EXAMINATION STUDY GUIDE:

REGULATIONS (MALAYSIAN FUTURES AND OPTIONS)

(MODULE 1)

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UPDATES FOR TOPIC 2

IN RELATION TO CONTRACTS FOR DIFFERENCE (CFD)

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(This document consist of 36 pages including the cover page)

Topic 2: Regulation of Derivatives

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Overview

Introduction

In this topic, we examine in detail the regulatory framework of the Malaysian derivatives industry and the legislation and obligations under which market participants operate. We will look at not only the specific provisions in the pieces of legislation, but also at the reasoning behind them. We will see that two main motives behind the enforcement of the various regulations are to regulate the market so that it provides fair trading opportunities for everyone, and to protect clients.

In approaching this topic, it is important to realise that the distinctive nature of the regulation of derivatives trading arises from special requirements necessary for high-risk leveraged transactions. The special features of derivatives trading have been addressed by both statute and the derivatives exchange's rules in a number of particular ways that are generally found in other well-regulated derivatives markets throughout the world. However, as the law is a constantly changing area and, as the rules of the derivatives exchange and clearing house are continually being updated, you should consult the latest versions of the legislation/rules before making any relevant decision.

Topic Objectives

At the end of this topic, you should be able to:

- list the three principal aims of the Capital Markets and Services Act 2007 (CMSA)
- explain the purpose of the Capital Market Compensation Fund
- list the requirements that an applicant for a licence must meet to be successful
- list the practices prohibited under the offence provisions of the CMSA

1 Overview of Derivatives Industry Regulation

1.1 Aim of Regulation

Public confidence in the soundness of the derivatives market is essential for its continued existence. As dealing in derivatives involves a high degree of risk, if people do not trust derivatives market participants, including companies and their employees, they will not be prepared to participate in the derivatives market, which will hinder the development of the Malaysian capital market.

Effective regulation of the derivatives market promotes domestic and international investor confidence, protects investors, ensures that potential investors have all the information they need to make their own informed assessment of the risks involved, and provides a deterrent to fraudulent behaviour by market participants via the possibility of enforcement action (e.g. prosecution).

Hence, there are three broad aims of regulation:

- to promote professional conduct among intermediaries
- to ensure fair and transparent markets
- to minimise the likelihood of systemic disruptions/failures.

Each of these aims is described in more detail below.

Professional Conduct

High professional standards among market intermediaries ensure fair and efficient markets.

Fair and Transparent Markets

A second aim of regulation is to ensure that markets are fair and transparent. By *fairness*, we mean that market participants are able to compete on a level playing field, i.e. no one group of individuals or corporations is advantaged at the expense of another, and there are equal trading opportunities for everyone. The existence of a level playing field is a prerequisite for promoting competitiveness between market participants, in particular, intermediaries. The expression *fairness* is sometimes also taken to encompass the notion of *investor protection* (such as the elimination of fraud and manipulation, and the protection of uninformed investors against exploitation by insiders).

Regulation of markets also seeks to enhance its *transparency,* which not only connotes a market that is *efficient* (where market information is disseminated on a timely basis) but also one in which there exists *legal certainty*.

Minimise Systemic Risk

Regulation is aimed at minimising the risk of default by one institution leading to defaults in the entire market or other markets or both. This risk is known as *systemic risk*, which has been defined by the Bank of International Settlements as:

> *the risk that a disruption, whether at a firm, a market segment or across markets, will cause widespread difficulties at other firms, in other market segments or in the financial system as a whole.*

1.2 Regulatory Framework

The derivatives industry is now governed by the CMSA. The CMSA consolidates the Futures Industry Act 1993 and the Securities Industry Act 1983.

The CMSA is administered primarily by the Securities Commission Malaysia. Certain powers under the CMSA, however, have been reserved for the Minister of Finance. Responsibility for the day-to-day supervision of derivatives markets, approval of entry into the derivatives industry, prudential controls and participantship regulatory responsibility are placed with the derivatives exchange and clearing house. The derivatives exchange and clearing house, known as *front-line regulatory organisations*, each performs its regulatory functions by establishing and enforcing a body of rules and policies known as Bursa rules.

The scheme of regulation in the derivatives industry in Malaysia is, therefore, one of co-regulation, between the Securities Commission Malaysia, as the public authority, and the derivatives exchange and clearing house as the front-line regulators.

The regulatory framework for Over-The-Counter (OTC) Derivatives: Contract for Difference (CFD) in Malaysia will be discussed in Topic 3.

Sources of Obligations

Arising from this co-regulatory structure are four sources of obligations imposed on participants in the derivatives industry:

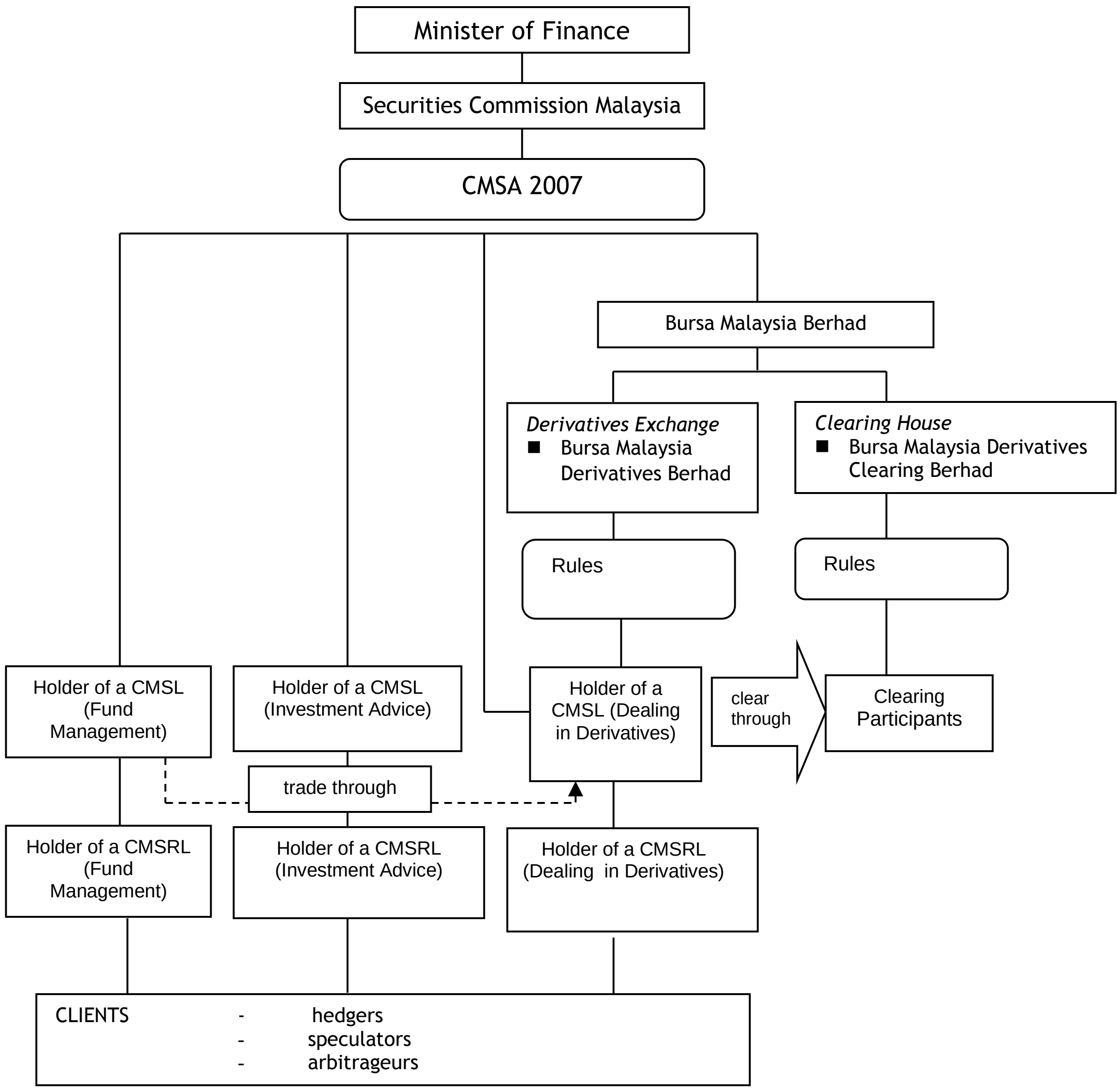
- Capital Markets and Services Act 2007 (CMSA)
- Capital Markets and Services Regulations 2007
- orders and directions given by the Securities Commission Malaysia under the CMSA
- guidelines and practice notes issued by the Securities Commission Malaysia
- the rules of the derivatives exchange and the clearing house.

Together, these laws, orders, directions, guidelines, practice notes and business rules, make up the regulatory regime of the derivatives industry. It should be noted that the nature of these sources of obligations are different. The CMSA, regulations made under the CMSA and orders and directions of the Securities Commission Malaysia under the CMSA, derive their authority from statute — they may, therefore, be said to have the force of law.

In contrast, the rules of the derivatives exchange and the clearing house are contractual in nature — the Rules of Bursa Malaysia Derivatives Berhad, for example, are a contract between Bursa Malaysia Derivatives Berhad and its participants. This is significant because contracts cannot be enforced by, or be enforced upon, somebody who is not a party to the contract. Therefore, as a general rule, the rules of a front-line regulatory organisation are only binding on its participants. However, the CMSA provides for certain circumstances where the rules may be enforced by 'outsiders' (see section 2.2 below).

Figure 1 outlines the supervisory roles of the Securities Commission Malaysia, derivatives exchange and clearing house, over participants, holders of a CMSL who carry on the business of fund management and holders of a CMSL who carry on the regulated activity of investment advice, and other traders.

Figure 1: Regulatory Framework in the Derivatives Market



From the foregoing diagram, we can see that there are three types of institutions that regulate the derivatives industry in Malaysia:

- the Securities Commission Malaysia — through the enforcement of the CMSA and its regulations, directions, orders, guidelines and practice notes
- the derivatives exchange (Bursa Malaysia Derivatives Berhad) — through the enforcement of its rules
- the clearing house (Bursa Malaysia Derivatives Clearing Berhad) — through the enforcement of its rules.

The remainder of this topic will focus on the CMSA and the obligations it places on participants in the derivatives industry.

1.3 The Capital Markets and Services Act 2007

The Capital Markets and Services Act 2007 (CMSA) outlines the powers and duties of the Minister of Finance and the Securities Commission Malaysia and the rights and obligations of participants in the derivatives industry, which include the derivatives exchange, the clearing house, intermediaries and traders.

Minister of Finance

The Minister of Finance is vested with certain powers under the CMSA, including the power to:

- grant and revoke, on recommendation of the Securities Commission Malaysia, the approvals of stock exchange or derivatives exchange and clearing houses
- the power to prescribe regulations under the CMSA
- the power to close derivatives markets in an emergency
- hear appeals against decisions of the Securities Commission Malaysia in respect of licensing.

Role of the Securities Commission Malaysia

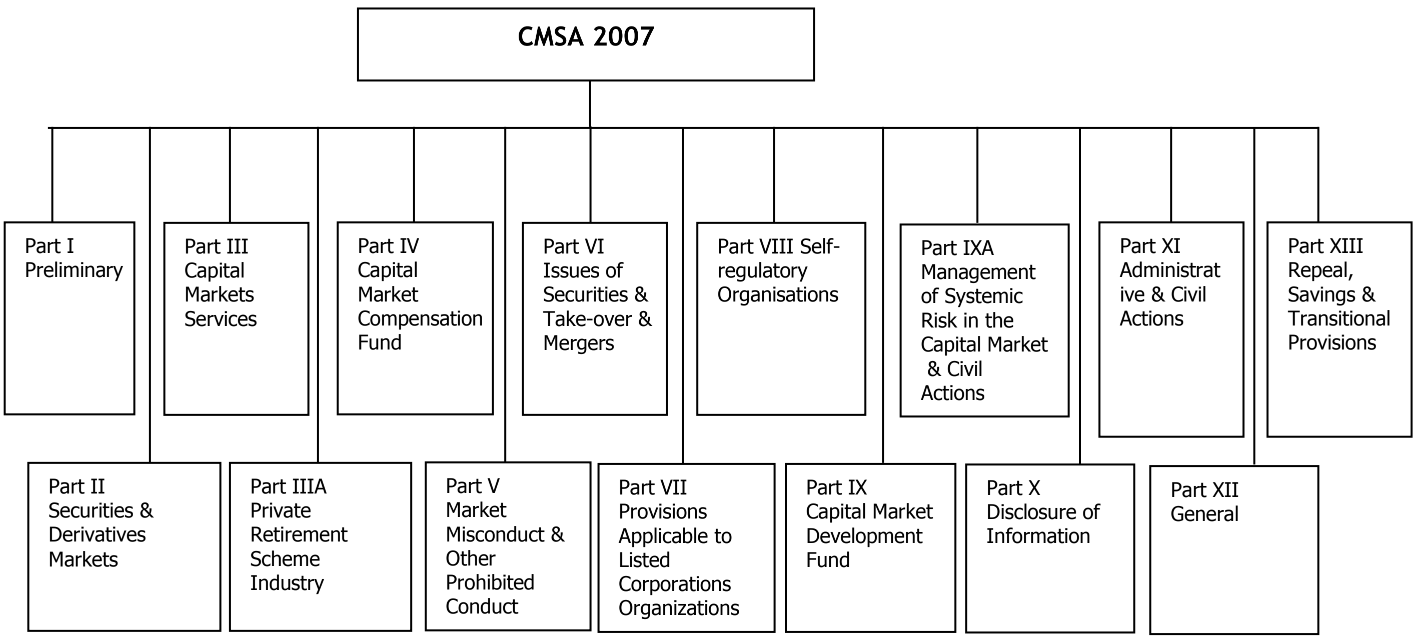
The Securities Commission Malaysia is charged with the administration of the CMSA. The Commission's role is to ensure the integrity of the derivatives industry so as to protect public interest and maintain investor confidence. It is responsible for:

- licensing derivatives market participants (holders of a CMSL and their representatives — however, a CMSL to carry on the business of dealing in derivatives can only be issued with the concurrence of the Minister)
- approving the rules of the derivatives exchange and the clearing house (as well as approving subsequent amendments to them)
- enforcement and prosecution
- advising the Minister of Finance in matters concerning the derivatives industry.

Components of the CMSA

The following diagram illustrates the components of the CMSA and is a useful tool for finding your way around this important piece of legislation. It shows that the legislation is divided into 15 main parts. Most parts are then divided into a number of sections (although these are not shown on the diagram) and these sections may then be further divided into a number of sub-sections. Some parts on the other hand, are divided into divisions, followed by sub-divisions, before being divided into sections and subsections.

Figure 2: Components of the CMSA Legislation



2 Establishment of Derivatives Markets

The CMSA is concerned with, among others, the regulation of derivatives markets. While at its narrowest, derivatives trading is sometimes regarded as trading that occurs on the floor of a derivatives exchange or via an automated trading system, this really begs the question as to what is a derivatives and what is a derivatives market. These issues are covered in Part I and Part II of the CMSA.

2.1 Derivatives Exchange

A derivatives market is defined as a market or other place at which, or a facility by means of which, futures and options are regularly traded. The CMSA requires that all derivatives markets must be conducted either on an approved derivatives exchange or on an exempt derivatives market.

- An approved derivatives exchange is defined under subsection 8(2) of the CMSA as a body corporate which has been approved by the Minister of Finance on the recommendation of the Securities Commission Malaysia. A body corporate that has been granted such an approval is known as *a derivatives exchange* under the CMSA.

- Exempt derivatives markets are markets that have been exempted from having to obtain approval under paragraph 7(3)(a) of the CMSA by the Minister of Finance. This exemptive power is exercised by the Minister to exclude, for example, certain over-the-counter (OTC) markets from some of the provisions of the CMSA, where the relative sophistication of the participants in those markets may render compliance with the provisions to be inappropriate and a cost burden.

Approval of Derivatives Exchange

Before granting approval, the Minister has to be satisfied that the derivatives exchange has complied with certain prerequisites set out in subsection 8(2) of the CMSA pertaining to, among others, the company's ability to:

- ensure that as far as is reasonably practicable, it will operate an orderly and fair market in relation to securities and derivatives that are traded through its facilities
- manage any risk associated with its business and operations prudently
- take appropriate action against its affiliates to whom the rules apply for any breach of its rules

In addition, the Minister may impose further conditions when granting the approval.

Once a company has been approved by the Minister as a derivatives exchange, it must meet certain continuing obligations. The continuing obligations of a derivatives exchange are set out in Part II of the CMSA.

Functions of the Derivatives Exchange

The regulatory framework under the CMSA both permits and obliges a derivatives exchange to perform two important functions:

1. To set up an organised exchange for dealing in derivatives and to develop the market for those contracts
2. To ensure that these markets operate in a fair and efficient manner

The second function is performed by the derivatives exchange in its capacity as a front-line regulatory organisation that:

- sets criteria for admission to participantship of the derivatives exchange
- makes rules to regulate the conduct of participants and other persons who trade on the derivatives markets conducted by the derivatives exchange

The criteria for admission are designed to ensure that the potential participant is financially sound and possesses personnel of good fame and character who have the requisite skill and expertise.

The rules of a derivatives exchange deal with matters such as:

- duties and responsibilities of holders of a CMSL who carry on the business of dealing in derivatives to clients
- requirements aimed at maintaining the financial liquidity of holders of a CMSL who carry on the business of dealing in derivatives
- improper trading practices
- submission of periodic reports on holders of a CMSL who carry on the business of dealing in derivatives activities and financial statements to the derivatives exchange
- audit of holders of a CMSL who carry on the business of dealing in derivatives accounts

Enforcement Powers of the Derivatives Exchanges

To enable the derivatives exchange to monitor compliance with and enforce the rules, the derivatives exchange reviews reports and audit accounts of holders of a CMSL who carry on the business of dealing in derivatives monitors training activities and practices and carries out investigations into any unusual activities and practices. If an activity involves a contravention of the CMSA, the derivatives exchange makes a report to the Securities Commission Malaysia. The derivatives exchange carries on regular dialogue sessions with the Securities Commission Malaysia in connection with the regulation of the derivatives markets.

As we have seen earlier, the rules are a contract between the derivatives exchange and its participants. Generally, persons who are not parties to a contract are not bound by the contract; neither can they enforce its terms. However, in the case of rules of the derivatives exchange and clearing house, s.355 of the CMSA provides that the Securities Commission Malaysia may take action against a person who fails to comply with, observe, enforce or give effect to the rules of a derivatives exchange or clearing house.

It is readily apparent that there is substantial overlap between the provisions of the CMSA and the rules. Breaches of the rules are pursued by the derivatives exchange, and typically result in fines or reprimands on the participants (or in more serious cases, suspension of, or expulsion from, participantship). Because of the overlap, a breach of the rules may also constitute a contravention of the CMSA, which may result in a criminal conviction.

The derivatives exchange is required to give such assistance to the Securities Commission Malaysia as it reasonably requires and notify it of disciplinary action taken against a participant. The Securities Commission Malaysia is entitled to full and free access to the trading facilities. The Securities Commission Malaysia also has the power to give directions with respect to the operation of the market.

2.2 Clearing House

Section 38 of the CMSA provides for the establishment and operation of a clearing house. Application for approval to establish or operate a clearing house must be accompanied by the rules of the clearing house, which must provide for, among others:

- efficient provision of clearing house facilities
- rules that cater for quick and fair method of settling disputes between clearing house and its affiliates and between its affiliates and their clients
- proper regulation and supervision of its affiliates using its clearing facilities

The clearing house is the central risk-taker in the market — because it guarantees the performance of all contracts by becoming the counterparty to all trades. The Bursa Malaysia

Derivatives Clearing Berhad, and its participants are regulated by rules which govern the operation of clearing participants and control the exposure of the clearing house to its participants.

It should be emphasised that the Rules of Bursa Malaysia Derivatives Clearing Berhad must not be confused with the Rules of Bursa Malaysia Derivatives Berhad, which are rules for, among other things, contract specifications and behavioural standards between the derivatives exchange and its participants and their clients. The clearing house's rules include procedures for the acceptance of contracts for registration on behalf of a clearing participant, the method of calculation of the margin and deposit and the cut-off times by which payment must be made.

Activity 1

(a) List the two (2) key functions of a derivatives exchange.

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(b) How does a derivatives exchange regulate its market?

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3 Derivatives Industry Participants

Licensing of derivatives industry participants (intermediaries) is dealt with in Part III and Schedule 2 of the CMSA. There are two types of licences issued by the Securities Commission Malaysia, namely the Capital Markets Services Licence (CMSL) and the Capital Markets Services Representative's Licence (CMSRL) for the following categories of regulated activities:

- Dealing in Securities
- Dealing in Derivatives or Dealing in Derivatives restricted to CFD
- Clearing for Securities or Derivatives
- Fund Management
- Dealing in Private Retirement Schemes
- Advising on Corporate Finance
- Investment Advice
- Financial Planning

However, this topic will only discuss licences for three of the regulated activities, namely those carrying on the business of dealing in derivatives, fund management, and investment advice, substantial to the derivatives industry.

3.1 Granting of Licences

There are a number of procedures and preconditions that apply to the granting of licences under the CMSA. They are contained within Part III, Division I of the CMSA. The Securities Commission Malaysia may refuse to grant a licence if it is not satisfied with any of the following:

- the financial resources of the applicant
- the skill and experience of the applicant
- the reputation of the applicant

Apart from the CMSA, applicants of licences are also required to observe the requirements stipulated in the SC Licensing Handbook which provides for, among others, the following:

- minimum assessment criteria
- application procedures and fees
- terms and conditions of licence
- ongoing obligations of licensed and registered persons

- disciplinary action

While the licensing requirements in respect of the above regulated activities are discussed briefly in this topic, reference needs to be made to the SC Licensing Handbook for better understanding of requirements of licensing and obligations of licence holders.

3.2 Holders of a CMSL Who Carry on the Business of Dealing in Derivatives

Holders of the CMSL who carry on the business of dealing in derivatives are the only intermediaries who can trade futures and options contracts on behalf of other persons.

The issuance of this CMSL by the Securities Commission Malaysia can only be made with the approval of the Minister. In order to obtain a CMSL to carry on the business of dealing in derivatives a person must:

- be a corporate entity incorporated in Malaysia
- be a participant of a derivatives exchange
- satisfy requirements with respect to representatives

Thus, the CMSA endorses the principle of co-regulation by stipulating that to obtain a licence, a holder of a CMSL who carries on the business of dealing in derivatives must also be a participant of a derivatives exchange with appropriate self-regulatory rules. Not only does this requirement ensure a double check on the suitability of the applicant’s participation in the industry, but it ensures that all holders of a CMSL who carry on the business of dealing in derivatives will be under continuing self-regulatory oversight.

Once the CMSL is granted, the holder of the CMSL must comply with a number of continuing obligations — these are described below.

Financial Requirements

The holder of a CMSL who carries on the business of dealing in derivatives must comply with the financial requirements set by the rules of the derivatives exchange and clearing house of which it is a participant. These financial requirements include:

- maintenance of a minimum amount of paid-up capital (as defined in the rules) to support its business
- ensure a minimum holding of liquid assets to meet actual and contingent short-term liabilities
- posting of margins to the clearing house
- monthly and annual reporting of its financial position to the derivatives exchange/ clearing house.

Accounting Records

Under the *Companies Act 2016*, a holder of a CMSL who carries on the business of dealing in derivatives has a duty to keep accounting and other records to accurately reflect its business. In addition, it has a statutory duty under s.108 of the CMSA, to maintain accounting and other records.

A holder of a CMSL who carries on the business of dealing in derivatives has an obligation under s. 104 of the CMSA to maintain records in relation to receiving instructions from clients. The records must set out particulars relating to the receiving and carrying out of clients' instructions. Furthermore, the holder of the CMSL must maintain records relating to its own account trading. These provisions are designed to prevent conflicts between the interest of the client and that of the holder of the CMSL and to ensure there is a clear audit trail of the its own dealings and those of its clients, to ensure that the holders of the CMSL who carry on the business of dealing in derivatives or their employees do not abuse their position.

Segregated Funds

A holder of a CMSL who carries on the business of dealing in derivatives must segregate funds or properties that belong to a client from its other properties. The aim of segregation is to:

- ensure ease of identification of clients' funds
- facilitate the transfer of clients' positions by the clearing house in the event of insolvency of a holder of a CMSL who carries on the business of dealing in derivatives
- protect funds from claims of creditors of an insolvent holder of a CMSL who carries on the business of dealing in derivatives

Holders of a CMSL who carry on the business of dealing in derivatives are required to initially place client funds received into a client's segregated account.

There are certain limited purposes for which a client's segregated funds may be used — these are prescribed in s. 118(3) and include making payments in accordance with the written instructions of the client, defraying brokerage and other charges incurred by the holder of the CMSL in making payments to the clearing house and making other authorised payments. It is a serious offence, under the CMSA, for the holder of the CMSL to withdraw a client's segregated funds for any other purposes.

A holder of a CMSL who carries on the business of dealing in derivatives is required to keep separate accounting records with respect to their segregated account, which separately records the deposits and withdrawals with respect to each client. Again, separate records must be kept with respect to property in safe custody. Segregated money or property is not available to pay its general creditors on liquidation or bankruptcy.

Contract Notes

Under the Capital Markets and Services Regulations 2012, a holder of a CMSL who carries on the business of dealing in standardized derivatives is required to give a contract note for every transaction that it undertakes on behalf of a client. The contract note must comply with regulation 3 of the Capital Markets and Services Regulations 2012 which requires among other things, that the contract note be given not later than the end of the next market day after the transaction. The contents of the contract note are specified in subregulation 3(2) and include:

- name and address of the client
- name of the derivatives exchange on which the holder of a CMSL who carries on the business of dealing in derivatives is an affiliate
- date of the transaction
- a description of the futures or option contract
- the quantity or number of the standardized derivatives
- the rate and amount of commission, levies, duties, and other fees and taxes payable in respect of the transaction
- the deposit paid or payable
- the price at which the transaction was affected

This ensures the client is made fully aware of contracts traded for them.

Conduct of Derivatives Business

Where the legal relationship between two people is such that one person trusts and places reliance on the abilities of the other person to act for the former's benefit, the law imposes certain duties on that other person. These *fiduciary duties*, which are derived from case law, prohibit the person (i.e. the fiduciary) in whom trust is placed, from:

- making use of his position to gain a benefit for himself, or
- placing himself in a position where his duty to the beneficiary conflicts with his own interests

The CMSA incorporates some of these equitable principles to ensure that holders of a CMSL who carry on the business of dealing in derivatives, on whom clients place reliance, conduct their businesses in a professional manner and with integrity and responsibility. This is essential to generate and maintain investor confidence in the capital markets.

Section 99 stipulates that a holder of a Capital Markets Services Licence who carries on the business of dealing in derivatives shall not, as principal, trade in any standardized derivatives with a person who is not such a holder unless he first informs the person in writing that he is acting in the transaction as principal and not as agent. Failure to do so is an offence that will result in a fine not exceeding one million ringgit or to imprisonment for a term not exceeding ten years or to both.

Section 92 places a substantial legal duty on the holder of a CMSL when giving advice to clients. This provision, sometimes referred to as the 'know your client and product' rule, requires a licence holder to have a reasonable basis for recommendations made to its clients. Section 92 provides that a reasonable basis exists where the licensed person makes recommendations based on the following consideration and investigation:

- the licensed person has, for the purpose of ascertaining that the recommendation is appropriate, taken all practicable measures to ascertain that the information possessed and relied upon by the licensed person concerning the investment objectives, financial situation and particular needs of the person is accurate and complete (the 'know your client' rule), and
- the licensed person has given such consideration to; and conducted such investigation of, the subject matter of the recommendation as may be reasonable in all the circumstances.

To illustrate, a licence holder who advises a widow, whose only source of income is her pension, to place her life savings in a highly speculative options strategy will *not* have a reasonable basis for his recommendation unless he has taken all practicable measures to ascertain that the information he has on the widow, relied upon in making his recommendation is accurate and complete. Equally, a licence holder who advises, without analysing the features of the derivatives or trading strategy that is the subject matter of its recommendation, will not have a reasonable basis for that recommendation.

A licensed person who contravenes the reasonable basis requirement may be liable to pay damages to the client who has suffered loss in reliance on the recommendation.

Section 104 governs the sequence in which the holder of a CMSL who carries on the business of dealing in derivatives is to send and carry out instructions of its clients, and in which trades are to be allocated. Generally speaking, where an instruction is received ahead of other instructions, that instruction must be carried out (or sent, as the case may be) first. Equally, trades must be allocated in the sequence in which they were matched and in which the instructions effecting the trades were sent. Section 104 also requires the holders of the CMSL to give priority to a client's order ahead of its proposed own account trades. In this regard, 'own account' includes trades belonging to associates of the holder of the CMSL, e.g. a related company.

The penalty for breach of this section is the same as that in s.99.

The requirement for holders of a CMSL who carry on the business of dealing in derivatives restricted to CFD will be discussed in Topic 3.

Activity 2a

(a) What is a clients' segregated account?

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(b) Give two (2) reasons why it is necessary for client funds to be placed in a clients' segregated account.

(i) ____

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(ii) ____

(c) Describe three (3) main purposes for which the monies can be used, once placed in the account.

(i) ____

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(ii) ____

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(iii) ____

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3.3 Holders of a CMSL Who Carry on the Business of Fund Management

Another category of licence under the CMSA is that of a holder of a CMSL who carries on the business of fund management. These licence holders are companies that undertake the management of a portfolio of securities and/or derivatives. The funds operate very much like unit trusts and enable small investors to pool their resources for management by licence holders. They must be companies, and their employees or agents who deal directly with clients are known as holders of a CMSRL who carry on the business of fund management.

Section 58 of the CMSA prohibits any person from carrying on the regulated activity of fund management or holding itself out as a holder of a CMSL who carries on the business of fund management unless it is duly licensed or registered.

Obligations

The obligations of holders of a CMSL who carry on the business of fund management are similar to those of the holders of a CMSL who carry on the business of dealing in derivatives. In addition to the statutory obligation to keep accounting records under the Companies Act, these CMSL holders must also comply with the requirements under Division 1 of Part III of the Companies Act relating to trust deeds and prospectuses.

The obligations under the CMSA include:

- those relating to the financial affairs of the CMSL holder imposed by the Securities Commission Malaysia under s.96
- the giving of information to prospective clients
- having a reasonable basis for recommendations (s.92)

3.4 Holders of a CMSL Who Carry on the Regulated Activity of Investment Advice

Holders of a CMSL who carry on the regulated activity of investment advice are companies who conduct a business of advising other people about securities and/or derivatives or as part of a business, issues or promulgates analyses or reports on securities or derivatives. The person that directly deals with clients are representatives of the holders of the CMSL, who are licensed as holders of a CMSRL. Section 58 of the CMSA prohibits any person from carrying on investment advice business or holding itself out as a holder of a CMSL unless it is duly licensed or registered under the CMSA.

Obligations

Holders of a CMSL who carry on the regulated activity of investment advice are not subject to the same stringent duties as holders of a CMSL who carry on the regulated activity of dealing in derivatives because they do not handle clients' money. As such, they are not required to segregate clients' funds or to keep statutory accounting records (unless the Securities Commission Malaysia otherwise prescribes). They are, however, subject to the obligation under s.92 and may also be subject to the common law duties of a fiduciary.

3.5 Holders of a CMSRL

Representatives are individuals who hold a CMSRL and act on behalf of their respective holders of a CMSL. They are required to be licensed under Part III of the CMSA. However, there are exemptions in the case of individuals who work as clerks, cashiers, and accountants for holders of a CMSL who carry on the business of dealing in derivatives and advisers.

As they represent their respective holders of a CMSL, representatives are also subject to the same obligations relating to the conduct of each respective category of licence. Under s.367 of the CMSA, if a representative commits an offence, the holder of the CMSL is also considered to have committed the offence.

Activity 2b

Complete the following table to show the obligations of the holders of a CMSL who carry on the following regulated activities.

Obligation	Dealing in Derivatives	Fund Management	Investment Advice
Must give information to prospective clients			
Must segregate clients' funds			
Must conduct their business in a professional manner			
Must be a participant of a derivatives exchange			

4 Trading Offences under the CMSA

Part V of the CMSA establishes certain trading offences. These include:

- false trading
- bucketing
- dissemination of information about false trading
- manipulation of price of derivatives and cornering
- employment of devices, etc., to defraud
- false or misleading statements
- prohibition of abuse of information obtained in official capacity.

These offences are designed to deter undesirable or fraudulent practices. They also discourage and prevent unfair use of advantageous positions and price distortions. The integrity and efficiency of the derivatives market should rely solely on the existence on the natural forces of supply and demand.

Failure to comply with the other requirements referred to above are, of course, also subject to penalties, which are, in some cases, substantial. In addition to these offence provisions, there are wide powers for the Securities Commission Malaysia or the derivatives exchange to seek orders for the enforcement of its rules, the restraining of trading in derivatives and the appointment of receivers to the property of holders of CMSA who carry on the business of dealing in derivatives.

4.1 False Trading

Under s.202 of the CMSA, no person is allowed to create, or cause to be created, or do anything that is calculated to create, a false or misleading appearance:

- of active trading
- with respect to the market
- with respect to the price of derivatives.

Section 204 prohibits a person from disseminating information that prices are likely to rise or fall because of the operations of someone who is in contravention of s.202.

4.2 Bucketing

Under s.203, no one is permitted to execute or hold himself out to having executed an order for the purchase or sale of a derivative without having effected a *bona fide* purchase or sale.

4.3 Manipulation of price of derivatives and cornering

Section 205 prohibits anybody from:

- manipulating the prices of derivatives or prices of the underlying instrument
- cornering the underlying market.

4.4 Employment of devices, etc., to defraud

Section 206 prohibits a person from:

- employing a device, scheme or artifice to defraud
- engaging in any act which operates or is likely to operate as a fraud or deception
- making any false statement of material fact or omitting to make a statement of material fact.

4.5 False or Misleading Statements

Under s.207, no person is allowed to make a statement for the purpose of inducing the purchase or sale of a derivative if that statement is:

- false, misleading or deceptive
- by reason of omission — false, misleading or deceptive.

4.6 Prohibition of abuse of information obtained in official capacity

The abuse of information obtained in official capacity is prohibited under s.208 of the CMSA. It holds that any person who has information:

- that is price sensitive
- that is obtained by virtue of his official capacity
- that is reasonable to expect not to be disclosed except in that official capacity

- which he knows is unpublished price sensitive information

must not make use of that information to gain an advantage.

Activity 3

(a) Explain what is meant by *bucketing*.

(b) Why do you think bucketing is prohibited under the CMSA?

5 Capital Market Compensation Fund

Part IV of the CMSA deals with the establishment of the Capital Market Compensation Fund (CMC)

5.1 Introduction

The CMC provides an avenue for individual investors to make a claim in the event a CMSL holder fails to pay amount owing to its investors. When a CMSL holder is unable or is likely to be unable to pay its debts due to fraud, defalcation or mis-selling which leads to insolvency, the CMC has the power to step in to work towards compensating individual investors' investments.

The following CMSL holders and their activities will be subject to the requirements and safeguards provided to the individual investor by the CMC:

- Participating organisations in relation to its investments on Bursa Malaysia Securities and recognised stock exchange pursuant to the rules of Bursa Malaysia Securities Berhad;
- Trading participants in relation to its investment on Bursa Malaysia Derivatives and on a specified exchange as provided for in Section 105 of the CMSA;
- Fund management companies, including Private Retirement Scheme providers; and
- Unit trust management companies which are licensed for dealing in securities restricted to unit trust.

5.2 Administration and Uses

A client of a Participating organisation or a Trading participant who invested in an exchange-traded product can make a claim from the CMC. Clients of fund management companies, unit trust management companies and Private Retirement Scheme provider can also make a claim from the CMC.

Activity 4

For each of the following, select the best response:

(a) Which of the following are requirements that must be met before a company can be approved as a derivatives exchange?

(i) the company must ensure that, as far as is reasonably practicable, it will operate an orderly and fair market in relation to securities and derivatives that are traded through its facilities

(ii) the company must manage any risks associated with its business and operations prudently

(iii) the company must take appropriate action against its affiliates to whom the rules apply for any breach of its rules

A (i) and (ii) only

B (i) and (iii) only

C (ii) and (iii) only

D All of the above

6 In Summary

In this topic, we have outlined the regulatory regime of the derivatives industry in Malaysia. We began by examining the overall regulatory structure and then focused on the provisions contained in the CMSA.

The provisions of the CMSA and the rules of the derivatives exchange are complicated in some areas. However, it is possible to trace the purpose of the more significant provisions by following the process, beginning with the introduction of a client to the market and the circumstances which follow:

- Before becoming a client, the client will be given a document that explains the risks associated with dealing in derivatives and client agreement to ensure he is fully aware of his obligations.
- Any margins money for, or on account of, trading must then be placed in a separate segregated bank account (clients' segregated account) which is kept for the money of the clients of the holder of the CMSL who carries on the business of dealing in derivatives. This ensures that client money is not used for the holder of the CMSL's dealings and protects this money from the general creditors in insolvency.
- Contracts must be executed for the client in a fair manner, generally in the order in which they are received and without the holder of the CMSL who carries on the business of dealing in derivatives or other clients receiving an unfair preference or advantage.
- The client must receive full information through contract notes and monthly statements of his trading and financial position.
- If a client does have a legitimate dispute with a participant of the derivatives exchange that cannot be resolved between the parties, he can ask that the derivatives exchange appoint an independent arbitrator to decide the matter.
- In the interests of all participants in the market, the CMSA and derivatives exchange rules provide provisions designed to ensure an orderly and fair market (i.e. to prevent manipulation and other abuses) and to provide appropriate penalties for those who do not comply.
- Both the CMSA and the rules of the derivatives exchange impose significant obligations on the holders of the CMSL who carry on the business of dealing in derivatives with a view to protecting clients in the areas of financial worth, auditing, record-keeping and compliance generally.

The requirements of the CMSA and the rules of the derivatives exchange are comprehensive and effective and have been recognised as such by both local and overseas regulators.

This topic also provided an initial introduction to the documents and legislation regulating the derivatives industry. It does not purport to advise as to the operation of the legislation in particular circumstances — you should examine for yourself, the detailed provisions of the CMSA. Where appropriate, you should seek and rely on your own legal and other professional advisers.

6.1 Key Terms

Now that you have completed this topic, review the following key terms and make sure you understand their meaning.

systemic risk	cornering
segregated funds	bucketing
risk disclosure document	

6.2 Review Questions

Question 1

List the three (3) key regulatory institutions in the Malaysian derivatives industry and the sources of their regulatory powers.

Question 2

List four (4) of the more important offence provisions contained in the CMSA.

Question 3

Once a company has been approved by the Minister as a derivatives exchange, it must meet certain continuing obligations. Outline four (4) of these continuing obligations as set out in Part II of the CMSA.

Question 4

Under s. 90 of the CMSA, a holder of a CMSL who carries on the business of dealing in derivatives is required to give a contract note for every transaction that it undertakes on behalf of a client. List six (6) items that must be included on the contract note.

Question 5

Outline the false trading provisions contained in ss. 202 and 204 of the CMSA.

Suggested Answers to Activities

Activity 1

(a) List the two (2) key functions of a derivatives exchange.

(b) How does a derivatives exchange regulate its market?

Answer: **(a)**

- **establish an exchange for dealing in derivatives and develop the markets in these contracts**
- **ensure that these markets are fair and efficient**

(b) Through establishing criteria for participantship of the derivatives exchange and through its rules which are binding on participants

Activity 2a

(a) What is a clients' segregated account?

(b) Give two (2) reasons why it is necessary for client funds to be placed in a clients' segregated account

(c) Describe three (3) main purposes for which the monies can be used, once placed in the account.

Answer: **(a) The clients' segregated account must be a bank account designated as such, into which all client funds are placed.**

(b) Any two (2) of the following:

- **to provide for separate accounting of client money**
- **to ensure that client money is kept separate from the broker's own funds**

- **to protect client money if the broker becomes insolvent (liquidation or bankruptcy).**

(c) Any three (3) of the following:

- **the payment of margin to a clearing house or other brokers on behalf of clients generally**
- **the making of investments permitted by s.118(3)(d) of the CMSA**
- **the making of payments directed by the client**
- **defraying brokerage and other charges.**

Activity 2b

Complete the following table to show the obligations of the holders of a CMSL who carry on the following regulated activities.

Obligation	Dealing in Derivatives	Fund Management	Investment Advice
Must give information to prospective clients			
Must segregate clients' funds			
Must conduct their business in a professional manner			
Must be a participant of a derivatives exchange			

Answer:

Obligation	**Dealing in Derivatives**	**Fund Management**	**Investment Advice**
Must give information to prospective clients	✓	✓	✓
Must segregate clients' funds	✓	✓	✗
Must conduct their business in a professional manner	✓	✓	✓
Must be a participant of a derivatives exchange	✓	✗	✗

Activity 3

(a) Explain what is meant by *bucketing*.

(b) Why do you think bucketing is prohibited under the CMSA?

Answer: **(a) Bucketing is an illegal practice whereby derivatives transactions are undertaken (or purported to be undertaken) outside a recognised derivatives exchange.**

(b) Bucketing is prohibited under the CMSA because the conduct of a derivatives business outside a recognised exchange compromises the integrity of the market.

Activity 4

Please select the best response:

(a) Which of the following are requirements that must be met before a company can be approved as a derivatives exchange?

(i) the company must ensure that, as far as is reasonably practicable, it will operate an orderly and fair market in relation to securities and derivatives that are traded through its facilities

(ii) the company must manage any risks associated with its business and operations prudently

(iii) the company must take appropriate action against its affiliates to whom the rules apply for any breach of its rules

A (i) and (ii) only

B (i) and (iii) only

C (ii) and (iii) only

D All of the above

Answer: (a) D

Suggested Answers to Review Questions

Question 1

List the three (3) key regulatory institutions in the Malaysian derivatives industry and the source of their regulatory powers.

Answer:

- **Securities Commission Malaysia — CMSA**
- **Derivatives Exchange — Rules**
- **Clearing house — Rules**

Question 2

List four (4) of the more important offence provisions contained in the CMSA

Answer: The more important offence provisions are as follows:

- **false trading**
- **bucketing**
- **dissemination of information about false trading**
- **manipulation of price of derivatives and cornering**
- **employment of devices, etc., to defraud**
- **false or misleading statements**
- **abuse of information.**

Question 3

Once a company has been approved by the Minister as a derivatives exchange, it must meet certain continuing obligations. Outline four (4) of these continuing obligations as set out in Part II of the CMSA.

Answer: Continuing obligations of a derivatives exchange:

- **to maintain a management structure in accordance with s.10 of the CMSA**
- **to submit proposed amendments to its constitution and business rules to the Securities Commission Malaysia for approval under s.9 of the CMSA**
- **to comply with directions of the Securities Commission Malaysia under s.355 of the CMSA**
- **to enforce its own business rules**
- **to keep records and accounts and ensure these records and accounts are audited.**

Question 4

Under s.90 of the CMSA, a holder of a CMSL who carries on the business of dealing in derivatives is required to give a contract note for every transaction that it undertakes on behalf of a client. List six (6) items that must be included on the contract note.

Answer: Details to be included on the contract note (any six of the following or as may be stipulated in the Capital Markets and Services Regulations):

- **name and address of the client**
- **name of the derivatives exchange on which the holder of the CMSL who carries on the business of dealing in derivatives is an affiliate**
- **date of the transaction**
- **a description of the futures or option contract**
- **the quantity or number of the standardized derivatives**
- **the rate and amount of commission, levies, duties and other fees and taxes payable in respect of the transaction**
- **the deposit paid or payable**
- **the price at which the transaction was affected**

Question 5

Outline the false trading provisions contained in ss.202 and 204 of the CMSA.

Answer: Under s.202 of the CMSA, no person is allowed to create, or cause to be created, or do anything that is calculated to create, a false or misleading appearance:

- **of active trading**
- **with respect to the market**
- **with respect to the price of derivatives.**

Section 204 prohibits a person from disseminating information that prices are likely to rise or fall because of the operations of someone who is in contravention of s.202.