

# Overview of new SEC Act



The Securities and Exchange Commission Act No.19 of 2021 (Act) came into force on 21 September 2021. This is the first consolidated Act since the original Securities and Exchange Commission Act

No. 36 of 1987. There have been amending Acts in 1991, 2003 and 2009

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The new Securities and Exchange Commission Act No. 19 of 2021 ('the Act') has been certified by the Speaker on 21 September 2021 and has thus become law. It repeals and replaces the Securities and Exchange Commission Act No. 36 of 1987.

The Act which has been in the pipeline for a considerable period of time contains well thought out provisions which have factored in latest developments in securities markets around the world and adheres to principles and standards propounded by the International Organization of Securities Commissions (IOSCO). It enables robust regulation whilst facilitating market development and will cater to both the present as well as future needs of Sri Lanka's securities market.

## **The process of drafting the Act**

The process of drafting a new law began in the year 2007, consequent to a gap analysis and extensive research carried out on the laws of other jurisdictions. The initiative received technical

assistance from the World Bank as well as experts in Sri Lanka.

The first draft had been completed in 2013 and approved by the Commission at the time. Since that had not been proceeded with, improvements had been made to that draft by the subsequent Commission and having received Cabinet approval, the Bill had been tabled in Parliament in 2018 but was not taken up for debate. Further changes had been made to that Bill by the previous Commission during the 2018/2019 period.

In finalising the Act, whilst retaining the core provisions found in the previous versions, the present Commission has taken steps to eliminate ambiguities and grey areas in order ensure that there will be no difficulties in its application and implementation. It must be acknowledged that there have been numerous consultations with all stakeholders as well as the public in this long drafting process and their contributions have been of immense assistance in the formulation of this law.

### **The structure of the Act**

The SEC Act comprises seven Parts which are further divided into a number of Chapters. A significant feature is that at the beginning of each Part, the ‘object and purpose’ of that particular Part is described in broad terms. This gives an indication of what is sought to be achieved through the provisions contained in such Part.

Part I deals with preliminary matters such as the application and objects and purpose of the Act, establishment of the Commission and its powers, duties and functions as well as matters pertaining to the Director General and staff of the Commission. Part II titled ‘Markets and Market Institutions’ provides for the establishment of Exchanges, Clearing Houses and a Central Depository. Part III titled ‘Issue of Securities’ deals with Public Offer of Securities, Market Intermediaries and the Protection of Clients’ Assets. Part IV deals with ‘Trade in Unlisted Securities’. Part V titled ‘Market Misconduct’ deals with Prohibited Conduct and Insider Trading. Part VI contains provisions in relation to the finances of the Commission and Part VII provides for general matters such as the implementation of the Act and punishments and enforcement mechanisms.

### **The salient features of the Act**

The Act contains many salutary provisions that will ensure efficiency, predictability and consistency in the regulation of the country’s securities market. Further, it enables the use of state of the art infrastructure and provides for the different fund raising requirements of issuers whilst the ability to introduce a variety of products offers investors a wider choice depending on their risk return characteristics.

### **Markets and Market Institutions**

Part II which is specifically dedicated to Markets and Market Institutions is an important part of the new law since the provisions contained therein are expected to ensure that these vital institutions perform their functions properly which in turn will help the effective and efficient

functioning of the securities market as well as help mitigate systemic risks.

These provisions stipulate in great detail the rights and duties of an Exchange, a Clearing House and a Central Depository, the requirements that have to be fulfilled if a license is to be obtained, when a license may be cancelled and the right of recourse if a license is cancelled, the effect of the Rules of these market institutions, appointment of directors, duties of an auditor etc.

An important feature is that a licensed Exchange can list its securities on its own Exchange. There is recognition of a Clearing House acting as a Central Counter Party (CCP) and a CCP has been defined. Further, detailed provisions dealing with default rules and proceedings have been included in order to cater to situations where a clearing member is unable to meet its obligations regarding unsettled market contracts. The default proceedings have been designed to bring about finality to trades.

### **Market Intermediaries**

It is also pertinent to note that the Act has redefined 'Market Intermediaries' and has added a few more categories of persons. They are 'corporate finance advisor', 'market maker', 'derivatives broker' and 'derivatives dealer'. The introduction of market makers is important since that will ensure continued and efficient exchange of securities between buyers and sellers.

As in the case with market institutions, their duties, requirements that have to be fulfilled if a license is to be obtained and renewed, grounds on which a license may be refused, suspended or cancelled, trading in securities by market intermediaries, duty of an auditor, etc. have been spelt out in great detail.

Market intermediaries play a pivotal role in the functioning of the market. Since they operate at the forefront of the market and thus are directly in contact with investors, it is imperative to ensure their credibility. Towards achieving this and to ensure that they conduct their functions more efficiently, certain requirements have been identified under the head of 'Protection of clients' assets'. They require that market intermediaries disclose certain interests they have in securities, establish and maintain certain internal procedures and processes and conform to business conduct that the Commission may spell out by way of rules. These are meant to minimise their own risk and exposure and to monitor compliance and are neither new obligations nor measures that will result in additional effort or expenditure to them. Such requirements exist even at present in the form of rules and standards introduced by the Commission from time to time. In contrast to the previous Act, the Act has incorporated these specific requirements in relation to market intermediaries in the body itself.

In addition to market intermediaries, the Commission can, by way of rules, require the registration of those who 'deal with clients for and on behalf of a market intermediary'. The Act has also recognised 'Supplementary Service Providers' such as actuaries, custodians, trustees and valuers on whom the Commission may exercise supervision in the future thereby fortifying public confidence.

### **Issue of Securities and maintenance of good corporate governance practices**

Part III deals with 'Issue of Securities' and the purpose of this Part amongst others, is to ensure timely disclosure of financial information by listed public companies and compliance with best corporate governance practices.

In order to ensure accountability of funds solicited from the public, the Commission will be entitled if it considers that such a step is necessary, to make Rules that will require unlisted companies to obtain its approval prior to certain types of public offers. Such requirement may be introduced taking in to consideration 'the volume of securities, class of securities, the number and type of investors, the nature of the issuer or the nature of the securities market'.

Based on disclosures made to the public, if any wrongdoing is detected, the Commission or the market institutions will be entitled to call for information from listed companies. The Commission has been empowered to take any enforcement action that is considered appropriate if 'after due inquiry or investigation' it is found that the listed company has contravened or failed to comply with any provision of the Act, regulations, rules or directives. Here again it must be stressed that this is part of oversight that is presently carried out by the Colombo Stock Exchange and the Commission through its corporate affairs division to ensure compliance with the Listing Rules and is nothing new. What has been done is to have these provisions specifically included in the Act in order to ensure adherence to best corporate governance practices.

It will be necessary for a person to obtain the approval of the Commission prior to accepting appointment as a director, chief executive officer or chief regulatory officer of a market institution and the grounds upon which such approval will not be granted have been spelt out. Further, directors or the chief executive officer of a listed company are required to comply with the fit and proper criteria specified by the Commission by way of rules made by it or the rules of an Exchange which have been approved by the Commission. Another new feature is that Auditors of listed companies, market institutions and market intermediaries have been obligated to report certain irregularities that he becomes aware of 'during the ordinary course of the performance of his duties'. As to what they are and to whom it has to be reported have been specifically stated.

It must be appreciated that these requirements have been introduced in order to ensure proper corporate governance in the said institutions and to mitigate systemic risk considering the pivotal role they play in the securities market. At a time when most of these practices have been embraced by the business community as part of the corporate governance framework that is being presently finalised, they cannot be construed as impediments to the smooth conduct of their businesses.

### **Main market offences**

Part V of the Act which encompasses the main market offences could be considered as a progressive step taken towards the regulation of the securities market of the country. This Part has been divided into two Chapters containing 'Prohibited Conduct' and 'Insider Trading'.

### **Prohibited Conduct**

Five different offences have been identified under Prohibited Conduct. They are ‘false trading and market rigging’, ‘stock market manipulations’, ‘making false or misleading statements’, ‘fraudulently inducing persons to deal in securities’ and ‘use of manipulative and deceptive devices’

The most significant introduction to this category of offences which is commonly known as market manipulation are the two offences found respectively in Sections 130 and 131 respectively. Whilst Section 130 precludes a person from making a statement or disseminating information that is false or misleading in a material particular which is likely to have an effect of raising or lowering the market price or volume of securities, Section 131 precludes a person from inducing or attempting to induce another person to trade by making or publishing any statement or by making a forecast that is misleading, false or deceptive.

As to what conduct is prohibited has been spelt out with utmost clarity. It therefore is not difficult to understand as to what ingredients have to be present to establish the commission of an offence under this Part.

### **Insider Trading**

All aspects pertaining to Insider Trading have been described with precision. As to when a person is considered to be an ‘insider’ has been clearly defined and what exactly such person is prohibited from doing has been spelt out with certainty. In addition, as to what would amount to information, when such information is generally available, what would be information which has a material effect on price or value of securities, when will a person be considered to have procured another, when information is deemed to be in possession as well as specific exceptions and defences available in respect of a charge of insider trading have been outlined in great detail.

These elaborate provisions have been included with the intention of taking away any uncertainty or ambiguity and to clearly demonstrate as to what conduct is permitted and what is prohibited so that those involved in the activities of the market are fully and well aware of the framework within which they ought to operate. Further, the fact that the commission of any such offence would give rise to the imposition of stringent penalties is intended to act as a deterrent and not as a means to stifle or discourage the activities of market participants.

Unlike the previous Act where charges were to be filed in the Magistrate’s Court, henceforth these offences are to be tried in the High Court and any person convicted of such offence would be subject to a penalty which could be either a fine of not less than ten million rupees or to imprisonment for a term not exceeding ten years or to both such fine and imprisonment.

### **Prosecutorial discretion of the Commission Criminal proceedings**



Consequent to the completion of investigations by the Commission, if the Commission is of the view that sufficient evidence exists to establish the commission of an offence under Part V, steps will be taken to institute criminal proceedings. Since criminal proceedings are to be instituted in the High Court and charges are filed in the form of an 'indictment' which can be presented only by the Attorney General as stated in the Code of Criminal Procedure Act (with the exception indicated in the Bribery Act), the Commission will refer the matter to the Attorney General for the filing of indictment and the prosecution will be conducted by the Attorney General. Even when charges were to be filed in the Magistrate's Court in respect of all offences under the previous Act, the preparation of the charges and the conduct of the prosecution was by the Attorney General.

The offences other than what is contained in Part V are triable in the Magistrate's Court.

### **Civil Proceedings**

A new feature that has been introduced by the Act is the discretion conferred on the Commission to institute civil proceedings in the High Court exercising civil jurisdiction which is commonly referred to as the Commercial High Court in order to recover damages and to seek the imposition of a civil penalty. The Act has specifically conferred this jurisdiction on the Commercial High Court. Such proceedings can be instituted against a person who has committed a contravention under Part V. The decision of the Commission to institute such proceedings will depend on the 'nature and manner of the contravention, the impact it has on the market and the extent of the loss caused to any investor'. The amount recoverable by the Commission will be three times the gross amount of the pecuniary gain made or loss avoided and the penalty the court can impose will not be less than ten million and not more than one hundred million rupees depending on the severity or gravity of the contravention. How damages so recovered will be distributed has also been stated.

The Commission has also been vested with the discretion to enter in to an agreement with any person with or without the admission of liability to pay an amount equivalent to three times the gross amount of the pecuniary gain made or loss avoided in respect of contraventions under Part V. Offences other than those enumerated under Part V can be compounded for a sum not exceeding one half of the maximum fine that can be imposed for such offence.

### **Administrative Sanctions**

Another important feature that has been introduced is the ability of the Commission to impose 'Administrative Sanctions' on wrongdoers. Previously, the Commission was not expressly empowered to impose penalties or other administrative sanctions although all contraventions were considered as offences.

However, depending on 'the nature and manner of the contravention, noncompliance or breach and its impact' this new provision leaves the Commission with the discretion (except in respect of offences under Part V) of imposing a variety of administrative sanctions such as a reprimand, penalty, restitution, imposing a moratorium on or prohibiting trading etc.

## **Steps to protect assets of investors and right to seek certain orders from Court**

Some of the other new features are the ability of the Commission to take certain steps to protect assets of investors, issue directives during the course of conducting investigations or inquiry known as ‘freezing orders’ (which are valid only for a period of seven days and thereafter to be confirmed by the Commercial High Court), power to apply to the Commercial High Court in situations of violations or imminent violations seeking certain orders such as a declaration that a securities transaction is void, directing a person to dispose of any securities etc.

## **Development of the capital market**

There are several provisions in the Act that will contribute towards the development of the market. The use of state of the art infrastructure such as the much needed Central Counterparty (CCP) has been recognised which will greatly minimise central counterparty risk and also enable the introduction of new products. The new law spells out the requisites for investing in derivatives (such as futures and options irrespective of the nature of the underlying asset), stock borrowing and lending, regulated short selling etc. This will enhance the liquidity levels in the market and take away the one sided potential that is presently available and help create a vibrant market. Long term investors will benefit from these opportunities.

The trading of unlisted securities is facilitated through a platform operated by a recognised market operator thus providing an additional trading platform. The ability for ‘market makers’ to operate as a market intermediary will ensure continued and efficient exchange of securities between buyers and sellers. This will provide depth to the market and also encourage the setting up of funds such as exchange traded funds.

Furthermore, the new law has redefined ‘securities’ to include an array of securities in keeping with new developments across the world. Similarly, there is also provision for ‘Collective Investment Schemes’ which go beyond Unit Trusts. As to what would come under this umbrella has been defined. These will provide new investment opportunities.

In line with expanding the product range that is currently available in the market, a category of persons have been recognised as ‘accredited investors’. Not only will this result in the protection of non-sophisticated investors, but will facilitate the issue of high risk instruments to the market which could be utilised by those who are in a position to take higher risks.

Provisions for the protection of whistle-blowers have been included with the expectation that it will facilitate the curbing of market malpractices. Whilst it is important to ensure that this protection is not abused by making frivolous claims, the benefits such a system can bring forth should not be discounted.

## **Checks and balances on powers and discretion of the Commission**

The Commission has been vested with wider powers and discretion under the Act in order to ensure that it can perform its functions as a regulator in a more meaningful and effective manner. However it must be borne in mind that the Commission does not enjoy immunity and like any

other public authority that has been vested with power and discretion, has to exercise such power and discretion according to law and will have to in all instances follow the rules of natural justice. It is relevant to note that the power and discretion vested in the Commission is circumscribed by several checks and balances that will ensure that the Commission will be held accountable and will not under any circumstance exceed its authority.

They take the form of provisions which mandates the commission to hear a party before it takes a decision against such party, affords a party a right of appeal, requires the Commission to give reasons for certain decisions as well as those that require the Commission to obtain orders from court and where the court is expected to afford a hearing to the affected party before making an order.

Further, the common law remedy of being able to challenge a decision of the Commission by way of a writ application in the Court of Appeal has been re-iterated in the Act thus statutorily fortifying the rights of an aggrieved party.

### **Conclusion**

It is expected that the progressive provisions of the Act will make sure that all market participants have the confidence and the necessary environment to engage in their activities which is the ultimate goal of a capital market. The Commission as the regulator of the market at all times will be aware of the perils of over regulation and therefore be committed to striking the right balance. At the same time it must be emphasised that if all market participants practice self-regulation and act within the confines of the law, there will be no necessity for most of the provisions contained in the law to be made use of.