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Position Paper

Manipulation in the Sri Lankan Stock Market

INTRODUCTION

A stock market is expected to present a level playing field to all investors. However, stock holders trading in the Colombo Stock Exchange (CSE) have encountered hurdles to trading, coming from both major private investors and errant government elements.

These hurdles refer to various methods of market manipulation, such as insider trading and "pump-and-dump" tactics that artificially jostle share prices towards the benefit of a handful of individuals. The distortion of the structure of the market through these market manipulations seem to go unpunished as investigations are halted or fade away from public interest rapidly, ensuring that the perpetrators of these white collar crimes go unpunished.

This Position Paper will examine the definitions and consequences of market manipulation and recent scandals that have shocked traders at the CSE. It will also investigate possible methods to prevent and diminish the occurrence of market manipulations at the CSE.

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Position Statement

The responsibility for maintaining a level playing field falls on the Securities and Exchange Commission (SEC) and the investors themselves. Directors, stock brokers and capitalists no longer play within the rules of the game and while "greed is good" in investing, it should be exercised within parameters applicable equally to all market players. It falls upon Civil Society Organizations (CSOs) to educate the public on the rules of the game and raise public awareness on the consequences of a corrupt stock exchange. It falls upon the SEC to resist politically-motivated impediments to investigation and efficiently regulate the market while prosecuting the perpetrators of white collar crimes. Additionally, it falls upon the SEC to educate the government on the purpose and effects of regulation, as it is currently seen as a negative influence in market economics. It falls upon the media to pursue alleged white collar criminals and expose their misdeeds in the public light, and to also raise public knowledge on the workings of the CSE and the links between good governance and good corporate practices.

What is Market Manipulation?

This refers to the deliberate interference in the free and fair operations of a financial market. The aim of manipulation is to paint a false picture of the market, misleading investors and analysts. The CSE has been plagued by a barrage of market manipulations in the recent past. In 2011, the Employees' Provident Fund (EPF) bought an 8% stake in Laugfs Gas PLC for Rs.1.6bn, pushing share prices up to between Rs.38-41 per share. However, through this inflation of share prices, the stock was sold at Rs.51 per share before coming down to Rs.40 that same day.[1] As at 4th July 2012, the share price of Laugfs Gas PLC is Rs.19, amounting to a loss of Rs.1,389mn to the EPF. It is clear that the brokers involved made a massive profit by artificially inflating share prices. This example highlights another problem, which is the misuse of public funds.

The manipulation described above is but one example of a myriad of "pump-and-dump" rackets witnessed on the trading floor. It involves the overvaluing of shares so that stock holders are able to sell their shares at an artificially inflated price. However, this comes at the expense of another party, in the example above the "loser" is the pool of EPF funds.

Another example of public funds being used in a pump-and-dump transaction is that of the EPF purchasing stock in Galadari Hotels (Lanka) PVT LTD in 2010. The EPF purchased 23.7 million shares in the company, at Rs.32.50 a share. The value of these shares, as at July 2012, is at Rs.11 per share, which amounts to a loss of Rs.500mn.[2] The previous owners of the share, Nawaloka Hospitals, was reported to have been "relieved" to have gotten rid of the "burden" of the loss making Galadari Hotels (Lanka) PVT LTD. It is convenient that a loss making company was transferred from private stock holders to an institution that deals with public funds.

The total value of losses incurred by the EPF in the stock market is placed at over Rs.4bn, according to Economist Dr. Harsha De Silva MP.[3] But the Central Bank of Sri Lanka has rebuffed any allegations of fraud in its dealings in the stock market, saying that there is "a long-term focus to generate profits and enhance the Fund's capital base".[4] However, investments made in 2010 seem to have generated massive losses all the way up to 2012, so the fruits of these "long term" investments are yet to be realized.

Insider trading is another form of market manipulation. It is the "unfair use of trading by those within privileged access ('insiders') to information that has not been disclosed by a company to the public ('undisclosed information') and which information would, if made public, have an impact on price of securities of that company."[5] The EPF also made clear its adherence to accounting standards and credibility of internal auditing procedures, rebuffing Dr Harsha de Silva's claims of market manipulation by alleging he had

1. "EPF loses Billions as Central Bank Buys Over Valued Shares in an Insider Trading Racket (4 July 2012) Hemmathagama, Ashwin (accessible at http://www.thesundayleader.lk/2012/06/03/epf-lose-billions-as-central-bank-buys-over-valued-shares-in-an-insider-trading-racket/)
2. EPF loses Billions as Central Bank Buys Over Valued Shares in an Insider Trading Racket (4 July 2012) Hemmathagama, Ashwin
3. Harsha Rebuffs CB's Rosy EPF Story (23rd May 2012) (accessible at http://www.ft.lk/2012/05/23/harsha-rebuffs-cbs-rosy-epf-story/)
4. EPF rejects UNP MP's Allegations of Fraud (22nd May 2012) (http://www.ft.lk/2012/05/22/epf-rejects-unp-mps-allegations-of-fraud/)
5. Quoting Mr. Arritha Wickremanayake,TISL Samabashana Discussion held June 4th 2012

a political agenda behind his analysis. However, once we move past the jaded political rhetoric of our Sri Lankan institutions and politicians, we find it hard to disregard the evidence of massive loss-making investments made by a company that deals with public funds. Laugfs Gas PLC, Ceylon Grain Elevators, Brown and Company, Galadari Hotels and The Finance Company all appear to be unsound investments, incurring huge losses to the EPF's pool of public funds.

An article titled "Insider Trading Unavoidable?" published in 2011 sheds light on a peculiar detail of Sri Lanka's investor community; the geographical distribution of stock market players aids in the speedy transference of material information. Nimal Perera, an investor at the CSE, mentioned that "we are all insiders, including the regulators, as we are a close-knit society."[6] These controversial remarks highlight not only the ease with which material information may pass through investor circles, but also the callousness with which perpetrators may publicly claim their nefariousness. The article goes on to describe the two types of insider traders -Primary insiders, who have access to material information and Secondary insiders, those who obtain material information from primary insiders.

Although conflicts of interest might not be a form of market manipulation, it is worth exploring the role they play in the erosion of fairness and transparency on the trading floor.

A scandal in the recent past is that of the National Savings Bank (NSB) purchase of The Finance Company (TFC). In a nutshell, this scandal is concerned with the purchase of 13% of TFC by NSB for Rs.49.74 a share, whereas typical share prices were at Rs.30.[7] Following public disclosure of this deal, President Mahinda Rajapaksa halted payment and ordered Secretary to the Treasury, Dr. P B Jayasundera to initiate an investigation into the deal. The 13% of TFC shares were to be purchased from two of the company's directors, Dinal Wijemanne, CEO of Taprobane Securities, and Raynor De Silva, ABC Radio Managing Director. It came to light that there is a conflict of interest at hand; Taprobane Securities was the firm that authorized the purchase of these shares and the director of the company was the individual selling these shares. The SEC has stated that they are investigating Taprobane Securities for insider dealing, front running and conflict of interest violations even though an internal investigation into the incident is yet to be undertaken.[8]

It is hard to pinpoint the exact cause of market manipulation; it could be greed in the mind of the controlling interest or senior ranking director or it could very well be poor corporate governance. As Warren Buffet once said, "Earnings can be pliable as putty when a charlatan heads the company reporting them."[9] A Sri Lankan example of this is the case of Watawala Plantations. Recently the directors stripped the company of its marketing division with no prior consultation with the shareholders.[10] Arbitrary decisions made without the consultation and consent of the stock owners points towards serious concerns over the transparency and good corporate practices of the directors. This section was sold for Rs.741mn when the company's true value stood between Rs.2.5-3bn. In this case, it is hard to see who gains from manipulating the market, yet it is easy to see how poor corporate governance leads to slights on the trading floor.

The question of who is involved with market manipulation is somewhat complex in its dimensions. As we can see from the examples cited in this document, the perpetrators are high ranking executives and stock brokers. The misuse of public funds seems to allude to the fact that there could be rouge political elements at play.

The Effects of Market Manipulation

It is a common misconception that white collar crime involves the rich stealing from the rich. However, in Sri Lanka this is not the case.[11] As seen in the NSB scandal, the savings of the Sri Lankan people were plundered in order to artificially inflate stock prices. This callous use of public finance has obvious repercussions; a poor investment, merely set in motion to paint a false picture of a

6. Insider Trading Unavoidable (21 July 2011) Antonio, Jithendra (accessible at http://srilankastockpicks.blogspot.com/2011/07/insider-trading-unavoidable.html)
7. NSB board on the Mat (6 May 2012), Obeyesekere, Srian (accessible at www.nation.lk/edition/latest-top.../5798-nsb-board-on-the-mat.html)
8. SEC Investigating Taprobane Securities for Multiple Offences on the NSB Deal , Yapa, Vimukthi (accessible at http://www.thesundayleader.lk/2012/05/20/sec-investigating-taprobane-securities-for-multiple-offenses-on-the-nsb-deal/)
9. Good Governance Equals Healthy Stock Market (accessible at http://www.greekshares.com/good_governance.php)
10. Watawala Plantations not Acting in the Interests of all Shareholders: Vignarajah (6th May 2012) (accessible at http://www.sundaytimes.lk/120506/Business-Times/bt10.html)
11. Interview with Mr.Arritha Wickremenayake (Conducted 12th July 2012)

company's value, yields a poor return in the long run, hemorrhaging money rather than appreciating the value of the initial investment. This erosion of value will put the NSB in hot water as bank patrons realize their money has been squandered in this investment process.

Another consequence of market manipulation is shareholder fatigue. This is a phenomenon that occurs when minority shareholders do not receive dividends on their preferred stock.[12] As company directors become tied up in the profit reaping on their manipulations, their companies usually suffer under long term over valuation of stock. As in the case of Watawala Plantations, ordinary shareholders are denied the right to exercise control over their company. Market economics dictate a divorce between company ownership and control, yet ordinary shareholders are presented with voting rights (whereas preferred stock holders typically do not receive voting rights) to steer the direction of their company.

Market manipulation allegations, whether proven or false, deter investors from entering the trading floor and impede foreign direct investment in the country. When the Sri Lankan civil war ended in 2009, the country seemed to have a bright economic future, with great foreign interest in investment opportunities.[13] In the previous year, Sri Lanka had witnessed massive investment from Malaysia and India, giving analysts the ability to predict good tidings for the Sri Lankan economy. However, the Central Bank of Sri Lankan (CBSL) mentioned in a 2009 report that foreign direct investment in Sri Lanka was inadequate.[14] Yet, by 2011, it seemed that Sri Lanka was far from the tiger economy status it had been bestowed in 2009. The bubble burst in 2011, with the all share price index reporting an all-time low of 3.5% negative earnings and a total loss of Rs.141bn in October 2011.[15]

A bubble occurs when share prices are inflated to levels higher than their real value, usually through the dissemination of false performance rumors by brokers and a myriad of other market manipulations and investor speculation.[16] The article cited for this claim also goes on to mention how brokers have a heavy hand to play in the creation of a bubble, as they gain on the commission received from brokering stock transactions. It also mentions a group of high net worth individuals who prop up the market through the purchase of illiquid stock (also known as penny stocks)[17]

The stock market crash of 2011 persists today, with a year-to-debt ratio of 20% reported in May 2012, which amounts to a loss of Rs.40bn.[18] We can now clearly see how brokers and investors play a crucial role in preventing a bubble from forming yet, in the Sri Lankan context, this responsibility is rarely carried out. We also see how one market manipulation can lead to a variety of unintended negative effects, i.e. over-valuation of stocks leading to a stock market bubble and subsequently, a crash.

In addition to the effects pointed out above, it is critical that we understand the erosion of confidence in the CSE, the irreparable damage done to once credible institutions such as the NSB and, ultimately, the unfortunate deterrence of investment in the Sri Lankan economy. Currently, the CSE is a vulnerable institution, illiquid and exposed to the whims of a few high value investors. The once bright outlook presented to investors in mid-2009 has now turned to a market rife with scandal and corruption.

Alleviating Market Manipulation

The Securities and Exchange Commission (SEC) was established in order to "promote, develop and maintain a capital market that is fair, efficient, orderly and transparent."[19] It is expected to advise the government on the development of the securities market and to regulate the listing and issue of securities in the licensed stock exchange. This institution subscribes to these lofty principals, but has been unable to curb market manipulation. The SEC has also undergone leadership changes

12. Interview with Mr. K.C. Vignarajah
13. Sri Lanka sees Foreign Investment Quadrupling as Civil War Ends (1st June 2009) Cherian, Thomas (accessible at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aAn_Qy8nT9mA)
14. Compilation of Foreign Direct Investments in Sri Laka 2009 report published by the Central Bank of Sri Lanka (http://www.cbsl.gov.lk/pics_n_docs/10_pub/_docs/other_publications/occasional_papers/op66.pdf)
15. Sri Lankan Stock Market Crashes to Lowest Level in 2011 (19th October 2011) (http://ictking.com/news/2011/10/sri-lanka-stock-market-crashes-to-lowest-level-in-2011/)
16. Broken Bubble (4th December 2011) (http://www.lankabusinessonline.com/fullstory.php?nid=262954294)
17. Interview with Mr. Arritha Wickremanayeke
18. Stock Market Crash Persists (30th May 2012),
19. Securities and Exchange Commission website (http://www.sec.gov.lk/?page_id=1434&lang=en)

that seem to allude to a corrupt stock market. In December 2011, chairperson of the SEC, Indrani Sugathadasa, resigned in order to "uphold her principles".[20] Her resignation could be chalked up to attempts to regulate more efficiently being shot down by the Brokers Association of the Colombo Stock Exchange. The Association met with President Rajapaksa in order to convey their concerns over regulation in the credit market. We see here that the brokers are able to sway the highest political order in the land in order to get their way.

While regulation is not a method in which market manipulation can be "cured", it "merely provides a basic framework of facilitating operation of markets."[21] There seems to be a Sri Lankan misconception that regulation inhibits the workings of a stock market, creating constraints to brokers. This conception might be true, if brokers would rather be free to carry out nefarious activities than be subject to a system of checks and balances! The point of regulation is to create barriers to those who would subvert the level playing field and prosecute those who "are foolish to flaunt it and get caught".[22] However, the SEC seems to be unable to carry out its duties, let alone prosecute the perpetrators. As we can see from the NSB-TFC deal, the SEC was sadly absent when the transaction was made. The SEC has assured traders that an investigation will be conducted.[23] Knowing that public funds were being used, the SEC should have intervened to halt the transaction, even when a clear conflict of interest existed in the brokerage house. The culture of regulation has become "lawless, due to a lack of regulation – giving rise to a class of criminals"[24] In order to alleviate this issue, the Government should be enlightened as to the beneficial effects of good and fair regulation, that it is not an impediment to success in the stock market and that it merely provides a framework for a level playing field. If we understand regulation to be simply that, then perhaps those who push for less market regulation are only attempting to cover up their tracks.

It is thus clear that the SEC ought to pipe up and do more than sit complacent with entities such as the Brokers' Association undermining their regulatory capacity. A more hands-on approach is required, one that investigates and fully prosecutes individuals accused of white collar crimes. The SEC Act is sufficient to regulate the market; however, the resources and infrastructure to prosecute perpetrators and regulate the market need to be built up to the point where the issue of white collar crime becomes something that is severely looked down upon in the public sphere. In addition,, the SEC Act should incorporate sections relating to "push-and-dump" transactions, providing a definition and definitive legal sanctions against perpetrators of these transactions.

As such, perceptions of white collar crime have to be changed; it is no longer a case where the rich are stealing from the rich, it is quite evident that the rich are stealing from society as a whole. Public awareness is essential in changing perceptions; the "rules of the game" must be disclosed to the public, in forums or educational programmes, any medium that allows society to gain understanding of the workings of financial markets. The fourth estate too plays a part in this as they are in charge of the dissemination of information to the public. It was made clear that certain "rotten" journalists aid the cause of errant traders, reporting facts that cause minority investors to hastily purchase a share, in order to send the price sky rocketing, while the controlling interests sell off their stock, making massive profits.[25] It must also be made clear to the investors that regulation is not aimed at people, it is supposed to be fair and transparent, giving investors rules to be followed by all involved on the trading floor. It should be free from political interference and should not be undermined by errant financiers.

In addition to this, the judiciary must be armed with the legal tools required to prosecute white collar criminals. As of the 17th of July, no code of conduct or ethics statement exists on the SEC website, indicating that this is an appropriate place to start

20. Sri Lanka SEC Head Resigns (2nd December 2011) (http://www.colombopage.com/archive_11B/Dec02_1322770426CH.php)
21. Mr. Arritha Wickremenayake at a Sambhashana Discussion held June 4th 2012
22. Mr. Arritha Wickremanayake at a Sambhashana discussion June 4th 2012
23. Rienzie Lashes out at Culture of Bad Governance (10th May 2012) Andree, Mario (http://www.island.lk/index.php?page_cat=article-details&page=article-details&code_title=51566)
24. Interview with Mr. K.C. Vignarajah
25. Interview with Mr. K.C.Vignarajah

making a difference; a code of conduct will ensure high standards of practice and a solid document that gives regulators some sort of "backbone". In the past, regulators have had too cozy a relationship with company directors.[26] This too will be addressed in an effective code of conduct.

In addition, CSOs have a large part to play in public awareness of white collar crimes. It is clear that the Sri Lankan public has very little understanding of how financial markets work. Given this gap in the knowledge base, those who do know the rules are able to manipulate them to gain personal advantage, or to even work in tandem with others in order to fix the market in their favor. In the case of the EPF, it seems that the public were unaware of the implications of public finance being used to play in the stock market.

26. Interview with Mr. Arritha Wickremanayake

Discussing insider trading

'Insider trading in the Stock Market' was the theme of a Sambhashana discussion organised by TISL in the aftermath of the NSB –TFC deal.

Opening the discussion, former Director-General of the Securities Exchange Commission (SEC), **Arittha Wickremanayake** said that there is a serious lack of understanding as to why insider trading is considered to be an offence. Adding that recent scandals have clearly highlighted that whilst people like the idea that there is a scandal, they don't really try to understand why it is dangerous, and the public interest in stopping it.

He added that although there is a dangerous perception that regulation is a cure for every market illness, it is not so. Regulation merely provides a basic framework for facilitating operations of markets, and in Sri Lanka, the object of the SEC is to create and maintain an orderly and fair market, and to regulate it and to ensure that professional standards are maintained, he said.

Parliamentarian **Sunil Handunetti** blamed the government for manipulating the share market by investing government pension funds like the EPF. Stressing that the government was responsible for the public funds, which are life-long savings of innocent people, he pointed out that instead of protecting these funds, the government is misusing public funds to inflate the capital market to create a false illusion in the minds of the people.

Parliamentarian **Eran Wickramaratne** pointed out the need to appoint a Parliamentary Select Committee to investigate the happenings of the stock market. Emphasising on the need to protect the funds of the employees, he pointed out that the government does not have a right to misuse this money for their personal glory.

AFP Bureau chief **Amal Jayasinghe** was the moderator.

Recommendations

- The government should reinvigorate its faith in the SEC as an efficient regulatory body and gain a deep insight into the beneficial effects of effective regulation in the stock market. The government should not cave into the demands of high net worth investors and must understand the highly illiquid nature of the stock market as it stands right now.

- The SEC must develop a strong stance on white collar crime, resisting both political interference and independent interference (from bodies such as the Brokers' Association). Through the CSE's education wing, public awareness must be raised on the overstepping of major investors and the effects of market manipulation.

- The SEC must also raise awareness on the ability of the SEC Act, that it is a legal document to be followed by investors that provides a level playing field. In this same vein, awareness of the various possible avenues of market manipulation must be made. This public awareness will instill a sense of what is acceptable and what is not on the trading floor.

- CSOs must conduct public awareness campaigns on the misuse of public funds in the stock exchange, how the stock market works in an elementary form and how white collar crime affects more than just "rich people". The need for a change in perception is stronger now more than ever. As mentioned earlier, public perception on white collar crime must be changed; the public must understand that the implications and consequences of market manipulation effect the overall wellbeing of the economy and thus, the public themselves suffer.

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"Sambhashana" is a biweekly programme presented by Transparency International Sri Lanka (TISL) aimed at stimulating public discussion on vital issues of governance and anti-corruption.