CHAPTER 4

RECOMMENDATIONS

Recommendations

INTRODUCTION

The Masterplan's recommendations have been formulated with consideration of the trends and challenges the capital market will have to deal with both in the immediate term as well as in the medium to longer term, and are premised on the vision, objectives and strategic initiatives set out in Chapter 3. Their formulation takes into cognisance the need to ensure a strong balance between the need for greater competition, innovation and liquidity with the overarching priorities of maintaining fair, orderly and efficient markets, with high standards of supervision, enforcement and investor protection. In addition, the urgency for change is weighed against the need to consider potential implications for market stability and integrity, and to ensure that the programme of change is consistent with broad national policy objectives. Among the factors that have been considered in this regard are the readiness of domestic market participants to respond to these changes, as well as prevailing market conditions and the stage of market development.

Taking these various issues into account, the recommendations within the Masterplan can be characterised into three distinct phases. Phase 1 (2001–2003) will see concerted efforts to expand domestic capacity and strengthen the foundation for further competition through progressive deregulation and selective liberalisation, with some relaxation of barriers to entry in certain nascent areas of the capital market in order to accelerate development of these sectors. In Phase 2 (2004–2005), the progressive expansion of market access and removal of barriers to entry will be gradually extended across other capital market segments with further efforts to develop the breadth and quality of services and infrastructure. Phase 3 (2006–2010) will see the implementation of further expansion plans focused towards enhancing the capital market's overall international positioning, particularly in areas of comparative and competitive advantage. This sequencing framework is explained in further detail in Chapter 5.

MARKET INSTITUTIONS

Objectives

A major challenge facing market institutions in Malaysia is that of remaining internationally competitive within a more aggressive and dynamic business environment. Amid the rapid growth in cross-border and cross-asset investment activity, as well as the recent experience of global financial crises, market participants are finding greater relative value in markets that exhibit large liquidity pools, low intermediation costs, regulatory soundness and certainty, and high levels of disclosure and transparency. In addition, alternative solutions to capital market processes such as trading, clearance and settlement and custodial services are emerging through the advent of rapid and significant advances in network technology and communications.

As a result of these developments and trends, market institutions around the world are facing greater international competition for their national franchises over order-flow and securities listings. Moreover, market institutions are being subjected to a process of value differentiation: that is, market institutions not seen to be creating value within this new environment are finding themselves increasingly marginalised from the mainstream of global investment activity. In response to these pressures, market institutions have begun to consider alternative business models—those better suited to an environment of more discerning investors, rapidly growing and highly-mobile capital flows, and heightened competition.

Malaysian market institutions must also ensure that their business models, and the organisational and physical structures within which they operate, are fully aligned with the evolving and dynamic global financial landscape. The market must present investment value within a liquid, efficient, secure and transparent trading environment at competitive costs. It must also offer competitive costs of raising funds and have a high degree of depth and breadth so that issuers are able to obtain appropriate value-recognition of their securities. In short, market institutions must strengthen, and where necessary redefine, their value proposition in light of the changing circumstances in which they are operating. This will require:

- Enhancing their collective efficiency through operational and organisational restructuring to tap economies of scale and scope, and the application of appropriate technological solutions to trading, clearing and settlement processes
- Being better positioned to respond to a more competitive and dynamic business environment through the adoption of facilitative business structures, and the formulation and pursuit of more commercially-oriented business strategies
- Strengthening the integrity of the market by raising standards of corporate disclosure, enhancing the transparency of both the primary and secondary market, improving market surveillance, and strengthening the framework for corporate governance

These raise at least three important implications for market institutions going forward: First, market institutions will have to continue pursuing and adopting international best practices in, among other areas: order routing; execution; matching; clearance and settlement; the timeliness and availability of information dissemination; the level of

disclosure and transparency; and regulatory practices. In the case of exchanges, the quality of listings and the investment value offered by them will be key factors in imbuing a competitive advantage.

Second, the governance structure of market institutions must be more customer-driven, particularly for its investors and issuers as well as being more market-orientated. In this regard, decisiveness and timeliness in considering the range of strategic options open to market institutions will be crucial.

And third, market institutions will need to undertake active promotion of their strengths to current and potential market participants, to ensure that they are made directly aware of the value proposition being offered. Above all, there must be no doubt among participants that Malaysian market institutions constitute the foremost venue for the listing, trading, clearance and settlement of Malaysian exchange-traded securities and futures.

The recommendations below, as well as other sections within this chapter, in particular, the Equity Market, the Derivatives Market, Corporate Governance, and Technology and E-Commerce, further elaborate on these and other aims in relation to the competitiveness and efficiency of Malaysia's market institutions. In terms of prioritising recommendations, wholesale enhancements to market processes will take time and are dependent to a large extent on broader organisational restructuring. However, more specific measures, such as improvements to the settlement process and to risk management arrangements can proceed in the interim. The main priority therefore is to start the process of restructuring and consolidation that will form the foundation for the further advancement of these institutions in the medium- to longer-term.

RECOMMENDATION 1

A single Malaysian exchange should be established through the consolidation of all existing exchanges by 2002

Mergers among some of Malaysia's market institutions within the last three years have seen a marginal decline in the number of exchanges. In order for the securities and futures markets to align their respective business development strategies better, and to facilitate efforts at enhancing their overall strategic positioning, in line with developments in other jurisdictions, the country's remaining exchanges should merge into a single Malaysian exchange.

It is important that the exchanges give a clear and timely signal to the market that they are aware of and responding pro-actively to the challenges being faced. Therefore it is recommended that the initial re-organisation of the exchanges to form a single Malaysian exchange takes place by 2002.

Specifically, the creation of a single Malaysian exchange would allow for a more co-ordinated approach to product development, investor education and market

promotion, and would allow for a more focused and consistent approach to investment in technology. The unified exchange would also be able to tap substantial economies of scale by saving on the administrative costs of running several exchanges, as well as economies of scope, in terms of being able to offer a breadth of products and instruments. A single exchange would also facilitate efficiency gains from the future integration of the diversity of systems and processes that currently exist in the domestic exchange-traded market. In terms of maintaining international competitiveness, a single exchange would be able to pursue strategic alliances and other international business strategies from a position of strength, compared to individual efforts of separate exchanges.

Concurrent with this exercise, the SC would take the necessary steps to ensure that the formation of a single new exchange does not in any way compromise public interest or necessarily restrict competition going forward. The SC would also ensure that the new exchange has sufficient capacity to perform its front-line regulatory responsibilities and will introduce appropriate market-based incentives into the regulatory framework governing the exchange.

RECOMMENDATION 2

MESDAQ should be merged with KLSE as part of the exchange consolidation process

The collective efficiency and competitive position of the various exchanges and clearing houses within the Malaysian capital market can be further strengthened by consolidating market segments that share similar characteristics, market infrastructure, intermediaries and investors. This would ensure that there is no undue fragmentation of liquidity between separate institutions, which is particularly pertinent in ensuring the effective development of market segments that do not presently have sufficient depth to support separate exchanges.

In view of this, merging MESDAQ and the KLSE as part of forming a single consolidated Malaysian exchange would establish a more cohesive market for listed securities in Malaysia. Apart from the obvious cost savings that would arise from reducing the duplication of resources, a merger would also increase the number of available market intermediaries with access to MESDAQ, thus expanding MESDAQ's investor base and making available a larger pool of potential liquidity for the market.

While the importance of maintaining a separate and unique identity for the high-growth exchange is recognised, MESDAQ should also be in a position to capitalise on the overall value-recognition efforts associated with the proposed consolidated Malaysian exchange, and benefit from promotional efforts undertaken by the exchange as a whole.

Importantly, a merger would ensure that MESDAQ gains access to sufficient financial support for further development, and continues to fulfil its function as a financing base for emerging high-growth issuers while ensuring that resources are efficiently focused on meeting the common objectives of the unified exchange.

Within a consolidated exchange, the inclusion of MESDAQ would add to the diversity of products and instruments that can be offered by the exchange, thus affording it a wider scope for pursuing strategic opportunities.

With these issues in mind, it is therefore recommended that MESDAQ be consolidated within the organisational structure of the proposed single exchange, with a view to move towards achieving greater integration in terms of systems and processes. The main priority currently is to ensure that the benefits outlined above are successfully tapped.

Further measures to enhance MESDAQ's role as a venue for listing, especially for high-growth companies, may be found in the Equity Market section.

RECOMMENDATION 3

The Malaysian exchange should demutualise and list on the stock market by 2003

Given the increased dynamism and competitive pressures of the global marketplace, timely decisions are crucial if the Malaysian exchange is to remain competitive and responsive to the demands of its market constituents. In order to achieve this, the proposed single Malaysian exchange should demutualise and list on the stock market by 2003.

Demutualisation has become an important strategy among exchanges around the world for anticipating the challenges being brought about by the onset of a more dynamic and highly competitive global business environment. By enhancing the professional management of the exchange and streamlining the organisational structure, demutualisation allows for more timely and focused responses to these challenges on the basis of more commercially-oriented strategies and practices.

Under a demutualised structure, commercial decisions are no longer being made on the basis of one-member one-vote, irrespective of the differing sizes of the broker members. Instead, other stakeholders in the market institution, including issuers and investors, are able to ensure their interests are better represented through ownership of the exchange. As a result, the exchange is better positioned to respond to the collective interests of its broader stakeholders, and consequently be more customer driven and market-orientated.

The economic interests represented by shareholdings in the demutualised entity should constitute freely tradable property rights, in contrast to the locked-in interests of exchange membership currently. What this does is to ensure that the interests of management are as closely aligned as possible with the exchange's commercial interests. In view of this, the exchange should list its shares on the Malaysian stock market.

Listing would facilitate greater diversity of exchange ownership, thus allowing for enhanced public representation in the governance of the exchange. Moreover, upon listing, the exchange would have a wider capital base with which to expand and further develop its scope and scale of operations. As a listed company, the exchange would also be subject to high levels of transparency and accountability, to the benefit of its stakeholders.

The transformation to a demutualised entity should not preclude the exchange from carrying out front-line regulatory functions. One reason is that it is recognised that the quality of listings as well as market integrity and fairness are among the key commodities of the exchange business. Another is that in a business environment in which a reputation as a fair and efficient market is seen as a competitive advantage, there exists sufficient incentives for a commercially-oriented exchange to devote resources to activities that enhance that reputation.

However, to ensure that the exchange continues to meet its public-interest obligations, the SC would retain strong regulatory oversight of the demutualised and listed entity. Suitable legislative and regulatory provisions should be put in place to safeguard not only public but also national interests.

To ensure the orderly and efficient progression of the various initiatives to be undertaken by the proposed Malaysian exchange, the exchange should become a demutualised and listed entity subsequent to the full implementation of the disclosure-based regime and the front-line regulation programmes.

RECOMMENDATION 4

The Malaysian exchange should implement a programme to enhance its value recognition both domestically and internationally

The growing commoditisation of exchange products and services, as well as the greater demands being placed on exchanges by market participants are increasing the competitive pressures on exchanges to achieve and maintain a critical mass of primary and secondary market activity. This situation is resulting in more urgent efforts by exchanges to create further value for their users, and to ensure that existing value is widely recognised by the market. Value recognition boosts market credibility, which in turn helps to attract more order-flows, encourage listings and reduce the likelihood of migration by listed entities to other stock exchanges.

In the case of investors, value clearly derives from superior (risk-adjusted) returns arising from high growth prospects, a high level of market liquidity, low transaction costs and confidence in the policy and regulatory environment. For issuers, value will be derived from the ability to obtain appropriate valuations for their securities, and to secure a competitive cost of capital. For market institutions these translate into, among other things, the need to maintain competitive issuance and trading as well as operating costs, and to widen the scope of exchange business activity so as to enhance liquidity and pricing efficiency.

From a broader perspective, it is hoped that this will lead to minimal divergence between Malaysian economic fundamentals and the value being reflected in market prices and activity. As a major indicator of economic activity, the current profile of the market should reflect the economic value and performance of the broader economy.

Therefore, it is important that the Malaysian exchange should formulate and implement an explicit and continuous programme to enhance its value recognition both domestically and internationally.

Strategies in this regard could possibly include the cultivation of a strong brand identity and raising awareness of relative value in the Malaysian exchange-traded environment to the wider market. This would assist in building stronger credibility both within the international as well as domestic markets in terms of commitment and responsiveness to the needs of market participants, and would further stimulate market liquidity through active product promotion and incentives.

RECOMMENDATION 5

The Malaysian exchange should pursue appropriate strategic alliances internationally

Strategic alliances have clearly become an important commercial strategy for many exchanges and other market institutions, in response to the more competitive environment and increased uncertainty over where the businesses of exchanges and clearing institutions can generate most value in the marketplace of the future. In efforts to enhance value recognition, smaller exchanges are, in some cases, increasingly leveraging on strategic linkages among one another, as well as with larger hubs, to garner critical mass. Such inter-exchange networks bring together a number of different national markets, thus removing or reducing barriers that would otherwise limit the growth of their markets and which would increase the cost of pre-existent cross-border investment activity.

Similarly, Malaysia's market institutions must also be fully prepared and able to utilise the mechanisms that have come to characterise the global network of financial markets to ensure their own future development. The Malaysian exchange should pursue strategic alliances with market institutions abroad in order to widen the range of business opportunities for its constituents, while at the same time raising its profile internationally.

The formation of explicit linkages and access between markets leads to significant cost reductions to investors that take positions across national boundaries, contributes to the opening up of new market opportunities and helps to increase market turnover. This, in turn, will potentially generate a higher volume of order-flows and therefore create greater liquidity in the Malaysian market.

In practice, such alliances have covered a host of associations and interactions among market institutions, including, among others, cross-listing and cross-trading arrangements, common clearing arrangements and remote-access memberships. Malaysia's market institutions must, at a minimum, continuously monitor and assess strategic opportunities that may exist with other market operators within the region and beyond. They must remain responsive to possible overtures from these operators and should not preclude pro-actively pursuing some of these opportunities itself.

As a first step, it is recommended that joint exploratory discussions with relevant market institutions within the region be undertaken. The issues to be discussed should include investor-following and technological structures, and the possible means of closer co-operation in developing cross-jurisdictional market interaction.

RECOMMENDATION 6

A common trading platform across all exchange-traded products should be established following exchange consolidation

The creation of a single Malaysian exchange would pave the way for the eventual rationalisation of the current multiplicity of front-end systems. Maintaining the separate trading platforms and applications currently adopted by the different exchanges—with their different outlays, protocols, interfaces and front-end systems—would over the longer-term add to the exchange's operating costs. It will also compound the costs of intermediaries who operate in all market segments of the exchange, as well as those of investors wishing to gain cross-asset or cross-market exposure.

Adopting a single integrated trading system for the exchange-traded market following the consolidation exercise among exchanges would thus eliminate a duplication of resources in areas such as front-end systems and investments in upgrades, capacity enhancements, training and surveillance systems. It would also minimise the risk of incompatible systems and standards, and facilitate future efforts at further integrating the trading and settlement processes into a seamless procedure for managing information flows associated with exchange transactions.

However, the development of a common trading system for the exchange-traded market should ideally await the formation of a single Malaysian exchange and the advent of a fairly advanced stage of operational and managerial integration. It would involve, among other things, an evaluation of the existing trading systems in respect of their capabilities, performance, ability for future upgrades and innovation, as well as connectivity to other telecommunication networks (including the Internet) and international trading systems.

The new system would have to be sufficiently flexible to support the appropriate protocols for the different clearance and settlement methods used for existing products, as well as any future enhancements to the respective clearance and settlement processes.

Given the time needed to undertake broader organisational integration, as well as to develop and implement the new systems, the preparations for the introduction of a common trading platform should be scheduled for completion towards the early part of Phase 2 of the Masterplan.

RECOMMENDATION 7

An integrated clearance and settlement system for all exchange-traded products should be established

Compared to many other jurisdictions, including some relatively more developed ones, the clearing and settlement framework in Malaysia is already relatively consolidated. The equity market is served by one clearing institution, SCANS, while the derivatives market is served by MDCH alone.

Nevertheless, there are benefits to further consolidation in this area, specifically in terms of an integration of the derivatives and securities clearing systems. The potential advantages this can bring to users can be considerable, in terms of cost savings and operational efficiencies for market operators as well as users of the clearing system.

These advantages may be derived from the lower costs and enhanced efficiency of clearing processing systems, communications and links to back office and payments systems. Users' liquidity management would be simplified and their margining costs reduced through mutual offsetting arrangements between the relevant stock and equity derivative positions.

However, there are substantial practical issues that must be resolved in achieving a union between the clearance and settlement systems operated by SCANS and MDCH respectively. The former operates a clearance and settlement system that essentially involves implicit risk management through a fixed delivery and settlement system, in which financial settlement is done on a "net basis". MDCH, on the other hand, manages risk explicitly through the calculation and imposition of margin requirements. Reconciling such fundamental issues, as well as that of how the new system ought to deal with the other non-common functions of the two current systems, will require thorough consideration before any integration measures may be logically taken.

These issues will have to be examined in more detail by a working group consisting of the relevant organisations, including the clearing houses and the SC. In view of the importance and complexity of the issues involved, the integration of the clearance and settlement systems for exchange-traded products should only be scheduled for implementation in Phase 2 of the Masterplan after the appropriate assessments have been made.

As a first step towards integration of clearance and settlement systems, it would be useful to consolidate the two present clearing houses into a single institution in order to facilitate the development of a unified system in the future (see Recommendation 8). The prospect of common clearing members will provide a way of achieving at least two key benefits of a unified system, ie, cost savings and operational efficiencies to clearing participants, and the netting of obligations, collateral and risk.

RECOMMENDATION 8

A single clearance and settlement institution for all exchange-traded products should be created by 2002

Consolidating SCANS and MDCH into a single Malaysian clearing house, and the establishment of common clearing accounts covering all products traded on the proposed Malaysian exchange will serve as an important step towards establishing a unified clearing and settlement system for the Malaysian securities and futures market.

The two clearing institutions should operate under a central administrative and management structure by 2002 in tandem with the consolidation of exchanges. The consolidated clearing house should in turn will be a subsidiary of the proposed single Malaysian exchange. To the extent that it will benefit the market and raise the efficiency of the trading, clearance and settlement process, consolidation of the clearing house and MCD, the central depository, should also be examined closely.

A single clearing institution would set the groundwork for examining the issues involved in the development of an integrated clearance and settlement system, by aligning the interests of the parties involved and bringing the relevant expertise and administrative functions under a common establishment.

Moreover, there are also economies of scale to be achieved in relation to the administration and management of the clearance and settlement process, and clearing members would be able to achieve cost-savings in relation to the management of their accounts across different products and markets.

The creation of a single institution would also pave the way for a system to be developed in time to allow for an overall view of risk across markets, products and participants, and for the application of enhanced risk-management techniques, such as portfolio-based approaches. Hence, in addition to better risk diversification for the clearing house, this approach would also allow a more efficient use of capital by clearing members.

The establishment of an integrated clearance and settlement system has significant implications for the roles and responsibilities of the single clearing institution as well as for the SC in managing systemic risk and ensuring that public interest is upheld. Therefore, the SC would maintain strong regulatory oversight of the clearing institution to ensure the robustness and integrity of the integrated clearance and settlement system. As with the consolidation of exchanges, the SC would also take the necessary steps to ensure that the formation of a single clearing institution does not impede competition through unnecessary access restrictions for clearance and settlement services going forward.

RECOMMENDATION 9

The money settlement system should be directly linked with the capital market trading and clearing systems

The integration of the money settlement system, operated by the central bank, and the clearance and settlement system of the exchange-traded market affords several major benefits, including significantly achieving international best practice in several key areas. An integrated system would help to reduce systemic risk, among other things, by introducing finality and certainty to payments, thus achieving DVP model 1, and would facilitate the reduction of the settlement cycle beyond T+3.[54,55]

Given the magnitude and scope of this task, the details of such integration would require a thorough review of possible approaches that may be undertaken. These include the approaches being examined by other jurisdictions involving the clearing institution holding a specific settlement account at the central bank, thus enabling it access to the real-time gross settlement system used by the interbank market. Other issues that will also require attention include the matter of proper liquidity management for clearing participants and the clearing house, and the possible need to enhance linkages with foreign systems in the future with a view to achieving more efficient settlement of cross-border transactions. Further details in relation to this process of integration are also addressed under the recommendations in the section on Technology and E-commerce.

To facilitate the process of integrating money and securities settlement, a revised legal framework should be introduced. It should cover issues including, for instance, ensuring that multilateral netting arrangements are legally binding, that securities markets adopt novation and explicit margining of outstanding positions, and that the clearing house has the capacity to guarantee settlement explicitly.

[54] DVP model 1 refers to a system that settles transfer instructions for both securities and funds on a trade-by-trade (gross) basis, with final (unconditional) transfer of securities from the seller to the buyer (delivery) occurring at the same time as final transfer of funds from buyer to the seller (payment).

[55] Both DVP and the T+3 settlement cycle are among several major recommendations by G-30, (CPSS) of the Bank for International Settlements BIS, and the IOSCO-CPSS Joint Task Force on Securities Settlement Systems (forthcoming) on international standards for securities clearance and settlement systems.

RECOMMENDATION 10

The settlement cycle should be shortened to T+3 in line with international best practice

The adoption of a trade settlement cycle in which settlement occurs on the third day after trade execution (T+3) instead of on the fifth day (T+5) would reduce settlement risk. In doing so, this move to shorten the settlement cycle will complement other measures taken to enhance Malaysia's market microstructure and to improve systemic risk management. It will also bring domestic settlement practices in line with international best practices.

The SC and the exchanges, in consultation with market participants, will work towards finalising the necessary requirements for a T+3 settlement cycle. This joint effort ensures that all business, operational, regulatory and policy issues are appropriately addressed towards smooth implementation of this measure. Going forward, the merits of moving to a further shortening of the settlement cycle will be examined in Phase 2 of the Masterplan.

Update: A T+3 settlement cycle was implemented with effect from 20 December 2000.

RECOMMENDATION 11

A global depository account for each investor will be established in the central depository

At present, investors must open a depository account with every stockbroking company through which they deal. Therefore, an investor who transacts orders through more than one stockbroker needs to have a separate account at the central depository for each one of the stockbrokers being used. A global depository account for each investor would effectively unify these accounts, reduce the number of accounts maintained and managed by the central depository, and give investors a more efficient means of monitoring and managing their overall exposure to the market.

To this end, the establishment of global depository accounts will be examined by the SC with the relevant exchanges and MCD, the central depository, with a view to implementing such a system within MCD by the end of 2002.

RECOMMENDATION 12

The SCANS clearing fee will be reduced from 0.05% to 0.04% with effect from 1 July 2001, subject to a maximum of RM200 per contract

RECOMMENDATION 13

The SCORE fee will be reduced in two stages to 0.005% and 0.0025% with effect from 1 September 2000 and 1 July 2001 respectively. Subsequently, SCORE fees will be reviewed further

RECOMMENDATION 14

The SC levy will be reduced to 0.015% from the present 0.02% with effect from 1 July 2001

In line with efforts to reduce overall transaction costs, the SCANS clearing fee, SCORE fee and the SC levy will be reduced. The quantum of these reductions are based on consultations and feedback from KLSE and the stockbroking industry, and after taking into account the competitive pressures facing market participants.

With regard to the SC levy, which is used to fund the SC's activities in regulating and developing Malaysia's capital market, this marks the second time it has been reduced. The first reduction coincided with the previous reduction of commission rates in July 1995, two years after SC's establishment, when the levy was reduced from 0.03% to 0.02%.

Update: These recommendations were announced by the SC on 21 April 2000.

RECOMMENDATION 15

Stamp duty should be capped at RM200 per contract for all trades on the KLSE and be further considered for eventual removal

Stamp duty is assessed at a rate of RM1 for every RM1,000 in value of shares traded on the KLSE. However, there is a maximum charge of RM200 that is applied to interbroker transactions. This means that trades between local and foreign brokers are capped at RM200, while no similar cap exists for other trades such as those between local brokers and local investors.

While this situation supports interbroker trading activity, it has to an extent disadvantaged domestic investors by imposing a higher cost of trading on them.

As part of overall efforts to make the costs of trading in the Malaysian stock market more competitive, it is proposed that the cap of RM200 be extended to all trades, including those routed directly through local stockbroking companies by local investors and be made effective by end–2001. In the longer term, the requirement for stamp duty should eventually be considered for removal by the relevant authorities in order to ensure that the Malaysian stock market remains cost-competitive against other jurisdictions.

Update: It was announced in Budget 2001 that, effective from 1 January 2001, stamp duty for all transactions on the KLSE involving foreign investors will be set at a maximum rate of RM200 regardless of whether the transactions are undertaken through foreign stockbroking companies or directly through local stockbroking companies.

RECOMMENDATION 16

Administrative procedures and rule-structures in relation to portfolio investments should be streamlined in order to reduce operational costs to investors

Certain requirements on portfolio investment have, in addition to their original objectives, also raised the administrative burden—and hence operational cost—of investing in the Malaysian stock market. In several cases, implementation costs appear to be negating many of the positive aspects of these measures. Given the increasingly competitive environment in which the region's stock markets operate, the presence of any additional cost can prove detrimental to the relative attractiveness of the market to investors.

For instance, administrative costs associated with measures introduced through the SICDA amendments of 1998 and the rules of the KLSE and MCD, which were aimed at enhancing the transparency of market transactions, have been cited as being one of several that have raised the cost of investment into the Malaysian stock market.

In the case of certain other measures, efforts to ease the severity and direct costs of requirements initially introduced are being offset by the administrative burden associated with implementing a revised framework. In the case of the current exit levy imposed on portfolio outflows, special operational procedures are required by clearing houses and custodian banks to administer the intricacies of the requirement. Given the highly-automated and increasingly standardised nature of back-office operations world-wide, this has raised the marginal cost of handling Malaysian-based transactions, and thus lowered the relative value of Malaysian stock market investment.

In light of these issues, the SC and the KLSE, in collaboration with other regulatory authorities, will be pursuing concerted efforts to lower any undue operational costs on the market arising from current regulatory measures, to ensure that the market remains competitive compared with other jurisdictions. In the introduction of future measures, a systematic approach will be taken to weigh the primary objectives of imposing regulatory requirements against relative costs as well as other considerations, among them, the ease of compliance and potential for circumvention.

EQUITY MARKET

Objectives

The equity market[56] has seen significant development over the last two decades, during which a number of important changes have played a role in making it a major funding avenue for the corporate sector in Malaysia. These include, among other things, the progressive automation of trading and settlement processes, the listings of a number of large privatised companies and the establishment of a Second Board on the KLSE for SMEs in 1988.

Widespread regulatory reforms of the fund-raising framework introduced after the formation of the SC in 1993 also played an important role in facilitating the rapid growth in activity and development. Among other things, efforts were heightened during this period to streamline the equity securities issuance process and widen the issuance and investment opportunities available to issuers and investors. The move from merit-based regulation to DBR was initiated in 1996 to reduce the involvement of the SC in assessing the merit of investment opportunities, and enhance the role of the private sector in capital allocation and decision making.

A total of RM87.7 billion was raised over the period 1990-99 alone. In comparison, the total amount raised on the KLSE over the preceding ten years was RM10.6 billion. Market capitalisation climbed to a peak of RM807 billion in 1996, at which point the KLSE was the third largest bourse in the Asia-Pacific (ex-Japan) after Hong Kong and Australia.

Even following the Asian crisis of 1997-99, the number of listings on KLSE continued to expand to 788 counters as at the end of September 2000. The issuer profile spans a diverse spectrum of industries ranging from the traditional mainstays of finance, property and manufacturing to technology and infrastructure project companies.

In particular, equity issuance among emerging knowledge-based and technology-oriented start-ups has been on the rise in recent years, in line with the shift towards a knowledge-based economy where venture capital financing is being increasingly viewed as a key source of funding for emerging high-growth companies.

The venture capital industry has grown from three venture capital companies managing RM47.8 million in 1990 to 30 registered venture capital companies managing cumulative investments of RM1.4 billion as at the end of 1999. The government also plays an active role in supporting the development of this sector, through the Malaysian Technology Development Corporation Sdn Bhd (MTDC) and Perbadanan Usahawan Nasional Bhd (PUNB).[57] In 1997, MESDAQ was approved as an exchange to provide an auxiliary route for high-growth and technology companies to raise funds through the capital market, serving as an exit mechanism for venture capitalists in the process.

The equity market performs functions that have been integral to the rapid expansion and development of the Malaysian corporate sector in the past. Amongst other things, it facilitates capital formation for companies, while providing an efficient means to mobilise investor savings and channel those funds towards productive uses. A well-functioning

[56] In this section, the equity market covers the issuance of equity securities by public companies and the secondary trading of these securities on Malaysian stock exchanges, as well as equity raised by emerging high-growth companies via the venture capital industry.

[57] MTDC invests primarily in new technology-based companies and facilitates commercial opportunities for research and development, whilst PUNB provides venture financing and other value-added services to potential Bumiputera entrepreneurs.

equity market also enables risk sharing by market participants, and provides appropriate market-based incentives for corporate governance and investor protection. Recent studies strongly suggest that equity market performance—defined in terms of size, liquidity and integration with international markets—positively influences economic growth[58].

In order to ensure that the equity market continues to play an important role in supporting the country's economic growth and the achievement of national aspirations in the coming years, it is therefore imperative that measures be taken to ensure that the equity market in Malaysia can continue to discharge its functions effectively.

Thus far, the equity market's ability to attract investment flows has been an important factor in its successful development over the years. This, in turn, has seen the expansion of this market in terms of liquidity and product diversity; both of which have played a role in providing the necessary impetus for the growth of related services such as corporate advisory services and venture capital management.

However, maintaining these aspects will become an increasing challenge as the financial landscape evolves, even for many other established capital markets. A major challenge facing the domestic equity market relates to its continued ability to meet the fund-raising needs of Malaysian companies in the face of an increasingly globalised business environment and heightened international competition to establish regional or global capital-raising centres.

With greater capital mobility and technological advances, seekers of capital are anticipated to increasingly be able to choose from a wider global pool of markets competing in terms of cost, liquidity and skilled professional services. Both issuers and investors will naturally choose to converge in markets where there are lower costs, better services and a vibrant market for diversified types of fund-raising instruments. And importantly, these markets must offer attractive value recognition for their equity issues and investments, not only amongst their existing circle of participants, but also within the global financial community.

A facilitative environment for continued domestic investor participation through ownership in listed companies will help mitigate fund outflows, whether in the form of portfolio capital or earnings distributions, when investments in the country are competitive vis-à-vis those overseas. Beyond providing such an environment, there are also tangible direct and indirect benefits —such as job creation and the promotion of entrepreneurship and innovation within the country—to be derived from having an active equity market that facilitates corporate and economic activity. This is particularly valid in respect of venture capital funding in value-added sectors that are fundamental to Malaysia's progress towards a knowledge-based economy and developed nation status.

As such, it is vital that suitable avenues for capital formation be available for quality and high-growth issuers in Malaysia. However, various challenges still need to be addressed if this is to be achieved. At present, the total amount of venture capital financing remains very small relative to other forms of financing, with the government providing the bulk of such funding. In addition, the development of MESDAQ has been hampered by low liquidity, compounded by the timing of its launch during the crisis.

[58] Source: "Securities Market Development: A Guide for Policymakers", Economic Development Institute of the World Bank, 1997.

More generally, in order for Malaysia's corporate sector to grow beyond domestic boundaries, there needs to be co-ordinated efforts to further develop and enhance the efficiency of the equity market. More specifically, this entails further enhancing the equity market's capacity to meet local fund-raising needs. In addition; there must be appropriate strategies to ensure that the domestic capital market remains the preferred equity fund-raising centre for companies operating in Malaysia; including those that seek to further expand their commercial interests in international markets.

To this end, several key strategic initiatives must be undertaken, including:

- Further enhancing the efficiency of the fund-raising process to ensure that the Malaysian capital market can be accessed on internationally competitive terms, particularly in terms of cost; the regulatory processes involved in the raising of equity capital; and the competitiveness of corporate advisory services related to the equity fund-raising process
- Expanding the breadth of investment opportunities within the equity market for investors by promoting a greater diversity of related products as well as high-quality and high-growth equity issuers
- Facilitating the development of the venture capital industry to effectively meet the financing needs of emerging high-growth companies in value-added industries through the provision of risk capital
- Fostering a liquid and efficient secondary market for the trading of equities to ensure Malaysia remains a competitive market for the raising of equity capital, whereby companies of different sizes and risk profiles are able to raise capital on competitive terms and obtain enhanced value recognition

RECOMMENDATION 17

A full disclosure-based framework for the offer and issuance of equity securities will be implemented in 2001

New equity issues have historically been regulated under merit-based regulation—the regime inherited and assumed by the SC upon its establishment in 1993—whereby proposals by public companies involving the issuance of securities are evaluated by the SC based on the merits of each proposal.[59] While merit-based regulation has played an important role in the early development of the market, in moving forward, the growing depth and complexity of fund-raising instruments available, combined with growing corporate funding needs, have been recognised by the SC as requiring a more flexible approach towards the regulation of new securities issues.

The shift from merit-based regulation to DBR is a key element in the efforts to enhance the issuance process. Under the DBR approach, the involvement of the SC in assessing the merits of investment opportunities is reduced, and the role of issuers and their advisers and investors in capital allocation and decision making is enhanced.

[59] This merit-based assessment covers, among other things, the financial viability and growth prospects of the company; the quality, integrity and capability of the management of the company; the pricing of securities to be issued; the valuation of assets to be acquired; the utilisation of proceeds raised from the issuance of securities; and the interests of the public.

Importantly, the shift to full DBR facilitates:

- An increase in the efficiency of the fund-raising process by removing the limitations which exist under merit-based regulation
- Higher standards of disclosure, due diligence and corporate governance as well as accountability by promoters, directors and advisors of public companies to investors
- Enhanced market discipline and market-driven pricing of securities and the valuation of assets

Therefore, DBR reduces the costs of approval and will provide incremental efficiency gains as the market grows in depth and breadth. More broadly, this approach is pivotal to the effective progression towards a more sophisticated and diversified financial system.

The SC has already initiated a gradual shift in its regulatory framework from merit-based regulation to DBR over three phases and will move to a full disclosure-based environment in 2001. The full implementation of DBR in 2001 will be premised in part on an assessment of market preparedness by the SC in the first quarter of 2001.

Table 3

Shift towards a DBR framework

Phase	Timeframe	Focus
1	1996-99	Flexible/hybrid merit-based regulation with enhanced disclosure, due diligence and corporate governance.
2	2000	Partial DBR with further emphasis on disclosure enhancement, due diligence and corporate governance as well as promotion of accountability and self-regulation.
3	2001 onwards	Full DBR with high standards of disclosure, due diligence, corporate governance and exercise of self-regulation.

Measures taken so far toward the implementation of full DBR include the enhancement of disclosure requirements and enforcement powers, the promotion of good corporate governance and a refinement of listing requirements.

A full DBR framework will see the issuance of securities being regulated through the quality of disclosure involved and approval of prospectuses, rather than through the regulator's assessment of the suitability of proposals. In this respect, the SC's primary focus will increasingly be on the quality of disclosures, with investors taking on the primary responsibility in determining the investment merits of the issue.

Going ahead, with the implementation of full DBR, the KLSE and MESDAQ are expected to assume greater responsibilities with respect to the issuance and listing of new securities. Therefore, the SC will work closely with the relevant exchanges through the front-line regulation programme to ensure that they are adequately prepared and possess sufficient capacity to discharge these additional functions effectively.

RECOMMENDATION 18

The involvement of multiple approving authorities in the fund-raising process should be further rationalised

The SC is charged with the principal regulatory responsibility with respect to all matters relating to the securities market under section 15(1) of the SCA. However, at present there are still many cases where multiple regulatory approvals, in addition to those of the SC and the various stock exchanges, are required for the issuance of securities.

There is a need to further streamline the involvement of multiple authorities in the approval process for the issuance of equity securities in line with SC's role as the single approving authority for all fund-raising activity through the issuance of securities. Also, in order to realise the full benefits of DBR, the involvement of the various authorities will need to be examined and rationalised wherever possible in order to shorten and enhance the efficiency of the fund-raising process. Areas for such rationalisation include the overlap between the ROC and SC's respective responsibilities for the registration and approval of prospectuses in respect of securities issues, and the roles of multiple regulatory agencies in the regulation of the issuance of PDS and related hybrid securities.

In addition, there are certain instances where approvals by other authorities, such as MITI and FIC, are needed in relation to the issuance of securities.[60] Where these authorities perform an essential function in ensuring that national policy objectives are complied with, it is envisaged that these functions will remain under their purview. However, to ensure that the overall process for securities issuance is continually enhanced in terms of efficiency, the SC will work closely with the relevant agencies to identify areas within the present framework that can be further streamlined.

Update: Amendments to the SCA, CA, BAFIA, FIA, and SICDA came into effect on 1 July 2000, conferring on the SC the responsibility for being the approving and registering authority for prospectuses in respect of all securities other than securities issued by unlisted recreational clubs, and centralising the regulation of the issuance of PDS and related hybrid securities with the SC. The transfer of these responsibilities from other regulatory agencies to the SC substantially rationalises the offering process and reduces the number of regulatory agencies that prospective issuers have to deal with.

[60] In the case of MITI, for example, its approval is required where a corporate proposal involves the issuance of securities by, or acquisition of, manufacturing companies which it licenses. MITI's approval is also required for the certification of investors comprising the 30% Bumiputera equity interest in companies seeking a listing. FIC's involvement, on the other hand, arises where the corporate proposal is subject to compliance with the Committee's government-mandated equity ownership requirements.

RECOMMENDATION 19

A shelf-registration scheme for the issuance of equity securities will be introduced

Modern companies operate in an increasingly competitive and fast-paced environment, giving rise to the need for management to be able to respond quickly to developments that affect their businesses. The ability to access capital markets at short notice enables the companies to capitalise on business opportunities that may not otherwise be within their means due to funding limitations. In recognition of these commercial considerations, shelf-registration schemes have been used in many capital markets to facilitate an expedited fund-raising process for eligible companies.

Under a shelf-registration scheme, issuers are allowed to publish a shelf document containing information based on guidelines prescribed by the regulator. If the issuer subsequently wishes to issue and list further shares over a specified period—usually within one to two years—all that is required is the publication of a short document containing information relevant to that particular listing, as well as details of any significant changes that have occurred since the shelf document was issued.

Shelf-registration schemes are generally seen to offer the following benefits:

- A significant reduction in the time taken to process documentation relating to an issuance of securities, thus providing companies with the flexibility to make an issue under optimal market conditions, as and when the opportunity arises
- A reduction in the amount of work required by a company and its advisers for each issuance of securities
- A reduction in costs for frequent issuers
- Investors receive a shorter and more focused offering document at the time of issue containing information relevant mainly to a particular issuance

The SC is looking into the possibility of introducing a shelf-registration scheme for the issuance of equity securities in 2002 after an appropriate evaluation of market readiness has been conducted, with a view to allowing participation in the scheme by PLCs which have demonstrated to the SC satisfactory standards of disclosure and corporate governance within a full DBR environment.

RECOMMENDATION 20

The market for the provision of corporate advisory services will be further deregulated

The efficiency and effectiveness of any fund-raising exercise process depends as much on the capabilities of the advisors as it does on regulatory processes. Advisors are currently defined to include merchant banks, public accounting firms, law firms and such other parties that provide advice to companies in connection with corporate applications submitted to the SC.

Of this list of advisors, only merchant banks and more recently, approved stockbroking companies, are allowed to submit applications to the SC and KLSE on behalf of clients for a full range of corporate proposals, including IPOs. In this regard, the SC's *Policies and Guidelines on the Issue/Offer of Securities*, which governs the requirements for securities issuance, stipulates the following:

- Listed companies or those seeking a flotation on the stock exchange submitting a proposal to the SC must do so through a merchant bank or an approved stockbroking company
- Unlisted companies, with the exception of those making an application for flotation, may do so either through a merchant bank, an approved stockbroking company or an approved firm of public accountants
- Companies, listed or unlisted, can also submit a proposal through a discount house or a commercial bank but only for issues involving non-equity linked debt securities

To enhance the competitiveness and efficiency of the equity fund-raising process, the SC will consider further deregulating the market for corporate advisory services to expand the categories of advisors that are authorised to provide the full range of corporate advisory services and submit applications for corporate proposals to the SC and the exchanges. Such deregulation will encourage greater innovation and lead to an improvement in the overall quality of services rendered by advisors, as well as promote a more competitive environment for the pricing of these services in tandem with the expected increase in the sophistication of the capital market.

The deregulation will be undertaken in stages to ensure an orderly shift towards an increasingly competitive environment. Qualified stockbroking companies are allowed to take on corporate finance work and make submissions of corporate proposals to the SC on behalf of clients, subject to the appropriate quantitative and qualitative criteria.

The SC will also examine the possibility of extending this to other qualified professional firms, subject to an assessment of the impact of initial deregulation on the competitive dynamics of the corporate advisory services industry. In addition, the SC will study the viability of permitting direct participation by foreign advisers and the potential adoption of an expedited timeframe with respect to the deregulation process, to deepen the pool of skills available to prospective issuers. A consultative paper in this regard will be produced by the SC by the end of 2001.

At all times, however, consideration will be given to ensuring that the providers of corporate advisory services in the Malaysian capital market continue to operate on high standards of prudential safety and business conduct, and satisfy the qualitative and quantitative criteria imposed by the SC.

Update: The SC has announced on 21 April 2000 that UBs will be allowed to take on the full range of corporate advisory services, including corporate finance work and making submissions of corporate proposals to the SC on behalf of clients.

RECOMMENDATION 21

Technological solutions that enhance the efficiency of the fund-raising process will be identified and implemented

There are significant benefits to be gained from the incorporation of appropriate technologies in the fund-raising process. Accordingly, the SC will work together with industry participants to identify and implement technological solutions to enhance the efficiency of the fund-raising process, while ensuring that these applications are supported by a regulatory framework that is technologically neutral and does not impose an unnecessary burden on issuers.

Areas to be examined include enhancing the process for the balloting of shares via electronic means, and allowing online IPOs on the stock exchanges. However, the move towards a more technologically enabled framework will be implemented only where there is sufficient assurance as to the capability and capacity of market participants to take on the changes as well as the integrity within which these processes will operate. To this end, the SC will undertake an assessment of market preparedness for new modes of raising funds such as online IPOs.

Online IPOs undertaken, for example, in conjunction with suitable share pricing and placement methods will not only improve the efficiency of the fund-raising process, but potentially facilitate a more open and transparent share allocation process. Issuers also stand to benefit from lower costs of distribution and enhanced valuations derived from a greater ability to gauge the demand for the securities being issued. Online IPOs are gaining popularity in markets such as the US, especially through the use of an open IPO process, which has enabled issuers to reduce underwriting fees substantially.[61]

[61] Typically, this is done through a "Dutch auction", which refers to an auction system whereby successful bidders are determined by tallying all the bids received, ranking the bid price from the highest to the lowest and applying the lowest bid price that results in the issue being fully taken up as the clearing price. Successful bidders are those who bid at or above the clearing price.

RECOMMENDATION 22

Breadth of listings in the Malaysian equity market will be gradually widened to include listings of foreign companies

To ensure that the Malaysian equity market remains attractive to issuers and investors, there must be sufficient breadth of types of listings that cater to various issuer profiles and investor interests. Efforts toward this have, to some extent, been achieved by introducing specific listing guidelines for infrastructure project companies, high-growth technology companies and closed-end funds.

As part of efforts to broaden the equity market, listings of foreign companies will be further encouraged, although the liberalisation process will be undertaken in phases. There are a number of significant high-quality foreign-owned companies operating in Malaysia that have contributed to the country's economic growth and would be appropriate candidates for potential listings. In addition, in line with the government's reverse investment policies, there are high-quality Malaysian owned companies operating abroad that should be allowed access to the domestic capital markets for capital formation purposes. The listing of these companies will not only increase the diversity and quality of issuers in the Malaysian capital market, but also expand the range of investment opportunities for investors.

Going forward, the possibility of further widening the categories of foreign listings to include secondary as well as primary listings of high-quality regional and international companies will also be considered. However, this will be premised on a careful assessment of market conditions and the economic environment. Clearly, whilst it is undeniable that widening the scope of equity market listings will enhance the breadth and liquidity of the stock exchanges and play a significant role in the integration of the Malaysian capital market internationally, it is important that this process be carefully managed.

The process of allowing foreign listings on the KLSE will therefore be implemented over three stages, with an assessment of market readiness and impact at each point before proceeding to the next stage.

In 2001, the SC will allow qualified Malaysian-owned foreign-based companies to seek a primary listing on the KLSE. In relation to this, the SC will revise and re-introduce its *Guidelines for Public Offerings of Securities of Foreign-Based Companies on KLSE*. The SC will also work with industry in formulating appropriate strategies to attract the listings of qualified Malaysian-based foreign-owned companies. The second stage to be implemented in 2002 will allow the secondary listing of qualified foreign-based companies, and in the third stage in 2004, subject to market readiness and prevailing economic conditions, the primary listings of foreign companies, particularly high-quality regional companies in value-added sectors, will be considered.

RECOMMENDATION 23

The introduction of Exchange Traded Funds will be allowed

An Exchange Traded Fund (ETF)[62] is an open-ended fund that trades in the same manner as individual stocks listed on an exchange. The trading value of the ETF is based on the NAV of the underlying securities in the index, with investors able to buy and sell ETF units in real time prices which fluctuate throughout the day to track the underlying index. At the same time, as an open-ended fund, units can be continuously issued or redeemed according to investor dictates unlike ordinary shares, thereby providing the necessary liquidity to maintain a balance of supply and demand in the market. The unique structure and method of operation of an ETF allows investors to arbitrage any discounts and premiums that may arise vis-à-vis the performance of the underlying index.

Key benefits potentially offered by ETFs to investors include the following:

- ETFs combine the flexibility of owning stocks with the diversification afforded by index funds. Similar to share trading, ETFs can be priced throughout the day compared to closed-end funds, which track the index only at the end of the day. The added advantage of ETFs is that the purchase of a single ETF unit enables investors to gain exposure to an entire index with a relatively low capital outlay
- ETFs offer a lower-cost alternative to mutual funds. As an index tracker, it typically charges lower management fees compared to active funds. Furthermore, it derives additional cost savings by allowing the creation and redemption of units *in specie*, thus eliminating most of the costs involved in buying and selling individual securities
- ETFs frequently offer competitive performance results vis-à-vis actively managed closed-end funds, as they do not need to retain cash for redemption purposes and operate under comparatively low-cost structures, which is to their advantage relative to other index tracking funds[63]

In view of the potential benefits to investors, and as part of efforts to expand the range of investment options available to them as well as further build liquidity within the equity market, the establishment of ETFs will be allowed. The SC will formulate a set of guidelines to provide guidance and clarify regulatory issues in this regard. In doing so, the authorities will work closely with relevant parties such as the sponsors, custodians and fund managers to facilitate the introduction of ETFs in Malaysia.

These guidelines will complement the *Guidelines for Public Offerings of Securities of Closed-end Funds* introduced by the SC in 1995, which allow closed-end funds to be listed on the KLSE. Both ETFs and closed-end funds provide investors with alternative avenues for participating in the capital market through professional fund managers.

[62] ETFs, which were first introduced in Canada in 1990, have increasingly gained acceptance as an instrument for equity investment in the US and Europe over the last few years. The current size of the ETF market is worth more than US$50 billion in the US alone. More recently, this trend has manifested itself in Asia with several exchanges in the region having announced proposals to launch ETFs. (Source: "The Evolution of Exchange Traded Funds", Merrill Lynch, September 2000.)

[63] Based on three-year average annual returns up to August 2000 for a selected group of ETFs and closed-end funds. (Source: Wiesenberger (part of the Thomson Financial Group, US).

RECOMMENDATION 24

Comprehensive measures to enhance MESDAQ's role as a fund-raising centre for high-growth companies will be implemented

To effectively establish a liquid and efficient market for the listing and trading of high-growth companies in Malaysia, comprehensive measures must be taken to ensure that the listing requirements and trading environment for these companies are highly facilitative as well as competitive relative to other high-growth exchanges within the region. Among other things, these measures must take into account areas where the accessibility and liquidity of counters listed on the exchange can be further improved.

Therefore, a review will be undertaken to identify areas where action can be taken to increase the exchange's commercial viability and attractiveness to technology and high-growth companies, while ensuring that the quality of listings on the exchange and national policy objectives are not compromised. This will entail, *inter alia*, a review of the overall listings costs, the procedures for the processing of applications, the time and cost required to complete a listing exercise and specific rules which may be seen to be possible impediments to potential issuers. Among the areas that will reviewed are: requirements for more than 50% of the total assets and operations of an applicant company to be situated in Malaysia at the time of admission to MESDAQ; the requirement that an applicant company must utilise at least 70% (or 51% on a case-by-case basis) of the listing proceeds within Malaysia; the length of the moratorium on the disposal of shares by promoters; and restrictions on dual listings of MESDAQ companies on other exchanges as well as listings of foreign companies on MESDAQ.

To further enhance liquidity and trading access to the exchange, membership and admission fees will also be reviewed. At the same time, ongoing efforts to deregulate the scope of activity of the stockbroking industry, together with the proposed consolidation of MESDAQ with the KLSE, are expected to result in an increase in the number of intermediaries participating on the exchange.[64] This is expected to extend MESDAQ's reach to a broader investor base.

Given the urgency of these issues, the SC will undertake a review of such areas together with MESDAQ and industry participants. Once identified, immediate priorities for action will be undertaken as soon as possible, in order to ensure that the development of the exchange is effected with minimum delay. These efforts, in conjunction with other measures that are discussed elsewhere in this chapter, will serve to enhance efficiency and facilitate a lowering of the cost of raising funds for high-growth companies.[65] In addition, the formulation and implementation of focused marketing and education programmes are important in overall efforts to generate greater investor awareness and promote participation by both retail and institutional investors in the market for high-growth companies' securities.

Update: It was proposed in the Budget 2001 that several listing requirements on MESDAQ will be liberalised, including a reduction in the requirement that 70% of the listing proceeds be used in Malaysia.

[64] As at end-2000, MESDAQ has 16 members compared to KLSE, which has 62 members. All MESDAQ members are also members of KLSE but not vice versa.

[65] Other measures discussed elsewhere in the chapter that will promote the further development of MESDAQ include: the facilitation of the use of technology in primary market offerings; the liberalisation of brokerage commission rates; and the deregulation of the market for the provision of corporate advisory services.

RECOMMENDATION 25

The listing of technology incubators will be allowed in 2001

Technology incubators provide funding to early-stage companies, that is, unlisted companies with little operating history. In addition, they also provide value-added services to investee companies in the form of management and recruitment assistance, office space, shared support services and equipment, amongst other things. The services provided by technology incubators relieves entrepreneurs of these burdens and enables management to focus on the business model at this critical juncture of the company's development, which serves to enhance the company's prospects of success.[66] The incubator, in turn, derives its income from the disposal of its interests as well as the fees paid by investee companies for its services.[67]

Allowing the listing of technology incubators will enable them to access a larger pool of funds, thus allowing them to increase and diversify their portfolio of investments, as well as enhance the supporting services provided to investees.

Therefore, the SC will work together with the industry to introduce suitable guidelines for the listing of technology incubators. This will not only facilitate the expansion of the total amount of venture capital funds available to start-up companies, but also provide a means for retail investors to participate in start-up companies at a relatively lower risk, given that the investments will be professionally evaluated and managed by the incubator.

RECOMMENDATION 26

The promotion and development of the venture capital industry should be centrally co-ordinated

In view of the nascent nature of the domestic venture capital industry, the appointment of a one-stop agency is essential to co-ordinate and spearhead its development and promotion, to effectively influence the circumstances and conditions in which venture capital financing may be made available to new and growing businesses.

Emphasis should be placed on establishing an enabling regulatory, legal and tax framework through the central co-ordination of the involvement of the various relevant regulatory authorities and industry participants in order to expeditiously identify and remove barriers to venture capital development. It is expected that the agency will also play a greater interactive role with industry players to create the optimal business environment for venture capital activity. Moreover, given that there is a proliferation of terms and concepts within the industry that lack harmonised or standard definitions, there is a need for the agency to consider producing a set of terminology to facilitate the consistent understanding and usage of terms.

[66] Some studies estimate that a new company spends half its time in the first six to nine months on such administrative needs (see, for example, "Networked Incubators" by M. Hansen, H. Chesbrough, N. Nohria and D. Sull, Harvard Business Review, September–October 2000).

[67] Technology incubators have become fairly common in more developed jurisdictions with some of the more well-known examples including Softbank in Japan, Jellyworks Plc in UK and Cyberwork Ventures in Hong Kong.

Within its capacity as the capital market regulator, of which venture capital is a subset, the SC is involved in several areas in relation to the venture capital industry. At present, venture capitalists are required under the SIA to hold a dealer's license or otherwise be specifically exempted. If any entity within the venture capital group provides fund management services to any legal entity and acts on behalf of this entity in relation to the management of a portfolio of securities, this entity is required to hold a fund manager's license issued by the SC.[68]

In addition, the exchange-traded equity market—MESDAQ in particular—plays a key role in providing exit opportunities and value recognition to venture capital investments, and its further development will contribute significantly in boosting the development of the venture capital industry.

Given that venture capital financing is closely intertwined with the broader capital market, the SC will work closely with the central co-ordinating agency to actively promote the development of the venture capital industry. To this end, such efforts will include providing assistance in formulating appropriate regulatory policies that will encourage small business formation and growth, that are favourable to greater private sector participation in venture capital financing.

Update: In recognition of the need for a dedicated authority to address the above issues, the Budget 2001 has proposed the establishment of an agency under the Ministry of Finance to co-ordinate the national development of venture capital.

RECOMMENDATION 27

Venture capital companies will be granted exempt dealer status under the SIA

Based on the SIA, venture capital companies fall under the regulatory purview of the SC by virtue of the definition of "dealers", which includes persons carrying on a business of dealing in securities as a corporation. Such persons, other than exempt dealers, are required to hold a dealer's license pursuant to section 12 of the SIA. The term 'exempt dealer' refers to a person who carries on a business of dealing in securities only through the holder of a dealer's license for his own account or for its related corporation.

A venture capital company is typically in the business of dealing in securities, and given the nature of venture capital financing, a venture capital company is likely to place investments directly in investee companies, and not through the holder of a dealer's license. As a result, through the act of investing in the securities of a corporation, either public or private, a venture capital company requires a dealer's license.

In addition, section 15A of the SIA requires any person acting as a fund manager to be licensed unless he is specifically exempt under the provisions of the Act. A venture capital company may operate a two-tier structure where a fund is set up and managed by a management company. It follows that the management company must be licensed as a

[68] This requirement holds unless the provider of the fund management services is an exempt dealer or an exempt fund manager under the SIA.

fund manager under section 15A, unless the company is a licensed bank or a merchant bank falling within that category. Otherwise, the management company requires a license, either as a dealer or a fund manager, unless otherwise specifically exempted.

To facilitate the development of venture capital financing, therefore, exempt dealer status will be granted to all venture capital companies and venture capital funds, subject to any conditions which may be imposed by these in order to facilitate industry development.

RECOMMENDATION 28

The establishment of venture capital trusts that can invest up to 100% in unquoted companies will be allowed

Venture capital trusts take the form of quoted trusts that invest in securities of new and emerging unquoted high-growth companies. Essentially, they offer a different way in which individuals can invest in small businesses, and provide an alternative method of mobilising professionally managed risk capital to new companies. Venture capital trusts allow for greater public participation in the funding of high-growth and high-technology companies, and pave the way for greater democratisation of the venture capital industry, previously accessible mainly by high-net worth individuals.[69]

The availability of venture capital trusts will not only support the development of equity capital financing for new companies, but also provide alternative investment opportunities for individual investors and venture capitalists. In view of this, the SC will facilitate the establishment of venture capital trusts that can invest up to 100% in unquoted investee companies. To this end, the SC will review its existing *Guidelines on Unit Trust Funds* and *Guidelines for Public Offering of Securities of Closed-end Funds* in order to accommodate investments in non-listed entities by venture capital trusts. The venture capital trusts will require a minimum amount of funds to be invested by an individual and would have the choice of being listed on the KLSE or MESDAQ.

[69] In the UK, for example, venture capital trusts are now accepted as a form of investment for private investors and a source of capital for unquoted companies. Venture capital trusts there were established by the Finance Act 1995 and invest principally in new securities, including loan stocks, of unquoted companies as well as securities of companies that are listed on AIM. In the period between 1 August 1995 to 30 June 1998, £535 million was raised by 26 venture capital trusts.

RECOMMENDATION 29

The SC will undertake a review of the tax framework for the venture capital industry in collaboration with the tax authorities, industry participants and the central co-ordinating agency for the industry

In light of the accreditation role for tax incentives granted to the SC during the Budget 2000, the SC will embark upon a review of the tax framework governing venture capital activity in collaboration with the tax authorities as well as the industry co-ordinating agency, and in consultation with industry participants.

The study will evaluate the effectiveness and relevance of existing tax structures and incentives, and identify additional areas where policies and incentives can be introduced to further promote the future development of the industry. These fiscal incentives will be targeted at facilitating the broad spectrum of venture capital activity. The issues to be considered will include venture investments in emerging high-growth companies by venture capitalists, business angels[70] as well as institutional investors; investments by individuals in venture capital trusts; stock options granted to investors and employees; and the employment of trained foreign professionals. Tax arrangements for newly established companies in high-growth sectors will also be examined.

RECOMMENDATION 30

Joint investment programmes between the government and private sector venture capitalists should be increased to boost private sector participation in disbursing government funds for seed and start-up capital

Given Malaysia's nascent venture capital industry, government financial assistance has been vital in supplying much needed capital to emerging companies at the seed and start-up levels. To this end, several programmes have been initiated by the government in collaboration with the banking sector and private sector venture capitalists to disburse earmarked government funds to start-up and emerging companies with high-growth potential.

In moving forward, joint investment programmes involving partnerships between the government and private sector venture capitalists, both local and foreign, should be further developed. These programmes should aim to share financial risks and rewards on a *pari passu* basis and be structured to ensure that the management of the finance available from government is subject to commercially-driven investment decisions by those in the private sector with the relevant expertise.

[70] The term "business angels" refers to private individuals who invest directly in new and growing unquoted businesses. Business angels usually provide finance in return for an equity stake in the business, but may also provide other long-term finance. This complements the venture capital industry by providing smaller amounts of finance at an earlier stage than most venture capital firms are able to invest.

Further government-private sector collaboration will be a useful starting point in enhancing the disbursement of government funds for seed and start-up capital, with the precise structure of joint investment programmes in Malaysia to be determined by the central co-ordinating agency. Nevertheless, although the government's role in monitoring the effectiveness of the management of these programmes should remain intact, the investment process should be largely left to the private sector partners who possess the requisite management skills to evaluate commercial investments and determine the allocation of funds.

Through these programmes, it is expected that investee companies will be supplied with more than just capital, but will be equipped with value-added advice and services in connection with management, strategy and financial advice. It will be in this connection that partnerships with the private sector will be most valuable.

Such partnerships between the government and private sector capital market players have proven to be successful in many other jurisdictions, including the US (through the Small Business Investment Companies programme) and Australia (through the Innovation Investment Fund programme).[71,72]

Greater international co-operation will also help to match domestic business ideas with global markets, and expand the market reach of domestic ventures through international venture capitalists' wider business networks. In this regard, the reach of these joint investment programmes should be expanded to include suitable international partners and foreign venture capitalists, in order to leverage from such partnership efforts to derive leading-edge technology and production capabilities, and enhance the process of product development and commercialisation.

RECOMMENDATION 31

The participation of local institutional investors in venture capital funds should be promoted

In many markets, investments in unquoted companies have traditionally been the preserve of venture capital companies and high-net worth individuals. However, institutional funds are increasingly becoming important players in this area, primarily through investments in private equity funds. Over 50% of investments in venture capital/private equity in the US, for example, currently come from institutional public and private pension funds with the balance coming from endowments, foundations, insurance companies, banks, individuals and other entities who seek to diversify their portfolio with this investment class.[73] Even though the actual percentage of private equity investment by institutional investors remains very small, this trend has led to an infusion of record amounts of capital in absolute terms, especially into the high-growth technology sector, and has helped to propel US economic growth over the last few years.[74]

[71] The US Small Business Investment Companies programme, which was started in the 1950s to facilitate the dissemination of public funds to small business and to develop the local venture capital industry, grooms private sector intermediaries specialising in small businesses investments and provides government-subsidised capital to small businesses through these intermediaries.

[72] The Australian government created the Innovation Investment Fund (IIF) programme in 1997 with the assistance and advice from the US's Small Business Administration. The IIF programme was aimed at assisting small, new-technology companies to gain access to venture capital in order to improve the commercialisation of Australia's research and development capabilities.

[73] Source: National Venture Capital Association.

[74] 3% to 5% of total funds in the US are typically invested into what pension fund managers refer to as "alternative investments", which includes private equity investments. In 1999 alone, a total of US$36.5 billion was raised for venture investments, exceeding the combined totals of the 3 previous years.

One of the reasons for this growth in the participation of institutional investors has been the growing appreciation of the attractive returns of private equity investments—while recognising their commensurately higher risks—compared to the returns obtainable from conventional index tracking or index-benchmarked portfolios of listed securities.

In Malaysia, investments in unlisted private equities by provident and pension funds, insurance companies, unit trust and asset management companies and other institutional investors continue to be minimal, due to some extent to restrictions that have been imposed on such investments. At the same time, there is a general conservatism and a lack of familiarity among such institutions of the benefits of such investments.

Given the large amounts of funds held by these institutions and the important role that they play in managing private funds, investments in the unquoted securities of high-growth companies will enable them to further diversify their holdings and enhance returns on their portfolios. Current restrictions on investments by these institutional investors should be eased to facilitate more effective management of their portfolios, subject however to appropriate prudential requirements. In addition, the SC, in collaboration with venture capital industry participants, will undertake programmes to create greater awareness of the investment opportunities among the directors of these funds and corporations.

RECOMMENDATION 32

Greater foreign participation in the venture capital industry should be allowed

The emergence of innovative, knowledge-based business ideas harnessing the use of new technology have resulted in the need for more sophisticated skill sets and techniques to screen, select and commercialise such ideas, and to develop them into successful enterprises. The increasing demand for technical know-how in resolving problems associated with the financing of new and innovative ideas such as appraisal techniques, adverse selection risks and information asymmetry have to be met in order to ensure that innovation-based businesses successfully develop and prosper in Malaysia.

Through the process of agglomerating foreign talent and expertise, knowledge transfer to local participants can be effected through shared proximity and concentration of activity, and provide greater opportunities for domestic companies to form strategic alliances with suitable foreign partners. Given the nascent domestic industry and the speed of innovation, there is an urgent need to expedite the process of developing deep pools of talent and expertise by increasing the participation of foreign venture capitalists.

Venture capital companies are typically subject to foreign ownership restrictions. In order to attract foreign direct investments as well as to obtain technology transfer, efforts should be taken to encourage more foreign venture capital participants to set up their operations in Malaysia. Among other things, foreign ownership restrictions placed on venture capital companies should be liberalised to allow for foreign equity participation of up to 100%.

However, where the management company has foreign equity participation of 70% or greater, the funds managed should only be subscribed by non-residents. This is consistent with the government's aim of promoting and attracting a greater amount of long-term foreign direct investments into the country.

Foreign professionals, particularly experts based in more mature markets with the requisite background in venture financing, can bring their experience in valuing intellectual property and understanding of new business models and risks to the Malaysian market through the provision of managerial guidance as well as extensive networking exposure to investee companies. It is therefore imperative that a larger pool of experienced and skilled venture capitalists, supported by a strong core of proficient and technology-savvy professionals, be available in Malaysia to support the development of young companies, and to accelerate the pace of commercialisation of new business ideas.

As such, the SC will collaborate with the relevant government authorities to encourage trained foreign venture capital professionals to work in Malaysia. These efforts will entail, among other things, working with the Immigration Department in looking at allowing a further relaxation of foreign immigration rules for qualified individuals, assisting in the competency assessments of suitable foreign professionals, and the identification of appropriate fiscal incentives.

BOND MARKET

Objectives

The Malaysian domestic bond market can trace its origins to the government's reliance on issuing bonds in the 1970s to meet the bulk of the massive funding needs required by the country's economic development agenda at the time. As government expenditure increased, so did the amount of outstanding government bonds, which grew at an average rate of 17% between 1970 to 1985. A substantial proportion of this outstanding amount was held by institutions such as the EPF.

In the mid–1980s the strategic national development agenda initiated a policy for the private sector to assume a greater role in economic growth and to shoulder the main burden of finance, while the public sector provided active support for the development process. Driven by the Privatisation Master Plan of 1991, privatisation was accelerated in the 1990s to cover projects in the infrastructure, utilities and transport sectors, as well as in the services sector, in particular education, training, and research and development.

The government, in providing the support required by the private sector in financing these projects, realised that existing financing mechanisms were inadequate to meet these long-term projects and sought to develop the corporate bond market to enable the private sector to tap alternative sources of financing. These development efforts were directed, amongst others, towards improving the regulatory framework and the market microstructure for the corporate bond market. Fiscal incentives were also introduced to allow for tax exemptions on interest earned by individuals and unit trusts from corporate bonds.

The development of a credit risk culture was actively fostered by the establishment of two local credit rating agencies in 1990 and 1995, and compulsory rating and investment grade requirements for new issues of bonds from 1992 onwards. In addition, a national mortgage corporation, Cagamas Berhad, was set up in 1986 to diversify the issuer base as well as part of overall efforts to promote the corporate bond market.

These initiatives and the high level of economic activity, reflected in the large infrastructure projects being implemented, saw the rapid expansion of the Malaysian bond market over the 1990s into one of the region's most developed bond markets in terms of size and market infrastructure. In 1999, total outstanding bonds amounted to 67% of GDP (nearly RM201.5 billion), behind Hong Kong within the region. However, of this amount, the total PDS outstanding less government-related issues such as Danaharta, Danamodal and Cagamas bonds, only stood at 38% of the total amount, or just over RM77 billion.

Despite focused efforts to develop the corporate bond market, the preferred funding source of the private sector still remains the banking sector. Corporate borrowers have relied mainly on bank loans and in some cases on foreign short-term financing to fund their long term needs. In 1999, the outstanding value of PDS amounted to RM111.8 billion, which came to less than 24% of bank loans outstanding.

A key priority for the development of the capital market is to establish a deeper, broader and more efficient corporate bond market that provides a competitive source of financing across a wide range of tenors. The need to deepen the market at the longer end of the maturity spectrum is especially pressing given the country's anticipated long-term investment spending needs going forward.

In implementing a comprehensive programme to develop the domestic corporate bond market, and as part of overall efforts to develop the financial system, the government established the NBMC in October 1999. In further developing the bond market, efforts will need to be directed at several key strategies. These include:

- Facilitating the domestic issuance of corporate bonds by lowering issuance costs and moving towards a more market based issuance process
- Establishing and developing liquidity of benchmark bond issues
- Ensuring that the bond market microstructure is robust and efficient, and facilitates innovation
- Promoting a greater breadth of investment in corporate bonds by both domestic and foreign investors

Underpinning these strategies should be the concurrent development of a financial system that is more market-based.

RECOMMENDATION 33

A full disclosure-based framework for the issuance of corporate bonds will be implemented

Market timing is of the utmost importance to issuers. A lengthy approval process heightens the uncertainty arising from changing market conditions, and can lead to higher costs of bond financing. In view of this, a full DBR framework will be introduced for the corporate bond market in order to ensure that issuers have more timely access to the market, as well as to promote greater transparency in the bond market. Once this framework has been fully implemented, the investment merits of a particular issue or the prices and quantity of issues brought to the market will not require regulatory assessment. The regulatory mandate will focus on setting clear issuance rules to market intermediaries and issuers whilst providing for investor protection.

Therefore a set of well-defined, unambiguous and objective issuing criteria will be published. This will allow the bond issuance process to be shortened to around 14 working days. Where necessary, regulatory preconditions by other authorities will be removed or encompassed within the single set of requirements imposed by the SC, so as to eliminate any unnecessary approval processes.

Although DBR will require the imposition of higher disclosure standards and continuous disclosure obligations than is currently required for bond issues, it is also important that the burden of disclosure should not counteract the efficiency of the corporate bond market as a source of financing.

Update: The SC introduced full DBR for the issuance of bonds when it became the single approving authority for corporate bond issues on 1 July 2000.

RECOMMENDATION 34

A shelf-registration scheme for the issuance of corporate bonds will be introduced

It is extremely important that companies are able to meet their financing requirements in the shortest and most cost effective manner possible. Shelf-registration schemes allow for an expedited bond issuance process and are generally recognised as having the following benefits:

- Investors would be able to receive a much shorter and more focused offering document at the time of the issue
- Reduction of costs to a frequent issuer
- Reduction in the amount of work required by a company and its advisers at the time of any issue
- Minimisation of the time taken to process documentation relating to the issue

Shelf-registration will require the issuer, who must meet certain eligibility requirements, to prepare and register a shelf prospectus containing all the relevant information with respect to the issuer and the issue of bonds with the SC. The shelf prospectus will not, however, contain details relating to the price of the securities and the actual number of securities, the payment schedule and the yield. The validity period for shelf prospectuses will be up to a period of two years from the date of issue of the shelf prospectus.

To ensure that the information provided by the issuer in the shelf prospectus is current throughout the validity period and prior to any actual bond issuance, the issuer will be required to submit to the SC a supplementary shelf prospectus for registration. This supplementary prospectus should contain the relevant information to ensure that any material changes in the position of the issuer or the issue since the registration of the shelf prospectus are adequately disclosed. Essentially, the function of the supplementary prospectus is to provide the details that are not included in the shelf prospectus. These details include the price at which the bonds will be issued, the number of bonds to be issued, the yield, coupon rate or profit and its payment schedule, and the offer period for the bond issue.

Update: The SC introduced a set of shelf-registration regulations for corporate bonds on 1 July 2000.

RECOMMENDATION 35

The mandatory requirement for credit ratings on corporate bond issues will be removed

Credit ratings will be made voluntary with respect to the offering of corporate bonds. This will broaden the corporate bond market and allow investors to select investments from a wider set of risk profiles. However this will only be implemented when the DBR framework is in place and the market is assessed to have a sufficient critical mass of sophisticated players that have sufficient independent skills in risk evaluation.

The removal of mandatory rating requirements will enable recognised, lower-risk corporations to issue bonds without a rating if they so choose. However, it is expected that most issues will be rated, as market pricing will favour bond issues with known credit ratings. Unknown, unrated enterprises will attract a risk premium from the market. If a rating is not perceived as adding value, ie if ratings have a weak record of accuracy and timeliness, the market will discount the value of a rating, and no price benefit will accrue to the issuer.

It is proposed that the move towards a voluntary rating programme be effected in the early part of Phase 2 of the Masterplan. Subsequently, the SC will carefully assess the results of voluntary rating for securities offerings and undertake appropriate corrective measures, where there has been a lack of or misleading disclosure of information, in the interests of investor protection.

Update: Although the mandatory rating requirement for all corporate bond issues is still in place, the investment grade requirement of BBB or more for all corporate bond issues has been removed with effect from 1 July 2000.

RECOMMENDATION 36

A framework for the issuance of asset-backed securities will be introduced

Securitisation offers a financing alternative for companies with good assets such as mortgage loans, trade receivables, car-loan receivables and hire-purchase contracts. Cagamas is already a successful issuer of low-risk housing mortgage backed securities and substantial benefits have been derived from the securitisation programme for housing development. In addition, the revenue streams from privatised infrastructure projects such as toll roads, power plants and building rental can be "brought forward" through the issuance of asset-backed securities.

In order to facilitate the issuance of asset-backed securities, a single set of guidelines on the issuance of asset-backed securities will be issued to facilitate the effective use of capital and increase the range of issuers and investment opportunities for investors. These guidelines will set out clear and transparent criteria required by all relevant authorities, both for financial and non-financial institutions. Furthermore, the SC will adopt a DBR framework for the issuance of asset-backed securities. This is consistent with the general approach being taken for the corporate bond market as a whole, although specific requirements will be introduced, where relevant, to cater for particular characteristics and risks of the asset-backed market. The use of credit ratings will be a central feature of this market-based approach in assessing the viability of asset-backed securities issues.

Other areas to be addressed include the following:

- Existing insolvency provisions must be reviewed to limit its broad ranging application and to ensure that special purpose vehicles are sufficiently bankruptcy remote
- The tax position surrounding securitisation structures should be further clarified and made transparent to ensure consistency of treatment
- There must be convergence in the criteria for true sale by all regulatory bodies and that this should be equally reflected in accounting standards to be applied
- To administratively rationalise the application of other regulatory requirements imposed by various regulatory bodies which might be triggered in securitisation structures so as to create certainty and to ensure time efficient compliance

RECOMMENDATION 37

The existing taxation framework for Special Purpose Vehicles should be clarified to reflect economic substance, and the stamp duty and Real Property Gains Tax on transactions relating to the issuance of asset-backed securities should be removed to encourage asset securitisation

Although Budget 2000 allowed for exemptions from stamp duty and Real Property Gains Tax (RPGT) for transactions related to the issuance of asset-backed securities up to 31 December 2000, other impediments to the development of this market segment remain. Such impediments include the taxation of the income of the Special Purpose Vehicles (SPVs) and the limited period given for the stamp duty and RPGT exemptions.

In an asset securitisation structure, SPVs are generally a flow-through vehicle that is used to isolate the security and cash flows, and are generally not profit generators. Upon maturity of the structure, all surpluses are refunded to the originator. The SPVs should therefore not be subjected to income tax, which may currently arise due to the timing mismatch between income and expenditure, overcollateralisation or the classification of the SPVs' tax profile.

Stamp duty and RPGT arising from the assignment or transfer of assets to a SPV, necessary for the purpose of asset securitisation, is a significant cost. Exemptions from these taxes need to be extended if asset securitisation is to make a meaningful contribution to the

bond market. To address these impediments and to encourage asset securitisation, the current exemption of stamp duty and RGPT should be extended and the existing taxation framework for SPVs should be clarified to reflect economic substance.

Update: The Budget 2001 has proposed the abolition of stamp duty and real property gains tax on transactions relating to the transfers of assets to a SPV.

RECOMMENDATION 38

Liquidity in benchmark issues should be developed and established

A deep and liquid domestic market in benchmark securities is essential for a well-functioning market for debt securities in Malaysia. It creates a "core" asset market, whose presence serves to benefit the financial system as a whole primarily by affording a mechanism for pricing other financial assets, in particular corporate bonds, and acting as an underlying asset or collateral for related markets in repos, swaps, futures and options.

While efforts have been made in the past to establish benchmark securities, none has singularly achieved the desired level of success and this has resulted in a variety of instruments that might be considered as possible benchmark bonds. MGS are the most widely accepted of the possible benchmark candidates as well as being the largest in issuance size. But although the bonds are recognised as having the lowest risk of default, their significance as a benchmark has diminished on account of a lack of sufficient and regular supply. Cagamas and quasi-sovereign bonds face a similar problem of irregular supply, although more importantly, these have higher default risk than the other candidates, which hinders their broad acceptance as a risk-free proxy. While Khazanah bonds were issued specifically to act as a benchmark security, they are not widely accepted by the market, especially by foreign investors. A lack of name recognition compared to MGS seems to be a particular issue. In the past, the coupons paid on currency swaps had been used as a proxy for ringgit-based risk-free yields, but the market has since stopped trading under the current fixed exchange-rate regime.

A major problem in developing liquidity in all these issues has clearly been a lack of sufficient and regular supply of these securities to satisfy market demand. Other problems have included institutional weaknesses that have hindered active trading and, in certain cases, limited acceptance by the market as a benchmark. These problems have meant that a liquid market—and hence efficient yields—in any of these instruments has been difficult to establish.

Hence, a key focus for bond market development efforts will be in formulating and pursuing an active programme for establishing and maintaining a set of benchmark bond issues, and in promoting an active secondary market in these securities. Corporate bond markets in more developed jurisdictions have developed on the basis of a liquid benchmark securities market, in most cases, that for government securities. The benchmark used for corporate bond pricing should have the lowest risk profile of all bonds in the market, broad market acceptance, large issuance sizes, a specific maturity profile tailored to the particular market they serve, and a regular and transparent issuance schedule.

RECOMMENDATION 39

A programme to issue MGS should be encouraged and promoted with a view to establishing them as the immediate benchmark securities for the Malaysian bond market

With MGS being virtually risk free, as well as being the best known to both foreign and domestic investors, these securities will have the lowest yield of all domestic bond issues. This broad market acceptance will enhance the willingness of the market to use these securities as benchmarks and to trade in them. Therefore of all the possible candidates for a benchmark instrument in Malaysia, MGS is the best choice for a market accepted, risk-free benchmark.

To ensure that MGS becomes a successful benchmark security, there will need to be a programme for the regular and frequent issuance of MGS in order to satisfy market demand and to allow for the establishment of a yield curve that spans the required terms to maturity.

Active benchmark securities markets usually consist of around 5-12 key maturities, more or less evenly distributed across each maturity zone. The issuance schedule for the benchmark securities should ideally be pre-announced to ensure that there is minimum uncertainty among market makers and traders over the prospective demand and supply conditions in both primary and secondary markets.

In addition to the task of issuing risk-free bonds, there should also be a debt conversion process to decrease the fragmentation of outstanding MGS and focus on large and liquid issues to ensure maximum liquidity. This can be achieved by re-opening on-the-run issues and regularly repurchasing or converting off-the-run issues that are less liquid. On the broader level, relevant macroeconomic policies such as the issue of how to manage surplus funds once the current federal budget deficit has been eliminated will need to be closely examined.

Update: NBMC has initiated an active programme for the issuance of MGS as the benchmark security. Among the steps undertaken was the release of a schedule of MGS auctions for the year in March 2000. The calendar seeks to increase transparency and build confidence in MGS issues as the benchmark securities. A total of RM16 billion worth of MGS was issued under this programme in 2000.

RECOMMENDATION 40

Regulated short selling of MGS and corporate bonds should be allowed

RECOMMENDATION 41

Non-financial institutions should be allowed to conduct the entire scope of repo activities

Ancillary markets facilitating financing and risk management activities by market makers and investors are critical elements in a liquid secondary market. Market participants must be able to take long and short positions on the benchmark and corporate bonds in the secondary market. Market makers need to be able to use the secondary market to offset positions arising from offering prices "both ways", ie, giving investors the option to both sell or buy. As market makers are required to offer prices for both buying and selling bonds, they should also be able to quickly reposition themselves so that they are not caught short or long, or hold an unwanted position.

Repos and reverse-repos allow market participants to finance their trading positions and hence promotes market liquidity. Repos also facilitate the taking of long and short positions and therefore reduce the costs to market makers. Without repo markets, financing has to be in the form of more expensive uncollateralised lines of credit from the banking system.

In view of these issues, a framework for the regulated short selling of bonds should be established by the SC. While a repo market already exists in Malaysia, it is not sufficiently deep to support liquidity in the bond market. Therefore, the range of participants in the repo market should be expanded to allow other selected participants (such as licensed institutions under the SIA and fund managers) to conduct repo transactions with the banking institutions.

Update: Amendments to BAFIA on 1 July 2000 now allow non-financial institutions to undertake repo transactions with financial institutions.

RECOMMENDATION 42

Markets in MGS futures and options should be established

Liquidity and efficient price discovery in secondary markets for bonds are also fostered by the development of organised futures markets offering instruments such as interest rate futures and options on government securities. The ability of dealers and other market participants to hedge their interest rate risk will support the growth of secondary market

activity in the bond market. The "when-issued" market—the market in securities that have not yet been issued, with trades being settled on issue day—also allows the hedging of auction bids. Such markets now exist in most of the G7 countries. Furthermore, as the bond market moves towards a more developed stage, investors and dealers would need suitable instruments to hedge their cash position and improve price discovery.

An organised futures market based on benchmark issues should be established to promote liquidity by allowing market makers to hedge their cash positions and generate trading volume in the underlying market through arbitraging and hedging. These futures and options markets, whose underlying instrument should ideally be MGS, should be introduced on the local derivatives market at an appropriate time, based on an assessment of market conditions by the derivatives exchange.

RECOMMENDATION 43

EPF's investment requirements should be eased to free up its "captive demand" for MGS

EPF's investment activities are governed by statute and it is required to invest at least 50% of its funds in any one year in MGS. The total amount invested in such securities at any one time must not be less than 70% of its total investments, unless otherwise approved by the Minister of Finance.[75]

The current available supply of MGS is insufficient to meet EPF's investment needs. New MGS issues are therefore quickly absorbed by EPF to meet its investment needs and also to replace maturing bonds. This inadequacy of the current supply in MGS to meet EPF's demand is a key feature that significantly distorts the liquidity and development of the Malaysian bond market.

In addition to creating demand and absorbing most of the MGS issues, the EPF also tends to hold these securities to match its long-term liabilities. While consistent with EPF's own investment mandate, this has adverse implications for the bond market as it minimises the level of free float of MGS in the market, which in turn impedes liquidity and the development of the benchmark yield curve.

The government has already taken some initial steps to deregulate the investment options of the EPF and allow employees to transfer a portion of their savings in the EPF to unit trusts and external fund managers. However, within the context of the development of the corporate bond market, it is clear that the current investment restrictions imposed on EPF need to be reviewed and amended to allow for a greater free float of MGS. Among the immediate initiatives that could be undertaken to address this issue is to widen the scope of instruments which can be used to fulfil EPF's statutory requirements.

At the same time, although this measure would to some extent alleviate the problem of captive demand, further deregulation of the institutional investment requirements with regard to MGS is necessary. Over the last decade, there has been increasing reform of

[75] The most recent EPF financial information indicates that approximately 30% of its portfolio is invested in MGS. This equates to holdings of some 66% of MGS currently in issue.

government pension funds around the world, which in many instances has seen the development of a more diverse and dynamic institutional investment sector in the respective jurisdictions. This in turn has further enhanced liquidity in their secondary corporate bond markets. The type of detailed reforms that might be needed to achieve these benefits are dealt with in further detail within the recommendations in the Investment Management section.

RECOMMENDATION 44

Access to trading on the over-the-counter market should be extended to a wider range of participants

A trading platform with diverse participants, with a variety of transaction needs and investment horizons, willing and able to buy and trade, is also important in enhancing market liquidity. For example, liquidity would be enhanced by the lifting of regulations that prevent particular capital market intermediaries from participating in trading on the over-the-counter (OTC) market. In this regard, wider financial deregulation to allow greater participation is important for increasing liquidity in bond markets.

Therefore, the range of market intermediaries that have access to the OTC trading system—including access to the Fully Automated System for Tendering (FAST), the Bond Informational Dissemination System (BIDS) and RENTAS, the auction, information and settlement systems for unlisted bonds respectively—should be expanded to include those other than the current approved financial institutions. This should include, in particular, securities industry institutions licensed under the SIA such as stockbroking companies and fund managers. Improving the accessibility to these systems will allow for greater competition, which is essential to ensure effective price recovery.

RECOMMENDATION 45

A phased programme to encourage international financial institutions and multinational corporations to issue ringgit bonds should be considered

Allowing the issuance of high-quality paper in Malaysia's bond markets would bring about a number of benefits, including expanding the market's breadth and depth, diversifying the investor base and raising the international profile of the market. Therefore a programme to allow and encourage international financial institutions and multinational corporations to issue ringgit bonds in Malaysia should be considered for implementation in Phase 2 of the Masterplan. In addition to broadening the range of products available in the market, this measure will also serve to introduce internationally-recognised papers that will facilitate and encourage the participation of foreign investors in the domestic bond market. As an initial step to increase interest in the Malaysian bond market, major institutions such as, the World

Bank, the International Finance Corporation and ADB should be encouraged to issue securities in the ringgit bond market.

The move to allow foreign bond issuers into the domestic market should be accompanied by clear guidelines and safeguards. It should be undertaken on a gradual basis, the precise timing of which will depend on a host of factors, including market preparedness and wider macroeconomic policy considerations.

RECOMMENDATION 46

International ratings for domestic bond issuance will be allowed

In line with the adoption of a full DBR framework for the issuance of corporate bonds, as well as the SC's emphasis on market-based assessments of the viability of securities issuance (including that of bonds), it is important, from the perspective of both the issuer and the investor, that credit ratings in the Malaysian market are of a high standard and benchmarked against international best practices. In order to achieve this, the SC encourages domestic credit rating agencies to ensure that skills are continuously upgraded and enhanced, possibly through forging greater alliances and participating in more technical assistance programmes with their international counterparts.

Nevertheless, as the Malaysian bond market becomes more sophisticated, the SC recognises that issuers will demand a more competitive ratings environment. The SC would therefore look to allow domestic issuers with ratings from recognised foreign agencies to issue paper in the domestic bond market. Such international ratings will reduce the cost of issuance for those companies that already have an international rating, and will serve to ensure that the domestic Malaysian rating agencies maintain standards on par with those internationally.

RECOMMENDATION 47

A programme for the establishment of a centralised platform for the clearing and settlement of listed and unlisted bonds should be pursued

The importance of allowing both listed and unlisted bonds to be cleared and settled by a central system is highlighted by the current situation in Malaysia where liquidity is fragmented, thus making the task of building critical mass more difficult. At present, the OTC market accounts for the majority of trading in bonds compared with the exchange-traded market. One of the main reasons for the relatively lower trade volumes for listed corporate bonds is the higher transaction costs involved. These costs become even more significant when compared to the relatively low margins involved in the trading of corporate bonds.

Experiences in other jurisdictions also illustrate the importance of allowing for the establishment of a centralised clearing and settlement system. In more developed capital markets it is common for bond issues to be listed on an exchange but with much of the trading occurring off the trading floor, in the OTC market. The chief reason that bond market trading is concentrated in OTC markets is that the diversity of debt securities (in terms of maturity, duration, coupons and credit risk) tends to result in limited trading of most corporate debt issues, and thus a dealership trading system can improve liquidity.

In order to improve order flow and minimise market fragmentation, the establishment of a single platform for the clearance and settlement system for both listed and unlisted bonds will be assessed. A centralised clearing and settlement system will help to build liquidity in the secondary market, by ensuring that clearance and settlement structures and mechanisms in the secondary market are robust, streamlined and efficient. Settlement and payment risks will be minimised, as well as costs associated with low turnover and price volatility. Such an environment also contributes to a reduction in systemic risk.

However the pursuit of such a programme will require the readiness of non-bank intermediaries to play a greater role in the bond market. Therefore in the immediate term and given the complexity involved in revamping the existing platform, it will be important to ensure that there is a continued favourable trading environment within the current structure.

RECOMMENDATION 48

The participation of retail investors in the corporate bond market will be encouraged through the promotion of the establishment of bond funds

As a general rule, the demand for corporate bonds is dominated by institutional investors, including insurance companies, pension funds, and unit trusts or mutual funds. In the US and UK, for example, the major investors in corporate bonds are insurance companies, pension and mutual funds. Although individuals have been an important source of demand in the markets of advanced economies, the recent trend has been for these retail funds to be directed through institutional investors such as pension schemes, unit trusts and insurance companies, reflecting the institutionalisation of portfolio management.

This highlights the importance of products such as bond funds and other debt-linked hybrid instruments in mobilising retail funds for the purpose of investing in the corporate bond market. In addition, bond funds are "total-return oriented" and as such their managers tend to trade their positions more frequently than "buy and hold" investors such as pension funds or insurance companies. Bond funds therefore add to market liquidity and add depth to the pricing of risk in the bond market.

Therefore the investment management industry will be encouraged to offer bond unit trusts, which is a necessity in order to increase the demand in the corporate bond market and to facilitate the participation of retail investors in the bond market. To supplement the important role that fund managers play in the development of the bond market, there will also be a review of the extent of their participation in the domestic corporate bond market and the subsequent removal of undue restrictions or disincentives to the setting up of bond funds.

RECOMMENDATION 49

The tax framework should be reviewed to encourage issuance and investment in debt securities

Current tax regulations favour investment only in certain categories of bonds, particularly for MGS. Stamp duty is also a significant impediment to securitisation. To promote the development of a liquid bond market and encourage investment in non-MGS issues, the tax environment needs to be neutral with respect to debt securities. Therefore, the following measures to encourage issuance of and investments in debt securities should be introduced:

- Tax deductions for the costs of bond issuance (these are currently non-deductible) should be allowed
- Non-resident withholding tax on interest on bond investments should be removed to facilitate participation by foreign investors, thereby placing overseas investors on an equal taxation basis with Malaysian investors. Withholding tax on interest payments to non-residents should be removed particularly where the absence of withholding tax does not increase the investor's tax burden in its home jurisdiction
- Presently, interest income earned by individuals, unit trusts and listed closed-end funds in respect of bonds (other than convertible loan stock) issued by a company rated by RAM or MARC, is exempt from tax. This exemption, however, has not been extended to resident corporations in Malaysia. Such interest income is still subject to the normal corporate tax, currently at the rate of 28%

To encourage investment in bonds by corporations and institutional investors, the anomaly in the tax treatment of interest income received from bonds should be rectified. Interest income received by corporations and institutional investors such as fund management companies from investment in bonds should be exempt from tax. It is also anticipated this will act as a stimulus for an increase in the demand for bonds.

DERIVATIVES MARKET

Objectives

The Malaysian exchange-traded derivatives market currently consists of KLCI futures and index options traded on KLOFFE; and CPO futures and three-month KLIBOR futures traded on COMMEX.

Until recently, the derivatives market in Malaysia was confined to only commodity futures traded on the former KLCE, which opened in 1980. The country's first financial derivatives exchange, KLOFFE was established in 1995 with KLCI futures launched the same year, while the three-month KLIBOR futures contract was launched in 1996 by what was then MME. The MME later merged with the KLCE to become COMMEX.

However, despite concerted efforts by the SC, market institutions, intermediaries and industry participants to build up the derivatives market over the past years, to date the Malaysian derivatives market has seen limited growth relative to the development of the equity market. This is partly due to the sharp reduction in foreign participation in the KLCI futures market at the height of the 1997-98 financial crisis. However, other factors such as the continued lack of active local institutional participation, low levels of investor awareness as to the use of derivatives and limited product range have also been cited as major reasons for the slow growth of the derivatives market.

Given the continuing inroads made by technology and the growing sophistication of the investing populace, the derivatives industry will have to look closely at where it can provide the most value in the years to come. Increasing competition for business among international exchanges poses significant challenges for the local derivatives industry. This is particularly pertinent since derivatives are essentially structured products that can be cash-settled, hence relatively easily replicated in offshore markets.

There are concerns that these issues, if left unaddressed, may lead to the greater diminution of activity and efficiency in the domestic derivatives industry. The lack of liquidity on the derivatives market will result in higher risks and relative costs being borne by market participants, intermediaries and exchanges. In the longer-term, the lack of cost-effective hedging and risk management facilities in the market will limit the capacity of investors and businesses to effectively manage the risks associated with their investment and business exposures domestically. Even if they look to other markets for suitable alternatives, this will entail genuine economic costs to resident investors and businesses.

Many of the issues facing the Malaysian derivatives market today require concerted efforts to expedite its development, so that it can ably meet these challenges. The domestic derivatives market should be the primary market catering to the risk management needs of investors in Malaysian securities and other assets in an efficient manner.

Liquidity is essential for the effective development of the Malaysian derivatives market. The most immediate measure will therefore be to build up critical mass. Once this has been established, market forces will, to some extent, drive efforts to improve efficiency and innovation to generate other value-added activities in the Malaysian market. For the

derivatives market to ensure its continued relevance to the wider economy and ultimately its long-term competitiveness, there should be concerted efforts to:

- Facilitate effective hedging by investors with exposures in the underlying markets through efforts to enhance liquidity in the derivatives market and allow the efficient pricing of risk
- Promote a culture of risk management among institutional investors by encouraging a more active approach towards hedging their investment portfolio exposures
- Enhance investor awareness and knowledge on the uses of derivatives
- Minimise transaction costs to enhance the attractiveness and accessibility of the exchange-traded risk management products to market participants
- Develop strong and well-managed derivatives market intermediaries, supported by skilled professionals, to ensure that participants in the local derivatives market can obtain services of a quality commensurate with those offered in mature markets
- Foster a market-driven approach towards the development of new products in order to encourage product innovation and facilitate pro-active solutions to investors' risk management needs
- Enhance liquidity and product diversity in the local derivatives market by capitalising on mutually beneficial cross-border partnerships and the involvement of global market participants

RECOMMENDATION 50

Restrictions on the participation of unit trust funds and closed-end funds in exchange-traded derivatives will be deregulated

To facilitate more active risk management within the local investment management industry, there will be further deregulation of restrictions on unit trust funds and closed-end funds with respect to their participation in exchange-traded derivatives. This will allow local investment management companies greater flexibility in hedging their portfolio exposures, with end-investors benefiting from the mitigation of excessive volatility and downside risk arising from unhedged portfolios.

As the domestic investment management industry matures, the broadening of the allowable investment portfolio will also promote higher levels of familiarity with increasingly complex products, and facilitate competition within the industry by allowing for greater portfolio diversification and product differentiation to cater to investors' different risk preferences.

The removal of investment restrictions on participation in exchange-traded derivatives, such as those imposed by the *Guidelines on Unit Trust Funds* and the *Guidelines for Public Offerings of Securities of Closed-end Funds*, would encourage more active risk management in the local investment management industry. The pragmatic deregulation of the investment guidelines would also be in line with overall efforts to allow these funds greater opportunities to add value to their clients. To this end, the amount of funds

allocated towards hedging with derivatives should be determined by the degree of investment exposure it is hedging, and not by a static limit. However, this deregulation will be subject to appropriate disclosure requirements and the prudential framework that governs the unit trust industry, in order to ensure the continued safeguarding of investor protection.

RECOMMENDATION 51

Derivatives funds will be allowed to be established and offered to investors in 2001

It is important for Malaysian investment managers to have access to a variety of instruments and investment techniques, to allow for the effective hedging of their portfolios and to provide competitive and efficient returns to their investors. Increased participation by investment managers will, in addition, assist in providing greater liquidity on the derivatives market.

The use of derivatives in investment management is becoming increasingly common throughout global markets. This provides investment managers with greater flexibility in balancing the risk, return, diversity and concentration of their portfolios. For investment managers dealing with the collective funds of sophisticated investors to whom greater risk may be acceptable, the dearth of alternative investment strategies locally may mean that they will look to avenues overseas to meet their investment preferences.[76]

Allowing domestic investment management companies to establish derivatives funds will provide a facilitative yet properly supervised environment to cater to Malaysian investors' investment preferences. This issue is expected to become more important in the coming years as investors look for increasingly competitive channels for the deployment of their excess funds. As such, it is only acceptable that the expansion of investment opportunities should be available to them, albeit on a gradual basis, in tandem with the development of public awareness and investor sophistication.

To this end, derivatives funds will be allowed to be offered in stages to Malaysian investors. The first stage will allow the offer of such funds to sophisticated investors or high-net worth individuals by end–2001. Derivatives funds offered to the general public will be allowed within a year after this initial stage.

The SC will introduce guidelines on derivatives funds to ensure that investors are aware of the associated risks of investing in these funds, as well as to maintain the necessary regulatory oversight of derivative market activities. Among other things, the guidelines will specify the standards of conduct of business for companies providing investment schemes involving the use of derivatives, the standards of disclosure to customers regarding the nature of such investments and the risks involved, as well as the standards of internal management expected of such futures fund managers.

[76] Foreign alternative investment schemes for high net-worth customers include those managed by commodity pool operators in the US, authorised unit trusts who operate non-geared futures and options funds or geared futures and options funds in the UK, and collective investment schemes subject to the Code on Unit Trusts and Mutual Funds in Hong Kong.

RECOMMENDATION 52

Restrictions on the participation of local institutions, including EPF and insurance companies, in exchange-traded derivatives should be deregulated

In most mature markets, domestic institutional players are typically the predominant users of derivative hedging and risk management products. This has not been the case in Malaysia where, for example, domestic institutions account for only a small proportion of total KLCI futures trading activity. This has been due, to a certain extent, to the absence of active competition within the local investment management industry, specific restrictions on derivatives participation in some cases, as well as a general lack of familiarity as to the usage of derivatives.

Local institutional funds such as the EPF, other provident and pension funds, and insurance companies, should have the flexibility to ensure that the portfolio risks borne by their contributors or investors are managed in the most cost-efficient manner possible. Given the important roles played by these institutions in managing private savings and other funds, it is imperative that they have access to tools for managing fluctuations in the value of their investment portfolios. As the local derivatives market was established for this purpose, current impediments such as those contained in the governing legislation of the funds, as well as other regulatory impediments such as investment restrictions, should be deregulated to facilitate more effective management of portfolio risks.

In addition, the SC, in collaboration with industry participants, will undertake a continuous programme for generating greater awareness among directors of these funds and corporations. The ability of these funds, as well as large corporations, to take a lead role in this regard will assist in advancing a culture of more active risk management among local institutions and promote a more balanced mix of participants in the local derivatives market.

RECOMMENDATION 53

KLOFFE and COMMEX should actively pursue the introduction of more derivative products

The Malaysian derivatives exchanges must give careful consideration to their current position and strategy for the longer term and, as such, are encouraged to actively pursue the further development of risk management instruments. These may include the introduction of products that cater to niche sectors of the investing public, such as investors in Syariah-approved counters. In this regard, the SAC's decision that the structural concept of index futures is permissible from the Islamic point of view opens up opportunities for the exchanges to explore the possible listing of Islamic derivatives.

The feasibility of introducing stock options and tailored regional and international derivative products should also be studied. The possible offering of regional or international products will assist in attracting greater foreign participation in the Malaysian derivatives industry, and in raising the international profile of the Malaysian capital market. Such products would also cater to investors wishing to take on some exposure to movements in regional markets without having to invest directly in those markets themselves, thus reducing some of the propensity for capital outflow to better-performing markets.

Update: The recent introduction of KLCI options in December 2000 was an initial step towards offering investors a wider range of hedging instruments.

RECOMMENDATION 54

The process for the introduction of new domestic exchange-traded derivative products will be streamlined

The SC will actively facilitate the further development of market breadth by streamlining the procedures for the introduction of new exchange-traded derivative products. This will minimise the time taken to roll out new instruments, vest the exchange with the primary responsibility for undertaking the necessary cost-benefits analysis of new products, and enable it to respond in the quickest manner possible to evolving risk management needs.

As such, the SC will introduce a framework that allows the introduction of new exchange-traded derivative products based only on the following minimum criteria:

- The economic function of the product must be identified and clearly defined
- There should be adequate prudential safeguards to address the issues of market integrity and potential market manipulation
- There must be adequate steps to ensure market readiness and education

Any proposal for a new derivative product deemed to have met the above criteria will be considered for the purpose of the amendment to the business rules of the derivatives exchange company. The fact that the number of futures instruments traded on Malaysian derivatives exchanges has remained relatively small while neighbouring exchanges have rapidly and successfully expanded their line of products indicates that there is scope for further broadening of the product range currently available locally. This new approach will enhance the overall transparency of the approval process, promote greater product innovation and enable the introduction of new products in a timely manner.

RECOMMENDATION 55

Local futures market intermediaries will be allowed to trade approved international financial derivative products by end–2001

Malaysian futures brokers may trade on overseas exchanges if such exchanges are recognised via a Ministerial Order as specified exchanges. The Futures Industry (Specified Exchanges) Order 1997 lists the recognised international exchanges and futures contracts that Malaysian futures brokers can trade on.

At present, however, the list does not include any exchange-traded financial derivative instruments. Thus, Malaysian market participants are unable to hedge against currency risk, foreign equity investment risk and foreign credit risk except through foreign brokers directly, or the more costly OTC market.

Given the diversity of hedging needs by investors, it is impossible for any single exchange by itself to be able to offer a sufficiently broad range of products to meet these demands. KLOFFE and COMMEX's natural prioritisation of offering derivative products with the greatest promise of viability and public acceptance means that they will be unlikely to offer less commercially viable instruments if such demand is from only a small minority. Consequently, such participants would benefit from being able to hedge with the relevant derivative contracts that are already being offered by foreign exchanges.

To cater to Malaysian investors' need for a wider range of cost-efficient hedging products, therefore, the list of specified exchanges will be expanded to include financial derivatives products that are traded on overseas exchanges. MDCH should act as the central collector and distributor of payment from local members for financial derivatives trades executed and cleared overseas. This not only allows the more efficient central co-ordination of payment to and from local members, it also retains a part of the clearing revenue within the country and provides a legitimate avenue for local participants to trade in recognised foreign exchanges in a more secure manner. Mutual offset arrangements will also allow positions to be transferred from one clearing house to another to offset existing positions maintained by the clearing house under the same client.

It should be noted that, in most jurisdictions, official regulatory recognition is usually needed before overseas exchanges' products can be offered in their respective jurisdictions.[77] To ensure the trading of financial derivatives in exchanges offshore is executed in a clear and orderly manner, the SC will pursue active discussions with its regulatory counterparts in relevant jurisdictions, where necessary, to assist in the necessary recognition requirements for such cross-border trading to take place. Such recognition, while not indemnifying market participants from making investment decisions at their own risk, provide a means of verification and possible further co-ordination at the regulatory level.

For additional transparency and investor protection purposes, the full list of licensed domestic futures brokers will be maintained on the SC website to ensure that investors are able to identify legitimate futures brokers that are licensed to broker international derivative products.

[77] For instance, KLOFFE is already designated as a recognised exchange by the Australian Securities and Investments Commission and the Securities and Futures Commission of Taiwan. Applications have also been made to the US Commodity Futures Trading Commission (CFTC) for KLOFFE to be given no-action relief under Part 30 of CFTC Regulation and for COMMEX to be accorded "comparability" treatment under Regulation §30.10 of CFTC Regulations.

RECOMMENDATION 56

A new category of International Members with full derivatives trading and broking rights will be allowed by 2002

As the domestic derivatives market is still very much at an early stage of development, there is substantial scope for further growth that may be accelerated through the greater involvement of foreign futures broking houses via direct membership in the exchange. Allowing these institutions membership in the exchange with full trading and broking rights will encourage their committed participation and consequently improve market liquidity.

International Members would differ from other domestic members in that 100% foreign-owned futures broking firms can be allowed International Membership status, and their scope of activity will be limited to servicing the needs of their foreign clientele only.

With foreign participation at only 14% of total volume for KLCI futures, 12% for CPO futures and 1% for KLIBOR futures in 1999, there is scope for facilitating greater foreign access to the local derivatives market, particularly given the need for greater liquidity on both exchanges. The number of such memberships will be limited at the initial stage to only 5 seats. Any review of this position will depend on, among other things, the level of activity or volume contributed by the foreign institutions.

RECOMMENDATION 57

Equity ownership requirements of futures broking firms will be liberalised to allow foreign majority ownership by 2003

There is a need to build up stronger futures market intermediaries with sufficient volumes of business, capital backing and expertise to adequately face the challenges of increased competition and liberalisation. The futures broking industry will have to look closely at where it can further enhance its services and generate value, particularly given the relatively nascent nature of the industry. This will involve broadening the depth and range of expertise of staff, and the development of an adequately advanced operating culture within the industry itself.

This can be facilitated by liberalising current limits on foreign equity ownership and allowing foreign parties to acquire a majority stake, subject to buying a stake in an existing futures broking company in Malaysia. The entry of high calibre foreign professionals with futures market expertise should also be encouraged, to allow the Malaysian futures market to reap the advantages of world-class technical expertise and the injection of foreign capital. It is recommended that this liberalisation of the equity ownership requirements of futures broking companies takes place by 2003.

RECOMMENDATION 58

Foreign Direct Clearing Memberships will be allowed to be established within MDCH by 2002

Internationally, the concept of admitting eligible foreign brokers and banks to be clearing members of the national clearing house is gaining ground given the development of remote clearing, where a foreign direct clearing member without a local presence can settle its position directly with the clearing house in the home jurisdiction. The foreign direct clearing member can transfer funds, clear its own trades and those of its foreign clients directly with the clearing house, thus saving on the additional costs of having to go through a local clearing member.

Direct clearing will allow foreign members to clear trades on the Malaysian derivatives market without having to take on exposure to local clearing members' risk. Although there is a possibility of a decrease in the clearing business for local clearing members, this should be outweighed by the benefits of allowing foreign direct clearing. Allowing qualified foreign institutions to become clearing members of MDCH will assist in accelerating the build-up of domestic liquidity by encouraging greater foreign participation.

It should be noted that these memberships apply for clearing operations alone, and all trades, whether foreign or local, will still have to be routed through a qualified futures broker. The potential increase in brokerage business should offset any potential loss of clearing business for the futures brokers. Payments between the foreign direct clearing members and MDCH should be settled in currencies approved by MDCH.

RECOMMENDATION 59

The SC will introduce guidelines for Introducing Brokers by end–2001

The effective development of the local derivatives industry requires comprehensive and wide-reaching marketing efforts to be targeted at market participants. This is particularly pertinent given the nascent stage of development of the industry and the low usage of derivatives for risk management among domestic institutional investors in general.

An Introducing Broker (IBs) is a person or firm that solicits and accepts orders from customers to be routed to a futures broker, but does not accept money, securities or property from the customer. Allowing IBs will ensure more focused efforts on the marketing and order-collection front, thereby expanding the reach of the futures brokers and fostering greater liquidity on the exchange.

In view of this, IBs will be recognised within the Malaysian derivatives market with the formulation of guidelines for IBs, to be drawn up by the SC in collaboration with the relevant industry participants. This development is also in line with international practice, as IBs are recognised in many other markets.[78]

[78] IBs are recognised in markets such as the UK, Australia and New Zealand. In the US, all IBs are registered with the CFTC and are required to carry all of their accounts through a futures commission merchant on a fully disclosed basis.

RECOMMENDATION 60

The futures broking commission rate will be fully negotiable by 1 January 2002

RECOMMENDATION 61

The futures clearing and exchange trading fees will be reviewed by 1 January 2002

Heightened competition for business among global exchanges, coupled with the relative ease of replication of similar contracts in the derivatives market, mean that transaction costs play a key role in attracting liquidity and ultimately the continued competitiveness of the Malaysian derivatives market.

Currently, KLOFFE *Business Rules* stipulate that the amount that the brokers may charge must not be less than RM50 per futures contract whereas COMMEX does not specify any amount. Most mature markets already have fully negotiable brokerage commission rates.[79] A host of other measures are also currently being undertaken by regional exchanges to lower other fixed transaction costs to facilitate investor participation and remain competitive, including reducing clearing and trading fees, providing exemptions from minimum brokerage requirements for products traded under specified trading linkages, and lowering transaction taxes.

The deregulation of fixed rate commissions will enhance competition between local futures broking houses and also put local futures brokers on a more competitive footing vis-à-vis foreign brokerage commissions. This will be particularly pertinent given efforts to attract greater foreign participation and to prepare the local futures broking industry for gradual liberalisation of the trading environment. A review of other fixed execution costs will also be undertaken, with a view towards further lowering the costs of participating in the derivatives markets and encouraging more active trading.

[79] These markets include the US, UK and Australia. Within the East Asian region, Korea—the most active derivatives market in Asia—and Singapore both have fully negotiable brokerage rates, while Hong Kong is targeting fully negotiable rates by 1 April 2002.

RECOMMENDATION 62

The commission sharing structure between futures brokers and their representatives will be fully negotiable in 2002

At present, commissions earned on KLOFFE trades between futures broker representatives and their clients must be shared between the representative and the futures broking company at a ratio of 40:60.[80] In relation to COMMEX, however, the commission sharing structure is already negotiable.

As the costs of futures trading are being liberalised, other static restrictions such as the commission sharing ratio need to be addressed as well. As such, the deregulation of the commission sharing ratio will provide an additional incentive for futures broker representatives to improve their services in an effort to boost their earnings and enhance their bargaining power with the futures broking company. This will, in turn, assist in creating a more competitive environment for futures broker representatives' services.

RECOMMENDATION 63

Recognised foreign exchanges will be allowed to place remote access terminals with Malaysian futures brokers in return for reciprocal remote access arrangements by 2002

Expanding the recognition and market reach of the Malaysian derivatives market is a critical component of the strategy towards enhancing its role within the domestic financial market. The rapid growth of global derivatives trading networks and the increasing mobility and sophistication of market participants mean that it is increasingly necessary to look into the potential benefits and implications of forging alliances and reciprocal trading relationships with global partners.

Some of the measures that may be considered for this purpose include reciprocal trading arrangements with foreign derivatives exchanges, and the introduction of derivatives based on underlying instruments traded in other jurisdictions that do not have formal derivative markets themselves.

Therefore, steps will be taken to accelerate the development of the local derivatives market and strengthen its longer-term capacity to operate as a viable trading place within the international market. As an initial measure, restrictions on the establishment of trading linkages, including remote access terminals, with recognised foreign exchanges, will be removed by 2002. This will be done after an objective assessment of the level of development achieved during the liberalisation programme for the industry up to that juncture.

[80] Guideline 3.1.5 of the KLOFFE *Business Rules*.

This recommendation is consistent with the recommendation to allow local futures brokers to trade approved international financial derivative products. In addition, reciprocal trading arrangements allow Malaysian derivatives to be traded offshore under the local exchange's purview, and, if efficiently organised, help to reduce offshore demand for non-approved Malaysian-based derivative products offered by other market institutions.

The potential additional benefits from remote access linkages with foreign market institutions include greater liquidity in domestic products through reciprocal arrangements, a broader range of products available at reasonable cost to Malaysian investors, and greater market penetration for local futures institutions and investment managers via access to foreign clientele.

RECOMMENDATION 64

Regulated short selling and securities borrowing and lending activities should be re-introduced by 2002

Short selling enables hedging and arbitrage activities in both cash and futures markets to be developed, and is an important step to ensure the development of a complete capital market. Essentially, short selling requires a securities borrowing arrangement to be in place at the time of the short sale, in order to ensure that the shortselling client is not carrying out a naked short sale and that he is able to deliver the securities when required to do so. The availability of such mechanisms also facilitates the prevention of trade settlement defaults, and is consistent with the G-30's recommendations in 1989 to develop SBL as a means of ensuring the timely settlement of securities transactions.

In recognition of these issues, the SC issued the *Guidelines on Securities Borrowing and Lending* in December 1995 to govern the practice of SBL in Malaysia. In respect of short selling, amendments were made to both the FIA and the SIA, which came into force on 25 November 1995 and 7 March 1996 respectively, to enable rules of the KLSE to be made to regulate short selling. RSS officially commenced on 30 September 1996.

However, these activities were suspended on 28 August 1997, during the height of the regional financial crisis, as interim measures to cordon off avenues that may have led to the exacerbation of the excessive volatility prevalent in the market at that time.

Since then, the economic recovery together with the extensive improvements to reporting requirements, prudential controls and the cessation of trading of KLSE-listed securities offshore, indicate that the time is conducive to the lifting of the suspension on RSS and SBL.

In addition, the regulatory provisions for SBL and RSS specifically incorporate comprehensive prudential safeguards to mitigate the risks of manipulation and abuse. These include provisions with regard to record-keeping, daily reporting, collateral management, counterparty risk management, client asset protection and client authorisation procedures, which are collectively aimed at ensuring that all such activity occurs within an orderly and regulated environment.

Also relevant to ensuring that short selling does not provide an avenue for the introduction of more volatility to the underlying market, short sales can be carried out only at prices at or above the last done price. This requirement, which is common practice in markets that allow short selling, serves to dampen large downward swings in prices and mitigates the potential effect of RSS on panic selling.

In addition, to safeguard against potential cornering and other forms of manipulation, the guidelines prescribe the implementation of appropriate credit and concentration limits, and only the most liquid securities may be approved for such activity. The criteria for these approved securities include predetermined benchmarks such as market capitalisation, public float, number of shareholders, volume traded and profit track record.

In moving forward, the re-introduction of RSS and SBL will also give the derivatives exchange a wider range of products that can be introduced, such as stock options and share futures, as additional tools for hedging and risk management.

ISLAMIC CAPITAL MARKET

Objectives

The Islamic capital market in Malaysia functions as a segment within the broader capital market for issuers and investors, and plays a complementary role to the Islamic banking and Takaful industry in broadening and deepening the Islamic financial sector. Within its mandate to foster the development of the domestic Islamic capital market, the SC has focused its efforts on two fronts: establishing the supporting infrastructure and widening the product base.

The equity market represents one of the most developed segments of the domestic Islamic capital market. As at end-September 2000, approximately three quarters of the total number of equity counters traded on the KLSE and MESDAQ are approved as Syariah-compliant. Reflective of the growing interest in Islamic stocks, two Syariah indices, the KLSE Syariah Index and the RHB Islamic Index, have also been introduced in recent years. This has provided a solid platform for the growth of the Islamic fund management and stockbroking industries in Malaysia.

In order to create a wider investment base, Malaysia has also made an effort to develop its Islamic bond market, and it has been in this area that much innovation in project financing has occurred. Many of the country's largest corporations have sought financing and issued long-term corporate bonds according to Islamic principles. In addition, the Malaysian government has issued Islamic investment certificates to provide liquidity and to facilitate asset management within the Islamic banking system, and issues of Cagamas bonds and Khazanah benchmark bonds have been constructed based on Islamic concepts and principles.

Against this backdrop, assets in the domestic Islamic banking sector have tripled from RM6.2 billion in 1995 to RM35.7 billion in 1999, with a compounded annual growth rate (CAGR) of 55%, compared to the CAGR of the overall banking sector over the same period of 21%. Similarly, assets of the Takaful industry, savings in Lembaga Tabung Haji or Pilgrims Fund Board[81] and Lembaga Tabung Angkatan Tentera or Armed Forces Fund, and the amount of funds invested in Bumiputera savings vehicles such as Skim ASB have risen significantly over the past few years.[82]

While some of these institutions do not invest solely in Islamic financial products, the size and growth patterns of the funds under their management provide an indication of the magnitude of funds available in Malaysia alone for investment into the Islamic capital market. Apart from this, market observers believe that there is currently a section of the local populace whose participation in the capital market has been negligible due to a lack of awareness of the investment opportunities afforded by the Islamic capital market.

[81] Previously known as "Lembaga Urusan dan Tabung Haji", its name was shortened to "Lembaga Tabung Haji" on 28 August 1997.

[82] Savings in LTH have risen from RM3.1 billion in 1995 to RM8.0 billion in 1999 while those in LTAT have risen steadily from RM3.5 billion in 1995 to RM4.7 billion in June 1999. In addition, the amount of funds invested in Skim ASB has increased significantly from RM17.3 billion in 1994 to RM28.2 billion in 1999. (Sources: BNM; Economic Report 1999/2000, Treasury, MOF; Skim ASB annual reports.)

At the same time, in the international context Islamic financial services and products have been gaining in importance and recognition as a viable alternative to those offered in conventional markets, especially in recent years. Recent estimates indicate that approximately US$800 billion of 'latent Islamic capital' are presently invested in banks throughout the world and that Islamic investment is expanding at a rate of between 12% and 15% per annum.[83] This points to a potentially significant amount of untapped demand for Islamic financial products, both domestically and internationally.

Malaysia is competitively placed to be a leading Islamic capital market centre within the regional, and even global, arena. Its strengths include a steadfast commitment to the observance of Islamic principles and strong government backing for the continued development of the Islamic financial sector in Malaysia. More specifically, there is already a relatively well-developed domestic Islamic financial sector which includes the Islamic capital market, banking and Takaful sectors. In addition, there is an established regulatory and legal framework supportive of an Islamic financial system, particularly with the introduction of the Islamic Banking Act 1983 and the Takaful Act 1984.

Malaysia has also earned a reputation as one of the pioneers in Islamic capital market-related research and development, partly driven by the SC's continued efforts in promoting this segment of the capital market. The country's increasingly affluent population with a high level of savings, coupled with the significant concentration of prospective consumers of Islamic financial services and products within Asia, provides a potentially significant market for Malaysian products and services which conform with Islamic principles.

These comparative advantages, combined with the relatively fragmented and less developed state of Islamic capital markets around the world compared to conventional markets, present many opportunities for Malaysia to establish its position as an international Islamic capital market centre. It is also well positioned to be one of the key players providing Islamic capital market services and products.

The further development of the Islamic capital market in Malaysia will add to the breadth and diversity of the overall capital market as well as provide a significant contribution to the overall growth of the financial services industry.

Development efforts, like those for the conventional market, must necessarily adopt a comprehensive, multi-pronged approach to enhance the international competitive position of Malaysia's Islamic capital market. To this end, several strategic initiatives have been identified that will need to be undertaken to achieve this objective, including the following:

- Facilitating the development of a wide range of innovative and competitive products and services related to the Islamic capital market
- Creating a viable market for the effective mobilisation of Islamic funds
- Ensuring that there is an appropriate and comprehensive accounting, tax and regulatory framework for the Islamic capital market
- Enhancing the value recognition of the Malaysian Islamic capital market internationally

[83] Sources: Labuan Offshore Financial Services Authority's Annual Report 1999; "Global Islamic indices join the FTSE family", FTSE International, 14 November 1999.

RECOMMENDATION 65

Efforts to introduce more competitive and innovative Islamic financial products and services will be actively pursued

There is a need for a wider variety of instruments to be developed to cater to the different needs of issuers and varying risk-return appetites of investors within the Malaysian capital market, and which provide viable alternatives to conventional financial market products. In particular, the range of Syariah-compliant fixed income and risk-management products should be increased, both for the purposes of capital raising as well as for private asset allocation, hedging and diversification needs.

Consistent with its mandate to develop the overall capital market, the SC will work closely with and facilitate efforts by the industry and academia to identify and develop innovative new Islamic capital market products and services. In structuring these products, the views of international Syariah scholars and investors will be sought to enhance the acceptability of these products within the international market.

In developing new products, there are essentially two methods which have been employed. The first is by identifying existing conventional capital market instruments that are acceptable to Islam. Irrespective of their origin, financial instruments that are by their very nature consistent with the teachings of Islam, or where elements that are unIslamic can be removed without affecting the utility of the instruments or imposing an undue cost burden, can be used. This approach facilitates product development efforts and offers a lower risk of non-acceptability by market participants since the products actually originate from the conventional market, with little or no modification.

The second method involves product origination and innovation based on various Islamic concepts such *Ujrah, Bai' Dayn, Ijarah, Istisna', Mudharabah, Murabahah, Qardhul Hasan* and *Musyarakah*.[84] This entails a detailed understanding of the various types of Islamic financial contracts and an appreciation of the contemporary needs of the issuers, investors and intermediaries in the market. Products are structured not only to satisfy the Syariah but also to be consistent with the commercial and legal systems of the country. In this regard, the ability of Islamic scholars and industry experts in Malaysia to work together to structure such products is clearly borne out by the past use of many of these various *muamalat* concepts in structuring Islamic debt papers and government investment certificates. Another important consideration is that the formulation of new products based on *muamalat* concepts takes cognisance of the differing schools of thought that exist in various countries. Where necessary, the SC will facilitate efforts to achieve uniformity of domestic Syariah interpretations with international norms.

In structuring new debt securities, there is a need to explore the possibility of introducing additional instruments which offer floating rates. At present, nearly all Islamic debt securities offer fixed rate returns based on the deferred lump sum sale and deferred instalment sale concepts. In contrast, conventional debt instruments commonly offer both fixed and floating rate returns.

[84] Definitions of these terms may be found in the glossary.

With regard to derivatives, the only products which are currently available are hybrids of equity products such as call warrants and TSRs. Another product which may be examined for possible introduction in the near future is an Islamic index futures contract, given that there are already two local Islamic equity indices and the SAC has approved the structural concept of such contracts, provided they are based on underlying assets that are Syariah-compliant.

These efforts to facilitate the introduction of additional Islamic financial products and services are expected to be fortified by concurrent measures to develop, among other things, the corporate bond market, the derivatives market and the investment management industry within the conventional capital market.

RECOMMENDATION 66

Efforts to introduce and promote a wider range of Islamic collective investment schemes will be facilitated

Although the Islamic collective investment industry has developed significantly over the past few years, it still possesses significant scope for expansion given a growing investor population with high rates of savings, a wide and growing range of eligible investment products, and the sizeable pool of global Islamic funds.

The growing awareness of the potential for growth in this area has already been reflected to some extent by the existence of several asset management companies solely dedicated to Islamic products in Malaysia. In addition, the management of Islamic unit trust funds has not been restricted to these specialists, whereby a number of the larger players in the domestic unit trust industry have also launched Islamic funds.

However, the present size and market share of Islamic collective investment schemes are still small in comparison with the broader investment management industry within the conventional capital market. While the number of Islamic unit trust funds within the Malaysian capital market has doubled from seven in 1995 to 14 in September 2000, the 14 funds still only represent RM1.7 billion or 3.6% of the total net asset value of the unit trust industry.

Accordingly, the SC will work closely with the investment management industry to facilitate the introduction and promotion of a wider range of Islamic collective investment schemes, including Islamic bond and derivative funds. The introduction of these funds will be facilitated to cater to investors who wish to invest in Islamic investment products, and to achieve a more effective mobilisation of their funds. Such initiatives will also create opportunities to tap external Islamic investment funds.

In line with the SC's broader objective of establishing a vibrant and more competitive investment management industry, the SC will ease the regulatory approval process for the introduction of new funds, including Islamic funds, by instituting a shift towards a full DBR environment. These efforts will also be supplemented by a recommendation in the section relating to investment management to introduce tax incentives to encourage individuals to invest in collective investment schemes.

RECOMMENDATION 67

Investment restrictions for the Takaful industry should be further liberalised to facilitate greater mobilisation of Takaful funds into the Islamic capital market

The Takaful industry represents an important component of the Islamic financial system, and as such is a significant source of investment funds for the Islamic capital market in the same way that insurance companies are key investors in the conventional capital market. In the three years leading up to the Asian crisis, the Takaful industry in Malaysia grew at a tremendous pace, with assets and income from contributions expanding at average rates of 45% and 49% respectively. Even the onset of the crisis in 1997–98 did not stifle the industry's growth, which continued to register double-digit growth in both years. The combined income from contributions of both family and general Takaful business increased by 40% in 1998, higher than the growth rate of 35% recorded in 1997.[85]

Although the Takaful industry is presently small relative to conventional insurance, its potential for growth is significant given the low level of life insurance penetration, especially among the Muslim population, as well as the overall low penetration rate of 27% in Malaysia as a whole. Furthermore, Takaful business is set to expand in line with further efforts to develop the industry.

With the Takaful system premised on the Mudharabah principle, which entails profit sharing arrangements between the Takaful company and its contributors, Takaful assets must be managed effectively in order to enhance returns. In this regard, the Islamic capital market offers a variety of viable investment options, whether in the form of Islamic equity or fixed income products.

However, investment restrictions have currently been imposed for the Takaful industry.[86] The liberalisation of these investment restrictions within the Takaful industry, subject to appropriate prudential requirements, will allow excess Takaful funds to be mobilised into the Islamic capital market. The mobilisation of the Takaful funds should also increase demand for Islamic financial products in general, and potentially promote the enhanced management of funds through engagement with professional fund managers.

[85] Source: Opening and keynote address by Y.Bhg. Tan Sri Dato' Seri Ali Abul Hassan bin Sulaiman, the then Governor of Bank Negara Malaysia, at the *International Conference on Takaful* on 31 May 1999.

[86] The restrictions relate, among others, to investments in Islamic quoted and unquoted shares; Islamic unit trusts and Islamic syndicated Bai` Bithaman Ajil financing; and government investment issues or government-guaranteed Islamic bonds.

RECOMMENDATION 68

Efforts to mobilise untapped Islamic assets through securitisation should be pursued

There is potential for further diversification of the Islamic capital market product base through the mobilisation of dormant Islamic assets. For example, a new class of debt securities could be created through the securitisation of real estate held by *Wakaf, Baitul Mal* and other Islamic institutions. Other possible candidates for securitisation would include the trade receivables of these institutions, in view of the collateralised nature of their cash flows. The securitisation process will enhance the liquidity and marketability of their assets, and provide these institutions with new and more competitive sources of income.

In particular, there should be a review of the commercial feasibility of securitising property[87] held by Wakaf Corporation, a subsidiary of Yayasan Pembangunan Ekonomi Islam Malaysia (YPEIM), which has been entrusted with the responsibility for developing Wakaf properties to enhance the socio-economic status of Muslims.[88]

The securitisation of Wakaf assets is not entirely unprecedented. In Jordan, for example, the issuance of bonds through the securitisation of Wakaf assets has been sanctioned by the authorities since the early 1980s. In addition, the introduction of Muqaradah Bonds by Islamic charitable trusts, similar to Wakaf, based on the securitisation of their land began even earlier, in the late 1970s. The returns to investors and issuers were determined based on an agreed percentage according to profit-sharing principles. Subsequently, the trading of Muqaradah Bonds on the Amman Stock Exchange was permitted, and Muqaradah Bonds have also received the approval of the Organisation of Islamic Conference (OIC) Academy.[89]

It should be noted that the asset securitisation process may not necessarily require the securitised asset to generate cash flows immediately. Therefore, such assets can be developed for future commercial use whereby cash flows will be generated once the project has been completed and sold or leased.

RECOMMENDATION 69

Efforts to increase the pool of Islamic capital market expertise through training and education will be enhanced

Human capital represents an extremely important dimension in supporting the objective of positioning Malaysia as an international Islamic capital market centre. A knowledgeable and skilled workforce is the key to sustaining a competitive advantage. Therefore, it is necessary to develop local expertise to ensure the availability of a pool of skilled professionals who are well-versed in Syariah matters and are able to provide a range of relevant high quality, value-added advisory and intermediation services.

[87] According to Jabatan Kemajuan Islam Malaysia (JAKIM), there are over 12,000 acres of land held by Wakaf throughout Malaysia.

[88] The Cabinet had, in 1993, accepted a resolution undertaken by the Kongres Ekonomi Bumiputera Ketiga that YPEIM should play a lead role in developing Wakaf properties in all states. In October 1995, YPEIM with cooperation from Bank Simpanan Nasional launched "Skim Pembangunan Wakaf Nasional" to collect contributions from the public to finance the commercial development of Wakaf properties.

[89] The OIC Academy, the Syariah board for the Islamic Development Bank, which is based in Jeddah, issued a fatwa concerning aspects of these bonds in 1988.

In developing these resources, the SC, through SIDC, and in collaboration with qualified institutions such as local universities and BIMB Institute of Research and Training (BIRT)[90], will initiate and consolidate efforts to provide training to enhance the technical knowledge and skills of professionals employed in the Islamic capital market. Among other things, SIDC will organise regular seminars and conferences to enable market professionals, issuers and investors to keep abreast of the latest developments in the Islamic capital market.

At the international level, the SIDC will also take steps to collaborate with training institutions in other Muslim nations to organise mutually beneficial training programmes. Such initiatives will heighten both domestic and international awareness of this niche segment of the market and facilitate dialogue and the sharing of ideas among the Syariah scholars and professionals working in this area.

At the same time, the availability of legal professionals and judicial officers who are conversant with Islamic financial transactions will be enhanced to further strengthen the pool of expertise within Malaysia's Islamic capital market. Therefore, training and education efforts will be initiated to build up competent legal professionals who possess the necessary technical expertise to handle Islamic financial cases within the judicial system. In this regard, the SIDC will collaborate with the Institut Latihan Kehakiman dan Perundangan (ILKAP) to provide the appropriate training for these professionals.

RECOMMENDATION 70

A single Syariah Advisory Council should be established for the Islamic financial sector

Presently there are two separate SACs advising the SC and BNM respectively. To provide counsel to the SC on Syariah matters pertaining to the Islamic capital market, the SC's SAC was established in 1996. This was followed by the establishment of BNM's own SAC in 1997 to advise on matters pertaining to Islamic banking and Takaful. Members of these councils comprise individuals who are in a position to present Syariah opinions and possess vast experience in the application of Syariah, particularly in the areas of Islamic economics and finance.

To enhance the co-ordination of Syariah rulings and ensure consistency of decisions, the two existing SACs[91] should be consolidated into a single SAC to provide advice on all matters pertaining to the Islamic financial sector, whether capital market, banking or Takaful related. The consolidated SAC should consider publishing a set of standardised Syariah guidelines and decisions to guide the appropriate treatment of financial services and products within Malaysia's Islamic financial sector. These guidelines and decisions should be regarded as binding national Syariah rulings.

[90] BIRT is a subsidiary of BIMB Holdings Bhd. Its main activity is to provide training and education in Islamic banking and finance to the financial services industry.

[91] The present members of BNM's SAC include all but 2 members of SC's SAC.

The consolidated SAC could operate administratively under the MOF, with its own Secretariat, with both BNM and the SC providing funding. To ensure that SAC decisions are enforceable in both the Islamic capital market and the Islamic banking sector, the powers of the SAC should continue to be drawn from existing statutory provisions under the purview of the SC and BNM respectively.

This means that the appointment of SAC members should be endorsed by both SC and BNM, with MOF acting as the co-ordinator to ensure that common appointments are made. As before, membership of the consolidated SAC should comprise Syariah scholars and representatives from the relevant sectors within the Islamic financial market.

RECOMMENDATION 71

A facilitative tax and legal framework should be established for the Islamic capital market

The tax treatment of certain Islamic financial transactions has not always been consistent with that of comparable transactions in the conventional financial market, resulting in the former bearing an additional taxation burden. Although some progress has been made to address this problem,[92] there is scope for more comprehensive measures to remove tax disparities of this nature, in order to allow consistent opportunities for development across both the Islamic and conventional capital markets.

To further ensure neutrality in the current tax regime governing Islamic securities transactions, the SC will collaborate with the tax authorities to accelerate the process of addressing tax provisions that may impede product development and innovation, or discourage participation in Islamic capital market transactions. This process will be further supported by the introduction of an advance ruling procedure to determine the income tax profile of newly introduced transactions and products. This will apply to conventional as well as Islamic capital market transactions, thus eliminating inconsistencies and uncertainty in the tax treatment of transactions with similar features.

There is also a need to review the regulatory framework and remove possible impediments to the development of the Islamic capital market. For example, the principles of Bai` Bithaman Ajil and Ijarah are not protected by the Hire Purchase Act 1967, which only deals with conventional hire purchase transactions. This creates potential difficulties for Islamic financiers in enforcing their contractual rights, and acts as a barrier to the formulation of capital market products based on receivables under Islamic financing schemes.

In addition, cases relating to Islamic financial transactions are considered as commercial and banking transactions and therefore come within the jurisdiction of the Civil Courts and Item 7 of the Federal List.[93] To enhance the legal process for cases related to such transactions, Islamic financial transactions should be clearly distinguished from conventional financial transactions, with due consideration of the relevant Islamic concepts and contracts. This will allow for fair treatment in the adjudication of Islamic financial transactions.

[92] For example, previous inconsistencies and ambiguity associated with the tax treatment of certain Ijarah transactions and stamp duty for refinancing purposes were addressed in proposals contained in the Budget 2000.

[93] Item 7 includes "banking, money lending, pawnbrokers, control of credits, bills of exchange, cheques, promissory notes and other similar instruments".

RECOMMENDATION 72

Efforts to develop an appropriate financial reporting framework for the Islamic capital market in collaboration with MASB will be pursued

Similar to conventional markets, a strong financial reporting framework is an essential requirement for a successful Islamic capital market. Such a framework should be benchmarked against international standards, facilitate informed decision making by market participants, and foster market integrity through the timely disclosure of relevant and reliable information.

To achieve the objective of becoming a leading Islamic capital market centre, the quality of financial reporting plays an indispensable role in ensuring that information about Islamic financial products and transactions which is disseminated to existing and potential investors, regulators and other market participants is of a high quality and benchmarked against international standards. As a first step, MASB is currently reviewing Islamic accounting standards issued by the AAOIFI for adoption in Malaysia.[94] The first standard resulting from this review is targeted for release in 2001.

Moving forward, the SC, together with the SAC, will collaborate closely with MASB to develop an appropriate financial reporting framework for the Islamic capital market. This work will include the resolution of issues concerning the accounting and reporting practices of existing transactions based on Syariah principles, and the identification of relevant new accounting developments and emerging needs for Islamic financial products and transactions. More generally, these collaborative efforts will also seek to ensure that the Malaysian Islamic accounting framework is consistent with international best practices.

RECOMMENDATION 73

Increased efforts to enhance the awareness of Malaysia's Islamic capital market at the domestic and international levels will be pursued

In keeping with its mandate to develop Malaysia's Islamic capital market, the SC will spearhead initiatives to enhance the awareness of the market at domestic and international levels. Therefore, a comprehensive educational and promotional programme, including presentations and conferences, will be initiated to ensure a co-ordinated approach towards such efforts.

At the domestic level, the programme will be primarily aimed at enhancing general awareness among Malaysian issuers and investors, and educating them on the merits of Islamic instruments, both as investments and as forms of financing. At an international level, tailored programmes will be drawn up to familiarise foreign intermediaries such as

[94] AAOIFI, which is based in Bahrain, is an organisation established in 1991 by Islamic financial institutions and other parties to set international accounting and auditing standards for Islamic financial institutions based on Syariah principles.

fund managers, investment bankers and other financial services providers in target markets with the products, services and supporting infrastructure for Islamic capital market transactions in Malaysia.

While the primary aim of these initiatives will be to generate domestic and international interest in the Islamic capital market, there are ancillary benefits that can be realised through proper planning. Among other things, promotional activities should be viewed as invaluable opportunities to initiate and establish business networks and strategic alliances, and conduct fact-finding exercises to identify the needs of an international client base.

Co-ordinated promotional efforts involving the authorities and key industry players are vital in achieving global recognition for the Malaysian Islamic capital market. To facilitate the implementation of these initiatives, a channel of communication will be established between the authorities and the industry through the formation of a working group comprising representatives from the SC, KLSE, Association of Islamic Banking Institutions Malaysia (AIBIM)[95] and other relevant industry groups such as the Federation of Malaysian Unit Trust Managers, the Association of Stockbroking Companies Malaysia and the Association of Merchant Banks Malaysia. The working group will also be used as a platform to discuss and obtain feedback on product development issues.

In particular, more focused promotional efforts will be directed towards international markets where main sources of Islamic funds are located such as those held by the governments in Middle Eastern countries, Middle Eastern religious bodies, high net-worth Middle Eastern individuals, and Islamic communities in the UK and US. The majority of these funds are reportedly managed by intermediaries in London and New York. Additionally, the promotion of greater awareness among markets within the same time zone as Malaysia, as well as other countries that have sizeable Muslim populations and investible funds, will be looked at closely.

RECOMMENDATION 74

Strategic alliances between Malaysia and other Islamic capital markets should be established

In order to survive and grow in an increasingly borderless world, it is incumbent upon the Islamic financial community to continuously explore and identify common areas for the purposes of developing products, services and ways of working together. At the same time, the advent of new technology facilitates international co-operation and alliances, in addition to providing many new opportunities for furthering the growth of Islamic financial markets on a larger scale than before.

To further enhance its international positioning, Malaysia will seek synergistic relationships with other major Islamic capital markets. Given the relatively embryonic nature of this segment of the capital market, strategic alliances provide invaluable opportunities for both Malaysia and its partners to build critical mass, by enhancing the matching of the global pool of funding sources from Islamic communities with Syariah-compliant investment opportunities.

[95] AIBIM represents the 2 domestic Islamic banks as well as the various Islamic windows located in the conventional banks.

Options that can be examined include the establishment of arrangements between Malaysia and relevant markets to facilitate the trading of a common set of Islamic financial products across different time zones. Over the longer term, by becoming part of an established Islamic capital market network, the international profile and value recognition of the Malaysian Islamic capital market will also be enhanced.

A logical first step for Malaysia would be to consider establishing strategic alliances with major Islamic financial centres such as Bahrain. Given Bahrain's own aspirations to be an Islamic financial centre in the Middle East, this will enable the two markets to play complementary roles.

RECOMMENDATION 75

The government and government-related entities should consider issuing Islamic debt securities in the global market

Malaysian government and government-related corporations have historically been major issuers of ringgit-denominated Islamic debt securities within the domestic capital market. However, international Islamic financial market participants have also expressed interest in investing in Islamic paper issued by the Malaysian government as well as the larger national corporations with strong credit ratings, especially those denominated in US dollars. Going forward, the viability of issuing foreign currency-denominated Islamic debt securities in major international financial markets should also be assessed, in order to enhance the profile of Malaysian Islamic paper within the global market and at the same time, tap global investment funds for capital raising purposes.

RECOMMENDATION 76

The listing of Malaysian Islamic equity funds in international markets should be pursued

Despite the nascent nature of the Malaysian Islamic capital market, it is relatively well developed within the context of the present stage of development of the global Islamic financial market, in terms of the depth and breadth of Islamic investment opportunities and market expertise. As noted before, a significant number of stocks listed on the KLSE are Syariah-compliant, representing a wide cross-section of sectors. Compared to most other major Islamic countries such as Bahrain, Oman, Kuwait, Saudi Arabia, Pakistan and Egypt, the stock market in Malaysia generally has a larger number of listed companies, significantly higher market capitalisation and greater liquidity.

Malaysia also has a comparative advantage given that in many of these markets, there is no centralised and systematic screening facility similar to that provided by the SAC to determine whether listed companies are Syariah compliant. For example, within the

region, only Indonesia has a similar facility in place with the launching of the Jakarta Islamic Index by the Jakarta Stock Exchange in 2000. In some Middle Eastern markets, this screening facility remains a market initiative whereby certain financial institutions and investment companies produce and manage their list of Syariah-compliant companies.

These attributes augur well for the development and projection of the Malaysian Islamic capital market towards an expanded marketplace. In particular, the listing of Malaysian Islamic equity funds on major exchanges such as the NYSE and the London Stock Exchange will serve to promote these Islamic equity products to a global audience and further enhance the international profile of the Malaysian Islamic capital market. To this end, the SC will actively work with domestic as well as international financial institutions that have an interest, and possess the capacity, to undertake ventures of this nature to facilitate the process.

RECOMMENDATION 77

Incentives to encourage the entry of foreign intermediaries and professionals with expertise in Islamic capital market-related businesses should be provided

To support the development of an international Islamic capital market centre within Malaysia, a competitive package of incentives will be provided to encourage foreign intermediaries with the relevant expertise to set up operations in the country.[96] At the same time, efforts will be made to facilitate the entry of trained professionals to work in Islamic capital market-related businesses. This will enable a wider array of more sophisticated Islamic capital market services to be offered and raise the quality of services provided, bringing greater depth and breadth to the market.

In view of this, the SC will work closely with other relevant authorities to identify and implement appropriate measures to encourage the entry of such intermediaries and professionals, particularly in areas where the critical skills are not available locally, such as Islamic corporate finance, investment advisory and investment management services. These measures will include the allocation of specific tax incentives and the relaxation of foreign immigration rules and ownership restrictions where necessary. As safeguards, however, various factors will be examined in allowing foreign intermediaries to operate in Malaysia, including:

- The ability of the foreign institution to enhance the quality of services in the Malaysian Islamic capital market and contribute to its development
- The extent of representation which the foreign institution's country of origin has in the Malaysian Islamic capital market services sector and investment interests in Malaysia
- The ability and commitment of the foreign institution to contribute to the development of technical expertise and skills of Malaysian professionals

[96] These refer to foreign financial institutions that provide expertise in Islamic financial advisory services and investment.

STOCKBROKING INDUSTRY

Objectives

The Malaysian stockbroking industry has seen significant development over the years, the last decade in particular. From 4 pioneer companies in 1960, the industry is now represented throughout the country by 62 stockbroking companies, with over 7,500 licensed remisiers and paid dealer's representatives employed within the industry.[97]

Although the market downturn in 1997–98 had an adverse impact on stockbroking companies—particularly those with lower capitalisation, weak risk management and poor internal controls—comprehensive measures have been introduced since then to substantially strengthen the industry as a whole and to instil a greater sense of financial discipline in brokers. Among other things, prudential measures were implemented based on international best practices, including the introduction of new risk-based capital adequacy requirements and new rules to enhance the protection of client assets.

Notwithstanding these efforts, the current status of the stockbroking industry needs an objective review and cohesive strategy moving forward, if the aim of developing a stronger and more competitive environment for intermediation services is to be achieved.

While having experienced substantial growth over the years, the domestic stockbroking industry has hitherto operated in a relatively sheltered environment owing to barriers to entry such as stringent licensing and ownership requirements, limitations on the concentration of stockbroking companies by geographical location, and protected revenue structures. Although these conditions have been influential in supporting the earlier development of the industry over the years, their continued applicability in the future must be reviewed. In particular, where earlier measures to promote the stockbroking industry are becoming impediments to its further development, there need to be measures to ensure that there are sufficient incentives for stockbroking companies to expand the breadth and depth of services.

In view of these issues, the industry must be well placed to develop sufficient financial capacity and offer a breadth of high quality, cost effective services within the growing and maturing marketplace. Many of the existing stockbroking companies remain medium to small-scale operations. The presence of a large number of small players competing with few dominant firms within a single service market points to the need for more focused efforts towards consolidation. These efforts are needed in order to achieve greater economies of scale and scope, and to facilitate the convergence of resources towards the creation of larger, better-capitalised and well-managed institutions, in order to provide investors high-quality services at reasonable cost and most importantly, to prepare the industry for the challenges of operating in a deregulated and liberalised environment.

At the same time, the shape of the international financial intermediation business is changing quickly. Around the world—as well as in Malaysia to some extent—the increasing conglomeration of financial services is seeing the blurring of the traditional boundaries

[97] As at end-September 2000.

separating banks, investment management companies, insurance companies and securities brokers. These changes have been driven mainly by the need to either grow larger or differentiate one's operations in order to remain competitive in the increasingly integrated global marketplace.

It is also expected that the level of competition among market intermediaries will rise even further with greater usage of technology in the capital market. Technology applications such as online broking, for example, have revolutionised the face of intermediation in many jurisdictions, allowing end-users faster, cheaper and more direct access to the market. As with intermediaries operating elsewhere, Malaysian stockbroking companies will need to respond to changing consumer demands, evolving competition, the threat of disintermediation, and opportunities for a new range of service and product offerings in order to provide internationally competitive services to their customers and create strong positions for themselves in the marketplace of the future.

Key measures that will be undertaken in developing the stockbroking industry include:

- Progressive domestic deregulation, which will entail allowing a more comprehensive range of services and products to be offered as well as geographical diversification of activity. Measures will also be taken to progressively deregulate the fixed fee structures that have controlled the pricing variability of the services offered by these institutions, and to reduce other costs of trading[98]
- Developing a core group of full-service domestic intermediaries, who are able to maintain strong market positions in facing the challenges of liberalisation and globalisation, and to provide a competitive market for integrated financial services
- Promoting consolidation efforts by the industry, to achieve greater economies of scale and scope, greater financial strength, and more efficient use of resources and professional skills
- Allowing greater foreign entry into the market under a pragmatic programme for liberalisation
- Facilitating industry use of technology solutions with the aim of further enhancing efficiency and introducing greater competition into the marketplace
- Enhancing the role of remisiers by expanding their scope of activities to offer a wider range of value-added capital market services

[98] Some of the measures relating to the reduction of trading costs can be found in the section on market institutions.

RECOMMENDATION 78

Efforts to promote the consolidation of the stockbroking industry will be pursued

The Malaysian stockbroking industry is populated by a large number of players with wide geographical reach collectively, but that are predominantly medium- to small-scale operations each offering essentially similar services. And although the relative stability of profit margins—given the prevailing fixed rate commissions—has seen the stockbroking industry flourish over the years, this growth has resulted primarily in the emergence of more small players and only limited expansion of larger players into other markets and activities.

The size and scope of activities of market intermediaries will become more important as the capital market develops and expands. Participants that are well capitalised with operational efficiencies, and good risk management and internal controls, will be well placed to forge a strong market presence in a dynamic and maturing market.

Recognising this, over the last few years, the government and the SC have emphasised the need for further and more effective consolidation of the stockbroking industry. Merged institutions would be better capitalised and more resilient to withstand the pressures from risks inherent in the stockbroking business, with a greater ability to expand their revenue base through diversification from the traditional pure agency transactions.

Consolidation among existing institutions provide an efficient way to streamline the industry and position it in a timely manner to meet the broader objectives of effective capital market development. Such measures are essential in order to support the overall systemic integrity of the marketplace in the event of future market downturns, and are required for the development of high-quality intermediation services that can be available at reasonable cost to the consumer.

While efforts can be made to strengthen these institutions on an individual basis without necessarily encouraging the mergers of existing stockbroking companies, this would be a piecemeal solution that may not necessarily be to the benefit of either consumers or, ultimately, the stockbroking industry as a whole. Past efforts to consolidate the industry also show that this approach is a lengthy and time-consuming process with no guarantee of progress or foreseeable outcome.

Therefore, although consolidation efforts should remain primarily private sector initiatives, there must be co-ordinated measures to facilitate and accelerate the attainment of this objective in order to ensure a minimum level of economic dislocation. The consolidation exercise will be allowed to proceed according to market-driven processes as far as the determination of merger partners and company valuations are concerned, subject to the appropriate safeguards.

The SC will closely monitor and review the progress of the industry consolidation exercise, and would like to see the consolidation exercise effectively completed, with the final consolidated groupings in place by end-2001. To facilitate the process of consolidation, tax incentives will be provided.

The process of consolidation should not be protracted. It is reasonable to expect that existing pressures from globalisation and technological advances will provide the industry with a relatively narrow window of opportunity to equip itself. Therefore, it is important that industry participants take steps to prepare themselves as soon as possible to face the inevitable challenges of increased global integration and liberalisation.

Update: The SC has announced a policy framework for the consolidation of the stockbroking industry on 21 April 2000.

RECOMMENDATION 79

A new category of full-service intermediaries to be known as Universal Brokers will be introduced

The financial crisis of 1997–98 highlighted the importance of having strong market intermediaries operating on high standards of business conduct and prudential safeguards. At the same time, the changing market landscape for capital market intermediation also points to the need for the development of a core group of well-capitalised full-service domestic stockbroking companies that can provide integrated capital market services, specialist expertise, a strong client network and brand recognition.

To this end, measures will be taken to facilitate the creation of a new category of intermediaries, UBs, who will be able to undertake the full range of capital market services, and are sufficiently strong and prudently managed to face the challenges of operating within a more deregulated and liberalised environment. In this respect, every stockbroking company seeking UB status is required to:

- Have a minimum paid-up capital of RM250 million, core capital of at least RM250 million and a capital adequacy ratio of at least 1.5 times
- Satisfy the necessary quantitative and qualitative criteria, which would include good governance standards and management capabilities
- Satisfy all other fit and proper criteria determined by the SC

To qualify as UBs, stockbroking companies will also be required to effect consolidation with at least three other stockbroking companies. The SC is of the view that an effective consolidation exercise should ultimately lead to the emergence of between 8 to 10 UBs by end-2001.

Following consolidation, UBs will be able to work towards strengthening their domestic market position through a diversification of activities and geographical reach, as well as building up their capital base ahead of further liberalisation of foreign ownership limits. The additional opportunities and expanded scope of operations allowed for these UBs are

outlined in further detail in Recommendation 80 and Recommendation 81. These incentives have been extended only to qualified UBs at this time, to provide the impetus for stockbroking companies to consolidate and to pursue the objective of becoming UBs in line with the broader aim of developing a core group of full-service intermediaries to provide integrated financial services. These incentives are intended to cultivate the development of a more competitive environment for integrated financial services, both *vis-à-vis* integrated domestic banking groups as well as foreign financial institutions servicing the Malaysian capital market.

Stockbroking companies that wish to focus on niche areas and do not plan to take on the mantle as UBs are free to pursue their course of operations, subject to the existing prudential and other regulatory requirements. Nevertheless, these brokers are encouraged to merge with at least one additional broker, in order to achieve greater economic efficiency both individually as well as collectively within the broader industry group. However, they will not be afforded additional privileges relating to unrestricted branching and the ability to conduct a full range of capital market activity, which will be reserved for UBs for the time being.

In the medium- to longer-term, UBs are also encouraged to forge strategic alliances with international financial institutions of good repute with a wide international presence. This will enable Malaysian-owned stockbroking institutions to more firmly entrench their domestic position, while facilitating the transfer of skills and domestic exposure to the foreign partner's global client network. Over the longer term, UBs are encouraged to pursue appropriate expansion of their operations within regional and international markets, in order to enhance the overall competitive position of the Malaysian capital market.

Update: SC has announced the introduction of UBs as part of the policy framework for the consolidation of the stockbroking industry on 21 April 2000. This was followed by the release of the Member Readiness Checklist for a Universal Broker and Guidelines for a Universal Broker on 2 October 2000.

RECOMMENDATION 80

Branching restrictions on stockbroking companies will be deregulated

Currently, branching restrictions limit the expansion of stockbroking companies to areas outside their geographical base. These restrictions were originally formulated to limit the concentration of stockbroking companies according to geographical location and ensure wide public access to stockbroking services, at a time when the impact of new technology such as the Internet was not a significant factor within the domestic capital market.

Moving forward, however, it is necessary to review the current and potential impact of technological advances in allowing global investors the connectivity necessary to participate in markets in multiple jurisdictions. As such, branching restrictions, while appropriate in the course of the market's early development, will impede the future competitiveness of domestic market intermediaries if maintained.

Furthermore, while technological advances may render the need for multiple physical offices moot in the future, this is not foreseen to be an immediate issue in Malaysia given current relatively low Internet penetration levels among the investing public and greater investor familiarity with human intermediation.

Therefore, branching restrictions will be deregulated such that UBs will immediately be allowed to operate an additional branch at a new location for every additional stockbroking license surrendered, subject to the SC's approval. UBs will subsequently be allowed to open branches throughout the country from 1 January 2002. Additional branching flexibilities for stockbroking companies may be permitted at a later stage, contingent on conditions and assessments to be determined by the SC.

The removal of branching restrictions will benefit investors by ensuring the expansion of public access to the services provided by UBs, while at the same time allowing these intermediaries the opportunity to broaden their market reach.

Update: The SC has announced branching flexibilities for UBs on 21 April 2000. This was followed by the release of Guidelines on the Establishment and Location of a Branch office by a Universal Broker and a Non-Universal Broker on 2 October 2000.

RECOMMENDATION 81

The scope of capital market services that may be offered by stockbroking companies will be widened

The increasing prominence of multinational integrated financial institutions in the global marketplace is redefining the competitive landscape for intermediation services. Increasingly, financial institutions are becoming actively involved in more than one core activity, and those that are not tend to be niche players offering specialised services.

Malaysian capital market intermediaries will inevitably face stiffer competition from both niche players as well as larger institutions as the market evolves and investors demand more efficient and convenient services. Larger financial conglomerates are able to offer a wide array of products and services across multiple markets, thus allowing greater convenience and accessibility for their clientele. In addition, specialised players offering services such as research or low-cost order routing and matching are competing with the traditional brokers who offer bundled transaction services.

To some extent, this growing convergence is already occurring within the Malaysian financial services market as well. Some insurance companies, for example, already offer the public investment-linked products while commercial banks, to some degree, act as distribution-networks for various unit trust and stockbroking companies with whom they have established business linkages.

Presently, participants require separate licenses and must set up separate entities to engage in distinct—albeit related—forms of capital market activity such as stockbroking, futures broking and investment management. These restrictions have arisen due to legacy regulatory structures as well as prudential reasons, and are outlined in greater detail under Recommendation 82. However, the realities of the financial landscape today point to the need for objective measures to ensure that Malaysian market intermediaries are optimally placed to service the needs of users of the Malaysian capital market, while not compromising high standards of prudential integrity.

In view of these issues, steps will be taken to deregulate restrictions on the activities that may be undertaken by stockbroking companies, to facilitate a fair and competitive market for integrated financial services. Qualified stockbroking companies meeting relevant quantitative and qualitative criteria will gradually be allowed to undertake a wider range of capital market-related activities than they have previously been allowed to, subject to conditions set by the SC. These services include the ability to undertake corporate finance work, make submissions of corporate proposals to the SC on behalf of clients and trade derivative products. Additional future activities may also include managing and trading all fixed income products, international securities and other financial instruments.

These measures will not only generate greater competition and efficiency in the financial services sector, but also provide an avenue for expansion of business activity and diversification of revenue. This will help diversify the income streams of brokers from mainly brokerage commissions and reduce their vulnerability to the vagaries of market cycles. In the longer run, it is envisaged that the widening of allowable activities will equip these intermediaries with the flexibility to innovate and differentiate themselves to better face the challenges of competition.

Update: The SC has already taken the first step towards the deregulation of restrictions on the scope of activity of stockbroking companies with its announcement on 21 April 2000 that UBs will be allowed to offer a full range of capital market services.

RECOMMENDATION 82

Stockbroking companies and their representatives will be allowed to offer a range of services under a single license

Currently, stockbroking companies are licensed by the SC under the SIA while futures brokers are licensed under the FIA. Also, in order to take on other activities such as investment management, and providing investment advice, market participants are required under the SIA to obtain additional separate licenses as well as set up separate entities. Similarly, representatives of the various intermediaries require separate licenses under the relevant statutes for each type of activity.

In line with the deregulation of restrictions on the activity that may be undertaken by stockbroking companies, the SC will initiate amendments to the relevant legislation to allow stockbroking companies and their representatives to offer a range of services under

a single license. This will provide the necessary flexibility for qualified stockbroking companies to offer both distinct and integrated services involving activities such as equity and derivatives broking, investment management and corporate finance advisory services, under a single license.

Pending these legislative amendments, qualified brokers will be allowed to hold individual licenses to operate under both the SIA and FIA within a single entity. By the same token, the representatives of these intermediaries who engage in the various permitted activities will also be allowed to operate under a streamlined licensing regime, based on appropriate fit and proper requirements determined by the SC.

Update: It was announced by the SC on 21 April 2000 that pending legislative amendments to the SIA and the FIA, UBs can be licensed under both statutes to trade in equity as well as derivative products.

RECOMMENDATION 83

Stockbroking commission rates will be liberalised in two stages:
Stage 1 - with effect from 1 September 2000, commission rates for all trades above RM100,000 will be fully negotiable while trades with contract values of RM100,000 and below are subject to a fixed rate of 0.75%
Stage 2 - with effect from 1 July 2001, commission rates will be fully negotiable for all trades, subject to a cap of 0.70%

Fixed stockbroking commission rates present implicit revenue guarantees for stockbroking companies through the standardisation of prices for the stockbroking services rendered. While such guarantees have helped in supporting the early development of the stockbroking industry, they create earnings streams that are not necessarily reflective of the scope, quality or efficiency of services rendered as the market moves towards a more competitive environment.

As it stands, brokerage commission rates in Malaysia are currently among the highest in the region. The move towards market-driven pricing of these services is therefore necessary to allow firms offering value-added services the flexibility to price their services differently from those who do not offer such services. At the same time, customers will now have more say in ensuring that the quality of services rendered is commensurate with the fees they are willing to pay.

Hence, measures will be taken to deregulate fixed brokerage commissions. The deregulation process will be undertaken in stages to allow stockbroking companies and remisiers time to prepare themselves. At the same time, given the high level of retail participation in the Malaysian stock market, a cap of 0.70% will be imposed in the second stage to safeguard the interests of retail investors. This cap will subsequently be reviewed with a view to removal after an assessment of market impact by the SC and the KLSE.

In this manner, there are greater financial incentives to the intermediaries to improve the overall variety and quality of services they provide. It is worth noting that the liberalisation of broking rates is an archetypal step that is taken as capital markets expand and mature. At present, 13 of the 15 largest stock markets in the world (by market capitalisation) have adopted a system of free negotiation.[99] In addition, the liberalisation of commission rates is expected to facilitate the growth of online broking, which should offer an additional means of facilitating greater investor access to Malaysian intermediation services.

Update: The phased liberalisation of commission rates has been announced by the SC on 21 April 2000.

RECOMMENDATION 84

Commission sharing arrangements between remisiers and stockbroking companies will be fully negotiable in 2002

At present, commissions earned on trades between remisiers and retail investors must be shared between stockbroking companies and remisiers at a ratio of 60:40.[100] The deregulation of commission sharing structures would allow remisiers to earn commissions that are appropriately reflective of the quality of the services rendered, and also provide them with an added incentive to enhance their services. It would also be consistent with broader efforts to create a more competitive market.[101]

In line with the liberalisation of brokerage commission rates, stockbroking companies and remisiers will also be allowed full flexibility in negotiating the sharing of brokerage commissions. The deregulation of commission sharing arrangements in 2002 coincides with a similar liberalisation of commission sharing arrangements between futures dealers' representatives and futures broking firms.

RECOMMENDATION 85

Foreign equity participation in domestic stockbroking companies will be liberalised in stages beginning from 2003

Liberalisation is an important factor in achieving the broader vision of developing a competitive and efficient capital market for Malaysia, and is a key step in order for the Malaysian capital market to remain competitive within the evolving international financial landscape.

[99] These include the US, the UK, Japan, France, Germany, Canada, Italy, the Netherlands, Switzerland, Spain, Australia, Sweden and Finland.

[100] Rule 4.8.2 (7) of the *Rules of KLSE*.

[101] Singapore, where a similar remisier system exists, has long had similar fixed commission sharing provisions in place but the Singapore Exchange has since liberalised this arrangement with effect from 1 October 2000.

Greater participation by suitable well-managed multinational financial intermediaries allows for the import of international skills, knowledge and technological efficiencies into Malaysia, creating a more competitive environment and facilitating greater product innovation. These firms will also potentially provide access to global client networks and introduce internationally accepted compliance systems to the domestic market.

However, in line with the strategic initiative of implementing a pragmatic programme for liberalisation supported by appropriate safeguards, the sequencing process must ensure that liberalisation is effected in a pragmatic yet non-arbitrary manner.

Malaysia currently allows up to 49% foreign ownership in domestic stockbroking companies. In the immediate term, the formation of strategic alliances with suitable foreign intermediaries within these parameters is encouraged, as this will assist in developing and preparing the industry ahead of further liberalisation. Such alliances will enable Malaysian-owned stockbroking institutions to more firmly strengthen their domestic position, while upgrading the level of domestic skills through technical agreements with the foreign partner.

In 2003, towards the end of Phase 1 of the Masterplan, a limited number of majority foreign-owned stockbroking institutions will be allowed to operate in the Malaysia capital market, through the purchase of existing licensed stockbroking companies and subject to other conditions as may be determined by the SC. By then, Malaysian stockbroking companies will have had several years to strengthen their domestic market share and position themselves for greater competition.

In Phase 2 of the Masterplan, covering 2004 to 2005, the SC will allow further liberalisation of foreign equity participation limits in the stockbroking industry. However, any liberalisation, including an acceleration of this process, will be undertaken after a careful assessment of market readiness.

The SC will provide detailed guidelines prior to each stage of liberalisation. Among the factors that may be examined in allowing new foreign stockbroking companies into the Malaysian capital market are:

- The ability of the foreign institution to enhance the quality of services in the Malaysian capital market and contribute to its development
- The extent of representation which the foreign institution has in the Malaysian capital market services sector and investment interests in Malaysia
- The ability and commitment of the foreign institution to contribute to the development of technical expertise and skills of Malaysian professionals in that sector

Other countries in the region have also taken steps to loosen foreign ownership restrictions in recent years and at this stage, majority foreign ownership is permitted in all the major regional markets.

RECOMMENDATION 86

Measures to facilitate online trading will be introduced

Online trading has seen a phenomenal surge in popularity in a number of markets over the last few years, accelerated by technological developments and the deregulation of fixed commission rates.

In Malaysia, the liberalisation of commission rates means that pure trade execution will likely become a relatively low-margin business over time. The utilisation of information technology and harnessing the power of the Internet through online trading and other means of e-commerce to provide value added services will present important avenues for stockbroking companies to enhance their market share and retain their competitive edge.

Although several stockbroking companies do already offer online share trading in some restricted form, full online trading is currently not possible due to regulatory and infrastructural factors. In view of this, the SC will work together with the relevant market institutions and market participants in amending existing regulatory provisions to facilitate the development of full online trading.

Among other things, the requirements set out in the KLSE *Guidelines on Electronic Client-Ordering System* code should be reviewed to allow stockbroking companies to develop their own Internet order-routing systems, either in-house or with pre-approved technology vendors. The *Rules of KLSE* should also be amended to allow orders from investors to be routed directly via a stockbroking company to the trading engine of the exchange without the need for manual intervention by a dealer's representative.

Also, the recommendation in the section on Market Institutions for a thorough assessment of the possible integration of the capital market trading and clearing systems with the money settlement system will help address a major impediment to the efficiency of online trading in Malaysia. Other areas that will be assessed and clarified include "know your client" rules and signatures, rules relating to advertising as well as the provision of investment information and advice, and electronic contract notes.

RECOMMENDATION 87

Efforts to develop a standardised and centralised back-office system for the stockbroking industry will be facilitated

The concept of consolidated, shared services is a trend that has gained increasing popularity over the last decade. This has largely come about at a time when companies are endeavouring to remain efficient in an increasingly competitive environment, while technological advancements have simultaneously made a shared service mode of operation both practical and cost effective.

In the stockbroking industry, back-office systems have traditionally been developed separately by individual companies to cater to their own specific needs. It is clear that substantial benefits can be derived from the standardisation and centralisation of back-office services for the industry. These potential benefits include:

- Economies of scale through the sharing of development and operating costs among industry players
- Centralisation of future systems upgrades
- Centralisation of the transmission of information and reporting to the authorities
- Improvement of overall systems and data integrity for the industry
- Improvement of the quality of transaction processing and administrative services available to stockbrokers due to specialisation by the service provider
- Creation of leaner and more effective organisational structures that allow management to focus on value-added core business operations

Therefore, the KLSE and the industry should examine the development of a dedicated centralised system. However, participation in the shared services programme should not be mandatory in order to maintain market-based incentives for the efficient management of such services, and stockbroking companies may choose to maintain proprietary systems based on commercial considerations.

RECOMMENDATION 88

Efforts to further promote the use of information technology and e-commerce by intermediaries will be facilitated

The SC fully supports and encourages the use of technology in the capital market where it facilitates greater efficiency, and innovation. In the course of consultation with the stockbroking industry, the SC is therefore pleased to note that the industry has been proactive in identifying a number of initiatives which it would like to undertake in promoting a greater and more effective use of technology, such as:

- The increased use of technology to disseminate information and transmit reports to the regulatory authorities with the view of ultimately moving towards a paperless environment
- The establishment of an industry-operated e-commerce backbone to reduce and share development and operational costs among industry players
- The establishment of an inter-connected electronic credit bureau to enable credit checks to be performed on customers based on their exposure to securities

The SC's view is that such initiatives should be industry-led and managed. At the same time, consistent with the views expressed in its consultation paper on *Framework for the Implementation of Electronic Commerce in the Capital Market*, the SC will adopt a facilitative and collaborative role in enabling the successful implementation of these and other initiatives for the benefit of the industry as a whole.

RECOMMENDATION 89

The scope of activities carried out by remisiers should be expanded to a wider range of value-added capital market services, including financial planning

The remisier network is a distinguishing feature of the Malaysian stock market and has been largely responsible for the significant participation of retail investors on the KLSE through its extensive and established nationwide client base. In the 1990s, in particular, remisiers' business flourished amid the rapid growth in market activity, with the total number of licensed remisiers more than doubling from 2,390 in 1994 to stand at 5,734 as at end-September 2000.

Notwithstanding this, the changing financial market landscape presents significant implications for remisiers' future scope of activities. The impending introduction of fully negotiable commissions is expected to have a considerable impact on their incomes, while the growing popularity of online trading will pose an increasing threat of disintermediation and challenge remisiers' traditional roles as middlemen between investors and the marketplace.

To enhance the role of remisiers within this rapidly evolving environment, and simultaneously capitalise on their positional advantage at the vanguard of the retail investor market, remisiers are therefore encouraged to expand their scope of activity beyond pure order taking for equities. Such an expansion of skills is envisaged to include dealing in a wider range of financial products, as well as providing value-added services such as those typically undertaken by financial planners in many advanced jurisdictions, subject to minimum entry requirements which may be imposed by the SC and other authorities.[102]

In particular, the need for a strong financial planning profession is seen to grow in tandem with an expected increase in the demand for such services as Malaysian consumers become increasingly better informed and sophisticated amidst overall economic and educational development, and rising income levels. To facilitate the process, SIDC and RIIAM will develop appropriate training programmes to complement those offered by the private sector, professional organisations such as the Certified Financial Planner (CFP) Board of Standards and various institutions of higher learning.[103]

[102] In countries such as the US, the UK and Australia, financial planning is usually provided by qualified professionals to individuals, and frequently encompasses wealth management and estate planning, as well as the sale of financial products such as insurance and unit trusts.

[103] It should be noted that the Financial Planning Association of Malaysia (FPAM) was formed in late 1998 to promote the benefits of financial planning in the country and has since been admitted to the International CFP Council which is based in the US.

INVESTMENT MANAGEMENT

Objectives

The efficient intermediation of funds by the investment management industry determines to a large extent how well the capital market mobilises and allocates capital in the economy; in this regard, an effective investment management industry is a hallmark of a well-developed capital market that is efficient and internationally competitive. In the context of Malaysia's capital market, an effective investment management industry is necessary for:

- Mobilising domestic savings more efficiently. Investors who wish to participate in the capital market but who lack sufficient skills or resources to undertake direct investments are provided with a more cost-effective means of investing their funds and can more effectively delegate the management of these funds through the investment management industry
- Providing a more effective means of meeting the investment needs of Malaysian investors and savers. Previous and current mechanisms for managing the nation's savings have served the country well over the years. However, as incomes continue to grow and the investment requirements of savers become more sophisticated, the investment management industry will have a greater role to play in meeting these needs
- Diversifying the financial system further by widening the scope of viable financial instruments available to savers. A major challenge is to reduce the concentrations of funds both within the investment management industry itself as well as within the financial system as a whole
- Enhancing the liquidity of the domestic market. The presence of an active institutional investor base provides a strong foundation for maintaining market liquidity. The high volume of order flows driven by the scale of trading generated by such investors' portfolio requirements supports an environment in which liquidity can flourish and grow. In addition, the presence of large active domestic players can to a certain extent act as a countervailing force to externally-generated influences and pressures, thus making liquidity less susceptible to the vagaries of international investor sentiment

The investment management funds in Malaysia consists of, among others, funds managed by provident and pension funds, unit trust management companies, asset management companies and insurance companies. In order for the investment management industry to be effective, the industry will need to be more competitive and vibrant. It must offer an attractive value proposition to current and potential customers through a greater diversity of products and services, and ensure that they operate cost-competitive fee structures. Domestic institutional investors must be more active if the market is to build up its "core"—that is, high and sustainable—liquidity. Liquidity typically expands with the scale of trading and the presence of large active institutional investors will foster a conducive environment in which liquidity can flourish. An ancillary benefit of more active domestic institutional participation in the capital market is that it fosters more institutionally-based shareholder activism and, as a result, encourages stronger corporate governance.

For there to be a more competitive and vibrant environment, development efforts going forward will focus principally on, among others, the following areas:

- Ensuring that there are a significant number and diversity of industry players with greater access to a larger pool of funds available for management
- Developing a large pool of highly-skilled professionals to foster greater innovation and competitiveness in the industry
- Ensuring a more facilitative regulatory framework that allows the industry to operate in a deregulated environment while at the same time achieving a high level of investor protection and market integrity

A greater breadth of industry players, including a significant number of diverse investment management intermediaries with sizeable funds under management, is a key to reducing the concentration of funds under management. For the industry as a whole, this will increase the scope for greater competition, and contribute to a greater diversity of investment management services and products; in addition, a more active and competitive industry will promote greater liquidity in the overall capital market and promote the development of a diverse range of investment styles. For particular industry players who hold large concentrations of funds, outsourcing a portion of funds to external fund managers can reduce the high costs typically associated with the market impact of directly investing large sizes of funds.

So far, only a small proportion of EPF funds have been allocated for external management. Moreover, there exist other pockets of concentration. Moving forward, therefore, measures will need to be taken to allow for the further outsourcing of EPF funds as well as of other institutional funds. In order to broaden the institutional investor base and to provide a viable additional mechanism for the mobilisation of savings, measures will be taken to facilitate the development of a viable private pension fund industry. A key to this will be the establishment of a more facilitative environment with appropriate incentives to encourage the growth of private pension funds.

While the freeing-up of funds for management is clearly crucial to fostering greater competition and vibrancy in the industry, the value proposition offered by private fund managers must also be significant enough to draw investors towards investment management products and services. Therefore, not only will the investment management intermediaries have to embark on greater promotional efforts, they will have to offer their current and prospective clients strong value. This will be generated through innovation and be manifested in a bigger choice of products and services, both of which require a deep pool of professional talent displaying a strong skill-base. To some extent, this will be achieved in an environment of greater competition among investment management intermediaries for investors' funds. However, in addition, there must also be further pragmatic liberalisation of the industry, by allowing greater foreign participation, as well as the easing of restrictions on the management of domestic funds by FFMCs. These efforts will help in increasing innovation and competition by adding to the diversity and skills-base of industry players. Stronger efforts in the area of training and professional development programmes for local investment management intermediaries will also play an important role in expanding the local pool of skilled professionals.

The development of a highly-professional, active and competitive investment management industry will also require a regulatory environment that supports greater promotion of the growth and development of the industry while ensuring a high degree of investor protection. In particular, decisions based on commercial considerations will not be unduly inhibited and competition will be allowed to thrive; for instance, there must be deregulation to allow greater scope for investment abroad. At the same time, a much greater emphasis must be placed on supervision and enforcement, as well as on enhanced disclosure and transparency over the products and services being offered, to promote greater confidence in the integrity of players and the industry as a whole. These describe, in essence, a more market-based approach to regulation, which, as discussed elsewhere in the Masterplan, the SC is adopting and applying more widely across the various aspects of capital market regulation.

This adoption of a market-based system of regulation will involve, among other things, a shift from the merit-based review of new investment products to a disclosure-based approach of regulatory approval; to streamline the approval process for products. In addition, the framework for licensing investment management intermediaries will also be streamlined, thus helping to reduce operational costs. There will also be greater use of appropriate incentive structures; investment and other restrictions that currently impose unnecessary constraints and costs on the industry will be eased or, in certain cases, removed entirely. Transparency in the industry will be boosted by measures to enhance disclosure of investment management practices and methodologies. In addition, the SC will identify, subject to appropriate criteria, suitable SROs among industry bodies to complement its regulatory function.

While a large part of development efforts tend to focus on the supply-side of the industry, it is also important to recognise the need to encourage the demand-side, in particular through promotion and the education of retail investors. In this regard, measures will be taken to facilitate the development of a domestic financial planning industry and to co-ordinate more promotional and educational programmes, in order to increase awareness among investors of investment management products and services. These measures, as well as the others outlined above, are described and discussed in more detail in the recommendations section below, and will be undertaken progressively over the period of the Masterplan.

RECOMMENDATION 90

A more market-based approach to regulation will be applied to the investment management industry

As the investment management industry grows and matures, there will be an increasing need to look at the continued effectiveness of existing regulatory methods in achieving the principal objectives of such regulation while at the same time facilitating further innovation and industry-driven enhancement of services and products.

Given these considerations, broad standards-based rules are preferred over prescriptive rules especially with respect to product and conduct regulation. Similar to the full DBR framework, the use of broad standards to regulate the industry provides a balanced framework that facilitates innovation, while providing the appropriate regulatory and market-based incentives for good governance and investor protection.

The use of broad standards to regulate business conduct and prudential requirements can therefore provide flexibility while not compromising on the overall soundness of the industry. It will also simplify and facilitate the imposition of equal regulatory treatment of all participants offering similar services, and allow for more cost-effective regulation.

Therefore, as the level of sophistication and complexity in the industry increases, the SC will gradually move towards a more market-based regulatory approach which is to be fully implemented by 2002. This will be accomplished through the progressively greater use of broad prudential standards to regulate investment management products, services as well as the conduct of the industry participants themselves.

At each stage, upon a satisfactory assessment of market readiness, there will be the appropriate deregulation of existing rules such as those pertaining to regulatory capital and prudential investment restrictions with a view to the application of broad standards in these areas. The SC will also strive to continuously ensure that the regulation of the investment management industry remains cost-effective and does not impose unnecessary costs to participants or unduly restrict competition and innovation within the industry.

In implementing a market-based regulatory philosophy, the SC will also undertake to ensure there is equal regulatory treatment of all participants offering similar investment products and management services. This will be done by working towards the harmonisation of the rules and regulations that currently apply to the industry, and where necessary will entail close inter-agency collaboration between the relevant regulatory authorities to remove differences in regulatory treatment. Issues that will need to be resolved in this regard include, among others, broad eligibility requirements for investment personnel, disclosure of performance data as well as ensuring that the accounting practices for all managed funds comply with acceptable predetermined standards.

RECOMMENDATION 91

The process for introducing new investment management products will be streamlined

Investment management products that are unit-based and share-based schemes which invest in either marketable securities or property or both, and that are offered to the public are subject to regulatory approval under the SCA.

At present, the introduction of such collective investment schemes is undertaken on a merit-based approach whereby the SC evaluates the merits of the proposed scheme prior to approval of its launch. While this hands-on approach has been instrumental in building a strong foundational structure on which the industry can develop, as the industry matures the level of product sophistication will require a move towards a disclosure-based approach from the current merit-based one.

To further enhance the competitiveness and efficiency of Malaysia's investment management industry, the approval process for unit trust funds and other collective investment schemes will be streamlined and made more efficient. This will involve the adoption of full DBR by 2002. This means that proposals for new collective investment schemes will increasingly be assessed *ex ante* on their disclosure standards rather than on merit-based assessments, thus promoting the speedier introduction of new schemes to meet consumer demand.

Importantly, this shift will help to maintain—if not lower—overall costs in bringing products to the market in the long run. In addition, better and more meaningful disclosures can help increase demand for investment management products and services by ensuring that all consumers have access to sufficient information on which to base their investment allocation decisions. By requiring high standards of disclosure through enhancing the transparency within the industry, risks associated with insufficient or less timely information will also be reduced.

In doing so, the proposed shift will strengthen the effectiveness of the current regulatory framework in ensuring that the interests of the investing public are protected, while at the same time fostering greater scope for diverse and demand-oriented investment management products and services.

RECOMMENDATION 92

A uniform regulatory framework streamlining the licensing rules for the investment management industry will be introduced

At present, while the operations of unit trust management companies and licensed asset management companies complement one another, there is also a degree of overlap in terms of the types of activities each carry out. The scope for greater convergence between their activities is anticipated to grow in the future as the marketplace evolves and competitive pressures call for the flexibility to expand into a wider scope of related business areas.

As such, the SC will work towards streamlining the licensing rules pertaining to the investment management industry by end-2003 to allow the convergence of the separate investment management functions and the rationalisation of related operations among companies offering investment management services and products. This streamlined framework will also ensure regulatory parity over the treatment of asset managers and unit trust managers carrying out similar activities.

A common unified framework under which all investment management activities can be undertaken will aid in lowering overall costs of managing a particular investment portfolio as well as facilitate better risk management of investments. For instance, under the streamlined framework, the requirement for holding two separate licenses for the management of equity and derivatives portfolios will be removed. Allowing market participants the flexibility to consolidate their operations will therefore enable them to lower the costs of managing and marketing their funds.

To ensure that this regulatory streamlining progresses smoothly in tandem with the deregulation and liberalisation process within the investment management industry, the SC will ensure that appropriate measures are in place to ensure that the various regulatory considerations of the different segments of the investment management industry, in particular, prudential standards and investor protection issues, are observed.

RECOMMENDATION 93

The management of investment funds should be further deregulated to allow for greater international portfolio diversification

Expanding the investment universe to include financial assets traded in foreign markets will help provide an expanded set of investable instruments, allow for greater differentiation of marketable portfolios, and increase the investment manager's capacity for creating an investment portfolio that maximises return for a given level of risk.

The unit trust management industry has enjoyed the ability to diversify a portion of its portfolio investments abroad since the first *Guidelines on Unit Trust Funds* was issued by the SC in 1994. In 1997, the investment restrictions placed on unit trust funds with respect to investment in foreign securities were further liberalised when the SC removed all restrictions with respect to international diversification. Other forms of managed funds, too, have over the years been given access to foreign securities for investment purposes.

However, despite the liberalisation measures taken over the last few years, there still exist certain limitations that affect the ability of investment funds to effectively undertake cross-border diversification, or setting up specialised funds that primarily invest in foreign markets. The restrictions should be reviewed to allow sufficient latitude for diversification and for offering appropriate value-added products to investors. The SC will work closely with other relevant authorities to review the existing rules with a view to developing a more facilitative framework.

RECOMMENDATION 94

The SC will recognise industry self-regulation within the investment management industry, subject to appropriate criteria and under strong supervision, to complement the SC's regulatory function

Self-regulation facilitates a market-driven approach to industry development and supervision. The transfer of certain responsibilities to recognised SROs from within the industry also enhances regulation of the capital market, given that those at the vanguard of the industry will already have the necessary expertise and familiarity with the operational details as well as the broader issues affecting the industry.

In view of this, the SC will look towards greater industry self-regulation to complement the SC's regulatory function. This will be accompanied by a clear demarcation of duties between the industry and the SC to ensure that there are no gaps or unnecessary overlaps in responsibilities. At the onset, industry self-regulation will be entrusted with matters such as member registration and training, as well as raising investor awareness of the investment management industry. In addition, there should also be a publicly accessible database of registered persons to enable easy consumer verification.

As self-regulation by the industry develops greater capacity and improved capabilities, the SC would, in due course, look to assigning the industry with more regulatory responsibilities. These would entail, among others, the formulation, implementation and enforcement of best practices and codes of conduct to be applied within the industry.

RECOMMENDATION 95

EPF's investment guidelines should be liberalised to allow the adoption of the "prudent person" approach

Internationally, either "asset restriction" or the more market-based "prudent person" investment rules have regulated pension funds. The EPF falls under the former as quantitative restrictions are imposed on its investments. Under the "prudent person" principle, however, quantitative restrictions are not applied but fund managers (or any other person entrusted with investment making powers) are expected to act as prudent professionals in making investment decisions, and adhere to the fundamental fiduciary duties of loyalty, impartiality and prudence.

Restrictions on the allocation of funds to predetermined asset classes, while having greatly assisted in ensuring a measure of stable returns for EPF contributors over the years, need to be reviewed in light of the changing circumstances of the financial environment. Typically, in cases where regulations put disproportionate emphasis on reducing risks, yields on assets held will be lower than they would otherwise be.[104] Studies from other jurisdictions have shown that whilst the restrictions have typically been instrumental in limiting portfolio risks, they have also set certain constraints on the performance of pension funds and their ability to maximise returns for their contributors.[105] Cumulatively, this would have an impact on the available funds for retirement.

The stability, efficiency and profitability of a scheme such as the EPF requires a balance between having sufficient flexibility in deciding how its investments are managed, with the necessary degree of prudence. The main objective of implementing the "prudent person" investment rules is to allow EPF to fully leverage its expertise and considerable experience in managing portfolio investments to further enhance the yields of national retirement savings. A more flexible investment philosophy will not only enable EPF to enhance its returns and diversification gains, but given its size it will also make a considerable difference in increasing liquidity—and, in some cases, creating critical mass—in all segments of the capital market in which it operates.

It is therefore proposed that the investment restrictions currently imposed on EPF be liberalised to enable greater portfolio diversification across a wider range of investments. Moreover, the investment framework should be reviewed given that the relevance of traditional restrictions for reducing risks may have changed with the financial landscape over the years, due to the increasing complexity of the capital market and the availability of new investment instruments and products.

[104] Research such as that conducted by the Organisation for Economic Co-operation and Development (OECD) ("Maintaining Prosperity in an Ageing Society", OECD, 1998) indicate that over the long term, pension funds' portfolio returns have been higher in countries with "prudent person" rules rather than jurisdictions with asset restrictions. One report based on a research done for the European Commission in 1999 also concluded that asset restrictions do not necessarily reduce risks, and long-dated historical performance showed that the returns from a "prudent person" pension portfolio is potentially 5.9 times greater than a portfolio with substantial asset restrictions.

[105] Some studies (see, for example, "The Private Sector in Social Security: Latin American Lessons for APEC", Valdes-Prieto, S., 1998; and "Asset Diversification: The Future Strategy for the Employees Provident Fund", Goldman Sachs) estimate that the EPF's real rate of return has historically been lower than the real rate of return obtainable from alternative portfolio allocations when averaged over the long term, when other factors such as risk and inflation are taken into account.

RECOMMENDATION 96

EPF should further diversify the management of its funds by placing out a greater portion with external fund managers

At present, the bulk of the management of EPF's portfolio is conducted in-house. Although EPF has already taken steps to diversify the management of funds under its care, the amounts allocated to external investment managers have been typically quite small, such that there has only been modest incremental benefit to overall management diversification and to competition for funds between local investment management companies.

In view of this, it is proposed that a larger portion of accumulated funds currently under the management of EPF be placed out for external management with Malaysian-based investment managers. The outsourcing programme will enable EPF to tap on to the wide array of investment management skills, while at the same time enhancing competition and activity within the private investment management sector through the decentralisation of a larger proportion of the funds concentrated within the EPF.

To ensure continued prudent management of these funds, however, it is recommended that EPF plays an oversight role with respect to the outsourced management of members' contributions. In this regard, it can draw from its own substantial experience and expertise to ensure that maximum value is extracted from its own core strategic investments, while funds that are externally managed incrementally enhance overall returns.

Another benefit in the outsourcing of EPF funds lies in the fact that the impact of investment decisions with regard to these funds on market liquidity and price discovery is dispersed, thus reducing confidentiality and disadvantageous price-impact concerns. This is because navigating the financial markets will prove to be more difficult especially where the large size of the fund relative to the financial market hampers discreet investments or disposals. In short, the bigger an investment fund gets relative to the market it invests in, the harder it will be for the fund to be managed efficiently.

Diversifying the management of an investment fund as large as the EPF is therefore a necessary step to ensure the effective de-concentration of investable funds. By having a diverse spread of investment managers managing the fund, there will also be increased competition with respect to providing superior risk-adjusted returns.

RECOMMENDATION 97

The eligibility rules pertaining to the EPF's Members' Investment Scheme should be lowered over the longer term

EPF has been the most important institution in Malaysia in ensuring that the post-retirement needs of Malaysians are catered for. However, as Malaysia develops into a fully developed nation, the life expectancy of its citizens is expected to increase further. Sufficient savings to ensure proper old-age security must accompany this increase in the life expectancy rate.[106]

To ensure that the post-retirement income pool is sufficient to provide security at the drawdown phase, there must be more effective investment management of the current pool of savings, while ensuring that a strong savings culture is maintained.

The EPF Members' Investment Scheme, which was implemented on 1 November 1996, provides an avenue whereby contributors can exercise greater control of their retirement savings and plan accordingly. However, under the present framework, the eligibility criteria is such that an individual earning RM3,000 per month would be only eligible for the scheme after more than 10 years of employment. This has meant that only higher income earners and longer-standing contributors—who presently constitute only a small fraction of total contributors to the EPF—are eligible to participate in the scheme.

Given the savings profile of retirees and the importance of early accumulation of retirement savings, measures should be undertaken to allow greater latitude in how the contributions are invested very early on. In any case, this recommendation would facilitate a greater degree of democratisation of contributors' retirement savings irrespective of the level of maturity or risk profile.

To this end, the eligibility threshold of RM50,000 in Account A and the 20% withdrawal limit should be eased to allow all contributors to be eligible to channel up to 50% of accumulated funds in Account A into funds approved under the Members' Investment Scheme.

In addition to expanding the ambit of the Scheme, the actual implementation of the collection and disbursement process should also be reviewed. Currently, contributors opting for any of the funds approved under the Scheme are treated as ordinary retail consumers and therefore pay retail up-front and annual fees to the fund providers. Moving forward, such costs should be reduced so as to achieve cost-neutrality between the Scheme and remaining with EPF.

On the whole, the further liberalisation of the eligibility criteria for the Scheme will allow contributors greater flexibility and responsibility in planning their future financing needs and customising investment strategies in a manner commensurate with their individual risk profiles and investment sophistication.

[106] According to the 1999 Insurance Annual Report, given the savings profile of EPF contributors aged 54 (that is, nearing retirement) as at the end of 1998, 81% had savings of less than or equal to RM30,000 while only 11% had amounts exceeding RM50,000. If this profile is maintained, such amounts would be inadequate to ensure sufficient post-retirement income given the life expectancy projections of more than 75 years going forward. Studies conducted by the World Bank (see, for example, "Pension systems in East Asia and the Pacific: Challenges and Opportunities", R. Holzmann, MacArthur and Sin, 2000) also estimate that the replacement rate, despite the 23% contribution rate to EPF, is unlikely to exceed 20-25% of the contributor's final salary.

RECOMMENDATION 98

Measures to facilitate the development of a private pensions industry will be actively pursued

In tandem with overall efforts to supplement the national pensions system and provide for greater competition and diversity in the institutional management of private funds, there is also a need for the development of the private pensions industry.

There are currently few private pension schemes operating in Malaysia supplementing the retirement needs of employees. As at the end of 1999, the estimated total accumulated contribution of all private pension/provident funds in Malaysia amounted to only RM28.5 billion or 2.4% of assets in the financial system.[107] Employer-sponsored schemes are even smaller: as at the end of 1998, it is estimated that the 13 largest funds only amounted to RM9.15 billion.[108]

One of the main reasons for the slow development of the private pensions industry in Malaysia at present is that establishing and managing an in-house private pension scheme is not seen to be cost-effective given the alternative of contributing to EPF. Currently, the mandatory employer contribution rate to the EPF is 12% of the employee's wages. Employers are also allowed to contribute an additional tax-deductible 7% to EPF or an approved scheme established by the employer for the retirement benefit of their employees. Given that the tax deduction is only applicable up to the additional 7%, it does not provide incentives for the creation of in-house pension schemes. In addition, given that the overall mandatory contribution to the EPF is 23%, there is little scope for an incentive to make additional contributions to private pension schemes unless appropriate reforms are introduced.

To facilitate the further development of the private pensions industry, the SC will work closely with the relevant authorities and the investment management industry to conduct a thorough study of the possible measures to promote the development of the private pensions industry. With regard to this, there should be a review of, among others, the current tax treatment to encourage greater use of in-house pension schemes.

Going forward, there should also be a review of the current mandatory contribution structure in order to determine if there is scope for greater use of private pension schemes. In this respect, a feasibility study should be conducted to examine the implications and issues of allowing employer contributions to the EPF (either statutory or otherwise) and any excess contributions that an employer may make to be channelled into privately managed pension schemes of the employee's choice.

[107] Source: Bank Negara Malaysia.
[108] Source: 1999 Insurance Annual Report.

RECOMMENDATION 99

The further outsourcing of the management of funds by insurance companies should be promoted

The outsourcing of funds by insurance companies to external investment managers is currently subject to restrictions. Among other things, these restrictions apply to the amount that may be outsourced by the insurance company to each investment manager as well as the aggregate amount that may be managed by any one particular investment manager.

However, the absolute limits in the guidelines are comparatively small and, being discrete amounts, do not take into account the asset growth of the insurance company or mergers between insurance companies. At the same time, insurance companies are restricted in their ability to award a larger mandate to better-performing external investment managers. Furthermore, as they are effectively only allowed to outsource a small portion to each external investment manager, it becomes more costly for insurance companies to outsource their investment function. Introducing some flexibility in these requirements while ensuring appropriate prudential safeguards will facilitate greater competition for market share to the benefit of the consumers and, at the same time, cut the costs of outsourcing for the insurance companies. Therefore the rules applicable to insurance companies should be deregulated to enable greater flexibility with respect to the outsourcing of funds by insurance companies.

RECOMMENDATION 100

Restrictions on the management of funds by Foreign Fund Management Companies will be liberalised

To support the development of the investment management industry in Malaysia, the SC released the *Guidelines on the Establishment of Foreign Fund Management Companies* in August 1995 to facilitate foreign participation in the domestic investment management industry. This was done with a view that increased participation by foreign investment managers would act as a catalyst to raise the level of activity and expertise in the industry. Subsequent amendments were made to the Guidelines in 1997 and more recently in 2000 to allow more flexibility with respect to its application.

At present, only joint venture FFMCs are allowed to manage locally-sourced institutional funds (including EPF funds) while wholly foreign-owned FFMCs are only allowed to manage foreign-sourced funds. In view of the need for the pace of development to be further increased, the SC will further liberalise the Guidelines to allow all FFMCs—whether joint ventures or wholly foreign-owned—to source funds from the EPF, subject to the eligibility requirements of the EPF, beginning from 2002. As a move to develop the domestic investment management industry, the mandates given to foreign-owned investment managers should include a condition that both local and regional mandates be managed within Malaysia.

RECOMMENDATION 101

Foreign ownership requirements will be liberalised to allow foreign majority ownership of unit trust management companies from 2003

The availability of broad public access to diversified investment management services is an integral part of the process of developing the overall capital market. High-quality intermediation by investment managers promotes demand for the professional management of pooled private funds that, in many developed markets, is a key feature in fostering a more liquid and dynamic capital market.

The degree of liberalisation within the domestic investment management industry at present differs. The asset management sector has undergone some liberalisation, as reflected in the *Guidelines on the Establishment of Foreign Fund Management Companies.* The unit trust industry—the retail segment of the investment management sector—however, is still subject to a 30% restriction on foreign ownership.

There is scope for further liberalisation of the unit trust industry to ensure that the retail segment also benefits from the availability of foreign expertise and capital. Such a move would benefit the unit trust industry not only through the injection of fresh capital and innovative methods, but also through the professional development of the industry's broad skills base and the introduction of new technologies, which in turn will facilitate innovation at a quicker pace. The introduction of greater competition through enhanced foreign participation, if managed in a pragmatic manner, will therefore bolster activity and efficiency within the industry, which is to the ultimate benefit of the end-consumers.

In view of this, the SC will implement a programme for the gradual liberalisation of the industry. As a first step, there will be a review of foreign ownership restrictions placed on investment management companies operating collective investment schemes such as unit trust funds. This will be done with a view to liberalising the foreign equity ownership limits in such companies from 2003, contingent on an assessment of market readiness by the SC.

RECOMMENDATION 102

The SC will examine the viability of implementing an investor compensation programme

A strong framework for investor protection supports the development of the investment management industry, and can help to counter any negative perceptions that may serve to discourage the use of investment management services. Together with a high level of compliance and high standards of business practices by the management of asset management and unit trust management companies, a strong investor protection programme can enhance investor confidence in the investment management industry.

There are various methods whereby an investor protection programme can be implemented. One such method is through the use of compensation schemes that indemnify investors in the event of firm failure up to a certain maximum amount. Compensation schemes provide wide coverage and target investors directly rather than the investment manager. Such schemes inevitably result in an increase in the contingent liability of other investment managers in the scheme when used in isolation. However when used in tandem with minimum capital requirements, the probability of a call on this scheme is reduced and the burden shifts away from members of the scheme to stakeholders of the investment management company.

Another alternative is through the use of professional indemnity insurance. Professional indemnity insurance indemnifies investment managers against financial losses resulting from firm negligence. The difference between compensation schemes and insurance schemes such as this is that a professional indemnity insurance programme insures the investment managers, not the investors and even then only for a subset of all the risks faced by investors. However, it is cheaper to implement and is far more economically efficient for low-frequency high-cost risks.

Although there are moral hazard risks and financial costs involved in implementing investor protection programmes, there is a welfare gain to be secured as it typically leads to increased confidence in, and hence, greater demand for, investment management products and services. Suitably constructed, investor protection programmes add value to the industry and can potentially bring significant benefits to the industry at a reasonable cost. In view of these issues, the SC will examine, in consultation with the industry, the viability of implementing an investor compensation programme for the Malaysian investment management industry.

RECOMMENDATION 103

Further tax incentives to encourage investments in collective investment schemes will be examined

The level of public awareness of the characteristics and availability of long-term investment instruments, such as collective investment schemes and private pension funds, is still at a nascent stage, incentives to encourage savings in this manner therefore should be considered. In view of this, the SC will work with the industry and the relevant tax authorities to assess the viability of introducing appropriate tax incentives to promote further investments in collective investment schemes. For instance, the introduction of a new annualised tax incentive such that an individual will be allowed deductions against taxable income where the funds are invested in approved unit trust funds should be considered. Such incentives should be structured so as to encourage medium to long-term investment. As with the incentive accorded to purchasers of insurance products, these tax incentives encouraging the use of collective investment schemes will aid in encouraging long-term investment and retirement planning.

RECOMMENDATION 104

Further efforts to promote investors' awareness of managed funds investment will be undertaken

The SC and the investment management industry itself have been very active over the years in educating the public and raising awareness of the benefits and associated risks of investing through managed funds, such as unit trust funds and closed-end funds. However, a large proportion of Malaysian retail investors still prefer to invest directly in the stock market, despite the benefits that the pooling of private funds confers in terms of risk management and cost reduction. This tendency has been attributed to, among other things, a lack of awareness of the benefits of investing through managed funds, as well as the nascent nature of the domestic investment management industry itself.

Therefore, in conjunction with the other recommendations intended to address and accelerate the overall development of the industry, the SC, together with the industry, will enhance promotional efforts to raise investor awareness of the benefits of investing in managed funds. In addition to roadshows, alternative media, including the Internet, will be used to foster such awareness among investors.

RECOMMENDATION 105

Training and professional development needs of the Malaysian investment management industry will be facilitated

The long-term growth of the investment management industry depends to a large extent on maintaining and expanding the requisite knowledge- and skills-base. This is particularly important given the mobility of investment management talent and the need to attract and retain investment management professionals with high skill levels. Therefore, there must be concerted efforts to build up the domestic talent pool so that it remains internationally competitive.

The implementation of the recommendations to increase the degree of activity and competition within the industry will play a crucial role in drawing and retaining professionals with the needed skills in managing funds. Given the importance of the need to have high-calibre personnel in the industry, however, the SC will work closely with the relevant authorities to identify and implement appropriate measures to deepen the pool of skills available. These include measures such as specific tax incentives and relaxation of foreign immigration rules, particularly where the critical skills in investment management are not available locally. In addition, the SC will continue to offer—and further develop—continuous education and professional training programmes for industry participants.

RECOMMENDATION 106

The development of the financial planning industry will be facilitated

A viable financial planning industry will complement the investment management industry, as the presence of independent financial planning professionals will help broaden consumer awareness of the different products and strategies available to them. More importantly, as financial markets and products become larger and more sophisticated, and as the array of choices available for retirement benefits planning grows, the services of qualified financial planners will become increasingly important.

In view of this, the SC, in collaboration with other relevant regulatory authorities, aims to facilitate the development of the financial planning industry. This will include a review of the feasibility of allowing qualified financial planners to sell capital market products that have been approved for retail distribution, in addition to providing financial planning services. As part of these efforts, licensing and registration requirements that are currently imposed on persons undertaking such activities will be reviewed to allow for the explicit recognition of a general class of financial planners.

RECOMMENDATION 107

The further development of the trust/custodial services industry will be promoted

The competitiveness and cost factor of the investment management function also depends on the efficiency and quality of the related service providers, particularly the trust/custodial services. A strong and effective trust/custodial services industry will improve the efficiency of the investment management industry as a whole.

Trustees/custodians that offer focused services such as the management of back-room operations on behalf of investment managers will facilitate more effective cost management. Investment managers will then be able to outsource more of their back-room functions and devote their resources to their core business of investment management, thereby allowing for the distinct specialisation of activities.

Therefore, the SC will facilitate the development of the trust/custodial services industry. In this respect, the SC will work towards further enhancing the skill quality and standards of professional conduct among industry participants. These efforts will focus on, among other things, ensuring a high standard of business conduct among trust/custodial services providers, as well as assisting the industry in designing a thorough training programme to enhance the participants' skill sets.

CORPORATE GOVERNANCE

Objectives

Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of other stakeholders.[109] A world-class capital market must have a transparent, accountable and performance-oriented corporate sector that is premised on sound and consistent governance of corporate activity. More succinctly put, good corporate governance is vital for ensuring that the Malaysian capital market provides a conducive environment for investors.

The onus of ensuring that proper lines of accountability for corporate actions exist and are enforced lies in the hands not only of the regulators, but also of the shareholders, directors, managers, employees and other stakeholders of the company. Therefore, a culture of good corporate stewardship and shareholder activism must be developed contemporaneously with sound regulatory enforcement in order to enhance the level of corporate governance among Malaysian PLCs. This will not only work towards ensuring that the corporate sector is provided with the proper incentives to continually focus on long-term performance enhancement, but also foster greater investor confidence in longer-term investment within the capital market.

While significant improvements in the active exercise of market discipline and enforcement mechanisms have been seen in recent years, particularly with the publication of the Finance Committee's *Report on Corporate Governance* in 1999 and the introduction of significant measures to enhance corporate transparency and accountability[110], the momentum of efforts to improve corporate governance practices should be sustained and further galvanised.

A vital thrust of such efforts is in instilling market participants with a keen awareness of their rights and duties in this regard. In addition, these efforts must be supported by appropriate rules in relation to transparency and disclosure, and a strong regulatory framework. This would include the enhancement of investor protection mechanisms through, among other things, enhancing the frontline responsibility by market participants themselves—encompassing the investors, issuers, intermediaries, market institutions and relevant professional bodies—who are actually at the vanguard of market activity.

At the same time, the availability of timely, relevant and accurate information is crucial so that investors can adequately judge the merits of the investment choices they are presented with. It should be noted that disclosure requirements have been reinforced significantly over the years, including to the extent of requiring quarterly financial reporting by all listed companies. However, to ensure a conducive investing environment in an increasingly globalised economy, there is a need to continue to further enhance and ensure benchmark disclosure and financial reporting standards meet appropriate international benchmarks.

[109] This definition of corporate governance is provided by the *Report on Corporate Governance* issued by the Finance Committee on Corporate Governance in 1999.

[110] These improvements included, among others, the strengthening of accounting standards and the enforcement thereof, the strengthening of insider trading laws and the introduction of the requirement for mandatory quarterly financial reporting. In addition, in January 1999 the Malaysian *Code on Take-overs and Mergers* was revamped to require higher standards of disclosure and corporate behaviour from those involved in mergers and acquisitions.

Competition for capital in the Malaysian and global equity and debt markets can be expected to increase in the years ahead and it is essential for Malaysian companies to strive towards reducing the risk premium attached to investments into Malaysian corporates. As the sophistication of investors and speed of information dissemination increase, the quality of corporate governance will play an increasing role in creditors' willingness to provide loans to companies, equity investors' willingness to buy their shares, and the cost of raising capital for issuers. Companies and countries with strong corporate governance practises will enjoy cheaper and better access to capital, and thus have a competitive advantage over those with weak corporate governance.

To ensure that the Malaysian capital market is characterised by high standards of corporate governance and shareholder value recognition, the SC will develop and build on its efforts in this area through the following measures:

- Ensuring that there is a facilitative framework that supports the adoption of high standards of corporate governance and the promotion of shareholder value, particularly with regard to the timely and effective implementation of the recommendations of the Finance Committee's *Report on Corporate Governance*
- Promoting shareholder activism through further improving the avenues for minority shareholders to exercise and enforce their rights with respect to the companies they invest in, and encouraging greater institutional investor participation in corporate governance and the promotion of shareholder value
- Further enhancing the awareness of and accountability for the duties and obligations of company directors, financial controllers, management and officers, and strengthening the role of auditors of PLCs
- Ensuring high standards of financial reporting and the continuous disclosure of timely, relevant and accurate corporate information to stakeholders

RECOMMENDATION 108

The recommendations contained in the *Report on Corporate Governance* will be effected in a timely and comprehensive manner

The *Report on Corporate Governance* by the Finance Committee on Corporate Governance is a comprehensive study on the state of corporate governance of PLCs in Malaysia. The report provides the principal recommendations of the Finance Committee that have been derived from this study. These recommendations have been further divided under three specific sections:

(i) **The Malaysian Code on Corporate Governance**. The Code is a self-regulatory approach encompassing principles and best practices of good corporate governance for companies, investors and auditors, and sets out the necessary pre-requisites to encourage compliance with the recommendations thereof. This private sector-led initiative allows for a more flexible and constructive response towards raising the standards of corporate governance, to complement the more specific responses required under statute or regulation. While compliance with the Code is voluntary,

the disclosures that will be required by the revised KLSE *Listing Requirements* in relation to the Code will be mandatory.

(ii) **Reform of Laws, Regulations and Rules**. The report identifies areas within existing laws, regulations and rules where legislative or regulatory reform is required to bring them up-to date with current commercial reality as well as with internationally accepted concepts of corporate governance. Major reforms to the laws and regulatory framework have been recommended in the following areas:

- Duties, obligations, rights and liabilities of directors, company officers, and controlling shareholders
- Adequacy of disclosures and conflicts of interests with respect to transactions that involve the waste of corporate assets
- Enhancing the quality of general meetings
- Shareholders' rights and remedies
- Developing effective governance and enforcement mechanisms within the regulatory framework

(iii) **Training and Education**. The report identifies the education and training needs to raise the level of awareness among directors, company secretaries, members of audit committees and investors as to their respective duties, obligations, responsibilities, rights and liabilities in respect of the governance of companies, and on the application of the Code. In addition, the report also discusses issues such as the agencies identified to conduct the programmes and the funding sources.

To fully reflect the potential benefits which may be derived from the report, it is essential that the recommendations are implemented in a comprehensive and timely manner. The initial impetus to develop the corporate governance standards in Malaysia should not be held back by any undue delays in the implementation programme.

The SC will therefore lead efforts in driving for the timely and effective implementation of these recommendations and will seek to ensure that members of the public are kept apprised of progress of implementation. The various agencies responsible for the implementation of the recommendations of the Finance Committee Report are targeting to complete their tasks by the end of 2001.

Update: The revised KLSE Listing Requirements were issued on 22 January 2001.

RECOMMENDATION 109

The SC will further facilitate efforts towards enhancing shareholder rights, especially those of minority shareholders, and broadening avenues for private enforcement of these rights

In Malaysia, as with many other parts of Asia, companies with large shareholders and owner-manager structures are relatively commonplace. While such organisational structures have been and still are important participants in contributing to economic growth, it is essential to ensure the existence of a system that promotes and preserves shareholder rights and how these rights are enforced in practice.

The Finance Committee, after reviewing the current legal and regulatory framework governing shareholder rights and remedies, has identified a number of additional initiatives that need to be considered. Amongst these initiatives are the introduction of a statutory derivative action and cumulative voting. The SC views the introduction of these initiatives as being critical as these mechanisms enhance investor empowerment by further strengthening the policing ability of minority shareholders.

A derivative action allows shareholders or directors of the company to bring an action on behalf of the company for a wrong done to the company, where the company is unwilling or unable to do so. Currently, a shareholder of a company can only undertake a derivative action under common law. However, the practical difficulties and cost considerations of enforcing this rule have made it extremely difficult for minority shareholders to enforce this right.[111]

This statutory derivative action will not impose a new form of liability on directors, but rather, remove uncertainty and therefore provide for a more effective mode by which directors' duties can be enforced. This ability to increase the scope of private enforcement will also serve to complement regulatory oversight. Furthermore, codifying the derivative action would potentially create a valuable tool to enhance corporate governance and investor confidence.[112]

Under cumulative voting, a shareholder is allowed to cast all his votes for one candidate standing for election on the board of directors (as opposed to casting one vote for each candidate). The shareholder is therefore allowed to cumulate his entitlement to one vote per candidate and cast it all in favour of one director.

Cumulative voting is an important mechanism for providing large minority shareholders, especially institutional investors, with an effective voice at the Board of Directors (by putting their representative on the Board). This allows these investors greater access to information about the company's activities than they would normally be able to obtain from the company's public disclosures.

[111] One major uncertainty in this regard is whether ratification by some shareholders of directors' breach of duty would result in denying other shareholders the right to bring a derivative action.
[112] Other countries such as Australia, Singapore and Canada have also introduced statutory derivative action.

At the same time, it should be noted that whilst cumulative voting can strengthen the monitoring power of large minority shareholders, it is of little direct help to retail shareholders. The idea, however, is that all shareholders benefit if large minority shareholders are able to more effectively monitor management and potential abuse by controlling shareholders.[113]

RECOMMENDATION 110

Minority shareholders' rights in respect of related party transactions will be further strengthened

The conduct of companies with regard to their minority shareholders' rights and the legal framework supporting these rights is a matter of priority in overall efforts towards reinforcing investor confidence in the Malaysian capital market.

Currently, section 132E of the CA prohibits a company from entering into any arrangement or transaction with its director (or a director of its holding company or a person connected with the director) to acquire or dispose of any non-cash asset, unless approval of the shareholders in a general meeting has been obtained. However, these laws allow for a transaction to be ratified by shareholders subsequent to its execution, and do not prevent persons with an interest in the transaction from voting, so long as the interests are disclosed.

While the SC and the KLSE have made revisions to existing rules in 1998 to provide greater protection to the rights of minority shareholders[114], in order to address issues such as those described above, the SC will work towards ensuring the implementation of the recommendations of the Finance Committee that pertain to related party transactions. Among other things, current provisions of the CA which allow voting by interested parties in related party transactions will need to be amended to reflect the philosophy of the relevant KLSE *Listing Requirements*.

The SC and KLSE will also work towards creating an environment that ensures the constant monitoring and enforcement of any breaches in the rules governing related party transactions. All related party transactions will be subject to higher levels of scrutiny to ensure that interested parties act in the best interests of the company and all its shareholders. Furthermore, the penalties for breaches will be reviewed and, where necessary, revised to amplify the deterrent value of the legislation and to ensure that the penalty is commensurate with the offence.

[113] Cumulative voting is currently practised in certain common law jurisdictions such as Canada and some states in the US.

[114] These revisions were made to the KLSE *Listing Requirements*, which among others now require a company to appoint an independent corporate advisor to advise the minority shareholders of the company, whether the transaction is fair and reasonable. The listing requirements also now clearly prevent directors, substantial shareholders and connected persons from voting on any resolution on a related or interested party transaction.

RECOMMENDATION 111

Public listed companies will be required to provide appropriate shareholder value disclosures for securities issuance, restructuring, take-overs and merger exercises

The basic concept of shareholder wealth creation remains a pivotal one to the long-term development of capital markets. In relation to the Malaysian corporate sector, effective shareholder value management may be considered vital given the need to ensure effective corporate restructuring and restrategising, especially in a post-crisis environment, and to reinforce investor confidence in the value-added opportunities of investing in Malaysian companies in general.

In the longer-term, a clearly-defined focus on shareholder value maximisation will enable Malaysian corporations to compete more effectively for global capital, and promote executive compensation structures that encourage the entry and development of skilled labour in the corporate sector. For some companies, focusing on shareholder value can also augment tools for supervisory operations whereby it becomes an explicit factor in daily decision-making at the operational level.

Given that shareholder value maximisation is the fundamental objective of companies, that is, the enhancement of shareholder wealth, it must be further emphasised as a key driver of corporate decision making in the Malaysian capital market. This means that there should be an emphasis for management to focus on long-run value creation, rather than on short term gains.

While much of this responsibility lies in the interaction between companies and their stakeholders, the SC will play an active role wherever possible to facilitate the development of an environment that places due importance on the duty of the company directors and management to enhance shareholder value.

More specifically, this may entail a requirement for management of PLCs to disclose the extent to which their proposals for securities issuance, restructuring, take-overs and merger exercises add value to shareholders. These disclosures could be in the form of a narrative statement of how they apply the relevant shareholder value maximisation analyses to their particular circumstances, as well as certain relevant metrics for illustration.

The specific shareholder value metrics (measures of shareholder value) to be adopted in these disclosures will be left to the PLCs to decide. As such, the management of these PLCs should be allowed to use these principles flexibly, after taking into consideration the varying circumstances of individual companies. However, to ensure clarity and the appropriate treatment in this regard, the SC will facilitate the introduction of standards of best practice for the preparers of financial reports in relation to this requirement in consultation with the industry.

In addition, the SC will also emphasise shareholder value maximisation by:

- Educating company directors and management on the importance of maximising shareholder value, as well as their duties in this regard
- Encouraging investors and investment managers to play an active role in ensuring that the firms they invest in place due priority on value creation, which will provide management with greater incentives to maximise shareholder value
- Promoting the creation of a broader and deeper market for equity capital

Therefore from the regulatory perspective, the shareholder value maximisation concept will be actively promoted to underscore the greater transparency, accountability and performance management needed to elevate corporate practices in Malaysia to more competitive levels.

RECOMMENDATION 112

A set of principles, best practices and standards will be developed to encourage institutional investor activism in corporate governance and the promotion of shareholder value recognition

Institutional investors such as investment management companies, pension and provident funds, and insurance companies, have an important role to play in strengthening the standards of corporate governance in Malaysia, and in promoting shareholder value recognition.

In view of this, substantial efforts have already been made to encourage institutional investor involvement in corporate governance.[115] However, to ensure the effectiveness of these reforms, there is a need to further encourage institutional investors to exercise their voting rights in companies in which they have invested. Institutional investors also should be encouraged to provide disclosure to their investor clientele as to the steps taken to ensure that these companies have undertaken applicable standards of corporate governance and shareholder value maximisation.

As such, the SC will collaborate with specific representative associations of institutional investors to publish a set of principles, best practices and standards for use by the respective members in determining their approach to promoting corporate governance. The proposed principles, best practices and standards should reflect the views of the investment community on the appropriate corporate governance "yardsticks" applicable to the Malaysian corporate environment. In addition, there should be an evaluation of the appropriate shareholder value maximisation disclosures that institutional investors should be required to provide with regard to their investment decisions.

[115] These include measures to promote the independence of the Board of Directors of financial institutions that provide investment services; expanding the fiduciary obligations of the directors of these institutions; reducing these institutions, conflicts of interest and related party transactions; and increasing these institutions' disclosure of information about their investments.

These efforts are intended to be considered with a view to requiring institutional investors to include in their annual reports and/or prospectuses a narrative statement of how they apply the relevant principles, practices and standards to their particular circumstances and to explain any circumstances justifying departure from them. This is to secure sufficient disclosure so that investors and other interested market participants can assess the institution's investment practices and correspondingly make more informed decisions based on this disclosure.

RECOMMENDATION 113

The SC will strongly support the efforts of Badan Pengawas Pemegang Saham Minoriti Berhad in promoting shareholder activism in Malaysia

Investors in the Malaysian capital markets generally lack sufficient information by independent sources on issues relating to the corporate governance standards adopted by PLCs. It is essential for investors to have access to independent and critical analyses of such matters in order for them to be in a position to assess the companies' performance and practices, and respond in an informed manner.

Therefore, the presence of independent shareholder watchdogs is encouraged. Such groups can establish efficient channels of disseminating information, such as through websites and other media, in order to provide minority shareholders with the necessary information required to undertake a comprehensive assessment of the standards of corporate governance practised by PLCs.

The setting up of the Badan Pengawas Pemegang Saham Minoriti Berhad (BPPSM), an independent minority shareholder watchdog group spearheaded by the EPF, is a significant step towards encouraging greater shareholder activism in Malaysia. Its establishment is especially timely given that shareholders, especially institutional shareholders are demanding and pursuing higher corporate governance standards.

The watchdog group's primary role is to monitor and combat abuses by insiders against the interests of minority shareholders. As an organisation representing the largest institutional investors in Malaysia, BPPSM is currently the best candidate to undertake the dissemination of such information to the public, in view of its members' resources, capabilities and access to information on PLCs.

The work that may be carried out by this independent shareholder watchdog group includes the provision of in-depth analyses of governance issues related to PLCs. These issues may include the composition of the Board of Directors of a company and its independence from the controlling shareholders, and advice to shareholders on the pros and cons of recent resolutions put forward by the boards of these companies.

To be effective, this group must not only be structurally independent but should be perceived to be independent, working for the benefit of minority shareholders. In view of this, the SC strongly supports the maintenance of autonomy in all its operations and decisions, and will play a facilitative role to assist the BPPSM to achieve its objectives.

RECOMMENDATION 114

The SC will work with relevant industry bodies in enhancing the quality and independence of auditors of public listed companies

Independent auditors have an important public duty. In arriving at their investment decisions, investors typically place a significant amount of reliance on financial statements prepared by PLCs and audited by independent auditors.

External auditors must perform their services without being affected by economic or other interests that would call into question their objectivity, and hence, the reliability of their attestation. The issue of auditor independence has received significant attention in recent times, particularly in certain jurisdictions such as the US. This has been prompted mainly by evidence of a growing dependence by public accounting firms on fee income from consulting services as well as the increasing number of business relationships between auditors and clients, which call into question the ability of auditors to be independent when discharging their statutory responsibilities.

The conduct and role of auditors for Malaysian PLCs is currently supervised by a number of regulatory and self-regulatory bodies. The MIA has powers to conduct investigations and undertake disciplinary action against auditors such as de-registration, while the ROC may take action against auditors for breaches of the CA. The SC is able to take actions against professional advisors, including auditors, under the SCA and its *Policies and Guidelines on Issue/Offer of Securities* if false and misleading information is found to have been provided in a corporate submission.

A re-examination of the role of auditors as service providers within the Malaysian capital market is timely at this stage. While an auditor's opinion does not guarantee the accuracy of financial statements, it furnishes users of these statements with critical assurance that the information therein has been subjected to rigorous examination by impartial professional accounting practitioners. This is vital in ensuring that the quality of financial reporting is kept at a high level, particularly given the shift towards more market-based regulation.

Going forward, a working group will be established comprising representatives from the SC and other relevant bodies to examine, among other things, the future role and responsibilities of the auditing profession; and to conduct a review of the approach to be taken with regard to the regulation of the profession. Apart from the SC, members of the working group are expected to include MASB, the Malaysian Institute of Corporate Governance (MICG), Federation of Pubic Listed Companies (FPLC), BNM, ROC, the stock exchanges and the Office of the Accountant General, in addition to representatives from the accounting profession such as MIA and MACPA.

The working group will examine the current framework with a view to implementing measures that will enhance auditor quality and independence. Particular attention will be given to the auditors of PLCs, as well as their subsidiary and associated companies, in view of these companies' responsibilities to the investing public.

Among other things, investors should be provided with sufficient information to enable them to evaluate the independence of a company's auditors. In this regard, proposed changes to the current framework will consider the introduction of additional disclosures by companies on the non-audit services provided by their auditors as well as imposing additional reporting requirements by auditors on issues such as fraud. If necessary, the framework will also identify non-audit services that, if provided to an audit client, would impair an auditor's independence. The rotation of auditors within a specified period of time and the establishment of a peer review programme among accounting firms will also be examined.

RECOMMENDATION 115

The SC will encourage the improvement of channels of communication between companies and their shareholders

Channels for the dissemination of information can be as important as the content of the information itself. While the disclosure of information is often provided by legislation, filing procedures and access to information can often be cumbersome and costly.

One approach to mitigating this problem is the setting up of investor relations units by companies to deal specifically with requests and queries by shareholders. This channel of communication between shareholders and their companies will facilitate the transfer of information to investors about corporate issues that they consider relevant to the exercise of their rights as shareholders. As such, the SC will encourage the establishment of investor relations units in PLCs to ensure an effective channel of communication is available for shareholders.

It is also recognised that electronic reporting can benefit businesses by reducing the costs of reporting, enabling more prompt reporting, and facilitating the dissemination of information to a wide audience. In this respect, while an increasing number of Malaysian companies have established websites on the Internet, there exists considerable diversity in terms of content, quality and presentation of information.

The SC encourages the use of electronic media to provide accurate, reliable, timely, up-to-date and readily accessible information to investors. To facilitate the process, the SC will work with KLSE and MASB to provide guidelines on the disclosure of information by PLCs through electronic media.[116]

While the focus of these guidelines will be on financial information, it is recognised that it may not always be easy to divorce the reported financial information from other information produced by the company about itself, or from information produced by other parties about the company. In formulating the guidelines, the SC will strive to achieve a balance to ensure that regulatory concerns are addressed while not imposing an undue burden of compliance on companies.

To further complement these efforts, mechanisms to facilitate electronic filings by listed and other regulated companies with the SC will be implemented.[117]

[116] Regulators in several countries such as France and Canada have introduced similar guidelines on electronic communications and disclosure in recent years.

[117] A number of developed markets such as the US (under the SEC's EDGAR programme) allow electronic access to company filings. This has vastly expanded the accessibility and availability of corporate and financial information about listed companies.

RECOMMENDATION 116

The SC and KLSE will initiate further measures to promote timely, comprehensive and regular dissemination of material and relevant company information to shareholders

A strong disclosure regime is a pivotal feature of effective monitoring of companies and is central to shareholders' ability to exercise their voting and other rights in an informed manner. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting on company-related issues.

Disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime is a cornerstone of a market-based regulatory framework, and can help to attract capital and maintain confidence in the capital markets. Insufficient or unclear information may increase the cost of capital and result in a poor allocation of resources.

Malaysian PLCs must practise a high degree and quality of continuous disclosure in order to ensure that their investors are provided with all material information required for informed decision-making.[118] This principle of ensuring all material information is disclosed in a timely manner is not expected to place unreasonable administrative or cost burdens on enterprises but rather offset the inefficiencies of an imperfect market. Companies are generally not expected to disclose information that may endanger their competitive position, unless the non-disclosure of this information leads to the investors being misled in undertaking their respective investment decisions.

Towards this end, the SC and the KLSE will actively work towards ensuring that directors are appropriately guided to effectively discharge their responsibilities to the shareholders in meeting their continuous disclosure obligations.

In developing such an environment, the SC will use a balanced regulatory approach utilising education, incentives and effective enforcement. Among the initiatives that will be undertaken will be the implementation of a scheme that favours and rewards the practice of high standards of disclosure by providing certain incentives to issuers that maintain these continuous disclosure obligations. Under this scheme, companies that practise high standards of disclosure and corporate governance may be provided easier access to the capital markets through for example, shorter prospectuses. The aim of the scheme is to instill greater discipline among PLCs pertaining to disclosure and corporate governance issues.

[118] Mandatory formal sources of information include announcements and circulars issued pursuant to the continuing disclosure requirements under the listing requirements of the relevant exchange and guidelines of the SC, prospectuses, other documents required to be lodged under the CA and annual general meetings.

RECOMMENDATION 117

Efforts to further enhance disclosures in annual reports by public listed companies will be examined

Given the increasing complexity of businesses today, there is a growing need for annual reports to include comprehensive yet concise disclosures of information that, among other things, analyse and explain the main factors underlying the results and financial position of a company.

Although listed companies in Malaysia already provide a certain level of such disclosure in their annual reports, typically as part of the Chairman's statement, the amount and quality of these disclosures—particularly those relating to non-financial information—tend to vary significantly from one company to another. Some issues that have surfaced in this regard include questions as to the depth and objectivity of the disclosure, a tendency to emphasise only positive developments, and occasionally confusing or incomplete statements.

In order to enhance existing practices, the SC will work together with MASB, KLSE, FPLC and the accounting profession to introduce guidelines to enhance the quality of non-financial information disclosed in annual reports by PLCs.[119] As a minimum, information disclosed in annual reports should incorporate the following characteristics:

- The information should be written in clear and lucid language
- The information disclosed should be balanced and objective, dealing even-handedly with both positive and negative events
- There should be sufficient discussion of individual segments of the business within the context of a discussion of the business as a whole
- There should be a discussion and analysis of the results of operations; trends and factors underlying the business that have affected the results but are not expected to continue in the future; as well as known events, opportunities and risks that are expected to have an impact on the business in the future

Also, although the information in annual reports relate to the year under review, the company should also aim to provide a forward-looking perspective through additional information such as management plans for the future; and an explanation of significant variations between actual business performance and previously disclosed opportunities, risks and plans. Such additional information, accompanied by appropriate and meaningful cautionary statements, and communicated in a responsible manner, will assist users in assessing for themselves the prospects of the business and for investors to have a sound basis on which to make investment decisions regarding the company.

[119] In the UK for example, the Accounting Standards Board has issued a Statement which provides non-mandatory guidance on the preparation of "Operating and Financial Reviews" appearing in annual reports.

REGULATORY FRAMEWORK

Objectives

Significant developments of the regulatory framework of the Malaysian capital market have been made over the last decade and in particular since the establishment of the SC in 1993. Efforts have been directed at streamlining regulation and the reform and promulgation of new laws and regulations. These measures have sought to, *inter alia,* improve the workings of the primary and secondary market, clarify and strengthen the framework for various capital market activities, and facilitate the expansion of market breadth. Significant efforts have also been directed at strengthening investor protection, enhancing disclosure and transparency standards, and improving corporate governance. These have included measures to strengthen and clarify the regulation of take-overs, mergers and acquisitions; enhance the protection of minority shareholders; and increase transparency, fairness and efficiency in the take-over process. In addition, laws on insider trading have been strengthened to cover all persons in possession of inside information and to provide for clear statutory defences where certain prohibitions do not apply so that legitimate and genuine commercial transactions are not inadvertently prohibited by the law. Significant milestones have included the publication of a report on improving corporate governance standards and regulation, which recommended, among other things, the establishment of a Malaysian Code on Corporate Governance.

However, as the capital market grows in complexity and sophistication, and as greater challenges as well as opportunities arise, it is imperative that these efforts to develop the regulatory framework continue, and are specifically directed towards meeting the overall objective of achieving a strong and facilitative regulatory framework. An important aim is to promote a high degree of confidence in the market within an environment that fosters innovation and competition. Toward this end, the SC will pursue a number of specific strategies over the course of the Masterplan.

In particular, efforts will continue to be directed at strengthening investor protection, primarily through the greater empowerment of investors. Measures will be introduced to enhance investor rights and to provide more effective avenues for the redress of grievances by investors. Education will play an important role in making investors more aware of their rights, obligations and the available channels for recourse, and more vigilant with respect to the existence and nature of the risks they face. In order to support these efforts, steps will be taken to ensure that high standards of disclosure and transparency are maintained so that investors are able to make informed choices in both their investment decisions and in their dealings with market intermediaries. Furthermore, continual efforts will be undertaken to ensure that regulation remains effective against market abuses and to ensure high standards of business conduct by market intermediaries. The SC will also:

- implement market-based regulation more widely across the capital market
- ensure regulatory parity and consistency through the adoption of full functional regulation
- further strengthen the enforcement of capital market regulation
- enhance systemic risk management within the capital market

The formulation of a comprehensive programme to gradually implement market-based regulation across all segments of the capital market further builds on the shift in the SC's regulatory philosophy, which, in part, has been reflected in the introduction of DBR for primary market activity. The full adoption of a market-based approach to regulation over the period of the Masterplan represents a clear shift on the part of the SC towards the use of competitive market disciplines and processes, with minimum direct regulatory intervention, in the pursuit of its regulatory objectives. There will be a greater emphasis on more active and risk-focused supervision, stronger and swifter enforcement, and the use of incentive structures to promote a high level of regulatory compliance. Enhanced disclosure and transparency, as well as greater regulatory accountability, will be central features of a market-based regulatory environment. There will also be greater consultation with industry in the formulation of policy as well as regulation in general. In addition, the SC will expect the industry to take a much greater role in market and product development going forward.

A market-based approach will therefore have a strong focus on the cost-effectiveness of regulation, and its pursuit will involve achieving an appropriate mix of regulatory effectiveness and efficiency. For instance, the SC will, among other things, progressively move towards adopting a full DBR regime across the entire spectrum of fund-raising activities, and will pursue a comparable approach for product approval more generally. However, the SC will continue to evaluate the quality of information disclosed to the public to ensure that the market is able to make informed choices over securities and product offerings. Similarly, in the regulation of market intermediaries, the SC will make increasing use of measures to ensure that market intermediaries have strong regulatory and market-based incentives to maintain high prudential standards and to ensure high standards of business conduct, without relying solely on specific prescribed rules to govern their behaviour. At the same time, however, the SC will also enhance its own standards of supervision, and allow for appropriate self- and front-line regulation to support its regulatory functions.

In the long-term, the ultimate aim of adopting market-based regulation will be to have no more regulation than is necessary to achieve the public policy objectives of safety and soundness, competition and the protection of consumer interests. Nevertheless, in embarking on a shift towards the wider adoption of market-based regulation, the need to ensure that there is also sufficient capacity and preparedness in the market is paramount. Implementation will therefore be appropriately managed, in close collaboration with the industry, and will take place in a pragmatic and sequenced manner. The overall progress towards market-based regulation across the capital market will therefore be achieved gradually over time and depend to a great extent on the level of industry readiness and feedback, and on regulatory capacity.

In addition to and concomitant with the shift towards market-based regulation, there will be a need to ensure that the regulation of all market participants in the capital market are subject to consistent regulatory obligations and oversight commensurate with their functional role and risks. As boundaries that demarcate institutions and activities continue to change and the market segmentation of capital market services, in particular, and the financial services sector in general is eliminated, it is important that the regulatory framework displays regulatory parity, in order to achieve competitive neutrality; hence, market intermediaries undertaking similar economic functions and that exhibit similar risks

should face comparable regulatory obligations. Over the course of the Masterplan, the SC will therefore work towards ensuring that the regulation of the Malaysian capital market is "seamless" and based principally on function rather than institutional form. In striving towards this, the SC will work closely with all relevant authorities within the overall financial services sector to ensure that appropriate review and changes are made to resolve potential differences in regulatory treatments as well as to ensure that appropriate mechanisms are in place for greater co-operation and co-ordination between all relevant regulatory authorities.

A move towards market-based regulation will also be supported by active efforts by the SC to ensure that there continues to be strong and effective enforcement of regulations governing the capital market. Stronger enforcement includes action that is timely and impartial with sufficient deterrent penalties. Continual efforts will be made to ensure that proscribed behaviour is clearly and unambiguously defined, and that rules are determined on a prospective basis, and are vigorously and fairly enforced. While the SC has broad powers under various legislations, further enhancements to regulatory capacity will be undertaken so that it is able to conduct its enforcement efforts more efficiently and effectively.

To ensure that systemic stability is not compromised within an increasingly deregulated, liberalised and integrated market environment, a systemic risk management framework will be formulated to ensure a co-ordinated and systematic approach to strengthening the market's capacity to withstand systemic disruption. Given the increase in external sources of risk in recent years, the systemic risk management framework will have an explicit programme for the surveillance of portfolio flows and trading activity in general to enable the early detection of heightened market volatility and other areas of systemic concern. It will also include enhancements and where necessary the further development and implementation of crisis management procedures for co-ordinating responses to crisis situations, should they arise, as well as a programme to identify weaknesses in the market microstructure with a view to reinforcing systemic stability within the capital market.

In order to pursue these aims effectively, the SC recognises the importance of having sufficient capacity and resources within its organisation: given the increasing complexity of the capital market and its network of participants, the SC will ensure a high degree of efficiency within its organisation, which will be characterised by high levels of proficiency and experience within its staff. To this end, the SC will strive to attract and retain high calibre staff with commercial and market expertise in order to enable it to fulfil its role as the capital market regulator effectively.

RECOMMENDATION 118

The SC will put in place a comprehensive programme that will gradually implement a system of market-based regulation across all segments of the capital market

In line with the objective of achieving a strong and facilitative regulatory framework, the SC will, over the period of the Masterplan, formulate and apply a programme to implement market-based regulation across all segments of the Malaysian capital market. This will involve the application of competitive market disciplines and processes in the pursuit of regulatory objectives, with minimum direct regulatory intervention. In doing so, capital market regulation will make greater use of, among things, appropriate incentive structures to induce market participants to behave in a way that is consistent with the objectives of maintaining systemic stability, ensuring strong investor protection and upholding market integrity. These incentives will award high compliance with lighter supervision and less direct intervention by regulatory authorities. As a result, regulation would not only be more efficient but also be more responsive to market developments and facilitative of innovation and greater competitiveness.

Nevertheless, in remaining vigilant and pro-active in its oversight of the capital market, the SC will ensure that the adoption of a more facilitative regulatory stance towards market competition and innovation in no way compromises investor protection, the integrity of the market and the systemic stability of the overall financial sector. Thus, the SC will ensure that appropriate regulatory safeguards, including the threat of swift enforcement action, continue to be in place within the market-based approach.

Along with these efforts, strong measures will continue to be taken to strengthen the framework for investor protection. While this has seen significant enhancements in recent years, future efforts will seek to improve investor empowerment through measures that will further enhance investor rights, enhance the scope for private enforcement channels and foster greater awareness and education over rights, responsibilities and avenues for redress. Efforts to enhance disclosure and transparency will focus not only on facilitating more informed investment decisions, but also on promoting a high degree of confidence among investors on the integrity of issuers and market intermediaries.

Investor education will also be promoted further to facilitate greater awareness and understanding of the scope and nature of risks in the market. Among other things, the SC has already established a Technical Reference Panel to handle complaints as well as investor alerts to increase information flows to and from investors. These, as well as other mechanisms to increase investor awareness, will be enhanced going forward.

Elements of a market-based approach to regulation are already incorporated into the SC's current regulatory philosophy and are reflected in certain aspects of the regulatory framework. In the primary market, DBR has been gradually introduced for the issuance of securities and will be fully-incorporated into the regulatory framework. This will involve a shift from an environment in which the SC regulates a securities offer by reviewing and

determining its investment merits to one in which the SC regulates the quality of disclosure, and where investors determine the merits of the offering. A similar approach will be pursued for product approval more generally, including the introduction of investment management products.

While the replacement of minimum liquid funds requirements for stockbrokers with Capital Adequacy Ratio (CAR) has introduced an element of market-based regulation to intermediary supervision, the SC will be adopting a more comprehensive approach that will see the increased use of market discipline to improve prudential management and the pursuit of high standards of business conduct. In broad terms, this will involve ensuring that there are appropriate incentives in place for market intermediaries to act in such a way that is compatible with regulatory objectives. This will be accompanied by enhanced supervision to reinforce the signal that market activity is being carefully and closely monitored. There will therefore be stronger surveillance of business activity as well as an increased focus on risk-based supervision, that is, on assessing the capacity of market intermediaries and institutions to manage their risks; in particular, supervision efforts will focus on appraising a firm's internal controls and the soundness of its operations and processes. In addition, stringent qualifying criteria will continue to form the basis for market entry.

Under a market-based framework, front-line regulation by market institutions and self-regulation by industry associations that set and enforce rules governing the conduct of business and financial resources of their constituent members will be an important complement to market supervision by the SC. The SC will itself take a more direct regulatory approach, however, where the significance of a particular situation warrants the SC taking the lead, or when the circumstances of the market as a whole has to be considered. In operating front-line and self-regulation programmes, the SC will enhance its review and oversight of audit and compliance programmes by FLRs and SROs, for instance, in the areas of: the effectiveness of compliance mechanisms; the timeliness of investigations into market misconduct and other inappropriate market activities by members; and the redress of market users' complaints. This may include, for instance, impromptu examinations by the SC of member companies and other regulated entities in order to assess the efficacy of front-line and self-regulation.

A market-based approach to regulation will also entail, among other things, greater transparency of the regulatory process in general and public dissemination of SC's policy views on issues. This will include regular public consultation on rule-making and a more explicit and public assessment of how new or amended regulation will affect the relevant market stakeholders. These and many of the points above which have been raised in the context of moving towards a full market-based regulatory environment are not exclusive to a market-based approach; but together, they provide critical support to the adoption of market-based regulation. Where relevant, separate recommendations concerning these issues have been formulated and elaborated in this section and elsewhere in the Masterplan.

RECOMMENDATION 119

SC will maintain the existing regulatory structure in relation to arrangements for the regulation of wholesale and retail markets

The current regulatory framework for the securities and futures markets recognises the linkage between the wholesale and retail segments of the markets. Consequently, the securities laws have always centralised the regulation of these markets in one single regulator. Hence, prior to 1993, the regulation of these markets were vested in the ROC, and consequent to the establishment of the SC in 1993, in the SC as the regulator over the securities and futures markets.

However, it has been argued that the structure of capital market regulation ought to explicitly reflect wholesale and retail activities, on the basis that the participants in the wholesale market are licensed financial institutions and are already subject to some form of prudential regulation. The argument is that the market regulation concerns for such wholesale market (eg, where government debt papers and corporate bonds are traded) may justifiably be differentiated from the regulation of markets where retail participation is concentrated.

While it is recognised that the extent and type of regulation appropriate for the wholesale and retail sectors are different, the experience of financial markets suggests that a high degree of prudence with regard to wholesale market regulation is still warranted. Events such as the collapse of Barings, significant losses at Daiwa, some of the customer disputes experienced by Bankers Trust and investigations into market manipulation of the copper market all reinforce the importance of conduct requirements aimed at maintaining orderly markets and creating a culture of compliance in wholesale markets.

There are additional drawbacks to proposals of having separate regulatory structures to address wholesale and retail activities in the capital market. First, the same institution may be engaged in transactions in both the wholesale and retail markets. Such a separation would necessitate market participants to restructure their businesses into clearly wholesale and retail components, neutralising regulatory efforts to eliminate extraneous segmentation between capital market activities, and reducing regulatory capacity to take effective enforcement action where market misconduct crosses such classification boundaries. Second, there are important links between the wholesale OTC markets and the public markets, with evidence from other jurisdictions indicating that transactions in the fixed interest and other wholesale markets have significant impact on the publicly-traded derivatives and equity markets. The growth in institutional fund managers also means that wholesale market activity directly influences the returns of retail investors held in managed funds.

Other capital market jurisdictions have recognised the linkage and in fact ensure a single regulatory structure for the wholesale and retail segments of the capital market. Nevertheless, in its approach, the SC recognises that the objective of regulating the wholesale markets is to ensure that the markets operate in an orderly manner and is free from abuses. There is, accordingly, less need for detailed individual disclosure requirements

and other conduct rules required at the retail end of the market. Retail market regulation is designed to redress the imbalances of information or issues arising from the fiduciary nature of investment management and advice relationships that often exist.

Accordingly, the current structure of regulation in relation to existing arrangements where the SC regulates both the wholesale and retail securities markets will be maintained. The SC will continue to adopt a holistic regulatory approach towards the securities markets, while ensuring that the requirements for retail transactions are not inappropriately applied to the wholesale markets, and that the regulation of the wholesale markets focuses on ensuring orderly markets and preventing misconduct.

RECOMMENDATION 120

Relevant identified market institutions will be established as full front-line regulators to complement the SC's role in the regulation of capital markets

FLRs are a valuable complement to the role played by the SC in achieving the strategic initiative of moving towards a more market-based regulatory approach, and has been recognised through the introduction of an FLR programme by the SC. As FLRs, market institutions will be able to exercise more direct responsibility for their respective areas by formulating and managing the rules and regulations relevant to their particular areas of concern. This introduces more flexibility and greater responsiveness to market conditions and market evolution into the regulatory system compared with a framework based on statutory regulation.

However, front-line regulation is typically restricted to the application of rules to specific market participants, such as market intermediaries. Statutory regulation, on the other hand, is capable of being applied to all market participants. Therefore, a balance between the two methods of regulation is needed to achieve cost-effective regulation of market conduct, whilst ensuring effective investor protection and market integrity.

Within this context, the SC will develop further, where appropriate, the concept of front-line regulation which will enable current market institutions to exercise more direct responsibility for their respective areas. Undoubtedly, a clear delineation of the roles and responsibilities between the SC and the FLRs is necessary to ensure that the regulatory system does not become over-burdensome to market participants. Ultimately, the level of self-regulation undertaken by an exchange and clearing house in assuming its role as a FLR will depend on its ability to ensure the protection of market integrity, with particular emphasis on investor protection; observe ethical standards in its market practices; and offer considerable depth and expertise regarding market operations and practices within its own organisation; and respond pro-actively, quickly and flexibly to changing market conditions.

Nevertheless, the FLRs will continue to fall under the oversight of the SC to ensure that they maintain the required standards when exercising their powers and delegated responsibilities. The SC, for its part, will structure appropriate incentive mechanisms to ensure that the FLRs undertake and perform these regulatory responsibilities efficiently and effectively. It will also periodically assess the exchanges' and clearing houses' capacity and capability to carry out their roles as FLRs, and will intervene where there has been failure to ensure that these responsibilities are met.

RECOMMENDATION 121

Appropriate industry associations will be identified and recognised as self-regulatory organisations to complement the SC's regulatory functions

Self-regulation is considered one of the most effective ways to regulate markets. Going forward, the SC will be introducing a SRO programme as a vital complement to the oversight role of the SC. Indeed, under section 15 of the SCA, it is the SC's statutory duty to promote self-regulation by professional associations or market bodies in the securities markets.

The cornerstone of effective self-regulation for market intermediaries is robust enforcement against those who have breached the rules of conduct laid down by the SROs. It is envisaged that SROs institute compliance and enforcement programmes that include the development of appropriate mechanisms to ensure compliance with rules, as well as enforcement and other appropriate means of response to breaches of rules. Such mechanisms include making the acceptance of and compliance with SRO rules a condition of continued membership of these organisations, and ongoing assessments or audits to verify an intermediary's compliance.

In addition to the benefits of peer regulation, the SRO programme will also pave the way towards granting SROs the responsibility of regulating certain operational processes, thus allowing for more efficient regulation of the capital market. One possible initiative is to provide recognised SROs with the authority to undertake the licensing of certain individuals and institutions involved in the securities and futures industries. At present, all licensing of relevant employees of stockbroking companies, fund managers and investment advisers is statutorily vested in the SC. However, when a SRO has developed sufficient regulatory capacity and a high standard of professional conduct, SROs could be considered for undertaking such licensing functions over time.

RECOMMENDATION 122

Further efforts will be pursued to achieve regulatory parity in the treatment of all participants in the capital market through functional regulation

In order to achieve regulatory parity—and hence competitive neutrality—across all participants in the capital market, concerted efforts must be made to ensure that regulatory obligations of all capital market participants are commensurate with their respective functional role and risks. While banking and capital market activities can continue to be directly regulated under their respective regulatory regimes, market regulation must remain effective even as traditional distinctions between different types of intermediaries within the financial system gradually disappear.

Regulation principally based on function rather than institutional form is important given the fact that many financial institutions currently engage in a wide range of broker-dealer, investment management and investment advisory activities that are comparable to, and competitive with, the services of licensed stockbroking companies, licensed fund managers and licensed investment advisers. However, existing securities laws exempt such institutions from the provisions of the law in particular with regard to licensing requirements. This raises a discrepancy in the regulation of financial services, in which institutions providing similar services and which carry similar risks are regulated differently. Because institutions and intermediaries providing like services and products are subjected to differential regulatory requirements and standards, this also affects the competitiveness of these institutions and intermediaries against one another.

The regulatory framework must encourage competition and innovation among not just capital market intermediaries but also within the financial system as a whole, while at the same time making certain that there are no regulatory gaps or overlaps in addressing issues of investor protection and market integrity. It is crucial therefore that securities laws in particular, and the regulatory framework in general, explicitly recognises and applies consistent regulatory obligations for all participants in the capital market that assume similar functional roles and risks. This would mean that intermediaries engaged principally in capital market activities would be subjected to capital market regulation to ensure that the appropriate regulatory principles are effectively applied in the regulation of these intermediaries. In addition, intermediaries engaged principally in capital market activities must be subject to oversight by the capital market regulator, directly or as the lead regulator where co-regulation exists. This will serve not only to enhance the competitiveness and efficiency in the financial system, but also to promote a high level of confidence in it.

To achieve functional regulation within the capital market, the SC will work closely with all relevant authorities within the overall financial services sector to ensure the appropriate review and changes are made to resolve potential differences in regulatory treatments as well as to ensure that appropriate mechanisms are in place for greater co-operation and co-ordination between all relevant regulatory authorities. This will be especially important

[120] The issues raised by the emergence of financial conglomerates have been comprehensively reviewed and analysed in the De Swaan Report of the Tripartite Group that comprised an informal group of regulators. The Tripartite Group came to the unanimous view that, while the solo supervision of individually regulated entities should continue to be the foundation for effective supervision, there is a need for the various supervisors to establish a co-ordinated approach to supervision so that a prudential assessment can also be made from a group-wide perspective.

in cases where difficulties arise in determining the appropriate regulatory approach towards financial conglomerates that conduct a wide range of businesses, and as segmentation within the overall financial system is gradually removed.[120]

RECOMMENDATION 123

Efforts to create a single licensing regime and consolidation of securities and futures legislation will be pursued

Malaysian securities legislation requires the licensing of the various classes of capital market intermediaries by the SC. The licensing requirement is an important regulatory tool because of the important role that capital market intermediation plays in facilitating liquidity and carrying out regulatory "gatekeeping" functions.

Although technology and competition may inevitably lead toward some disintermediation, regulation of the capital markets should be accomplished with recognition of the importance of financial intermediation and the regulatory framework should not inhibit the intermediaries' ability to perform that role. In this regard, the exact functional scope of the intermediaries' role should be ultimately determined by competitive market forces.

Therefore, the existing multiple licensing regime for securities and futures intermediaries will be reviewed with a view to creating a common regulatory framework for all intermediaries. This would involve the revision of licensing provisions in the SIA and the FIA, including policies on the admission criteria and scope of activities for such intermediaries.

The SC will also study the possibility of consolidating the various securities and futures laws over the longer-term into an omnibus legislation for the capital market to further enhance regulatory consistency in the treatment of capital market participants and activities. Given the increasing inter-linkages that are becoming prevalent across capital market products and activities, a consolidation of securities and futures legislation would further ease the application and understanding of law by all capital market participants, and would ensure effective and consistent regulation, and facilitate enhanced supervision and enforcement of the capital market.

RECOMMENDATION 124

Measures to eliminate market segmentation in respect of underwriting, corporate finance, asset management and brokerage services will be introduced

Innovation in products and technology, as well as increased consumer sophistication, are combining to challenge the traditional segmentation of financial services. Intermediaries today are increasingly expected to deal in and advise on securities, futures and other investment products. Effective financial services regulation should therefore allow for rigorous competition among all market participants. To this end, changes will be made to facilitate the broadening of services catering to the primary and secondary markets in securities through the removal of market segmentation with respect to the provision of underwriting, corporate finance, asset management and brokerage services. In addition, the SC will work with other relevant authorities in the financial system to ensure that segmentation within the overall system be further liberalised to promote greater competition.

In this regard, it is envisaged that as merchant banks develop as full service investment houses and stockbroking companies as UBs, they should have meaningful opportunities for market participation. It should be noted that, in order to be effective, intermediaries involved in capital market intermediation activities must be allowed to engage in entrepreneurial, risk-taking activities crucial to the capital formation and intermediation process as long as investor protection, market integrity and systemic stability are not compromised. Regulation of these intermediaries should be, therefore, based on capital market regulatory objectives and subject to similar oversight. In certain jurisdictions, capital market-based activities such as those undertaken by investment houses, are commonly structured within subsidiaries that are directly regulated by the capital market authority. Accordingly, as part of broader efforts to the consistent application of regulatory obligations to capital market participants, the SC will work closely with relevant authorities to ensure the harmonisation of regulatory requirements in relation to underwriting, corporate finance, asset management and brokerage services, as well as to ensure more broadly that an appropriate regulatory regime exists for the regulation of these intermediaries.

RECOMMENDATION 125

Cross-market surveillance as well as co-operation and co-ordination between regulatory authorities should be enhanced to strengthen market oversight, and to ensure the consistency and effective pursuit of regulatory objectives and priorities

Inter-linkages among various components and players of the financial system, as well as between the financial system and the broader economy have strengthened and become increasingly complex in recent years. The existence of these linkages has placed a greater premium on regulatory harmonisation and consistency, particularly as a result of the growth in cross-market and cross-border activity, and the blurring of traditional distinctions between market players. Issues such as these must be resolved in order to ensure that the capital market's potential for growth is not unduly encumbered by regulation.

There is a need therefore to ensure enhanced cross-market surveillance and increased co-operation and co-ordination between the SC and other agencies involved in the regulation of the financial system. In broad terms, better overall monitoring of sources of risk within the financial system as a whole and improved regulatory collaboration supports the objective of developing a more facilitative and stronger regulatory environment. In particular, they facilitate effective functional regulation by enhancing the efficiency of regulation and supervision of intermediaries conducting capital market activities and by reducing any undue burden arising from a duplication of regulatory efforts and by facilitating the development of more consistent prudential and regulatory standards.

Various modalities may be considered to ensure effective co-ordination and enhance mutual assistance and co-operation. Many developed capital markets use memoranda of understanding (MOUs)—commonly entered into between the banking, securities and corporate regulator—to delineate the responsibilities of the various agencies particularly in areas of supervisory overlap or lacuna in order to ensure clear accountability on specific issues. Some, particularly those with a large number of financial conglomerates, have sought to avoid large-scale regulatory reorganisation, but to allow for adaptation to market developments and a clear focus on the objectives of supervision, through the formation of a forum for regular consultation between the various financial authorities.

To a certain extent, the SC's current board structure already fosters closer co-ordination and co-operation among various regulatory and statutory agencies. Those appointed to the SC's Board of Commissioners comprise high-level officials from BNM and the MOF. Such relevant agencies are able to participate at the broad decision-making level of the SC, bringing with them the expertise and experience of their respective agencies. Going forward, there must be administrative mechanisms to ensure better regulatory management of the financial system overall, as well as improved policy co-ordination at the micro and macroeconomic level. In addition, appropriate mechanisms might also be set up to prescribe a protocol for information sharing to enhance cross-market surveillance.

RECOMMENDATION 126

Measures to enhance regulatory transparency, accountability and independence will be introduced

The SC is entrusted with a wide range of powers that enables it to make decisions that have an impact on market participants and the environment within which they operate. It is therefore essential that such powers be accompanied by a strong measure of regulatory transparency, accountability and independence.

As a fundamental pre-requisite to an efficient and transparent market, regulators must ensure that information regarding the institutional arrangements for the regulation, supervision, and the oversight of the capital market is provided to all interested market participants on an understandable, accessible and timely basis. The SC is guided by the SCA's provision relating to its objectives, functions and general duties, and aims to promote transparency in its policy and administrative activities. However, as part of its work, the SC is necessarily subject to secrecy and confidentiality requirements of the law, and specific information cannot always be publicly disclosed. In addition, the SC is accountable to the Minister of Finance and is required to present its annual accounts to Parliament. Decisions of the SC are also subject to judicial review. These arrangements provide mechanisms for public accountability by the SC.

In line with the shift to a more market-based regulatory environment, the SC will identify, where possible, additional mechanisms to further enhance regulatory transparency and accountability by assessing the scope for enhancement in certain areas. Amongst others, these areas include the disclosure of its obligations and duties; the modalities of its accountability; its relationship with other regulatory agencies, the government and SROs; codes of conduct of the staff of the SC as well as any rules concerning the prevention of conflict of interest.

Another mechanism of transparency is the establishment of public consultation in cases of substantive technical changes to the structure of capital market regulations. To a certain extent, the SC has already undertaken such consultation in the promulgation of new guidelines and regulations. Going forward, the SC will take further steps to ensure more effective dialogue and consultation between the regulators and market participants to identify and address issues of common concern, the application of new laws and their interpretations. These processes might, among others, take the form of an exposure draft which will be published for public perusal and input where necessary. In doing so, regulation will be more sensitive and responsive to the market dynamics inherent in the raising and investment of capital, to truly assist the creation of a more competitive and efficient Malaysian capital market. Hence, the aim of improving regulatory accountability going forward will be to achieve greater disclosure to the market, as well as a better understanding of policy decisions by relevant stakeholders.

RECOMMENDATION 127

Measures will be introduced to enhance processes and capabilities for effective enforcement

An important element of market-based regulation is strong supervision of market intermediaries and effective enforcement. Effective enforcement of securities laws ensures that investor rights are protected, and that confidence in the integrity of the market is maintained at all times. This serves to raise the quality of financial services in the country and promotes further confidence in the capital market.

Enforcement action that is seen to be timely, impartial and carrying sufficient deterrent penalties provides a strong incentive to comply with regulation and to exercise best industry practices. At the same time, the SC is also aware that self-enforcement through strong peer pressure within groups of regulatees is another useful compliance mechanism against those who might be inclined to breach regulation and deviate from best practices. The SC will therefore adopt an even more proactive stance towards enforcement and supervision. Monitoring functions will be enhanced to ensure the SC and, where relevant, FLRs, are able to anticipate possible future transgressions with a fair degree of certainty and through early intervention—in the form of advice, warnings, required compliance reports and undertakings and so on—to prevent them from taking place.

The ability to enforce efficiently and swiftly depends as much on the tools available as on the jurisdiction to cover the range of potential capital market transgressions. Under its governing laws currently, the SC is equipped with a host of enforcement powers to ensure effective enforcement. Within these laws, the SC may, among other actions, initiate investigation, commence criminal prosecutions with the consent of the Public Prosecutor, institute civil proceedings and apply to the court for restraining orders in relation to activities of a licensed person, impose and compound penalties, and suspend or revoke approvals or remove persons from acting as corporate officers.

However, given the dynamic nature of the capital market, and the potential for new forms of transgressions as a result of technological and other developments, the SC will continually review the laws governing fraudulent activities and market abuses to ensure that investor protection concerns are not compromised at any stage of the development of the market. The SC will, for instance, consider remedies as an option to ensure swift and immediate action to prevent further abuse or damage to the market and its investors. Many regulatory authorities have adopted regulatory tools such as injunctions, cease and desist orders, and restraining orders in which immediate action may be taken in the case of a suspected or anticipated market transgression. Other possible regulatory tools include requiring undertakings from individuals over their obligations under the law, a digression from which would be legally enforceable.

Mechanisms for dispute-resolution will also be enhanced through administrative means. Tribunals and the office of an ombudsman are some of the mechanisms which are becoming increasingly popular in more developed capital market jurisdictions and their usefulness within the context of Malaysia's capital market will be reviewed by the SC.

Administrative mechanisms would allow for easier access for investors to seek redress in terms of cost and time. Therefore, the SC will assess the viability of introducing such administrative dispute-resolution mechanisms.

In addition, the SC will also aim to provide further clarification on the application and parameters of securities laws, in an effort to improve market participants' understanding of the regulatory framework, and to reduce uncertainty in order to promote higher standards of business and market conduct. Amongst others, proscribed behaviour will be clearly and unambigously defined so that market participants can have a firm understanding of what the rules are to ensure that a reasonable person is capable of determining whether their action is permissible within the law. Predictability in the regulatory regime will serve to promote greater certainty in market activities.

To complement the enforcement actions available domestically, the SC will further improve cross-border surveillance, monitoring and enforcement capabilities. The globalisation of markets increasingly requires a higher degree of cross-border co-operation and information sharing between market regulators: technological developments and the advent of globally-active financial conglomerates, for instance, have increased the scope for enforcement action across several jurisdictions. Going forward, the capacity for regulators to undertake strong enforcement actions, surveillance and monitoring will require further enhancement.

RECOMMENDATION 128

Measures will be taken to enhance the enforcement capacity of the SC

The conduct of enforcement is typically resource intensive. However, the growing complexity and dynamism of financial activity have added further pressure on the enforcement function of market regulators. Among other things, the globalisation of financial activity, aided by advancements in financial as well as communications technology, has seen rising numbers of transactions that cross different geographical and jurisdictional boundaries; previous distinctions between institutions and between the kinds of activity they conduct are becoming increasingly blurred; and there is an increasing number of ways of gaining access to markets, and a wider array of media through which market activity can be performed.

These trends suggest that the enforcement function of regulators must have the capacity to handle an increasingly wider and more complex set of factors—for instance, the ability of players who are concurrently active in several markets, whether based on asset-classes or geographical location, to exploit regulatory loop-holes relating to supervision and enforcement across different jurisdictions. Hence, enforcement is an area that the SC will be continually upgrading over the period of the Masterplan. In particular, strong efforts will be directed at improving the ability to analyse and understand market activity and processes better in order to detect early warnings of risks, instability and non-compliances. The aim in this case would not be the total elimination of risks but rather the timely anticipation of inherent risks which may give rise to future problems.

An important aspect of enhancing the SC's enforcement function will be to enhance the skill of its enforcement staff further. It will continue to seek, recruit and retain high-quality and competent staff, and develop a programme for on-going training in relation to surveillance, monitoring, investigation and prosecution capabilities. A key objective will be to ensure that staff members are equipped with up to date knowledge and information on financial transgressions which are becoming more complex in their execution. Furthermore, the SC will continue to ensure that it maintains high standards of professionalism and efficiency.

RECOMMENDATION 129

The regulatory framework will be enhanced to provide for appropriate mechanisms for systemic risk management

The environment in which the financial system operates has become increasingly complex and dynamic. As the East Asian and other international financial crises have shown, sources of systemic risk can no longer be neatly packaged. Disturbances across the broader financial system and the macroeconomy can adversely affect the smooth-functioning of markets, which in turn increases systemic stress to the capital market. These disturbances involve, among other things, asset-specific and cross-asset volatility, severe weakness among financial intermediaries and a sharp decline in market confidence.

In light of these issues, the regulatory framework will be enhanced to manage the risk of systemic disruption, in particular, through enhanced surveillance of market activity and processes, and the identification of areas of risk concentration. This will include the regular monitoring and analysis of, among other factors, areas of potential weakness in the market microstructure, patterns of trading activity, the impact of portfolio flows, the behaviour of major market participants, the accumulation of destabilising pressures within the market as well as broader economy, and developments in the international environment in order to detect risks to capital market stability.

Toward this end, appropriate mechanisms will be established to facilitate a full and timely analysis of market and economic conditions. Where necessary, information will be further collated from a wide range of external and internal sources into a comprehensive historical and cross-sectional database, and regularly monitored. Information will cover, among others, indicators of financial soundness of market participants and detailed as well as consolidated views of market activity to allow for a better understanding of the health of the capital market at any point in time.

In addition, appropriate procedures will be formulated to ensure the timely reporting of an increase in systemic risk, and to have at hand appropriate operational and policy responses in the event a crisis occurs. These will include the introduction of explicit operational processes within the SC as well as the establishment of formal and informal arrangements between the SC and other regulatory agencies and relevant industry participants.

RECOMMENDATION 130

The SC will develop a regulatory framework for the implementation of electronic commerce in the capital market

Given the pivotal role that e-commerce is likely to play in the capital market going forward, a comprehensive regulatory framework with regard to the application of such technology within the capital market is vital for ensuring regulatory clarity and facilitating innovation. At the same time, the SC takes the view that the development of this framework must be a collaborative effort between the public and private sectors so as to be able to determine the proper level of regulation. This was demonstrated in the publication of the SC's consultation paper for the *Framework for the Implementation of Electronic Commerce in the Capital Market* in March 2000, which forms the basis of the regulatory framework for the implementation of e-commerce in the capital market.

Update: Based on the feedback obtained since its publication, the SC has already begun implementing the recommendations made in the consultation paper through the formation of working groups to implement the various recommendations. The membership of the working groups and the consultation process with relevant stakeholders ensure the implementation continues to be a collaborative effort between the public and private sectors.

RECOMMENDATION 131

The SC will introduce measures to improve the assessment of regulatory cost-effectiveness

Cost-effective regulation is key to the effective functioning of any capital market, and is consistent with a market-based approach to regulation in which there is no undue regulatory burden on participants in the capital market. Although the benefits of regulation are difficult to value with any precision, many of the outcomes of regulation are akin to intangible assets such as reputational value. The benefits of such cost-effective regulation arise from, among other things, greater certainty in private arrangements, reduced monitoring and screening costs, and the heightened international profile of Malaysian markets and participants. More generally, they also boost investor and issuer confidence in the Malaysian capital market, and benefits that flow from mutual recognition by overseas regimes of our standards and requirements for internationally active entities.

To ensure that the regulation of the domestic capital market continues to be carried out in a manner that entails the least collective cost to those affected by it, and remains consistent with a market-based approach, the SC will put in place appropriate mechanisms for compliance cost and performance assessment. This will be done through structured

performance assessment and to ensure practitioner and user input into the systematic review of the regulatory effectiveness of major regulatory programs. The main thrusts of such a comprehensive framework for assessing cost-effectiveness will address:

- The criteria for assessing whether the regulatory requirements achieve the outcomes desired
- The efficiency with which these requirements are delivered, and in so doing, will take into account not merely the direct costs but also the full range of indirect costs and benefits
- An assessment of the costs and benefits over time rather than as a static exercise and taking into account those costs which would be incurred as part of good business practice in any event
- In undertaking international comparisons or benchmarking, the need to take into account differences in size and structure of the different markets
- The actual costs to market users of undertaking cost-benefit evaluations

RECOMMENDATION 132

A five-year review to monitor effectiveness of regulatory structure and framework will be conducted

The regulatory system can be expected to evolve over time as the markets mature and institutions themselves modernise. Although the SC continually reviews the efficiency and effectiveness of the capital market regulatory framework, it must also have the powers and flexibility to develop rules and regulations as the market evolves to achieve the objectives and strategic initiatives as set forth in the Masterplan.

The review process will co-opt experts in law, commerce and finance to assist and advise the SC on an ad-hoc basis, as well as for a stocktake review. The latter review should take place every five years to ensure that the regulatory structure and framework in place is meeting the needs of the financial markets and the aspirations and goals of the Malaysian economy. An advisory committee would submit its proposals to the SC for it to evaluate and assess how the regulatory framework for the capital market can be further improved.

RECOMMENDATION 133

A comprehensive review of the current tax framework relating to the capital market should be carried out

Taxation has a pervasive influence on the capital market in that it has a fundamental impact on the investment and business decisions of market participants. At the same time, globalisation and the increasing embrace of e-commerce offer companies additional options in their choice of national base so that international differences in business tax systems will play a greater role in that choice, and exert greater pressure on Malaysia's competitiveness, thus raising the premium on an efficient tax framework.

It is therefore necessary for the taxation framework to evolve to provide a foundation that is able to adapt to a changing and increasingly sophisticated business environment, and facilitates the future development of the Malaysian capital market. Going forward, key features of the framework must include neutrality, transparency, efficiency, simplicity and certainty.

Therefore, a comprehensive review of the tax framework in Malaysia should be carried out to support the vision of developing an internationally competitive and efficient capital market. The review should address current taxation philosophy and bases, and consider issues such as tax neutrality; the application of core principles to accommodate financing from an Islamic dimension as well as those arising from e-commerce and the use of technology in capital market activities, which create singular difficulties in terms of pinpointing individual taxable transactions and the tax jurisdiction in which they occur.

It is worth noting that in the last 10 to 15 years, countries such as Australia, New Zealand, the UK and Singapore, which share a common heritage in income tax legislation, have modified their tax rules for the determination of taxable income to accommodate developments in financial market instruments.

As an interim measure, advance ruling procedures should be considered for the purposes of establishing the income tax profile of new transactions and products. This will promote an early and informed consideration of complex financial transactions by specialist personnel with expertise and knowledge of the capital market. An advance ruling on the tax treatment of particular transactions is particularly pertinent in the context of the current transition to a self-assessment system. In fact, advance ruling procedures are essential components of self-assessment systems in the United States, the United Kingdom and Australia, as well as more matured jurisdictions which have not fully introduced self-assessment systems such as Canada.

TECHNOLOGY AND E-COMMERCE

Objectives

Advancements in information technology (IT) and the subsequent development of e-commerce are driving significant changes in many aspects of the capital market. These changes affect the operation and structure of markets, the roles and relationships between exchanges, intermediaries and investors; and the product scope of markets. In particular, new technology is leading to the creation of new competitive structures, facilitating cost-savings, allowing for greater market efficiency and creating easier accessibility to markets.

The profound impact of the Internet on the capital market at national, regional and global levels has played a major role in generating major new opportunities and challenges for market participants. Technology has also facilitated the development of ATSs that compete with more traditional exchange structures, particularly in the US and Europe, by providing cost-effective order-driven electronic screen trading virtually 24-hours a day. This has prompted market institutions the world over to undertake major changes not only to their systems, but also to their governance structures, in order to remain competitive.

Malaysia's capital market intermediaries and institutions must therefore be able to navigate this new environment successfully by keeping attuned to the present and potential opportunities afforded by available state-of-the-art technology, and by adopting business strategies capitalising on such applications to generate added value and accelerate growth. Where the greater ease of access afforded by technology and e-commerce have actually increased pressure for greater disintermediation of capital market activity, these forces will compel market intermediaries to restrategise and possibly restructure themselves in order to remain relevant in this new economy.

To a large extent the Malaysian capital market already makes extensive use of technology. Indeed, many key aspects of the capital market infrastructure, such as trading, clearing and settlement and depository systems, had already moved to electronic platforms by the beginning of the 1990s. Moreover, Malaysia has achieved significant progress in its policy framework for the New Economy. For instance, Malaysia's cyber-law framework is comparatively advanced in relation to many other economies, in particular, the Communications and Multimedia Act 1998 and the Digital Signature Act 1997. However, given the dynamic nature of technology and the threat of a widening "digital divide" between industrialised and developing economies, it is critical that the Malaysian capital market continues to maintain and extend its relative advantage wherever possible.

To do this will require an industry-wide effort in which market participants and the authorities work in close co-operation. The SC has taken the first step in this effort by issuing a proposed *Framework for the Implementation of Electronic Commerce in the Capital Market* for market feedback, in order to initiate co-ordinated discussion on the orderly and effective implementation of e-commerce in the capital market.

Following from this, the recommendations that follow aim to:

- Promote continued technological innovation in the capital market
- Enhance the efficiency of market infrastructure
- Facilitate the acceleration of capital market development

The recommendations take into account the need to use scaleable technologies, effectively integrated and enhanced legacy systems, the adoption of international industry standards, and safeguarding the robustness and security of systems. Due to the dynamic nature of technological changes taking place, the SC will work closely with the public and private sectors in achieving a balance between enterprise and regulation, but with a view towards facilitating the greater use of innovation and technology in supporting overall market development.

RECOMMENDATION 134

Capital market regulation will be technology-neutral and facilitative of innovation

In line with the national agenda of pursuing the development of technology and e-commerce, a proactive approach in promoting the use of technology and e-commerce in the Malaysian capital market will be adopted. The SC, in conjunction with the relevant authorities, will review and amend regulatory provisions to enhance regulatory clarity while encouraging the development and implementation of technology in all aspects of the capital market.

Regulation will be technology-neutral and forward-looking. Consistent with the fundamental principles of securities regulation, the SC will ensure that the legitimate use of technology by market participants and markets is not unduly impeded. The aims of regulation will be to ensure that the markets operate in an efficient, cost-effective and fair manner.

The SC will take the lead in promoting and facilitating the adoption of electronic transactions in the capital market. In order to provide consistent policy setting and to facilitate the dynamic process of innovation, the following pre-defined principles, among others, will be used. The SC will:

- Apply fundamental principles of regulation of the capital market regardless of medium of operation
- Ensure transparent and consistent application of the regulatory framework in the electronic environment
- Undertake co-operation and sharing of information with other capital market regulators, particularly in the areas of surveillance and training
- Ensure appropriate access to market information, without any one medium having undue advantage over the others

RECOMMENDATION 135

Access to the market's trading infrastructure will be enhanced

The value of greater access to the market's trading infrastructure—for market intermediaries, investors and market institutions themselves—has increased as the capacity and efficiency of trading linkages have improved through multimedia network-based channels, such as those provided by the Internet. Market intermediaries can maintain a competitive edge in providing cost-efficient and value-added intermediation services; investors stand to benefit from lower execution costs and more direct participation in their investment decisions; while market institutions can gain from the increased turnover and liquidity that comes with the existence of alternative channels of access.

In view of this, several approaches will be adopted in the development of the trading infrastructure to improve access to the exchange by investors and intermediaries:

- First, brokers will be able to develop their own order-routing systems in-house
- Second, brokers will be able to develop order routing systems in collaboration with third party vendors
- Third, the exchange should look into developing an integrated trading platform to incorporate gateway solutions to enable open access regardless of medium

A trading infrastructure environment will be created where individually developed systems can co-exist with the exchange's system. This provides an opportunity for larger brokers who wish to develop their systems to differentiate their services from that of other brokers, as well as allowing smaller brokers to invest in technology infrastructure, to take advantage of technological innovation at minimum cost. These trading systems, either in-house or with technology vendors, will be able to route orders directly to the exchange through brokers provided that they comply with the systems, interface and other relevant regulatory requirements. The KLSE's existing *Guidelines on Electronic Client-Ordering System* will be reviewed to incorporate such requirements, which will address matters such as security, cost, equal access, reliability and availability, as well as ease of monitoring and surveillance.

However, in the interest of technology-neutrality, the trading infrastructure must also cater for other mediums via which trades can be directly routed to the trading engine of the exchange. Examples of recent developments in order-routing technology include short messaging services (SMS) and wireless application protocols (WAP).

RECOMMENDATION 136

Regulatory issues relating to the primary market offering and secondary market trading of capital market products through electronic means will be clarified

When a primary market offering of securities is presented to residents of a jurisdiction electronically, the offer and the person making the offer may be subject to the local regulation of any jurisdiction. For instance, the SC's policy statement entitled *Primary Offers of Securities via the Internet* serves as a guide to Malaysian issuers who wish to post their issues or offers over the Internet. The statement, which is based on IOSCO's guidelines on the matter, will enable issuers to avoid falling foul of legislative prohibitions of other jurisdictions.

However, technology remains dynamic. Wherever possible, regulation will therefore be reviewed and amended to encourage the development of efficient and transparent primary offering processes as new technology arises. Among the issues in relation to the primary offering of securities via electronic means, such as through the Internet, the following will have to be addressed:

- Electronic prospectus - The fundamental objectives of electronic prospectus provisions are to ensure that investors are able to make informed investment decisions, on the basis of a prospectus containing all material information about the securities being offered and about the issuer. Electronic prospectuses must be complete, protected from alteration and fairly distributed
- Advertising and sharehawking - The accessibility of the Internet makes it difficult to ascertain the distinction between advertising and securities hawking. The basis of this distinction is required to prevent the distribution of misleading or fraudulent statements and direct solicitations to purchase shares
- Information vs. offer - The posting of corporate and securities information on an issuer's web site would require the SC's approval if it constitutes an offer of securities

Clarification statements will be issued to address these issues, as well as other issues that may arise in relation to the primary market offering of securities via electronic means.

In relation to secondary market activity, the SC will continuously assess electronic mechanisms through which orders are routed, matched and confirmed, and trades cleared and settled. Where relevant and necessary, the SC will ensure that it clarifies the rules and regulations regarding the usage of such mechanisms within the Malaysian capital market.

RECOMMENDATION 137

End-to-end straight-through processing in the Malaysian capital market should be achieved, with appropriate linkages with international systems to be facilitated

Current transaction practices require the re-entry of data many times over and draw from a wide variety of sources. This makes the processing of transactions susceptible to manual errors, discrepancies, delays and possibly even fraud. As cross-border and cross-asset transactions continue to grow, deficiencies in information flow become even more apparent.

To reduce processing inefficiencies and minimise their associated risks, thus lowering overall transaction costs, there will be efforts made towards establishing STP across virtually every aspect of capital market activity. STP involves electronically capturing and processing financial transactions right from the point of initiation through to final settlement and confirmation.

In order to achieve STP, this recommendation foresees the need to develop a robust financial infrastructure consisting of linkages between exchanges, clearing houses and the national payment system. In particular, the establishment of STP would have to consider the development of a variety of specialised systems that form the building blocks of STP, including:

- Transaction flow managers (TFMs) that pre-match transactions to reduce the risk of settlement failure
- Online transaction routing systems (TRSs) that, among other things, allow for order-entry through multiple channels
- Electronic transaction interfaces (ETIs) that continue to reflect internationally-accepted communication standards for cross-market transactions, such as ISIN for financial products, Bank Identifier Codes for financial institutions, and ISO message standards

In addition, STP would ideally require clearing houses to have direct access to the interbank payment system, so that payment and settlement risks are minimised. Where appropriate, efforts will also be taken to facilitate direct, secure and efficient links between the central depository with other national or international depositories.

Co-operative efforts among the relevant authorities are needed to facilitate and ensure the legal standing of electronic processes across the entire course of a financial transaction, and the establishment of uniform protocols and message standards in line with international standards. Also, there should be efforts to ensure that common practices among market participants are established and adhered to. The development of industry standards for STP is seen as an important precursor to further reduction in the securities settlement period, especially if the move is made towards achieving a further shortening of the settlement cycles.

STP requires certain prerequisites, which will have to be addressed as part of the broader move towards developing e-commerce foundations for the capital market. Market participants, both within and from outside Malaysia, must be able to communicate and interact through compatible systems. In this respect, it is of paramount importance that domestic participants ensure they maintain common and robust standards—for instance, in terms of international messaging formats, data requirements and transactions procedures—and that these standards are further enhanced to reflect international best practices.

Going forward, Malaysia should actively participate in global efforts in establishing STP standards, such as those being driven by the Global Straight-Through Processing Association (GSTPA).[121] It is important that Malaysian market institutions and intermediaries appreciate and actively pursue the objectives of improving and accelerating the flow of information within the market, increasing settlement efficiency, lowering risks and enabling greater inter-connectivity among each other both within and outside of Malaysia.

RECOMMENDATION 138

The facilitation of electronic trade settlement through the integration of the technologies of the clearing and settlement system with the payment system will be examined

The development of online trading systems necessitates more direct linkages between the capital market clearing and settlement system and a corresponding payment system to facilitate online transmission of money settlement via electronic links to banking institutions and other payment sources. Currently, online transactions are cleared and settled in the same way as traditionally routed trades using the real time gross settlement (RTGS) operated by BNM. An integrated settlement system will improve risk management across markets through the reduction of settlement and default risks while attaining DVP model 1 status.[122] This will facilitate efforts to establish STP in relation to achieving a shorter settlement cycle for online transactions.

Therefore, efforts will be made to explore the possibility of integrating the current clearing and settlement system into a single integrated payment system. The compatibility of systems and the efficiencies of network integration will have to be compared against the need to develop a new system or incorporate gateway solutions.

[121] The GSTPA comprises various global market players and aims to create the infrastructure and standards to enable STP to be implemented across markets.

[122] A system that settles transfer instructions for both securities and funds on a trade-by-trade (gross) basis, with final (unconditional) transfer of securities from the seller to the buyer (delivery) occurring at the same time as final transfer of funds from buyer to the seller (payment).

RECOMMENDATION 139

The development of online value-added services and innovations such as financial portals and financial hubs will be facilitated

Malaysian capital market participants should not be subject to undue impediments in order to exploit value opportunities that exist in new and different spheres of market activity being offered by new technology. There may be scope, for instance, to bridge more traditional intermediary services and venture into an entirely new service-space such as offering integrated financial solutions to capital market consumers by co-ordinating the services being offered by existing intermediaries through media, such as Internet portals.

In recognising these trends, the SC will take the necessary steps to continually review the regulatory framework to reduce undue hindrances to the development of innovative value-added services in the electronic environment, and to the development of perhaps newer forms of capital market intermediation.

The SC has already begun to make a preliminary assessment of some of these issues. For example, it is recognised that some forms of financial portals are providing "value-added" innovation that links several brokerage and investment advisory services together. A key consideration is to recognise the valuable role played by new service providers while ensuring that all capital market intermediaries, regardless of how they conduct their services, provide minimum standards of service to safeguard the interests of the investing public. In this regard, the SC will be carefully considering the role of these new service providers and innovators against those of traditional intermediaries, particularly in terms of assessing the risks and responsibilities of undertaking capital market transactions .

In striving to facilitate the development of value-added electronic-based conduits, the SC has also identified several other areas for regulatory clarification and review, including "know your client" rules and signatures, investment information and advice, and electronic contract notes. Internet-based advisers will require a license if it can be proved that they carry on the business of providing investment advise. However, the dissemination of purely factual information through information service providers will not be considered as investment advice.

RECOMMENDATION 140

Online trading of units in unit trust funds will be permitted

Going forward, it is likely that there will be increasing pressure on unit trust companies to take advantage of technology to provide value-added services to their customers. These services may include, among others, providing online fund performance information, personal account information, investment advice and the sale of units over the Internet. At present, however, regulation does not allow transactions of units in unit trust funds to be done electronically.

Therefore, regulation preventing the electronic sale of fund units will be removed to allow investors to purchase units online. The SC has recommended that it will work with third party solutions providers to develop guidelines and standards for the electronic sale and purchase of units. These guidelines and standards will provide assurance that investor protection is not compromised while facilitating the surveillance function of the regulator. However, companies offering online unit trust funds will be responsible for ensuring the security, reliability and efficiency of their systems. Emphasis must also be placed on protecting the privacy of online consumers in relation to the accessibility and use of personal information provided online.

RECOMMENDATION 141

Surveillance and enforcement capabilities of online capital market activities will be enhanced

Although the advent of Internet technology has significantly remodelled the landscape of capital markets, it has also made it easier for traditional types of fraud to flourish. The IOSCO Technical Committee has raised three concerns on this front:

- Individuals and entities previously enjoined from illegal activity can mask their identities over the Internet
- One individual or entity responsible for transmitting information on a particular topic can give the appearance that the information emanates from multiple sources
- Tracking and locating offenders may be made more difficult through the use of these devices

In view of these concerns, regulations will be amended where necessary to facilitate the effective surveillance, investigation and prosecution of those committing offences utilising electronic media. Internet surveillance programmes will include the identification and detection of problems and contraventions such as market manipulation, fraud, spamming, misrepresentation and the sale of bogus or unapproved investments. Moreover, the SC will work towards increasing its capacity—in terms of skills, specific functions and powers, among others—to deal with the challenges of market supervision, regulation and enforcement in an online electronic environment.

Industry self-regulation will also be encouraged wherever appropriate, and training and education will be provided to market institutions and market participants in areas of self-policing. Individuals will be encouraged to report suspicious Internet activities and potential abuses through easily accessible channels made available by the regulators.

The cross-border nature of the Internet also requires capital market regulators to forge close working relationships and co-operation in areas of enforcement and surveillance. Therefore, the SC will explore opportunities for international co-operation to protect investors in the Malaysian capital market and to prosecute false, deceptive and fraudulent electronic-based market practices. To this end, efforts through IOSCO and with foreign counterparts will be enhanced to facilitate international co-operation in information sharing, the use of effective surveillance methods and approaches to enforcement of securities laws over the Internet.

RECOMMENDATION 142

Training and education programmes for market institutions, market participants and investors on the use of technology and e-commerce will be enhanced

An important starting point for regulators in minimising investors' susceptibility to fraud through electronic media, in particular the Internet, is the use of training and education as a tool for enforcement. Even if effective surveillance and enforcement methods are put into place, a sound foundation of investor awareness coupled with strong self-regulation are important defences against fraud.

A pro-active approach will be taken in the education of investors about financial products, services and investment opportunities available through electronic media. In this regard, the SC will use its web site as an interactive tool to educate investors about online investment risks, provide information about possible fraudulent activities, and list licensed entities and securities offers that are approved by the SC.

Training programmes will also be offered to capital market professionals in an effort to better equip them to provide value-added services and innovative solutions to face the challenges of disintermediation brought on by technology. At the same time, the continual training of market institutions' staff will ensure they have the skills and the expertise in electronic surveillance and monitoring techniques needed to effectively perform their functions.

It is also important for the industry—in particular, the market institutions and intermediaries—to recognise the crucial role they have in participating in the educational process by providing material, information and disclosures to investors on the use of technology to offer financial products and services, as well as the potential risks of doing so.

RECOMMENDATION 143

International standards of security, reliability and privacy will apply to technology infrastructure

An individual's reasonable expectation of privacy regarding access to and the use of personal information should be assured in electronic transactions. Investors must have the confidence that their transactions and data provided over the Internet are safe from unauthorised access or modification.

Companies have the responsibility to develop and maintain sound security policies, practices and standards for their systems. Market participants and institutions must ensure that their systems and infrastructure are secure and reliable. The consistent use of a range of technologies—such as encryption, authentication, password controls and firewalls—will be encouraged to enhance the security of systems. The role of privacy policies encompassing, among other things, the disclosure of information practices, confidentiality clauses and provision to customers with choices regarding the use of personal information, will also be emphasised.

To promote solid security practices, market intermediaries are encouraged to develop and disclose their privacy policies to their customers. In moving forward, the need to mandate security and privacy requirements on intermediaries' electronic communications systems will be carefully studied in order to put in place effective procedures in protecting and securing the confidentiality of electronic information from unauthorised use.

TRAINING AND EDUCATION

Objectives

The role of human capital is pivotal to the development of a world-class capital market for Malaysia. Access to large pools of highly skilled and efficient human resources enhance the productive capacity of the Malaysian economy and is critical for development of its service sectors such as the capital market.

The Malaysian capital market already possesses some fundamental advantages in this respect. The availability of a literate and educated workforce, relatively low incidence of work disruptions from industrial disputes, and strong support for professional training and education, particularly in knowledge-based specialisations, provide a solid foundation for the further development of the capital market. The SC, through its training arm, the SIDC has been actively involved in facilitating the creation of skilled professionals for the capital market by providing education and training tools that promote continuous learning and skills upgrading.

In moving forward, however, the major challenge is to ensure that the quality and strength of the human resources available are sufficient for the capital market to compete effectively in an increasingly globalised and competitive environment. This entails focused efforts towards enhancing the productivity, skills, managerial competence and entrepreneurship of those working within the capital market.

The effects of globalisation and communications advancements have transformed financial markets worldwide by enabling the development of new products and services, and redefining traditional job specifications. As a result, the required functions and skill sets of market professionals are constantly evolving to serve the changing financial landscape. This dynamic environment means that workers need to be equipped with skills that are not static, but are flexible enough to enable them to react to different opportunities presented by fast-paced market forces. It is therefore critical that Malaysia's capital market be characterised by large pools of skilled professionals who are able to adapt readily to changing skills demands, to achieve a maximum allocation of resources to areas of work which are productive and useful to develop the capital market. At the same time, given the increasing sophistication of markets today, there is a need to further develop core specialist skills, especially in areas such as risk management and the Islamic capital market where there may be a supply shortage.

In view of this, it is important for all relevant stakeholders within the capital market to increase efforts in retraining, redevelopment and skills upgrading to foster a culture of dynamism in human capital development and management, to cope with the shift towards knowledge-based products and services. Towards this end, the SC will work closely with market institutions, the relevant industry associations, and organisations such as, among others, MICG, MIA, MACPA, and the Malaysian Institute of Directors. In addition, SIDC will also focus on greater training and education efforts for regulators including front-line regulators and self-regulatory organisations, to enhance the levels of skill and expertise needed to regulate an evolving financial marketplace.

Continuous education is needed from the investors' perspective as well. As the capital market continues to develop, products and services will become increasingly complex and varied, and consumers must correspondingly ensure they are equipped with the knowledge and skills to make informed investment decisions and to be aware of the benefits and risks associated with different kinds of investment. Moreover, with the shift in regulatory philosophy from merit-based regulation to DBR, investors are expected to take on greater responsibility for their investment decisions, and hence play a more significant role in assessing the merits of their own investments.

The SC recognises the strategic importance of increasing investors education initiatives to enhance investor sophistication and public awareness of capital markets. With better knowledge and awareness of the attendant risks and rewards, investors will have greater confidence to place their savings in the capital market. In this regard, the SC together with industry will continue to initiate efforts at educating the investors, to ensure that investors are provided with sufficient opportunity to furnish themselves with knowledge and information on capital market products and services.

The SC will also increase efforts to highlight its educational role to the public in order to reach out to investors seeking clarification and understanding on how to invest in the capital market, particularly for investors who lack sufficient information or experience to make sound financial decisions. Through programmes that will focus on helping investors make better informed choices, the SC will aim to equip investors with sufficient knowledge of their rights and responsibilities. The SC will also aim to offer assistance and guidance through language and materials that are user-friendly and simple for the lay investor o understand.

Taking into consideration the resources which the SC possesses through SIDC, and given the role that SIDC has played in developmental projects in other capital markets, there is substantial scope for further expansion of these services and the positioning of SIDC as a regional capital market training centre. This will entail, among other things, providing technical assistance and serving as a resource bank for other capital markets within the region through arrangements with similar training organisations in those markets.

The SC will also position SIDC as a leading training, education and resource centre in the region for Islamic capital markets. In tandem with Malaysia's aspiration of becoming an international Islamic capital market centre, these efforts will aim to promote greater appreciation of Islamic capital markets through training and education efforts aimed at professionals, investors and regulators.

Skilled human capital is an intangible asset that Malaysia urgently requires for the development and improved value proposition of its capital market and broader economy. With rapid advances in technology and globalisation, and the emergence of knowledge-based economies, capital markets around the globe are increasingly being driven by the need to create new sources of competitive advantage through the development of human capital. The quality of market professionals must be nurtured as both immediate and longer-term priorities of Malaysia's capital market development and, both directly and

indirectly, for furthering economic growth. As such, the following are three key thrusts for developing human capital for the domestic capital market:

- Development of a highly skilled pool of professionals for the domestic market, that is flexible and responsive to changing market forces, as well as possessing specialist skills in certain critical areas
- Providing education and training for investors to acquire greater knowledge and understanding of capital market products and services
- SC to work closely with industry to enhance the training, education and resource capacity within the Malaysian capital market

RECOMMENDATION 144

Training programmes to create highly skilled and flexible market professionals will be developed

Training programmes will be designed to foster the development of specialised skills required to support the future needs of industry, and to allow new entrants to acquire skills that are relevant to the marketplace. In doing so, the SC will aim to build a framework for developing such training programmes that will take into account current human resource gaps, as well as strategies to foster co-operation and links with appropriate domestic and international training bodies.

Under the framework, training programmes will also be crafted for the existing pool of capital market professionals to undergo retraining and redevelopment to meet the demands of an increasingly dynamic market. Such programmes would include training in crucial areas of growth such as investment management, investment analysis and risk management. In addition, accreditation programmes with internationally recognised bodies offering advanced and specialised professional qualifications will be sought to increase the level of professional skills and to ensure that market participants are exposed to globally benchmarked programmes on technical skills and know-how.

These efforts will be consolidated and streamlined with those of all relevant market participants, including the market institutions, industry associations and professional bodies, to ensure that all aspects of capital market education are provided, and to provide training to specific target groups in the market.

RECOMMENDATION 145

A culture of continuous learning and skill enhancement will be encouraged through Continuing Professional Education programmes

The introduction of Continuing Professional Education (CPE) is aimed at creating a culture of lifelong learning amongst market professionals. Its primary objective is to maintain and enhance technical knowledge and professional expertise of licensed representatives in the Malaysian capital market. The CPE programme will commence in 2001.

The CPE will act as a professional competency model, aimed at benchmarking the development of licensed representatives, on the level of technical knowledge and professional skills expected throughout the cycle of the profession. The CPE will enable licensed representatives to chart their career path by indicating specific training needs and anticipating levels of competency required in the short, medium and long term. The CPE also aims to provide some degree of assurance to investors that market intermediaries have the technical knowledge, competency and professional skills required to effectively serve the marketplace.

Update: The SC launched a mandatory CPE programme for licensed representatives on 18 January 2001, whereby dealers' licensed representatives will have to begin complying with the programme from 1 July 2002, followed eventually by all other categories of licensees.

RECOMMENDATION 146

Skills of regulators, including front-line regulators and self-regulatory organisations, will be strengthened

The SC recognises the significant demands placed on regulators in a constantly changing and increasingly sophisticated environment. As such, the SC will focus efforts on enhancing its regulatory capabilities as well as those of the FLRs and SROs within the capital market. In particular, resources will be concentrated on providing appropriate training in the areas of supervision, monitoring, compliance and enforcement in order to enhance the role of regulators in ensuring a fair, transparent and competitive market with high standards of disclosure and conduct. In doing so, the SC will promote the optimal use of technology in carrying out regulatory functions and services by equipping regulatory professionals with adequate training and education on relevant technological developments.

In addition, the extensive reach of technology and trends in globalisation, which challenge the borders of traditional capital markets and increase the complexity of transactions, call for enhanced regulatory capacity to deal with such issues and the strengthening of links between regulators internationally. In this regard, the SC will foster greater skills among its

staff, particularly in cross-border surveillance and supervision, through information sharing of regulatory experience and, where possible, appropriate attachments or secondments with industry participants and international regulators. These efforts will ensure the continued cognisance of domestic issues as well as best practices and global trends in international capital markets, to assist in crafting policies that are relevant and responsive to the changing financial landscape.

RECOMMENDATION 147

Efforts will be made to increase the availability of skilled graduates for the capital market through arrangements with universities in curriculum development

The SC, through SIDC, will promote study and research in the area of capital markets through joint collaborative efforts with universities by providing, *inter alia*, necessary input into degree or diploma syllabi, and increasing the exchange of knowledge between regulators and academicians. This initiative has already started with some universities on the subject of the derivatives market and will extend to the remaining universities in Malaysia by 2003, with further refinements to the depth and variety of the syllabus to be made within that time frame.

Joint certificate/diploma programmes on the capital market will also be introduced to university students in 2003. This programme, to be jointly developed with the universities, will be offered as an option to complement the undergraduates' existing programmes.

RECOMMENDATION 148

Licensing examinations for capital market professionals will be streamlined

Licensing examinations allow an efficient and objective means of ensuring the minimum standards for entry into the capital market as licensed/registered representatives are met. In view of this, these examinations will continue to be designed to meet with regulatory expectations, and to be highly responsive to the changing needs of the capital market, particularly with regard to:

- The emergence of new players, eg, dealer's representatives for UBs, financial planners and compliance officers
- The forces of globalisation, liberalisation and technological development that continuously redefine the marketplace
- The extent of regulatory reforms aimed at streamlining, updating or consolidating laws, regulations, policies and guidelines

The streamlining of all licensing examinations under the purview of the SC allows for the scope and flexibility needed to co-ordinate the development of the examination modules with regard to these issues. With rapid changes in the global capital market environment, it is envisioned that the licensing examinations will be on par with international standards, whereby they are issued locally but may be used and recognised internationally. This external recognition will also assist in foreigners' validation of the quality of skills and capabilities of local capital market intermediaries who wish to widen their operational base overseas. To this end, a comparative study to refine the current examination module to be on par with international standards will be conducted in 2001.

RECOMMENDATION 149

Education, training and licensing examinations will be made more accessible

In order to make training programmes more readily available throughout Malaysia, particularly in remote locations across the nation, the SC, through SIDC, will initiate affiliations with training counterparts or market intermediaries to conduct training programmes. Examination centres will also be set up in specific locations to allow individuals to choose examination centres closer to their homes. This will be done in stages through affiliations with relevant training institutions to provide manpower and logistics arrangements.

The Internet will be assiduously employed as a delivery method to widen the accessibility of training and education programmes to the public. E-learning allows busy individuals the flexibility to participate in courses without the restrictions of fixed timetables and physical attendance requirements. In view of this, the SIDC will work towards conducting examinations online, as the delivery of the examination is more efficient and cost-effective. Examination materials will be sold in CD-ROM format, and the web will also be used as a marketing tool to release up-to-date information on the capital market. Capital market intermediaries will be able to collect their CPE points by accessing certain topics online or attending web tutorial sessions. Seminars or training material may be broadcast live to other training centres to allow for more interactive proceedings. Investors may download important information, play capital market simulation games, buy publication materials online and register for training courses online.

RECOMMENDATION 150

The skills, knowledge and competencies of Bumiputera intermediaries will be enhanced

The Bumiputera Training Fund (BTF) programme introduced in 1997 to provide training for Bumiputera employees of stockbroking firms has proven to be a success. Sessions on sectoral analysis, investment management, self-improvement skills and current issues are already being held periodically to enhance the technical and development skills of Bumiputera professionals in the stockbroking industry.

With new developments occurring in the capital market, it is crucial for Bumiputera licensed representatives and other professionals to acquire new skills and knowledge, to increase the level of highly qualified and expert Bumiputera workers in the market. In this regard, more BTF programmes will be introduced and tailored to focus on the development needs of Bumiputera professionals.

RECOMMENDATION 151

Investor protection and education will be further promoted through awareness programmes

To further enhance investor protection and education, the SC, together with the industry, will initiate focused efforts towards educating and disseminating information on the fundamental structure and systems of the capital market, the different types of financial products and services available and their corresponding risks and benefits, and the regulatory framework, including remedies for investor protection. This will generate greater awareness among the public, and increase public accessibility in relation to the provision of information and protection to the consumer of capital market services and products.

With the progression to a DBR regime, the onus will shift from regulators to investors to evaluate the merits of investments in the capital market. In this regard, it is crucial for corporations to be fully aware of their responsibilities in the provision of full, accurate and timely disclosure of information to investors. As such, there will be efforts to create greater awareness among individual players such as directors, chief executive officers, advisers, auditors, promoters, custodians to be conscious of their rights, duties, obligations and their liabilities/ penalties for non-compliance with the relevant laws under the DBR regime. In addition, emphasis will be placed on inculcating a culture of shareholder value maximisation among company directors and management, and encouraging investors and fund managers to play an active role in ensuring that the firms they invest in accord due priority to value creation.

The SC will also play a greater role in enhancing public awareness of current market issues and their likely impact on investments, to enhance investors' understanding of how the capital market functions, in language and materials that are simple and user-friendly to even inexperienced consumers. More emphasis will be taken to promote awareness in smaller towns and rural areas, where initiatives will be focused on promoting fundamental capital market literacy. Such efforts will also be promoted through collaborative efforts with external parties such as exchanges, consumer groups and intermediaries.

RECOMMENDATION 152

The SC will develop SIDC as a regional capital market training centre

To support the creation of a world-class capital market, the SC will develop SIDC's role as a leading training and resource centre for capital markets in the region. In doing so, there will be efforts to provide quality training and education for the development of technical knowledge and skills of market players and regulators to create a pool of highly skilled professionals and advisers.

The SIDC will also embark upon programmes and initiatives on knowledge sharing with regional and international institutions, through the development of training modules for developing economies in the region. These training modules will be focused on sharing SIDC's experience in skills training and knowledge management of the Malaysian capital market to other markets in the region.

In enhancing its role as the training centre for the Islamic capital market, for instance, training programmes will be carried out with other appropriate organisations such as ILKAP and BIRT. These programmes will not only cover fundamental theories, principles and practical aspects of the Islamic capital market, but also include the analysis of global trends in the Islamic capital market, to raise awareness levels of course participants concerning the development and direction of this sector internationally.

In addition, the SIDC will set up a resource bank on capital markets for the domestic market as well as regional markets. The resource centre will house information on finance, securities, business, legal and capital market matters and will be easily accessible to industry participants.

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