



## CONSULTATION PAPER

NO. 2/2006

# ESTABLISHING A FRAMEWORK FOR REGULATING SELF-REGULATORY ORGANISATIONS

The Securities Commission invites your written comments on the issues set out in this consultative paper. Comments are due by **7 June 2006** and should be sent to:

Anil Joshi  
Law Reform and Regulatory Policy Department  
Securities Commission  
3 Persiaran Bukit Kiara  
50490 Kuala Lumpur  
e-mail : [anil@seccom.com.my](mailto:anil@seccom.com.my)  
Fax : +603-6201 5101

Additional copies of this document may be made without seeking permission from the Securities Commission or downloaded from its website at [www.sc.com.my](http://www.sc.com.my).

**Confidentiality:** Your responses may be made public by the Securities Commission. If you do not want all or part of your response or name made public, please state this clearly in the response. Any confidentiality disclaimer that may be generated by your organisation's IT system or included as a general statement in your fax cover sheet will be taken to apply only if you request that the information remain confidential.

## 1. Establishing a Framework for Regulating Self-Regulatory Organisations (SROs)

### *Background*

- 1.1 Regulation of the capital market involves the use of a variety of tools including statutory regulation, market based regulation and self-regulation. Section 15 of the SCA reiterates this position by stating that it is SC's statutory duty to promote self-regulation in the capital markets.
- 1.2 As stated in recommendation 121 of the CMP, to promote self-regulation, the SC will introduce a SRO programme that will enable appropriate industry associations to be identified and recognised as self-regulatory organisations. In line with this recommendation, a regulatory framework to formally regulate SROs is being proposed.
- 1.3 The proposed provisions relating to SROs seek to achieve the following –
  - (a) ***Establishing the pre-requisites that must be satisfied by an organisation in order to be accorded the status of a recognised SRO by the SC.*** The intent of this provision is to ensure that an organisation must first have obtained the prior approval of the SC before being designated as an SRO. In giving its approval, the SC will examine, amongst others, the organisation's financials, administrative resources and the fit and properness of the organisation's officers.
  - (b) ***Enabling the SC to revoke the approved status of an SRO.*** The framework also enables the SC to revoke its approval in certain specified instances such as where the SRO has failed to commence operations within 3 months after an approval has been granted or where the SC is not satisfied that the SRO is properly performing or is able to perform the functions or powers delegated to it.
  - (c) ***Specifying the function of an SRO.*** The SC may specify the terms and conditions upon which the function of the SRO may be exercised. Some of these conditions may relate to operational issues such as spread of board representation, funding structure, specific functions of the SRO and utilisation of fines imposed by the SRO. As the provisions in the law are proposed to be broad and generic in nature, these requirements can be set out as specific conditions that would be applicable to the SRO that is being approved. This would ensure that specific concerns relating to a particular SRO are addressed.
  - (d) ***Requiring the SRO to exercise its functions or powers for public interest having particular regard to the need for investor***

***protection and to ensure that the market operates in a fair manner,*** and

- (e) ***The standards that must be adhered to by the SRO rules.*** The proposed regulatory framework on SROs sets out minimum standards that must be complied with by an SRO in respect of its rules governing its membership. The SRO rules must –
- (i) promote investor protection and ensure that the market operates in a fair manner, treat all its members and any prospective person who applies for membership in a fair manner;
  - (ii) set standards of behaviour for its members that promotes investor protection and the fair operation of a market;
  - (iii) manage any possible conflict of interest that may arise by virtue of the role and function carried out by the SRO;
  - (iv) ensure that there is a fair representation of members in the selection of its officers who manage and administer the affairs of the SRO;
  - (v) promote healthy competition in the market;
  - (vi) ensure that its members and officers duly comply with securities laws, regulations and guidelines issued by the SC; and
  - (vii) prevent the usage of any information by its members or officers that may result in its member or officer making an unfair gain.

## 2. SC's Oversight of SROs

2.1 The IOSCO Objectives and Principles on Securities Regulation emphasises the need for strong oversight of SROs by the regulator. Hence, the proposed regulatory framework on SROs approaches the oversight issue of SROs in the following manner –

- (a) ***Oversight over the SRO rules*** – In this respect the SC will vet the rules of an SRO before it approves the SRO. Further, any proposed amendments to the SRO rules must also receive SC's prior approval. The SC may issue a written direction to the SRO to suspend a specified provision of its rules, to amend its rules so as to conform to this Act, any regulations made under this Act or the rules of the stock exchange or futures exchange. Further, the SC may also direct the SRO to implement or enforce its rules;
- (b) ***Oversight over the appointment of officers*** – In this respect the proposed regulatory framework provides that the SRO will have to inform the SC of a person's appointment as an officer of the SRO. Additionally, the

composition of the SRO board of directors should include a number of public interest directors. Further, the framework also provides that where the SC has reasonable grounds to believe that an officer of the SRO is not fit and proper or a particular person's appointment or continuing in office as an officer is likely to be detrimental to the SRO or to affect public interest, the SC may, after giving the officer and the SRO reasonable opportunity to make representations, direct the SRO not to appoint the person as an officer, or to terminate the services of the officer; and

- (c) ***Oversight of the SROs disciplinary proceedings over its members*** – The framework requires the SRO, when it expels or suspends any of its members, or otherwise disciplines any of its members, to give to the SC particulars of the action taken against its member. Further, the proposed regulatory framework provides that notwithstanding that a member has been disciplined by the SRO, this will not preclude the SC from taking any of the actions that it is empowered to take under the law against that member.
- 2.2 Under the proposed regulatory framework, SROs must also maintain proper accounting records and those records must be audited.
- 2.3 Another issue that needs to be considered is whether certain corporate governance standards should be imposed on SROs via statutory provisions, for instance, one-third of the board should consist of independent directors. While this is a useful practice in order to bring about higher standards of governance at board level, we note that there are no set standards imposed via the law in other jurisdictions. Given that the SRO is not a listed entity, it may not warrant such standards to be imposed on an SRO.
- 2.4 Lastly, the question arises as to how membership issues should be addressed. For instance, should all intermediaries providing a particular function be required to apply for membership to the SRO and on what basis can the SRO exclude particular persons from membership. We note that section 15A-g of the US Securities Exchange Act 1934 provides that a registered securities association may deny membership on grounds such as –
- (a) it serves public interest or it is necessary to protect investors' interests;
  - (b) the person is subject to statutory disqualifications; or
  - (c) the person does not meet financial standards set by the association.

**The public's views and comments are sought with respect to:**

- 1. The proposed regulatory framework for self-regulatory organisations (SROs).**
- 2. Whether the proposed regulatory framework for self-regulatory organisations should include any other measures that can be adopted to strengthen the regulator's oversight of an SRO.**