Suruhanjaya Sekuriti
Securities Commission

SPEECHES

Asia Pacific Futures Regulators' Forum

Introduction to futures regulation in Malaysia
1.1 Commodity Futures

Futures trading in Malaysia commenced in July 1980 with the establishment of the Kuala Lumpur Commodity Exchange (KLCE). The introduction of the commodities futures market in Malaysia was against the background of in-creasing production of primary commodities particularly palm oil, cocoa, rubber and tin. The objective of the KLCE, much like that of futures ex-changes in other jurisdictions, was to provide modern hedging and risk transfer facilities and better price discovery of commodities produced in the region.

Commodity futures in Malaysia is regulated by the Commodities Trading Commission under the Commodities Trading Act 1985.

The years since the establishment of the KLCE have seen a transformation of the Malaysian economy from one that was agriculture-based, to one in which the manufacturing and services sectors contribute to more than three quarters of GDP. Malaysia, however, retains some primacy in much of the infrastructure support and research expertise in the commodity products. There is, therefore, real potential for new commodity futures contracts on the KLCE, to complement the existing Crude Palm Oil contract.

1.2 Financial futures

The evolution of the futures industry in Malaysia has charted a course not dissimilar to that of other more developed markets in that the development that began in commodity futures preceded the advancements of the last 20 years in financial instruments and their markets. Since last December, Ma-laysia has seen the emergence of not one but two financial futures exchanges: Kuala Lumpur Options and Financial Futures Exchange (KLOFFE), which at present offers an index futures contract on the bench-mark Kuala Lumpur Composite Index; and the Malaysia Monetary Exchange (MME) on which a 3 month interest rate contract is traded. These two markets are cleared by a single clearing house, the Malaysian Deriva-tives Clearing House, more of which you will hear this afternoon.

The financial futures (and the securities) markets in Malaysia are regulated by the Securities Commission under four Acts of Parliament.

1.3 A common regulatory framework

It is apparent that Malaysia does not have a securities/futures dichotomy as that in the United States, but rather the regulation is based on a distinction between commodity and financial futures. In May of this year, the govern-ment has decided that the regulation of all futures markets be placed under one regulator and one regulatory framework. The Commodities Trading Act, 1985 is being repealed. A Bill has been prepared to make the neces-sary adjustments to the Futures Industry Act 1993 and the Securities Commission Act 1993 to place the regulation of both markets under the Se-curities Commission, and is anticipated to be laid before Parliament within the next two weeks. When this Act comes into force, all risk-transfer and capital formation markets in Malaysia will be under the aegis of the Commission.

Oversight of Exchanges and Clearing Houses
2. Regulation of market institutions in Malaysia

I have taken the liberty of changing the topic of my presentation this after-noon from the "Oversight of Exchanges and Clearing Houses" to "Regulation of Exchanges and Clearing Houses" as I am sure no regulator will want to be accused of oversight.

2.1 Introduction: the regulatory scheme

The scheme of regulation in Malaysia is one of co-regulation and follows broadly that of the major markets. In principle, it may be said that the Secu-rities Commission concerns itself with general policy formulation, licensing, product and market approval, and enforcement, whilst leaving standards of entry into the industry, prudential controls and membership regulatory re-sponsibility to the exchanges and the clearing house. The day-to-day supervision of markets is done concurrently by the Commission and the self-regulatory organisations (or SROs) or, as I like to call them, the Front Line Regulators. Primary responsibilities for the proper regulation of futures activities are placed on the SROs or FLRs constituted for that purpose to ensure that futures markets are free to operate with only as much regulation as is necessary to allow them to function in an efficient, competitive and or-derly manner.

2.2 Market Structures

As explained this morning, Malaysia has two financial futures exchanges: the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE), which at present offers an index futures contract; and the Malaysia Monetary Ex-change (MME) on which 3-month interest rate futures contracts are traded. In addition, there is a commodity futures exchange, the Kuala Lumpur Commodity Exchange (KLCE) of which the MME is a wholly-owned subsidi-ary. There are significant differences between the operation of KLOFFE and MME, not just in the products that are offered in each exchange, or the trad-ing and settlement systems employed, but also in their ownership structures and therefore, as a corollary, their business philosophies. These differ-ences have introduced additional complexity in the regulatory landscape. These differences are summarised in this table:

KLOFFE	MME
privately owned exchange	owned by the Kuala Lumpur Commodity Exchange, which in turn is a member-owned exchange
screen-based trading system	open outcry trading system
offers index futures	offers interest rate futures
participants a mixture of retail investors and fund managers	participants are financial institutions and large corporations

2.3 Privately-owned exchanges

The treatment of privately-owned exchanges requires careful thought on the incentive structure of such markets and careful tweaking of existing micro-economic policies and legal provisions; policies and provisions which typically would have been drawn with the traditional member-owned ex-change in mind. The concern is that the business objectives of a futures exchange may run counter to the interests of members of the exchange and that of the market as a whole.

There is no restriction imposed on the distribution of profits by KLOFFE to its shareholders, since to do so will result in removal of a major incentive for the very establishment of the exchange. It is crucial, however, for the man-agement of the exchange to have regard to the public interest and to have in mind the general well-being of the industry. This is achieved by several means: firstly, the Futures Industry Act 1993 displaces the principle that powers of a company are vested in the shareholders by specifically provid-ing that the management of exchanges and clearing houses be vested in their respective boards of directors. Secondly, a balance is achieved in the composition of the boards between directors appointed by the shareholders, the ministerial appointees and those elected by members of the exchange. In addition, the law requires that the memorandum of association of a fu-tures exchange includes an object to act in the public interest.

It is also essential that a regulator ensures that the shareholders of pri-vately-owned exchanges commit sufficient capital for proper continued management and growth of the exchanges' markets. Without regulatory intervention in this respect, it may be difficult for the management of an ex-change to raise further capital from shareholders, who have understandable commercial concerns. Nor can a regulator take the view in the case of ex-changes that ailing commercial concerns should be allowed to fail, so long as they do so in an orderly manner (as a regulator may do in relation to market intermediaries). The regulatory function that exchanges play in the maintenance of market integrity, as well as the impact that such a failure will have on investor confidence place the stakes too high.

2.4 A case of too many exchanges?

In KLOFFE, MME and the KLCE, Malaysia has three futures exchanges. The oft-asked question is "Why does a market such as Malaysia need so many exchanges?".

As a regulator, the Commission does not take a view on a matter which is largely a commercial decision. If economic forces dictate that the ex-changes merge (and the anticipated consolidation of the financial futures and commodity futures regulation make this a real possibility in the case of MME and KLCE), then so be it. The Commission takes the view that the more significant issue is the need for a single clearing house.

2.5 Clearing house

The initial proposals from KLOFFE and MME had envisaged each of them making their own arrangements for the clearing and settlements of contracts traded on the respective exchanges. MME had intended for the clearing functions to be conducted by the MFCC (Malaysian Futures Clearing Corporation), which has been providing clearing facilities to the Kuala Lum-pur Commodity Exchange (which owns MME and 28% of MFCC). KLOFFE, on the other hand, had adopted an integrated electronic trading and settlement system from the Deutsche Terminbörse; the clearing and settlement func-tions were therefore intended to be undertaken by a department in the exchange.

2.5.1 Economic benefits

The financial markets today are seeing a trend of the centralisation of clearing and settlement facilities. The economic implications of this trend are well known: centralised clearing facilities allow a cross-market view of risks of clearing members which in turn results in more efficient margining of trades and more effective use of a clearing member's capital. In addition to lower costs of trading, there are opportunities for reduced costs of com-pliance and lower settlement costs from economies of scale. Liquidity risk is also reduced by the immediate funding of losses on one market from gains on another.

2.5.2 Impact on regulatory policies

A single independent clearing house also has deeper policy implications on the regulatory scope of market institutions in the futures markets by the fact that there will be a bifurcation of regulatory responsibility into the responsi-bility for market integrity, on the one hand, which is undertaken by the exchanges; and the responsibility for financial integrity, on the other hand, which is undertaken by the clearing house. It has been said that people take comfort from the existence of an independent clearing house which undertakes clearing and risk management solely for the benefit of financial integrity and systemic stability of the market. Where exchanges conduct clearing, competing interests may arise-see, for example, the official re-port of the Singapore Ministry of Finance on the Barings incident which recognises that the promotional role that exchanges play in re-spect of their markets may sometimes run counter to the objective of maintaining financial integrity in markets . The fact that most exchanges which operate their own clearing houses do so with a separate manage-ment for the clearing division further underscores the benefits of objectivity in the analysis financial risk.

These reasons led to the establishment of the MDCH by KLOFFE and MME, who each hold a 50% stake in the clearing house, despite the not insub-stantial short-term systems costs involved. The role of MDCH in the protection of financial integrity is expected to increase with the carrying of financial audits by the clearing house in the near future.

2.6 Quo Vadis?

Impending legislative amendments to the regulatory framework in Malaysia may very well see changes in the market structure in the near fu-ture. Certainly, a regulator in this position may gear microeconomic policies so that the push/pull effect of incentives guides those changes in a path such that resources in the industry are employed in the most efficient man-ner. Equally certain is our belief in the merits of a common clearing policy, particularly in the context of emerging markets.

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