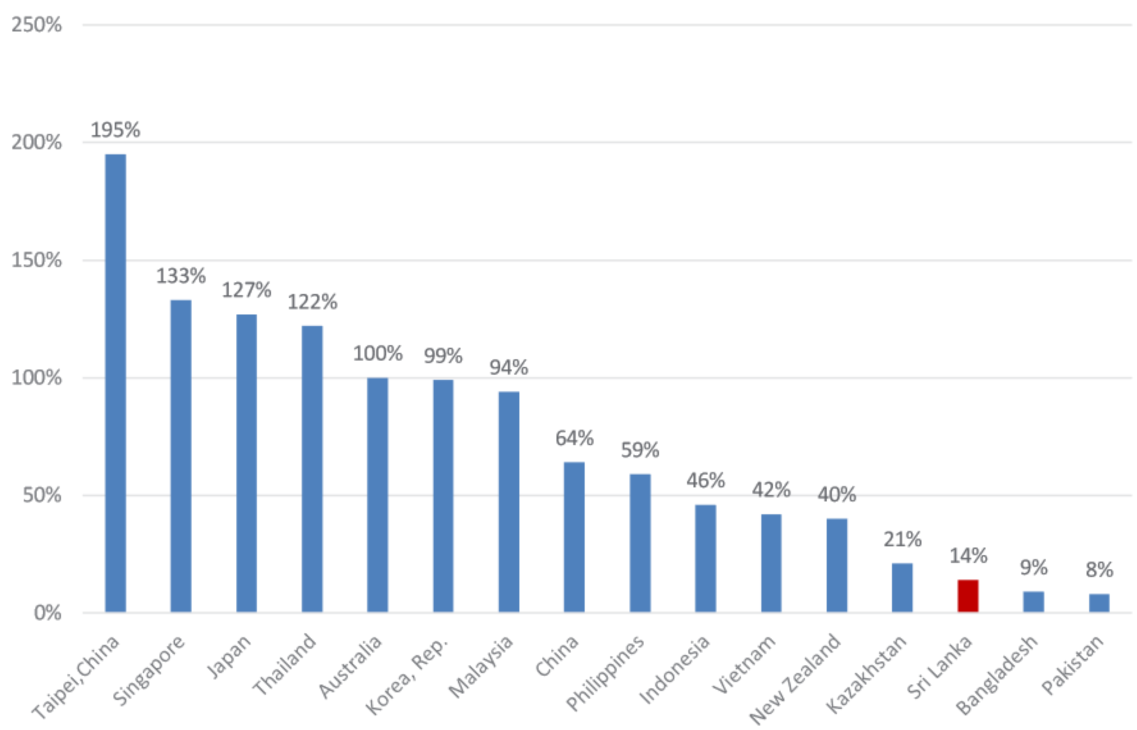
4.SECURITIES SECTOR VULNERABILITY ASSESSMENT

Figure 1: Market Capitalization of Securities Sector (as a % of GDP) of the Region in 2022



Source: Asian Development Bank (ADB) Key Indicators Database

4.1 Introduction

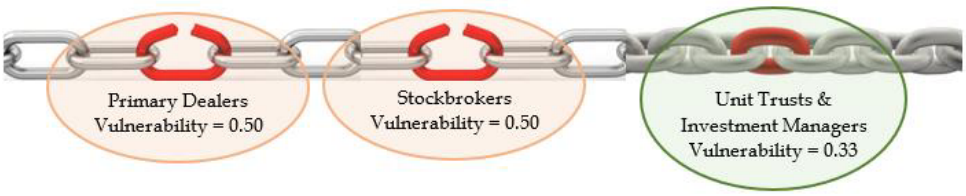
The securities sector of Sri Lanka is regulated by the SEC with the Colombo Stock Exchange (CSE) as its only licensed stock exchange. The CSE's Market Capitalization of USD 11.9 billion stood at 14 per cent of the GDP according to September 30, 2022, figures, which is low compared to those of most other emerging markets in the region (Figure 1). There are 3 main product types available to investors on the CSE, namely, equity, debt, and units of closed end funds. An analysis of the total volume of trading in all types of securities shows that around 99 per cent of the turnover is generated from equities, and the majority of the remaining 1 per cent from debt. Accordingly, SBs, PDs and Unit Trusts and Investment Managers (UTs and IMs) were selected for the risk assessment of the securities sector.

4.2 Sector Overall Assessment

The securities sector of Sri Lanka does not have many products on offer (e.g., Derivatives, etc.) compared to other developed markets. Even though Institution types such as Investment Managers, Wealth Managers, Unit Trusts, etc., are emerging in the securities sector compared to 2014 situation, the complex products they offer are not significant in value, compared to the value of predominant products in the securities sector which are equity and debt. Therefore, the vulnerability of the sector is mainly related to the quality of the general AML controls, compared to the inherent vulnerability.

The overall capital market vulnerability to ML is rated ***Medium*** (0.50) for PDs and SBs. For UTs and IMs assessed together, the overall vulnerability to ML is rated ***Medium Low*** (0.33). This assessment is also in line with the low number of ML convictions related to the securities sector in the country.

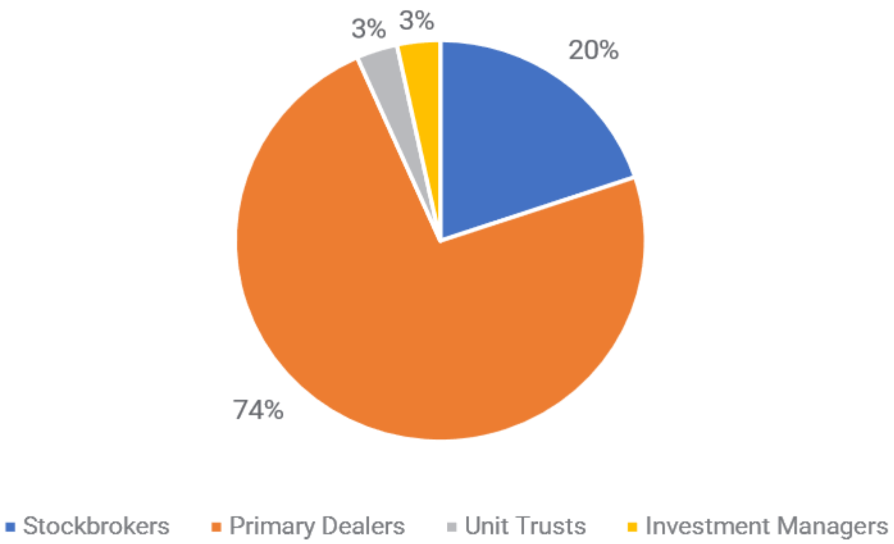
Figure 2: Highlights of the Securities Sector Vulnerability Assessment



4.3 Data Collection Methodology

A detailed questionnaire was used to gather data from a sample of 20 institutions which comprised of 8 SBs, 8 PDs, 2 UTs and 2 IMs, to assess 25 variables in the WB Risk Assessment Tool for assessing the quality of AML controls and inherent vulnerability of each Institution type. The sample was selected considering the portfolio value, annual holdings and Assets Under Management and it represented more than 64 per cent of the total turnover levels of the market (as of end 2021). The other required information on the regulatory framework, supervision and enforcement actions were collected from the SEC and CBSL (BSD and Department of Supervision of Non-Bank Financial Institutions (DSNBFI).

Figure 3: Representation of Assets Under the Management of Securities Sectors in the Sample Group



Source: Institutions in the sample group

4.4 Quality of Anti-Money Laundering Controls

There is a high level of awareness and conformity by the securities sector Institutions on the AML legal and regulatory framework in Sri Lanka, which primarily comprises of following legal instruments:

- Prevention of Money Laundering Act, No. 5 of 2006 (PMLA)
- Financial Transactions Reporting Act, No. 6 of 2006 (FTRA)
- CDD Rules for FIs and other Rules and Regulations issued under the FTRA

In the Securities and Exchange Commission Act, No. 19 of 2021, SEC is idenitifed as the licensing and supervising authority for SBs. In the Registered Stock and Securities (Primary Dealers) Regulations, No. 01 of 2009 (as amended) and the Local Treasury Bills (Primary Dealers) Regulations, No. 01 of 2009 (as amended), DSNBFI and BSD are identifed as the relevant authorities for Non-Bank PDs and Bank PDs, respectively. FTRA provides AML regulatory powers to the FIU for SBs, PDs, and UTs and IMs under the definition of Institutions. There are adequate administrative and criminal sanction provisions available in the FTRA and other legislations applicable for all Institutions ranging from warning letters to imposing penalties and suspension of businesses.

The incidents of integrity failures involving securities firm staff is low, and there are appropriate mechanisms in place to protect the securities firm's staff regarding the reporting of STRs to the FIU and other actions relating to compliance with AML obligations. The AML knowledge of the staff at SBs and Bank PDs is at a reasonable level. However, the engagement of UTs and IMs with SEC on AML specific matters is minimum resulting in a low level of AML knowledge of the staff in that sector. SBs are engaged with FIU more than other Institution types due to their threshold and STR reporting process. Therefore, the compliance function of SBs is regularly reviewed by the FIU making its effectiveness high. Furthermore, Bank PDs benefit from the effective compliance function of their Banks. The compliance function of the UTs and IMs is less effective since they are not under the reporting purview of the FIU due to their relatively low footprint in the financial sector.

Most PDs have specialized AML monitoring systems which support risk profiling of customers. However, during 2015–2022, PDs have reported only 1 STR. SBs report monthly compliance reports to the SEC and CSE and have reported 16 STRs to the FIU during 2015-2022. UTs and IMs are currently not reporting STRs to the FIU and confirm certain information to the SEC through the monthly compliance reports. Bank PDs have systems for transaction/client profile recording and monitoring, automated systems to monitor transactions for AML screening, but SBs, UTs and IMs have less effective automated systems. Most Institutions have manual/automated systems for PEP monitoring and sanction screening, reviewed by Compliance Officer and subject to internal audit.

On a sector-wise analysis as per WB tool's model, overall vulnerability to ML is rated ***Medium*** for PDs and SBs, with a rating of medium for the quality of general AML controls and inherent vulnerability for both sectors. However, the WG is of the view that SBs had a slightly better rating for the general AML controls compared to PDs, but a slightly higher rating for the inherent vulnerability compared to PDs.

The key contributing factors for the above ratings are:

- Medium high level of comprehensiveness of AML legal framework for both PDs and SBs.
- Medium level of effectiveness for suspicious activity monitoring, reporting and compliance function for both sectors, where SB ratings are slightly higher than PDs.
- Medium level of availability and effectiveness of entry controls, quality of AML supervision, AML knowledge and integrity of staff for both sectors, where quality of AML supervision for SBs is rated better than PDs.
- Medium level of effectiveness of supervision procedures and practices, and availability and enforcement of administrative sanctions for both sectors, where SBs are rated better than PDs.
- For both sectors, availability and enforcement of criminal sanctions is rated as medium low, indicating an area to be improved. The enforcement actions taken by the SEC ranged from warning letters to suspensions, compounding, and convictions, which were mainly against insider dealing, market/price manipulation, and violation of SEC rules. The SEC has also imposed an administrative penalty of Rs. 500,000 on a Stockbroker for having contravened the provisions of the SEC Act.

For UTs and IMs, quality of AML controls is rated as medium, even though their ratings for effectiveness of suspicious activity monitoring and reporting, and effectiveness of compliance function are rated as medium low. However, as they are having medium low inherent vulnerability due to their low footprint in terms of total managed assets, final vulnerability of UTs and IMs is rated as ***Medium Low***.

4.5 Deficiencies / Gaps Identified and Proposed Actions to Rectify the Issues

1. AML/CFT related provisions could be incorporated in following regulatory instruments to enhance the coverage of AML/CFT supervision for the securities sector:
   - Securities Exchange Commission Act, No. 19 of 2021
   - Registered Stock and Securities Ordinance
   - Code of Conduct for Primary Dealers (2003)
   - Direction on Customer Charter for Primary Dealers and their Customers dated November 07, 2013
2. As the AML/CFT supervisor, FIU's supervision of the securities sector should be enhanced by providing adequate resources to the FIU (especially human resources). Also, knowledge of prudential supervisors (SEC / BSD / DSNBFI) should be increased to cover AML/CFT aspects during their supervisions. The possibility of undertaking the supervision of UTs and IMs by the CSE needs to be assessed.
3. Licensing and supervision of PDs were initially handled by the Public Debt Department of CBSL, and it was later assigned to DSNBFI in June 2016. Then in May 2018 it was further divided as Bank and Non-Bank PDs and assigned to BSD and DSNBFI, respectively. This segregation created a lack of attention for supervision of PDs in non-prudential areas like AML/CFT among BSD and DSNBFI.

4. Administrative sanctions provisions in relation to non-compliances with obligations pertaining to AML/CFT could be included in the sector supervisors' legal framework, and enforcement of administrative sanctions could be increased by the sector supervisors BSD and DSNBFI.

5. Even though the supervision is segregated among BSD and DSNBFI for PDs within CBSL, licensing for new PDs is not clearly set out in the relevant regulations.

6. There is a considerable gap between Bank PDs and Non-Bank PDs in the effectiveness of compliance functions due to operating structure (Bank PDs being more compliant than Non-Bank PDs).

7. Specialized systems to identify suspicious transactions must be implemented and relevant staff should be trained in the securities sector to increase the effectiveness of suspicious activity monitoring and reporting.

8. With the perceived low risk of the securities sector, cost of conducting KYC and requirement to promote investments to the country, the possibility of applying simplified KYC process for the securities sector Institutions could be considered.

9. Inclusion of securities sector Institutions in the shared KYC project would also reduce the cost and effort of conducting KYC for the customer onboarding, thereby allowing the Institutions to attract more customers and investments.

4.6 Challenges in Data Collection and Actions for Better Analysis in Future

The main challenge in collecting the data was the unavailability of statistics in the securities sector according to the classification required by the assessment tool/methodology. The systems available with the Institutions are mainly for trading purposes. Hence, the data available could not be directly mapped with the requirement of conducting the assessment.