

Regulation of derivatives



By Yip Jia Hui

Significant amendments came into force in Malaysia on October 3, 2011 *vide* the Securities Commission (Amendment) Act 2011 and the Capital Markets and Services (Amendment) Act 2011 (the Acts) respectively. These new amendments are a continuum of a series of legal and regulatory developments in the capital market space in line with the strategies outlined in the Capital Market Masterplan 2. The amendments introduce a number of major revisions which are aimed at promoting the development of the capital market in Malaysia and include a new framework for the regulation of derivatives.

Overview of the amendments

Before these new legislations came into force, the regulation of derivatives was fragmented with several regulatory bodies having jurisdiction over different types of derivative contracts. The Central Bank regulated interest rate swaps and foreign currency forwards under the exchange control rules whereas the Securities Commission regulated structured products.

The Acts introduce the concept of 'capital market products', which includes any securities, derivatives, units in a unit trust scheme and a private retirement scheme. The Acts also create a separate class of products known as 'derivatives', which are defined as any contract, either for the purposes of creating an obligation or a right or any combination of both, of which its market value, delivery or payment obligations are derived from, referenced to or based on, but not limited to, underlying securities or commodities, assets, rates, indices or any of its combinations, whether or not a 'standardized derivative' or an 'over-the-counter derivative'.

Capital market products: The Acts provide for the general regulation of capital market products, regardless of the different types of product. In particular, the Acts allow the Securities Commission to specify the nature and extent of information to be given to a person who invests in any capital market product. As a result, any person

who makes representations in relation to capital market products are under an obligation to provide information to potential investors on, amongst others, the key characteristics of the product, the nature of the obligations assumed by the parties dealing in the product, the risks associated with the product and the details of the essential terms of the product.

Standardized derivatives: A 'standardized derivative' means a derivative that is traded on a derivatives exchange, whose intrinsic characteristics are determined by that derivatives exchange and whose trade is cleared and settled by an approved clearing house. In this respect, the new Acts introduce provisions on the regulation of trading by the holder of a CMSA license for its own account, trading limits in standardized derivatives, the sequence of sending and carrying out of orders and trading outside Malaysia.

Over-the-counter derivatives: An 'over-the-counter derivative' is generally defined in the new legislation as a derivative other than a standardized derivative. The most common form of an over-the-counter derivative is the ISDA form of derivative contract.

The Acts introduce a new regulatory regime for over-the-counter derivatives. Amongst others, the amended CMSA imposes a reporting obligation on CMSA license holders and any other person dealing in derivatives to report to a trade repository all information relating to over-the-counter derivatives that they have entered into. It is an offence if a person fails to report its over-the-counter transactions to the trade repository or if it submits false or misleading information or if it submits information from which there is a material omission.

Conclusion

The recent global financial crisis has shown the impact that derivatives can have on the financial markets. As such, the introduction of a framework for the regulation of derivatives is certainly a long-awaited and welcomed one. However, there is still a need for further regulation as the Acts do not seem to provide sufficient guidelines on the substantive aspects of the derivative products which they seek to regulate.

Tay & Partners

6th Floor, Plaza See Hoy Chan

Jalan Raja Chulan, 50200 Kuala Lumpur

Tel: (603) 2050 1888 (Gen)

(603) 2050 1966 (DID – Yip Jia Hui)

Email: jiahui.yip@taypartners.com.my

www.taypartners.com.my