Governance Strategies for Investor Protection and Stability

CHAPTER 4

GOVERNANCE STRATEGIES FOR INVESTOR PROTECTION AND STABILITY

In creating an enabling environment to foster innovation and diversity in capital market intermediation, it is necessary to ensure that governance arrangements provide robust safeguards to protect the interests of investors and the stability of the market.

CMP2 outlines the strategies to ensure robust governance arrangements to manage the risks to investor protection and stability.

GOVERNANCE STRATEGIES:

1. **Enhance product regulation to manage risks.** Foster a more conducive environment for product innovation and diversity while ensuring that active fund-raising and financial innovation benefit investors.

2. **Expand accountabilities as intermediation scope widens.** Create an enabling environment for participants to broaden intermediation activities and strengthen industry capabilities and standards.

3. **Robust regulatory framework for a changing market landscape.** Ensure a consistent regulatory approach to a changing market environment and focus on enhancing the quality of markets.

4. **Effective oversight of risks.** Expand regulatory coverage, capacity and tools to ensure effective supervisory reach and strengthen oversight of risks to market stability.

5. **Strengthen corporate governance.** Strengthen the effectiveness of corporate governance through broad-based approaches to promote greater stewardship, more active shareholder participation and strengthen gate-keeping accountabilities.

6. **Broaden participation in governance.** Promote active participation of stakeholders in shaping intermediation and corporate behaviour and to promote a culture of integrity and increased emphasis on socially responsible goals.

4.1 Enhance product regulation to manage risks

Fund-raising and product regulation in Malaysia historically evolved from a merit-assessment regime. As the capital market broadened over the past decade, there was a progressive shift from merit assessment towards disclosure-based regulation (DBR) for both fund-raising and investment products. To accommodate this shift, the regulatory framework was oriented towards placing greater emphasis on the accountability of issuers and professionals for the disclosure of information.

The implementation of DBR was aimed at providing a facilitative framework to enhance efficiency and transparency and to provide greater clarity in approval requirements. This offered greater certainty which enabled issuers and intermediaries to raise funds and launch products in a timely and cost-efficient manner.

Over the years, the global financial landscape has significantly changed with financial innovation facilitating the packaging of risks into small, diversified and liquid tranches. This has enhanced the role of markets in financing economic activities but, at the same time, financial innovation is also posing new risks detrimental to the overall safety of investors and markets. (See Table 4)

Table 4

Product risk issues during the global financial crisis

Products	Risk issues
Subprime mortgages	• Lax lending practices with fraud or misrepresentation • Concealment of high risks • Conflicts of interest affected CRA assessment • Poor documentation posing problems for transfer of property rights during bankruptcy proceedings
Credit default swaps	• Lack of transparency and disclosure; product risks were hidden • Conflicts of interest among counterparties in securitisation and credit default swap transactions • Inter-dependence among counterparties and high leverage posed financial stability risks
Auction rate securities	• Auction rate securities were misrepresented as cash equivalents but purchasers were unable to liquidate when market crashed • Difficulties in estimating fair value due to lack of transparent pricing
Money market funds	• Major money market funds unable to meet par value of US$1.00; prompting concerns which required intervention • Failure to provide material information on investments to Boards, investors and rating agencies
Hedge funds	• Perceived as a source of volatility and systemic risks • Highly leveraged structure made them vulnerable to failures at prime brokers resulting in hedge fund assets being frozen • Lack of transparency and regulatory oversight – with some hedge funds possibly used as vehicles for insider trading and market abuse • Conflicts of interest affecting performance measurement, fees, redemption rights and treatment of clients
Exchange-traded funds	• Some ETFs have large tracking errors • ETFs played major role in flash crash in US market on 6 May 2010

In moving forward, there is a need to foster a conducive environment for innovation to expand the role of the Malaysian capital market in financing economic growth. This is best achieved through increasing the efficiency in assessing the quality of products while ensuring that financial innovation benefits investors.

To cater for a broadening in the variety of products, the framework for fund-raising and product offerings will be streamlined to increase process efficiencies while disclosure and other regulatory requirements will be refined to ensure that adequate safeguards against risks to investors and market stability are maintained.

4.1.1 Conducive environment for product innovation

Legal definitions are critical in scoping the range of products and the entities that can intermediate these products, and provide a basis for regulators to exercise oversight over intermediation activities as well as for the settlement of disputes. From a historical perspective, there are well-established doctrines and practices to regulate the traditional asset classes of equities, debt and futures.

However, financial innovation has widened the possible range of products from the traditional asset classes. In line with similar efforts in other jurisdictions, the *Capital Markets and Services Act 2007* (CMSA) will be expanded to facilitate the ability of market participants to intermediate a wider range of asset classes and product structures as well as to bring under regulatory oversight previously unregulated activities and participants.

One complication is that derivatives and hybrids can be assembled to mimic the properties or economic pay-offs of traditional assets. Yet the regulatory requirements and legal consequences are different.

In many jurisdictions, the general approach is to extend the existing laws that apply to a particular asset class to securities-related products to ensure regulatory consistency. This will ensure, for example a commodity-related derivative or swap, will then be regulated in the same manner as an underlying futures contract. Regulatory requirements can then be varied at the operational level to cater for different ownership rights, rules and practices for trading, custody, clearing and settlement.

Overall, the CMSA will be reviewed to facilitate product and service innovation through widening the range of asset classes for intermediation while ensuring that all comparable investment products and services operate within a framework of regulatory oversight and reach and are consistently regulated for investor protection.

4.1.2 Efficient framework for fund-raising and product innovation

In fostering a more conducive environment for product innovation, there will be a need to manage the balance between the pace of innovation with the degree of safety offered by regulatory assessment. One of the lessons to be drawn from the global financial crisis is the need to tilt regulatory balance towards improving the quality of fund-raising and financial products to meet the goals of investor protection and market stability.

The guiding principle is that there shall be no regulatory vacuum. This requires direct and coordinated oversight and reach over participants involved in originating products. In this regard, there should be clarity on the obligations and accountabilities of various parties for disclosure and conduct during the offering period, for continuous disclosure and for specific actions to be taken on the occurrence of material events.

"The guiding principle is that there shall be no regulatory vacuum."

The regulatory framework for fund-raising and product offerings will also be delineated to facilitate a streamlining of assessment processes, and disclosure and suitability requirements to be tailored more specifically to the needs of different categories of products and investors. This will allow the removal of redundant requirements while at the same time ensuring more effective investor protection.

Efficiency will be increased though streamlining assessment processes and disclosure requirements and improving time-to-market by further standardising information requirements for well-established products.

Delay in bringing new products to the market usually arises because of the difficulty in assessing potential impact as well as the time required to write new rules or modify existing rules to cater for the new product. The uncertain regulatory requirements create a disincentive for intermediaries as this affects the cost and timing of product launches with consequential effects on commercial viability.

A risk-based assessment process will therefore be established for new products. Greater clarity and certainty will be provided to market participants through a well-defined process that focuses on an assessment of risks and how these can be managed through internal controls and regulatory requirements for disclosures and accountabilities. Product regulation works most efficiently when all parties collaborate to ensure that investment products contain the necessary safeguards to meet the objectives of investor protection and market stability.

While retail investors are typically afforded higher levels of protection, the conventional approach assumes that sophisticated investors have sufficient knowledge and understanding of product risks. However, the global financial crisis showed that even sophisticated investors were unable to appreciate the risks inherent in highly complex

products. There were also concerns that some of these products were reaching retail investors. Individual investors were also affected by the impact of product failures through the losses incurred by investment institutions and pension funds.

This experience points to the need to review the regulation of sophisticated products, including assessing the potential impact of these products on investors. Additional safeguards including the capacity of issuers and originators to manage inherent risks will be considered.

There is also scope to further refine the definition of sophisticated investors to allow a more targeted approach to matching product characteristics with the categories of investors. This may create more opportunities to distribute products with minimal regulatory requirements to investors who have both the necessary experience and financial resources to assess the risks associated with specific products.

4.1.3 Strengthen disclosure and post-issuance obligations

As with any other consumer products, financial products create value by offering benefits for the buyer. However, financial products differ from consumer products in that investors, in effect, supply capital through purchasing equity ownership, debt or investment contracts that promise a combination of returns and risks. As the ability of a financial product to deliver on its promises is dependent on uncertain events in the future, the main tool for the protection of investors must mainly rest on the quality and reliability of information disclosures.

In this regard, the lack of reliable, uniform and timely information results in information asymmetry, where the seller operates at an advantage because he knows more than the buyer, and inhibits market development. Investors need to be given adequate information to assess prospects and risks so that they can make well-informed decisions before purchasing the product.

Disclosure therefore functions as the primary basis for the regulation of products by imposing obligations to address information asymmetries. Disclosure provides investors the necessary information to assess the product, and forms the basis for enforcement action.

Over the past decade, DBR has provided a facilitative issuance environment through enhancing efficiency and transparency and is well accepted by both issuers and investors. The role of disclosure as the primary tool for investor protection will be further enhanced through greater emphasis on achieving disclosure that is timely, simple, relevant and meaningful.

"...the main tool for the protection of investors must mainly rest on the quality and reliability of information disclosures."

Disclosure requirements will therefore be increasingly oriented towards specific and comparable metrics including through the use of more standardised formats which focus on information relating to returns, risks, fees and costs. In addition, disclosures shall also provide greater clarity on the obligations of issuers and professionals and must address commitments to take specific actions in response to material events.

Additional disclosure requirements and safeguards will be imposed on high-risk and complex products. These include disclosures on potential risks through pay-off structures to increase investor awareness of potential maximum loss and the circumstances that can trigger such losses.

"Additional disclosure requirements and safeguards will be imposed on high-risk and complex products."

Where appropriate, continuous disclosure obligations will also be imposed in relation to post-issuance events such as a material change in underlying assets or a default. Accountabilities will be established for timely continuous disclosures.

Greater clarity will be provided on accountabilities particularly for the conduct of due diligence exercises and more stringent standards of liability will be imposed on those responsible for information disclosures.

Financial products are also unique in that consideration is given to the fact that investors may not possess the necessary knowledge to assess the product. In this regard, investor education requirements will be imposed on products with a high-risk profile.

More broadly, there is a need to address information asymmetry by ensuring investors have ease of access to product information in a convenient format. Towards this end, the SC will establish a central repository for offering documents and continuous disclosures and promote the use of interactive data formats.

4.2 Expand accountabilities as intermediation scope widens

Intermediation diversity is a key feature of a dynamic capital market functioning to meet the expanding needs of issuers and investors in an economy undergoing structural transformation. Over the course of the decade, intermediaries will require greater regulatory flexibility to expand their services as well as to reconfigure their operations to suit their business strategies and capabilities.

As intermediation scope widens, there will be a need to ensure intermediaries and other participants involved in capital market-related activities operate on higher standards and capabilities in terms of managing business conduct, and operational and financial risks.

The increasingly transactional nature of the capital market will also require greater focus on regulating the client-intermediary agency relationship to minimise conflicts of interest arising from involvement in multiple activities.

Overall, the regulatory framework will be streamlined, to facilitate greater variation and efficiency in businesses, and correspondingly strengthened, to maintain the integrity of business conduct and performance of fiduciary duties, to sustain confidence in the capital market.

4.2.1 Widen intermediation scope

In the past, regulation of participants was a passive outcome of the institutional structure of financial services which had well-defined business functionalities. While regulatory boundaries have remained relatively static, the changing dynamics of intermediation have increasingly dispersed functions such as sales, advice, investment management, research, trade execution, settlement and custody.

The trend towards dispersal of intermediary functions requires evolving a regulatory approach that increasingly focuses on functionalities and ensuring clear points of accountability, while gradually permitting a broadening in the scope of capital market activities that may be undertaken by participants. This will involve reviewing the definition of capital market activities to provide greater consistency in regulating various functionalities and revenue-sharing arrangements along the transaction value chain.

It will also be necessary to provide greater flexibilities to intermediaries to de-couple and outsource business functions. However, regardless of the configuration of business operations, regulatory requirements and supervisory reach will be extended to all parties who are collectively involved in a regulated intermediation activity. This will include ensuring that specific regulatory requirements for capital, capabilities and other controls, related to the satisfactory management of risks, are in place.

A review of the licensing and registration process will be undertaken to enhance the efficiency and effectiveness of the licensing process, starting with a reduction in administrative requirements for annual renewal of licences.

"The trend towards dispersal of intermediary functions requires evolving a regulatory approach that increasingly focuses on functionalities and ensuring clear points of accountability..."

Following the completion of CMP1, international participation in Malaysia's capital market is now largely liberalised. The challenge ahead is to manage the balance between the benefits from expanding participation and the risks from competitive intensity.

Broadly, Malaysia's capital market will benefit from domestic and international entrants as the expansion in the numbers of participants will generally have a positive impact on increasing products and services, creating jobs, expanding capabilities and enhancing productivity, all of which contribute to the industry learning curve and growth. However, the growth objectives must be balanced with the need to manage risks from competitive intensity and ensure an orderly operating environment.

Therefore, entry policies will be oriented towards attracting domestic and international participants that offer value propositions that can promote the growth and competitiveness of the Malaysian capital market. In addition, transparent exit policies will also be established to ensure that all participants have sufficient operational capabilities to operate in Malaysia's capital market.

4.2.2 Strengthen intermediation standards and capabilities

Over the years, markets have progressed from caveat emptor or "buyers beware" towards the higher ethical standard that the interest of investors shall be the primary concern. The evolving concept of investor protection extends beyond just ensuring that investors, particularly retail investors, are provided the necessary information to make informed decisions but also gives due consideration to the fact that many retail investors may not have the necessary knowledge to assess investment products or their own financial requirements.

In this regard, disclosure alone is usually insufficient to address the information asymmetry problem that exists between buyers and sellers of financial products. The regulation of business conduct therefore supplements product regulation by governing the interaction between intermediaries and their clients.

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One of the oldest regulatory principles is that investors should be able to rely on intermediaries for impartial advice through the fiduciary nature of their relationship which requires intermediaries and their agents to give priority to the interests of their clients. Generally, intermediaries have far better access to information and are more knowledgeable; therefore they operate in a position of trust and have responsibilities to serve the needs of their clients. However, self-interest can lead intermediaries and their agents to engage in conduct that poses risks both to the well-being of their clients and the safety of the financial system.

Regulation serves to ensure intermediaries conduct their business in line with their fiduciary duties, give due regard to the interests of clients and have appropriate safeguards that would ensure fair treatment of clients.

The management of the intermediary-client fiduciary relationship and conflicts of interest is becoming all the more challenging in a changing market landscape (See Box 12). As intermediation activities undergo change, the specification of responsibilities and requirements and the manner in which regulatory oversight and reach is to be effected will need to be continuously reviewed.

The increasing dispersal of intermediary functions will require that supervisory oversight is focused at the level of the firm with greater accountabilities placed on Boards and management to monitor and ensure that their employees and agents conduct business to the highest professional standards. The range of supervisory actions for shortcomings in managing the conduct of employees and agents will be expanded to reflect the importance of ensuring high standards of business conduct.

Box 12

Impact of electronic channels on client-intermediary relationships

The emergence of electronic channels has changed the dynamics of the landscape for intermediation and led to de-personalisation of the relationship between intermediary and client.

Electronic channels allow services to be easily disaggregated as they create an environment where trade execution and advice can be provided by different online intermediaries. With disaggregation, investors can simultaneously choose a number of service providers for different aspects of an investment transaction and to shop around for the most advantageous terms and prices for specific services.

As the reliance of clients on intermediaries diminishes, the client-intermediary relationship can also be more easily terminated. This reduces the opportunities for intermediaries to understand the background and needs of clients as required by their fiduciary duties.

Disaggregation therefore gives rise to interactions different from those arising from personal relationships and gives rise to greater transience in client-intermediary relationships. The increasing de-personalisation of the client-intermediary relationship in an electronic environment will require the evolution of approaches to regulation that will provide adequate levels of protection to investors.

Intermediaries are also likely to become more involved in multiple activities where they act as principals as well as agents representing the interests of clients. Conflicts of interest are likely to emerge as the major risk, given the increasing frequency of overlapping roles. Such situations occur when investors are sold products which are not suitable for them, bear hidden costs, have unfair contract terms or when trade execution disadvantages the client or there is improper use of client information and assets. In addition, there is also a need to protect investors from selling practices that are predatory or fraudulent in nature.

Therefore, priority will be placed on ensuring that intermediaries strengthen internal controls to manage conflicts of interest. Intermediaries will be required to review their policies and procedures for disclosure of conflicts, prohibition of unethical conduct and detection of non-compliance. Industry associations will be encouraged to provide guidelines on business conduct and internal controls.

Boards and management of intermediaries will also be required to take a more proactive role in ensuring that compliance functions have the necessary stature and visibility to be effective and to promote a culture of integrity to enhance the reputation of the firm.

As intermediaries expand their range of activities, they would need to upgrade their capabilities to manage financial, product and technological risks on an enterprise-wide basis as well as to strengthen their management of risk exposures to operational and financial counterparties. Boards and management are expected to take an active role in managing enterprise-wide risks and to ensure continued improvements in risk management policies and capabilities to match the expansion in intermediation activities.

"...the scope of investor education shall be broadened to include SRI and corporate governance."

Investor education is indispensible as a tool to strengthen the relationship between the client and the intermediary. In this regard, intermediaries must take the lead in shifting investor education from classrooms, and must identify opportunities to integrate investor education at points of contact with clients.

There are also opportunities for greater industry-wide collaboration to expand the range and quality of investor education materials. In addition, the scope of investor education shall be broadened to include SRI and corporate governance.

During the global financial crisis, it was evident that the growing inter-connectedness of markets and products had increased the systemic significance of potential vulnerabilities across a chain of activities undertaken by regulated and unregulated market participants.

As weak links in the transaction chain may become a future source of systemic risks, the expansion of regulatory oversight to facilitate inquiries, on-site examinations and, where required, to compel participants to address weaknesses and vulnerabilities in their internal control systems will be necessary.

The process of extending regulatory oversight started in 2006 with the registration of credit rating agencies (CRAs). The CRA regulatory framework will be further enhanced to cover rating criteria transparency and policies, the rating review process and governance structure, in tandem with evolving international standards and best practices. (See Box 13)

Regulatory oversight will also be extended to cover the VC and PE industries to enhance investor confidence in these industry segments as well as other participants involved in the safekeeping of client assets such as custodians and trustees. Regulatory oversight will take into account the unique characteristics of these industries and aim to establish standards of professional management and safeguards. It will also provide for the maintenance of records.

Box 13

Regulation of credit rating agencies

Malaysia became one of the earliest jurisdictions to bring CRAs under regulatory oversight through requirements for registration and compliance with the IOSCO Code of Conduct. In 2006, the SC released a *Practice Note on the Recognition of Credit Rating Agencies* to ensure mandatory registration of domestic CRAs and to provide requirements for rating process quality and integrity, disclosure transparency and timeliness, monitoring and updating process, independence and avoidance of conflict of interest, the adequacy of expertise and resources.

The 2007–2008 global financial crisis called into question the credibility of credit ratings. In response to the perceived lapses in CRA practices, the G-20 Declaration in April 2009 called for the extension of regulatory oversight and registration of CRAs to ensure they meet the international code of good practices and to prevent conflicts of interest. Subsequently, IOSCO added a new principle to its *Objectives and Principles of Securities Regulation* in June 2010 to subject CRAs to registration and supervisory oversight.

4.3 Robust regulatory framework for a changing market landscape

The exchange landscape has been dramatically transformed over the past two decades. Exchange demutualisation separated the historical umbilical cord between broker members and the ownership of the exchange. This set in motion a series of transnational mergers and acquisitions among flagship exchanges in different continents even as new competitors emerged in the home market.

Rising demand from investors for international assets increased the pressure to adopt international standards, thereby leading to increased international mobility of order flows and products. In the process, markets have become so diverse and fragmented that they are now less defined by geographical boundaries.

Financial innovation and technological advances also spawned an astounding variety of products that are now traded and settled through a network of multi-functional platforms. The value chain of market transactions has been disaggregated such that a single electronic device is now capable of routing messages and orders and matching them in several regulated or unregulated venues.

"...new functionalities and speed appear to be undermining the traditional modes of intermediation and rules..."

The new functionalities and speed appear to be undermining the traditional modes of intermediation and rules which imposed distinctive parameters on market activities. These emerging structural trends are affecting the quality of markets and their economic function in promoting long-term economic growth.

Technological advances have increased the permutations with which trades can be routed, executed and booked and are transforming client-intermediary-exchange relationships. These developments are adding significant potential for abusive behaviour in trade execution and for diversion of transaction flows to opaque venues while possibly weakening traditional fiduciary and self-regulatory duties.

The changing competitive dynamics is also exerting greater commercial pressures on exchanges and participants to focus on liquidity. This seemed to have led to the tendency for liquidity to concentrate in a smaller proportion of listed companies and products, thereby reducing the amount of liquidity available across the breadth of the market and diminishing the role of markets in promoting capital formation.

The full implications of the emerging market landscape are yet to be fully understood and are still being assessed by regulators around the world. Regardless of how the landscape evolves, the priority is to adopt a consistent approach to regulating markets to ensure markets perform their vital tasks of efficient capital allocation and to protect the interests of investors.

4.3.1 Rationalise regulatory arrangements for markets

Historically, exchanges were regulated either as securities or futures markets with a broad range of self-regulatory obligations. Today, the term "markets" refers to a broad group of entities with varying functionalities, products and participants with most markets operating as a node in an international network rather than as a silo.

In effect, the multi-functionality of platforms makes it increasingly difficult to determine whether an entity in a transaction chain is undertaking the provision of information, the conduct of intermediation or market activities. For example, communication through discussion boards, forums and chat rooms can conceivably function as an avenue for the provision of advice and be used to search, solicit and match orders.

In addition, practices such as trading algorithms (programmes that automate trade execution across market venues), trade internalisation (brokers matching client trades internally instead of routing orders to market) and the emergence of competing market venues (with diverse order-matching algorithms, transaction cost structures and order exposure rules) are fragmenting price discovery which used to be centralised at traditional exchanges.

While the newer marketplaces are facilitating innovation, increasing efficiency and lowering transaction costs, they are also effectively arbitraging the higher regulatory obligations of traditional exchanges. There are emerging concerns that differentiated regulatory obligations are tilting the competitive balance between new and traditional markets.

There is also concern over rising competition between exchanges and intermediaries for order-flow which are increasing conflict of interest situations. Potentially, exchanges can use their rule-making capability to secure competitive advantages while intermediaries can use their knowledge of order-flow to internalise trades thereby reducing the transparency of price discovery. Ultimately, the growing commercial orientation of market participants is fragmenting price discovery and posing new risks to market integrity and stability.

> "...differentiated regulatory obligations are tilting the competitive balance between new and traditional markets."

Various jurisdictions have adopted different approaches to the regulation of markets – by either treating the new platforms as an expanded function of a broker (the Alternative Trading Systems (ATS) rules in the US) or by imposing the same regulatory requirements through a functional approach (the Markets in Financial Instruments Directive (MiFID) in Europe).

As the market landscape changes, there will be a need to review the definition of markets and the responsibilities of participants that provide services which fall within the ambit of operating a public market. This will include consideration of various obligations in relation to listing, pre-trade and post-trade transparency and clearing and settlement.

The regulatory duties of traditional exchanges will also be reviewed in relation to listing rules, broker supervision, participant conduct and readiness, market surveillance and supervision of clearing and settlement participants. Trading and clearing memberships will be de-coupled to provide greater flexibility to intermediaries to reconfigure their operations while the rules for trading, clearing and settlement will be modified to cater for a multi-product environment.

The changes in the competitive structure of markets will also require a review of regulatory arrangements for rule-making by exchanges as well as the setting of conditions for market access and pricing of services to ensure they are reasonable and non-discriminatory.

4.3.2 Enhance market quality

The trend towards electronically-driven market transactions has intensified competition among exchanges and other market venues offering a variety of auction mechanisms, transmission speeds and pricing schemes to vie for order flow. This has altered market structures with a significant proportion of equity trading migrating from traditional exchanges to venues where pricing and order flows are not transparent to the public.

Traditional providers of liquidity such as specialists and market-makers have also found their ability to provide orderly two-way price quotations being dis-intermediated by high-frequency trading (HFT) and other algorithmic trading strategies.

There are growing concerns that the new trading methods can be disruptive particularly when strategies are used to locate and trade in front of large orders or when rapid order submission and cancellations are used to ignite rapid price movements. In these instances, these electronically-driven strategies tend to subtract rather than add to liquidity as they reduce the depth of order books and leave the market susceptible to volatile price movements.

This increases the risk of sudden and sharp price movements that can disrupt orderly trading conditions which may cause some participants to experience large losses with potential knock-on effects on other participants and clearing houses.

The trend towards proprietary trading and trade internalisation by intermediaries has also raised concerns over increasing conflicts of interest with intermediaries possessing better information on order-flow and having priority on trading. This leads to information asymmetry which can reduce fairness in market transactions, affect order execution quality for clients and open up greater possibilities for market abuse.

The changes in equity market structure have also been associated with the tendency for liquidity to concentrate in the largest listed companies and on products such as ETFs and related derivative products. This has raised concerns that concentration is diverting liquidity away from small and mid-cap companies.

These developments are viewed to have undermined the traditional broking model of research, distribution and market-making and diminished the attractiveness of IPOs for small and mid-cap companies; leading to a reduction in the level of capital formation in developed markets.

The implications of changes in equity market structure are being reviewed by regulators in major developed markets who are concerned over its impact on the quality of markets and long-term investor confidence.

Broad regulatory changes will be considered towards improving the level of transparency and fairness among participants to enhance market quality. This will include strengthening the monitoring of proprietary trading for potential conflicts of interest and reviewing trading practices to ensure intermediaries execute trades in the best interests of their clients.

In addition, the varying access and capabilities of different market participants and their impact on the integrity of price discovery will be reviewed to ensure that participants operate with obligations that are compatible with their preferential access.

"Broad regulatory changes will be considered towards improving the level of transparency and fairness among participants to enhance market quality."

To ensure more effective safeguards and oversight, reporting obligations and real-time data collection will be enhanced to facilitate more effective market surveillance and higher levels of market transparency. Risk management of automated trading and market systems will also be strengthened to manage potential risks from trading disruptions.

The role of equity markets in promoting capital formation will be enhanced by reviewing arrangements to promote intermediation activities to support research and liquidity in small and mid-cap companies. This will require the evolution of new business models and regulatory facilitation to provide incentives for intermediaries to commit greater resources to promote the growth of small and mid-cap companies listed on the exchange.

Despite these structural weaknesses, well-organised public markets proved their value by being able to operate with minimal disruption during the global financial crisis. This experience illustrates the value of transparency arising from information disclosures, price discovery and the role of central counterparty clearing systems in minimising systemic risks.

Systemic risks emanated largely from the OTC markets where opaqueness facilitated significant leverage and abusive practices. It became evident during the 2007–2008 financial crisis that risks from unregulated venues can easily cascade through global markets due to increasing inter-connectedness between products and markets.

There is a need to learn from international experience and to address regulatory gaps to strengthen market stability. This will require facilitating the trading of a wider range of standard derivative contracts on public markets and strengthening the transparency of OTC transactions through the establishment of trade repositories.

4.4 Effective oversight of risks

The increasing diversity of financial activities and products, fragmentation of transactions, transience in client-intermediary relationships and international mobility of assets and capital have increased the fragility of markets.

A succession of financial crises has given rise to concerns on the adequacy of existing global regulatory frameworks to manage risks from the changing patterns of intermediation. New vulnerabilities are regularly emerging and gaps quickly exploited.

In this context, the objectives of securities regulation remain consistent in seeking to protect investors and to manage the risks to market stability. However, the approaches to regulating markets will require constant refinement to adapt to a continuously changing landscape.

> "With markets becoming increasingly transactional in nature, the priority is to identify critical points of accountability and controls so as to effectively address risk vulnerabilities."

It is important to ensure that appropriate oversight arrangements are always in place even as the parameters and boundaries of regulation shift and that there is no regulatory vacuum. The evolution of regulatory standards is ultimately shaped by public expectations and tolerance of risks.

Going forward, the challenge is to design robust regulatory frameworks and pragmatic and effective approaches to mitigating emergent risks. With markets becoming increasingly transactional in nature, the priority is to identify critical points of accountability and controls so as to effectively address risk vulnerabilities. Regulation is likely to be most effective when it addresses specific accountabilities and risk outcomes.

4.4.1 Expand regulatory coverage, capacity and tools for investor protection

Over the past decade, the Malaysian regulatory framework has been enhanced to meet international benchmarks. Regulatory accountabilities for disclosure have been raised to correct for information asymmetries. Conflicts of interest have been addressed through establishing standards for fair and ethical business practices and strengthening internal controls.

The regulatory framework for investor protection has been reinforced by active supervision and enforcement to provide an environment of reasonable safety from fraudulent and predatory practices while avenues for recourse and restitution have been established for aggrieved clients.

The global financial crisis has highlighted the need for regulators to remain vigilant in responding to emerging challenges from a changing market landscape. The SC is fully committed to vigorously enforcing securities laws to reinforce the central task of regulation in maintaining public confidence in the integrity of the Malaysian capital market.

The SC will seek to expand regulatory coverage and improve its capacity and tools to ensure effective supervisory oversight over participants, markets and listed companies.

"The SC is fully committed to vigorously enforcing securities laws to reinforce the central task of regulation in maintaining public confidence..."

One area of concern has been the need to detect and address vulnerabilities along an elongated and fragmented transaction chain. In this regard, a review will be undertaken to provide the necessary legal reach to exercise authority and to facilitate effective intervention such as the ability to undertake examinations to cover a broader spectrum of intermediation-related activities.

The expansion of supervisory coverage in terms of participants, products and activities will require the SC to strengthen its resources, expertise and tools for surveillance, examination and enforcement. In particular, examination capabilities will be strengthened to improve assessments of operational capabilities in back-office and safe-keeping functions and the effectiveness of internal controls at intermediaries.

The risk-based supervisory approach will be reinforced by strengthening the ability to identify emerging trends that may adversely affect the interests of investors. In this context, work will be undertaken to enhance the profiling of risks at individual firms which will provide the basis for identifying the need for regulatory intervention. Regulatory action will be taken against firms where internal controls and discipline fall short of required standards.

In this regard, training programmes for analytical techniques, product risk assessment and fraud detection will be stepped up and technical capacity will be augmented by recruiting or tapping specialised expertise. There will be further investments in technology to expand the monitoring of market activities.

The SC will also introduce initiatives to strengthen the overall investor protection framework through an expansion of investor education programmes and enhancing the mechanisms for redress such as complaints management, investor compensation schemes and dispute resolution mechanisms.

"...enforcement capabilities will be strengthened through the development of specialised investigation and prosecution skill sets."

Regulatory effectiveness is ultimately judged by swift enforcement actions. There will be greater focus on enhancing processes to expedite investigation and prosecution of cases. Towards this end, enforcement capabilities will be strengthened through the development of specialised investigation and prosecution skill sets. In addition, strategies will be developed to maximise the deterrent effects of enforcement actions and to enhance public awareness on the consequences of securities fraud. Greater efforts will also be made to encourage members of the public to volunteer information and evidence of possible violations of securities laws.

The new landscape will also require increased coordination among domestic and international regulatory and law enforcement agencies through information-sharing arrangements and cooperation to investigate cross-border fraud, to trace the movements of proceeds and to freeze assets suspected to be illegally obtained.

In tandem with the expansion in regulatory coverage and capacity requirements, regulatory fees and charges will be reviewed to ensure more equitable matching between costs and benefits of regulation.

4.4.2 Oversight of risks to market stability

Financial innovation and structural changes have modified the nature of capital market intermediation, changed the relationships between market segments and increased the likelihood of contagion risks being transmitted through market channels.

Capital market intermediation activities and products can now facilitate credit and maturity transformation and the insuring of risks. In effectively "mirroring" other financial functionalities, market-based intermediation has become similarly exposed to over-leveraging and pro-cyclical liquidity risks.

The efficiency and flexibilities provided by innovative financing structures unfortunately also have the disadvantages of facilitating circumvention of regulatory restrictions, masking leverage and a build-up in risks, which cumulatively pose a systemic threat to stability.

In this regard, financial innovation facilitated the creation of synthetic products constructed through futures, derivatives, swaps and indices which allowed financial institutions to manufacture a limitless supply of products to meet demand; implicitly increasing leverage and tightening the linkages between investment, financial institutions, products and markets.

The intensity and speed with which systemic problems can spread through markets has highlighted the need for new approaches to address market-driven systemic risks and inter-linkages between participants, products and markets.

Increasingly, the regulation of capital markets has to take on board the responsibility of monitoring and ring-fencing intermediation and product activities to prevent a build-up in risks, to erect safety barriers against the transmission of contagion along market channels and to facilitate decisive and timely resolution in the event of a crisis.

In line with global requirements, the SC will extend its regulatory mandate to provide for a more explicit role in promoting financial system stability. Securities regulators contribute to the reduction of systemic risks through strengthening investor protection, market integrity, transparency and business conduct. (See Box 14)

Measures relating to the detection and mitigation of systemic risk will increasingly be incorporated into the SC's existing conduct of market surveillance and supervisory oversight. This will include expansion of regulatory tools by strengthening data and information collection and analytical expertise for detection and diagnosis of a build-up in concentration risks.

In particular, the SC will work closely with intermediaries and market venues on areas of systemic concern through synthesising organisation-wide risk profiles, undertaking quantitative analysis of large intermediaries and complex products and through regular stress-testing of risk exposures. This will facilitate testing the potential cascading effects of volatile price movements that might affect significant financial institutions through sharp reductions in collateral values and facilitate better pre-emptive management of contagion events.

Product regulation will also be enhanced to incorporate additional safeguards through post-issuance and trade data collection, the introduction of facilities to mitigate product illiquidity risks, arrangements to protect client and counterparty assets in the event of insolvency and higher standards of documentation to provide greater legal certainty to pre-empt settlement disruptions.

Box 14

Role of securities regulators in promoting financial system stability

The International Organization of Securities Commissions (IOSCO) has identified reducing systemic risks as one of the three objectives of securities regulation. Eight principles were added to the IOSCO *Objectives and Principles of Securities Regulation* including the need to monitor, mitigate and manage systemic risks and to undertake regular review of the perimeter of regulation.

In February 2011, the Working Group on Systemic Risk noted that promoting financial stability is a shared responsibility amongst the regulatory community and that securities regulators, through their traditional focus on transparency and disclosure, are well placed to work towards an appropriate flow of information to market participants, investors and regulators.

The Working Group highlighted the need for securities regulators to develop a more robust framework of oversight and supervision that emphasises:

- Greater transparency and disclosure throughout markets and an expansion of the scope of supervision;
- An approach to financial innovation that seeks to better understand potential risks and find the right balance between unrestrained innovation and over-regulation;
- Increased internal resources for monitoring market developments and identifying emerging risks; and
- Engaging with other regulators and supervisors, both nationally and internationally, to produce a more robust and coordinated framework for promoting financial system stability.

A review will be undertaken to assess whether the ability to prohibit products or transactions that are detrimental to the stability of the market or its participants is required. Intermediaries will also be required to strengthen their governance and risk management processes in relation to product innovation.

The SC will also strengthen its communication on risks as low awareness of risks among investors and participants leads to improper incentives for risk-taking. Increasing transparency provides important information about risks related to products, markets and participants.

There will be increased efforts to enhance industry risk management capabilities. In particular, there will be more extensive monitoring of risks for integrated financial institutions. These institutions undertake a broad range of activities such as product origination, proprietary trading and the financing of trading counterparties.

Integrated financial institutions will be required to undertake more frequent stress-testing of balance sheet positions, enhance their risk reporting capabilities, ensure segregation of duties to strengthen the independence of the risk identification and mitigation process and expand their risk management coverage to qualitative elements relating to broad strategic challenges and reputational risks.

Inter-jurisdictional communication and information exchange among regulators on systemic risks are also essential to prevent the emergence of gaps in oversight and to identify and monitor transmission channels for transfers of risks across jurisdictions as early as possible.

There are already on-going efforts to broaden participation and improve coordination between national and international regulators to ensure more effective management of systemic risks. Regulatory arrangements will also be further reinforced to facilitate supervision of capital market participants that operate in multiple jurisdictions.

4.5 Strengthen corporate governance

Corporations not only create jobs and business activities but also issue equity and debt that provide returns on long-term savings. As PLCs expand their influence in the economy, the potential impact of governance failures on society becomes increasingly significant.

Hence, there was widespread public outrage over fraud and lack of monitoring and oversight that caused the high-profile collapse of companies like Enron, Worldcom and Parmalat in early 2000. This prompted the introduction of the *Sarbanes-Oxley Act 2002* in the US to strengthen the accountability and independence of corporate boards and audit functions. The occurrence of the global financial crisis in 2007–2008 shifted the focus of reforms towards incentive structures and risk management controls in financial institutions.

In Asia, the 1997–1998 regional financial crisis exposed weaknesses in the overall standards of governance and was the catalyst for regulatory reforms to increase transparency, strengthen internal controls and ensure adequate protection for minority shareholders.

Malaysia was among the earliest in the region to implement reforms with the introduction of the *Malaysian Code of Corporate Governance in 2000*. This was subsequently followed by initiatives to strengthen the responsibilities of Boards and audit committees as well as the introduction of whistle-blowing provisions. In tandem with this, the civil and administrative enforcement powers of the SC were broadened. (See Table 5)

Table 5
Corporate governance milestones in Malaysia

Year	Milestones
1999	• High Level Finance Committee Report on Corporate Governance
2000	• *Malaysian Code of Corporate Governance* • Minority Shareholder Watchdog Group (MSWG)
2001	• Capital Market Masterplan (CMP1) • First CG Report on the Observance of Standards and Codes (ROSC) on Malaysia • Corporate governance requirements incorporated into Bursa Malaysia's listing guidelines
2004	• Whistle-blowing provisions in securities laws
2005	• Second CG ROSC on Malaysia
2007	• Qualification criteria for directors, strengthened audit committee and mandated internal audit function • Enforcement powers for civil and administrative actions expanded to allow recovery of up to three times the amount of losses for wider range of misconduct including market manipulation • MSWG *Guide of Best Practices for Institutional Shareholders*
2009	• Enforcement scope broadened to cover actions against those causing wrongful loss as well as to make it an offence to influence persons preparing or auditing financial statements of listed companies
2010	• Audit Oversight Board (AOB)

The adoption of international best practices represents substantive progress in establishing a robust corporate governance framework which defines the benchmarks, processes and accountabilities in the corporate decision-making process. The corporate governance framework also provides safeguards so that when transgressions occur, there are effective avenues for redress and enforcement.

Corporate governance remains very much work-in-progress in Malaysia, and elsewhere around the world, as corporate practices still lag regulatory developments. In effect, there are no objective criteria that can guarantee good faith. Regulation is therefore needed as a tool to shape societal norms and generate peer pressure to embed the practice of ethical conduct and integrity into corporate cultures.

One difficulty is in precisely fitting the requirements for corporate governance to cater for a diverse range of situations given wide variations in ownership structure, size, diversity and nature of operations.

Concerns have been expressed over the cost of compliance arising from increasing governance requirements. In particular, smaller companies may not have sufficient resources to meet extensive requirements while poorly-performing companies are reluctant to disclose information since this may work to their disadvantage.

Nonetheless, there continues to be rising public and institutional investor pressure to raise the bar on corporate governance standards for those seeking access to public funds. So long as there continues to be corporate transgressions, there will be a need for robust regulation to provide assurance to investors and other stakeholders that there are sufficient safeguards to minimise potential misconduct and to facilitate swift enforcement.

An effective corporate governance framework requires a broad-based approach that calibrates the many complementary levers of control to achieve the desired outcomes. Towards this end, the SC has established an International Corporate Governance Consultative Committee, comprising representatives from the private and public sectors, to provide policy recommendations for a comprehensive five-year blueprint to further raise the standards of corporate governance in Malaysia.

"An effective corporate governance framework requires a broad-based approach that calibrates the many complementary levers of control to achieve the desired outcomes."

4.5.1 Board of directors as a focal point for corporate governance

While there have been substantial reforms, it has been observed that many PLCs tend to comply with the form rather than the substance of corporate governance codes. The recurrence of corporate scandals clearly indicates a gap in the active and independent monitoring of corporate conduct.

Boards of directors are the natural focal point for providing the necessary leadership on corporate governance. In this regard, Board structure, composition and dynamics are the critical elements that determine whether corporate decision-making is likely to be dominated by owners and management or whether Boards can effectively exercise the independence required to perform their stewardship duties. (See Box 15)

It is therefore important that regulation facilitates a more balanced mix of directors in terms of independence, size and stakeholder representation to ensure that corporate decision-making benefits from diverse views and expertise and takes into account the requirements of a broad range of stakeholders. Board deliberations will also benefit from diversity of expertise, background and gender.

The increased presence and effectiveness of independent directors can be a critical factor in ensuring greater reliability of financial information, in deterring self-dealing, in managing conflict of interest situations, in assessing corporate transactions and in assessing the performance of management.

The effectiveness of independent directors in fulfilling their function of impartiality and integrity is particularly critical during shareholder disputes where they need to act as stewards of the interests of the ordinary investor or the larger interests of society.

In tandem with this, there will be a need to organise efforts to identify a pool of experienced and respected individuals that qualify to be appointed as independent directors. This may be complemented by adequate training programmes and appropriate compensation to expand supply. The increase in remuneration shall be accompanied by greater disclosure and robust processes that link compensation to long-term value creation.

Box 15

Findings from the SC's review of Board structures of Malaysian PLCs

In 2009, the SC undertook an extensive review of PLCs to identify the common characteristics of Board structures. The findings were:

- **Related independent directors.** A significant number of PLCs have independent directors who are related to each other. This raises concern about the ability of independent directors to discharge their responsibilities effectively.

- **Long tenure of independent directors.** While a large majority of PLCs comply with the requirement to have one-third independent directors, half of these companies have independent directors with tenures exceeding nine years. About 20 PLCs have independent directors with tenures exceeding 30 years. The risk that independence may be undermined by long tenure cannot be disregarded.

- **Relationship between Chairman and CEO.** While around three-quarters of PLCs separate the role of the Chairman and CEO, in many instances the Chairman and the CEO are related. This nullifies the benefits of having dual roles on the Board.

- **Sizeable number of executive directors.** A quarter of PLCs have more than three executive directors on the Board and, in some instances, more than half the Board comprise executive directors. There are instances where the executive directors are related while some individuals serve in an executive director capacity in more than one company. The independence of the Board may also be compromised by the large presence of executive directors.

New technologies can be tapped to improve disclosures and communications between Boards with their stakeholders particularly in obtaining the views of minority shareholders and communities on a broad range of strategic and social issues. As society becomes increasingly transparent, it must be recognised that the decisions and conduct of companies will be widely scrutinised by the public.

Boards can also broaden their discussions to encompass a wide range of safety, sustainability and social issues, and to increase their engagement with communities affected by their operations. This will ultimately enhance the reputation of the firm and translate into sustained and healthy returns to shareholders.

4.5.2 Promote active shareholder participation

Direct monitoring and active participation by shareholders is a natural complement to the role of the Board in enhancing corporate governance. In this regard, shareholders, as providers of capital, are the ultimate beneficiaries of responsible corporate behaviour.

Ownership across Asia, including Malaysia, tends to be concentrated. This ownership pattern is generally deemed to increase the risks of self-dealing whereby corporate transactions may be used to expropriate profits for the benefit of majority shareholders while providing minority shareholders insufficient avenues to examine or challenge dubious transactions.

It is thus important that shareholders with economic interests are actively engaged in the appointment of the management of the company. The foremost lever for shareholders is their ability to monitor the performance of the directors and to participate actively in the nomination and election process.

More active shareholder participation in voting decisions is the primary means for shareholders to communicate their views and to influence the behaviour and conduct of directors. Directors will be more sensitive to shareholder views once they recognise that their election is vulnerable to shareholder pressure. This will place greater awareness on Boards of their duties and professional conduct.

"...shareholders, as providers of capital, are the ultimate beneficiaries of responsible corporate behaviour."

The nomination and voting processes need to be enhanced to expand the role and ability of shareholders to influence board composition. This includes facilitating nominations, providing more information and opportunities to assess the nominations and providing room for wider representation by different constituencies.

Consideration can also be given to streamlining the nomination and voting processes in relation to the appointment of proxies and facilitating the use of technology to enhance communication of information and to reduce the costs, length of time and complexity of casting a vote.

The changing pattern of savings intermediation has seen institutions emerge as the dominant owners of shares and, by inference, the grouping with the greatest influence on corporate behaviour. Institutional investors are duty-bound by their fiduciary duties and "prudent person" obligations to manage equity ownership risks through portfolio diversification.

The shift in investment focus to the safety and performance of the portfolio has led to a detachment of ownership interests from oversight of management capabilities or long-term corporate strategies and this weakens their role in influencing corporate governance and capital formation.

There are practical constraints for institutional fund managers to participate more actively as this exposes them to the risks of insider trading, particularly in take-over situations, conflicts of interest arising from related-party corporate transactions and political and reputational risks from active involvement in decision-making. It is far easier and more cost-effective for institutional investors to buy and sell liquid and large index component stocks.

"...the strategic direction is to promote more concerted and coordinated efforts to enhance the role of shareholders to become a more powerful force in ensuring good governance."

Some jurisdictions have tried to address the institutional passivity through promoting codes of stewardship particularly for the large pension funds and sovereign wealth funds. These codes typically emphasise transparency and ethical codes of conduct for the management of the funds but do not address the more difficult issue of how institutional investors can best exercise a positive influence over corporate strategies.

The long-term consequences of institutional investors maintaining their posture as passive and detached investors will skew institutional investments towards avoiding risks and this will weaken the intermediation link between savings mobilisation and direct investment.

Institutional investors can afford to invest in building specialised skill sets to enhance their involvement in influencing Board composition, governance practices and the shaping of strategies for investee companies.

Therefore, the strategic direction is to promote more concerted and coordinated efforts to enhance the role of shareholders to become a more powerful force in ensuring good governance. It will be through the enlightened perspective of conscientious shareholders that the corporate agenda can be broadened beyond short-term profits towards greater responsibility for creating sustainable corporate value.

4.5.3 Strengthen gate-keeping accountabilities

Good corporate governance is predicated on the reliability and quality of information disclosures. The task of verification and certification of information lies with the reputational intermediaries represented by the various professions such as accountants, advisers, analysts, auditors and valuers.

Boards, in performing their monitoring duties, are often unable to detect fraud directly. They exercise oversight mainly through the choice of auditor, reporting requirements and control over accounting practices.

This increases the reliance on third-party monitors or gate-keepers to ensure a supply of reliable information. However, past financial crises and corporate failures have highlighted that conflicts of interest have inevitably led to shortcomings in the exercise of independent judgement to deter mis-statements, questionable corporate actions and fraud.

Each failure in the discharge of the monitoring role has prompted calls for greater oversight and regulation of reputational intermediaries. Widespread concern over persistent failures of gate-keepers to provide stringent oversight of primary misconduct has led to suggestions that there is insufficient deterrence and a need to expand liability of those who vouch for the accuracy for disclosures.

"Widespread concern over persistent failures of gate-keepers to provide stringent oversight of primary misconduct has led to suggestions that there is insufficient deterrence and a need to expand liability of those who vouch for the accuracy for disclosures."

Several options are open for consideration. First, the management of conflict of interest situations can be tightened through strengthening internal control processes or imposing external requirements.

The second is to strengthen the accountabilities, adopt more stringent standards for liabilities and expand the range of regulatory actions that will apply in the event of shortcomings in monitoring or in the event gate-keepers participate in devising or abetting the questionable corporate actions.

The third is to review disclosure rules and to enhance the role of other sources of monitoring such as analytical reports, whistle-blowing or public complaints to increase the pressure on third-party monitors to meet the required standards.

4.6 Broaden participation in governance

Governments have reacted to repeated episodes of market failures by adding new layers of regulation. In this regard, regulatory reform plays a key role in correcting for past market excesses to restore public confidence and to motivate a resumption in investment activities. Yet regulation is not intended to be a substitute for vigilance on the part of capital market stakeholders. Stakeholders need to actively exercise their rights to provide checks and balance to irresponsible financial and corporate behaviour. It is indifference that lies at the root of every financial crisis.

The expansion of the role of the capital market therefore needs to be accompanied by more active stakeholder participation in shaping intermediation and corporate behaviour to promote a culture of integrity and to align business policies with social goals.

The achievement of sustainable and inclusive growth to complement high growth is dependent on forging a more positive relationship between businesses and society. The extensive public participation in markets signifies that many individuals have entrusted their retirement savings to intermediation agents.

"...it will be active stakeholder participation in ensuring governance in markets that will bring about greater social acceptance of growth-enhancing financial innovation."

The long-term savings need to be efficiently intermediated not only for financial returns but also to achieve socio-economic returns to bring improvements in living standards, promote more widespread distribution of economic activities and strengthen environmental sustainability.

It is therefore of paramount importance that governance arrangements for capital markets are sufficiently broad with widespread and active stakeholder participation to meet the challenges of the decade.

Regulatory policy will play a crucial role in defining the arrangements that reinforce investor trust and confidence in the integrity of markets but it will be active stakeholder participation in ensuring governance in markets that will bring about greater social acceptance of growth-enhancing financial innovation.

4.6.1 Promote active stakeholder participation in governance

Throughout CMP1, Malaysia adopted a regulatory philosophy of promoting market and self-discipline with strong oversight. The strong regulatory oversight has generally proven successful in restraining market excesses and has contributed significantly to the resilience of Malaysia's capital market.

Malaysia's capital market has since matured such that intermediaries, investors and other stakeholders can take on a more active role in shaping sustainable and socially aligned behaviour. Therefore, one major thrust is to strengthen the preconditions for more active stakeholder participation in governance as this will ultimately determine the quality and success of Malaysia's capital market.

Transparency, information and education are the fundamental building blocks in facilitating active stakeholder participation in the capital market. In this context, strengthening disclosure requirements and the information infrastructure and widening the channels of corporate communication will facilitate better flow of information to stakeholders.

The proficient use of information requires greater understanding of issues relating to investment needs, product knowledge, the rights and responsibilities of investors and more broadly how stakeholders can actively participate in influencing intermediary and corporate behaviour and activities.

Towards this end, the SC will broaden the scope of its investor education programmes to promote more active stakeholder participation in the capital market. This will include current efforts to promote financial literacy and expand the base of knowledgeable and vigilant investors. The scope of investor education will be broadened to cover issues such as ethical conduct and integrity, raise public awareness on the consequences of corporate fraud, promote active participation in corporate voting and investing in environmental, social and governance-related investment products.

Closer collaboration will be sought with capital market intermediaries to participate in investor education programmes to promote financial inclusiveness and to expand the range of suitable products to cultivate the savings habit and investment capabilities of a broader proportion of the population.

The efforts to address informational requirements will be complemented with strategies to broaden the base of active stakeholders, particularly those with the resources, expertise and incentives to monitor disclosures and events. A large base of informed stakeholders is an essential precondition for effective monitoring and in raising the levels of public expectations.

The more active and heightened role played by various stakeholders such as interest groups, investors, analysts, academics and financial counterparties can complement the investigative and analytical reporting by the media to promote more informed debate and improve the reliability of market discipline.

"The higher levels of transparency, improved flow of information and educational efforts form an important aspect of governance arrangements..."

The higher levels of transparency, improved flow of information and educational efforts form an important aspect of governance arrangements to prompt more timely market reactions that would ultimately influence the actions of Boards and management of intermediaries and PLCs. The vigilance and knowledge of active stakeholder participants can amplify regulatory actions which will in turn convey signals to other market participants.

4.6.2 Promote greater participation in achieving socially responsible goals

Economic and social goals are inevitably intertwined. When profits are pursued as the sole motivation of business enterprise and achieved at the expense of social goals, this can lead to an eventual breakdown in trust and confidence. Businesses cannot flourish without the confidence, support and participation of the public at large.

Growth and prosperity can only be sustained over the long-term through achieving a better balance between the interests of business and society. Broad stakeholder participation in shaping an agenda for governance provides a moral underpinning for business activities that are bound by the ideal of a greater good.

Business activities create economic value through creating jobs and generating economic activities but they equally also impose costs on society through impacting social and environmental conditions. These social costs become more evident in a transparent and knowledge-based society and may attract adverse reactions from affected and other interested stakeholders.

"Social and environmental issues need to gain greater prominence in the corporate decision-making process."

In an environment of rising public expectations, businesses must be more assertive in taking on greater responsibility for the impact of their actions on the environment and society. In this regard, the continued advancement of society requires business stewards who possess a sense of purpose to provide the leadership to elevate social and environmental concerns on the corporate agenda.

Social and environmental issues need to gain greater prominence in the corporate decision-making process. There are many opportunities to integrate social and environmental considerations into business processes with priority given to minimising and mitigating activities that have a negative social or environmental impact.

Environmental criteria can be applied across a range of products and processes or corporate practices can be adopted to promote greater use of energy-efficient and renewable applications or conservation of bio-diversity and habitats. Other approaches include participating in community-based projects to enhance social infrastructure or employing the under-privileged and physically challenged.

Tackling social and sustainability challenges will also provide opportunities for businesses to work with the government, non-governmental organisations (NGOs) and customers to strengthen their relationship with a broader range of stakeholders and to demonstrate a sense of shared values to promote a sustainable future.

Greater efforts are also required to cultivate social norms to sustain the momentum of sustainable development. Corporations and intermediaries can promote public awareness through outreach and educational programmes on environmental preservation and social inclusiveness.

Social practices will also be advanced through the development of metrics and disclosures to measure the impact of business on the environment. The development of sustainability reporting will provide greater opportunities for more dynamic engagement between businesses and their internal and external stakeholders on specific initiatives that can be implemented to achieve social goals.

Global standards and best practices are still evolving to provide frameworks for sustainability reporting. The adoption of these sustainability reporting frameworks will encourage communication of practices at the strategic level, provide a form of internal monitoring as well as facilitate greater disclosure of adherence to relevant norms, standards and other international benchmarks.

GOVERNANCE STRATEGIES

ENHANCE PRODUCT REGULATION TO MANAGE RISKS

Conducive environment for product innovation

- Review CMSA definitions to widen the range of asset classes for intermediation
- Ensure comparable investment products and services operate within regulatory oversight and reach and are consistently regulated for investor protection

Efficient framework for fund-raising and product innovation

- Streamline fund-raising and product assessment processes and disclosure requirements
- Establish risk-based assessment process for new products
- Enhance regulation of sophisticated products

Strengthen disclosure and post-issuance obligations

- Require simple, relevant and meaningful disclosure
- Strengthen disclosure requirements and safeguards for high-risk and complex products
- Provide greater clarity on accountabilities and more stringent standards of liability
- Impose investor education requirements for products with a high-risk profile
- Establish central repository for offer documents and promote use of interactive data formats

EXPAND ACCOUNTABILITIES AS INTERMEDIATION SCOPE WIDENS

Widen intermediation scope

- Broaden intermediation scope of capital market intermediaries
- Ensure greater consistency in regulating activities and revenue-sharing arrangements
- Provide greater flexibility to de-couple and outsource business functions
- Streamline licensing and registration processes
- Facilitate entry of domestic and international participants with value propositions that promote growth and competitiveness
- Develop transparent exit policies to ensure participants have sufficient operational capabilities

Strengthen intermediation standards and capabilities

- Place greater accountability on Boards and management to monitor business conduct of employees and agents
- Enhance internal controls to manage conflicts of interest
- Ensure Boards and management take active role in overseeing compliance and risk management functions
- Enhance role of intermediaries in investor education
- Extend regulatory oversight over participants across the transaction chain

ROBUST REGULATORY FRAMEWORK FOR A CHANGING MARKET LANDSCAPE

Rationalise regulatory arrangements for markets

- Review definition of markets and obligations of market operators
- Review regulatory duties of Bursa Malaysia to cater for a changing market environment
- Review regulatory arrangements for exchange rule-making, access and pricing

Enhance market quality

- Strengthen monitoring of proprietary trading and trade execution practices
- Review obligations of market participants operating with preferential access
- Enhance reporting obligations and risk management of automated trading and market systems to minimise market abuse and disruption
- Review impact of equity market structure changes on economic functionality of the exchange
- Enhance transparency of OTC transactions

EFFECTIVE OVERSIGHT OF RISKS

Expand regulatory coverage, capacity and tools for investor protection

- Extend regulatory oversight and reach to cover a broader spectrum of intermediation activities
- Strengthen resources, expertise and tools for examination, surveillance and enforcement
- Increase supervisory focus on management of operational risks and internal controls
- Further strengthen the investor protection framework through expansion of investor education and enhancing mechanisms for redress

- Develop strategies to maximise deterrent effects of enforcement actions
- Strengthen inter-agency cooperation on cross-border fraud
- Undertake cost-benefit review of regulatory fees and charges

Oversight of risks to market stability

- Strengthen regulatory oversight over systemic risks
- Strengthen capability of intermediaries for risk management
- Collaborate with industry on early risk identification and mitigation
- Strengthen oversight of product risks
- Strengthen transparency and communication on risks
- Enhance coordination with national and international regulators on systemic risks

STRENGTHEN CORPORATE GOVERNANCE

Board of directors as a focal point for corporate governance

- Regulatory facilitation to achieve more balanced Board composition
- Expand pool of independent directors
- Improve disclosure of remuneration
- Facilitate use of technology to improve disclosures and communications

Promote active shareholder participation

- Enhance nomination and voting processes
- Streamline processes for appointment of proxies
- Strengthen role of domestic institutional investors in corporate governance

Strengthen gate-keeping accountabilities

- Strengthen internal and external controls to manage conflicts of interest
- Strengthen accountabilities, more stringent standards for liabilities and expand range of regulatory actions
- Strengthen disclosure rules and broaden stakeholder monitoring

BROADEN PARTICIPATION IN GOVERNANCE

Promote active stakeholder participation in governance

- Broaden scope of investor education to promote more active stakeholder participation in the capital market
- Collaborate with intermediaries in investor education programmes to promote financial inclusiveness

Promote greater participation in achieving socially responsible goals

- Promote greater prominence and stakeholder participation in achieving socially responsible goals
- Promote the adoption of sustainability reporting and disclosure