

Capital Market Masterplan 2



Suruhanjaya Sekuriti
Securities Commission
Malaysia

Suruhanjaya Sekuriti Malaysia

3 Persiaran Bukit Kiara

Bukit Kiara

50490 Kuala Lumpur

Malaysia

Tel: 603-6204 8000 Fax: 603-6201 5078

www.sc.com.my

Copyright

© April 2011 Securities Commission Malaysia

All rights reserved. No part of this publication may be reproduced, stored in or introduced into a retrieval system, or transmitted in any form or by any means (graphical, electronic, mechanical, photocopying, recording, taping or otherwise), without the prior written permission of the Securities Commission Malaysia.

Perpustakaan Negara Malaysia

Cataloguing-in-Publication Data

Capital market masterplan 2 : Malaysia

ISBN 978-983-9386-66-0

1. Capital market--Malaysia. 2. Malaysia--Economic policy.

I. Suruhanjaya Sekuriti Malaysia.

332.041509595

This book is printed using eco-friendly
recyclable and bio-degradable paper



CONTENTS

FOREWORD BY THE PRIME MINISTER OF MALAYSIA	viii
INTRODUCTORY REMARKS BY THE CHAIRMAN OF THE SECURITIES COMMISSION MALAYSIA	x
CHAPTER 1: BUILDING THE FOUNDATIONS IN CMP1	1
1.1 From a narrow to a broad capital market	2
1.2 Evolved into a well-regulated and resilient capital market	6
CHAPTER 2: MEETING CHALLENGES OF THE DECADE	9
2.1 Transforming the competitive dynamics of the Malaysian capital market	10
2.2 Managing risks from a changing landscape	13
2.3 Growth prospects to 2020	16
CHAPTER 3: GROWTH STRATEGIES TO EXPAND ROLE OF CAPITAL MARKET	19
3.1 Promote capital formation	20
3.1.1 Increase private sector participation in the venture capital and private equity industries	
3.1.2 Strengthen economic functionality of the stockmarket in promoting growth of small and mid-cap companies	
3.1.3 Widen access to the bond market	
3.1.4 Promote socially responsible financing and investment	
3.2 Expand intermediation efficiency and scope	30
3.2.1 Facilitate efforts to enhance efficiency of public sector savings intermediation	
3.2.2 Expand diversity and value-add of private sector savings intermediation	
3.2.3 Expand scope of market intermediation	
3.3 Deepen liquidity and risk intermediation	38
3.3.1 Address concentration of savings	
3.3.2 Facilitate efficiency of price discovery and hedging across markets	
3.3.3 Widen market connectivity and participation	

3.4	Facilitate internationalisation	42
3.4.1	Expand international intermediation capabilities	
3.4.2	Widen Islamic capital market's international base	
3.5	Build capacity and strengthen information infrastructure	49
3.5.1	Build capacity to meet future requirements	
3.5.2	Strengthen information infrastructure to support transition to a highly electronic environment	

CHAPTER 4: GOVERNANCE STRATEGIES FOR INVESTOR PROTECTION AND STABILITY 57

4.1	Enhance product regulation to manage risks	58
4.1.1	Conducive environment for product innovation	
4.1.2	Efficient framework for fund-raising and product innovation	
4.1.3	Strengthen disclosure and post-issuance obligations	
4.2	Expand accountabilities as intermediation scope widens	62
4.2.1	Widen intermediation scope	
4.2.2	Strengthen intermediation standards and capabilities	
4.3	Robust regulatory framework for a changing market landscape	68
4.3.1	Rationalise regulatory arrangements for markets	
4.3.2	Enhance market quality	
4.4	Effective oversight of risks	72
4.4.1	Expand regulatory coverage, capacity and tools for investor protection	
4.4.2	Oversight of risks to market stability	
4.5	Strengthen corporate governance	77
4.5.1	Board of directors as a focal point for corporate governance	
4.5.2	Promote active shareholder participation	
4.5.3	Strengthen gate-keeping accountabilities	
4.6	Broaden participation in governance	83
4.6.1	Promote active stakeholder participation in governance	
4.6.2	Promote greater participation in achieving socially responsible goals	

ACRONYMS AND ABBREVIATIONS 93

REFERENCES 95

ACKNOWLEDGEMENTS 97

CONTENTS

Charts

Chart 1:	Malaysia's capital market grew 11% pa during CMP1	1
Chart 2:	Malaysia is the 3rd largest local currency bond market in Asia	4
Chart 3:	High-growth investment management industry	5
Chart 4:	Malaysia's Islamic capital market tripled in size	5
Chart 5:	Projections for Malaysia's capital market to 2020	16
Chart 6:	Venture capital funding and investee companies	21
Chart 7:	IPOs by market capitalisation 2000–2010	24
Chart 8:	Growth companies by market capitalisation 2000–2010	24
Chart 9:	Institutional funds as a % of nominal GDP	30
Chart 10:	Regional turnover velocity in 2010	38
Chart 11:	Risk-return profile of selected markets 2000–2010	38

Tables

Table 1:	Malaysia's stockmarket ranks highly for access to financing	2
Table 2:	Strong growth across market segments	3
Table 3:	Turnover velocity by market capitalisation in 2010	39
Table 4:	Product risk issues during the global financial crisis	58
Table 5:	Corporate governance milestones in Malaysia	78

Box Articles

Box 1:	Expanding role of markets in the global economy	11
Box 2:	Changing patterns of global market development	14
Box 3:	Promoting venture capital investments through the capital market	23
Box 4:	Growth prospects for equity market to 2020	25
Box 5:	Growth prospects for bond market to 2020	28
Box 6:	Growth prospects for investment management industry to 2020	34
Box 7:	Development of the private retirement scheme industry	35
Box 8:	Growth prospects for derivatives market to 2020	41
Box 9:	Equity market capitalisation to GDP ratios	44
Box 10:	SC survey on international expansion plans of intermediaries	46
Box 11:	Growth prospects for Islamic capital market to 2020	47
Box 12:	Impact of electronic channels on client-intermediary relationships	65
Box 13:	Regulation of credit rating agencies	67
Box 14:	Role of securities regulators in ensuring systemic stability	76
Box 15:	Findings from the SC's review of Board structures of Malaysian PLCs	80



Growth with Governance



FOREWORD

by **YAB DATO' SRI MOHD NAJIB TUN ABDUL RAZAK**

Prime Minister and Minister of Finance, Malaysia

Malaysia is steadfastly moving forward to achieve its aspiration to become a developed nation. The New Economic Model (NEM) and Economic Transformation Programme (ETP) jointly provide a broad overarching framework for structural reforms to catalyse change and to initiate a continuous sequence of high-impact investment projects to accelerate the economic growth momentum.

The Capital Market Masterplan 2 (CMP2) forms another vital contribution to the collective and coordinated efforts to invigorate the economy through expanding the role of the capital market in financing the country's development.

CMP2 is a comprehensive plan that provides clarity on the strategic direction of the Malaysian capital market over this decade. It is envisaged that the Malaysian capital market will play an increasingly important role in the efficient intermediation of ample domestic savings in seeding emergent companies, promoting the growth of small and mid-cap companies and financing the undertaking of large investment projects. It also identifies new growth opportunities to widen the complement of competitive strengths of Malaysia's capital market.

The CMP2 strategies are intended to create a conducive environment to enlarge the role of the private sector and the financing of entrepreneurial and innovative economic activities that are so critical to the future of the Malaysian economy. This will create new growth opportunities for capital market intermediaries to expand their range of value-add products and services. In tandem with this, it will be necessary to build capacity and to change the mindset for competitiveness, risk-taking and innovation for the country to meet the challenges in the future global landscape.

The lessons from past financial crises are that rapid growth is not sustainable unless it is underpinned by well-grounded ethical beliefs and high levels of integrity. CMP2 provides equal emphasis to achieving governance objectives to ensure Malaysia's capital market continues to be well-regulated with participants strengthening their capabilities and professional standards and exercising a strong sense of responsibility towards the interests of their customers.

In pursuing growth objectives, CMP2 also provides for greater prominence to be given to social and environmental issues. Through integrating social and environmental considerations into business operations, the capital market can assist in the building of a sustainable and inclusive economy that generates long-term wealth.

I would like to express my appreciation for the contribution of the Securities Commission Malaysia and also to others who have provided their valuable input and support to the formulation of the Masterplan. In this regard, the first Capital Market Masterplan (CMP1) provided the strategic vision for Malaysia to develop a broad and well-regulated capital market that contributed to nation-building efforts. I am confident that CMP2 will shape greater collaboration and partnership with domestic and international participants for Malaysia to achieve a fully developed capital market within this decade.

1Malaysia "People First, Performance Now"



DATO' SRI MOHD NAJIB TUN ABDUL RAZAK

April 2011

INTRODUCTORY REMARKS

by **TAN SRI ZARINAH ANWAR**

Chairman of the Securities Commission Malaysia

Markets provide a useful means to mobilise capital and harness economic interests in an efficient manner to drive innovation and growth. Yet, at the same time, self-interests may create behaviours that pose risks to the safety of investors and the integrity of markets. It is thus important that we learn the lessons from past financial crises that growth is only sustainable if it is underpinned by a proper system of accountabilities and governance.

The CMP2 theme of “Growth with Governance” describes the challenges for our capital market in expanding its role in invigorating national economic growth while addressing concerns about the efficacy of markets in the aftermath of the global financial crisis.

Growth with governance is about getting markets to work better for everyone. We need to ensure that our markets are efficient at utilising our savings for capital formation, to create opportunities and jobs and to finance investments in infrastructure and technology to provide better amenities and improve the quality of life.

It is equally important that fair and adequate returns are distributed back to investors who are reliant on the accumulation of income from their investments to sustain their living needs.

The pursuit of growth requires that we are open to opportunities and to risks. Our choices are limited if we only seek opportunities within our boundaries. Similarly, we limit our ability to grow if we limit the risks we are willing to take. Fostering entrepreneurial and innovative zeal therefore requires openness and greater appetite for risk-taking.

We have sought in CMP2 to outline the strategies to unleash these dynamics in our capital market. Ultimately, sustainable growth propositions are crystallised through pragmatic policies and mindset changes that motivate us to continuously seek new opportunities, persist with change and persevere until we achieve success.

In as much as markets are about growth, markets are also about our values and our sense of morality. In this regard, markets promote risk-taking by spreading the gains and losses among market participants who may have differing risk-return profiles. But it is important that everyone trusts that the risks and rewards will be distributed fairly. If rewards are retained by a few while the risks are borne by many, this will erode confidence in the integrity of markets. Markets are impoverished when they lose their sense of moral values.

The hallmark of the market that we aspire to build is one that will be distinguished by the quality of its governance. We have used the term governance broadly to describe how regulation interacts with market mechanisms to allocate capital resources efficiently and fairly. The governance process is enriched by extensive participation and engagement to ensure that the rights and interests of stakeholders are properly safeguarded.

It is therefore the central task of regulation to ensure that governance arrangements are sufficiently robust in maintaining public confidence in the integrity of our markets. It is certainly the Malaysian experience that effective and efficient regulation promotes orderly and sustainable growth, and engenders investor confidence and trust.

Nevertheless, the regulatory duty has become more challenging as capital markets are today far more significant and complex than they were before. The increasing complexity of intermediation makes it difficult to tailor regulation to precisely fit requirements. In addition, the optimal level of regulation is a moving target calibrated by public expectations shaped by changing times and circumstances.

In CMP2, we have aimed for regulation to be effective and relevant, and we will dispense with unnecessary procedures and requirements. But it is still the regulator's job to constantly ask the hard and probing questions to ensure probity in behaviour.

Good governance is not the responsibility of the regulator alone but is one that requires all participants to exercise greater care and responsibility for the consequences of their actions. It also calls for their active participation and vigilance to make markets work better for the well-being of society.

It is my hope that CMP2 continues in the tradition of the previous Capital Market Masterplan in representing the SC's commitment to meeting the future needs of the nation. CMP1 continues to retain its strategic clarity and relevance even after a decade. The Capital Market Masterplan will continue to serve as an important medium of communication to provide market participants a sense of consistency and certainty on the direction of our long-term policies in a changing environment.

The success of CMP2 will, as always, be dependent on the hard work and unfailing commitment of the staff of the SC, and our stakeholders who have contributed to all our efforts. To all of you, I express my sincere gratitude and look forward to your continued support and contribution.



TAN SRI ZARINAH ANWAR

April 2011



Building^{the} Foundations in CMP1

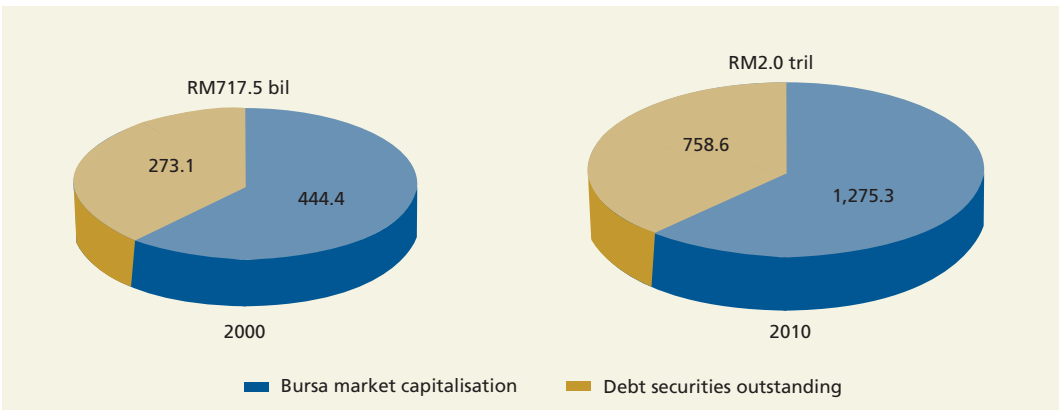
CHAPTER 1

BUILDING THE FOUNDATIONS IN CMP1

Launched ten years ago, the first Capital Market Masterplan (CMP1) guided the development of the Malaysian capital market for the period of 2001 to 2010. CMP1 aimed to build a capital market that would be competitive in meeting the country’s capital and investment needs and support long-term nation-building efforts.

Since 2000, the growth of the Malaysian capital market had outpaced the economy, with the size of the capital market expanding from RM718 billion to RM2 trillion or at an annual compounded growth rate of 11%. This strong growth was achieved through rapid industry expansion and strong regulatory oversight that underpinned investor confidence in the capital market.

Chart 1
Malaysia’s capital market grew 11% pa during CMP1



Source: Securities Commission Malaysia, Bursa Malaysia

From a capital market comprising mainly equities and government debt securities in 2000, significant market segments were successfully nurtured for private debt securities and investment management, coupled with the development of a comprehensive and innovative Islamic capital market (ICM).

Today, these market segments rank among the leading centres in the region, broadening the Malaysian capital market landscape and complementing a well-established stockmarket which provides equity financing to almost one thousand PLCs and which has functioned as a growth platform for many small and mid-cap companies.

Table 1
Malaysia’s stockmarket ranks highly for access to financing

Attributes	Ranking
Financing through local equity market	8
Number of listed companies per 10,000 people	11
Stockmarket capitalisation to GDP	5
Stockmarket turnover ratio	24

Note: Survey based on 57 countries
Source: Financial Development Report 2010, World Economic Forum

CMP1 provided a comprehensive roadmap for the orderly growth and diversification of Malaysia’s capital market. The plan identified a total of 152 recommendations with strategic initiatives to strengthen fund-raising, promote the growth of the investment management industry, enhance market and intermediation competitiveness, provide a strong and facilitative regulatory regime and establish Malaysia as an international Islamic capital market centre.

By the end of 2010, 95% of the recommendations in CMP1 had been completed, with the establishment of a facilitative regime that promoted rapid industry growth and the building of a regulatory and institutional framework that provided investor protection at levels comparable with international jurisdictions. Malaysia’s regulatory framework ranks highly for investor protection, corporate governance, anti-money laundering and enforcement. Malaysia is also viewed as providing the most consistent and comprehensive regulatory framework for Shariah compliance.

1.1 From a narrow to a broad capital market

In the mid-1990s, Malaysia’s capital market was relatively narrow and infrastructure projects were largely funded by the banking system. The maturity mismatch was identified as a major source of systemic risk during the 1997–1998 Asian crisis.

Since the implementation of CMP1, there have been structural changes in the channels of savings mobilisation and intermediation in Malaysia to address funding vulnerabilities. The sources of financing have been broadly diversified in tandem with the expansion of the Malaysian capital market. This has reduced concentration and maturity mismatch risks as well as provided greater avenues for the financing of large-scale projects. The diversification of financing sources through broadening the capital market provided a prudent balance between debt and equity assets and strengthened the resilience of the national financial system.

“The sources of financing have been broadly diversified in tandem with the expansion of the Malaysian capital market.”

The rapid growth in capital market assets over the last decade reflected the rising sophistication in financial intermediation. Deregulation and liberalisation lowered friction costs, increased economies of scale, reduced time-to-market and expanded distribution channels. The increased efficiencies and competitiveness provided the basis for rapid growth of the Malaysian capital market.

Table 2
Strong growth across market segments

Market segments	2000 (RM bil)	2010 (RM bil)	CAGR %
Stockmarket capitalisation	444.4	1,275.3	11.1
Debt securities outstanding	273.1	758.6	10.8
Derivatives (notional value traded)	84.0	512.1	19.8
Investment management (assets under management)	55.2	377.4	21.2
Islamic capital market	293.7	1,050.1	13.6

Source: Securities Commission Malaysia, Bursa Malaysia

During the past 10 years, stockmarket capitalisation grew by 11% annually to triple in size from RM444.4 billion in 2000 to RM1.3 trillion in 2010. The exchange landscape was transformed with the consolidation of exchanges and clearing houses. This was followed by the demutualisation and listing of the exchange. Transaction costs were substantially reduced while market infrastructure was upgraded with new trading platforms and a shortening in the settlement cycle to T+3 in line with international benchmarks. The consolidation of stockbrokers also increased the soundness of capital market intermediaries and strengthened competitiveness; with some stockbroking firms evolving into investment banks.

Malaysia's bond market grew annually by 10.8% with outstanding debt securities tripling from RM273.1 billion in 2000 to RM758.6 billion in 2010. During this period, Malaysia emerged as a leading regional bond market with an average issue size of RM670 million and an average weighted tenure of 16 years during 2000–2010.

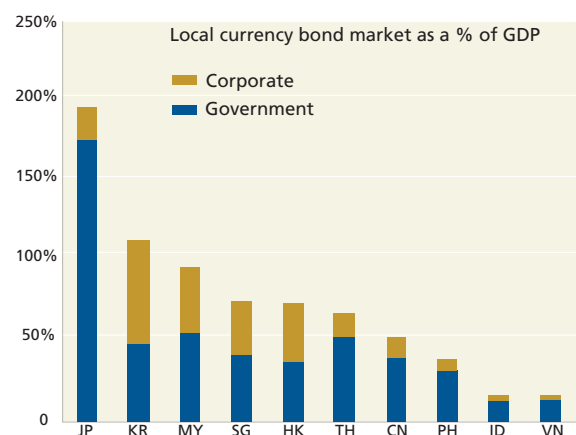
The development of a vibrant bond market was supported by a facilitative regulatory framework that streamlined the issuance process with the introduction of disclosure-based guidelines for private debt securities, asset-backed securities, structured products and Islamic securities. The enhancements to the rating process, improved price transparency and a conducive tax environment attracted a wide range of issuers including multilateral development banks, foreign multinational corporations, foreign governments and agencies.

The derivatives market, anchored by its strength as the global price discovery centre for crude palm oil (CPO), saw the notional value of derivatives traded annually grow by 19.8% from RM84.0 billion in 2000 to RM512.1 billion in 2010. Bursa Derivatives has positioned itself for rapid growth through a strategic partnership with the CME Group Inc. (CME Group), the world's largest derivatives exchange, and migrating to CME's Globex trading platform in 2010.

"The investment management industry witnessed high double-digit growth over the past 10 years."

Chart 2

Malaysia is the 3rd largest local currency bond market in Asia



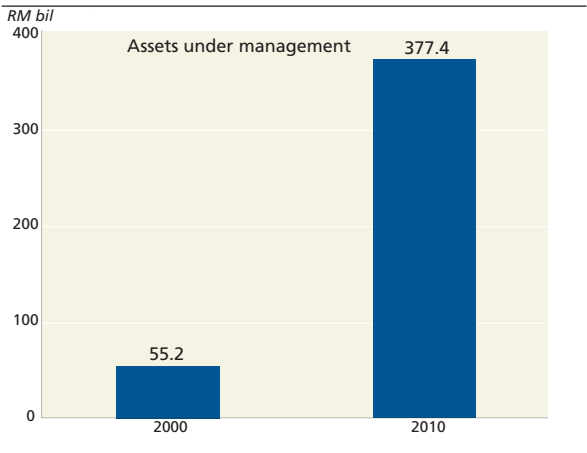
Source: Asia Bonds Online as at September 2010

The investment management industry witnessed high double-digit growth over the past 10 years. Assets under management (AUM) grew by 21.2% annually from RM55.2 billion in 2000 to RM377.4 billion in 2010. The rapid growth was largely driven by the unit trust industry where net asset value (NAV) grew by 18.0% annually from RM43.3 billion in 2000 to RM226.8 billion in 2010.

The penetration rate of the unit trust industry (measured by unit trust NAV over stockmarket capitalisation) rose from 10.0% in 2000 to 17.8% in 2010.

The robust growth of the investment management industry was due to several factors, including regulatory enhancements that facilitated product expansion and increased investor safeguards, favourable demographics in the form of an expanding labour force and high domestic savings. Regulatory facilitation increased time-to-market efficiencies and promoted an expansion in the range of collective investment schemes such as real estate investment trusts (REITs), exchange-traded funds (ETFs), wholesale funds as well as the development of over-the-counter (OTC) and structured products. The liberalisation of restrictions on investing abroad facilitated the launch of international product offerings by domestic intermediaries. Distribution channels were also widened to encompass institutional agents, fund supermarkets and financial planners.

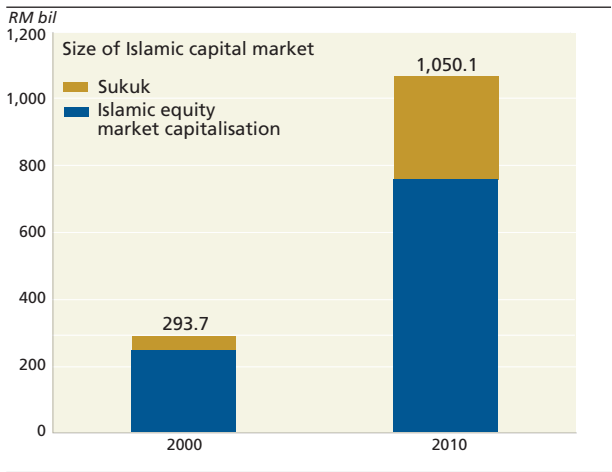
Chart 3
High-growth investment management industry



Source: Securities Commission Malaysia

Reflecting the strong underlying demand for Shariah-compliant assets, growth in ICM outpaced the conventional sector, expanding by 13.6% annually from RM293.7 billion in 2000 to slightly over RM1.0 trillion in 2010. As at the end of 2010, more than half of Malaysia’s capital market assets were Shariah-compliant.

Chart 4
Malaysia’s Islamic capital market tripled in size



Source: Securities Commission Malaysia

Over the past decade, Malaysia established itself as a major centre for the innovation and intermediation of Shariah-compliant products. Malaysia pioneered the launch of many ICM products and structures such as the exchangeable sukuk, sovereign sukuk and Islamic REITs, and maintains a significant presence in the global sukuk market and fund management industry.

Malaysia's ICM also benefited from a comprehensive regulatory framework for Shariah compliance and Shariah decisions, based on scholarly research, made by the Shariah Advisory Council. The Malaysian framework provided the advantages of clarity and consistency in investor protection on an extensive range of products such as sukuk, structured products, REITs and ETFs. Close collaboration between the Shariah Advisory Council, regulators, industry players and the exchange also facilitated the launch of Bursa Suq Al-Sila', a Shariah-compliant commodity trading platform.

Tax incentives were offered to attract greater international participation in origination, trading and fund management activities in Malaysia. This resulted in international sukuk issuances and listings and attracted international players to establish Islamic fund management operations as well as international Shariah advisers to offer their services in Malaysia. The success in growing international participation was spurred by the promotional efforts under the Malaysia International Islamic Financial Centre (MIFC) initiative; in which the SC has been active in efforts to strengthen international profiling of Malaysia's ICM.

"The Malaysian framework provided the advantages of clarity and consistency in investor protection..."

1.2 Evolved into a well-regulated and resilient capital market

Throughout CMP1, the SC adopted a regulatory model premised on market-based regulation with strong oversight to provide a balance between facilitating intermediation activities and ensuring high levels of investor protection. The strengthening of the regulatory framework underpinned the healthy and sustained growth of the capital market over the decade.

As market participants and advisers enhanced their professional standards and capabilities, there was a progressive shift to a disclosure-based regime that reduced issuance costs and shortened time-to-market for equity and debt fund-raising activities and the launch of investment products.

At the same time, investor protection requirements were reinforced through higher standards for disclosure, due diligence and accountability. Intermediaries were subject to ethical codes of conduct, know-your-client (KYC) rules and were also required to upgrade internal controls on governance, compliance and safe-keeping of client assets.

The increasing convergence of financial activities prompted a pragmatic shift towards risk-based supervisory approaches from a prescriptive rule-based approach. Regulatory oversight was extended to credit rating agencies and bond trustees to ensure higher professional standards. Surveillance and supervisory coverage was also expanded to improve early detection of incidents of market abuse and misconduct as well as to enhance the effectiveness of regulatory actions.

The shift to market-based regulation was also assisted through the formal recognition of the Federation of Investment Managers Malaysia (FIMM) as a Self-Regulatory Organisation (SRO), responsible for registering and monitoring the conduct of unit trust agents.

Legislative changes were enacted to broaden the range of civil and administrative enforcement tools, including extending the SC's ability to pursue enforcement action beyond disclosure-related offences and providing the ability to disgorge profits as well as to seek restitution for investors.

Over the years, the SC used its civil and criminal prosecution powers to take action against directors and officers for falsifying financial accounts of listed entities and furnishing misleading statements, against individuals and hedge funds for market rigging and manipulation and successfully disgorged profits for insider trading. The SC cooperates with other international regulators in actions against internet scams and ponzi schemes and, in a major case, obtained restitution for 19,000 investors.

In addition to the existing compensation fund, the investor safety net was strengthened with the establishment of the Securities Industry Dispute Resolution Center (SIDREC) in 2010. SIDREC acts as an independent redress mechanism for the mediation and adjudication of small monetary claims filed by individual investors in their dealings in capital market products. The SC also launched a comprehensive investor education blueprint to promote financial literacy and widen investor knowledge with coverage of more than 40,000 individuals annually.

Malaysia was among the earliest in the region to implement corporate governance reforms. The *Malaysian Code of Corporate Governance* was issued in 2000 and incorporated into Bursa Malaysia's listing rules in 2001. Consequently, the roles and responsibilities of Boards and audit committees were strengthened while internal audit guidelines and whistle-blowing provisions were introduced. The Audit Oversight Board (AOB) was established in 2010 to enhance the quality of audits and raise professional standards. Malaysia has also committed to converge with the International Financial Reporting Standards (IFRS) in 2012.

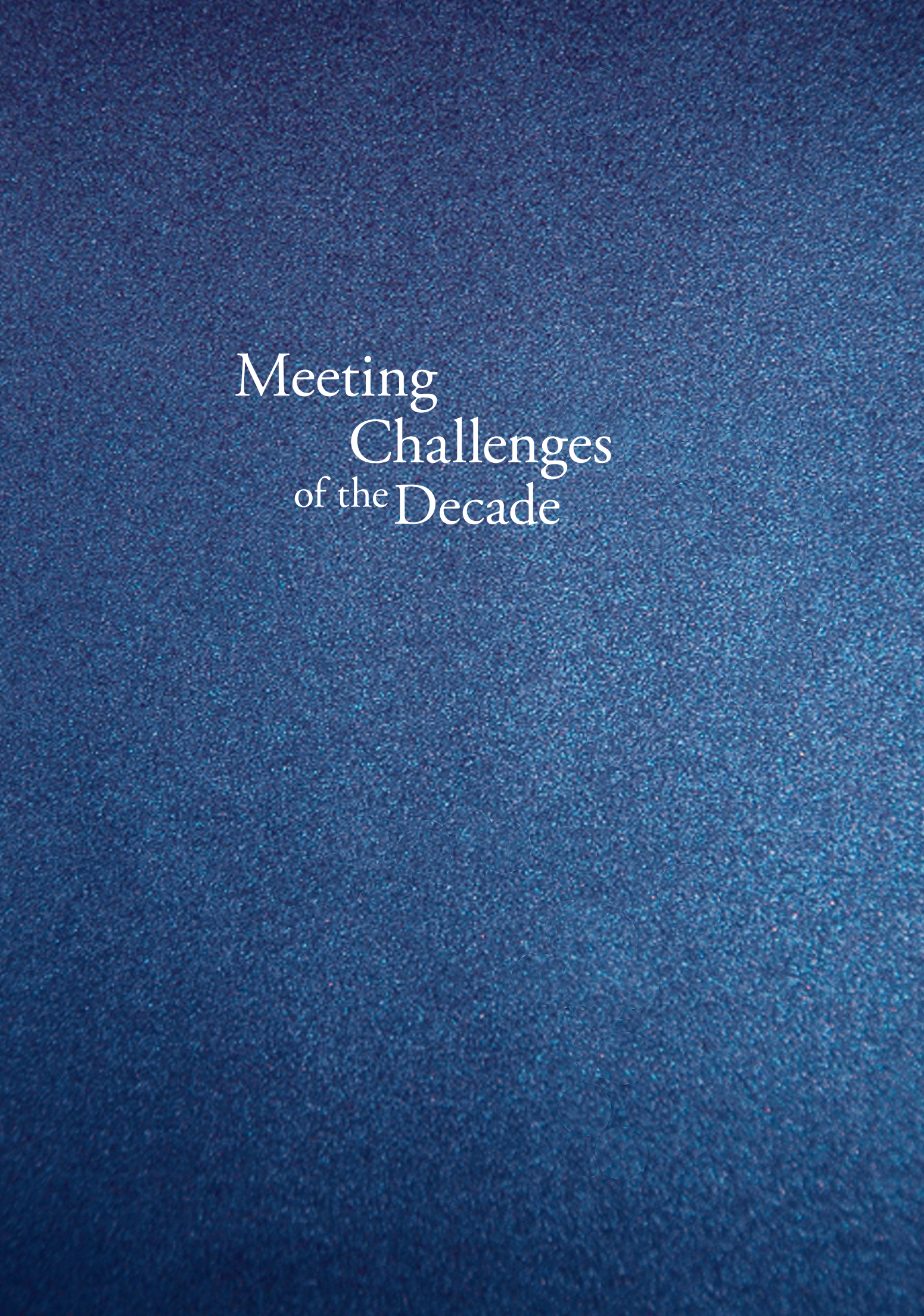
"Malaysia was among the earliest in the region to implement corporate governance reforms."

Prudential safeguards against systemic risks were also strengthened through the introduction of a risk-based capital adequacy framework and the ring-fencing of customer assets and capital to minimise potential areas of vulnerability to contagion risks. Market stability objectives were achieved through the introduction of circuit breakers, extensive market surveillance and a regulated framework for short-selling. Malaysia was relatively unaffected by the 2007-2008 global financial crisis due to regulatory requirements that ensured the financial soundness of its intermediaries.

Over the decade, there has been increasing international recognition of Malaysia's achievements in regulating its capital market. The SC became a signatory to the International Organization of Securities Commissions' (IOSCO) Multilateral Memorandum of Understanding (MMOU) for international cooperation on cross-border enforcement. In 2007, Malaysia was assessed as being highly compliant with the IOSCO *Objectives and Principles of Securities Regulation*.

Global recognition of Malaysia's regulatory framework and capabilities is already providing tangible benefits by supporting positive international assessments of the country, attracting portfolio investments and paving the way for Malaysian intermediaries to gain access to other markets via cross-border regulatory arrangements.

Through building a diversified market with strong intermediaries operating in a well-regulated environment, CMP1 provides a sound foundation from which to move forward with CMP2.



Meeting Challenges of the Decade

CHAPTER 2

MEETING CHALLENGES OF THE DECADE

The challenges of this decade are different from those that Malaysia faced over the previous ten years. The level of uncertainty in the operating environment is far greater, with the global economy and markets still adjusting to the long-term consequences of the global financial crisis in 2007–2008.

Malaysia is already undergoing structural changes as a key feature of the nation's transformation into a high-income and high-growth economy. Malaysia ranks among the leading trading nations and is a successful middle-income economy. The process of transforming Malaysia's economic structure and performance has begun with the implementation of recommendations under the New Economic Model (NEM) and National Key Economic Areas (NKEA).

The formulation of CMP2, therefore, occurs at a critical juncture. There is a need to strengthen the positioning of the capital market to meet challenges from the changing global landscape and to support the national economic transformation process.

In this context, deep and broad markets are a necessary prerequisite to enable the private sector to expand its role in intermediating savings to meet the investment needs of the population and to provide competitive funding sources to meet the financing needs of private sector businesses. In doing so, capital markets play an important role in financing business ventures, creating jobs, widening ownership of assets, and generating returns on long-term savings.

Towards this end, CMP2 outlines the strategies to transform the competitive dynamics of the capital market over the next 10 years. It outlines growth strategies to address key structural challenges and critical linkages to foster a more diverse and innovative intermediation environment and to nurture new growth opportunities.

“...CMP2 outlines the strategies to transform the competitive dynamics of the capital market over the next 10 years.”

In tandem with the changing intermediation landscape, CMP2 outlines governance strategies to ensure robust regulatory oversight and active stakeholder participation to enhance confidence in the integrity and soundness of Malaysia's capital market.

2.1 Transforming the competitive dynamics of the Malaysian capital market

Well-regulated markets strengthen the efficiency of capital allocation and engender the trust that is effectively required for the private sector to function as a source of dynamic growth. Over the years, capital markets have broadened access to financing, covering a full spectrum of economic activities and entities ranging from start-ups to large-sized privatisations.

Capital markets have also widened their reach to millions of investors and have become essential channels of organised investment schemes including managing retirement savings. These savings are matched with financing needs through a wide array of products to increase a nation's capacity to grow.

The growing role of markets thus reflects the vital contribution of capital markets in financing the development of a diverse and vibrant global economy. (See Box 1)

By global benchmarks, Malaysia is generally regarded as having well-developed equity and debt markets as its markets are relatively large compared to the size of the economy. As at the end of 2010, Malaysia's equity market capitalisation and outstanding debt securities were at 165% and 97% respectively as a proportion of nominal GDP.

While the core building blocks for market intermediation were built in CMP1, there are still gaps and inefficiencies that inhibit the level of financing activities, either directly or indirectly, for primary and secondary investments. Several of the weaknesses relate to the broader eco-system and these are being addressed by initiatives in the NEM and Economic Transformation Programme (ETP).

"The growing role of markets thus reflects the vital contribution of capital markets in financing the development of a diverse and vibrant global economy."

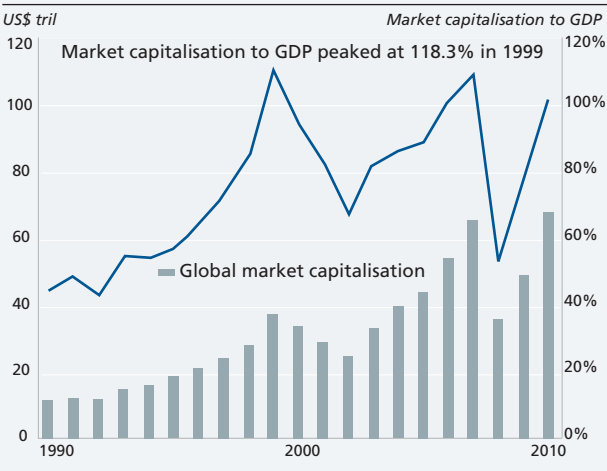
Box 1

Expanding role of markets in the global economy

The past two decades marked the remarkable ascendancy of markets in the global economy. As a reflection of this trend, global equity market capitalisation amounted to US\$10.4 trillion - less than half nominal GDP in 1990. As markets expanded rapidly, their influence on economic activities increased. By 2010, equity market capitalisation had risen more than six-fold to US\$67.3 trillion or 108.9% of global GDP.

In 1999, powered by internet stocks and in 2007, powered by emerging markets, global equity market capitalisation rose to 120% of GDP, only to retreat after a market downturn. Market volatility through its impact on valuations, returns and long-term expectations, is exerting greater influence on long-term economic growth prospects.

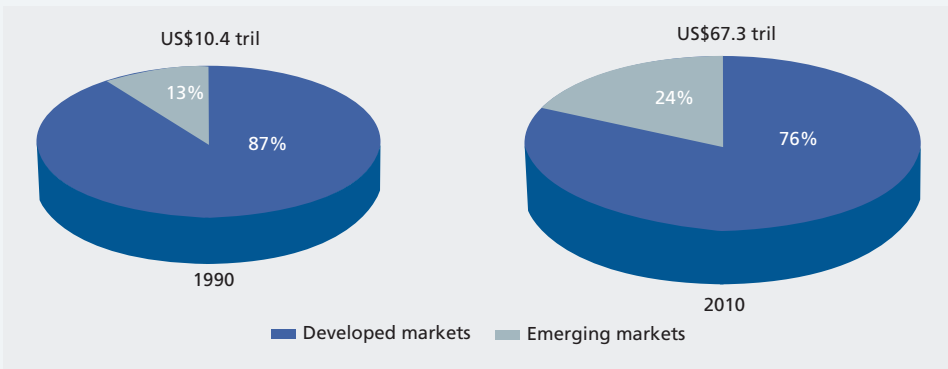
Global equity market capitalisation to nominal GDP ratio 1990–2010



Source: World Federation of Exchanges, World Bank and Securities Commission Malaysia estimates

The gap between developed and emerging markets has narrowed, reflecting the spread of financial activities and innovation worldwide. The emerging markets' share of global equity market capitalisation rose from 13% in 1990 to 24% in 2010.

Distribution of global equity market capitalisation



Source: World Federation of Exchanges, World Bank and Securities Commission Malaysia estimates

CMP2 focuses on addressing the structural weaknesses, and enhancing efficiencies in critical linkages in the capital market, to foster a more diverse and innovative intermediation environment and to nurture new growth opportunities. In relation to this, several key challenges were identified as follows:

- **Increase capacity and efficiency of the capital market in financing investment requirements for economic growth.** The ETP estimates that RM1.4 trillion in investments are needed to achieve economic growth targets over this decade. One of the priorities is therefore to strengthen the role of the capital market in promoting capital formation from start-up stage to the financing of large-scale projects and innovation;
- **Address structural imbalances between private sector savings and investments.** Malaysia has large domestic savings which are currently not efficiently intermediated to finance investments in the economy. Over the past decade, the success in establishing prudent institutional management of savings has led to savings being increasingly concentrated in a narrow range of highly liquid and low-risk investments. This in turn has limited the diversity of intermediation products and services and reduced the supply of risk capital that is needed to drive vigorous economic expansion;
- **Deepen secondary market liquidity.** The savings concentration that occurred during the past decade resulted in institutional demand for high-quality assets far exceeding supply. This subsequently reduced the free float and liquidity for these capital market assets. The low liquidity is also caused by the low tolerance for risks, the insufficient diversity in investment strategies, the low levels of risk intermediation (hedging and arbitrage), relatively high friction costs and the limited electronic channels for trading;
- **Build scale and identify new growth opportunities.** The size of Malaysia's capital market relative to the economy suggests that the capital market is approaching the limits of growth based on the domestic economy. The reliance on domestic growth has also tended to limit revenue growth, operational scale and, to an extent, the ability to compete for talent. There are several inter-related approaches to expanding growth boundaries. They include pursuing opportunities through greater internationalisation, identifying untapped growth opportunities outside core intermediation areas, and facilitating business models oriented towards capturing scale-driven efficiencies or high value-add in niche areas; and
- **Build capacity and strengthen the information infrastructure.** Apart from strengthening the ability to attract and retain talent, there will be a greater need to adapt to a changing workforce, a diffused working environment and the pervasive use of technology in many aspects of capital market activities in the future landscape. The infrastructure for the development of human capital, and for capital market information, will increasingly define the potential for future growth.

2.2 Managing risks from a changing landscape

The growth of capital markets around the world has been driven by financial innovation that provided new tools to organise tangible and intangible capital into productive ventures. Advances in financial theory and technology facilitated the conversion of properties, commodities, businesses, and ideas into readily tradeable assets. This underpinned an expansion in the financing of new ventures and the emergence of new industries.

While financial innovation has channelled greater flows of capital into financing innovation and enterprise, it has also increased the financialisation of economic activities relative to the generation of productive wealth. The rising proportion of financial assets relative to physical assets is a phenomenon arising from the globalisation of financial markets as well as the expanding role of intangible assets in creating wealth.

The financialisation of economies is also perceived to be a major source of instability. In this context, there has been an increase in the occurrences of financial crises around the world over the past two decades. The impact of these financial crises has been substantial. Societies have been affected by market failures which caused severe losses in the value of retirement savings as well as the closure of businesses and loss of jobs.

Although not perfect, markets are still by far the most effective tool to allocate resources and manage risks. In allocating resources and risks, market imperfections reflect the tensions in maintaining a delicate balance between the interests of different stakeholders and the need to manage the risks inherent in transactions.

The lessons are that increasing financialisation needs to be accompanied by strong regulatory oversight and governance arrangements to manage the risks from profit-seeking tendencies that result in excesses, abuses, and the preoccupation with short-term outcomes.

Historically, incremental layers of regulation were added to restore public confidence in capital markets after each episode of market failure. Regulation plays a crucial role in correcting market excesses by reassuring investors that investment and market activities will be conducted in a fair manner and in their best interests.

“Regulation plays a crucial role in correcting market excesses by reassuring investors that investment and market activities will be conducted in a fair manner and in their best interests.”

The challenges to the Malaysian capital market stem not only from the intrinsic instability of increased financial activities but also from the increased complexity of financial intermediation in a multi-venue, multi-product and multi-asset environment. (See Box 2)

Box 2

Changing patterns of global market development

Financial and technological innovation has changed the pattern of global capital market development through stimulating variety and diversity. Rising sophistication, flexibility, and mobility of capital market activities pose greater challenges for regulators to manage the risks to investors and stability.

- **Greater choice, diversity and complexity.** Markets today offer considerably more choice with an expanded range of products that facilitates more precise combinations of risks, returns, and liquidity to accommodate a variety of issuers and investors.
- **Fragmentation of activities and assets.** Capital market activities are increasingly being transacted electronically with multiple parties handling specialised parts of a transaction. Securitisation and derivatives are also being used to alter the economic rights, risk characteristics and transparency of products. This presents difficulties in understanding and valuing products, affects monitoring of market transactions and presents challenges in risk assessment.
- **Increasing shift from relationships to transactions.** With electronic channels, investors are simultaneously using a number of service providers to obtain more advantageous terms and prices. Contact between clients and intermediaries are increasingly based on transactions and this is creating greater transience in intermediation relationships.
- **Increasing international mobility.** The creation of common rules, standards, and infrastructure links across markets has improved the mobility of economic activities, assets and transactions across borders.

It is important to learn from the lessons of past financial crises that innovation and complexity will create risks that will continuously test the resilience of the Malaysian capital market. Managing these risks will be the key challenge in deepening and broadening the Malaysian capital market.

In this regard, Malaysia has maintained strong regulatory oversight over the past decade and it is the Malaysian experience that sound regulation grows resilient markets and healthy industries. It is the SC's view that regulation plays a crucial role in defining the governance arrangements to reinforce investor trust and confidence in the integrity of markets and in ensuring widespread social acceptance of growth-enhancing financial innovation.

However, it is not intended for regulation to be a substitute for capital market stakeholders being vigilant and actively shaping governance practices that ultimately result in responsible and conscientious financial and corporate behaviour which generates sustainable long-term wealth.

CMP2 will therefore focus on ensuring robust governance arrangements to manage the risks to investor protection and stability. In this context, managing the risks from a changing intermediation landscape will require the following:

“CMP2 will therefore focus on ensuring robust governance arrangements to manage the risks to investor protection and stability.”

- **Clear points of accountability with effective regulatory oversight and reach.** In the changing landscape, intermediation will be more diverse and fragmented with potential vulnerabilities across the entire transaction chain. This requires an extension of oversight to ensure there is no regulatory vacuum. Regulation must be strengthened to address information asymmetries, ensure fair conduct as well as provide sufficient avenues for recourse to aggrieved customers;
- **Higher standards and capabilities in the operation of intermediaries.** The pursuit of high growth inevitably encompasses higher levels of risk. These risks must be managed through ensuring higher standards of ethical conduct as well as placing priority on clients' interests and internal controls;
- **Extension of regulatory focus to stability risks.** It is necessary to ensure markets have the resilience to withstand shocks to mitigate disruptions to the intermediation process that may be severe enough to impair the efficient allocation of savings. Sufficient regulatory oversight and reach will be required to detect risks hidden in complex products and opaque venues and to facilitate timely action to mitigate or resolve emergent risks;
- **Higher corporate governance standards.** Investors need to be assured of their rights as shareholders to encourage greater supply of capital. Greater stewardship by Boards, more extensive shareholder participation, and increased accountability for the reliability of disclosures, will reinforce good governance practices; and
- **Broadening participation in governance.** Market and self-disciplinary mechanisms can only function effectively through the active participation of all stakeholders in shaping the norms and beliefs to reinforce ethical conduct in the capital market and to broaden the scope of business to encompass socially responsible objectives.

2.3 Growth prospects to 2020

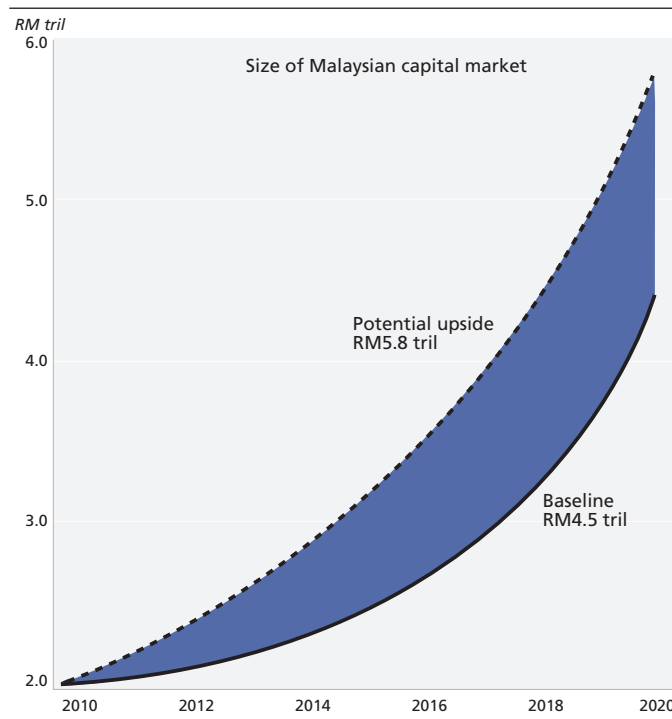
The Malaysian capital market has significant growth prospects. The SC estimates the size of Malaysia's capital market (comprising stockmarket capitalisation and debt securities) to more than double from RM2.0 trillion in 2010 to RM4.5 trillion by 2020.

The baseline forecast is predicated on annual real GDP growth of 6.5% and historical market benchmarks, and is subject to prevailing economic and market conditions. Overall, the long-range forecasts provide a reasonable reflection of baseline growth prospects based on extrapolation of historical trends.

Further analysis indicates there are strong upside prospects for the Malaysian capital market. The structural reforms and high impact investment projects under the NEM and ETP can accelerate economic growth momentum with a significant impact on the upside for the long-term growth of the capital market.

Chart 5

Projections for Malaysia's capital market to 2020



Source: Securities Commission Malaysia estimates

Based on benchmarks for regional financial centres, it is estimated that internationalisation of the stockmarket could increase the potential size of the Malaysian capital market by another 30% to RM5.8 trillion in 2020. Higher levels of internationalisation would also have positive growth effects on the bond market and ICM.

In addition, several segments are expected to achieve critical mass such as ICM which is projected to increase from RM1.1 trillion in 2010 to RM2.9 trillion in 2020 and the investment management industry where AUM is projected to rise from RM377.4 billion in 2010 to RM1.6 trillion in 2020. The most important effect from achieving critical mass is the facilitation of volume strategies and higher efficiency from increased economies of scale.

Based on historical trends, the growth of the investment management industry is likely to outpace the growth of equity assets over this decade. This is a feature typical of an economy in transition from middle income to developed status. Projections indicate that the penetration rate for unit trusts is likely to almost double from 18% in 2010 to 34% in 2020, which is closer to levels usually seen in developed markets.

The annual notional value of derivatives trading of RM512.1 billion in 2010 is currently largely based on CPO futures contracts. There is substantial upside from further expansion of derivative products and this will deepen liquidity across market segments through positive spill-over effects from higher levels of inter-market trading, hedging and arbitrage.

With the core intermediation industries reasonably developed, the developmental focus will shift towards nurturing future growth segments particularly in ancillary layers supporting intermediation activities. The development of more competitive niches will foster higher productivity and value-add activities with the supporting clusters providing positive growth feedback effects.

Overall, CMP2 offers a broad set of strategies that are aimed at addressing key structural challenges and critical linkages to create a conducive environment for private sector intermediation and expanding the growth boundaries of the capital market.

These will be complemented with strategies to ensure effective governance arrangements to sustain confidence in the integrity of Malaysia’s capital market and to maintain strong regulatory oversight to safeguard the interests of investors.

OVERVIEW OF CMP2 STRATEGIES	
GROWTH	GOVERNANCE
<div><div></div><div>Promote capital formation</div></div>	<div><div></div><div>Enhance product regulation to manage risks</div></div>
<div><div></div><div>Expand intermediation efficiency and scope</div></div>	<div><div></div><div>Expand accountabilities as intermediation scope widens</div></div>
<div><div></div><div>Deepen liquidity and risk intermediation</div></div>	<div><div></div><div>Robust regulatory framework for a changing market landscape</div></div>
<div><div></div><div>Facilitate internationalisation</div></div>	<div><div></div><div>Effective oversight of risks</div></div>
<div><div></div><div>Build capacity and strengthen information infrastructure</div></div>	<div><div></div><div>Strengthen corporate governance</div></div>
	<div><div></div><div>Broaden participation in governance</div></div>



Growth Strategies to Expand role of Capital Market

CHAPTER 3

GROWTH STRATEGIES TO EXPAND ROLE OF CAPITAL MARKET

The CMP2 outlines the strategies to transform the competitive dynamics of Malaysia's capital market over the next 10 years. The development of the capital market is an important aspect of the nation's economic transformation since deep and broad markets are necessary prerequisites to achieving high growth and high income.

The strategies aim to expand the role of the capital market in financing business ventures, creating jobs, widening ownership of assets, and generating returns on long-term savings.

GROWTH STRATEGIES:

1. Promote capital formation. Create a conducive intermediation environment to seed emergent companies and industries, nurture the growth of small and mid-cap companies, finance large and high-risk ventures, and promote investments in socially responsible projects.

2. Expand intermediation efficiency and scope. Address structural constraints to increase the efficiency of savings intermediation and foster an innovative and diverse intermediation

environment to expand the supply of assets to meet the needs of investors.

3. Deepen liquidity and risk intermediation. Broaden the diversity of investment strategies and strengthen market connectivity through risk intermediation products and widening the range of participants.

4. Facilitate internationalisation. Expand growth boundaries by tapping global opportunities to facilitate an expansion in

scale and to capitalise on hub opportunities in areas of comparative advantage.

5. Build capacity and strengthen information infrastructure. Strengthen the knowledge base through talent development and acquisition to support the expansion of the capital market into high value-add areas and build a strong information infrastructure to address information asymmetries and promote service innovation and efficiency in a highly-electronic environment.

3.1 Promote capital formation

There are abundant growth opportunities in Malaysia with prospects across a broad front of emergent competitive niches in service-based segments such as healthcare, tourism, logistics, education and food as well as knowledge-based segments such as creative industries, green technology, biotechnology and information technology.

There are also opportunities arising from innovative re-design of service processes and products in traditional sectors such as manufacturing, agriculture and infrastructure while new markets and opportunities are likely to emerge from growing cross-border regional trade and investment.

Since CMP1, business enterprises in Malaysia have considerable choice in financing their growth with the broadening of fund-raising avenues. This provides flexibility to opt for varying debt or equity financing arrangements depending on market conditions and to choose a capital structure that optimises returns to shareholders.

“Addressing these gaps and inefficiencies will overcome investment bottlenecks and increase the rate of capital formation as well as the supply of quality assets...”

Malaysia has more than sufficient domestic financial resources to finance higher levels of domestic investments to achieve higher growth. However, there appear to be gaps in the eco-system from the start-up stage through the entire deal-flow pipeline which inhibit a higher level of completion of primary transactions. Addressing these gaps and inefficiencies will overcome investment bottlenecks and increase the rate of capital formation as well as the supply of quality assets in the Malaysian capital market to match the substantial needs of investors.

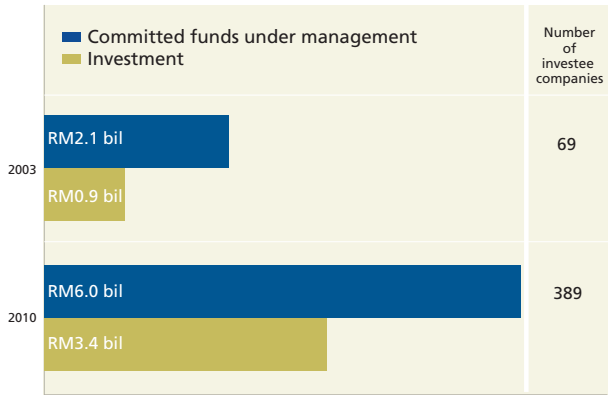
3.1.1 Increase private sector participation in the venture capital and private equity industries

The government recognised the important role of the venture capital (VC) industry as a source of financing to emerging high-growth companies and provided significant funding and tax incentives to promote the growth of the industry. Arising from the strong government commitment, the Malaysian VC industry has enjoyed high growth with committed funds growing by 16% annually from RM2.1 billion in 2003 to RM6.0 billion in 2010 with about half of the funds disbursed for investment. (See Chart 6)

Despite the growth, the VC industry has yet to achieve sufficient critical mass to generate self-sustaining growth momentum. A broad range of industry challenges were highlighted in a study on funding for an innovation economy overseen by the Malaysian Venture Capital Development Council (MVCDC) while the NEM has made several key recommendations to strengthen the growth of the industry.

As an outcome of these recommendations, there are on-going efforts to streamline national initiatives to promote innovation and to ensure more coordinated and effective public sector funding of the VC industry. In this regard, there are considerable benefits from closer partnerships based on public funding and private sector expertise through co-investment approaches such as matching government grants or initial funding schemes.

Chart 6
Venture capital funding and investee companies



Source: Securities Commission Malaysia

There are also opportunities for further public-private sector collaboration in the critical areas, namely at the start-up stage or in nurturing patents towards the commercialisation stage. Initiatives such as angel networks will assist in seeding the formation of innovation-based companies.

Moving forward, the expansion of the role of the private sector in developing the VC industry and the complementary development of the private equity (PE) industry are important strategies to broaden the sources of financing. Higher private sector involvement in these industries are critical to providing technical skill sets and market knowledge to assist new ventures to quickly build commercial track records to increase VC deal flow.

Currently, private sector participation in the VC and PE industries is relatively low-key and loosely organised. This is partially due to the limited range of legal structures for pooling of investments and will be addressed through corporate law reform and regulatory changes to facilitate a widening of the asset classes for intermediation. It also underlines the need to attract investment from institutional and high net-worth investors.

In addition, the PE industry comprises a broad range of regulated and unregulated participants investing in a broad spectrum of unlisted and listed assets. The lack of formal regulatory oversight hinders the orderly development of a highly professional industry.

Towards this end, a framework to formalise regulatory oversight will be developed to promote investor confidence in the VC and PE industries, taking into account the unique characteristics of these industries. Regulatory oversight will aim to establish standards of professional management and safeguards. It will also provide for the maintenance of records and facilitate a more effective tax regime.

In tandem with this, it is strategically important to expand the participation of the public and private sector investment management industry in VC and PE. First, increasing the portfolio allocation into primary investments will strengthen the intermediation linkages between savings and capital formation. Second, it will reduce the correlation between investment portfolios with market risk, thereby reducing systemic risks. Third, the investment management industry is now sufficiently large to be able to dedicate the necessary resources to accumulate the expertise and build the capabilities to assess and manage the risks of investing in primary transactions, either on their own or through outsourcing mandates. An increase in institutional demand for VC and PE assets and services is critical to promoting the growth of the industry.

“...increasing the portfolio allocation into primary investments will strengthen the intermediation linkages between savings and capital formation.”

One major constraint for institutions to invest in unlisted assets relates to the illiquidity of these investments. A review would be undertaken to assess the viability of establishing facilities to mitigate illiquidity risks of investing in VC and PE assets.

Efforts will also be made to promote greater PLC participation in seeding the formation of innovation-based companies or through providing greater support to the VC and PE industries. In this regard, collaborative initiatives will be identified to facilitate PLCs to provide greater support to VC investee companies via vendor schemes, co-investment arrangements or through their participation in an angel network.

The VC industry is also generally constrained by the inadequate number of professionals, high staff turnover and a general lack of the deep technical and market knowledge to assist successful commercialisation of technological-based ventures.

It is important to target the critical talent linkages that may affect the investor's perception of the prospects for a large pay-off within a reasonable time frame. The selection of management teams with the perceived capability of overcoming challenges typically associated with new ventures would provide greater confidence and increase the willingness to invest in companies without a track record.

Towards this end, Talent Corporation Malaysia Bhd (TalentCorp) can facilitate connecting domestic and international talent with global industry knowledge and track records with the opportunities that are available in Malaysia's VC and PE industries. These strategies will provide the foundation to strengthen professional management and ensure more organised and efficient efforts in promoting early-stage capital formation.

Box 3

Promoting venture capital investments through the capital market

To promote the growth of the venture capital industry, the MESDAQ Market was launched in 1998 to cater for the listing of high-growth and technology companies. MESDAQ has been a major success as a growth platform and has now been re-positioned as a sponsor-driven market called the ACE Market to further broaden access to equity capital for domestic and international companies.

The number of companies listed on ACE Market (formerly MESDAQ) has increased from 12 companies in 2002 to 113 companies in 2010. The market has also nurtured growth companies which have been promoted into the Main Market of Bursa Malaysia. In total, 23 companies have transferred to the Main Market; of which 15 companies had a market capitalisation in excess of RM100 million as at the end of 2010.

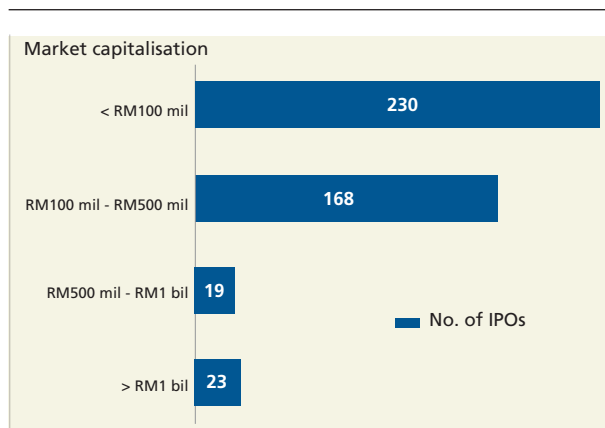
The ability of the investment management industry to participate in primary investments and in the VC and PE industries has been expanded over the past decade. Flexibilities were provided for the investment management industry to invest in unlisted securities and wholesale funds to invest in venture capital funds. Collective investment schemes such as unit trust funds and closed-end funds were also allowed to invest up to 10% of their net asset value (NAV) in unlisted securities. The framework for listing of special purpose acquisition companies (SPAC) provides another vehicle for capital-raising by VC and PE firms.

3.1.2 Strengthen economic functionality of the stockmarket in promoting growth of small and mid-cap companies

Once companies reach a sufficient size, public markets can promote their growth through providing a healthy initial public offering (IPO) market for small and mid-cap companies. Small and mid-cap companies contribute significantly to innovation, job creation, economic growth and shareholder returns over the long term.

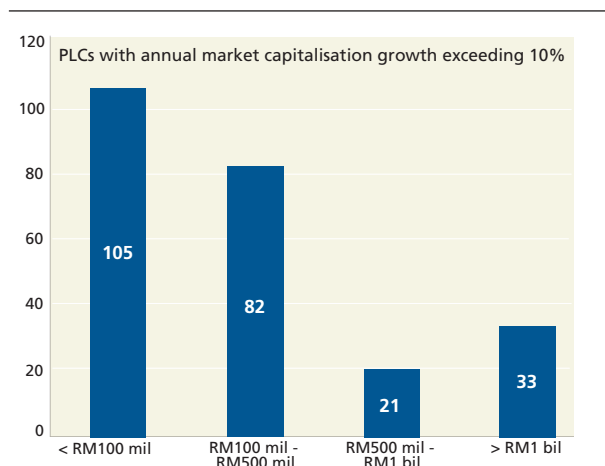
Over the past decade, the Malaysian stockmarket has been successful in providing equity finance to small and mid-cap companies. Of the 440 IPOs on Bursa Malaysia over the past 10 years, 230 companies or 52% of IPOs started with a market capitalisation of less than RM100 million. Another 168 companies or 38% of IPOs had market capitalisation of between RM100 million and RM500 million. (See Chart 7)

Chart 7
IPOs by market capitalisation 2000–2010



Note: IPO size based on listing year-end market capitalisation
Source: Securities Commission Malaysia

Chart 8
Growth companies by market capitalisation 2000–2010



Note: Based on initial market capitalisation as at end-2000 or year-end of IPO listing
Source: Securities Commission Malaysia

Small and mid-cap companies contribute on the margin to current market capitalisation and trading value. Nonetheless, they are an important source of future growth both for the economy and the capital market. Many of Malaysia's large companies today were once small companies two or three decades ago.

Of the 955 companies on Bursa Malaysia, 241 public-listed companies (PLCs) grew their market capitalisation by more than 10% annually for the period 2000 to 2010. Of these, 60 companies had annual growth rates exceeding 25%. The majority of the high-growth companies, comprising 78% of the 241 PLCs, started with a market capitalisation of less than RM500 million. (See Chart 8)

Longer-term global trends in relation to changes in equity market structure portend future challenges in nurturing the growth of small and mid-cap companies using traditional intermediation models. In many markets, the viability of the traditional agency distribution model (comprising research, distribution and market-making) that supported active trading

in small and mid-cap stocks has diminished since the emergence of electronic trading which has tended to concentrate liquidity within the largest stocks.

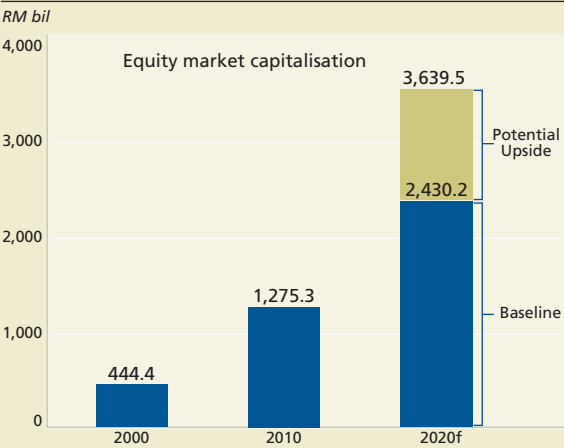
The equity market structure changes have resulted in a weak IPO environment and low valuations and trading inactivity of listed small and mid-cap companies. The weak equity market environment has also raised concerns over the knock-on effects affecting venture capital, private equity and mergers and acquisition (M&A) activities. As a consequence, some developed markets have experienced a decline in IPOs and an increase in de-listings since 2005.

There is also a need to anticipate challenges to the Malaysian equity market arising from the relative maturity of the economy. Therefore, greater efforts are required to strengthen the economic functionality of markets in promoting the growth of small companies and in serving the interests of long-term investors.

Box 4

Growth prospects for equity market to 2020

Equity market capitalisation to double to RM2.4 trillion in 2020



Source: Securities Commission Malaysia estimates

Historical trends suggest that underlying growth in equity market capitalisation is largely driven by long-term economic and corporate earnings growth. At the baseline level, it is projected that the size of equity market capitalisation will double from RM1.2 trillion to RM2.4 trillion by 2020 – based on real GDP growth of 6.5% and a historical average market capitalisation to GDP ratio of 139%.

There are significant upside growth prospects from the structural reforms and investment projects being undertaken under the NEM and ETP. In this context, the implementation of structural reforms can accelerate the growth of the real economy while greater internationalisation of domestic listed companies and additional foreign listings can facilitate a significant expansion in equity market capitalisation. It is estimated that internationalisation of the stockmarket can increase its potential size by 50% to RM3.6 trillion in 2020.

In addition, the large domestic investments, new listings of government entities and the rapid growth of Malaysia's broad base of small and mid-cap stocks will contribute significantly to market capitalisation growth over the decade.

Further collaboration with capital market intermediaries, PLCs and relevant organisations is required to identify and address issues relating to the growth of listed small and mid-cap companies. Regulatory facilitation will be provided to enable intermediaries to evolve business models that promote research, distribution and market-making support for these companies. The establishment of venues for unlisted companies, where access will be limited to sophisticated investors, will also provide greater access to funding and fast-track their transition to a listing in a public market.

Investor confidence has also been affected by investments in listed companies which experience persistent losses or are in financial distress. Poor corporate performance may arise from a combination of difficult industry operating conditions, mismanagement or weak governance. It is important that investor confidence issues in relation to poorly-performing companies are proactively managed including through initiatives that facilitate a turn-around in operational viability.

3.1.3 Widen access to the bond market

The development of a significant bond market provided critical long-term financing to many large-sized and catalytic economic projects, resulting in Malaysia having one of the best infrastructures in the region, ranging from international airports and highways to power plants and telecommunications. The bond market has also been a source of financing support for banks and corporations and provided liquidity to balance sheets through the securitisation of mortgages and other receivables.

“Widening the credit spectrum therefore requires strengthening investor confidence, increasing the participation of the public and private investment management industry, expanding the product range and enhancing the market infrastructure.”

In tandem with the economic transformation plans, there is a need to broaden the capability and capacity of the bond market to supply financing to a wider base of industries and projects; particularly in supporting the structural shift towards the services and knowledge-based industries.

The ability to widen access to bond financing for more sophisticated ventures is critically dependent on broadening the investor base and appetite for a wider array of debt products and credit risks.

Widening the credit spectrum therefore requires strengthening investor confidence, increasing the participation of the public and private investment management industry, expanding the product range and enhancing the market infrastructure.

Towards this end, market standards and practices will be enhanced through improving documentation and disclosure standards as well as clarifying post-issuance disclosure obligations and requirements. The credit rating agency (CRA) framework will be further enhanced to converge with new international standards and best practices covering key areas such as the transparency of rating criteria and policies, rating reviews and the governance structure of CRAs.

“The participation of the public and private sector investment management industry in fixed income investments needs to be further strengthened.”

The default process for bonds will also be reviewed to provide greater clarity and certainty to investors. In tandem with this, efforts will be made to promote a more active market for the pricing of distressed issues.

The participation of the public and private sector investment management industry in fixed income investments needs to be further strengthened. This will require building their fixed income investment capabilities to enable their participation in a broader spectrum of structures and credits.

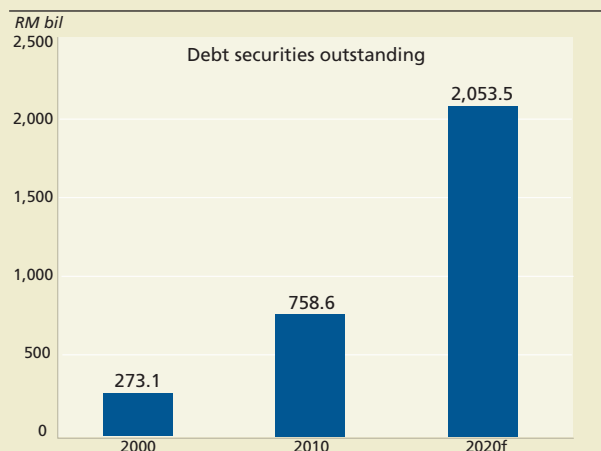
There is also a need to increase transparency and liquidity in the secondary market to match the growth in primary issuance. This will be achieved through strengthening the environment for electronic trading and infrastructure in the areas of bond lending, market-making, trading, clearing, settlement and custodian services.

Efforts will also be made to promote greater retail participation in the bond market through developing a framework to facilitate the offering of corporate bonds to retail investors, covering the eligible issuer base, mode of offering, format of offering documents, price transparency, investor protection and education activities. In addition, distribution channels will also be widened to enable greater retail investment.

The availability of a broad range of interest rate-sensitive products is required for the application of sophisticated fixed-income investment strategies and to promote active trading and arbitrage in the bond market. In conjunction with increasing institutional investment in fixed income, the product range will be broadened to include fixed-income indices and inflation-linked products.

Further additional mechanisms will be considered to widen participation and deepen liquidity in the bond market. The establishment of Danajamin Nasional Bhd provides a means for less-established companies to gain access to the bond market and to establish their track record for credit-worthiness while a review will be undertaken to assess the viability of establishing facilities to mitigate illiquidity risks of bond funds.

Box 5

Growth prospects for bond market to 2020**Debt securities to exceed RM2 trillion in 2020**

Source: Securities Commission Malaysia estimates

Malaysia's bond market is relatively well-developed with outstanding bond issuances approximating 97% of GDP. It is ranked the third largest bond market in Asia by GDP. Market depth is reflected by an average weighted bond tenure of 16 years and an average issuance size of RM670 million, while market width is reflected by the diversified range of conventional and Islamic instrument.

The bond market is expected to sustain reasonable growth over this decade. The ETP has already identified several major infrastructure projects which will underpin strong domestic issuance. Demand growth will be driven by the increasing participation of the investment management industry in fixed income investments and through growing international participation in Malaysia's bond and sukuk market.

Further improvements in the legal, regulatory and institutional framework will support the continued deepening and broadening of the bond market. The growing pool of fixed income professionals will provide the necessary expertise to originate debt and sukuk structures to match the financing requirements for infrastructure projects and the investment needs of both the private and public sectors.

3.1.4 Promote socially responsible financing and investment

Financial innovation can be harnessed to create market-based solutions to mobilise investments in technology and projects that promote sustainable and inclusive development. There is room to expand the role of the capital market in developing innovative approaches to finance environmental projects such as the development of alternative energy sources or clean technologies. A broad range of financing instruments can also be developed to finance community infrastructure development and the building of educational, healthcare and cultural facilities.

The financing of these projects typically requires multi-stakeholder involvement including governments, regulators, businesses, NGOs, consumers, intermediaries and investors. Many aspects of environmental projects are dependent on collaboration to create the necessary infrastructure for standardisation, certification and transparency. These projects usually require government support, including incentives.

Innovative products such as green funds or bonds can be used to finance investments in low-carbon technologies and support various programmes to test innovative approaches to managing climate change such as forestry and energy renewal. The creation of these funds usually requires coordination between academic and research institutions to provide businesses and intermediaries access to technical expertise. Greater coordination in financing green technology investments will also assist the fulfilment of national commitments on environmental sustainability.

Malaysia's economic and resource base will provide longer-term opportunities for the trading of environmental products such as carbon credits or alternative risk transfer mechanisms such as weather derivatives or catastrophe bonds.

As Malaysia becomes increasingly affluent, it is critical that PLCs and intermediaries enhance their international reputation through increasing their participation in projects which promote sustainable development.

Globally, the investment management industry has provided substantial impetus in recognising societal concerns as part of its corporate responsibility. The momentum of socially responsible investing (SRI) funds reflects the growing interest of institutional investors to build a sustainable economy that generates long-term wealth. Their innovative investing styles have influenced corporations to improve their practices on environmental, social and governance issues.

SRI provides a base for the launch of investment products such as SRI indices and exchange-traded funds (ETFs). SRI can also be used to finance small and local community projects such as for affordable housing, small business creation, development of community facilities, empowerment of women and minorities, education, childcare and healthcare.

3.2 Expand intermediation efficiency and scope

There have been structural changes in the channels of savings mobilisation and intermediation in Malaysia since 2000. The first occurred with the diversification of the sources of financing in the Malaysian capital market. The financial deepening broadened the intermediation base and increased the avenues for financing large-scale projects to reduce concentration risks and maturity mismatch.

The second structural change occurred with the rapid growth of institutional funds relative to the size of the economy, similar to the trends witnessed in developed markets. Using assets under management (AUM) by licensed fund managers and the Employees Provident Fund (EPF) as a proxy, aggregate institutional funds as a percentage of nominal GDP rose from 65.4% in 2000 to 101.7% in 2010.

The large amount of savings managed by organised public and private investment schemes relative to the size of the economy reflects the increasing influence of investment strategies of institutional investors on the capital market and economy. Effectively, their collective demand for assets shapes the intermediation landscape and how savings are invested in the economy.

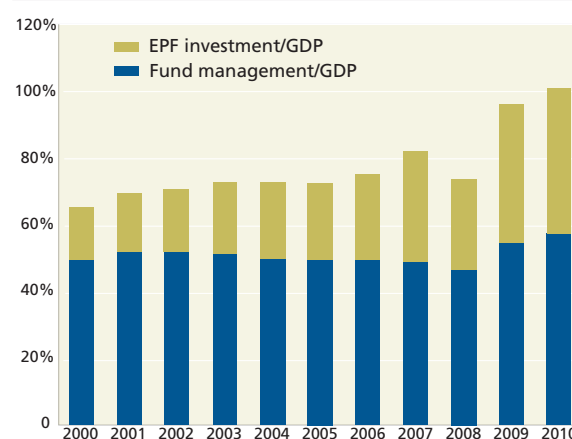
Institutional investors have tended to concentrate their investments in liquid and high-quality assets. This “narrowness” of the demand

for assets implicitly limits the availability of financing to high-risk ventures. As an outcome, Malaysia’s intermediation landscape is similarly characterised by relatively narrow product silos, reflecting in part the lack of substantial demand for a broader range of intermediation services.

The growth of Malaysia’s capital market and its contribution to economic activities can be expanded by addressing structural constraints to the efficient recycling or intermediation of high national domestic savings.

Fostering an innovative and diverse intermediation environment requires tackling demand through broadening the risk profile of savings intermediation as well as simultaneously expanding supply by strengthening capabilities and the range of products and services.

Chart 9
Institutional funds as a % of nominal GDP



Note: Fund management excludes Employees Provident Fund mandates

Source: Securities Commission Malaysia

3.2.1 Facilitate efforts to enhance efficiency of public sector savings intermediation

Historically, investment institutions such as the EPF and Permodalan Nasional Berhad (PNB) were established to mobilise savings to finance government infrastructure development and to broaden Malaysian participation in the industrialisation process.

As the capital market deepened over the decades, public and private sector investment institutions inevitably shifted from their developmental objectives towards greater emphasis on prudent and passive investment strategies aimed at ensuring safety and returns to contributors and investors. This resulted in a tendency to replicate the most successful investment strategy, namely buying and holding the largest PLCs.

While risks may appear diversified at the level of the individual investment institution, when the effects are viewed on an aggregated basis, the adoption of similar investing strategies inadvertently reduces diversification of national savings. The replication of portfolios across investment institutions increases the correlation of national savings with market risks.

Passive institutional investment strategies also result in long-term funds being largely invested in liquid instruments. This leaves an equity gap in entrepreneurial financing that is critical to driving the nation's economic growth which, in turn, reduces the supply of risk capital to support the creation of new assets for the capital market. With savings outpacing the creation of equity assets, this aggravates the effects arising from an imbalance between domestic savings and investments.

“...the optimal deployment of GLIC funds is central to increasing the intermediation efficiency of national savings...”

In this context, the structural imbalances evolved out of the success in implementing policies to ensure prudent institutional management of national savings. The domestic institutional funds are responsibly managed and represent a strategically important liquidity buffer that lends strength to Malaysia's financial soundness and underpins its ability to internally finance future growth.

Therefore, addressing the savings-investment structural imbalance requires careful assessment of the system-wide effects of institutional investment strategies and the impact of subsequent changes to existing policies on the capital market and economy.

Arising from the NEM and ETP, there are already on-going efforts to review the government's role in business and to optimise the deployment of Government Linked Investment Corporation (GLIC) funds. In this context, the optimal deployment of GLIC funds is central to increasing the intermediation efficiency of national savings with substantial positive benefits on capital formation, private sector participation, secondary market liquidity, risk-taking and product and service diversity.

There is room to reduce areas of overlapping activities among GLICs to achieve greater diversity in investment strategies to optimise returns and reduce the correlation of aggregated portfolios with market risk.

There is a need to review the impact of the GLICs' collective investment strategies on the development of the capital market particularly in relation to their role in increasing the supply of investible assets to more closely match their investment needs.

“...the broad objectives are to achieve greater diversification of GLIC investment strategies and allocations from a system-wide perspective...”

In this regard, GLICs are a natural source of “patient” capital given the long-term nature of their funds. It will be consistent to match their long-term funds with a higher level of investments in ventures or projects with long-term pay-offs. This will require a change in mindset and investment mandates to provide greater tolerance for risks and a strengthening in the capabilities for assessing, monitoring and managing the risks associated with these ventures. Towards this end, there is room for some GLICs to either directly build up direct investing capabilities or to increase their portfolio allocations to the VC and PE industries.

Another key area relates to the need to increase the diversification of aggregated portfolios either at the level of the individual GLICs or through re-positioning of some GLICs to adopt more specialised investment mandates. In this context, some GLICs can be positioned to act as cornerstone investors to stimulate demand for a broad range of capital market products and services or have targeted mandates such as investing in small and mid-cap stocks.

Ultimately, the broad objectives are to achieve greater diversification of GLIC investment strategies and allocations from a system-wide perspective as this is a critical factor in reducing systemic risks and in ensuring more efficient intermediation of national savings to promote the growth of the capital market and the economy.

The diversification in investment strategies can either be directly undertaken by GLICs or through increasing their outsourcing fund mandates to private sector players, which offers the additional benefit of building private sector intermediation capabilities.

3.2.2 Expand diversity and value-add of private sector savings intermediation

The broadening of portfolio risk profiles is an important aspect of enhancing savings intermediation efficiency. Effectively, when investment preferences are limited to safe and liquid instruments, this reduces demand for higher-risk and less liquid products on the capital market. The widening of risk profile in organised investment schemes is critical to ensure more widespread and effective deployment of long-term savings to finance economic growth.

The intermediation of savings through public institutions moderates the level of risk-taking and active management on account of the higher level of responsibility and sensitivity inevitably associated with investments made by government entities.

Enhancing savings intermediation efficiency therefore requires an expansion in the role of the private sector in managing long-term savings. In this regard, the private sector is better positioned to increase the variety of financing alternatives and investment outlets, and to implement strategies for managing risks.

“...the investment management industry acts as a value-add intermediation layer that amasses high-level skill sets and connects the different segments of the capital market with the economy.”

The ability to pool risks through multiple investments provides the ability to absorb losses from a majority of investments as high pay-offs from some successful investments will still result in a net positive return on capital. This characteristic of widening the risk profile will be instrumental in encouraging more active exploration of investment opportunities in new growth and innovative areas.

The private sector, through expanding the range of value-add products, can therefore play a key role in diversifying system-wide risks with positive benefits on domestic direct investment, secondary market liquidity, and product and service diversity.

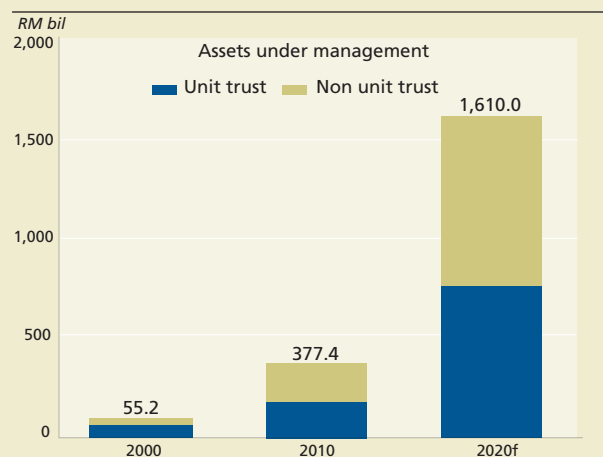
Over the past decade, the private sector investment management industry has grown rapidly due to product and channel deregulation undertaken in tandem with a strengthening in the standards of investor protection through enhancing disclosure and governance standards. The AUM grew at a compounded pace of 21.2% per annum from RM55.2 billion in 2000 to RM377.4 billion in 2010.

The investment management industry performs two valuable functions. First, the industry manufactures investment products for savings and second, the industry provides advice on the management of savings and purchase of products. In this manner, the investment management industry acts as a value-add intermediation layer that amasses high-level skill sets and connects the different segments of the capital market with the economy.

Box 6

Growth prospects for investment management industry to 2020

Assets under management projected to reach RM1.6 trillion in 2020



Source: Securities Commission Malaysia estimates

Malaysia's investment management industry is among the fastest growing segments in the capital market. Based on historical trends, AUM is projected to rise from RM377.4 billion in 2010 to RM1.6 trillion in 2020 as critical mass effects facilitate the adoption of volume strategies and higher efficiencies from increased economies of scale.

The unit trust NAV is projected to increase to RM827.9 billion in 2020. The penetration rate for unit trusts is likely to almost double from 18% in 2010 to 34% in 2020 – a feature typical of an economy in transition from middle income to developed status.

Long-term growth prospects continue to be favourable due to Malaysia's encouraging demographics, expanding workforce and high savings rate. Domestic demand for professional advice from fund managers, investment advisers, and financial planners is expected to grow in tandem with rising affluence and sophistication.

In addition, the pace of growth in the wholesale segment is expected to outpace the retail segment as the industry broadens with contributions from the private retirement scheme industry, Islamic fund management, and external mandates.

The role of the investment management industry is expected to further expand with the establishment of a private retirement scheme industry to complement existing mandatory schemes. The private retirement scheme industry will assist in promoting greater diversity in the management of long-term savings. (See Box 7)

The participation of the investment management industry in direct investing will be enhanced by expanding the range of legal structures to facilitate pooling of investments. The introduction of limited liability partnerships and managed investment schemes will broaden the range of vehicles for risk-sharing and investing in long-term projects.

In tandem with this, a regulatory framework will be established for the VC and PE industries to attract greater institutional investment. This will be complemented by the development of Islamic funds that invest based on the principles of active partnership and risk-taking.

Box 7

Development of the private retirement scheme industry

Malaysia's mandatory provident fund is considered among the leading schemes in the world and has served the needs of its contributors well. However, the mandatory scheme mainly covers employees and does not provide sufficient replacement income to meet post-retirement needs. Hence, the government decided to establish a voluntary private retirement scheme to ensure a robust and sustainable multi-pillar pension system.

Under the framework, employers and contributors will have greater flexibility and a wide range of choice in supplementing mandatory retirement savings to ensure greater sufficiency of retirement income. Approved providers will offer a choice of dedicated fund options catering to the different investment and risk profiles of contributors.

A strong regulatory and supervisory framework will be established to ensure an effective governance structure, sound risk management practices, and internal controls to safeguard the interests of contributors.

Malaysia's private retirement scheme industry, which is being developed in line with international best practices, represents a new growth segment for the capital market. Over the next ten years, it is projected that assets under management in the private retirement scheme industry will grow to RM30.9 billion.

The range of asset classes for intermediation will also be broadened to facilitate portfolio diversification into commodities and other non-securitised investment opportunities. To add greater dynamism and diversity to the industry, a framework will be established for eligible boutique fund managers.

It is also critical to strengthen the branding of the investment management industry through promoting its participation in SRI. Industry is encouraged to develop specialised funds and listed investment products that promote investing in socially-oriented and sustainable projects.

3.2.3 Expand scope of market intermediation

Capital market intermediaries play a key role in connecting customers with products. They provide services through originating products, providing advice, facilitating transactions through various channels, and ensuring seamless and convenient execution and settlement of transactions. Intermediaries also rely on the use of their balance sheets, skills, and relationships to provide liquidity through underwriting, distribution, and active trading to ensure markets are vibrant and efficient.

Compared to a decade ago when the intermediation landscape was fragmented and weak, Malaysia today has strong domestic intermediaries offering a broad range of services to both domestic and regional clients in a liberalised environment. The strong balance sheets and capabilities of the domestic intermediaries provide a sound foundation for further expansion.

“...Malaysia today has strong domestic intermediaries offering a broad range of services to both domestic and regional clients in a liberalised environment.”

The changing intermediation landscape is already posing new challenges. The emergence of new technologies is eroding the value in traditional order-taking business. In this regard, there is still too much reliance on static and narrow product silos and traditional low-cost models which are ineffective in meeting changing customer preferences.

The future growth of Malaysia's capital market therefore requires further broadening of the range and scope of intermediation activities. Diversity provides greater choice and will attract more customers who can have varying preferences in terms of costs, efficiency, convenience, product customisation, advice and service requirements.

Expanding the range of value-add services is key to fostering an innovative and competitive intermediation environment where intermediaries are quick to identify new areas of demand growth and capture productivity gains from delivering services in a seamless manner in a highly electronic environment.

It is a core strategy of the CMP2 to increase intermediation efficiency and scope through fostering a conducive environment for innovation, facilitating greater diversity and expanding growth prospects across the value chain. This includes providing a regulatory environment that supports the ability of capital market intermediaries to offer a wide range of services subject to their capabilities in managing the risks of their operations.

“...there is room to explore growth opportunities in ancillary industries that support the capital market.”

The regulatory framework will also be revised to facilitate de-coupling and outsourcing of business functions including separating trading and settlement membership. This would create an enabling environment for industry to reconfigure their operations to leverage on their competitive strengths rather than incur the costs of maintaining full service operations.

Improvements will also be made to the market infrastructure to broaden the use of technology through a wide array of electronic devices and interfaces to enhance customer reach and increase operational efficiency.

The SC will collaborate with industry to strengthen their competitive positioning through facilitating the development of business models such as for promoting the growth of small and mid-cap companies and for market-making.

In particular, strategies will be identified in collaboration with industry to strengthen the role of remisiers, unit trust agents and financial planners in the changing intermediation landscape, given their value-add in providing personalised customer services. This would include increasing the opportunities for upskilling and expanding the range of products and services.

Intermediation diversity will also be expanded through facilitating the entry of domestic and international participants that offer value propositions which can promote the growth and competitiveness of the Malaysian capital market.

While the core intermediation industries are reasonably developed, there is room to explore growth opportunities in ancillary industries that support the capital market. The SC will extend its developmental focus across a broad range of middle and back-office functions covering advisory services, research, risk management, compliance, settlement, custodian, trustee and other services in capital market-related areas.

Efforts will be made to attract international players to use Malaysia as a regional base for their middle and back-office functions. The development of more competitive niches will foster productivity and higher value-add activities with the supporting clusters providing positive feedback effects.

3.3 Deepen liquidity and risk intermediation

Secondary market liquidity in Malaysia remained persistently low throughout the last decade despite efforts to enhance the trading environment through upgrading market infrastructure and widening participation. As a result, turnover velocity has lagged the other Asian stockmarkets. (See Chart 10)

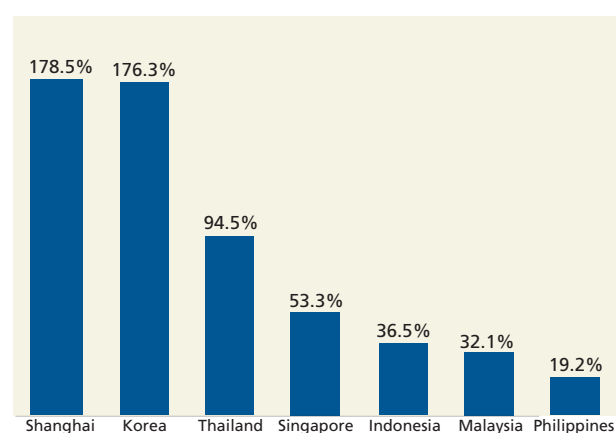
The low liquidity is also reflected in Malaysia's narrow risk-return profile. The annualised standard deviation of return for Malaysia's stockmarket index, the FBMKLCI, hovered around an average value of 13.1% over the past decade, far below the average of 22.8% recorded by other markets. In tandem with the lower volatility, the average annualised returns of 8.0% from FBMKLCI surpassed those of developed markets but were below those in Indonesia, India and Korea. (See Chart 11)

The risk-return profile of Malaysia's stockmarket reflects its attractions to long-term investors as the narrow dispersion between risk and return signifies an orientation towards safety. However, the low price volatility also implies reduced trading opportunities relative to other markets and this decreases the level of transactions relative to market capitalisation.

It is critical therefore to deepen secondary market liquidity to provide efficient exit markets that incentivise upstream investing activities by the VC and PE industries to finance start-ups and small firms which are an important source of economic growth.

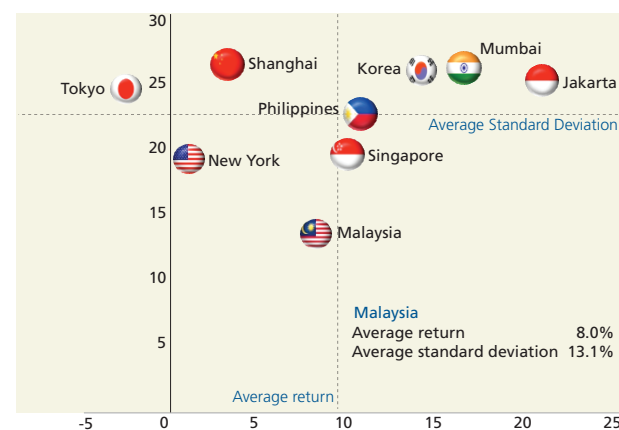
The role of secondary market liquidity in promoting investments becomes more important as the economy structurally shifts from traditional manufacturing activities, which offer tangible collateral, towards services and innovation-based activities where the assets are intangible and future values are often associated with higher levels of uncertainty and volatility.

Chart 10
Regional turnover velocity in 2010



Source: World Federation of Exchanges

Chart 11
Risk-return profile of selected markets 2000–2010



Source: Securities Commission Malaysia estimates

The shift to a high-growth path may therefore be constrained by bottlenecks caused by relatively low levels of risk intermediation. Short-term risk intermediation activities assist in facilitating greater completion of secondary market transactions which in turn improves the level of risk-taking activities and generates economic growth momentum.

“Short-term risk intermediation activities assist in facilitating greater completion of secondary market transactions...”

3.3.1 Address concentration of savings

Generally, in most other markets, liquidity tends to be concentrated in the largest stocks. This is not the case in Malaysia where the trading velocity of the largest market-capitalisation stocks, about 45 PLCs accounting for 72.4% of equity market capitalisation and 60.8% of total equity trading value, is unusually low at 25%. Therefore, it is important to increase trading in the largest market-capitalisation stocks to increase turnover velocity in Malaysia.

Table 3
Turnover velocity by market capitalisation in 2010

Market capitalisation segment	No. of PLCs	Outstanding market cap (RM bil)	Turnover value (RM bil)	Turnover velocity (%)
More than RM5 bil	45	902.1	224.5	25
RM1 bil – RM5 bil	96	207.5	75.7	36
RM100 mil – RM1 bil	369	118.4	57.9	49
Less than RM100 mil	445	18.4	10.9	59
TOTAL	955	1,246.4	369.0	30

Notes: Market capitalisation excludes non-equity instruments and is based on year-end. Turnover value includes direct business transactions.

Source: Securities Commission Malaysia

The anomaly in the distribution of market liquidity arises from the relative dependence of domestic institutions on investing in the domestic equities market to generate returns on their funds. The size of these funds, which are concentrated in several investment institutions, exceeds the supply of sizeable and liquid equity assets.

The requirement for major domestic institutions to hold large and liquid stocks on a long-term basis reduces the amount of readily-available sizeable blocks for trading. This in turn increases the price impact of large trades, thereby making it more expensive to buy or sell stocks.

The deepening of secondary market liquidity in Malaysia therefore requires promoting greater diversification of portfolio asset allocations by the major domestic institutions. An important aspect of these efforts is to broaden the range of investment strategies and styles to even out the distribution of investments by asset size and class.

3.3.2 Facilitate efficiency of price discovery and hedging across markets

Financial innovation has shifted price discovery from underlying physical markets to derivatives markets because of their cost-efficiencies and flexibilities for hedging. Around the world, trading on futures and derivatives has expanded to a multiple of trading volumes in the physical market.

Futures and derivative products have become increasingly popular as they can be engineered to provide more precise combinations of risk, return and liquidity and to provide cost-effective cover to hedge risk exposures. They also perform the important function of increasing connectivity between market segments and various asset classes through facilitating efficient price arbitrage.

“A vibrant and comprehensive derivatives market is therefore required to reinforce dynamism in other segments of the Malaysian capital market...”

Currently, Malaysia's secondary market for risk intermediation is narrow due to the limited range of products on the derivatives exchange. As a result, derivatives trading on Malaysian assets has migrated to offshore and OTC markets.

The lack of a comprehensive derivatives market poses challenges to increasing liquidity and connectivity between different market segments and asset classes. This leads to pricing inefficiencies which increases transaction costs and reduces trading activities due to the high costs of hedging and arbitrage.

The development of a well-regulated derivatives market in Malaysia is also critical to strengthening the industry learning curve, retaining talented risk product specialists and developing onshore capabilities for risk intermediation thereby creating more business opportunities.

A vibrant and comprehensive derivatives market is therefore required to reinforce dynamism in other segments of the Malaysian capital market and to underpin an expansion in the range of intermediation products and services.

The re-positioning of Malaysia's derivatives exchange has already started with a strategic alliance between Bursa Derivatives and the CME Group. This will be followed by an expansion of the product range to enable hedging and arbitraging activities across market segments. In tandem with this, the infrastructure for clearing, cross-margining and settlement will be enhanced to ensure higher levels of operational efficiencies.

The SC will also collaborate with industry participants to facilitate a broadening of the range of product and service offerings by futures brokers, promoting a strengthening in the capabilities and standards of industry participants and through expanding reach to customers.

Box 8

Growth prospects for derivatives market to 2020

Projected growth in derivatives market



Source: Securities Commission Malaysia estimates

Malaysia is the global price discovery centre for crude palm oil (CPO) prices. Over the next decade, this strength will be complemented by substantially widening the product range to match the rapid advances made by other Asian derivatives markets.

The strategic alliance between Bursa Derivatives and the CME Group and migration of trading to CME’s Globex trading platform will widen distribution of Malaysian products to international participants and facilitate the ability of domestic intermediaries to trade international products.

The broadening of Malaysia’s capital market, the increasing sophistication of the investment management industry and the increased use of technology will underpin demand for an expansion in the range of derivative products. This will have a positive spill-over impact on liquidity in the equity and debt markets as higher levels of hedging and arbitrage activities occur across different market segments.

3.3.3 Widen market connectivity and participation

Structural changes in the global market landscape have transformed trading venues from national-centric silos into nodes in a global electronic trading network. As market structures evolve, the patterns of liquidity flows have altered with the emergence of electronic proprietary and hedge fund trading eroding the traditional dominance of market-makers and retail participants as the main suppliers of liquidity.

In the changing landscape, the challenge for the Malaysian capital market is to attract more short-term international and domestic traders, including retail investors, to bring about better balance to a market environment that is currently dominated by long-term investors.

There will be continued efforts to increase market connectivity through strengthening market infrastructure to promote greater use of technology. Regulatory facilitation will be provided to encourage the stock exchange and intermediaries to pursue cross-border alliances that promote higher levels of cross-border flows, particularly within ASEAN in line with the aspirations to promote integration of capital markets in the region. This will include regulatory mutual recognition agreements that would facilitate cross-border offerings, listings and exchange alliances.

“Regulatory facilitation will be provided to encourage the stock exchange and intermediaries to pursue cross-border alliances...”

The prevailing market arrangements and tax structure deter individuals from being effectively organised into firms as professional traders who can provide liquidity across a broad range of markets. A review will be undertaken to facilitate the establishment of specialist trading firms that will undertake proprietary trading and market-making across market segments.

The trading patterns of retail investors have also changed with a trend favouring electronic access through the internet or other telephony devices. In this regard, the costs of technology have fallen so rapidly that relatively sophisticated tools, such as algorithmic trading and technical analysis software, and the convenience offered by electronic services are now readily available to individual clients at relatively low costs.

Towards this end, the role and capacity of remisiers, unit trust agents and financial planners will be strengthened to enable them to meet the challenges from the changing intermediation landscape with a view to attracting higher retail participation in the market.

3.4 Facilitate internationalisation

Globalisation presents new challenges but globalisation also provides opportunities that form the basis of future growth in productivity and living standards. In this context, global financial deepening and the convergence to international standards are enabling greater international mobility with issuers, investors, and intermediaries increasingly accessing more markets. At the same time, exchanges are offering a cosmopolitan menu of products to complement traditional equity products.

The changing landscape dynamics require strategies that facilitate connectivity to improve access to global transaction flows and to expand product and service offerings to attract more customers.

Internationalisation is also a key requirement for an economy seeking to make a transition from middle-income to high-income. Internationalisation expands business relationships and operational scale and therefore enlarges growth boundaries beyond the constraints of a domestic economy.

Domestic intermediaries gain new business opportunities from transacting in foreign products and, in the process, reduce the leakage of intermediation value-add. International competition also provides a useful benchmark to domestic firms and accelerates learning curves and the building of capabilities. Inevitably, domestic firms must compete with international firms, whether onshore or offshore, to generate high income and to attract and retain talent.

3.4.1 Expand international intermediation capabilities

Global trends suggest equity markets grow in tandem with the economy. As markets mature, the size of the domestic economy tends to constrain the growth of the market. However, the growth of markets can be augmented by internationalisation. (See Box 9)

Over the past decade, Malaysia has already liberalised its capital market through facilitating international fund-raising, listings, participation, access, and investments abroad. The future growth of Malaysia's capital market will increasingly be shaped by internationalisation strategies aimed at maximising international participation and strengthening the ability to build scale and take advantage of business opportunities.

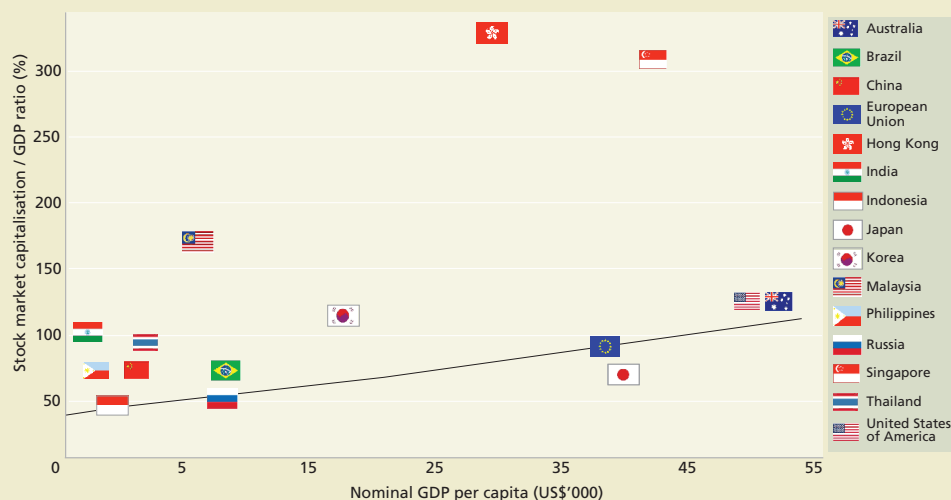
It is anticipated that the future landscape will become characterised by a multi-venue, multi-product and multi-asset environment. The effects of these landscape changes are already evident with new competitors such as multilateral trading facilities and dark pools eroding the market share of traditional exchanges. This has already triggered several transnational exchange take-overs as well as a re-configuration of exchange business models to de-couple trading, clearing, and settlement functionalities.

Malaysia had adopted a pragmatic approach in responding to the changes in the exchange landscape. Bursa Malaysia has pursued strategic alliances with other exchanges, particularly within ASEAN and its subsidiary, Bursa Malaysia Derivatives, has already tied up with the CME Group to widen its reach to global customers. Further opportunities will be identified to strengthen Malaysia's positioning in the fast-changing global exchange landscape including through strategic alliances and partnerships.

Box 9

Equity market capitalisation to GDP ratios

Global equity market capitalisation to GDP ratios



Note: The world stockmarket line is estimated based on a sample of 98 countries in 2010. Hong Kong's market capitalisation to GDP ratio exceeded 1,200% as at end-2010.

Source: International Monetary Fund, World Bank and World Federation of Exchanges; Securities Commission Malaysia estimates

There is a long-term relationship between stockmarkets and economies with corporate profits acting as the causal link between market capitalisation and nominal GDP. As depicted in the chart, developed stockmarkets tend to converge around a market capitalisation to GDP ratio of between 90% to 120%. Malaysia can be regarded as having a well-developed stockmarket with its market capitalisation to GDP ratio fluctuating within a range of 90% to 170% during 2000 to 2010.

International financial centres such as Hong Kong and Singapore have been able to maintain high market capitalisation to GDP ratios in excess of 300% through their ability to attract foreign listings to sustain expansion in market capitalisation relative to the size of their economies. Internationalisation can also add to market capitalisation growth through domestic companies expanding abroad.

Malaysia has also strengthened the positioning of its bond market with the removal of withholding tax coupled with a facilitative approval framework. These developments have resulted in Malaysia being recognised as an important hub for cross-border investments and issuances in the region. Since 2004, foreign issuers have issued RM18.6 billion worth of bonds and sukuk. Foreign investments in local currency bonds amounted to RM121 billion in 2010.

Overall, further improvements will be made to enhance the connectivity of the clearing and settlement infrastructure while friction costs will be reduced to attract more active international investor trading in the secondary equity, bond, and derivative markets.

The changing pattern of global savings intermediation augurs strong growth prospects for domestic intermediaries based in Asia. Asian intermediaries benefit from home ground advantage in recycling substantial domestic savings surpluses and from their proximity to new growth opportunities.

In recognition of the benefits of higher intra-regional participation, the ASEAN Finance Ministers endorsed an Implementation Plan from securities regulators to promote the development of an integrated capital market in ASEAN by 2015.

The Implementation Plan offers a comprehensive set of strategic initiatives and specific implementation actions to pursue regional integration. This includes mutual recognition frameworks for cross-border offerings, listings, and professionals, the formation of exchange alliances, and the development of a conducive regulatory framework and infrastructure to facilitate cross-border transactions among capital markets in the region.

Domestic intermediaries have already been preparing to operate in a more open and competitive environment. They have strengthened their presence in the regional market and advised on international transactions. They have also embarked on distribution of international products to domestic clients. (See Box 10)

The SC will continue to pursue cross-border regulatory arrangements to facilitate the expansion of domestic intermediaries and distribution of products in other markets. In addition, intermediary standards and capabilities will be strengthened across a broad range of industry segments to facilitate their participation in international transactions and markets.

Apart from its core industry segments, Malaysia has natural strengths in many parts of the value chain for capital market transactions. Internationalisation will be an important catalyst to unlocking hub opportunities in a broad range of middle and back-office functions covering advisory services, research, risk management, compliance, settlement, custodian, trustee and other services.

In this regard, Malaysia is well-positioned to attract international participants as it offers an attractive choice of locations in Kuala Lumpur, Labuan and Iskandar; each with its own advantages. This needs to be complemented with strategies to attract talent with knowledge of international practices related to the capital market, law, accounting, tax and Shariah, to build an eco-system that provides cost-effective support for the structuring and processing of international capital market transactions.

“Internationalisation will be an important catalyst to unlocking hub opportunities in a broad range of middle and back-office functions.”

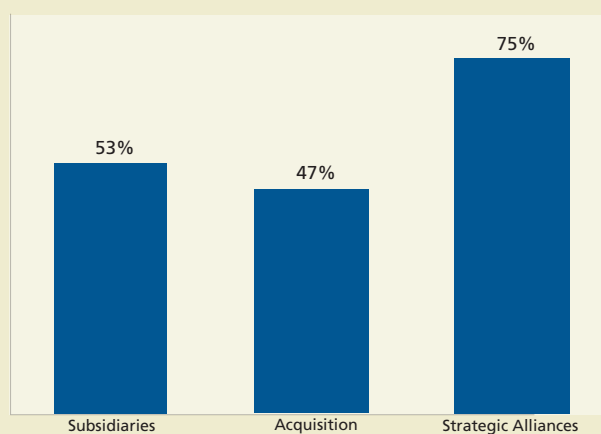
Box 10

SC survey on international expansion plans of intermediaries

In 2009, the SC conducted a survey of 89 capital market intermediaries on their international expansion plans over the next ten years. The survey results are highlighted below:

- 94% of domestic intermediaries anticipate expanding business abroad through establishing strategic alliances, subsidiaries and through acquisition of foreign entities;
- The share of profits from international operations is expected to grow from less than 10% of total profits to between 30% and 50% over ten years; and
- Domestic intermediaries expect their sales of foreign products to rise from 10% currently to about 30% of revenues.

International expansion by strategy



Source: Securities Commission Malaysia

3.4.2 Widen Islamic capital market's international base

Malaysia is among the pioneers in Islamic finance and has a successful track record in innovating and commercialising many Shariah-compliant products. Arising from this, Malaysia's sukuk market has evolved into the world's largest with Bursa Malaysia as the leading exchange for listed sukuk in terms of value. Malaysia is also among the global leaders in the Islamic fund management industry. (See Box 11)

Box 11

Growth prospects for Islamic capital market to 2020

ICM by Segments

Market segments	2000 (RM bil)	2010 (RM bil)	CAGR % (2000–2010)	2020 (RM bil)	CAGR % (2010–2020)
Market cap of Shariah-compliant companies	254.1	756.1	11.5	1,551.1	7.4
Sukuk	39.6	294.0	22.2	1,331.5	16.3
Total ICM	293.7	1,050.1	13.6	2,882.6	10.6
Shariah-compliant unit trust NAV	1.7	24.0	30.3	158.0	20.7

Source: Securities Commission Malaysia estimates

Malaysia’s ICM has grown rapidly over the past decade, generally outpacing the conventional sector, with double-digit growth in the market capitalisation of Shariah-compliant equities, value of sukuk outstanding and NAV of Shariah-compliant unit trust funds. As at the end of 2010, 88% of companies listed in Malaysia and 39% of total bonds outstanding were Shariah-compliant.

Reflecting the strong underlying demand for Shariah-compliant assets, the range of Shariah-compliant products has also expanded to include real estate investment trusts (REITs), exchange-traded funds (ETFs) and this has been complemented by the establishment of a commodity *murabahah* market.

Over the decade, the ICM is expected to sustain double-digit growth to almost RM3 trillion in 2020. The ICM will achieve critical mass and will benefit from increased scale efficiencies from sustained product and service enhancement and innovation. In addition, there is potential growth upside from increasing internationalisation of Shariah-compliant intermediation activities through on-going efforts in product development, fund management and cross-border collaboration.

Malaysia already has the advantage of having a capital market where the majority of assets are Shariah-compliant, which therefore attracts participation of both Shariah and conventional investors. The broad customer demand and liquidity provide positive reinforcement while Islamic products and services also benefit from the advantages of the broader investor protection framework with the additional assurance of greater consistency and clarity in Shariah governance.

Greater internationalisation of the capital market is a critical aspect of the strategy to strengthen Malaysia’s positioning as a global ICM hub. This will be complemented by strategies to strengthen the distinctive value propositions offered by Malaysia for a broad range of Islamic intermediation activities.

The sukuk market, where Malaysia is a global leader, represents an attractive international value proposition. There is a need to strengthen the capacity to structure multi-currency and cross-border transactions and to build greater scale to enable Malaysian intermediaries to make further inroads into the international market.

Malaysia has a strong base in equity and equity-related products and services. In this regard, the SC will collaborate with industry players to expand the range of Shariah-compliant stockbroking and portfolio products and services. At the current stage of development, there is also a need to strengthen the service and operational infrastructure so that domestic Islamic products and services can be effectively marketed to global customers. This requires a widening of international distribution channels coupled with intensified profiling of Malaysia's ICM.

There is also a need to accelerate the building of critical mass for the onshore portfolio management. The development of a significant Islamic fund management industry is critical to build domestic take-up capabilities for innovative domestic and international Islamic products. In this regard, widening the range of Shariah-compliant products – in the form of collective investment schemes, indices, ETFs and REITs – and the diversity of their investments by sector and by geography, can attract more domestic and international investors. Mutual regulatory arrangements to facilitate cross-border distribution will be expanded.

“A seeding strategy will be developed to increase the diversification of Islamic investment strategies and styles.”

A seeding strategy will be developed to increase the diversification of Islamic investment strategies and styles. Priority will be placed on nurturing Islamic fund management services with high value-add such as the Shariah-compliant VC and PE industries that invest based on the principles of active partnership and risk-taking, and SRI based on Islamic principles. In this context, the Islamic fund management industry will play a key role in developing products and services that not only generate economic returns but also comply with universal ethical standards to strengthen the distinctive value proposition of Malaysia's ICM.

In order to further facilitate internationalisation of the ICM, the SC will promote a shift from a Shariah-compliant approach to a Shariah-based approach where the underlying structures of products such as *mudharabah* and *musharakah* would originate from risk-sharing principles and offer significantly different pricing and returns characteristics. There is a need therefore to focus on product innovation and development efforts that will provide a comprehensive array of Shariah-based products for the industry. Towards this end, there will be further development of the Shariah legal, regulatory and governance framework.

The shift to a Shariah-based approach will require a higher level of risk tolerance and acceptance of the longer gestation arising from participating in business ventures with more direct linkages between risk and returns.

The SC will also collaborate with the industry to identify potential hub opportunities in ICM-related services, particularly in the provision of middle and back-office functions. This will be supported by initiatives to ensure a facilitative operational, tax and human capital infrastructure to enhance the attractiveness of Malaysia as a base for regional and international operations.

“The depth and width of Malaysia’s ICM has broadened the base of intermediation capabilities in terms of Shariah research, advisory and compliance expertise.”

The depth and width of Malaysia’s ICM has broadened the base of intermediation capabilities in terms of Shariah research, advisory and compliance expertise. Further efforts will be made to enhance Malaysia’s contribution to Shariah research through increased international collaboration on Shariah research and product development to sustain the rapid pace of innovation. The SC will also develop a code of conduct for Shariah advisers and further strengthen training and professional education to increase the supply of Shariah experts on a broad range of capital market activities and to maintain Malaysia’s position as a leading centre for ICM.

3.5 Build capacity and strengthen information infrastructure

Over this decade, intermediaries will increasingly need to adapt to a changing workforce, a diffused working environment, and the pervasive use of technology in many aspects of capital market activities. In the changing environment, knowledge in the form of skills and capacity for innovation will increasingly define competitive advantage and economic growth potential.

Initiatives are required to strengthen the knowledge base to support the expansion of the capital market into high value-add areas and to ensure the availability of skills to support innovative business processes. This requires ensuring that the educational and training pipeline provides a sufficient supply of skilled workers whose knowledge is reinforced through an effective learning environment through close collaboration between industry, academia and the public sector.

The rapid assimilation of skills and application of knowledge also requires an information infrastructure that facilitates cost-effective and efficient regulatory oversight, risk management, service innovation, and operational efficiency as the capital market shifts into a highly electronic environment.

3.5.1 Build capacity to meet future requirements

Achieving high income and sustaining high growth require public and private sector investment in skills and capacity to build a strong knowledge base and to acquire the ability to transform knowledge into growth in the form of innovative products, processes and solutions.

In line with this, there is a need to increase the supply of capital market specialist skills that underwrite growth in processes such as quantitative and modelling techniques, technology, regulatory compliance, and middle and back-office operations.

Increased interaction between industry, academia and investors is needed to create a favourable environment for the diffusion of knowledge and to strengthen the discovery and innovation process.

Greater industry input and participation are required to deepen applied and specialist research and training and to enhance linkages between theoretical research and product development. Grants and incentives from intermediaries can encourage universities to undertake innovative research to design, improve and integrate advanced technology in capital market processes.

In recent years, global competition for talent has intensified and Malaysian talent is highly sought after in many countries. Malaysia's high income strategy is clearly inter-linked with a strategy to attract and retain talent which requires narrowing the remuneration differential with international financial centres. This underscores the urgent need for high growth strategies for the Malaysian capital market to generate revenue growth to increase the capability to offer higher salaries to compete for talent.

The demand for Malaysian talent overseas and Malaysia's ability to draw foreign students suggests that Malaysia has strengths in the education industry to evolve into a regional centre for education and professional development in capital market-related areas. Strategies will be developed to pursue hub opportunities for education, training and professional development in capital market-related areas and to develop specific niches for thought leadership through establishing world class centres of excellence.

It is also important to promote greater diversity of the workforce to benefit from broadened perspectives as this would result in more robust processes and innovation. Knowledge of international practices is also required to build greater cross-border capabilities and market share in international transactions.

This needs to be complemented with an open policy that creates jobs to attract international talent in the capital market as well as in other professional and ancillary industries such as the legal and accounting professions. Lack of openness inhibits the industry learning curve and technical deepening as on-the-job exposure to global work cultures and environments is critical to reinforce classroom learning.

3.5.2 Strengthen information infrastructure to support transition to a highly electronic environment

It is envisaged that there will be pervasive use of technology across a broad spectrum of products, activities and processes over the decade. As the Malaysian capital market becomes increasingly advanced, there will be a need to strengthen operational efficiencies and to provide cost-efficient access to information.

Malaysia's trading infrastructure for equities, derivatives, and bonds has already been upgraded to improve market access and connectivity. However, market participants require further reductions in friction costs and a seamless post-trade infrastructure for clearing and settlement.

There are several areas to be addressed to achieve straight-through processing (STP) which include reducing the gap in delivery versus payment (DvP) arrangements, strengthening the process for failed trades and improving the efficiency of depository, custody and collateral management practices. The integration of the clearing and settlement system with the payments system will also be a priority.

“...pervasive use of technology across a broad spectrum of products, activities, and processes...”

Increasing market connectivity will also require the ability to cater for an environment with national differences in legal and taxation regimes, differing disclosure and corporate action requirements, ownership and custodian requirements, various administrative and approval processes, and settlement time frames and operating hours.

Moving forward, there will be a need to address how best to integrate efficiencies across diverse entities with their varying systems, data environment, protocols and processes. Market participants will also seek better access to trade transactions and control, higher levels of data consistency and quality, more efficient collateral management and more convenient processes for securities lending and borrowing. There is a need to facilitate greater electronic connectivity starting at the client level and to provide the necessary inter-operability with different back-office systems.

The importance of information is underscored by how real-time information gaps in the global financial crisis posed considerable challenges for the detection and management of operational and financial risks for market participants and regulators.

The quality of markets is also judged by how information asymmetry – a situation where one party has more information than the other party – is addressed. It is not only important that there is adequate disclosure of information, but that the information is also easily available and accessible to all investors.

Overall, it is envisaged that the Malaysian capital market environment will be highly electronic in the future. This would necessitate substantial increases in building information capacities and infrastructures as well as in terms of information technology (IT) expenditures. There is a need for a clear and holistic roadmap for the development of the information infrastructure to ensure greater synchronisation of industry IT strategies to achieve cost-effective investments in technology. The roadmap will cover:

- Benchmarking of implicit and explicit transaction and post-trade costs to identify areas for improvement;
- Enhancing post-trade settlement efficiencies through the implementation of STP capabilities. This will include identifying required improvements in clearing and settlement, depository, custody and collateral management practices, and the requirements to facilitate integration of clearing and settlement with the payments system;
- Establishing the technological standards, protocols and capacity requirements to ensure greater inter-operability across a broad range of systems, data environment, and entities in various market segments;
- Identifying infrastructure improvements to support technology-driven innovation and business strategies and to enhance service capabilities. This would enable intermediaries and participants to undertake specialised functionalities in trading, products, and services on a cost-effective basis and support enhancements in customer interfaces and back-office connectivity; and
- Addressing information asymmetry challenges through strengthening the infrastructure for cost-effective and efficient data capture, information gathering, analysis, disclosure and corporate communication.
 - Efforts will be made to establish a data framework for taxonomy with unified naming conventions while data management policies will be developed to ensure data consistency and integrity to meet requirements for aggregation and automation of data flows.
 - Data reporting requirements would also be strengthened to facilitate aggregation of enterprise-wide and market data on a real-time basis for risk monitoring, surveillance and supervision.
 - The SC will establish a central electronic disclosure system based on interactive data formats such as the eXtensible Business Reporting Language (XBRL) for prospectuses, financial reports, and updates for continuous reporting obligations to facilitate efficient information access.
 - Greater use of technology will be facilitated for the dissemination of information and communication by PLCs to their shareholders as well as for the conduct of AGMs and for voting. Regulatory changes will be undertaken to facilitate transition to a highly electronic environment, including the abolishment of non-electronic disclosure requirements, and through mandating the dissemination of information through electronic channels for disclosures and corporate actions.

GROWTH STRATEGIES TO EXPAND ROLE OF CAPITAL MARKET

PROMOTE CAPITAL FORMATION

Increase private sector participation in the venture capital and private equity industries

- Establish regulatory framework for VC and PE industries
- Expand participation of investment management industry in VC and PE
- Establish facilities to mitigate illiquidity risks for investments in VC and PE
- Promote PLC participation in supporting growth of VC investee companies
- TalentCorp to facilitate connecting talent with VC and PE opportunities

Strengthen economic functionality of the stockmarket in promoting growth of small and mid-cap companies

- Industry collaboration and regulatory facilitation to evolve business models to promote growth of small and mid-cap companies
- Facilitate establishment of venues for unlisted companies
- Proactively address investor confidence issues in poorly-performing PLCs

Widen access to the bond market

- Strengthen disclosure and documentation standards and practices
- Enhance the CRA regulatory framework
- Review bond default process and promote active market for pricing of distressed issues
- Expand participation of investment management industry in bond market
- Strengthen bond trading and post-trade infrastructure
- Facilitate greater retail participation in bond market
- Expand range of fixed income products

Promote socially responsible financing and investment

- Facilitate innovative approaches to finance socially responsible projects
- Promote socially responsible investing

EXPAND INTERMEDIATION EFFICIENCY AND SCOPE

Facilitate efforts to enhance efficiency of public sector savings intermediation

- Review impact of GLICs' investment strategies on the development of the capital market

Expand diversity and value-add of private sector savings intermediation

- Establish private retirement scheme industry
- Enhance participation of investment management industry in direct investing
- Widen range of asset classes for intermediation services
- Establish framework for eligible boutique fund managers
- Strengthen branding of the Malaysian investment management industry

Expand scope of market intermediation

- Widen the range of capital market intermediation services
- Facilitate de-coupling and outsourcing of business functions
- Facilitate greater use of technology in intermediation
- Extend developmental focus across the capital market value chain

DEEPEN LIQUIDITY AND RISK INTERMEDIATION

Address concentration of savings

- Broaden diversity of investment strategies in the investment management industry

Facilitate efficiency of price discovery and hedging across markets

- Expand range of derivative products
- Strengthen infrastructure for derivatives cross-margining, clearing and settlement
- Collaborate with industry to expand products and services and to strengthen the capabilities and standards of futures brokers

Widen market connectivity and participation

- Increase connectivity through technology, cross-border alliances and facilitating regional integration
- Facilitate establishment of specialist trading firms
- Enhance the role and capacity of remisiers, unit trust agents and financial planners in attracting retail participation

FACILITATE INTERNATIONALISATION

Expand international intermediation capabilities

- Strengthen Malaysia's positioning in the global exchange landscape
- Strengthen connectivity of clearing and settlement infrastructure and reduce friction costs
- Pursue cross-border regulatory arrangements to facilitate the expansion of domestic intermediaries abroad
- Identify hub opportunities in middle and back-office functions

Widen Islamic capital market's international base

- Build scale in the Shariah-compliant equity, sukuk and investment management segments
- Strengthen service and operational infrastructure to expand ICM's international reach
- Promote shift from Shariah-compliant to Shariah-based approach
- Collaborate with industry to expand range of Shariah-compliant stockbroking and portfolio products and services
- Develop seeding strategy to increase diversification of value-add Islamic investment strategies and styles
- Increase international collaboration on Shariah research and product development
- Develop a code of conduct for Shariah advisers
- Strengthen training and professional development to increase supply of Shariah experts

BUILD CAPACITY AND STRENGTHEN INFORMATION INFRASTRUCTURE

Build capacity to meet future requirements

- Increase public-private sector collaboration to strengthen capital market skill sets
- Pursue hub opportunities for education, training and professional development
- Promote a deepening of knowledge of international capital market industries

Strengthen information infrastructure to support transition to a highly electronic environment

- Benchmark transaction and post-trade costs
 - Facilitate implementation of straight-through processing
 - Enhance infrastructure to support technology-driven business strategies
 - Strengthen infrastructure for information reporting, disclosure and communication
- 



Governance Strategies for Investor Protection and Stability

CHAPTER 4

GOVERNANCE STRATEGIES FOR INVESTOR PROTECTION AND STABILITY

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

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

GOVERNANCE STRATEGIES:

1. Enhance product regulation to manage risks.

Foster a more conducive environment for product innovation and diversity while ensuring that active fund-raising and financial innovation benefit investors.

2. Expand accountabilities as intermediation scope widens.

Create an enabling environment for participants to broaden intermediation activities and strengthen industry capabilities and standards.

3. Robust regulatory framework for a changing market landscape.

Ensure a consistent regulatory approach to a changing market environment and focus on enhancing the quality of markets.

4. Effective oversight of risks.

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

5. Strengthen corporate governance.

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

6. Broaden participation in governance.

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

4.1 Enhance product regulation to manage risks

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

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

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

Table 4
Product risk issues during the global financial crisis

Products	Risk issues
Subprime mortgages	<ul style="list-style-type: none"> • Lax lending practices with fraud or misrepresentation • Concealment of high risks • Conflicts of interest affected CRA assessment • Poor documentation posing problems for transfer of property rights during bankruptcy proceedings
Credit default swaps	<ul style="list-style-type: none"> • Lack of transparency and disclosure; product risks were hidden • Conflicts of interest among counterparties in securitisation and credit default swap transactions • Inter-dependence among counterparties and high leverage posed financial stability risks
Auction rate securities	<ul style="list-style-type: none"> • Auction rate securities were misrepresented as cash equivalents but purchasers were unable to liquidate when market crashed • Difficulties in estimating fair value due to lack of transparent pricing
Money market funds	<ul style="list-style-type: none"> • Major money market funds unable to meet par value of US\$1.00; prompting concerns which required intervention • Failure to provide material information on investments to Boards, investors and rating agencies
Hedge funds	<ul style="list-style-type: none"> • Perceived as a source of volatility and systemic risks • Highly leveraged structure made them vulnerable to failures at prime brokers resulting in hedge fund assets being frozen • Lack of transparency and regulatory oversight – with some hedge funds possibly used as vehicles for insider trading and market abuse • Conflicts of interest affecting performance measurement, fees, redemption rights and treatment of clients
Exchange-traded funds	<ul style="list-style-type: none"> • Some ETFs have large tracking errors • ETFs played major role in flash crash in US market on 6 May 2010

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

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

4.1.1 Conducive environment for product innovation

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

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

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

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

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

4.1.2 Efficient framework for fund-raising and product innovation

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

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

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

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

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

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

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

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

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

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

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

4.1.3 Strengthen disclosure and post-issuance obligations

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

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

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

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

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

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

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

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

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

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

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

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

4.2 Expand accountabilities as intermediation scope widens

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

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

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

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

4.2.1 Widen intermediation scope

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

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

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

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

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

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

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

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

4.2.2 Strengthen intermediation standards and capabilities

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

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

“The regulation of business conduct therefore supplements product regulation by governing the interaction between intermediaries and their clients.”

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

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

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

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

Box 12

Impact of electronic channels on client-intermediary relationships

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Box 13

Regulation of credit rating agencies

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

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

4.3 Robust regulatory framework for a changing market landscape

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

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

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

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

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

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

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

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

4.3.1 Rationalise regulatory arrangements for markets

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

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

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

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

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

“...differentiated regulatory obligations are tilting the competitive balance between new and traditional markets.”

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

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

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

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

4.3.2 Enhance market quality

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.4 Effective oversight of risks

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

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

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

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

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

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

4.4.1 Expand regulatory coverage, capacity and tools for investor protection

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.4.2 Oversight of risks to market stability

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

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

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

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

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

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

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

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

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

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

Box 14

Role of securities regulators in promoting financial system stability

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

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

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

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

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

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

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

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

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

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

4.5 Strengthen corporate governance

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

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

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

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

Table 5

Corporate governance milestones in Malaysia

Year	Milestones
1999	<ul style="list-style-type: none"> High Level Finance Committee Report on Corporate Governance
2000	<ul style="list-style-type: none"> <i>Malaysian Code of Corporate Governance</i> Minority Shareholder Watchdog Group (MSWG)
2001	<ul style="list-style-type: none"> Capital Market Masterplan (CMP1) First CG Report on the Observance of Standards and Codes (ROSC) on Malaysia Corporate governance requirements incorporated into Bursa Malaysia's listing guidelines
2004	<ul style="list-style-type: none"> Whistle-blowing provisions in securities laws
2005	<ul style="list-style-type: none"> Second CG ROSC on Malaysia
2007	<ul style="list-style-type: none"> Qualification criteria for directors, strengthened audit committee and mandated internal audit function Enforcement powers for civil and administrative actions expanded to allow recovery of up to three times the amount of losses for wider range of misconduct including market manipulation MSWG <i>Guide of Best Practices for Institutional Shareholders</i>
2009	<ul style="list-style-type: none"> Enforcement scope broadened to cover actions against those causing wrongful loss as well as to make it an offence to influence persons preparing or auditing financial statements of listed companies
2010	<ul style="list-style-type: none"> Audit Oversight Board (AOB)

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

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

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

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

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

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

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

4.5.1 Board of directors as a focal point for corporate governance

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

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

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

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

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

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

Box 15

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

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

- **Related independent directors.** A significant number of PLCs have independent directors who are related to each other. This raises concern about the ability of independent directors to discharge their responsibilities effectively.
- **Long tenure of independent directors.** While a large majority of PLCs comply with the requirement to have one-third independent directors, half of these companies have independent directors with tenures exceeding nine years. About 20 PLCs have independent directors with tenures exceeding 30 years. The risk that independence may be undermined by long tenure cannot be disregarded.
- **Relationship between Chairman and CEO.** While around three-quarters of PLCs separate the role of the Chairman and CEO, in many instances the Chairman and the CEO are related. This nullifies the benefits of having dual roles on the Board.
- **Sizeable number of executive directors.** A quarter of PLCs have more than three executive directors on the Board and, in some instances, more than half the Board comprise executive directors. There are instances where the executive directors are related while some individuals serve in an executive director capacity in more than one company. The independence of the Board may also be compromised by the large presence of executive directors.

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

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

4.5.2 Promote active shareholder participation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.5.3 Strengthen gate-keeping accountabilities

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

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

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

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

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

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

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

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

4.6 Broaden participation in governance

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

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

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

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

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

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

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

4.6.1 Promote active stakeholder participation in governance

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

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

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

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

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

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

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

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

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

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

4.6.2 Promote greater participation in achieving socially responsible goals

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

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

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

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

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

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

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

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

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

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

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

GOVERNANCE STRATEGIES

ENHANCE PRODUCT REGULATION TO MANAGE RISKS

Conducive environment for product innovation

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

Efficient framework for fund-raising and product innovation

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

Strengthen disclosure and post-issuance obligations

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

EXPAND ACCOUNTABILITIES AS INTERMEDIATION SCOPE WIDENS

Widen intermediation scope

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

Strengthen intermediation standards and capabilities

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

ROBUST REGULATORY FRAMEWORK FOR A CHANGING MARKET LANDSCAPE

Rationalise regulatory arrangements for markets

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

Enhance market quality

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

EFFECTIVE OVERSIGHT OF RISKS

Expand regulatory coverage, capacity and tools for investor protection

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

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

Oversight of risks to market stability

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

STRENGTHEN CORPORATE GOVERNANCE

Board of directors as a focal point for corporate governance

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

Promote active shareholder participation

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

Strengthen gate-keeping accountabilities


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

BROADEN PARTICIPATION IN GOVERNANCE

Promote active stakeholder participation in governance

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

Promote greater participation in achieving socially responsible goals

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

ACRONYMS AND ABBREVIATIONS

ACE	Alternative stockmarket on Bursa Malaysia, formerly known as MESDAQ
AGM	Annual General Meeting
AOB	Audit Oversight Board
ASEAN	Association of Southeast Asian Nations
ASIC	Australian Securities and Investments Commission
ATS	Alternative Trading Systems
AUM	Assets under management
CAGR	Compounded annual growth rate
CESR	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission
CME	Chicago Mercantile Exchange
CMP1	Capital Market Masterplan
CMP2	Capital Market Masterplan 2
CMSA	<i>Capital Markets and Services Act 2007</i>
CPO	Crude palm oil
CRA	Credit rating agency
DBR	Disclosure-based regulation
DvP	Delivery versus payment
EPF	Employees Provident Fund
ETF	Exchange-traded fund
ETP	Economic Transformation Programme
FBMKLCI	FTSE Bursa Malaysia Kuala Lumpur Composite Index
FIMM	Federation of Investment Managers Malaysia
GDP	Gross domestic product
GLIC	Government Linked Investment Corporation
HFT	High-frequency trading
ICM	Islamic capital market
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IMF	International Monetary Fund
IPO	Initial public offering
IT	Information Technology
KYC	Know-your-client
M&A	Mergers and acquisitions
MESDAQ	Malaysian Exchange of Securities Dealing and Automated Quotation
MIFC	Malaysia International Islamic Financial Centre
MiFID	Markets in Financial Instruments Directive
MMOU	Multilateral Memorandum of Understanding
MSWG	Minority Shareholder Watchdog Group
MVDC	Malaysian Venture Capital Development Council

NAV	Net asset value
NEM	New Economic Model
NGO	Non-governmental organisation
NKEA	National Key Economic Areas
OECD	Organisation for Economic Co-operation and Development
OTC	Over-the-counter
PE	Private equity
PEMANDU	Performance Management and Delivery Unit
PLC	Public listed company
PNB	Permodalan Nasional Berhad
REIT	Real estate investment trust
ROSC	Report on the Observance of Standards and Codes
SC	Securities Commission Malaysia
SEC	Securities and Exchange Commission
SIDREC	Securities Industry Dispute Resolution Center
SPAC	Special purpose acquisition companies
SRI	Socially responsible investing
SRO	Self-regulatory organisation
STP	Straight-through processing
TalentCorp	Talent Corporation Malaysia Bhd
VC	Venture capital
WFE	World Federation of Exchanges
XBRL	eXtensible Business Reporting Language

REFERENCES

- Adair Turner, 2010, Chapter 1 – *“What do Banks do? Why do Credit Booms and Busts Occur and What can Public Policy do about it”*, The Future of Finance: The LSE Report.
- Assaf Hamdani, 2003, *“Gatekeeper Liability”*, The John M. Olin Center for Law, Economics and Business, Discussion Paper no 442.
- ASEAN Capital Market Forum (ACMF), 2008, *“The Implementation Plan”*.
- Australian Securities & Investment Commission (ASIC), 2010, *“Australian Equity Market Structure: Draft Market Integrity Rules”*, ASIC Consultation Paper 145.
- Committee of European Securities Regulators (CESR) and European Central Bank, 2009, *“Recommendations for Securities Settlement Systems and Recommendations for Central Counterparties in the European Union”*.
- Charles Goldfinger, 2003, *“ISD II Directive Debate about the Trading Venue Diversity: the Tree and the Forest”*, European Capital Markets Institute, Working Paper.
- Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), 2010, *“Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issue”*.
- David Weild and Edward Kim, 2010, *“Market Structure is Causing the IPO crisis and more”*, Grant Thornton Capital Market Series.
- Economic Planning Unit Prime Minister’s Department (EPU), 2010, *“Tenth Malaysia Plan (2011–2015)”*.
- Fabrice Demarigny, 2010, *“An EU-Listing Small Business Act: Establishing a Proportionate Regulatory and Financial Environment for Small and Medium sized Issuers Listed in Europe (SMILEs)”*.
- Franklin Allen & Glenn Yago, 2010, *“Financing the Future: Market-Based Innovations for Growth”*, Wharton School Publishing-Milken Institute.
- G-20 Working Group 1, 2009, *“Enhancing Sound Regulation and Strengthening Transparency”*, Final Report.
- International Organization of Securities Commissions (IOSCO), 2010, *“Objectives and Principles of Securities Regulation”*.
- , 2009, *“Approaches to Market Surveillance in Emerging Markets”*.
- , 2010, *“Effectiveness of Market Interventions in Emerging Markets”*.
- , 2011, *“Mitigating Systemic Risk: A Role for Securities Regulators”*.
- , 2011, *“Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies”*, Final Report.
- Iris H-Y Chiu, 2007, *“Securities Intermediaries in the Internet Age and the Traditional Principal Agent Model of Regulation: Some Observations from European Union Securities Regulation”*, Virginia Law and Business Review.
- Lawrence A. Cunningham, 2008, *“Some Investor Perspectives on Financial Regulation Proposals”*, George Washington University.

- Lawrence E. Mitchell, 2009, *"The Innocent Shareholder: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits"*, Wisconsin Law Review.
- National Economic Advisory Council (NEAC), 2010, *"New Economic Model for Malaysia Part 1: Strategic Policy Direction"*.
- , 2010, *"New Economic Model for Malaysia Concluding Part: Strategic Policy Measures"*.
- Organisation for Economic Co-operation and Development (OECD), 2009, *"Corporate Governance and the Financial Crisis: Key Findings and Main Messages"*.
- Performance Management and Delivery Unit (PEMANDU), 2010, *"Economic Transformation Programme: A Roadmap for Malaysia"*.
- Renee B. Adams, Benjamin E. Hermalin and Michael S. Weisbach, 2009, *"The Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey"*.
- Securities Commission Malaysia, 2001, *"Capital Market Masterplan"*.
- , 2004, *"Capital Market Development in Malaysia: History & Perspectives"*.
- Shanti Geoffrey, 2010, *"Capital Market Laws of Malaysia"*, Lexis Nexis.
- Securities and Exchange Commission (SEC), 2010, *"Concept Release on Equity Market Structure"*.
- The de Larosière Group, 2009, *"The High-Level Group on Financial Supervision in the EU"*, Report.
- US House of Representatives, 2010, *"Dodd-Frank Wall Street Reform and Consumer Protection Act"*, United States Government Printing Office.
- World Economic Forum, 2004, *"Values and Value: Communicating the Strategic Importance of Corporate Citizenship to Investors"*.

ACKNOWLEDGEMENTS

The formulation of CMP2 benefited substantially from the extensive deliberations on national economic policy issues in relation to the 10th Malaysia Plan, the New Economic Model (NEM) and the National Key Economic Areas (NKEA) as well as from the discussions on global regulatory reform at various forums, most notably at the International Organization of Securities Commissions (IOSCO) and the ASEAN Capital Market Forum (ACMF).

In addition to these discussions, the work on CMP2 drew from the numerous studies and resources on the websites of securities regulators, universities and other organisations that now represent an invaluable resource for research on capital markets around the world.

It has also become an integral part of the SC Business Plan implementation process to undertake continuous engagements and dialogues with industry stakeholders on a broad range of issues. The SC wishes to thank these stakeholders for their views and support that contributed to the successful implementation of CMP1 and that assisted the formulation of CMP2. In particular, the SC would like to express our appreciation to the following individuals and organisations for their invaluable time in providing feedback and insights at various high-level workshops and engagements:

- Abdul Wahid Omar (Dato' Sri)
- Ali Abdul Kadir (Datuk)
- Andrew Sheng (Tan Sri)
- Azlan Zainol (Tan Sri Dato')
- Azman bin Hj Mokhtar (Tan Sri Dato')
- Azman Hashim (Tan Sri Dato')
- Claire Suddens-Spiers
- Hamad Kama Piah Che Othman (Tan Sri Dato' Sri)
- Jean-Marc Poullet
- Johan Raslan (Dato')
- Jose Isidro N. (Lito) Camacho
- Mohamad Nasir Abd Latif
- Mohammed Azlan Hashim (Dato')
- Mohammed Rashdan Mohd Yusof
- Nazir Razak (Dato' Sri)
- Ong Leong Huat
- Rajeev De Mello
- Stephen Hagger
- Tim Leissner
- Yusli Mohamed Yusoff (Dato')

- Association of Stockbroking Companies Malaysia
- Bank Negara Malaysia
- Bursa Malaysia Bhd
- Employees Provident Fund
- Federation of Investment Managers Malaysia
- Khazanah Nasional Bhd
- Labuan Financial Services Authority
- Malaysian Association of Asset Managers
- Malaysian Investment Banking Association
- Malaysian Futures Brokers Association
- Ministry of Finance, Malaysia
- Permodalan Nasional Berhad

We would also like to extend our special thanks to the Minister of Finance II, YB Dato' Seri Ahmad Husni Hanadzlah and to the members of the SC Commission for their invaluable support and insights and to Michel Prada who acted as the external reviewer for CMP2.

The steering committee led by Tan Sri Zarinah Anwar, comprising Dato Dr Nik Ramlah Mahmood, Datuk Ranjit Ajit Singh and Goh Ching Yin, and together with the other senior members of management Datin Teh Ija Mohd Jalil, Eugene Wong, Zainal Izlan Zainal Abidin, Dato' Latifah Merican Chong and Foo Lee Mei, provided the direction and shaped the policies for CMP2.

The analysis and writing of CMP2 was undertaken by the Strategy and Research Department comprising Phuah Eng Chye, Aida Jaslina Jalaludin, Ong Toon Yeow, Azreen Idayu Zainal, Amiruddin Putra Ghazali, Cheam Tat Hong, Fara Halina Abdul Halim, Lim King Yoong and Paul Goh Chee Yan.

Many SC staff participated and contributed to the preparation of CMP2 which started 18 months ago. Special thanks is extended to Anil Joshi Hari Chand, Attila Emam, Shamim Fyaz Hajamaideen, Siti Loreley Bakri and Sujatha Sekhar Naik who spent many hours providing input and ideas while other staff members contributed significantly through their active participation in various work teams and brainstorming labs. They include Aishara Abdul Rahim, Aliza Nayan, Amardeep Kaur Inderjit Singh, Azryta Abdul Aziz, Carrie Cheah Beng Kyee, Chong Wui Jean, Eileen Wong Li Yin, Farah Nabila Daud, Feizal Mustapha, Ho Siow Keng, Jas Bir Kaur, Jimmy Teo, John Zinkin, Kaleon Leong Rahan Leong, Kamarudin Hashim, Kelly Leong, Khairul Ridzwan Abd Kuddus, Kiran Kaur Gill, Lai Yu Jen, Liew Kim Yuen, Lini Hazlinda Khalid, Loong Yeow Boon, Marina Yeop Adlan, Md Noor Abd Rahim, Mohd Rabani Sabain, Mohd Radzuan A Tajuddin, Murugiah M N Singham, Musa Mahmood, Neetasha Rauf, Nicole Denise Especkerman, Noraizat Shik Ahmad, Norlin Fatima Albakri, Nurfazrina Daing, Oong Eng Sing, Dr Roselee Shah Shaharudin, Salmah Bee Mohd Mydin, Shamsul Bahriah Shamsudin, Shanti Geoffrey and Wong Yoke Weng.

Designed, illustrated and edited by the Corporate Affairs Department.

Securities Commission Malaysia
3 Persiaran Bukit Kiara, Bukit Kiara
50490 Kuala Lumpur, Malaysia
Tel +603 6204 8000 Fax +603 6201 5078
Website www.sc.com.my