

A BRIEF OVERVIEW OF THE NEW SECURITIES AND EXCHANGE COMMISSION ACT

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The new Securities and Exchange Commission Act No. 19 of 2021 ('the Act') has been certified by the Speaker on 21st September 2021 and has thus become law. It repeals and replaces the Securities and Exchange Commission Act No. 36 of 1987¹.

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 finalizing the Act, whilst retaining the core provisions found in the previous versions, the present Commission has made every attempt 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 Act comprises of 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 Depository², the requirements that have to be fulfilled if a license is to be obtained³, when a license may be cancelled⁴ and the right of recourse if a license is cancelled⁵, the effect of the Rules of these market institutions⁶, appointment of directors⁷, duties of an auditor⁸ etc.

An important feature is that a licensed Exchange can list its securities on its own Exchange⁹. There is recognition of a Clearing House acting as a Central Counter Party (CCP) and a CCP has been defined¹⁰. 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

² The duties of an exchange, a clearing house and a central depository have been set out in §27, §37 and §56 respectively.

³ §25, 34 and 54 prohibit the establishment of an exchange, a clearing house or a central depository without a license, while §26, §36 and §55 deal with the manner in which a license ought to be obtained.

⁴ Grounds to be found in §28, §39 and §57.

⁵ A right of appeal is available to the Minister. See §28 (8), §40 and §57 (8).

⁶ See §64

⁷ See §68

⁸ See §74

⁹ As per §31, a listing is possible with the approval of the Commission and the Ministry of Finance.

¹⁰ The definition can be found in §32.

¹ See §187 - Repeals, savings and transitional provisions.

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regarding unsettled market contracts¹¹. 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'¹². 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 renewed¹³, grounds on which a license may be refused, suspended or cancelled¹⁴, trading in securities by market intermediaries¹⁵, duty of an auditor¹⁶ 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'¹⁷. They require that market intermediaries disclose certain interests they have in securities¹⁸, establish and maintain certain internal procedures and

processes¹⁹ and conform to business conduct that the Commission may spell out by way of rules²⁰. These are meant to minimize 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'²¹. The Act has also recognized 'Supplementary Service Providers'²² such as actuaries, custodians, trustees and valuers on whom the Commission may exercise supervision in the future thereby fortifying public confidence²³.

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'²⁴.

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 companies²⁵. 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 directives²⁶. 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 out²⁷. 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 Commission²⁸. Another new feature is that Auditors of listed companies²⁹, market institutions³⁰ and market intermediaries³¹ have been obligated to report certain irregularities

11 See § 32 for definition of 'default proceedings', 'default rules' and 'defaulter', § 42 which spells out what default rules are and §43 to 46 with regard to default proceedings.

12 See §188 which defines as to who 'market intermediaries' are as well as individual definitions of those who belong to that category.

13 See § 94 (1), §101 (1), and §101 (2) and (3) which deal with the renewal of such a license.

14 See § 95 for grounds for refusal and renewal and §105 for cancellation or suspension.

15 See § 106

16 See §108

17 See § 109 – 115 in Chapter 3 titled 'Protection of Clients' Assets' of Part III.

18 See § 113

19 See § 114

20 See § 111

21 See § 97

22 See § 188 for definition.

23 See § 169. They do not have to be licensed or registered by the Commission, but the Commission may call for information from them and request them to take corrective action in certain instances.

24 See § 80

25 See § 85

26 See § 86

27 See § 68

28 See § 89 (2)

29 See § 90

30 See § 74

31 See § 108

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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 finalized, 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'³², 'stock market manipulations'³³, 'making false or misleading statements'³⁴, 'fraudulently inducing persons to deal in securities'³⁵ and 'use of manipulative and deceptive devices'³⁶.

The most significant introduction to this category of offences which is commonly known as market manipulation are the two offences found 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 precision³⁷. As to when a person is considered to be an 'insider' has been clearly defined³⁸ and what exactly such person is prohibited from doing has been spelt out with certainty³⁹. In addition, as to what would amount to information⁴⁰, when such information is generally available⁴¹, what would be information which has a material effect on price or value of securities⁴², when will a person be considered to have procured another⁴³, when information is deemed to be in possession⁴⁴ as well as specific exceptions⁴⁵ and defenses available in respect of a charge of insider trading⁴⁶ 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 Court⁴⁷ 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 imprisonment⁴⁸.

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 Act⁴⁹ (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 General⁵⁰. 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.

32 See §128

33 See §129

34 See §130

35 See § 131

36 See § 132

37 See Chapter 2 of Part V § 133 to §146

38 See §137 (1)

39 See § 137 (2) and (3) which constitute the offence of 'insider trading'.

40 See § 133

41 See § 134

42 See § 135

43 See § 136

44 See § 138 and § 139

45 See § 140, § 141, §142, §143, §144 and §145

46 See § 146

47 As per § 148 (Jurisdiction of the courts) "every offence committed under this Part shall be triable upon indictment by the High Court".

48 See § 147

49 See § 12 of the Code of Criminal Procedure Act No. 15 of 1979

50 See § 149

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The offences other than what is contained in Part V are triable in the Magistrate's Court⁵¹.

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 jurisdiction⁵² which is commonly referred to as the Commercial High Court in order to recover damages and to seek the imposition of a civil penalty⁵³. The Act has specifically conferred this jurisdiction on the Commercial High Court⁵⁴. 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'⁵⁵. 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 contravention⁵⁶. How damages so recovered will be distributed has also been stated⁵⁷.

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 V⁵⁸. 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 offence⁵⁹.

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, non compliance 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 etc⁶⁰.

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 investors⁶¹, issue directives during the course of conducting investigations or inquiry known as 'freezing orders'⁶² (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 orders⁶³ 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 recognized which will greatly minimize central counterparty risk and also enable the introduction of new products. The new law spells out the requisites for investing in derivatives⁶⁴ (such as futures and options irrespective of the nature of the underlying asset), stock borrowing and lending, regulated short selling⁶⁵ 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 platform⁶⁶ operated by a recognized market operator thus providing an additional trading platform. The ability for 'market makers'⁶⁷ 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 world⁶⁸. Similarly, there is also provision for 'Collective Investment Schemes'⁶⁹ which

64 See definition in § 188 and also § 183 (1) (p) where rules can be made by the Commission in this regard and also §184 where a derivative contract is not to be construed as a gaming or wagering contract.

65 See § 183 (1) (q) where the Commission is permitted to make rules in this regard.

66 See Part IV and definition in § 188 where a 'market operator' registered by the Commission can operate a platform for the sale and purchase of unlisted securities in Sri Lanka.

67 The role of a 'market maker' is described in the definition found in § 188. See also § 185.

68 See § 188 for the definition of 'Securities'.

69 See § 188 for the definition of 'Collective Investment Schemes'.

51 See § 175 (3)

52 See the definition of 'court' found in § 188.

Accordingly, wherever a reference is made to 'court' in the Act, it will be a reference to the Commercial High Court.

53 See § 152 (1) and (2)

54 See § 152 (3) which in addition spells out the manner of institution of proceedings and states that the procedure spelt out in the Civil Procedure Code will become applicable to such proceedings.

55 See § 152 (1)

56 See § 152 (2)

57 See § 152 (5)

58 See § 152 (4)

59 See § 177

60 See § 178

61 See § 179

62 See § 167. These orders can be made during the course of an inquiry or investigation in order to make sure that the purpose of the investigation will not be made meaningless.

63 See § 180

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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 has been recognized as 'accredited investors'⁷⁰. 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 utilized by those who are in a position to take higher risks.

Provisions for the protection of whistleblowers⁷¹ 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 party⁷², affords a party a right of appeal⁷³, requires the Commission to give reasons for certain decisions⁷⁴ as well as those that require the Commission to obtain orders from court⁷⁵ and where the court is expected to afford a hearing to the affected party before making an order⁷⁶.

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 reiterated in the Act⁷⁷ 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 emphasized 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.



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⁷⁰ See § 188 where a detailed definition has been given as to who would come under this category.

⁷¹ See § 172 and the definition found in § 188.

⁷² § 28 (7), § 39 (6), § 57 (7) provide market institutions with an opportunity to be heard prior to the cancellation of a license. Also see § 105 (2), § 95(2) and § 179 (2) for instances where market intermediaries are given opportunities to be heard and § 178 (2) where the Commission cannot impose administrative sanctions without providing the party an opportunity to be heard.

⁷³ See §28 (8), § 40 (1), § 57 (8), § 67 (4) and 178 (6) for instances where a party is granted a right of appeal.

⁷⁴ See § 178 (1) where the Commission should have regard to the nature and manner of the contravention and its impact on the market and then impose a penalty in proportion to the severity or gravity of the contravention.

⁷⁵ See § 180 (1)

⁷⁶ See § 167 (3), § 180 (3) and § 180 (9)

⁷⁷ See § 186