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Seminar on Stock Index Options: A New Frontier for the Malaysian Derivatives Market

**Opening Address
by
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Distinguished Guests, Ladies and Gentlemen.

Introduction

A very good morning to all present. Welcome to the Stock Index Options Seminar jointly organised by KLOFFE and SIDC. Your presence here today is a clear indication of continued interest in the development of our local derivatives market. Let me also take the opportunity to welcome all speakers, foreign and local, to the SC and to thank all of you for taking time off your busy schedules to share with us your knowledge, expertise and experience on various aspects of stock index options. I believe there is so much to learn from this seminar, and hope that participants would treat it not only as a source of education and information, but also as a platform for the establishment of networks and strengthening of relationships.

The launch of Stock Index Options in Malaysia

The stock index option is a much-awaited product which was launched late last year, after extensive deliberations and consultations. Although the timing for its introduction had to be reviewed for several unforeseen reasons, most notably the financial crisis which resulted in a temporary re-adjustment our capital market development priorities, nevertheless, the SC continues to maintain our sight on the longer-term need to facilitate the development of the derivatives markets given their important economic function as an alternative risk management tool. Furthermore, companies need derivatives to reduce their cost of financing, portfolio managers need them to reduce risks and to enhance returns, and investors need them to hedge their investments in the cash market.

The launch of the index option contract has not only complemented the existing futures contract on the Kuala Lumpur Composite Index (KLCI), but also provided a significant contribution to the whole derivatives markets. With the launch, we now have more

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derivatives products to choose from to suit the various investment and trading strategies, and risk management needs of investors, corporations and fund managers within the Malaysian capital market.

Liquidity continues to be a concern

The stock index option contract was officially launched on 1st December 2000, about five years after KLOFFE launched its first financial product that is the futures on the KLCI. A total of 105 contracts were traded on its first trading day. This, I am told, has unfortunately remained the highest volume recorded so far. Our major concern is again the low level of liquidity which has persistently been plaguing the derivatives market due to, among others, lack of active local institutional participation and interest, and low level of investor awareness and understanding as to the use of derivatives.

Although various measures have been undertaken to address the liquidity problem, we have only managed to do so with a limited degree of success. This, if not addressed adequately and immediately, could create an undesirable situation as persistent liquidity problem may pose additional risks and relative costs being borne by market participants, rather than providing a market place where risks could be minimised or transferred effectively and efficiently to a willing third party. In short, the derivatives markets may not be able to fully serve the role and functions that they are intended and expected to play.

KLOFFE's major challenge would be to respond to desires for improved price discovery, lower costs, faster trading, better execution and greater access. Since index option is a very new product in our market and in the absence of market makers, aggressive marketing and promotion need to be undertaken, and close and continuous attention must be given to training and education so as to increase awareness and understanding of market participants and the investing community in general.

Derivatives are a cornerstone of modern finance

All over the world we are witnessing rapid advancement and improvement in technology and communication. These factors, apart from stiff competition and financial innovation, are driving exchanges towards demutualisation. New technology does not come cheap and thus calls for broader access to capital. Increasing competition between exchanges and other trading systems requires exchanges to become more efficient and effective in all activities, including their decision making process.

However, a point worth noting is that, in the process of consolidation and technological innovation, derivatives were never left behind. They remain to be part, indeed an integral part, of a successful financial market and a significant contributor to the new entity. For

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example, the merger of the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange Limited (SIMEX) to form Singapore Exchange (SGX) which is the first demutualised, integrated securities and derivatives exchange in Asia Pacific or the merger of the stock and futures exchanges and clearing houses in Hong Kong to form the Hong Kong Exchanges and Clearing Limited.

Clearly, derivatives represent an integral component of an efficient capital market and a cornerstone of modern finance. Thus, the way forward is continuous developmental effort to build and further strengthen the market. The survival of the derivatives market is important not only for domestic corporations, fund managers and institutions to manage their risks and to reduce the cost of doing business, it is also vital in fulfilling Malaysia's aspirations to have a world class capital market.

To this end, the SC, as the regulator of the capital market can only help to guide and pave the way but more initiatives would have to come from the industry. Concerted effort from all parties is crucial to move the market to greater heights.

Increasing global competition requires immediate response

The changes in the global financial landscape brought about by mergers and alliances of exchanges, consolidation of financial markets, and technological and market innovation would certainly create greater competition for businesses. Given that derivatives are easily replicated, the sensible way to maintain competitiveness is to recognise the needs of the specific market and to respond accordingly.

Survival means adapting quickly, and the challenge for the exchanges is to remain relevant. Exchanges, which previously were domestically focused, are now providing direct access to global investors who are more sophisticated and often want to trade directly across markets. Exchanges now, would have to grapple with the extension of trading hours, the entry of new classes of competitors, and the promise of exchange-alliances within and across time zones. The pie is now larger but so are the people competing for a slice of it.

The SC, in an effort to ensure that the Malaysian capital market is not left behind, recognises this need. This brings me to the recent launch of the Capital Market Masterplan (CMP).

The Capital Market Masterplan

The CMP is a comprehensive plan charting the strategic positioning and future direction of the Malaysian capital market for the next 10 years. It aims to address weaknesses in the capital market that were perhaps best highlighted by the recent financial crisis, provide a strategic road map to facilitate future business development and assist in the creation of a

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resilient and competitive capital market. The recommendations are based on the current and projected state of play and reflect SC's belief and commitment towards further development of the market, including the derivatives market.

In addition to the broad recommendations to enhance and strengthen the local market institutions, such as consolidation and demutualisation of the local exchanges, establishment of a common trading platform and an integrated clearing and settlement system for both the equity and derivatives markets, the CMP also provides specific recommendations aimed at facilitating further development of the derivatives industry.

CMP recommendations for derivatives market

Specific recommendations for the derivatives market include further deregulation of restrictions on the participation of institutional market participants in the trading of exchange-traded derivatives. It is hoped that with the removal of such restrictions, more institutional players would participate and enhance their portfolio management. Another important recommendation is the introduction of derivatives funds under a supervised environment to cater to the need of sophisticated investors with greater appetite for risk. This offer would be subsequently extended to the general public. These strategies are intended to create more depth and promote a more balanced mix of participants in the local derivatives market.

As a measure towards enhancing market attractiveness and appeal to the global investors, the trading of approved international derivative products will be allowed and the process for the introduction of new exchange-traded derivatives products will be streamlined. This would be complemented by further liberalisation of the futures broking commission rate and clearing and exchange trading fees.

To create greater market access and in line with global developments in major marketplaces, the concept of Introducing Brokers or "IBs" which is currently adopted in some developed jurisdictions will be introduced to enable futures trading to be available to a larger spectrum of the investing community. In addition, it is also recommended that a new category of International Members with full derivatives trading and broking rights will also be allowed and equity ownership of futures broking firms will be liberalised to allow foreign majority ownership sometimes in the future.

Together with the CMP recommendations, the SC is putting in place an implementation programme which we are very committed to. Although the implementation of these recommendations will be done in phases some of them may be fast tracked or where necessary delayed to respond to the changing environment. The most immediate measure is of course the building up of a critical mass to improve efficiency and facilitate innovation for more value added activities in the market. The SC, in its course of duty, would be adaptable and flexible within the constraints of its statutory obligations as a show of our commitment

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towards the development of the industry. It is our hope and our wish that all market participants would with us in implementing the recommendation of the CMP.

Training and education to play key roles

As I have mentioned many times before, the liquidity problem could only be solved if there is a drastic change in mind-set of the investing community and the way to achieve that is through improving knowledge and creating greater public awareness on the use of derivatives. As such, I thank the SIDC and KLOFFE for co-ordinating this seminar and view it as an important move towards creating greater awareness on the stock index option product, and the derivatives market as a whole.

I hope that each of you would make the most out of this seminar and benefit from the experience and expertise of all the speakers today and I hope to see more of this kind of seminars in the near future. I wish you all a productive and fruitful session.

Thank You.

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