



## Part Two

### **Promote fair, efficient and orderly market**

We have moved towards a principles-based approach to supervision which encourages and fosters good business practices. It allows market participants to discover effective ways of meeting a mandated principle yet operate and evolve without being constrained by overly burdensome regulation.

# PROMOTE FAIR, EFFICIENT AND ORDERLY MARKET

## INTRODUCTION

In 2007, we make further progress towards putting in place a principles-based supervisory regime. We assessed the supervisory activity against the outcome. A supervisory activity with minimum beneficial outcome would be given less priority because the cost, to both the intermediaries and the SC, was not commensurate with the benefit of the outcome.

We continued to reduce the burden of regulation where cost outweighed the benefits of regulation. Cost in this context was not limited to financial implications, but also involved a consideration of impact to investors and the market, as well as industry preparedness.

Increasingly, we shifted from prescribing requirements to outlining the principles of regulation. This allowed flexibility in applying the regulation according to the needs of the intermediaries. Some of our intermediaries expressed discomfort, given such a wide interpretation of a principle, as opposed to a prescribed requirement. We advise our intermediaries, who are apprehensive, to consult us. Communication is the key to success, and we have taken great strides to be transparent in our activities and encourage engagements and collaboration with industry.

Our focus for the year was on instilling professional conduct and ethical practices, while developing an appreciation for quality risk management and strong internal controls. As these attributes become entrenched in the Malaysian capital market, we will further deregulate aspects of intermediaries' activities and remove regulatory barriers to accommodate new types of businesses which would increase the competitive strength of our intermediaries and provide consumers with a wider range of quality services.

## SUPERVISION OF INTERMEDIARIES

Since the introduction of principles-based supervision at the start of 2006, we have complemented it with the adoption of a risk-based approach in the supervision of intermediaries. This way, any misconduct in the capital market will be detected or pre-empted at an early stage.

During the year, we conducted a number of visits to market intermediaries to review their operational and risk management policies, and at the same time, update their risk profile. We also increased our focus on market abuse, particularly abuse committed by market intermediaries, and on various market manipulation activities.

### Risk Assessment Model

We have a comprehensive risk assessment model to establish the risk profile of all market intermediaries and to continuously update their risk profiles. This allows us to prioritise the deployment of our resources to market intermediaries and issues where their impact on our regulatory objectives, combined with the probability of risks crystallising, is greatest.

As part of our strategy to have a better understanding and a holistic profile of our intermediaries, we have an in-house information system which comprehensively procures accurate, reliable and timely disclosure of all concerns within the capital market and the SC.

At the same time, we mitigate these risks by taking both pre-emptive and responsive actions in addressing the regulatory concerns by using a range of supervisory tools.

They include engagements with Board of Directors and senior management of the intermediaries, and heavy penalties via administrative actions against them if found to be in breach of regulatory rules.

### Examination of Stockbroking Companies

Examination of intermediaries is one of our key supervisory tools. Our on-site examination is focused on directing the industry towards achieving the highest professional standards by monitoring the development of the industry and its compliance with relevant laws, regulations and guidelines.

During the year, our examination team completed—

- six risk-focus examination of stockbroking companies, with key focus on compliance with regulatory requirements, and extended our scope to cover the companies' anti-market abuse systems and controls;
- three surprise visits on stockbroking companies focused on areas of significant compliance, operational, and financial risks; and
- three joint due diligence reviews with BNM on stockbroking companies to check if they had complied with the necessary preconditions to be an Investment Bank.

The main objective of our examination was to assess the adequacy of the stockbroking companies' efforts and measures in conducting their business activities in a manner which contributed to the maintenance of a fair and orderly market.

### Transparent Regulatory Approach and Process

We believe that effective communication with our stakeholders is an essential part of the regulatory process as it helps us achieve the appropriate balance between protecting investors and fostering fair and efficient markets.

During the year, we conducted meetings with boards of directors and senior management of stockbroking companies and investment banks to discuss regulatory concerns

identified and to obtain their feedback and updates on their business strategies and plans for our ongoing review.

Co-operation with the industry is a key strategy to proactively prevent, detect, and deter misconduct in the capital markets and to raise the standard of compliance culture and good practice.

We led in efforts to increase the level of consultation and engagement with the industry by giving a number of presentations and actively consulted industry associations, industry participants, investment banks, stockbroking companies, compliance officers, and other regulators. Topics discussed included capital market issues, promoting good market conduct, sharing our supervisory approach, promoting market vibrancy, and maintaining public confidence. This approach was successful in fostering a compliance culture within the industry, and creating a better understanding and support for, and alignment to our supervisory approach.

We also engaged BNM on various issues, such as supervision of Investment Banks and successfully completed the mutual recognition of Financial Analysts and Financial Planners.

Following an industry consultation on guidelines on market conduct and business practices for stockbrokers, their representatives and employees, we are in the final stage of issuing the guidelines. We will formally roll-out and publish the guidelines, which provide commentaries and examples of how stockbroking companies may organise and control their affairs responsibly and effectively in order to comply with their obligations under the securities laws, rules, regulations and guidelines. These efforts are part of the CMP strategic initiatives of anchoring Malaysian intermediation services on appropriate prudential standards, with high levels of business conduct and professional skills.

### Administrative Actions

During the year, we took stern actions against those guilty of breaches of conduct, rules and regulations.

Table 1 shows some of the notable administrative actions taken in 2007.

Table 1  
Administrative Actions Taken Against Intermediaries in 2007

Types (or Nature) of Actions Against Intermediaries*	Number of Actions
Reminders/Warnings	4 IB, 2 SBC
Fine and Reprimand	2 IB, 1 SBC, 1 FSBC, 1 AMC
Business expansion restriction	1 IB

\* IB – Investment Bank  
SBC – Stockbroking Company  
FSBC – Foreign Stockbroking Company  
AMC – Asset Management Company

### Common Findings from Examination on SBCs

Common findings uncovered during our examinations included:

- Ineffective management supervision over the business conduct of their dealer's representatives;
- Breach of licensing conditions prohibiting an unlicensed person to deal in securities;
- Breach of Bursa rules restricting a trading clerk from taking orders directly from clients;
- Breach or violation of regulatory requirements not promptly reported to the SC;
- Know-your-client information not updated periodically and formally documented;
- Employees' trading policies and procedures not adequately reviewed and enforced; and
- Incomplete or inadequate account documentations.

### Risk-based Supervision for Fund Managers

In line with CMP's objective of promoting an effective investment management industry and recognising the growth of the investment management industry as a segment of the capital market, the SC established a dedicated Investment Management Supervision Department in May 2007 which uses risk-based supervision tools. With these tools, we strive to achieve a holistic supervision of the industry, and encompass a combination of self-assessment tools coupled with periodic regulatory audits. Self-assessment

tools require intermediaries to submit the Compliance and Risk Assessment Questionnaire (CRAQ) and a semi-annual report on the operation of compliance policies and procedures. Such self-assessment exercises are in line with principles-based supervision and disclosure-based regime. Regulatory audits complement the self-assessment exercises as a process which strengthens the veracity of such assessments.

### Examination of Fund Managers

In 2007, the SC examined fund managers to ensure adequacy and effectiveness of internal controls and procedures, state of compliance and supervisory systems, compliance with rules and regulations, and to identify areas for improvement.

The fund management companies were also examined for their financial strength, corporate governance, client asset protection, trading practices, criteria for assessing service providers, and compliance with anti-money laundering regulations.

During the year, our examination team completed–

- two risk-based examinations of fund management companies, encompassing a wide range of risk areas of operations and compliance with rules and regulatory requirements; and
- two risk-focused examinations of fund management companies, with key focus on trust accounts and profit-sharing schemes.

In addition, several engagements were conducted with fund management companies to assess the adequacy of their business activities and address areas of concern.

### Credit Agricole as Foreign Fund Manager

In November 2007, we approved the establishment of Credit Agricole Asset Management as another foreign fund management company to provide a greater range of services and product choice to investors. Credit Agricole is the fourth foreign fund management company to be granted a licence under this special scheme.

## SINGLE LICENSING REGIME

The CMSA came into effect on 28 September 2007 and introduced a single licensing framework for all capital market intermediaries in Malaysia. The new law which repeals the SIA and FIA removed the need for separate licences when a capital market intermediary undertakes businesses in both the securities and futures market.

### Reduce Cost and Regulatory Burden

A capital market intermediary need hold only one licence to carry on the business in any one or more of the six regulated activities.

Also, administrative approvals and notifications by capital market intermediaries, which previously had to be submitted separately under the SIA and FIA, can now be submitted together under the CMSA.

The CMSA introduces two types of licence – the principal licence is known as a Capital Markets Services Licence (CMSL) and the representative's licence is known as a Capital Markets Services Representative's Licence (CMSRL). An entity which has met with the necessary quantitative and qualitative fit and proper criteria as provided in the *Licensing Handbook* can now be approved to carry on a total of six different regulated activities under a single licence, as is the case with investment banks. The six activities are:

- dealing in securities;
- trading in futures contracts;
- fund management;
- advising on corporate finance;
- investment advice; and
- financial planning.

A holder of a CMSL or a CMSRL can apply to the SC to add on or reduce its regulated activities by applying for

a variation of its licence and in the case of a CMSRL holder, to change the principal who employs him.

### Corporate Finance and Research Analysts

Prior to the CMSA, individuals employed by stockbroking companies and investment banks who carry on the business of advising on corporate finance and providing investment advice were subjected to less regulatory requirements compared to individuals who were employed by boutique investment advisory companies. Only the latter were required to pass modules 12 and 15 of the licensing examinations conducted by the SIDC and were subjected to licensing requirements before commencing business.

With the CMSA, both categories of professionals are now subjected to similar regulatory requirements including licensing, compliance with a wide range of investor protection provisions provided under the securities laws, and continuing professional education to enhance their competence. To facilitate a smooth transition and maintain business efficacy, all existing corporate finance executives and research analysts employed by stockbroking companies and investment banks are deemed to hold a CMSRL to carry on the regulated activity of advising on corporate finance or investment advice, as the case may be, for a period of one year from the effective date of the CMSA. However, they must have met the SC's minimum requirements stipulated in the *Guidelines for Dealer's and Dealer's Representatives under the SIA* before the CMSA came into force.

### Restricted Dealing Licence

We have also introduced a restricted dealing licence for unit trust management companies who market and distribute unit trust products. Under the old regime, unit trust management companies had exempt dealer status for their dealings in unit trust products. Under the CMSA, they must obtain a CMSL. Again, to facilitate a smooth transition and maintain business efficacy, all unit trust management companies are allowed to continue with their activities for a period of one year from the effective date of the CMSA.

The restricted dealing licence is also applicable to financial planners or fund managers who wish to market and distribute unit trust products. It is also applicable to other categories of intermediaries, such as the funds supermarket who distribute third-party funds.

Only the principal company is required to hold a CMSL for dealing in unit trust products, while their agents and employees are required to be registered with FMUTM. They must pass the examinations for persons dealing in unit trusts (PDUT) or any other qualification recognised by the FMUTM and approved by the SC in order to carry on dealing in unit trust products.

## EFFICIENCIES IN LICENSING

The *Licensing Handbook* was introduced as a single document which enumerates the minimum assessment criteria for granting a CMSL and CMSRL for all six regulated activities under the CMSA. The handbook, issued on 28 September 2007, replaced a total of eight licensing-related guidelines and incorporated the conditions and restrictions of licences, and set out application procedures, relevant fees and forms. To facilitate the transition process arising from the coming into effect of the CMSA, a set of FAQs on the single licensing regime and licensing related issues was posted on the SC website.

### Longer Licence Tenure

As an incentive to capital market intermediaries with high standards of corporate governance and market conduct, we will extend the licence tenure to 36 months for qualified CMSL holders and to 24 months for qualified CMSRL holders. The period is expected to benefit market participants by reducing administrative steps in their renewal process. We are confident that this liberalisation does not impair our ability to step in to review the conduct of licensed persons at any point in time since the CMSA provides the SC with a wide range of powers to take appropriate action on licensed persons for market or unethical misconduct. The longer period will also allow the SC to undertake a more rigorous assessment on whether the licensed persons are fit and proper, and whether to allow them to continue with their regulated activities.

With the shift to a two-year renewal, licensed representatives are now given the flexibility of collecting the necessary CPE points within the 24 months period instead of 12 months. The extended time frame will allow licensed representatives to identify CPE courses which benefit and interest them.

### Appointment of Directors

A capital market intermediary can now appoint a director or a chief executive officer without having to obtain the SC's prior approval. However, before appointing a director or chief executive officer, the capital market intermediary must undertake the necessary due diligence to find a candidate who is fit and proper, and suitably qualified to assume the position.

The capital market intermediary must notify the SC within two working days or prior to any public announcement, whichever is earlier when making such appointments. For supervisory purposes, the SC will carry out its post-appointment assessment on these individuals. If our assessment reveals that a director or a chief executive officer is not fit and proper, we can direct the person to be removed from the position.

Investment banks must also comply with the *Guidelines on Investment Banks* for the appointment of its directors and chief executive officers, requiring BNM's prior approval.

### "Controllers"

Prior to the CMSA, all changes to the shareholding of a capital market intermediary, whether directly or indirectly, require the SC's prior approval. Now, prior approval is only needed where the change in shareholding, directly or indirectly, results in a change in the "controller" of the capital market intermediary.

"Controller" is defined in the CMSA as a person who is entitled to exercise, or control the exercise of, not less than 15% of the votes attached to the voting shares in the CMSL holder; or has the power to appoint or cause to be appointed a majority of the directors of the CMSL holder; or has the power to make or cause to be

made or give effect to decisions made on the business or administration of such a CMSL holder.

Where changes in shareholding composition or paid-up capital does not result in a change of controller, a capital market intermediary need only notify the SC within 14 days of the occurrence of the event.

Again, investment banks must also comply with the *Guidelines on Investment Banks* for changes in its shareholders which requires BNM's prior approval.

### Adequate and Competent Personnel

It is very important that a capital market intermediary has adequate and competent personnel with integrity and professional skills appropriate to the nature and scale of its business. Therefore, we have increased the minimum number of CMSRL holders from one to two for each regulated activity being carried out by a capital market intermediary. For a CMSL holder who applies to carry on dealing in unit trust products, the capital market intermediary must have two individuals registered with the FMUTM. This increase in minimum number of licensed representatives better safeguards the capital market intermediary's clients as it ensure business continuity.

To ensure that a capital market intermediary has a person to provide direction and feedback to the board on issues relating to the regulated activity, we have retained the requirement for at least one licensed director who must have at least 10 years of relevant experience in the regulated activity for which the company is licensed.

If the capital market intermediary carries on more than one regulated activity, it must appoint a head with at least eight years of relevant experience for each additional regulated activity. By doing this, the SC expects that a person with the necessary skills and expertise will provide guidance and supervision to the representatives carrying on that particular regulated activity.

### Removal of Experience Requirement

Since the supervision of the company's licensed

representatives will be carried on by either a licensed director or a head of regulated activity who each has the necessary experience in the regulated activities, candidates with relevant tertiary or professional qualification are no longer required to have three years of 'direct and relevant experience' when applying for a CMSRL. This was a prerequisite before the CMSA for candidates applying to carry on investment advisory activities, corporate finance, and financial planning. The only exception to this is for candidates applying for a CMSRL to carry on fund management where two years of 'relevant' experience would still be required for applicants with relevant tertiary or professional qualification.

## SUPERVISION OF MARKETS

### Surveillance Priorities

We prioritise our surveillance functions to meet challenges posed by the dynamics of the Malaysian capital market, as well as uphold its integrity and credibility. Given the dynamic nature of the capital market and innovative financial instruments which contribute to market complexity, surveillance has become increasingly challenging, and we need to continue redefining the scope of our surveillance functions.

During the year, we maintained our focus on early detection of market irregularities and abuses, so that pre-emptive remedial actions could be taken against the perpetrators. We worked closely with Bursa Malaysia, as the front-line regulator, in detecting market abuse, and took appropriate and timely actions. We also benchmarked ourselves against other jurisdictions and adopted their best practices and systems.

To achieve desired outcomes, we continue to adopt the existing surveillance framework:

- Adopt a proactive approach to contain market irregularities and maintain market integrity, with timely and effective market intervention and surveillance actions;
- Take immediate action on intermediaries, listed companies, and investors to contain market irregularities, and minimise or prevent possible systemic effect on the market;

- Worked with Bursa Malaysia through technical working groups and quarterly meetings to discuss and resolve operational issues and work towards strengthening Bursa Malaysia's role as a front-line regulator (FLR); and
- Clear demarcation of functions between the SC and Bursa Malaysia to harmonise and distinguish roles and responsibilities.

To achieve higher surveillance standards, we implemented a new automated system and developed a framework for enhanced disclosure to strengthen the price discovery process and pre-empt insider trading violations.

The new automated system has capabilities of providing enhanced solutions for market surveillance and operational control, such as:

- Detection of irregular price and volume movements, and behaviour of individual securities or market, based on current and historical trend;
- Alert parameters which are dynamic, based on current and historical trend of each stock;
- Automatic alert of unusual market behaviour; and
- Ability to perform simulation of various market scenarios.

## SUPERVISION OF BURSA MALAYSIA

Bursa Malaysia Bhd (Bursa Malaysia) as the FLR overseeing public-listed entities plays an important complementary role to the SC. An MOU and the Guidance on Regulatory Role of Bursa Malaysia govern the relationship between the SC and Bursa Malaysia, minimising duplication of activities and fostering mutual assistance through co-operation and effective communication.

### Bursa Malaysia as a Regulatory Body

As inherent conflicts of interest may arise between Bursa Malaysia's self-interest as a profit-oriented PLC and a FLR, the SC remains statutorily responsible for supervising and monitoring the activities of the entities within the Bursa Malaysia Group, namely;

- Bursa Malaysia Securities Bhd;
- Bursa Malaysia Derivatives Bhd;
- Bursa Malaysia Securities Clearing Sdn Bhd;
- Bursa Malaysia Derivatives Clearing Sdn Bhd; and
- Bursa Malaysia Depository Sdn Bhd.

The SC's supervisory responsibilities over Bursa Malaysia is through—

- ongoing off-site monitoring of Bursa Malaysia's regulation over public-listed entities, its supervision over its members and surveillance of secondary markets. We also determine if sufficient resources are devoted to regulatory functions; and
- annual onsite audit; the first of which commenced in 2005 (after the demutualisation of the exchange) with the recent third regulatory assessment completed in November 2007. The SC's regulatory annual assessment on Bursa Malaysia is essentially based on the Annual Regulatory Report submitted by Bursa Malaysia. The ARR sets out the extent and scope of Bursa Malaysia's compliance with its statutory obligations and its salient activities for the financial period.

On an ongoing basis, the SC discusses issues with Bursa Malaysia, such as improvements in governance structures, regulatory functions, and other services offered to their stakeholders.

Furthermore, as a FLR, the market behaviour of market participants is regulated by rules issued by Bursa Malaysia. All amendments to such rules require our approval. To ensure all submissions by Bursa Malaysia are managed efficiently and without delay, we maintain continuous engagement to deal with issues that may arise.

### Product and Infrastructure Development Oversight

We review proposals submitted by Bursa Malaysia, including market or product development initiatives. We oversee selected areas of Bursa Malaysia's infrastructure development and work to ensure the provisioning of automated systems

with adequate capacity, security arrangements and facilities, as well as industry readiness.

Having launched BursaTrade Phase 1A – the trading platform on derivatives on 20 November 2006, Bursa Malaysia is currently targeting to launch BursaTrade Phase 1B – the systems infrastructure for the equity market. It is undergoing systems testing, and implementation is expected in the first quarter of 2008.

The SC granted an approval in principle to introduce Direct Market Access (DMA) for the derivatives market which will enable zero touch execution of trades by clients via the broker. It is expected that DMA facilities will provide an impetus in advancing the utilisation of sophisticated technology by brokers and its clients in this market. With DMA, the speed of execution by a client will be much faster. The SC and Bursa Malaysia are looking at appropriate controls to put in place to manage risks related to DMA, both at the stockbroking companies and at the exchange. DMA is expected to be launched in first quarter of 2008.

### **Bursa Malaysia as a PLC**

In our capacity as the regulator of Bursa as a PLC, we monitor and enforce the Listing Rules of Bursa Malaysia Securities on Bursa Malaysia where necessary. This includes compliance with all disclosure requirements, monitoring unusual market activity, and others.

## **SUPERVISION OF BOND MARKET**

### **Intermediaries**

We adopt a risk-based approach in supervising bond market intermediaries, namely, bond trustees and credit rating agencies (CRAs), where the focus of supervision is closely tied to risks posed to the markets. In adopting this approach, the SC conducts regular and timely oversight by examining submissions, reports, and other documents to ensure that bond market intermediaries continuously exercise high standards of professionalism and compliance, and to safeguard the interest of bond investors.

There are 14 bond trustees registered under the *Practice Note on Registration by the SC for the Purpose of Acting as a Bond Trustee* issued in 2006. Following registration, the SC conducts close supervision on these bond trustees by monitoring compliance with requirements under the practice note, and addresses various issues, including those raised by bond investors and other market participants on the role and performance of the bond trustees.

The SC also conducts oversight of CRAs recognised under the *Practice Note on Recognition of Credit Rating Agencies by the SC for the Purpose of Rating Bond Issues*, also issued in 2006, particular on their compliance with the stipulated recognition criteria, as follows:

- High standards of professionalism in rating and monitoring corporate bonds;
- Adequate and timely dissemination of rating information; and
- Compliance with IOSCO's Code of Conduct Fundamentals for CRAs.

Several non-compliance of the recognition criteria were detected, mainly on timely dissemination of rating information, and appropriate actions were taken with the CRAs to address the issues.

### **Trading**

Unlike the equity market, bonds are traded in the over-the-counter market, largely by sophisticated institutional investors and financial institutions. As savvy investors and mostly regulated institutions, the SC expects these market participants to exercise high standards of professionalism and conduct in the secondary bond market. We adopt a balanced approach in overseeing the conduct of trading in the bond market, with the underlying objective of ensuring a fair and orderly market.

Our oversight efforts serve to detect market abuses, deter misconduct, and enable timely supervisory actions to be taken. We constantly conduct enquiries on unusual trades to determine compliance with securities laws.

This consequently builds and maintains confidence, upholds market integrity and promotes greater professionalism among the market participants. More importantly, it also serves to maintain investors' confidence in the bond market.

### **Infrastructure – Electronic Trading Platform**

The SC, together with BNM, is facilitating the development of a centralised electronic trading platform (ETP) by Bursa

Malaysia for secondary bond trading. Once fully operational, the ETP will capture, store and disseminate real-time information, and at the same time, provide electronic trading facilities for bond and money market instruments.

While the development of the ETP is aimed at enhancing price transparency and discovery process in the secondary bond market trading, the availability of pre- and post-trade information provide an effective check and balance mechanism in ensuring proper conduct by market participants.