



# SRI LANKA

## TECHNICAL ASSISTANCE REPORT—ENHANCING THE EFFECTIVENESS OF THE SRI LANKAN SECURITIES MARKET ENFORCEMENT PROGRAM

May 2019

This Technical Assistance report on Sri Lanka was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on October 2017.

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
PO Box 92780 • Washington, D.C. 20090  
Telephone: (202) 623-7430 • Fax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) Web: <http://www.imf.org>  
Price: \$18.00 per printed copy

**International Monetary Fund**  
**Washington, D.C.**

**INTERNATIONAL MONETARY FUND**

Monetary and Capital Markets Department



**SRI LANKA**

**ENHANCING THE EFFECTIVENESS OF THE SRI LANKAN  
SECURITIES MARKET ENFORCEMENT PROGRAM**

**Phyllis Cela and Matthew Britton (MCM Experts)**

**April 2018**

The contents of this report constitute technical advice provided by the staff of the International Monetary Fund (IMF) to the SEC of Sri Lanka (the "TA recipient") in response to their request for technical assistance. This report (in whole or in part) or summaries thereof may be disclosed by the IMF to IMF Executive Directors and members of their staff, as well as to other agencies or instrumentalities of the TA recipient, and upon their request, to World Bank staff and other technical assistance providers and donors with legitimate interest, unless the TA recipient specifically objects to such disclosure (see Operational Guidelines for the Dissemination of Technical Assistance Information—

<http://www.imf.org/external/np/pp/eng/2013/061013.pdf>).

Disclosure of this report (in whole or in part) or summaries thereof to parties outside the IMF other than agencies or instrumentalities of the TA recipient, World Bank staff, other technical assistance providers and donors with legitimate interest shall require the explicit consent of the TA recipient and the IMF's Monetary and Capital Markets Department.

Contents	Page
Glossary .....	4
Preface.....	5
Executive Summary .....	6
I. Background.....	9
II. Findings.....	11
A. SEC Enforcement Program Structure .....	11
B. SEC Investigation Process .....	11
C. SEC Initiatives to Address Recommendations of the World Bank FSAP and IOSCO RT ...	12
III. Recommendation .....	13
A. Streamline the Enforcement Program.....	13
B. Adaptation of Criteria for Prioritizing Investigations/Cases.....	14
C. Accountability Management System .....	14
D. Publication of the Results of Enforcement Actions, Policies, and Procedures.....	16
E. Metrics to Measure the Effectiveness/Credible Deterrence of the Enforcement Program ....	16
Table	
1. Summary of Key Recommendations .....	8
Figure	
1. Surveillance, Investigations, and Enforcement Process Flowchart .....	12
Box	
1. Summary of IOSCO Findings.....	10
Appendix	
I. Improvements Made in the Last Two Years based on the World Bank FSAP and IOSCO RT ....	18

**GLOSSARY**

CD Report	IOSCO's Paper: "Credible Deterrence in the Enforcement of Securities Regulation"
CSE	Colombo Stock Exchange
FSAP	Financial Sector Assessment Program
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MCM	Monetary and Capital Markets Department
MMoU	Multilateral Memorandum of Understanding
MSCI	Morgan Stanley Capital International
IOSCO RT	IOSCO Review Team
SEA	Draft Securities Exchange Act
SEC	Sri Lanka Securities and Exchange Commission
SEC Act	Sri Lanka Securities and Exchange Commission Act

**PREFACE**

At the request of the Democratic Socialist Republic of Sri Lanka's Securities and Exchange Commission (SEC), a Monetary and Capital Markets (MCM) mission visited Colombo during October 3–10, 2017 to assist the SEC in enhancing the effectiveness of its enforcement program. The mission comprised Ms. Phyllis Cela and Mr. Matthew Britton (MCM experts). MCM staff (Nobuyasu Sugimoto, Financial Supervision and Regulation Division) provided supervision of the mission work.

The mission met with the SEC Chairman, the Director General, relevant Division Directors and staff, members of the Attorney General's Department staff, members of the Colombo Stock Exchange staff, and a member of the legal fraternity. The mission wishes to express its appreciation to the management and staff of the SEC for their gracious hospitality, cooperation and assistance.

## EXECUTIVE SUMMARY

**After three decades of civil war and political instability that ended in 2009, Sri Lanka has embarked on a program of reform intended to enable the country to emerge as an internationally competitive middle level economy.** In the last couple of years, the SEC has undergone multiple assessments against international standards which have contributed to the design of its financial sector reform program. In 2015, The World Bank Market Development Financial Sector Assessment Program (FSAP) highlighted the challenges facing Sri Lanka and recommended modernization reforms. In July 2016, an IOSCO Review Team (RT) assessed the SEC against IOSCO’s Objectives and Principles and made detailed recommendations for amendments to the SEC Act, including for the enforcement program.

**To complement the work done by the World Bank FSAP and the IOSCO RT, the mission focused on the SEC’s enforcement program organization, operations and investigation processes and training.** The mission also reviewed selected, anonymized investigation files. The mission generally used as a framework the work of the IOSCO RT and the seven factors identified in IOSCO’s June 2015 paper entitled “Credible Deterrence in the Enforcement of Securities Regulation” (CD report).<sup>1</sup>

**The mission concentrated on practical, operational steps that the SEC could take to build capacity to increase the deterrent impact of its enforcement program in the current and anticipated regulatory environments.**<sup>2</sup> The mission noted that the SEC, under the current leadership, has taken significant steps in the last two years to address the enforcement program deficiencies identified by the World Bank FSAP and IOSCO RT.

**The SEC’s recent enforcement reform include several initiatives.** These include: increasing the number of investigation staff from 2 in 2015 to 10 in 2017; selecting new staff with diverse professional backgrounds, including accounting, law and supervision; streamlining the process for opening investigations; enhancing accountability by instituting the practice of creating detailed investigation plans; creating an electronic filing system accessible only by investigation staff to house investigation and resource files; entering into a consultation arrangement with the Attorney General’s office for the services of dedicated counsel who provide advice as

---

<sup>1</sup> The seven factors discussed in the CD report are: **Factor 1:** Legal certainty: Certain and predictable consequences for misconduct; **Factor 2:** Detecting misconduct: Being well connected and getting the right information; **Factor 3:** Co-operation and collaboration: Eliminating safe havens by working together; **Factor 4:** Investigation and prosecution of misconduct: Bold and resolute enforcement; **Factor 5:** Sanctions: Strong punishments - no profit from misconduct; **Factor 6:** Public messaging: Promoting public understanding and transparency; and **Factor 7:** Regulatory governance: Good governance delivering better enforcement.

<sup>2</sup> The SEC and government of Sri Lanka have been vetting a draft Securities Exchange Act (SEA). The draft SEA would expand the SEC’s jurisdiction to cover more participants in the securities market and provide the SEC significant new enforcement tools, including expanded administrative and civil remedies. While there is no date certain for Parliament to consider the draft SEC Act, the mission is informed that it is possible that it will be enacted by the end of calendar year 2017. The recommendations in this report are applicable in the current regulatory regime and could accommodate the new powers provided in the draft SEA.

appropriate, evaluating investigation files for criminal prosecution and advising enforcement staff; and formalizing criteria for CSE surveillance referrals.

**The mission recommended that the SEC continues to pursue measures to improve efficiency, effectiveness and accountability.** These include: streamlining enforcement related processes to facilitate timely and efficient investigations and prosecutions; adopting criteria for prioritizing investigations and cases and publishing such criteria, where appropriate, to instill public confidence in fair and orderly markets; adopting an accountability mapping system (*i.e.*, program management tools) to track investigation plans and human and financial resource allocation; establishing expert units and/or identifying individual experts to handle specific types of complex investigations and cases (e.g., insider dealing and manipulation); developing staff training modules on these complex matters; and enhancing the enforcement policies and procedures manual to create a detailed, organic and electronic roadmap readily accessible by enforcement staff to guide the conduct of investigations and prosecutions.

**To augment the impact of the enforcement program, the SEC is encouraged to foster public transparency to the extent possible without compromising confidential enforcement processes and activities.** The SEC could usefully inform the industry of its enforcement policies and processes and publicize the results of its enforcement actions.

**The SEC is also encouraged to evaluate the credible deterrence of its enforcement program on an ongoing basis.** Key to credible deterrence is ensuring that the enforcement program is sufficiently robust and flexible to address evolving market misconduct in a timely and dissuasive manner. The SEC should routinely assess its program against emerging market trends and make adjustments as circumstances warrant.

**While the recommendations in this report will improve the effectiveness of the SEC's enforcement program, credible deterrence cannot be achieved without the new civil and administrative enforcement authority in the draft Securities Exchange Act (SEA).** The current law effectively limits the SEC to make criminal referrals to the Attorney General to prosecute market misconduct. The criminal standard of proof and reliance on the limited resources of the Attorney General have severely limited the SEC's flexibility to take timely and dissuasive enforcement action and contributed to undermining the public's confidence in the regulator and the market.

**Enhanced enforcement powers alone will not suffice to achieve credible deterrence unless the SEC is able to build capacity to administer the new authority.** This will require a multi-pronged approach, including, at a minimum, adopting criteria for applying the new enforcement tools, recruiting an experienced director to oversee a robust, independent and fair enforcement program, and hiring and training capable, professional staff to investigate and prosecute administrative and civil cases. Presently, the investigation files mostly concern cases of trading misconduct. That is likely to change with the new authority under the SEA and with increased public participation in the securities market. Business conduct breaches by market intermediaries, including both front office and back office violations, will present additional challenges for enforcement and supervision staff and require specialized training.



**Table 1. Summary of Key Recommendations**

<b>Responsible Authority</b>	<b>Recommended Action</b>	<b>Timeframe</b>
SEC	Streamline enforcement related processes to facilitate timely and efficient investigations and prosecutions.	Within 2 years
SEC	Adopt criteria for prioritizing investigations/cases.	Immediate
SEC	Design and implement an accountability management system to track investigation plans/timelines and allocation of human and financial resources.	Immediate
SEC	Identify and train experts on staff to handle particular types of complex investigations and cases. When resources permit, establish expert units to handle different types of complex investigations and cases.	Immediate/ongoing
SEC	Enhance the policies and procedures manual to make it an operations road map accessible electronically by enforcement staff. The manual should be a living document to take account of changes in law, policy and investigative techniques.	Immediate/ongoing
SEC	Publish the results of enforcement actions and enforcement policies and procedures, provided publication will not compromise confidential law enforcement techniques.	Immediate/ongoing
SEC	Design and employ metrics to measure the effectiveness/credible deterrence of the enforcement program.	Immediate/ongoing

## I. Background

1. **Established in 1987, the SEC is an independent regulatory body in charge of the regulation and supervision of the securities market in Sri Lanka.** Sri Lanka has experienced significant post-war growth that Sri Lankan authorities recognize will only be sustained with equally significant structural reforms. The development of deep and liquid capital markets is a priority in this reform program.
2. **In 2016, the SEC adopted its Capital Market Strategy 2020 “to enhance regulatory strength and readiness and effectively deliver governance, enforcement and compliance.”** Over the medium to long term, reforms proposed as part of the Capital Market Strategy 2020 are intended to qualify Sri Lanka to be reclassified from a Morgan Stanley Capital International (MSCI) Frontier Market to an MSCI Emerging Market.
3. **The SEC Act is in the process of being replaced with more comprehensive governing legislations.** A consultation draft was circulated for public consideration in 2017. The new law includes enhancement of the regulatory framework such as the strengthening of the governance standards of the SEC, providing for the establishment of a clearing house acting as a central counterparty (CCP), regulating demutualized exchanges, recognizing new categories of market intermediaries, introducing a wide range of enforcement tools to deal with market misconduct, enhancing the accountability of all capital market participants, and encouraging early reporting to the SEC on possible market malpractice through provisions for whistleblower protection.
4. **The Capital Market Strategy 2016–2020 was formulated by the SEC as a blueprint for regulatory and developmental measures to be adopted in the medium-term.** The Regulatory and Governance Strategies aim to: strengthen the regulatory and governance environment, increase accountability and market oversight, raise the standards and competencies of capital market participants, and manage and mitigate systemic risk. The Capital Market Strategy seeks to: introduce an effective deterrence mechanism for curbing capital market misconduct; promptly investigate market offences; ensure the responsiveness of the SEC in carrying out its objectives in an effective, efficient and timely manner; build the competencies of the regulator by having measures in place to recruit and retain a proficient workforce with unquestionable integrity, appropriate technical knowledge, and demonstrable professionalism.
5. **The IOSCO RT assessment was an initiative of the Capital Market Strategy.** The IOSCO RT noted that the key to building deep and liquid capital markets is building investor trust and confidence in those markets. The World Economic Forum’s Global Competitiveness Report for 2015–16 ranked Sri Lanka 51st with respect to financial market development based on a series of parameters that addressed efficiency, trustworthiness, and confidence in its financial markets, compared with Malaysia (ranked 9th) and Thailand (ranked 39th).
6. **The IOSCO RT<sup>3</sup> had several findings and made recommendations on the SEC’s enforcement program that were relevant to the mission’s findings and recommendations.** These are related to: 1) enforcement results and process, 2) staff training and development, and 3) transparency (Box 1).

---

<sup>3</sup> Many of the findings and recommendations of the IOSCO RT echo the work of the World Bank FSAP in 2015.

### **Box 1. Summary of IOSCO Findings**

#### **Enforcement results and processes**

- Although market misconduct is prohibited by law in Sri Lanka and there are systems in place to identify, investigate and prosecute it, the overall market misconduct framework is insufficiently dissuasive.
- While the supervisory framework has identified suspicious trading and compliance weaknesses, there is little evidence that these findings have led to timely enforcement outcomes, or to prompt changes in firm behavior.
- Even where investigations have been undertaken, there have been limited enforcement outcomes. There have been very few criminal prosecutions brought, a small number of administrative actions (including license suspensions or removal of the certification of relevant individuals to deal with clients) and a number of cautions and warnings.
- Slow prosecution processes—including decisions by the Attorney General’s Department on referrals from the SEC and slow Court processes—contribute to an environment in which acting promptly and decisively is challenging. The relatively greater use of warnings, cautions and “compounding” supports the perception of the enforcement regime lacking credibility. “Compounding” (under SEC ACT s. 51A) involves the Commission imposing a penalty of 0.3 of the maximum for an offence, with the entity not being required to make an admission of guilt. “Compounding” is available for all offences under the SEC Act.

#### **Staff Training and Development**

- The SEC lacks consistency in the expertise and experience of staff at the senior management level in certain critical areas which are necessary to deliver on its core responsibilities. This has meant that talented middle level staff members lack the direction, mentoring and guidance needed to build a strong and effective cadre of regulatory professionals. These resourcing issues at senior management level also mean that the Director General, and at times the Commission, play a greater role in operational decision making, limiting the time available to them to provide strategic direction to the SEC and to monitor its progress.
- Scope remains to improve the level of understanding by staff of the entities regulated. There is a need to develop staff in these areas.
- A training strategy targeted at tailored development of high potential staff should be developed. Training across the organization should focus on improving staff understanding of the businesses they regulate.
- Consideration should be given to developing a talent management strategy which targets high potential staff and supports them with tailored training and development opportunities.

#### **Transparency**

- The SEC should develop and publish written guidance about how it interprets its authority, make greater use of policy guidance in key areas, and consider formalizing more granular guidance regarding the application and exercise of its powers under the SEC Act.
- Guidance should also be provided on its internal review procedures. These measures would provide a basis for ensuring greater consistency in decision making and confidence in that consistency.
- Once the proposed amendments to the SEC Act are approved, the SEC should develop, publish and implement a comprehensive enforcement policy setting out its approach to using the enforcement tools available to it.
- The enforcement policy should present the conditions on which administrative, civil and criminal powers are used and the approach to applying fines and other penalties.

## II. Findings

### A. SEC Enforcement Program Structure

**7. The SEC is organized into operating divisions, all reporting to the Director General who is accountable to a 10-member Commission.** The divisions most directly engaged in enforcement program activities are: Surveillance, Investigations and the new Litigation Division (whose functions were previously handled by the Legal and Enforcement Division).

**8. At present, the position of Director of Investigations is vacant, and the Director of Surveillance is also overseeing the External Affairs Division.** The SEC is actively recruiting to fill the open director positions, but there is a very limited pool of candidates in Sri Lanka qualified for these highly-specialized leadership roles.

### B. SEC Investigation Process

**9. SEC investigations are commenced based on a variety of sources of information, including internal market surveillance, referrals from the CSE and other governmental bodies, tips and complaints from the public and SEC review of media reports.** Information related to market misconduct is directed to the Surveillance Division for preliminary review.

**10. Trading misconduct matters that the Surveillance Division believes warrant investigation are then referred to the Surveillance and Investigations Committee to determine whether an investigation or inquiry should be conducted by the Investigations Division.** The Committee consists of the Director General, who heads the Committee and the Supervision Director. The Surveillance Director convenes the meetings and attends, along with the Investigations Director. The Director General can invite any other Director to participate in deliberations. The Supervision Director participates in the committee by discussing recommendations and reaching consensus with the Director General on whether to forward matters to the Investigations Division for investigation or inquiry. Decisions to open an investigation are made on the basis of a range of factors, including the impact on the market of the relevant activity, profit/loss resulting from the trading and the extent of the moral turpitude of the perpetrators. The criteria are not contained in a formal Commission policy and have not been disclosed to the public.

**11. Matters that the Surveillance and Investigations Committee determines warrant investigation are forwarded to the Investigations Division with notice to the Commission.** The Investigations Division cannot open a matter without authorization by the Committee.

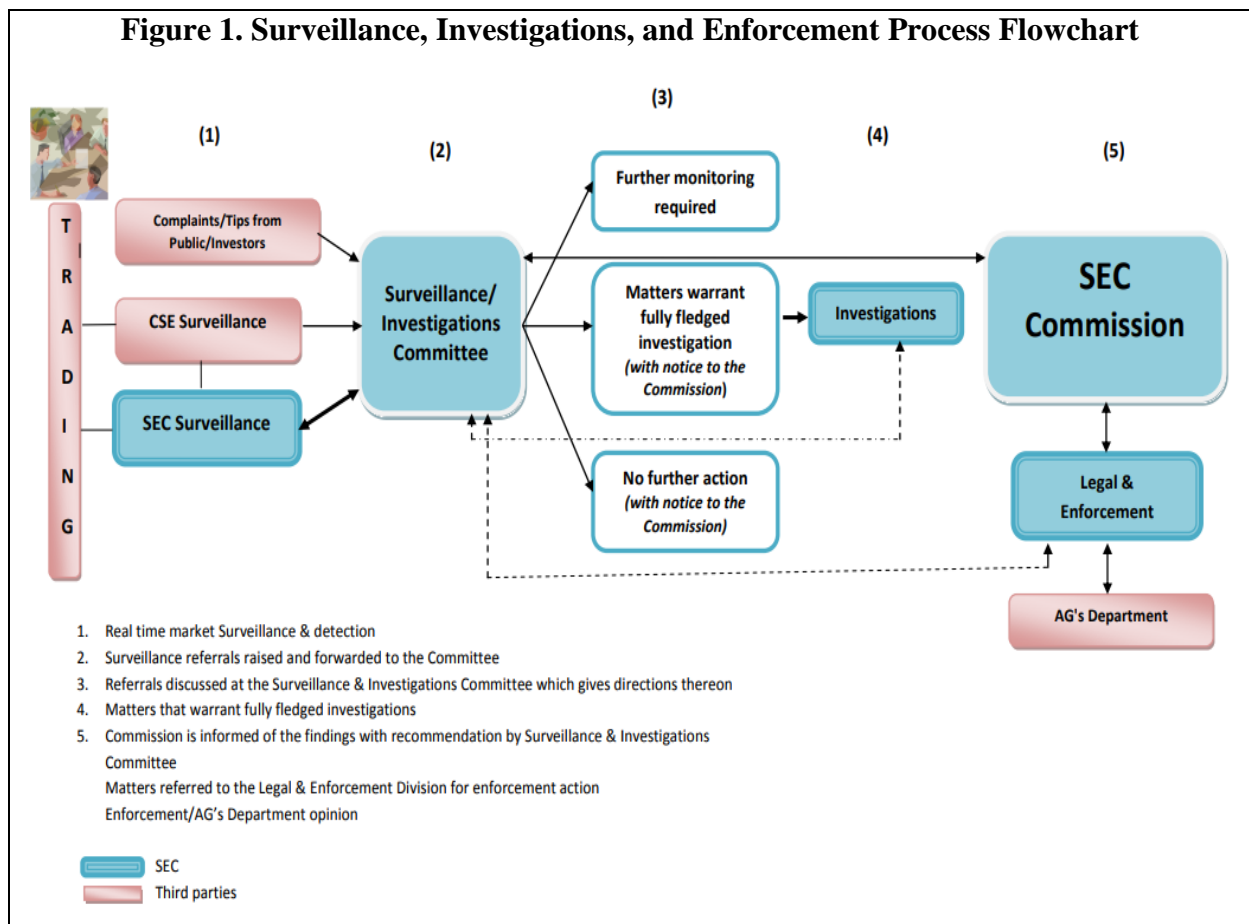
**12. Upon completion of an investigation, the Investigations Division prepares a report of its findings and recommendations and sends it back to the Surveillance and Investigations Committee for consideration.** The Committee then decides whether to accept, reject or modify the recommendations of the Division (e.g., to take enforcement action or close the matter), or send the matter back to the Division for further investigation.

**13. Decisions of the Surveillance and Investigations Committee are then sent to the Commission for consideration.** The Commission can accept or reject Committee recommendations for enforcement and further actions and issue any instruction related to the

matter, including closing the matter, referring certain aspects of the investigation to other agencies, directing further investigation, or directing the Secretariat to take any other enforcement action not recommended by the Surveillance & Investigations Committee. Matters that result in enforcement action are forwarded with Commission instructions to the Litigation Division.

**14. In the case of criminal enforcement action, the Litigation Division prepares the case for submission to the Attorney General for criminal prosecution.** Enforcement action under the SEC Act and rules is effectively limited to criminal prosecution, except for certain administrative actions involving regulated entities.<sup>4</sup>

**15. The following flowchart describes the enforcement process for trading-related misconduct cases.** Such cases make up the entire docket of the Investigations Division.



**C. SEC Initiatives to Address Recommendations of the World Bank FSAP and IOSCO RT**

**16. The SEC has taken significant steps in the last two years to address the enforcement program deficiencies identified by the World Bank FSAP and IOSCO RT.** Several of these initiatives are still in the process of being implemented. The initiatives taken include:

<sup>4</sup> The SEA would significantly expand the enforcement remedies to include administrative and civil enforcement actions and increased fines.

1) increasing the number of staff, 2) reorganizing the Investigations Division by bringing in a team of multi-disciplinary professionals, 3) streamlining the process for opening investigations, 4) developing electronic investigation and research files accessible by all investigation staff, 5) entering into a formal consultation arrangement with the Attorney General's Department to expedite the selection and completion of investigations that are ready for criminal prosecution, 6) recruiting a class of management trainees and 7) creating a new Litigation Division able to focus on litigation management functions. Refer to Appendix I for more detail.

**17. Despite these initiatives, the SEC still has not taken any significant enforcement action.** The mission has been advised by the staff that they have made substantial progress in completing several significant investigations that will be sent to the Commission for enforcement action in the near term. The Attorney General's representatives who have been working with the Investigations Division staff have confirmed this information. If the Commission is able to bring several high-profile criminal actions soon, this should have a positive impact on the public's confidence in the SEC as a regulator. The CSE similarly observed that it is imperative that the SEC bring enforcement actions for there to be credible deterrence in the securities market.

### III. Recommendation

**18. While the mission has been impressed by the initiatives taken thus far to improve the efficiency and effectiveness of the enforcement program, additional steps should be taken to continue the progress.** These recommendations will be particularly important once the SEA is in force granting the SEC significant new enforcement authority.

#### A. Streamline the Enforcement Program

**19. The SEC should streamline the Enforcement program to make the investigation-prosecution processes more efficient.** As the enforcement program matures and the SEC's enforcement authority expands under the SEA, the mission recommended that the investigation-prosecution decision making process be streamlined. Consideration should also be given to combining the investigation and prosecution functions into a single Enforcement Division.

**20. Under current operating procedures, investigations cannot be commenced without the authorization of the Surveillance and Investigations Committee.** That requires staff to spend time preparing written materials for the deliberations and recording the disposition by the Committee. The process also takes up the valuable time and attention of the Director General, time which could be better spent designing and implementing the strategic plans of the Commission. The mission understands that the investigation team is new and there is no Investigations Division Director in place at this time. Eventually, however, it will be appropriate for the SEC to consider the costs and benefits of the committee process to determine whether, all things considered, it should continue to make the "go/no go" decisions on opening investigations. Over the next couple of years once a new Investigations Director is in place and the investigations staff establishes a track record of timely and effective enforcement, the SEC should re-visit the process.

**21. The Committee also plays a dispositive role in the decision to recommend enforcement actions.** Perhaps in the future, the Committee could perform more of a consultation function, only providing advice on the merits of taking enforcement action, and leaving the

responsibility for making enforcement recommendations to the Investigations Division. The goal should be to establish an independent enforcement program free of conflicts of interest and shielded from undue political influences. A professional and effective enforcement program should be empowered to assess, on its own (and in consultation with other operating divisions, as appropriate), the merits of the referrals it receives from the other divisions and the public, consistent with the enforcement priorities established together with the Director General and the Commission. Over time, the Director General should be able to step back into more of an oversight role, freeing him to focus on overall regulatory policy development and implementation.

**22. It is typical of other mature enforcement programs that the investigation and prosecution functions operate out of a single division and are subject to the same supervisory structure.** Such organizational streamlining facilitates the ability to apply consistent approaches across cases and within a single case from investigation through prosecution, provides flexibility to deploy resources quickly to respond to emerging enforcement challenges, and centralizes accountability for achieving a credible enforcement program.

### **B. Adaptation of Criteria for Prioritizing Investigations/Cases**

**23. The SEC should adopt criteria for prioritizing investigations/cases.** This could be made by establishing a framework for evaluating investigations to ensure that its resources are spent on the matters that will have the greatest impact on market behavior. Such criteria appear to be in use on an informal basis by the Surveillance and Investigation Committee, but should be formalized and published to provide transparency to the process and instill public confidence in the regulator. The mission was informed by Surveillance staff that the criteria they consider include the market impact of misconduct, the extent of profits and losses, moral turpitude and recidivist behavior.

**24. To restore its reputation, the SEC has determined to re-investigate some suspicious trading activities that took place in 2010–11, a notorious period of high volatility.** At the moment, the investigation team has prioritized several re-opened matters involving trading activity in 2010–11, which was a highly volatile period for the CSE. These matters had been prematurely closed without thorough investigation. The SEC has suffered reputational harm as a result because the public had expected the SEC to take action to address apparent trading irregularities by certain high-profile market participants. The SEC has determined that it is key to regaining public confidence for it to take another look at these matters.

**25. Under the SEA, the SEC will have significantly greater enforcement authority leading to a larger docket of investigations and prosecutions.** Prioritizing those matters will be critical to enabling the enforcement program to achieve maximum deterrent impact.

### **C. Accountability Management System**

**26. The SEC should employ an accountability management system to track investigation plans/timelines and allocation of human and financial resources.** Accountability mapping goes hand in hand with prioritizing case selection. The Investigations Division has already begun to employ investigation plans and adjust such plans as circumstances warrant. The SEC should take such planning to the next level by adopting a formal time and

resource management system which would provide the SEC with the record basis to evaluate the deployment of its limited resources. The SEC has been criticized in the past because investigations have not been thorough, have taken too long to complete and rarely resulted in enforcement action. Accountability mapping would enable the SEC to evaluate the productivity of investigation teams to determine whether they are operating efficiently. Project management software programs are available off the shelf. Such a system would provide management with a dashboard on how its human and financial resources are being deployed.

**27. Enforcement needs to identify and train experts on staff to handle particular types of complex investigations and cases.** When resources permit, enforcement should establish expert investigation and prosecution units. The recent reorganization of the Investigations Division brought together a team of talented professionals with diverse expertise, but no experience in handling investigations. The team has been learning on the job to develop the skills and knowledge needed to perform in their new roles. The SEC has relied principally on training opportunities offered by other securities regulators around the world. The new investigations team can play an important role in bringing some of that training in-house and leading expert teams in handling complex market misconduct cases. Expert teams will enhance the SEC's ability to move quickly to handle complex matters. When the SEA is proclaimed, there will be a greater need for subject matter experts to investigate cases promptly. As the enactment of the new statute nears, the SEC should also begin to recruit litigators with sufficient litigation and capital markets knowledge who can litigate enforcement cases using the new administrative and civil proceedings. This development will release enforcement from its dependence on the overburdened staff of the Attorney General's Department for the promotion of its cases in a back-logged criminal justice system ill-equipped to efficiently hear capital markets cases.

**28. Enforcement should enhance the policies and procedures manual to make it an operations road map accessible electronically by enforcement staff.** The manual should be a living document to take account of changes in the law, policy and investigative techniques. The enforcement manual should be a practical, step by step primer on how to conduct particular investigations and prosecutions. It should include available precedents of the documents staff need to use in the investigative and prosecutorial process. These materials should be all available online and should be supplemented as staff carry out different procedures under the new legislation. A detailed Enforcement manual is an effective tool in educating new hires in Enforcement.

**29. The existing investigations manual is more like a guide to the internal SEC enforcement processes,<sup>5</sup> rather than an instruction manual on how to conduct an enforcement investigation under the SEC Act.** The mission annotated the existing manual to identify the kinds of information that would assist enforcement staff in carrying out investigations (see Appendix II). Such information is typically included in manuals of other mature securities regulators around the world. The annotated manual is attached as Appendix II to this report and was provided to the SEC during the mission. There are several examples of such manuals available on the internet. The U.S. SEC manual, for example, is available on the U.S. SEC website. The new investigations team has done a good job of pulling together some of

---

<sup>5</sup> The investigations manual should be updated, at a minimum, to reflect some of the recent organizational and process changes at the SEC. A more comprehensive overhaul will be required when the SEA is enacted.



the raw materials that could form the basis for a comprehensive enforcement manual (e.g., investigation plans and research materials).

#### **D. Publication of the Results of Enforcement Actions, Policies, and Procedures**

**30. The SEC should publish the results of enforcement actions and enforcement policies and procedures.** The SEC currently publishes its enforcement actions with the names of the persons/entities against whom/which such actions were implemented in its own website, in line with the publication policy of the SEC. However, the existing Policy has exempted certain enforcement actions from being published and has time limitations for the publication of certain enforcement actions other than convictions. Therefore, such enforcement actions shall be removed from the website upon the expiry of such periods and only convictions shall remain on the website indefinitely. This policy needs to be revised. As a result, the SEC has been criticized for a lack of transparency.

**31. The IOSCO CD paper makes the point that credible deterrence requires that the results of enforcement actions be published along with enforcement priorities, policies, and procedures.** Publication educates market participants on how regulators do business and enables market participants to adapt their practices to comply with the law. It also instills public confidence that the regulator can and will act to ensure a fair and orderly market.

**32. The mission was informed that the time limitations set for the publication of certain enforcement actions negatively affects the transparency of the regulator.** The SEC has a publication policy which specifies which enforcement action to be published on its own website and how long such enforcement action to be kept on the website. However, the time limitations set for the publication of certain enforcement actions negatively affects the transparency of the regulator and therefore the policy needs to be revised. Moreover, the policy itself should be published and the file of enforcement results should be maintained permanently on the SEC's public website.

**33. Critical to instilling confidence that the SEC handles its responsibilities in a fair and consistent way is for the members of the Commission and other decisional officers to be transparent on contacts received from the public on ongoing enforcement related matters.** Other mature Commissions address this concern by discouraging communications outside the regular channels and by creating a written record of such communications and making them available to the public.

#### **E. Metrics to Measure the Effectiveness/Credible Deterrence of the Enforcement Program**

**34. The SEC should design and employ metrics to measure the effectiveness/credible deterrence of the Enforcement program.** The SEC specifically requested the mission to identify ways that it could enhance the effectiveness and credible deterrence of its enforcement program. To date, there have been insufficient enforcement results to have a significant impact on conduct in the securities market. Going forward, the SEC's initiatives outlined above and enactment of the SEA should dramatically change its enforcement profile. Thus, it is the right time to for the SEC to consider how it should measure its effectiveness, so that it can properly set priorities.

**35. Measuring effective enforcement is a difficult endeavor.** The most common enforcement statistics are those that measure outputs, e.g., numbers of investigations, cases filed, amount of penalties imposed, and licenses revoked. Qualitative measures are less obvious, but arguably better reflect the success or failure of an enforcement program.<sup>6</sup>

**36. Each regulator must consider what evidence will provide confidence that its enforcement program is having its intended effect.** For example, during the mission, enforcement staff opined that one measure of effectiveness may be the extent to which members of the general public entrust the SEC with information about market irregularities in the expectation that the SEC will take remedial action. Another measure suggested by the staff is to monitor the financial media to see how often and in what light the SEC is mentioned in press reports. By both of these measures staff felt that public perception of the SEC's effectiveness has improved since the new administration took over two years ago.

**37. In addition, the SEC might want to invite stakeholders to attend an annual conference where the SEC could receive feedback on whether it is achieving credible deterrence.** The SEC is encouraged to consult with other regulators to see how they measure effectiveness.

---

<sup>6</sup> The following examples of qualitative measures are among those described in the IOSCO CD paper: market cleanliness statistics count the number of potential suspicious market transactions that occur immediately before a company announcement and compare that data to actions against market abuse or insider dealing taken by the regulator. Another example is the number of audit reports qualified for client money reasons.

## **Appendix I. Improvements Made in the Last Two Years based on the World Bank FSAP and IOSCO RT**

- Increasing the number of investigations staff from 2 to 10, including 2 legal counsel (2 of the 10 staff members have been authorized, but have not yet commenced work.) This is particularly significant at the moment since the Commission reopened a number of closed investigations related to suspicious trading during the period of significant market volatility in 2010–2011. Staff informed the mission that the original investigations did not gather and analyze bank and telephone records, the types of information that, typically, are critical to establishing manipulation and insider dealing violations.

As a result of reopening these matters, the Investigations Division is handling a larger-than-usual caseload. The Investigations Division can expect to have an increased docket into the future as the SEC's jurisdiction and enforcement tools are expanded under the SEA. The appropriate size of the enforcement program should change over time in relation to the size of the market and emerging trends in market behavior. Commission resources committed to enforcement must be sufficient to have a dissuasive impact on market misconduct.

- Reorganizing the Investigations Division by bringing in a team of multi-disciplinary professionals, including staff with accounting, supervision and legal backgrounds, and training them in investigation techniques. The strategy has included designing and implementing comprehensive investigation plans. In addition, the assignment of legal counsel ensures that investigation plans are focused from the outset on developing evidence that will satisfy the elements of potential offenses and the required standard of proof, avoiding unnecessary delay on the back end of investigations.
- Streamlining the process for opening investigations. The new process eliminates the step of having the Commission approve the opening of investigations and delegates to the Investigations Division discretion in designing investigation plans. There is room, however, for additional streamlining over the next couple of years once a new Investigations Director is in place and the investigations staff establishes a track record of timely and effective enforcement.
- Developing electronic investigation and research files accessible by all investigation staff. The new investigations team has established an electronic filing system to maintain investigation plans and keep track of investigation records and other materials relevant to their work. This is a good start toward the larger goal of developing a comprehensive enforcement program policies and procedures manual that can act as a roadmap for investigating and prosecuting enforcement cases. Such a manual will enhance the quality and consistency of staff work product, avoid duplication of effort, facilitate the onboarding of new enforcement program staff and reduce the burden on experienced staff to guide the work of new hires.
- Entering into a formal consultation arrangement with the Attorney General's Department to expedite the selection and completion of investigations that are ready for criminal

prosecution. Both the World Bank FSAP and IOSCO RT criticized the SEC for not having formal arrangements with the Attorney General's Department. The lack of cooperation between the two agencies was believed to have contributed to the dearth of enforcement actions. The new consultation arrangement has tremendous potential to expedite investigations and produce successful criminal prosecutions. Both the investigations staff and the Attorney General's representatives involved in the new consultation process have confirmed that the process is working well and has already produced important results. The mission was informed that several enforcement recommendations will be submitted to the Commission soon with support from the Attorney General's staff.

- Developing criteria for the CSE to apply in making referrals to the SEC and inviting the CSE surveillance staff to attend meetings of the Surveillance and Investigations Committee during deliberations on their referrals. The CSE and SEC run parallel surveillance programs to identify misconduct in the market. The staff of the two organizations discuss their surveillance results informally, but the CSE claims that it does not get formal feedback as to whether its surveillance activities are of assistance to the SEC. From their point of view, they make referrals to the Surveillance Division, but never see any enforcement actions resulting from their referrals. By inviting the CSE to attend committee meetings during deliberation of CSE referrals the SEC will provide welcome transparency about its internal processes.

The Surveillance Division believes that many of the matters referred by the CSE are too small to merit SEC attention and that the threshold for referrals should be raised. Such matters will remain under consideration by the CSE and be re-evaluated if a pattern of wrongdoing emerges or other circumstances develop to warrant referral to the SEC. By providing guidance to the CSE, the Surveillance Division will save staff review time and the CSE will get the feedback it needs to focus its surveillance activities.

- Recruiting a class of management trainees. The SEC has had a difficult time finding trained managers to lead its specialized operations, including investigations. The SEC has proactively instituted a management trainee program selecting eight candidates from an applicant pool of several thousand. The mission is advised that these trainees are undergoing a rigorous program to develop the SEC's future leaders. This will be particularly important when the SEA is enacted and the SEC is called upon to implement its new authorities.
- Creating a new Litigation Division able to focus on litigation management functions. The former Legal and Enforcement Division was responsible for both policy development and litigation supervision. Under the SEA, the SEC will have independent authority to commence civil and administrative enforcement cases. The new powers will require the SEC to have experienced litigation counsel to effectively prosecute cases, rather than simply act as liaison between the SEC and the Attorney General's Department. Establishing a Litigation Division will position the SEC to be able to move expeditiously to handle both its liaison role and new prosecution functions. The remaining Legal Division will function more as a General Counsel's Office focusing on policy development in administering the SEC Act and acting as counsel to the Commission, Director General and staff.