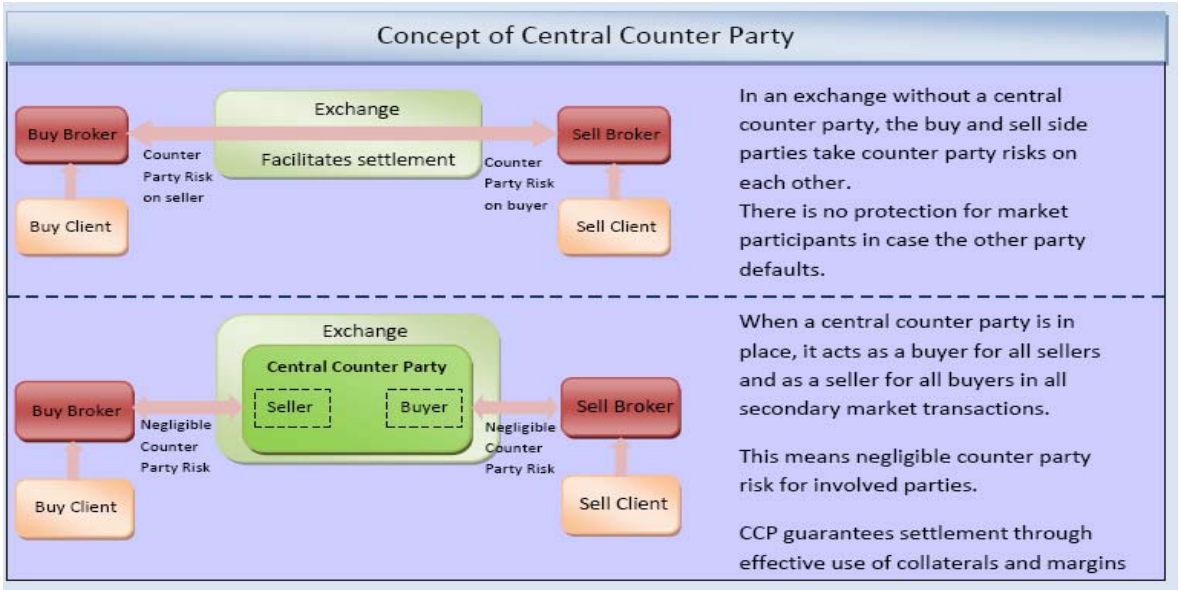
Mr. Balendra stated that one of the ***advantages of demutualization*** is *you move from being an Exchange which serves the interests of the Members, to an Exchange which serves the interests of shareholders and all the other stakeholders.* It also provides for a *more flexible governance structure fostering decisive actions in response to changes in the business environment, greater investor participation in the governance of the Exchange, improved competitive prospects as against alternative trading systems* and *increased resources for capital investment raised by way of equity offerings or private investment.*

Most of the Exchanges worldwide have been demutualised and Sri Lanka is also heading in that direction.

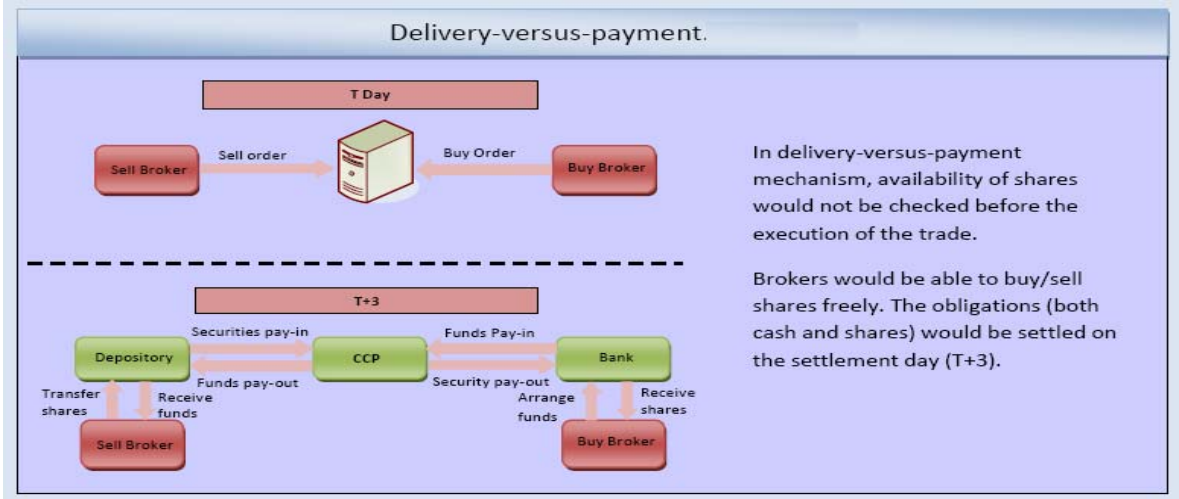
- Bombay (2007)
- Hong Kong (2000)
- Singapore (1999)
- Australia (1996)
- Malaysia (2004)
- Tokyo (2001)
- Philippines (2001)

Mr. Balendra provided details on the following *future initiatives of the CSE to develop the Sri Lankan capital market*;

A. **Establishing a Central Counter Party** (CCP) guarantee system to address Counter Party Risk – Currently the market participants take the risks of trades. With the establishment of a CPP, settlement will be guaranteed, thereby minimizing the risk for the counter party.



B. **Delivery versus Payment** (DVP) system to address Asset Commitment Risk.



The Chairman of the CSE explained the following benefits would accrue to Brokers with the presence of the CCP guarantee system and the DVP system;

- Guaranteed settlement.
- Efficient use of capital.
- Day trading.
- New business – Stock Borrowing and Lending as well as Margin Trading.
- Higher trading volumes.
- Foreign investments – It will enhance our market ratings and enhance global recognition, thereby *drawing increased foreign investments*.
- Pre-requisite for a derivatives market.

Mr. Balendra also highlighted the need to have **more investors in the capital market** and **to encourage more investors to invest in unit trusts**, since most investors feel that they lack the knowledge to invest directly.

IV Focus on Corporate Bonds: What needs to be done to develop the Corporate Bond market as the market is very small in Sri Lanka

The Chairman of the CSE highlighted that the value of the global bond market has grown to a record USD 91 trillion in 2009. In the USA, the bond market is 76% of total corporate borrowings, in Europe 33% and in China 4% of total corporate borrowings. In Sri Lanka is it very small, almost non-existence. The value of listed corporate bonds is just LKR. 30 billion.

In the Government bond market a number of measures have been taken. It has developed over the last 15 to 20 years. In 1996, the Government treasury bond market was opened to foreign investors for up to 5% and now it is 10%.

In terms of the size of the Sri Lankan financial system, total commercial paper and corporate bonds is LKR. 46 billion, whereas deposits in banks is LKR. 2.3 trillion. Thus the Chairman of the CSE emphasized that the Corporate Bond market **requires considerable focus and effort, needs to be developed in a *big way* and needs to follow global trends.** He also stated that there is a need to develop the corporate bond market as *another instrument for allocating savings.*

Following is a summary of the Commercial Paper and Corporate Bond market in Sri Lanka;

		2008	2009	2010
Deposits in Banks	LKR. Bn	1,681	1,993	2,301
Commercial Paper/Corporate Bonds	LKR. Bn	35	28	46
Total value of Commercial Paper guaranteed by Banks	LKR. Mn	23,800	21,500	12,000
% of Commercial Paper with maturities < 3 months	%	91%	90%	97%
Total outstanding value of Commercial Paper	LKR. Mn	4,100	5,800	4,000
Turnover of CSE - Debt	LKR. Mn	103	137	72
Turnover of CSE - Equity	LKR. Mn	110,400	142,500	570,300

The Chairman of the CSE further explained why the Sri Lankan *corporate bond market needs to be developed.* He pointed out that in Sri Lanka, strong economic growth generally creates high demand for funds by the corporate sector. He stated that we have seen in the equity market this year a large number of IPOs and Rights Issues, but we *do not particularly see new Corporate Bond Issues.* Mr. Balendra said that if we look at the balance sheet of companies, possibly because of the uncertainty that the war created in the past, Sri Lankan companies were reluctant to borrow. Their debt to equity ratios are very low, with almost no debt and a net cash position in their balance sheets. He stated that this *will have to change* and *will change* – with more confidence and certainty in the outlook and in the economy, corporates and banks will raise more debt. The Chairman of the CSE said that it is critical that the capital market in this regard develops *to encourage the issuance of listed corporate bonds.*

Other reasons highlighted by Mr. Balendra for developing the corporate bond market are as follows;

- A well-developed corporate bond market also plays a *vital role in the risk diversification of the financial system.*

- Provides businesses the opportunity to address capital needs more effectively and allows companies to *match their asset-liability profiles.*

A few steps have been taken in the *right direction* following certain representations made by the SEC including:

- ✓ Relaxation of Exchange Control regulations permitting foreigners to invest in corporate bonds.
- ✓ Unification of withholding tax treatment between government and corporate bonds.
- ✓ Extension in the yield curve with a few long-term bond issues, thereby establishing a benchmark for the market.
- ✓ Adopting a stable monetary policy over the last two years and managing inflation expectations.

The Chairman of the CSE pointed to the following **Key Drivers** necessary to **develop the Corporate Bond market**;

1. Development of a benchmark yield curve;
2. Improving market liquidity; and
3. Widening the investor base.

1. The development of a benchmark yield curve

- Extension of maturities to cater to diverse funding requirements *currently not catered to* by the Banking industry.
- Creating an *active secondary market*.
- Providing an avenue for development of *long-term investment funds*.

Due to the uncertainty which resulted from the war, Mr. Balendra commented that Sri Lanka had not seen stable interest rates over the last 30 years (over most of the last 30 years interest rates have been 15% plus), but over the last 18 months single digit interest rates prevail in our market. If inflation falls towards the end of the year and interest rates can remain in single digits, this is an **opportunity to create a benchmark long-term yield curve**. The *impact on the economy of something like that is immense* because, for example, the mortgage market is very minute in Sri Lanka as the cost of mortgages have been high, with the high interest rates. If there is a long-term yield curve in single digits, the Chairman of the CSE stated that we are *likely to see more corporate bonds and other debt instruments developing.*

- **What is required**
  - A stable and liberalized interest rate environment and *credible inflation expectations.*
  - *Cater products* to insurance funds and unit trusts.
  - Further development of a long-term savings culture to ensure matching of assets and liabilities.

2. Improving market liquidity

- It mirrors the level of participation in the bond market.
- *Key to attracting foreign investors* who seek an exit route.

The Chairman of the CSE suggested improving market liquidity through **attracting large liquid issues** and **improving trading platforms**. Also, **awareness among debt trading participants** and **active trading of Government securities on the market with the participation of all trading members** is required.

3. Widening the investor base

The investor base needs to be widened. **Foreign institutions need to be attracted into the corporate bond market.** One important development here is that *foreign funds can now invest in listed corporate bonds.* But in addition to that, in order to widen the investor base Mr. Balendra stated that **awareness of corporate bonds needs to be improved among the general investing public**.

- **What is required**
  - Development of *alternative instruments* which cater to diverse investor profiles (infrastructure bonds, indexed bonds etc.).
  - *Incentivise companies* to list debt with *longer maturities* and *larger values.*
  - *Further awareness programmes* on *diversification* and benefits of channeling savings *into long-term investments.*

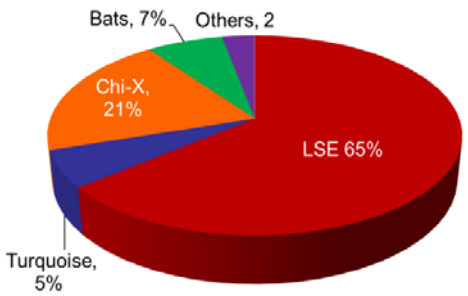
The Chairman of the CSE re-iterated that the purpose of his presentation was to show the progress of capital markets worldwide and the progress of capital markets in emerging markets and in the Region in particular, to demonstrate that **there is long way for the capital market of Sri Lanka to go in terms of its importance relative to the rest of the economy.** A lot of steps have been taken by the SEC and the CSE, but ***a lot more needs to be done*** and he said that *the audience, being the key stakeholders,* the movers and shakers of the capital market in Sri Lanka, **have an obligation, to play their part in developing the capital markets in this *exciting era of the Country.***

Keynote Speaker : Mr. Tony Weeresinghe *Director Global Development LSEG*

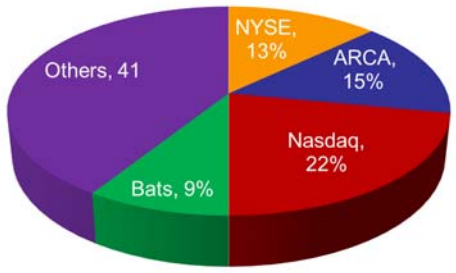
Mr. Weerasinghe discussed the origins of the stock market and the role of technology in a stock market. The advent of the stock market in the USA started off under an open outcry system with 'joggers' carrying the orders of the brokers to the exchange. The question arises as to whether the traditional system of trading provided for a level playing field in the market? The market having progressed to the automated trading system (ATS), the next question arises as to what the ATS has done for the markets? The USA organized itself to regulate their stock market by establishing the Securities and Exchange Commission. The United Kingdom soon followed with the establishment of the Financial Services Authority.

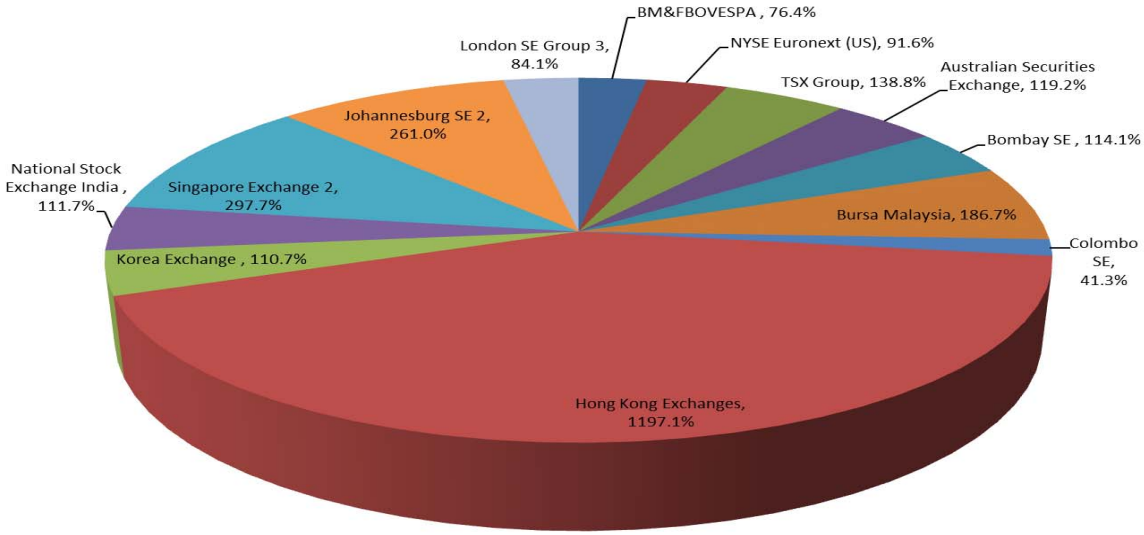
Mr. Weerasinghe opined that market competition can only be countered with technology. To understand the innovative necessity and speed of technological development, it is important to understand the process of activity of the human brain as opposed to a super computer. A brain has one trillion cells, 100 trillion connections and 10 quadrillion instructions in processing activity, whereas a super computer processes 20,000 trillion instructions and 20 petaflops equal to 20 quadrillion instructions. According to Mr. Weerasinghe, presently the London Stock Exchange (LSE) holds the reputed name as the fastest processing exchange in the world since its use of the Millennium Exchange, the fastest trading system in the world. For instance LSE's market share rose from 40% to 65% after its acquisition of state of the art technology.

UK Market Share



US Market Share





Mr. Weerasinghe said that technology development and innovation will lead to a *redefinition of brokerage*. It would create electronic arbitrage, new algorithms indicating the results of an intended transaction and electronic news feeds. Technology development and innovation requires one to ascertain what the market participants require, what they want to trade and how they wish to trade.

Mr. Weerasinghe stated that the general accusation that the recent failures in the markets were as result of technological errors, is incorrect. Technology did not cause it, but had technology been used appropriately the ultimate impact of these impugned transactions would have been foreseen and avoided.

Jurisdictions need to draw up the necessary rules & regulations and have them in place at the opportune time. When trading is on electronic platform, the supervision and investigation and tracking be on similar electronic platform. Transactions carried out on electronic mode cannot be tracked or followed suite manually.

What's Next?

The question arises whether speed is conducive for a market? No expert could provide an answer. Speed of transactions may be good individualistically, but would it do any good to the market? There is no right answer, according to Mr. Weerasinghe.

Advanced technology will lead to **International Boards** and create new participants know as Broker Sponsors. You would be able to buy any London Stock Exchange listed share in Sri Lanka. The Colombo Stock Exchange (CSE) stocks may trade on the London Stock Exchange 'International Board'. Technology will bring the trading of stocks to anywhere in the world the investor may be.

In response to a question raised by the Director Investigations at the Securities and Exchange Commission of Sri Lanka, Mr. Dhammika Perera, on how a Sri Lankan Regulator can expect compliance to local rules for possible companies listed on the International Board, Mr. Weerasinghe replied that the London Stock Exchange will not proceed in isolation. A reciprocal agreement will have to be entered into, on how this situation will be tackled. Rules will have to be formulated within Sri Lanka.

Chief Executive Officer Heraymila Securities, *Mr. Ravi Abeysuriya*, commenced his briefing by acknowledging the idea of having an 'International Board' which, in his opinion, would give people the opportunity to diversify their investments to all five asset classes, one being the ability to invest overseas. He pointed out that the Central Bank of Sri Lanka has given its approval and it is a question of the Colombo Stock Exchange facilitating it.

He suggested our market may benefit from having the PhD holders Mr. Tony Weeresinghe mentioned that write algorithms, or the surveillance systems that automatically build the relationships, to catch the culprits in Sri Lanka engaged in market manipulation which would help develop our capital market into one of the most efficient markets.

Mr. Abeysuriya is of the view that if Sri Lanka is to generate double digit economic growth, the importance of a mechanism to attract savings and channel them into investments that create wealth is vital. He explained that it is the capital market that attracts medium to long-term assets of business enterprises and governments, through various types of financial instruments such as equity, debt, derivatives and commodities traded in the capital market.

Mr. Abeysuriya opined and credited the Chairman of the Colombo Stock Exchange for highlighting the importance of **Demutualization of the Stock Exchange, a Central Counter Party system** and the **development of the Listed Corporate Bond market as vital components needed** to both sustain and take the Sri Lankan capital to the next level. The Central Country Party (CCP) is vital as the stock market daily volumes are increasing, reaching one to two billion per day and if one of the brokers fail to pay, the systemic risk is very high. The CCP is a must and he strongly advised that this be implemented as soon as possible, before something terrible happens.

He emphasized that **measures are needed to increase investor confidence.** He stated that the market needs ethical practices to instill public trust in the market. He said we need fair play and less conflicts of interest and "the need of the hour is the visionary leadership and the political commitment to make the necessary changes to develop the Sri Lankan capital market". Some of the policy reforms he suggested are **pension reforms, expansion of the institutional investor base and the listing of state institutions,** a lot of policy reform from the government front needs to happen. Mr. Abeysuriya also drew the audience's attention to the remarks made by the Chairman of the Securities and Exchange Board of India. An important point is to create competition among the Exchanges and create competition among the bodies really helps to develop the price discovery mechanism.

In terms of promoting the trust in our market, he identified **the need to increase investor awareness to much higher level than it is today.** He identified the TV programmes conducted by the Securities and Exchange Commission of Sri Lanka and the Colombo Stock Exchange (CSE), and acknowledged the importance of those programmes to obtain wider public participation in the capital market.

While encouraging more participation, he emphasized the importance of **ensuring public fairness in the market.** A reason provided by investors for not investing in our stock market is they believe that it is largely a punting or short-term, opportunistic market, not a *viable, long-term investment vehicle*. He used a example of an IPO where there was a private placement one year ago at a 50% discounted price. He explained that investors who had invested in the company through the CSE, believe that more than half of the private placement investors had divested their stakes during the first two days of trading.

According to Mr. Abeysuriya, investors are of the view that the Regulator has a say in the IPO price, which is not the case in anywhere in the world (i.e. it is a disclosure based). The public does not know or they are not aware of how IPO's are priced. They believe that the Regulator has no teeth to address such situations and that the issuing company and their advisors are 'rip off artists'. Therefore, he strongly felt that the *maintenance of a higher level of ethics and avoiding the deepening of public mistrust of the market is essential.* He is of the view that **private placements should be defined properly** and **there is a need for proper rules and regulations to ensure fairness** and **to prevent the public's interest in investing in IPOs diminishing.**

Mr. Abeysuriya also said that we **need more trained persons among the broking community.** Certain groups are able to engage in the advisory role, engage in investment banking and also engage in the broking function through the same group. Hence only the clients of the people who invested in the private placement get the benefit of investing at a much lower price, which is not fair.

Mr. Abeysuriya also stressed the **importance of disseminating price sensitive information by listed corporates swiftly through CSE announcements and averting leakage of price sensitive information** knowingly or unknowingly.

On regulatory aspects, Mr. Abeysuriya pointed out the **importance of amending the SEC Act to provide for civil sanctions and significant enhancement of powers to deal with market manipulations and insider dealings.** In terms of policy reforms, he recommended the **payment of interest on IPO proceeds after 3 days.**

Mr. Abeysuriya commented that everyone talks about the **Unit Trust Industry** and **Corporate Bond Market Development**, but there have been no major changes since the last Capital Market Development Workshop held in 1999. These two areas need to be looked at more seriously to increase the **institutional investor base participation, particularly in the debt market and to have a higher level of trading (not just buy and hold)**. Mr. Abeysuriya was also keen to see **full service brokers** where investors are able to use and diversify their total investment into different asset classes, including bonds, equity, money market, commodities and investments overseas. In terms of the unit trust industry, Mr. Abeysuriya would like to see **pooled investment schemes** where funds of many individual investors can be aggregated and invested. Mr. Abeysuriya also hopes that the SEC and the CSE will work with the banking system to have **paperless transactions, where electronic confirmations can be given to investors**.

President of the Colombo Stock Brokers Association, *Mr. Sriyan Gurusinghe*, emphasized said that over the course of the last few years, the retail segment has taken over the role of institutional investors and foreign investors. He said that the brokerage community has a role to play in **getting more institutional investors into the market.**

Mr. Gurusinghe also said that is a large demand for more investment advisors. The industry needs to attract more accounting/finance professionals such as CIMA passed finalists. He said that he would request the FSA to **enroll more CIMA passed finalists into the program and issue them with a temporary license, until they qualify as investment advisors.**

Director Capital Market Development and Research at the Securities and Exchange Commission of Sri Lanka, *Mr. Vajira Wijegunawardane*, *opined* and *credited* the Chairman of the Colombo Stock Exchange for highlighting the *importance of developing the corporate bond market in Sri Lanka*: the reference to the capital market is often associated with the equity market only. Mr. Wijegunawardane said that the banking sector dominates the corporate financing and fund mobilization activity in Sri Lanka and alternate sources are required to compliment the banking sector, in order to have a robust financial system. Over the recent past, the total new issuance of listed corporate bonds was only about LKR. 15 billion, compared with the *growth in total loans and overdrafts by the banking sector*, which was over LKR. 400 billion. The latter figure is an indicator of the *potential corporate bond financing opportunities*, but there are other practical realities we are faced with he said. He opined that there is **no real incentive for corporates to access the market directly and issue corporate debt securities** because Banks generally lend to blue chip companies at rates well below the Average Prime Lending Rates since Banks have access to cheap funding through bank deposits.

He said that at the current juncture of capital market development, **awareness building is key, especially to enhance the sophistication level of investors.** A study done by the Securities and Exchange Commission of Sri Lanka, found that, during the last 10 years, equity is the only asset class which has provided real returns (after providing for inflation) in excess of 20% p.a., compared with the negative real returns provided by bank deposits.

The media should highlight the *long-term positive returns* of the equity market and **promote it as a *long-term asset class*** that can enhance one's wealth. Furthermore, **long-term pension funds need some equity market exposure to enhance the returns of its members.** In fact, the SEC has made representations to the Ministry of Finance and Planning to enable private pension funds to invest up to 20% in listed securities.

Mr. Wijegunawardane highlighted the need for **Broker Firms and other market players to set up regional branches outside urban areas**, to attract investors outside urban areas to invest in capital market instruments, as the distribution and non-availability of capital market products in those areas is one reason that the Banks dominate in the said areas.

Post Workshop Agenda for
Shaping the Next Phase of Development for the Capital Market

I. *Facilitate the Demutualization of the Stock Exchange and* ***fast-track*** ***the establishment of a Central Counter Party guarantee system*** *to take the Sri Lankan capital market to the next level.*

II. *Broker Firms to improve their internet trading platforms and* ***promote internet trading****.*

III. *Consider setting up more* ***regional branches of Broker Firms*** *and other market players outside urban areas and in peripheral areas.*

IV. *Encourage* ***more institutional investors*** *into the equity market and the listed corporate bond market to expand institutional investor participation (a separate section on the Post Workshop Agenda for Developing the primary and secondary markets in* ***Corporate Debt*** *is included under Session 6).*

V. *Facilitate exposure of* ***long-term private pension funds*** *to listed securities.*

VI. *Awareness building to enhance the* ***sophistication level of investors****.*

VII. *Consider private placements to ensure fairness.*

VIII. *Industry to facilitate* ***development of the Unit Trust Industry****.*

IX. ***Industry to encourage more investors*** *to invest in* ***Unit Trusts*** *and pooled investment schemes where funds of many individual investors can be aggregated and invested.*

X. *Explore the 'international board' proposal of the London Stock Exchange Group.*

XI. *Consider measures to* ***increase the number of Certified Investment Advisors*** *or issue temporary licenses to CIMA passed finalists.*

XII. *Amending the SEC Act to provide for* ***civil sanctions*** *and the* ***significant enhancement of powers*** *to deal with market manipulations and insider dealings.*

XIII. *Facilitate listing of state institutions.*

XIV. *Consider increasing the* ***speed of dissemination of price sensitive information*** *by listed corporates swiftly through CSE announcements to avert leakage of price sensitive information.*

XV. *Consider the* ***IPO refund*** *payment timeline and explore the possibility of payment of interest on IPO proceeds starting from three days from the closure of the issue.*

XVI. *Facilitate full service brokers* ***(universal brokerage)****.*

XVII. *Facilitate* ***paperless electronic transaction confirmations*** *to be provided to investors.*

Session 2

Unit Trust as a conduit for Unsophisticated Investors to access the Capital Market

Keynote Speaker – Mr. U. K. Sinha
Chairman of the Securities and Exchange Board of India (SEBI)
Chairman of the Asia Pacific Regional Committee of the International Organization of Securities Commissions (IOSCO)

Session Chairman – Mr. S. Jeyavarman, *President Unit Trust Association of Sri Lanka*

Discussants – Mr. Sheyantha Abeykoon, *Director CT Capital*
Mr. Namal Kamalgoda, *Director Supervision, SEC*
Mr. Chitra Sathkumara, *CEO Ceybank Asset Management (Pvt.) Limited*

Rapporteurs – Ms. Himani Weerasekera, *Asst. Director Supervision, SEC*
Mrs. Saumi Kodippily, *Senior Executive Supervision, SEC*

Keynote Speaker : **Mr. U. K. Sinha** *Chairman SEBI*
Chairman of the Asia Pacific Regional Committee of IOSCO

Mr. Sinha's presentation discussed *three main areas*;

1. Macro Rationale for Unit Trusts;
2. Global Development and Indian Development; and
3. The Consumer Protection perspective.

I. Macro Rationale for Unit Trusts

The Chairman of SEBI stated that Mutual Funds, as an investment vehicle, have *gained immense popularity* in the current global scenario, which is clearly reflected in the *robust growth levels of assets under management* and thereby savings play an important role, whether in the Developed Markets or Emerging Markets. Much depends on the growth of the economy and whether the economy is *banking driven* or *market driven*. However there is empirical evidence that if the *economy is market driven*, the *benefits* to both the individuals and the macro economy are *more significant*.

During 2009, in *India*, he mentioned that Household Savings had been 18% of GDP, whist Net Savings had been 24% of GDP. There has been a significant increase during the year 2009 of Household Savings from 14% to 18% and National Savings from 18% to 24%. The trend of rising personal incomes has been witnessed not only amongst the young population, but also amongst the high net worth segment. The household segment therefore proffers immense scope for attracting investments. Over time savings have improved and, as a percentage of GDP, it has increased to 6% during that year he said.

However, Mr. Sinha indicated that although Indians have a positive attitude towards increased savings, in the event it is not channelized towards financial instruments, it may be invested in Real Estate, Gold and leisure, which are non-financial instruments. This manifests tremendous opportunity for growth in Mutual Funds. He said that penetration levels of Mutual Funds in the smaller towns lags behind that of urban cities.

In *Sri Lanka,* the GDP Per Capita income is around USD 2,000, with an annual growth rate of 8%. The Per Capita GDP and growth indicate a **healthy signs for savings**, which he said is **important to be channeled to the Capital Market.**

II. Global Development and Indian Development

In the global economy, Mr. Sinha stated that the total market value of Mutual Funds is **USD 25 trillion** and within the last five years, the CAGR has been around 7% (50% of this was contributed by North America).

In *India*, there was a situation where significant activities were taking place in the banking sector. In 1964, the Government of India set up the Industrial Development Bank of India (IDBI) to provide long-term project finance and during the same year, another institute was set up, namely the Unit Trust of India (UTI) to attract domestic savings.

The **four phases of the development of Mutual Funds in India** was as follows;

i. 1964-1987: UTI was the only Institute that offered Mutual Funds;
ii. In 1967: Public Institutions were permitted to float Companies and enter the Mutual Fund Industry. The *Financial Institutions entered the industry* and during 1987-1993 there was competition and growth in the Mutual Fund Industry.
iii. During 1993 – With the opening up to the private sector, *large global names entered the market*. Initially 100% owned foreign companies were not permitted however, with time, this was relaxed.

In 2003, with the **market misconduct** that happened between **2001/2002**, the Mutual Fund industry was divided into *two parts*, a set of unit trust schemes which were non-compliant with market regulations and which were under the purview of the Unit Trust of India Act, were *taken over by the Government of India*, and those schemes that were complaint with the SEBI Regulations were permitted to continue as Unit Trust Asset Management Companies.

At that time, there were *many questions* as to why the Government was taking over the liabilities of the non-compliant Unit Trust Companies as there was *no guarantee on the returns of those funds*. However it was due to the large number of unit holders in India; the Government provided a safety net to the whole market.

He was proud to note that in India *Assets Under Management* have managed to record a **CAGR of 28%** over 2006-2010 and that **India** has **51 Asset Management Companies** and **1,100 schemes** with Assets Under Management of over **USD 160 billion**. SEBI regulates the Unit Trust Industry in India and there is also an Association for the Mutual Funds in India.

III. The Consumer Protection perspective

Mr. Sinha mentioned that **Mutual Funds as an investment vehicle in India** have gained *immense popularity*, which is clearly reflected in the *robust growth levels* of *Assets Under Management*. However despite this growth, penetration levels in India are low, as compared to other global economies. However it is imperative for any Regulator to ensure that measures are initiated **to avoid mis-selling of products with guidelines communicated to the distributors in the Mutual Fund Industry**.

During the crisis In September 2008, many Unit Trust Funds in the category of short-term money market funds had invested in short-term papers of corporates. Those funds were stressed, as the investments were in certain non-performing sectors such as real estate. As such, those papers were permitted to be used as collateral to borrow money from Commercial Banks. When such announcements were made, there was immediate confidence in the market, which led to market growth and stability. Therefore it is **vital to instill a high degree of disclosure** (eventhough some were of the view that SEBI disclosure requirements were onerous).

Furthermore, during 2009, it was decided that there shall be **no entry load for all mutual fund schemes**. The restriction on entry load on existing and new mutual fund schemes marked *a turning point* in the functioning of the Mutual Fund industry. This in effect has had a huge impact on the **commission structure of distributors**, requiring them to restructure their business and operating models in order to arrive at a profitable solution.

Considering the importance of transparency and in an endeavor to *improve the manner in which the message is communicated to the investor*, *the* **Unit Trust Advertisement Code** specifically states *what can and cannot be claimed in Unit Trust advertisements.* As such **Celebrity Endorsements are not permitted** in accordance with the Unit Trust Advertisement Code.

He said that SEBI and the market today have *many good research analysts and rating companies* so that any investor can approach a third party to obtain an **assessment on the Unit Trust scheme** *in a risk weighted manner*, rather than determining it in an absolute manner. As such, it is a **requirement to specify the Risk adjusted returns for the investor** in order to take informed decisions and the **disclosure requirements should hold consistently across all Asset Management Companies** in order to institutionalize *greater transparency* in the system.

Costs and fees are another area that Mr. Sinha stated plays a pivotal role for the investors of Unit Trusts. Previously, the Unit Trusts charged 6% for the *distribution and launching of a Unit Trust scheme which was amortized over a period.* In a matter of time, those Corporates who exited fast, left the individuals to bear such costs. As such, this was prohibited and **currently they cannot amortize**, but charge the entire amount at the outset.

Various measures are being taken by *distributors of mutual funds in India,* to **spread access and reach to the semi-urban and rural segments**. Clearly the **role of technology as a growth enabler**, has assumed enhanced responsibility in this respect, to enable improved reach, inclined towards efficient distribution. India has also moved towards an electronic based environment where **statement of accounts can be provided electronically** and **a National Depository has been created** to store all data on Unit Trusts in India.

In moving towards an assessment of the regulatory environment which entwines the industry, and virtually steers the direction of the Mutual Fund sector, the Indian Mutual Fund industry is undergoing a transformation, *adapting to the various regulatory changes in effect*. However the market perceives that when the Regulator works well with the industry, the end consumer has more confidence in the industry. Further, India maintains a *robust retail clientele* and with the emergence of **Systematic Investment Plans,** India is taking steps towards *inclusive growth*.

Summary

- Mutual Funds are the **ideal product for Retail Investors** and **uninformed investors** to access the Capital Market.
- Mutual Funds are an *effective way of mobilizing savings.*
- At the macro level, it provides **stability to the system** and although foreign money is welcome, the effort is to *localize the industry.*
- To lure investors to the Mutual Fund industry, **Investor Awareness** has to spread its wings to lead sustainable growth of the Industry and the main focus should be on **consumer protection**.
- Between 2006 and 2007, there was a move towards more risky schemes by the Retail investor.
- **Real Estate Mutual Funds** have become the *next step for the Industry,* provided the Regulators bring in more clarity on the tax and regulatory aspects.
- In today's volatile market environment, *Mutual Funds* are looked upon as a **transparent and low cost investment vehicle.**

The President of the Unit Trust Association of Sri Lanka, ***Mr. S. Jeyawarman,*** stated that Unit Trusts commenced operations in Sri Lanka during the year 1991, at which point the industry was provided with a preferential tax saving for investors.

The first fund that was launched attracted more than 25,000 unit holders and raised over LKR. 1 billion. However, the investors *did not understand* that Unit Trusts were *long-term investments* and they invested in Unit Trusts expecting rapid returns. During 2001, with the market downturn there was a close watch for a period of 7 years and when there was no improvement, there was an expectation for the investors to exit the industry.

One of the main concerns for the industry is **'awareness'** which is *at a very low level*, thus affecting the *growth* of the industry. In today's dynamic environment, **spreading financial literacy** is the most critical imperative for spearheading growth in the Unit Trust Industry. Today, we see more Fund Managing Companies as entrants to the Unit Trust Industry, leading to more products and competition.

He further said that it is appreciative to note the **concessions from the Budget** on the *removal of taxes and relaxed exchange control regulations* enabling foreign investors to invest in equity and all types of fixed income funds and as such foreign investors can now invest in all types of Unit Trusts.

Director Supervision at the Securities and Exchange Commission of Sri Lanka (SEC), ***Mr. Namal Kamalgoda,*** stated that the Unit Trust Industry, a *vital segment of the Capital Market of Sri Lanka*, is the best conduit to mobilize savings of the *less sophisticated investors in the Country*. However the Industry is yet to reach its full potential when benchmarked with other jurisdictions, where the majority of retail investments are channeled to the Capital Market through Unit Trusts. Hence, *in spite of resurgence of the market*, the Unit Trust Industry has remained largely *static* at around **25,000 unit holders**.

Furthermore, there are continuing concerns that the Industry has been grappling with over a considerable period of time, such as the **under-penetrated population, inaccessibility in smaller towns due to lack of an efficient distribution network, heavy reliance on institutional sales, low financial literacy levels** and **cost pressures emanating as a result of inefficiencies in systems and processes**.

He emphasized that there is a need for the Unit Trust Managing Companies to *reach out to the Provinces* to capture a wider share of investors by **broadening their distribution channels**. Together with **investor education**, **segmenting the client base** and **aligning product offerings** to cater to the requirements of customers are also key to redefine the business and operating models to enhance key investment related value propositions. It is important to note that the requirements of investors today is mapped into a hierarchy of needs: the new age investor demanding a higher rate of return, more transparency and most importantly, the freedom to chose from a *wide range of product alternatives*. Moreover it is essential to gauge that *investor needs differ in urban cities to smaller towns*, hence **investor awareness programs** need to be *designed* accordingly.

The SEC has taken various measures to assist the development of the Unit Trust industry, including the preferential allotment in IPO subscriptions of up to 10% under the Unit Trust Investor Category, granting approval for the listing of the first close-ended fund and supporting a study undertaken by the Unit Trust Association to develop a strategic marketing plan to popularize unit trust products in the country. We have also taken action to frame suitable guidelines to encourage the introduction of new funds namely *Real Estate Investment Trusts* and *Exchange Traded Funds*.

In conclusion Unit Trust Managing Companies today need to stay focused on a few aspects in order to ensure that the industry meets its growth objectives and the Business Strategies should continue to focus on **reach, diversified customer base, investment performance** and **product innovation**;

1. **Alternative Product Offerings**;
2. **Exchange Traded Funds (ETFs) and Real Estate Mutual Funds**;
3. **Investments in Technology**; and
4. **Cost Rationalization**.

CEO Ceybank Asset Management (Private) Limited, *Mr. Chitra Sathkumara*, emphasized that small investors are confused as to how to invest, where to invest and when to invest as the *majority of the Public has not understood the concept of Unit Trusts*, due to the lack of awareness and the short- term direction of the Market. In recent times, there has been more interest in the Unit Trust Industry but the potential investors need to recognize that Unit Trusts are profitable and safe for the small investor. Unit Trusts are considered as a financial intermediary where a common pool of savings is created by a number of investors or considered simply as a mechanism of pooling resources by issuing units to the investors.

The investors enjoy a host of benefits by investing through Unit Trust. The main advantages of investing in Unit Trusts are;

- *Diversification* of the investments;
- Expert professional fund management *at a lower cost*;
- Easy to buy and sell, or to transfer;
- Long-term prospects.

Issues that Need to be Addressed

I. Asset Management Companies need to introduce products that *cater to investor needs*;

II. *Create ease of access to the small investor* through *effective distribution channels*, which brings about challenges to distribute units in the Provinces.

III. The subsidiaries of the large Banks have been Unit Trust Managing Companies which arises to conflicts of interest. However, recent changes in the Banks' income sources which *target fee based income* has given opportunity for Unit Trusts to *market their products via the wide network of branches of the Banks and Financial Institutions.* There is also a need to develop the distribution network to facilitate Banks to distribute units by *encouraging Unit Trust Managing Companies to maintain sales staff in the Banks to sell units.* The cost of setting up a separate distribution network is *not financially feasible*.

IV. With the increase in internet activity in the Provinces, the *internet can be used a method of distribution.* Therefore, websites with all the information should be provided for this purpose.

Director CT Capital, *Mr. Shehantha Abeykoon,* framed his presentation into three main areas;

1. The Unit Trust Industry has been challenged for the last 20 years where *competing with other products have been challenging*, whilst it has been *difficult to scale up* and the penetration levels have been low. Companies at the inception commenced with some foreign affiliation so therefore they had sophisticated processes, research, compliance procedures and maintained a certain level of integrity amongst the players and the industry as a whole. Since most of those players have been in existence for a very long time it is useful to use that knowledge and take advantage of the current context to develop the market.

2. The answer as to why the market has not taken off as expected, is that the Unit Trust Companies *did not have the resources financially to market the products*. However, there has been an increase in the number of firms that have obtained licenses to become Unit Trust Managing Companies and this is a positive development in the Unit Trust Industry.

3. There has been a further boost for Unit Trust Companies, as *foreign residents can also invest in all unit trusts*. Previously a foreigner could only invest in Growth Funds. Although ETFs and other developments are taking place, it is **important to develop the distribution network**. There is potential to bring in more non-residents into the market and for the Industry to move forward. Currently local market sales are around LKR. 150 million to LKR. 200 million a month, which shows growth and acceptance of Unit Trusts in the local market. There is a need for **more aggressive selling** to develop this industry.

Post Workshop Agenda for Development of Unit Trusts as a conduit for Unsophisticated Investors to access the Capital Market

I. *The penetration levels of the Unit Trust Industry have not increased since the inception of Unit Trusts.* ***Unit Trusts need to be distributed particularly outside of Colombo****. The industry should* ***increase the access points for distribution****.* ***Retail participation should be encouraged*** *with* ***increasing consumer protection*** *by highlighting the benefits of investing in unit trusts. These would also boost investor confidence.*

II. *Unit Trust Managing Companies need to* ***introduce a new range of products that are more innovative*** *to the market in order to attract investments.*

III. ***Exchange Traded Funds*** *should be given a boost and* ***brought into increased focus for the Investor****.*

IV. ***Investments in technology*** *which will help streamline distribution networks and increase efficiencies in business.*

V. ***Investor Education*** *which is an unspoken responsibility of the Unit Trust Management Companies to spread financial literacy among investors, which will inevitably lead to increased penetration of their products. Awareness campaigns and education drives should be undertaken on* ***regular intervals****.*

VI. ***Cost Rationalization*** *where optimum operating efficiencies need to exist and hence cost containment measures need to be undertaken by the Unit Trust Management Companies.*

Session 3
Governance in the Capital Market

Keynote Speaker – Mr. Asite Talwatte, *Senior Partner Ernst & Young Sri Lanka*

Session Chairman – Mr. R. Theagarajah, *Managing Director Hatton National Bank PLC*

Discussants – Mr. Arjuna Herath, *Council Member ICASL and Partner Ernst & Young Sri Lanka*
Dr. H. Dissa Bandara, *Director Capital Market Education and Training, SEC*
Mr. Renuke Wijayawardhane, *AGM Regulatory Affairs, CSE*
Mr. K. C. Vignarajah, *Investor*

Rapporteurs – Mrs. Ayanthi Abeyawickrama, Asst. *Director Legal and Enforcement, SEC*
Miss Rosheni Wickramaratne, Executive *Legal and Enforcement, SEC*

The Keynote Speaker : Mr. Asite Talwatte *Senior Partner Ernst & Young Sri Lanka*

Mr. Talwatte focused on where Sri Lanka is placed at present with regard to Corporate Governance compared to Best Practices and stimulated a discussion *identifying gaps* and raised questions as *to 'how much more' to mandate*?

Principles on Corporate Governance have been evolving since the **Cadbury Report** in 1992. The failure of businesses was the main reason for the evolution of these Principles at the time, in the United Kingdom and Europe. The *executive pay of Directors* became an issue in 1995. The *failure of certain Finance Companies* was the main reason for *Sri Lanka* to focus on Principles of Corporate Governance. The establishment of the Sri Lanka Accounting and Auditing Standards Monitoring Board which requires all specified business enterprises, including listed companies, to comply with the *Sri Lanka Accounting Standards* was a direct result.

In 2002, the **Turnbull Report** focused on the need for companies to have internal controls and systems in place. In 2006, the Securities and Exchange Commission of Sri Lanka (SEC) and the Colombo Stock Exchange (CSE) adopted part of the Turnbull Report, by incorporating certain Corporate Governance Principles into the Listing Rules of the CSE. These Rules are applicable only to Listed Companies. They mainly focus on Non-Executive Directors (NEDs), the appointment of Independent Directors, certain disclosures relating to Directors and the criteria for defining 'independence'. The Rules further provide for the setting up of a Remuneration Committee which recommends the remuneration of the CEO/equivalent position and the Executive Directors and an Audit Committee which specifies certain functions as to the internal controls and systems within the company.

The Sri Lankan *Code of Best Practice on Corporate Governance* on the other hand, in addition to the above, focuses on the Chairman's role, the financial and business acumen of the Directors, their appointments, the Remuneration procedure and appraisal of Board performance, the appraisal of the Chief Executive Officer, the constructive use of the Annual General Meeting, the conduct of EGMs or General Meetings and on the rights of the different classes of shareholders, like the institutional investors and others in respect to voting etc.

The *year 2010* saw key changes in the *UK Code on Corporate Governance*. The Board of Directors were made responsible for determining the nature and extent of the significant risks it would take in achieving its strategic objectives. The Chairman were encouraged to make a statement on the performance of the Board (evaluations of board performance are to be done *once in every three years by an independent body*), the role of the *Senior Independent Director* was enhanced, and factors pertaining to diversity, including *gender* have been mandated to be considered for *new board appointments*.

Other changes include;

- Challenging performance criteria, including *Non-Financial metrics*, for Executive Director bonus entitlements (i.e. performance-based pay);
- '*Claw-back' provisions* for Bonuses (i.e. to draw back in the event of business failure, or the bonus to be kept aside to be taken at a later date or at retirement (a medium term lock-in option);
- *Absence* of *performance-related elements* in NEDs remuneration; and
- An enhanced disclosure of the *Business Model* and *Strategy* in the Annual Report.

It was also significant to note that, at certain IPO bootcamps offered for companies considering an IPO, by the **NYSE**, when participating companies were asked to name their top three challenges in preparing for an IPO, 64% were of the view that *improving Corporate Governance* was the main challenge. Preparation of a *robust Business Plan* and the *preparation of the Financial Track Record*, took the second and third place respectively, in terms of challenges.

The results of a study done by **KPMG India** in 2008 highlighted the following gaps in Corporate Governance (CG) principles;

- That Independent Directors *do not adequately challenge* the Executive Directors and the Management of the Company, in the process of discharging their governance responsibilities;
- That efforts need to be made to address the *concerns* of the *Minority Shareholders*;
- That Audit Committees are *not effective enough*;
- That Audit Committees' skills *need enhancement*;
- That Boards are *not responsible enough for sustainability*; Boards should be made fully responsible for triple bottom line sustainability in profitability and social responsibility in respect of *people* and the *environment.*

Mr. Talwatte invited the Sri Lankan Capital Market Regulators to consider methodologies on the following as a means of developing CG Rules further.

To have CG audits for;

- Appraisal of *Directors' performance*;
- Appraisal of the *effectiveness* of the respective *Committees*;
- *Enhance* areas of *Internal Control*;
- Require a *Code of Good Conduct and Ethics* to be adopted by companies; and
- To disclose benefits from transactions with the company in respect of procurement, marketing, sales etc.

Mr. K. C. Vignarajah, an investor, who was a discussant at this session, highlighted the importance for companies **to disclose material information in a timely manner**. He pointed out that the confidence of the public at large is a crying need. He also said that that the lacuna created by low foreign investments was being filled by the State sector funds like the EPF and pension funds. He cautioned that the State controlling business

enterprises is not a healthy feature and should not be encouraged. He also pointed out the need to **give protection to whistle blowers in the Law** in order, to deal with the few *errant Directors*. "There must be support for the Regulators and support for good Directors" he said. "It is also a fallacy to say that *Independent Directors* should not have a stake in the company. They should also be given an *incentive*, so that they will play a more effective role" he said.

Director Capital Market Education and Training at the Securities and Exchange Commission of Sri Lanka, ***Dr. H. Dissa Bandara,*** highlighted **the need for Company Directors to have proper Education and Training for this role.** He advocated for existing Company Directors to maintain proficiency by following programmes conducted by professional organizations. He also highlighted that **Board Evaluation was very poor in Sri Lanka.**

AGM Regulatory Affairs at the Colombo Stock Exchange, ***Mr. Renuke Wijayawardhane,*** commented on some of the CG principles followed in *foreign jurisdictions* and made recommendations for *Sri Lanka* to **consider the possibility of adopting CG principles in respect of the following;**

- Board Procedures – To have rules which govern the number of Board Meetings and their frequency and to mandate having a minimum number of Directors in attendance;
- With regard to the Appointment of Directors – To evaluate Directors' performance through a *Nominations Committee*. The Nominations Committee to comprise of only *Independent Directors*;
- Ensure that major shareholders *do note vote* in respect of the *Appointment of Independent Directors* and that Independent Directors be appointed for a fixed term;
- Related Party Transactions (RPTs) – A need for RPTs to be approved by the Audit Committee; and
- To require companies to obtain a *certification* in respect of their adoption of CG principles from an independent source.

The Managing Director, Hatton National Bank PLC, ***Mr. R. Theagarajah,*** proposed that the Regulator adopt a **tier-based regulation in respect of CG Rules.** He pointed out that it was more meaningful in terms of cost-benefit. "The cost overload vs. work overload should be looked at without diluting the principles" he said.

Post Workshop Agenda for Governance in the Capital Market

I. *Explore the possibility of* ***developing Corporate Governance (CG) rules further*** *on the following areas;*

1. *CG Audits for –*
   - *Appraisal of Directors' performance;*
   - *Appraisal of the effectiveness of the respective Committees;*
   - *Enhance areas of Internal Control;*
   - *Require a Code of Good Conduct and Ethics to be adopted by companies; and*
   - *To disclose benefits from transactions with the company in respect of procurement, marketing, sales etc.*

2. *Board Procedures – To have rules which govern the number of Board Meetings and their frequency and to mandate having a minimum number of Directors in attendance;*

3. *With regard to Appointment of Directors – To evaluate Directors' performance through a Nominations Committee. The Nominations Committee to comprise of Independent Directors.*

4. *Ensure that major shareholders do note vote in respect of the Appointment of Independent Directors and ensure that Independent Directors are appointed for a fixed term.*

5. *The need for Related Party Transactions to be approved by the Audit Committee.*

6. *To require companies to obtain a certification in respect of their adoption of CG principles from an independent source.*

7. *Consider tier-based regulation in respect of CG Rules.*

II. *Facilitating the disclosure of material information in a timely manner by listed companies.*

III. *Explore the possibility of* ***providing protection to whistle blowers*** *in the Law.*

IV. *Facilitate appropriate Education and Training tailored to* ***Listed Company Directors*** *which addresses their responsibilities.*

Session 4

Is the Stock Market Over Regulated?

Keynote Speaker – Mr. Aritta Wikramanayake, *Precedent Partner Nithya Partners*

Session Chairperson – Ms. Surekha Sellahewa, *CEO Colombo Stock Exchange*

Discussants – Mr. Hiran De Alwis, *Director Colombo Stock Exchange*
Mr. Dhammika Perera, *Director Investigations, SEC*
Mr. Ray Abeywardene, *CEO Acuity Partners*

Rapporteurs – Mrs. Ayanthi Abeyawickrama, Asst. *Director Legal and Enforcement, SEC*
Miss Sharmila Panditaratne, *Manager Legal and Enforcement, SEC*

Keynote Speaker : Mr. Aritta Wikramanayake *Precedent Partner Nithya Partners*

Mr. Wickramanayake through his address laid a constructive platform for a frank discussion on the challenges a Regulator faces in laying down a regulatory framework for the capital market, the issues arising out of regulation and suggested some criteria in which a market can be judged on how effective the regulation is.

Mr. Wickramanayake pointed out that the role of a Regulator was always a challenge and that criticism was "cheap and easy". "It is always criticized as over or under-regulated" he said. Citing the SEC Act, Mr. Wickramanayake commented that the SEC's role was to promote, develop and maintain a securities market that is fair, efficient, orderly and transparent. "It is a tall order. It is a task which is wide and multi-faceted requiring a balanced appraisal of the interests of listed companies and those of the investors, which may be in conflict" he said. "We are aware that Regulators cannot regulate in a vacuum. They are forced by circumstances to take extraneous considerations including socio-political factors into account. Regulators are therefore constantly challenged. This requires a Regulator to be dynamic and proactive by tweaking regulation. This is required in all markets be they emerging markets, frontier markets or developed markets. A Regulator cannot keep everyone happy. Nowhere in the world has a Regulator always got it right. However this does not mean that they cannot be made accountable to the public" Mr. Wickramanayake added.

Commenting on some criteria upon which a market can be judged, he pointed out the lack of a universally accepted standard to judge whether a market is over or under-regulated, but suggested the following as a benchmark, though fraught with embedded difficulties;

1. By the amount of laws or rules enacted – The more the laws, the greater the regulation. But then quantity can be misleading, because all are *not enforced*. "Our laws are limited providing a mere framework" he said.

2. By the cost of compliance – As no formal evaluation has been done on the costs of compliance, it is difficult to gauge. Regulatees have to incur considerable costs such as costs of listing, of dissemination of information, in responding to questions of the Regulator, transaction costs etc.

3. By asking the question whether interference from the Regulator is burdensome?

   He cited the rules limiting private placements, and the rules pertaining to the extension of credit by brokers as examples. He suggested that the imposition of price bands by the Regulator as a response to certain peculiar and worrisome situations may have resulted in over regulation as it would have artificially held down prices.

Highlighting the conflict between merit and disclosure based regulation, he pointed out that the rule on extending credit bordered on merit regulation. He said that "direct or indirect regulation cannot be the answer. The answer lies in **creating awareness and the enforcement of existing regulations**." He also advised to **"Increase capital requirement based on exposure**".

4. By the level of market satisfaction – He said that going by the 'rumblings' one hears in the cocktail circuits, the market is over-regulated. However he cautioned that the Regulator must not be dismissive of criticism and ignore the 'signals'. Regulation must be practiced 'in spirit'.

He commented that the stock market is by and large not over-regulated, although there are some areas that are widely considered as oppressive.

Is there transparency and fairness in Regulation?

Over-regulation is the word increasingly used for market discomfort. Good regulation must be facilitative and *must respond to market demands*. The SEC must have a constant and open dialogue. "This does not appear to exist adequately. Professional associations have failed to speak in one voice. The top down approach used is met with resentment. The constant 'tinkering' with regulation could give the impression of incompetency". He urged the SEC to follow a path of consulting all stakeholders prior to imposition of rules so that their voices are heard. He commended the regulator for the public consultations that were held in relation to amending the TOM Code. Commenting on the principles on private transfers, he advised the SEC to devise policy guidelines that will create consistency. There appears to be a serious trend to flex the powers of Sections 46A and 51 of the SEC Act at the merest hint of a violation. "Powers must be used carefully and must be used when it is absolutely necessary. The SEC has to exercise powers read with its objectives and not with impugnity, and must not tread on powers vested on other regulatory bodies" he cautioned.

Maintaining confidentiality

Mr. Wickramanayake contended that the industry and in particular a listed company have about the level of confidentiality of information they provide in response to Directives. I have had No reason to believe such information is misused. However there are many instances where the information provided has appeared in the media and amongst the public "no sooner the Commission has made a decision causes concern to those affected by it." **The SEC must ensure that it maintains credibility with the industry in this respect** he advised.

Managing *Conflicts of Interest*

Mr. Wickramanayake pointed out that there is a widely held perception in the market, that the regulatory system is also rife with conflicts. Admittedly this is a universal problem he said, whether in Sri Lanka or abroad. However in other jurisdictions, the slightest appearance of conflict will, in most cases, lead to severe sanctions and reprimand. The principle must be very strongly maintained that those who advise or are part of the Regulator, whether the Colombo Stock Exchange or the Securities and Exchange Commission of Sri Lanka, *should not have* any *personal or professional dealings with those bodies*. He said that it is important to understand that, in so much as the Regulators require the industry to be governed by codes of conduct, the *same standards should be applicable to the Regulators*.

Is Regulation Effective?

Mr. Wickramanayake said that market activity is going on which is questionable. Insider dealing and market manipulation can be damaging to the entire market over time. **Regulators must act fairly to put an end to this. Prosecutions, fines and compounding should be made transparent. Introduce provisions for whistle blower protection.** "Sweeping issues under the carpet will only make some people make short-term gains, leaving the market exposed to greater damage in the long-term."

"Make the market **sustainable over the long-term**" he advised.

Director Colombo Stock Exchange, *Mr. Hiran De Alwis*, reiterated that what the market needed was the **effective enforcement of the existing laws**. "A regulator should be a facilitator. It should not be a dampener" he said. Regulation should be aimed at developing the market along the "capital market highway, and should not have too many red lights" he opined.

CEO Acuity Partners, *Mr. Ray Abeywardhene,* commented that the market is *not over-regulated*. "**There has been an exponential growth in the market and the regulation has to be strengthened and improved to meet the new challenges accompanying the growth of the market.** The Regulator is the last line of defense that an investor has. Therefore a fine balance between the divergent interests has to be maintained so that the market is not hampered by over-regulation" he said.

Mr. Abeywardhene further drew the attention on the two-pronged approach adopted by the Regulator in regulation needing quick decisions and the regulations derived through the participation of the industry. "Wherever possible the market participants should be brought in" he requested. He referred to the Directives issued by the SEC in recent times pertaining to share allotments at IPOs and the extension of credit by brokers. He said that the brokers have to incur heavy costs in transferring money from broker accounts to margin trading accounts and recommended the creation of **consultative committees** on the lines adopted by the Central Bank of Sri Lanka on many issues.

Director Investigations at the Securities and Exchange Commission of Sri Lanka, *Mr. Dhammika Perera,* explained that capital market regulations are not static and that regulations are applied in a practical manner according to the circumstances and the demands of a particular situation. He stated that the recent regulatory measures were brought in to address a particular 'market condition', and that price bands were introduced due to the prices of fundamentally unsound stocks escalating by 100%. "By this timely intervention we prevented another *Bangladesh*" he said. "Thereafter stakeholders were consulted and the price bands were lifted and applied only to stocks coming within a specially developed 'formula' (referred to as the 'gonibilla' by some market players) and that too only for a limited time period."

Referring to the limitations imposed on brokers in respect of extending credit to clients Mr. Perera explained that there were brokers who extended credit, without ascertaining the credit worthiness of the client. "A man worth LKR. 10,000.00 was given a LKR. 10 million loan which drove penny stocks up." Though the time period granted to brokers to square off positions has been extended, the policy of the SEC in respect of broker credit remains unchanged, he pointed out.

Explaining the policy behind the Directive issued in respect of share allotments at IPOs Mr. Perera said that privileged investors were obtaining bank guarantees, preventing genuine retailers from being allotted shares at IPOs.

Defending the allegations that the SEC was performing merit regulation, Mr. Perera contended that there was no 100% merit or disclosure based regulation. He denied that the recent regulatory interventions were merit based.

Ms. Surekha Sellahewa pointed out that different stakeholders had different aspirations and called for the SEC to act with care when balancing out the different aspirations.

Mr. Ravi Abeysuriya, a member from the industry who was in the audience, stated that the price bands and the directive prohibiting brokers from extending credit resulted in a huge cost to the market. "The price bands prevented price discovery. Disallowing broker credit is affecting the market" he said.

Mr. Murtaza Jafferjee, another member from the industry, strongly advocated a move towards risk- based capital adequacy requirements as there is a huge cost to move investors from brokers to margin trading accounts.

Mr. Devanesan Evanson, Former Chief Regulatory Officer, Chief Market Operations Officer & Senior Vice President, Legal Advisory for Market Supervision at Bursa Malaysia and currently Director Ernst and Young Malaysia, explained that Malaysia measures the risk exposure of the brokers on a daily basis, at the end of the day. Malaysia permits brokers to extend credit only through Margin Accounts. The formula adopted is that a Capital Adequacy Requirement ratio of 1.2, between Liquid Capital and Total Risk Requirement, must be maintained and that a 150% collateral on Margin Accounts must be maintained.

Mr. Ajith Devasurendra, a member from the industry, called upon the CSE and the SEC to look to the future and at new ways of developing the market, as '**market makers' were coming in**. He also advised the SEC to reconsider the policy on brokers extending credit and to instead seriously consider a **Value at Risk** margin.

Another member of the audience referring to the SEC describing some stocks as 'penny stocks' called upon the Regulator to refrain from classifying stocks as 'penny stocks' and 'blue chips' and suggested that the **NAV's of companies and the price should be highlighted** as an objective standard instead.

Post Workshop Agenda

I. *The Securities and Exchange Commission of Sri Lanka (SEC) notes all the concerns expressed by the key note speaker and others and will strive to address the concerns. The SEC will also strive to move towards a regime of transparency in respect of decisions taken affecting the rights of stakeholders, will strive to maintain utmost confidentiality and will be conscience to strictly avoid situations where there are conflicts of interest and to balance divergent interests fairly when regulating the market.*

II. *The SEC will ensure that the industry is consulted through a consultative committee prior to the introduction of new rules or regulations wherever possible, other than in instances where immediate action is called for by the SEC to abate a crisis and will strive to bring in rules and regulations in a manner that will be facilitative of market development.*

III. *The SEC will seriously consider the introduction of whistle blower protection into SEC law.*

IV. *Avoid referring to company stocks as 'pennystocks' or by any other name which may be prejudicial.*

Session 5

Risk Management in the Equity Market

Keynote Speaker – Mr. Devanesan Evanson
Director Ernst & Young Malaysia
Former Chief Regulatory Officer, Chief Market Operations Officer & Senior Vice President, Legal Advisory for Market Supervision at Bursa Malaysia

Session Chairman – Dr. Saman Kelegama, *Director CSE*

Discussants – Mr. Chandu Epitawala, *Director Surveillance, SEC*
Mr. Murtaza Jafferjee, *MD and Chief Executive Officer J B Securities*
Mr. Rajeeva Bandaranaike, *AGM Clearing and Settlement, CSE*

Rapporteurs – Ms. Himani Weerasekera, *Asst. Director Supervision, SEC*
Mrs. Saumi Kodippily, *Senior Executive Supervision, SEC*

The Keynote Speaker : **Mr. Devanesan Evanson** *Director Ernst & Young Malaysia*
Former Chief Regulatory Officer, Chief Market Operations Officer & Senior Vice President, Legal Advisory for Market Supervision at Bursa Malaysia

The growth and dynamics of global capital markets have created new securities markets, Exchanges and financial centers, along-with the emergence of progressively complex financial products. The evolving market scenario and the need for better allocation of resources have prompted regulators to find effective methods of identifying, measuring and mitigating risks posed by the new breed of market participants and financial products. Added to this, whilst many jurisdictions still practice 'sectoral' regulation, whereby banking and capital market services are subject to different sets of regulations and regulators, the advent of structured products which straddle the cash, fixed income and foreign exchange markets has blurred the lines between 'financial products' and 'capital market products'. As the Regulator for the Capital Market, the statutory responsibilities of the Securities Commission include making markets fair, efficient, transparent and safe for all stakeholders in general and investors in particular.

The risk in the equity market is two fold, *Systemic Risks* and *Unsystemic Risks*. As such, the *Clearing and Settlement system* is a *critical component of the infrastructure of global financial markets*. In recent years, trading and settlement volumes have soared, as securities markets have become an increasingly important channel for intermediating flows of funds between borrowers and lenders and as investors have managed their securities portfolios more actively, in part because of *declining transaction costs*. As such, risk management in the equity market requires a structured approach to understanding the capital market intermediaries' business strategies and organization structure, assessing the quality of management and control environment and *identifying key Risk Factors and Risk Mitigants*. This identification process enables regulators to rank the capital market intermediaries by the risks they pose and therefore allocate supervisory and inspection resources to the riskier institutions.

The Malaysian Experience

The area of Risk Management and compliance has come to the forefront of the capital market and financial services sector, not only for Regulators but amongst industry practitioners as well. Mr. Evanson highlighted the Risk Management measures in place at Bursa Malaysia, in relation to the following market participants:

- For the stock-broking industry;
- For dealers representatives – In Malaysia they have commissioned dealers representatives and paid dealers representatives (who are employees of the broker);
- For the listed companies;
- For market activities.

Bursa Malaysia has **capital adequacy requirements** which they use to evaluate the risk of a broker as a broker vis-à-vis the Exchange. They are concerned with five categories of risk:

- Counterparty risk – Every time the broker does a trade there is a counter party involved and this is computed;
- Operations risk – Every time a broker takes a position, there is a position risk;
- Position risk;
- Underwriting risk – in Malaysia brokers are permitted limited corporate finance activity and they can underwrite certain IPOs and that gives rise to a risk;
- Large exposure risk – Bursa Malaysia has thresholds. If a broker invests in a particular security, there is a risk charge that the broker incurs.

All these risks are calculated to give the **Total Risk Requirement**. The Exchange knows that each broker's Total Risk Requirement against the broker's **Liquid Capital** (i.e. level of financial resources or capital convertible to cash within a day or two to meet a broker's Total Risk Requirement at any point in time; there is a formula to compute Liquid capital), at the end of the trading day.

Broker firms are required to maintain a minimum **Capital Adequacy Requirements (CAR) ratio** of **1.20** at all times (weekly submission if CAR ratio is around 2.5). Capital Adequacy Requirements ratio is the ratio of the Broker's Liquid Capital against the Broker's Total Risk Requirement).

The risk based approach not only enhances the effectiveness and efficiency of Bursa Malaysia's monitoring, but assists the Brokers in allowing them to take the necessary improvement measures through identification of risk areas. As such, the Capital Adequacy Requirements (CAR) ratio was developed with the objectives of:

- Assisting a stock broking company (SBC) in managing it's risk appetite.
- Ensuring that the level of risk assumed by a SBC is commensurate with its level of capital.
- Making regulatory capital requirements more sensitive to differences in risk profiles among SBCs.
- Minimising disincentives to holding liquid, low risk assets.
- Achieving greater flexibility in the evaluation of capital adequacy among SBCs.

Prior to the development of the CAR framework, stock broking companies (SBCs) in Malaysia were required to maintain a prescribed level of liquid funds (Minimum Liquid Fund requirement), regardless of the risk profiles of their portfolios.

He said that it was interesting to note that recommendation 39 of the Sri Lanka Capital Market Master Plan dated 1st August 2006 states that there is a need to "strengthen the capital adequacy requirements to reduce systemic risk in the market", which means systemic risk is something real and relevant for the Sri Lankan capital market.

<u>Essential features of CAR ratio framework</u>

- SBCs are required to submit their CAR ratio reports to Bursa Malaysia on a daily basis at the end of day, on an on-line basis, via a pre-defined template.
- Collateral is subject to appropriate 'hair cuts'.
- Should a SBC's CAR ratio fall below 1.20 at any time, Bursa Malaysia can impose penalties on prohibiting trading on the 'buy side' of a SBC until the ratio is restored.

- Bursa Malaysia's Early Warning signal:
  - When CAR ratio falls between 1.25 to 1.30, the SBC is subject to close monitoring of its risk and liquid capital positions.
- Action taken when CAR ratio deteriorates further:
  - Specific action would be undertaken by Bursa Malaysia (such as conducting an audit of the SBC to verify the accuracy of the CAR ratio computation).
  - A SBC which has breached the prescribed trigger levels would be instructed to submit action plans to improve its CAR ratio and to implement risk management measures (such as impact tests).

Margin Accounts

Mr. Evanson stated that giving of credit by brokers is not permitted in Malaysia as it was felt that brokers are not in the business of lending money and because brokers do not have a license to give credit. The only concession given to brokers obtained was to switch to Margin Accounts (hybrid lending activity with collateral).

Margin Accounts have a collateral requirement of 150% mark to market on a daily basis. Whenever the collateral in a client's margin account falls below 150% but above 130%, the SBC is required to call their client to top-up the collateral immediately (with collateral that is liquid, i.e. more shares or more cash).

Whenever the collateral requirement falls below 130%, the SBC has the absolute right and the discretion to (and without notice to the client) *immediately* liquidate the collateral in the market, to minimize the risk exposure. These are the minimum requirements prescribed by Bursa Malaysia with regard to Margin Accounts. **Risk Management is the prerogative of the broker** and the broker may impose more stringent requirements if they wish.

Bursa Malaysia's Responsibility to ensure a Fair and Orderly Market

He said that it is imperative for listed companies in Malaysia to have an internal audit function as it provides assurance on risk, controls and governance. Bursa Malaysia has issued guidance notes on internal audit. **The speaker emphasized awareness on the same in the Sri Lankan Securities Market.** Listed companies are also required to make a statement on the State of Internal Control, in the Annual Report, upon review by the External Auditors.

Further under the listing requirements in Malaysia **every director of a listed company must attend a 1.5 day training program** wherein one of the modules covered is Risk Management. **The speaker highlighted the importance of same to the capital market participants in Sri Lanka.**

Regardless of these challenges, *Risk Management* in the equity market remains a *crucial element for capital market and financial services regulators* in successfully addressing the rapid evolution of the global capital and financial services industry. Hence, successful implementation of focused, proactive and efficient risk based supervisory methodologies is imperative in achieving the objectives of capital and financial stability, the maintenance of market integrity and the protection of investors.

Director Surveillance at the Securities and Exchange Commission of Sri Lanka, ***Mr. Chandu Epitawala,*** emphasized the importance of Risk from a Regulators perspective, stating that the Regulator is essentially a *Risk Manager* focusing on three key areas;

I. The prevention of systemic failure of a market participant;
II. To create and maintain a fair, transparent and efficient market; and
III. The protection of Investor Interests.

Effective risk management results in industry stability which in turn leads to *confidence in the investing public and counterparties.* There is no such thing as zero risk. The most prudent is to reduce risk to an acceptable level. As such, when the SEC receives a proposal, issue, situation or introduction of a new product for approval, we ask ourselves the question *"What can go wrong?".*

Failure of an intermediary is one of our main concerns. It could happen due to prudential or operational reasons resulting in a loss of investor confidence. Investor confidence provides the foundation on which capital markets are built. *In that respect risk management in the equity markets is imperative* for the supervision of capital market intermediaries to prioritize use of resources available with the regulator in a timely manner.

Other jurisdictions focus on impact and probability assessments in their risk assessment frameworks: Impact to the market being the risk posed by an intermediary to the market which is determined by its relative size and significance; *probability assessments is the business model and the adequacy internal controls and risk management which influences the probability of events occurring that require regulatory attention.*

Furthermore, he also stated that credit is essential for the market to function however the level of credit should be monitored and regulated since a build up of credit in the market could lead to a gradual creation of an asset bubble and lead to a separate set of issues and as leverage represents higher returns the tendency for the market participants is to leverage. As such, we need to identify the quantum of risk in the equity market.

He answered the question of "Is it possible to prevent everything that can go wrong – creation of a risk- free environment?" No, all what the regulator can do is to formulate rules and regulations to prevent risk to a certain extent in order to bring in stability, a level playing field and a degree of certainty to the market place and effective enforcement in compliance with the applicable rules and regulations.

He accentuated on the need for the market participants to look at what the regulator does in a positive light because it is vital for maintaining confidence in the investing public and counterparties which in turn assist them to conduct and nurture their business operations maintaining integrity in the Capital Market.

Managing Director and Chief Executive Officer of J B Securities, *Mr. Murtaza Jafferjee*, emphasized the **requirement of a Central Counter Party (CCP) which has been in discussion for as long as four years.** The limitations in securities settlement systems can be a source of systemic disturbance to the capital market. A financial or operational problem at any of the institutions that perform critical functions in the settlement process could result in significant liquidity pressures or credit losses for other participants. Moreover market liquidity is critically dependant on confidence in the safety and reliability of the settlement arrangements.

For many years the stock broking companies remained at 15 and now it has increased to 28, where the market participants cannot always manage their credit risks bilaterally through their choice of counter party since determination of the counter party when a trade is channeled remain a challenge. Therefore **margins are important on the type of stock and the quantum of trade** since impact costs are higher due to illiquid securities prevailing in this equity market. Mr. Evanson also **underscored the need for a CCP in a situation where counter party cannot be chosen by stock broking companies.**

Mr. Jafferjee indicated that at present the stock broking companies are required to maintain a minimum net capital requirement which is *not risk-weighted* and is *not based on liquid capital.* As such formulation of a risk weighted capital adequacy framework is of paramount importance to relate the level of capital to the level of exposure. At present the requirement to maintain the net capital requirement and a mere increase of the minimum amount to address risk will not be the most prudent measure of assessment on the institution's risk profile and thereby what we need to focus is on **liquid capital as an interim measure until the establishment of a Central Counter Party.**

In response to the question posed by Mr. Jafferjee to the Colombo Stock Exchange (CSE) on whether the CCP and Risk Management Project would be a 'destination' or a 'journey', the Chief Executive Officer of the CSE confirmed that the Project would be a 'destination'.

AGM Clearing and Settlement at the Colombo Stock Exchange, ***Mr. Rajeeva Bandaranaike,*** emphasized that the procedure in which securities are traded, cleared and settled plays a *crucial role in the ability of the Stock Market to attract investors.* As such, mitigating capital market infrastructure risk is important in *attracting investment* and *helping to increase market liquidity* and it is therefore a priority for the Colombo Stock Exchange (CSE) *to work towards international standards in clearing and settlement services.*

He pointed out that the *global standards for clearing and settlement systems* are set out in namely three reports and that the CSE is benchmarking these standards;

- The Recommendations for Central Counter Parties - published in 2004 by IOSCO and the Bank for International Settlements (BIS).
- Recommendations for Securities Settlement Systems - published in 2001 by IOSCO and BIS.
- The Report on Delivery Vs. Payment (DVP) in securities settlement systems - published in 1992 by BIS.
- A consultative report titled 'Principles for Financial Market Infrastructures' - published by IOSCO and BIS in March 2011. This may now become the new standard soon.

Present Position of the Clearing and Settlement initiatives taken

The CSE official stated that it has been a huge learning curve for the industry over the last two and a half years and it has come to a point where **certain key decisions can now be taken** to establish a Central Counter Party system and to introduce DVP.

As such, the *CSE has identified* two Principle Risks from the IOSCO/Bank for International Settlements recommendations that are prevalent in our market, namely the ***Asset Commitment Risk*** in the absence of a DVP system and the ***Counter Party Risk*** or **Settlement Risk** in the absence of a *Central Counter Party guarantee system.*

The Central Counter Party and Risk Management (CCP Project) Committee

A *Joint Committee* comprising two Commission Members of the Securities and Exchange Commission of Sri Lanka (SEC), two Directors of the Colombo Stock Exchange (CSE), the Director General of the SEC, the Chief Executive Officer of the CSE and other Senior Officials of the SEC and the CSE, was set up *to address the aforementioned Principal Risks.* The Joint Committee is facilitating the establishment of a Clearing House to act as Central Counter Party and facilitating the introduction of DVP. The CCP Project is now **at a juncture where certain key policy decisions need to be taken** ***to take this project forward.***

Settlement (DVP) Model

The CSE would be hoping to follow the **Settlement Model III** out of the three settlement models identified by the Bank for International Settlements (BIS). This system would be to settle transfer instructions for both securities and funds on a *net basis*, with final transfers of both securities and funds occurring at the end of the processing cycle. For a DVP system to operate, the ATS and the CDS which is presently coupled, would have to be de-coupled. This would mean that the check on whether sellers have shares in the CDS would no longer be available and therefore the risk of sellers selling shares that they do not have (short selling) may arise. This Risk can be mitigated with a **Risk Management System for Broker Firms and the CSE**. The brokers would be required to have the sell check built into their back office systems and therefore it is imperative that all brokers have **a robust Risk Management System and a back office system, prior to implementing DVP.**

Issues that *need to be addressed*

Issue#1 Permitting of **intra day short selling** and prohibiting inter day short selling *through applicable rules.* It would therefore be possible to go short during a trading day, but the shortfall has to be covered by buying the shares *before the close of trading.* However short positions cannot be carried overnight.

Issue#2 Creating a **buying-in board** in the ATS, enabling **stock borrowing & lending** in order to cover any shortfalls and having **default procedures** are necessary.

Issue#3 Prior to decoupling the ATS and the CDS, it is mandatory that **Broker level Risk Management System is in place and the CSE is *able to* monitor, in real time, the trading exposure of Members.** Therefore the members ability to trade on a particular stock would be based on the ability of the member firm to provide the required margin to the clearing house.

Issue#4 In turn how the member would cover itself is by obtaining margins from their clients to cover the level of exposure to a particular stock. **A Risk Management System will enable brokers to monitor and limit not only their exposure to a *particular stock*,** but also **exposure to a *given client*.**

Issues relating to Risk Management that *need to be considered*

Issue#5 What the various *acceptable* forms of collateral (cash / non-cash) will be?

Issue#6 Should margins be calculated real time or end of day?

Issue#7 Should margins be charged pre-order or post trade?

Issue#8 Do we apply gross margins or net margins?

Issue#9 What margin types do we use? Is it a **fixed margin** like at present for trades over LKR. 20 million OR a **Value at Risk margin**? Preferably it should be based on the Value at Risk method which *takes into account the volatility of each stock*.

Issue#10 Do we margin custodian trades? If so, who would bear the margin until trade affirmation?

Post Workshop Agenda for
Risk Management in the Equity Market

I. *A decision has already been taken that a Clearing Corporation needs to be established as a matter of priority* ***to address Counter Party Risk****.*

The following policy decisions need to be finalized by the CSE and SEC:

- *The target date for setting up the Central Counter Party in Sri Lanka*
- *CCP Settlement Guarantee Fund (Initial Margin & Variable Margins)*
- *Ownership Structure of the CCP and the target date for setting up of a for profit company*
- *The eligibility criteria of regular clearing members and professional clearing members*
  Option 1: High Capital, Low Margins
  Option 2: Low capital, high margins

SEC rules are being finalized by a team of officials from the SEC, CSE and the Department of the Legal Draftsman.

II. ***To address*** *the* ***Asset Commitment Risk****, a decision has already been taken to introduce a Delivery vs. Payment system and hence the ATS and CDS need to be decoupled. Prior to decoupling, broker-level and CSE risk management systems (RMS) need to be in place (the broker-level risk management systems should interface with the CSE risk management system).*

The following policy decisions need to be finalized by the CSE and SEC:

- *Mandating* ***Broker level Risk Management Systems*** *within a period of 6 months.*
- *Procurement of a* ***Risk Management System by CSE****.*
- ***Decoupling of the CDS and ATS*** *after RMS implementation.*
- ***Buying-in Board*** *in the ATS and* ***stock borrowing & lending****.*
- *The* ***Delivery Vs. Payment model****.*
- ***Permitting intra day short-selling*** *and prohibiting inter day short-selling through rules with severe penalties for non-compliance.*

III. ***Awareness/Training*** *for Broker Firms and Custodian Banks.*

IV. ***Training Programme*** *tailored to Directors of Listed Companies.*

Session 6

Developing Primary and Secondary Markets in Corporate Debt

Keynote Speaker – Mr. S. Nandakumar
Senior Director Global Infrastructure and Project Finance Asia Pacific, Fitch Ratings India

Session Chairman – Mr. Maninda Wickramasinghe, *Country Head Fitch Ratings Sri Lanka*

Discussants – Mr. Ajith Devasurendra, Chairman *Taprobane Holdings*
Mr. Ajith Fernando, *CEO Capital Alliance*
Mr. Adrian Perera, *CEO RAM Ratings Lanka*

Rapporteurs – Miss Madhugayanie Balapitiya, *Manager Investigations, SEC*
Miss Sharmila Panditaratne, *Manager Legal and Enforcement, SEC*

Keynote Speaker : **Mr. S. Nandakumar** *Senior Director Global Infrastructure and Project Finance Asia Pacific Fitch Ratings India*

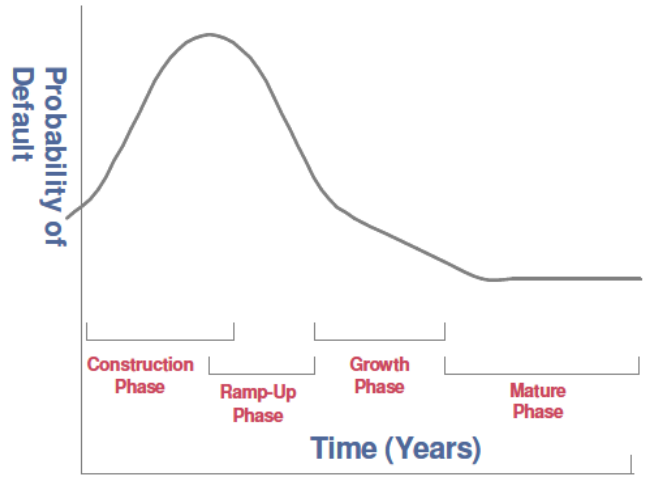
Characteristics of Infrastructure Finance

Infrastructure assets in most instances are structured by utilizing a project finance model. Project finance often features stand-alone, non-recourse, and sometimes single-asset financing and it relies on the economic value of its projects, the integrity and conditionality of its contracts, and the ability and willingness of its counterparties to honour the provisions of those contracts.

It also relies on the availability and depth of the transaction's risk mitigation provisions, such as reserves, liquidity facilities and insurance coverage. Infrastructure finance always has layers of risk, even when the eventual off-taker is a highly rated government entity.

Infrastructure Assets – Risk Profile over Time

The risk profile of the stand-alone project shifts over time and the financing package and risk mitigants must be adjusted to each stage in the project's life cycle.



Understanding the Annuity Value Proposition of Infrastructure

Infrastructure assets are long-gestation projects and most properly conceived and structured projects have a long economic life and hence capacity to pay for cost of construction and maintenance.

Infrastructure projects need long-term finance to match their revenue generation and risk profile and the long economic life and essential public service role of infrastructure assets create a potential annuity value for investors that cannot be matched by the corporate sector.

Although projects' default risks may vary case by case, there is little likelihood of winding down a national airport, a state highway or a municipal water system.

The match between infrastructure projects, as assets in need of long-term borrowing, and Asian pension and life insurance funds, in need of long-term investments, seems ideal. However, it is made difficult due to restrictive investment regulations, the absence of long-term debt, and lack of understanding by investors of infrastructure risks.

Infrastructure Finance – Current Scenario

Long-term capital is practically non-existent in most parts of the world. Long-term amortizing structures are available in the US through the bond markets; India has medium term amortizing commercial bank loans and Europe has medium to long-term amortizing bank loans. Other countries such as Australia have medium term bullet maturities which introduces refinancing risk.

Are Capital Markets the Solution to Funding Infrastructure?

Given competing demands on scarce resources, Governments are increasingly faced with the challenge of finding sufficient capital to build, refurbish, expand and maintain vital infrastructure.

The situation is even more challenging in emerging markets or developing countries wherein lack of adequate infrastructure clearly inhibits economic growth aspirations. Involvement of private capital is no longer a choice but has become a necessity and bond markets provide the ideal platform for marrying the needs of long-term investors such as pension funds and insurance companies seeking fixed 'annuity' type returns with infrastructure projects seeking long-term finance.

Pension Assets Under Management – Asia-Pacific

Country (USDbn)	2004	2015
Japan	761.1	896.6
Australia	527.5	1,908.70
Singapore	68.8	123.9
Hong Kong	39.6	112.0
Republic of Korea	31.4	275.0
China	8.2	134.7
Thailand	8.1	32.9
India	4.9	162.2
Taiwan	2.7	98.5
Totals	**1,452.3**	**3,744.5**

The Indian Experience

Characteristics of Indian Bond Markets

In terms of outstanding issued amount, the Indian debt market ranks as the third largest in Asia next only to that of Japan and South Korea.

According to the estimates of the Bank for International Settlement (BIS), the size of India's corporate bond market was a mere 0.3 % of the nominal GDP in December 2003 – well below those of Malaysia (43.3%) or South Korea (27.7%).

- Government accounts for more than 75% of total debt issuance in the Indian bond market;
- Private placements dominate public issues;
- Banks, Financial Institutions and Public Sector Undertakings are major issuers;
- Private sector accounts for only about 20% of debt raised;
- Low retail participation;
- Limited secondary market activity;
- Only 3% of trading is in corporate debt while the bulk of the activity is concentrated in gilts;
- Over a ten year period ending FY05, municipal bond issuances were just eleven and
- garnered some INR 8.5bn only;
- Hardly any appetite for lower rated instruments;
- Over 90% of issues are rated AA(ind) or above while less than 2% of the issues are
- Rated in the BBB(ind) category;
- Banks which form the majority of the class of institutional investors by amount in corporate debt paper, adopt an asymmetric credit evaluation methodology when they are willing to provide loan to a client but unwilling to invest in the debt paper issued by the same borrower if the debt paper is not rated very highly by the rating agencies.

Historical Perspective – Key Observations

Over the years, a very limited number of entities have accessed domestic bond markets for infrastructure financing.

These have been predominantly by way of private placement of bonds to select institutional investors (mainly Banks and Provident Funds); partly driven by regulatory investment allocation criteria.

Public offerings have been even more limited in number and Issuers predominantly state-owned corporations. Some of these suffer from the weak credit quality of the state governments that are either a counter-party or guarantee the debt service or both.

Aggregate amounts raised (Fitch estimates this to be less than INR500bn) is a miniscule percentage of the total funds invested in infrastructure. Several of the issuances have been credit enhanced – mainly by government guarantees and structured payment mechanisms.

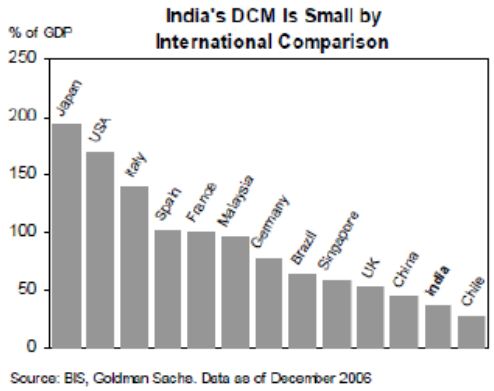
Classical project finance issuances are very negligible and tenor have generally not exceeded 10 years and in many cases, maturities have been 5-7 years and /or put & call options exercisable at the end of say, 3, 5 or 7 years. Not much secondary market trading activity in these bonds and this brings on a liquidity a concern.

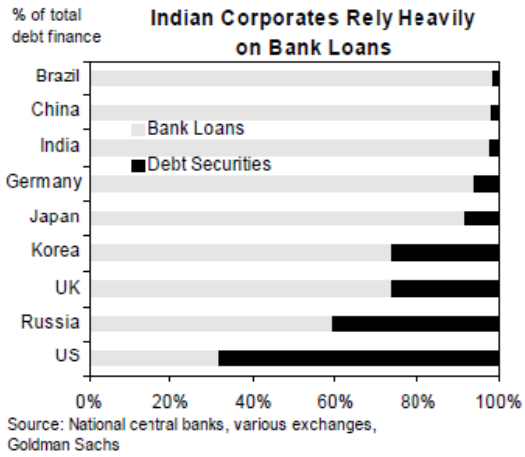
Categories of Issuers

- Corporates;
- Banks/FIs;
- Electric Utilities;
- Irrigation Corporations;

- Finance companies – some raising resources for lending to infrastructure projects; others for many other types of lending as well such as corporate loans;
- Urban Local Bodies;
- Industrial Promotion Boards;
- Private Sector Developers/Operators (very few in number);
- Some recent issuances by operating, annuity road projects.

Size & Composition of India's Debt Capital Market





> 90% of debt issuances is via private placements

Private Placement of Corporate Bonds Listed on NSE and BSE

Year	No. of Issues	Amount (INR Crore)
2007-08	744	118,485
2008-09	1,041	173,281
2009-10	1,278	212,635
2010-11 (till Nov 10)	929	147,400

1 crore = 10 million

Impediments to the Development of a Strong Domestic Bond Market in India for Infrastructure Projects: Demand-Side Constraints

- Lack of a steady pipeline/supply of strong, bankable projects and dearth of quality projects with escrowable cash flows;
- Lack of: (a) transparency in the awarding of projects, (b) strong oversight over project execution, and (c) monitoring of cash flows;

- The issuing entities not fully acclimatised to the rigours of bond market discipline:
  - timely payment of principal and interest; and
  - adherence to transaction structures.
- Role and functions of trustees and 'Easy' availability of commercial bank loans
- Relationship banking imparts a feeling of comfort among issuers:
  - Flexible financing terms.
- Cumbersome primary issuance guidelines and high transaction costs;
- Direct lending by multilaterals with an express or implied sovereign guarantee;
- Perceived macro risks (political, economic, regulatory and environmental) traditionally associated with infrastructure projects; accentuated in certain sectors.

Impediments to the Development of a Strong Bond Market in India for Infrastructure Projects: Supply-Side Constraints

Partly driven by regulation and partly by internal investment guidelines, many institutional investors do not invest in bonds rated below an 'A+'. There is also the constraint on foreign investment in debt instruments.

Insurance companies - Investment guidelines of the Insurance Regulatory and Development Authority (IRDA)

Financial assistance has to be in "secured" form as otherwise it attracts the risk of being classified in the "other than approved investment" (OTAI) category of investments.

Any investment that is rated below 'A+' or the financial assistance that is in 'loans' form (other than loans which are secured by way of mortgage of property) is categorised as 'Other than Approved Investment' (OTAI), which may not exceed 15% of aggregate financing/investment and is subject to exposure and prudential norms

Insurance companies - Nature of current inflows for insurance companies

IRDA mandates that life insurance companies must invest a minimum of 15% of their funds in infrastructure and social sectors in respect of traditional insurance policies such as endowment, whole life or term insurance.

However, a significantly fast increasing number of investors now prefer the unit-linked insurance policies (ULIPs), which are short-term orientated and have no mandatory requirement of investment in the infrastructure sector.

In the case of ULIPs, insurance companies are required to invest according to a pattern of investments/scheme selected by the policyholders, which usually is weighted in favour of equity.

Banks

Asset-Liability management stipulations – most deposits are short-to-medium term while infrastructure projects require long-term funding. Additionally another factor is "mark-to-market" implications in bond investments.

Banks also face small-sized pension funds and virtually no dedicated infrastructure funds.

Risk Mitigation from a Bond Investor Perspective

Creating a relatively stable macroeconomic environment – Countries that have taken steps to control inflation and external debt, increase official international reserves and exploit trading partnerships often provide fertile ground for all types of domestic and foreign private investment, including in infrastructure.

Developing the legal framework – If a country's public policy seeks to encourage private sector participation in the financing of infrastructure, its laws should support that policy. Laws governing concessions and/or privatisations, requires a clear process for dispute resolution, the ability to enforce contracts, and lender remedies under bankruptcy and insolvency will support this aim.

Ensuring a relatively stable regulatory framework –

- Independent Regulator
- A base set of regulations developed in tandem with the legal framework for concessions and privatizations.
- Regulations focussed on the project's lifecycle (ie its design, construction, operation and eventual return to the public sector).
- Investors can price onerous regulations, but cannot sustain surprises.

Ensuring value for money in project selection – Choice of projects should be a vis-à-vis the political vs economic value and there should be a process for selecting "bankable" projects and for keeping a stream of projects coming to the market.

Attention to the "value-for-money" concept has been successfully developed in Australia and this will allow projects to be screened according to whether they are best funded by the public sector, or by the private sector, or through a partnership.

Obtaining better, more reliable feasibility studies – Value for money considerations are difficult in Asia since developing rigorous feasibility studies are still work-in-progress. Feasibility studies help calibrate the proper allocation of risk between the public and private sectors (to optimize the mix of debt, equity and government viability gap funding).

The importance of economic and financial feasibility studies are under-estimated due to:

- minimum revenue guarantee;
- project sponsor motivated by a large construction contract; and
- a portfolio lending approach.
-

Establishing a credit culture –

- Present lending practices are relaxed toward infrastructure project risk;
- Use of Credit Ratings;
- Financial Discipline.

The Role of Credit Enhancement –

- Capturing long-term cash flow value requires sculpting the debt with cash flows, including financial covenants, and considering credit enhancement;
- Credit enhancement for project debt in the form of a subordinated line of credit would promote market appetite for the senior debt of concession based projects;
- Many projects have an adequate loan-life-coverage, but inadequate debt service coverage during the initial ramp-up years of operation.

Conclusion

A well-functioning debt capital market provides the ideal bridge between long-term savings, seeking fixed returns and companies/projects seeking long tenor finance

- A very attractive supplement to traditional bank debt;
- A number of constraints have held back this channeling of capital flows;
- These impact both availability of capital and demand for funds;
- Appropriate risk mitigation (including structuring) and policy reform could help bridge this gap.

Chairman Taprobane Holdings, *Mr. Ajith Devasurendra,* stated that the capital market needs to keep pace with the Banking sector as it has developed considerably in the recent years. He pointed out that **Banks are planning to introduce tier two capital**, which is an opportunity.

He pointed out that there is a *great disparity* between *Sri Lankan interest rates* and interest rates in most other countries (such as the USA).

He stressed that the way forward is to have a '**shopping list' of initiatives that need to be fast-tracked for the development of the Sri Lankan Corporate Bond market** and most importantly, to **create an environment to list debt instruments as a priority wherein Banks could undertake the clearing function**. Mr. Devasurendra also stressed the fact that a **'Market Maker' is essential** to arrive at a buying price and a selling price.

He concluded his remarks by stating that a *quantum leap is essential* in order for *us all* to develop the capital market of Sri Lanka.

CEO Capital Alliance, *Mr. Ajith Fernando,* highlighted the striking feature in the case of the government bond market, as well as in the equity market, is that there is a single champion for the cause. However, while clearly the Corporate Bond Market vests under the purview of the SEC, the SEC itself concentrates more as an equity market Regulator and it was his opinion that the SEC does not feel the pulse of the Corporate Bond market. Mr. Fernando was of the opinion that the time was *opportune* to develop the corporate debt securities market as the *technical expertise and capital were both in place*.

Mr. Fernando also raised the fact that the Central Bank of Sri Lanka (CBSL) disseminates a **'Road Map'** at the beginning of the year, **setting out the initiatives and plans for the relevant year.** It was Mr. Fernando's suggestion that the SEC and CSE too should introduce a similar plan, comparative to CBSL at the beginning of each year in order that this plan could be revisited in the following year to assess how much has been achieved. This would also *put pressure on the market participants*. He noted that it is clear that what was lacking is *not planning*, but the **implementation aspect**. This was Mr. Fernando's first proposal.

The second proposal Mr. Fernando focused on the area of intermediaries. He stated that in both the equity market, as well as the government securities market, there was a set of **dedicated intermediaries who basically drove the market.** However this was lacking in the case of the Corporate Bond market in Sri Lanka and therefore it was his contention that to **look at the Primary Dealers since they posses both the expertise and the funds required for this purpose.**

On the idea that Banks provide funds at a lower cost than the market, he was not quite convinced that this was always the case, other than in some of the bluest of blue chips. He said that Banks provide cheaper *short-term funds* and *most companies run significant interest rate risks* by borrowing short-term to fund long-term projects.

Mr. Fernando concluded his remarks by stating that the *recent opening up of the Corporate Bond market to foreign investment* is probably going to be the *kick start that Sri Lanka has been waiting for* and stated that market participants should grab this opportunity to develop this previously missing link in our capital market.

Mr. Fernando also mentioned that a Report was compiled two years ago by the SEC on the steps required to develop the Corporate Bond market but nothing seems to have transpired.

Director Capital Market Development at the SEC, *Mr. Vajira Wijegunawardane,* responding to this statement said that this Report was certainly not gathering dust and some *important recommendations have already been acted upon*, including proposals made by the SEC to the Central Bank of Sri Lanka to allow foreigners to invest in Corporate Bonds, relaxing restrictions placed on foreign investments in Unit Trusts that invest in debt instruments and addressing the anomaly in the treatment of withholding tax on Corporate Bonds vis-à-vis government securities. He also mentioned that most other recommendations will be enabled with the amendments to the SEC Act which is currently being worked on.

CEO RAM Ratings Lanka, *Mr. Adrian Perera,* stressed the fact that **knowledge is a key element** for the development of the Sri Lankan capital market. Mr. Perera' personal view was that **investment banks** are an important stakeholder in the capital market but **should not be controlled by banks**. He pointed out the **lacuna with regard investment banks being unregulated**.

Mr. Perera also suggested that there should be a 'Development Road Map' where the capital market is concerned and that *Sri Lanka should benchmark other countries* and referred to the economic development trends in Malaysia.

Assistant Director Legal and Enforcement at the SEC, *Mrs. Ayanthi Abeyawickrama*, inquired from the session discussants whether Sri Lanka is ready to regulate the Corporate Debt market. Mr. Ajith Devasurendra stated that it will not be a perfect market and there will be consequences but Mr. Devasurendra believed that SEC should start the initiative. Yet another participant of the session stated that **Trust Certificate market** also **needs to come under the purview of the SEC.**

Country Head for Fitch Ratings Sri Lanka, *Mr. Maninda Wickramasinghe,* highlighted to the audience a statement made by Mr. Alan Greenspan, Former Chairman of the Federal Reserve Bank;

"The existence of a *deep and liquid* Corporate Bond market could make emerging economies *less vulnerable: especially to volatile capital inflows.*"

In Sri Lanka, Mr. Wickramasinghe stated that there is a *listed securities market* and an *OTC market* for corporate debt.

The listed corporate bond market is *extremely small*, with hardly any trades taking place. It is;

- Regulated by the Colombo Stock Exchange and the SEC;
- Has access to *ratings*;
- The volumes of the listed debt market are very small and known;
- Listed debt securities are *held to maturity* and there is *no mark to market*.

The OTC debt market is *much more active* than the listed corporate debt securities market. However;

- There is no depository or trading platform;
- Outstanding volumes;
- *Subject to systemic risk* due to absence of a trading platform;
- OTC securities are mostly *held to maturity*;
- *No mark to market* and can be sold at a premium;
- Active 'repo' market;
- Price and volumes unknown. No price formation;
- It is *unregulated*.

Mr. Wickramasinghe's suggestion was to **converge the two markets.**

Intermediaries in the debt market regulated by the SEC are brokers, and the intermediaries in the market regulated by the Central Bank of Sri Lanka are primary dealers and Banks. There needs to be **one trading platform** he said. "You *do not need default* to consider systemic risk. There *is systemic risk*." He also said that **visibility** and **price discovery** are required. 'Repo' is very crucial to liquidity in the market. He commented on the following:

- What do investors want from bond markets? They seek *inflation adjusted returns*, low to moderate risk and medium to long-term returns and an *exit mechanism*.
- What do Issuers want? To raise *medium to long-term capital* at the *lowest possible cost*.

Mr. Wickramasinghe was of the view that all securities and exchanges should come within the purview of the SEC (after all 'SEC' he said stands for Securities and Exchange Commission). Whilst the SEC regulates the listed corporate debt securities market, the Central Bank of Sri Lanka regulates the government securities market. The intermediaries which fall under the purview of the SEC are margin providers, fund managers, stock dealers and brokers. The intermediaries which fall under the purview of the Central Bank of Sri Lanka are Licensed Commercial Banks, Licensed Specialized Banks, primary dealers, leasing companies and finance companies. The Insurance Board of Sri Lanka regulates the insurance companies and brokers. These Agencies will have to think alike and *work together to develop this market*. It is the time to make the right moves he said.

There is a requirement to **facilitate trading of corporate debt in a much less riskier environment**. Debt trading is mostly a *wholesale market*. He indicated that you cannot have individual securities accounts having 10,000 worth of bonds.

Mr. Wickramasinghe also commented on a **scripless system for the corporate debt market**. The CSE, CDS and the SEC have a role to play in facilitating this market he said. The companies that issue commercial paper or debentures **should lodge their securities with the CDS**. The CDS can facilitate the transfer of title to an eventual buyer. Both the **stock brokers and money brokers can facilitate a price discovery mechanism** and *traded prices can be reported at the end of the day.* At present this market has *no reporting or regulatory mechanism* whatsoever. He opined that this framework would open up the market for lodging OTC corporate debt in the CDS.

He recommended permitting **any financial institutions registered with the SEC or Central Bank of Sri Lanka** (CBSL) **to be a member of the debt trading platform**. The intermediary/broker would maintain two accounts with the CDS; a broker account and a customer aggregate account. The CDS is linked to RTGS of CBSL. For securities settlement, the CDS can transfer securities in 'demat' form and funds can be settled through the RTGS system that in turn is linked to all Banks and LankaClear (the automated clearing house). The CDS can

facilitate the outright sell and buy of securities as well as 'Repo' transactions. The securities could be *commercial paper, medium-term securitised paper and long-term debentures*. There would be *end of day reporting* of all outstanding volumes of trades, prices traded etc.

Mr. Wickramasinghe said that there is a need to **encourage private sector pension plans and insurance funds** to invest in listed corporate bonds (the insurance industry being another long-term contractual saver). With expectations of a dramatically ageing population by 2020, reforms in the area of retirement benefits will need urgent attention. The only mechanism for these funds to *increase their returns* would be to **authorize larger asset allocation into debentures and equity**.

He was of the opinion that **Universal Brokerage** should be permitted for better price formation. Brokers are those who find buyers and sellers and put them together. Universal Brokerage will provide diversification: a brokerage needs to be a multi-product company. The role of the money broker or a stockbroker could expand into bonds, stocks, corporate bonds, derivatives etc. Mr. Wickramasinghe also proposed having a **National Mortgage Association in Sri Lanka**.

He concluded his presentation by also recommending that a **road map needs to be created, prioritizing what needs to be done**, as suggested by ***Mr. Ajith Fernando***. He emphasized that now is the time (***Mr. Ajith Devasurendra*** revealed that foreign investors will be investing in Sri Lankan corporate bonds) and *we all need to work together to achieve what is required.*

Post Workshop Agenda for
Developing Primary and Secondary Markets in Corporate Debt

I. ***Industry to identify initiatives to be fast-tracked*** *for developing the Corporate Bond market (listed and unlisted).*

II. *Consider a* ***separate set of intermediaries*** *with necessary capital and skills to facilitate corporate bond market activities.*

III. *Facilitate the introduction of '****Market Makers' to add liquidity to trades*** *by quoting two-way prices (buying and selling).*

IV. *Explore the concept of* ***universal brokerage*** *where a broker can trade in government securities, commercial paper, stocks, corporate bonds, derivatives etc.*

V. *Together create* ***the environment and systems conducive to trading*** *of listed corporate debt and consider converging the listed debenture market and OTC corporate debt securities into one trading platform.*

VI. *Creation of a* ***long-term benchmark yield curve*** *by Central Bank of Sri Lanka to encourage the issuance of long-term instruments.*

VII. *Explore the CDS facilitating a* ***scripless system*** *for the listed and unlisted corporate debt market. With the CDS being linked to RTGS, for securities settlement consider the option of the CDS transferring securities in 'demat' form and for funds settlement* ***settling funds through the RTGS system****.*

VIII. *Market players to encourage private pension funds, insurance funds, unit trusts, foreign institutional investors and long-term investment funds to invest and trade in corporate bonds, by* ***structuring appropriate products.***

IX. *Market players to encourage companies to list corporate debt with* ***longer maturities and larger (liquid) values****.*

X. ***Industry to create awareness among the general investing public*** *on the benefits derived from diversification, benefits of channeling savings into long-term investments and on the attributes of debentures and debenture trading.*

XI. *Explore Stock Brokers and Money Brokers facilitating a* ***price discovery mechanism*** *for Corporate Bonds, with traded prices to be reported at the end of the day and available in a central platform.*

XII. *Consider appropriate regulations to be introduced applicable to* ***investment banks/comparable institutions, the unlisted bond market*** *and the* ***trust certificate market.***

XIII. *Industry to create an* ***Annual Road Map*** *at the beginning of the year for developing the primary and secondary markets in Corporate Debt, setting out the initiatives and plans for the year.*

XIV. *Explore the possibility of creating a National Mortgage Association in Sri Lanka.*

Key Recommendations of the Capital Market Development Workshop 2011

- Fast-track the establishment of the Central Counter Party guarantee system and the Risk Management initiatives through the joint committee set up for these purposes.

- The industry to identify initiatives to be fast-tracked for *developing the Corporate Bond market (listed and unlisted).*

- The Unit Trust industry should *increase the access points for distribution* particularly *outside Colombo*. Retail participation should be encouraged with increasing consumer protection by highlighting the benefits of investing in unit trusts. Unit Trust Managing Companies need to introduce a new range of products that are more innovative to the market in order to attract investments.

- Wherever possible other than where immediate action is called for, a priority will always be given to consult the industry prior to introducing new rules and regulations, through a consultative committee.

- Explore the possibility of developing Corporate Governance rules further on the areas highlighted at this Workshop and to seriously consider the introduction of whistle blower protection into SEC law.

- Explore the 'international board' proposal of the London Stock Exchange Group.