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**Compliance In The Malaysian Capital Market:
An Overview
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Introduction

Ladies and gentlemen: good morning. We are pleased to welcome you to the Securities Industry Development Centre's Seminar on Enhancing Compliance in the Malaysian Capital Market. It is a pleasure for me to be here today with so many compliance professionals from the Malaysian securities industry. At the same time, someone has pointed out that this conference presents some rather alarming implications, as we have some 200 compliance professionals from both the Commission and the industry absent from their posts to be present here today!

Nevertheless, I am heartened to note the importance that you attach to the role of compliance in your respective organisations. In this regard, we share common goals. We all wish to ensure that the Malaysian securities industry and those associated with it are in full and complete compliance with the law, and we all would like to see adequate resources and attention devoted to ensuring compliance on an ongoing basis.

Significance of compliance in the capital market

The topic of compliance is a significant one. Today's increasingly complex and diverse markets have made the task of policing the activities of market participants a progressively difficult one. As such, the principle of compliance-whereby a firm should comply with all regulatory requirements applicable to the conduct of its business activities-is crucial for the effective development of the Malaysian capital market. With four exchanges, some 750 public listed companies and a wide array of market intermediaries, the duty of every market participant to observe the relevant rules and regulations is a formidable, yet necessary, one.

I say that such observance is necessary because these rules safeguard the objectives fundamental to our capital markets: namely, to protect the interests of investors and to safeguard confidence in the integrity of the marketplace. This was underscored by a report released last year by the International Organisation of Securities Commissions (IOSCO), where "the implementation of an effective compliance programme" was cited as one of the 30 core principles of securities regulation.

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However, it must be emphasised here that the regulators can only do so much with regards to ensuring that regulatory standards are adhered to. The Commission can enforce the rules, but its primary role is that of the industry watchdog, not the industry bloodhound. It is the exchanges as front-line regulators (FLRs), the self-regulatory organisations (SROs) and the market participants who must also play their part as the key guardians of these interests. In other words, the key to effective compliance lies in the hands of those who are best placed to conduct the day-to-day supervision of their own operations.

Compliance should not be looked upon merely as passive adherence to the laws, rules and guidelines issued by the authorities. Benefits from maintaining high standards of compliance can accrue to the adherents in many ways. Public confidence in a firm's integrity and transparency, for instance, can foster long-term profitable relationships with business partners. Effective compliance with prudential requirements will enable market intermediaries to manage risk better, thus enhancing risk-adjusted returns to shareholders and providing greater certainty for cash flow management purposes. On a more general but no less important level, compliance with high standards of industry practices will help minimise credit, systemic and reputational risk in the interest of promoting the long-term development of the industry.

Key expectations of SROs and member companies

The adoption of rules is of little use unless firms and markets comply with these requirements. Consequently, there are certain key expectations of the market institutions and industry groups whom we hope will play an increasingly active role in promoting a culture of compliance among their members and colleagues.

A recent case illustrates the importance of such vigilance. In June this year, the US Securities and Exchange Commission alleged, in a rare instance of enforcement action against the New York Stock Exchange, that between 1993 and 1998 the NYSE had failed in its supervisory duties by not detecting illegal trading by floor brokers. This action was taken after eight independent floor brokers were found participating in an unlawful profit-sharing scheme. The SEC also said that the exchange "knew or ... should have known" that its surveillance system was inadequate. Now, although the NYSE has since taken measures to address these flaws, market commentators have noted that the affair has affected the confidence of some investors.

The implication is that market institutions and participants must have in place an effective framework to secure compliance with the rules established by the authorities. This entails the formulation of procedures for detecting instances of non-compliance with the rules they are obliged to follow. Adequate surveillance of business activity would include regular monitoring of all counterparties and transactions, and both regular and unannounced audits of financial, trading and other records. To incorporate these

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elements, a structured internal control framework with the appropriate "Chinese walls" or informational and operational barriers must be given serious consideration.

Following from this, I would also like to emphasise our desire to promote a high level of professionalism amongst our market participants. A system of effective compliance relies on the basis that the professionals undertaking the reporting and compliance functions will conduct sufficient due diligence to ascertain the veracity of the facts and figures they release. As such, we desire to see a culture where integrity and unbiased judgement are not only expected, but regarded as indispensable to navigating the issues and situations that will inevitably crop up in this age of global market integration. In particular, we have a common obligation-both as regulators and professionals-to elevate existing practices in the securities industry to the highest levels.

Regulatory requirements to enhance compliance in the Malaysian capital market

Let me now delve into some of the issues in relation to the Commission's efforts to enhance compliance in the Malaysian capital market.

One example lies in the need for tighter controls on company reporting, as emphasised in the recent financial crisis. As companies face sharp declines in profits, or even losses, it is essential that the real state of their finances is clear. There have been examples of listed companies releasing information to the market which was subsequently found not to reflect their true financial position, or even be misleading. As we move towards a disclosure-based regime, it is critical that issuers make timely disclosures to keep the market informed. A number of listed companies have already been reprimanded by the KLSE for various breaches of disclosure requirements. The authorities take a very serious view of these matters as they undermine confidence in the Malaysian stock market.

To this end, the Policies and Guidelines on Issue/Offer of Securities released in April this year included specific provisions requiring issuers, promoters and directors of public companies, as well as advisers, reporting accountants and experts must comply these guidelines. The penalties of non-compliance were also spelt out clearly, reflecting the Commission's expectation that the responsibility of compliance should not be taken lightly. Similarly, provisions for compliance with other regulatory guidelines including the Malaysian Code on Take-overs and Mergers 1998, which came into effect in January this year, also stressed the importance of providing accurate and material information in compliance with the requirements of the code.

We do acknowledge that a key challenge lies in fine-tuning the system to achieve the right balance between flexibility and discipline. Companies need the flexibility that allows efficient use of resources in order to remain competitive. However, it is important that they also practice high standards of reporting to allow valid comparisons between them

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to be made, and to reinforce confidence in the transparency and integrity of the Malaysian corporate system.

The need for adequate reporting and internal controls also applies to market intermediaries such as unit trusts, asset management companies and stock and futures broking firms. Common problems that emerged during the recent market crisis at the secondary market level included inadequate internal controls, poor segregation of duties, a lack of adherence to "know your customer" provisions and lax credit management. These problems were largely a result of non-compliance with the relevant securities rules and regulations.

Recognising this, the Commission has initiated efforts to improve matters in this regard. Stockbroking companies are now required to formulate adequate supervisory and compliance programmes, comprising sufficient controls and monitoring mechanisms. Work is also currently underway to require all stockbroking companies to have an audit committee. Additionally, amendments were made in May 1999 to the practice notes of the Guidelines on Unit Trust Funds in relation to the submission of monthly statistical and compliance returns, in order to better monitor these companies' compliance with the said guidelines.

Setting up a compliance unit and qualifications of compliance officers

In addition, the appointment of compliance officers in member companies operating in these markets has also been set in motion in order to ensure investor protection and market integrity. The compliance officer's basic responsibility is to secure effective internal controls and an active segregation of duties between trading and operational functions within the firm.

Given that compliance officers are our first line of defence in maintaining the integrity of the securities industry and protecting investors, what are the necessary qualifications of compliance officers? Our guidelines are quite clear: they should be persons who, having passed an examination approved by and registered with the relevant exchange, hold a senior position in the organisation of the member company and who can act independently and is able to fully affect decisions. The educational and professional qualifications as currently prescribed in the KLSE and MESDAQ Business Rules, for instance, outline the minimum experience that these personnel must possess.

However, we are aware that there are some concerns that the compliance units face substantial obstacles in their efforts to carry out their duties effectively. Our own findings continue to reveal a divergence between the actual compliance activities of certain market intermediaries and what we expect to be the quality and standard of compliance work performed by Compliance Officers in the industry. With this in mind, allow me to just elaborate on several elements that I feel are needed to ensure that the compliance units are not unduly hampered in their tasks.

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First, the firm should be committed to monitoring and enforcing its compliance procedures. As such, there should be adequate channels for the detection of early warning signals that imply questionable conduct. These sources of such signals may vary from formal exception reports to ad hoc customer complaints. The compliance officer must be able to have unlimited access to all information and records in relation to the company's business activities.

Second, it is essential for a compliance officer to have the authority within the firm to address inappropriate conduct. This should include the ability to question and impose sanctions on employees who have breached the rules. At a minimum, they should have available to them adequate lines of communication with supervisors all the way up to the senior management level to ensure that the problem is remedied.

Last, compliance must have the proper resources to be effective. A compliance department may not be on the priority list for resource allocation as it does not offer immediate tangible benefits. Nevertheless, public trust is critical to any successful securities market operation. Therefore, compliance should be provided with sufficient resources to be effective.

We want compliance units to be prominent within their respective firms, and for the business lines to have a healthy respect for the important role that compliance plays in the organisation. Increasing competition, pressure to operate profitably and to improve performance, product innovation and rapid advancements in information processing and dissemination technology have, in some cases, resulted in new challenges for market intermediaries in monitoring their own operations. With this in mind, provisions for best sales practices and compliance have been put in place in the Business Rules of the various stock and derivatives exchanges given that the compliance unit is of critical importance given the rapid changes and developments in the financial services sector.

Challenges for the future

Finally, I would like to touch on the challenges we envisage will become increasingly important with regard to the role of the compliance function as the market develops and expands. For one, we need to inculcate a compliance culture whereby adherence is proactive rather than reactive, and where dishonesty is not tolerated. The culture of self-compliance should be ingrained in the management and execution of daily business activity. In other words, what we envision is that, although the primary responsibility for compliance still rests with the Head of the Compliance Department, compliance would relate to each person within an organisation or industry being aware and committed to the regulatory requirements.

Following from this, the need to promote incentives for compliance points to the need for sound codes of conduct to advocate ethical and professional discipline within every

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segment of the market. This would help clarify individual and collective responsibilities in the administration of each party's duties.

This is particularly critical in the ever-changing environment we live in today. It has become almost trite to say that technology has changed the face of the capital market as we know it. For the securities industry; it has changed the way people trade and the way they raise capital. New electronic trading systems pose competitive challenges to the traditional trading floors. As geographical limitations and traditional barriers to competition are broken down, intermediaries can expect to face increasing pressure to diversify or strengthen their core business.

The composition of the investing public may also change as increasing globalisation affects the concentration of capital. New entities may emerge that fall outside the ambit of existing regulations. The recent near-collapse of Long-Term Capital Management demonstrates the possible extent of the dangers posed by inadequate internal controls in a single institution, which, in tandem with other factors, gave rise to significant systemic risks to the global financial system.

All these developments will drive changes in the way capital markets operate, and possibly the regulatory structure of these markets. One question that I am often asked, which I have also asked myself, is how the Commission will regulate this new industry. Will our regulatory approach continue to make sense in the environment of the new millennium?

Our goal is to do the best we can to ensure that it does. The key, I believe, lies in regularly re-assessing our position in the face of the rapid changes in the markets that we regulate. Only then can we hope to forge ahead instead of lagging behind the learning curve.

I think and hope that the industry will share this regulatory challenge.

Thank you.

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