

REGULATION OF SECURITIES MARKETS

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1. INTRODUCTION : SOME FUNDAMENTAL CONCEPTS

Why securities markets exist and the way they work are questions which lend themselves to relatively easier analysis and treatment in comparison to how these markets ought to be regulated. The economic purpose served by securities markets is plain. These markets provide a source by which businesses obtain equity capital and long-term debt from the public. The markets themselves have two distinct components : the primary and the secondary markets. The primary markets are also at times referred to as the "new issues" markets as opposed to the "trading" or "secondary" markets. The two are interlinked very closely. Companies raise needed capital and funding through the primary markets but this function is best performed if purchasers of securities at the primary level are enabled to sell these securities, if need be at a price level reasonably related to the initial offer price. Hence, the language of "liquidity" enters the arena. The underlying idea is as attractive as it is plain : investors will provide capital and funds to companies by purchasing new issues if they are assured of liquidity.

The secondary or trading markets are thus of great importance in the overall process of capital-raising. Issuance of securities, as well as the assurance of liquidity of the securities issues, are matters of high economic moment.

Markets themselves can be conceptually distinguished from exchanges. Whereas the secondary markets provide the trading mechanism for post-issue transactions, the securities exchanges provide the arena or facility by which mutually satisfactory prices between sellers and purchasers can be arrived at through organized rules and procedures of trading.

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As essentially a price-setting mechanism, the secondary markets fulfil other additional functions. They provide a basis for the valuation of securities for other purposes, including providing a price determinant for the issue of additional securities by companies.

The underlying economic functions of securities markets and exchanges can thus be stated as a list of simple and concise propositions. To ensure that these important economic functions can be performed and maintained, a suitable regulatory structure must be found. At this point, we orientate our emphasis from economics to law. Regulations are the product of legal processes and legal reasoning, but in the area of securities laws, these must nevertheless be grounded on some economic fundamentals and some basic principles pertaining to the operation of markets and exchanges. It is often not very easy to strike a good and reasonable balance of regulatory control, but a balance must nevertheless be struck.

It is one of the fundamental purposes of regulatory control of markets that rules must exist to ensure that these markets are fair, honest and efficient. If these values are eroded, then likewise investor confidence will be eroded. Without investor protection and investor confidence, the economic functions of the markets and exchanges will dissipate willy-nilly. One commentator has successfully formulated the basic premise with eloquence : "If investors believed that prices were driven by backroom agreements rather than by supply and demand, or if they believed that only "insiders" trading on confidential information could profit, they would take their money elsewhere. Without confidence in the markets, investors would, understandably, simply decline to participate. "[Michael Mann, "What Constitutes a Successful Securities Regulatory Regime" (1993) Australian Journal of Corporate Law, Vol. 3, No 2, pg. 178.]

"Fairness", "Honesty" and "Efficiency" are key concepts in the system of regulatory control. They have much to do with the idea of the "level playing field" market where investors have equal access to corporate information necessary for informed investing. Such markets would be one where there exist equal access to investment opportunities as well as equal exposure to investment risks. Such a system would also ensure the fullest possible disclosure of corporate information and exclude market malpractices of various forms. In such a system too, markets would function as an efficient price-setting mechanism where supply and demand will match at their appropriate levels free of contrived distortion. Information necessary for informed investing will neither

be distorted nor disproportionate, and price and volume of securities traded will be determined by real and not artificial forces of supply and demand. In short, an effective regulatory system should at least satisfy three critical elements :

- (1) that there be truth and reliability in corporate information disclosed.
- (2) that all material and relevant corporate information be fully disclosed; and
- (3) that there be fair dealing among those who deal in securities.

The first element would cover areas of prospectus requirements and particular mandated disclosures. The second element would embrace the area of corporate disclosure policy and the avoidance of misleading, incomplete, misrepresented, and at times, false dissemination of corporate information. The third element has much to do with the control of various forms of market manipulation and malpractices, namely all forms of artificial control of securities prices.

2. THE MALAYSIAN STATUTORY CONTEXT

The notion of "the false market" and its proscription is explicitly recognised in Malaysian statutory law. Part IX of the Securities Industry Act, 1983 (SIA) contains numerous provisions in point. Take for instance Section 84(1) :

"A person shall not create, or cause to be created, or do anything that is calculated to create, a false or misleading appearance of active trading in any securities on a stock market in Malaysia or a false or misleading appearance with respect to the market for, or the price of, any such securities."

The broadly formulated Section 87A of the SIA likewise is another statement and is a reinforcement of the general principle :

"It shall be unlawful for any person directly or indirectly in connection with the purchase or sale of any securities :-

- (a) to use any device, scheme or artifice to defraud;

- (b) to engage in any fact, practice or course or business which operates or would operate as a fraud or deceit upon any person; or
- (c) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading."

Part II of The Malaysian Code On Take-Overs and Mergers goes directly to the point by enjoining all parties to a take-over or merger transaction to "make every effort to prevent the creation of a false market". It is also opposite in this connection that the internal rules of the Kuala Lumpur Stock Exchange likewise refer to it by the more general verbal formula of "a fair and orderly market" (See Rule 334 of Listing Requirements, for example).

Suffice to say the fundamental principles of regulation I earlier alluded to have found concrete and sometimes express, legal expressions in many statutory provisions and eventually in various internal rules of the KLSE.

Aside from the detailed rules, the parameters of regulatory control have also been set by statute. Section 15(1) of the Securities Commission Act, 1993 has at least three headings of control pertaining to the secondary market. The Securities Commission (SC) has as one function the taking of "all reasonable measures to safeguard the interests of persons dealing in securities" - a statutory recognition of investor protection. Secondly the SC is to "promote and encourage proper conduct amongst members of the exchanges and all registered persons". Nor less important, the SC is to "suppress illegal, dishonorable and improper practices in dealings in securities ... and the provision of investment advice or other service relating to securities."

3. THE MARKET SUPERVISION FUNCTIONS OF THE SC

In terms of regulation of the secondary securities markets, the relevant Division of the SC is the Market Supervision Division ("MSD"). MSD itself comprises three separate Departments, namely (a) the Market Surveillance and Compliance Department, (b) the Investigation and Enforcement Department and (c) the Licensing Department. The functions performed by the Division cover the entire range of secondary market

trading, except direct licensing powers over market intermediaries (currently reposed in the office of the Licensing Officer under the SIA). To uphold and maintain the concept of a fair, honest and efficient securities market, MSD undertakes various specific duties, to include :

- (a) complete surveillance of trading patterns and the detection of unusual market activity;
- (b) analysis of trading data;
- (c) analysis of corporate deals;
- (d) analysis of corporate changes, whether changes of shareholders or personalities;
- (e) analysis of specific returns supplied by stockbroking companies;
- (f) initiating compliance measures where necessary;
- (g) monitoring of corporate disclosures;
- (h) undertaking periodic surveys and inspections of stockbroking companies, whether general or specific;
- (i) undertaking full-scale investigations into market irregularities and malpractices by utilising the SC's wide statutory powers of investigation and examination;
- (j) undertaking prosecution;
- (k) liaising with and making recommendations to the Licensing Officer on market intermediaries;
- (l) oversight of the operations of trading rules and where necessary making suggestions for change or improvement.

Since coming into existence on 1/3/93, the SC, through its Market Supervision Division, has conducted and performed various supervisory activities. Included among its function as well is the function of being responsible for supervising and monitoring the activities of the exchange and its clearing house. The KLSE is perceived as being more than a market operator. As a self-regulatory organisation, the KLSE is seen as the front-line regulator. Being the agency with its nose closest to the ground, it is only to be expected that the KLSE shall be the first-level control mechanism, especially in relation to matters of trading practices and rules. The SC has generally supervisory oversight and as rule will only intervene directly to supplement the powers of the KLSE, as when it acts upon a referral from the KLSE in a market manipulation matter. As far as MSD is concerned, the closest contact is maintained with the AWAS Department of the KLSE, and to a somewhat lesser extent, with the Listing Department.

The "micro" aspects of market supervision are necessarily wide and varied. On these operational matters, close contact is maintained between SC and the KLSE. Matters of concern are discussed on a regular periodic basis, and the basis of regulation may perhaps be categorised as co-operative regulation, with the SC having general supervisory oversight and reserving the right to intervene directly where circumstances require, particularly in the interest of speed and immediate effect.

CONCLUSION

Beginning with the basic fundamentals of market regulation, I have proceeded to locate and outline the statutory and legal fleshing of the main idea of regulation. I have devoted full emphasis on the regulation of the secondary market, since much of the work performed by the Market Supervision Division lies in this area. The "micro" measures of supervision are addressed in part against the earlier general setting. At the root of it all, the regulatory system aims at preserving market integrity and market efficiency. Investor protection is one critical component, but any system of securities regulation has at the same time to recognise the need for investor responsibility. Securities regulation is designed to facilitate informed and prudent investment decisions by the investor. The regulator should take no view on the price of securities traded in the secondary market. The ultimate judgement and responsibility in relation to the worth of the securities the investor purchases or sells on the secondary market is his and his alone.