BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Principles for a Fair and Effective Financial Market for the Malaysian Financial Market

Applicable to:
All Financial Market Participants

Issued on: 13 April 2017 BNM/RH/CP 030-2

The purpose of this concept paper is to invite comments on the proposed policy document to be issued by the Bank on Principles for a Fair and Effective Financial Market for the Malaysian Financial Market. The proposed policy document will serve as an anchor for various codes of conduct and any activities related to promoting the fair and effective functioning of the financial market.

Comments on this concept paper may include suggestions on areas to be clarified and other aspects of the principles that the Bank should consider. The written feedback should be supported with clear rationale, accompanying evidence or illustrations as appropriate to facilitate review of this Concept Paper.

Responses must be submitted by 28 April 2017 to:

Pengarah
Jabatan Dasar Monetari
Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur
Email: bnmcoc@bnm.gov.my

Electronic submission is encouraged. Submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

Issued on: 13 April 2017

TABLE OF CONTENTS

PART A OVERVIEW

1 Introduction

1.1 Financial markets are a critical component of the modern economy, providing a key conduit through which savings and investments can be efficiently allocated between economic sectors and agents. An important element that needs to exist to allow financial markets to function effectively is an environment of confidence and trust that market participants' activities can be undertaken in a fair and competitive setting.

1.2 Over time, financial markets have grown increasingly complex with highly sophisticated instruments and strategies. Market players have also evolved, driven by the changing environment and also regulations. Adverse incentives have often caused market participants to abuse their positions and take advantage of information asymmetries for unfair and dishonest financial gains. In some segments of the financial market, activities have become more opaque. This has led to a trust deficit fuelled by the significant amount of volatility and uncertainty, which has the potential to impair the function and effectiveness of the financial market.

1.3 Malaysia has a highly open and accessible financial market, where foreign investors are active and significant. To date, it has shown a significant degree of resilience against external shocks and sharp movements of capital flows. Nevertheless, vulnerabilities to speculative investment flows and at times, uncompetitive market behaviours have led to sharp volatilities and price misalignments, as well as questionable activities and conducts by segments of the market players. In this regard, more needs to be done to avoid market activity that could be disruptive to underlying economic activities and diminish trust in the system.

1.4 It is against this backdrop that the Principles for a Fair and Effective Financial Market ('Principles') are introduced. This is in line with the recent global efforts to restore integrity and trust in financial markets by reviewing and setting new standards of best market practices, raising the level of professionalism and enforcing regulation. The Principles also takes into account Malaysia's structural difference as an emerging market, which may require different approaches compared to that of advanced markets. For a market such as Malaysia, it is important that the principles also promote or preserve a state of balance in the financial markets, between various interest groups, supporting fair play and outcome for all.

1.5 The aim of these Principles is to achieve a financial market environment that is trusted, competitive, resilient and best positioned to support the sustainable growth of the Malaysian economy. These Principles will provide guidance such that it can be universally internalised and applied by all market participants in the form of their own internal codes of conduct, guidelines, organisational and governance structures, as well as in their financial market activities.

2 The Global Context

2.1 Several high-profile scandals have led to a heightened global movement to review the current state of play in international financial markets. These cases culminated in large fines, criminal lawsuits and losses that went into the billions of US dollars. It also threw into question the integrity, reliability and effectiveness of the financial market in serving the best interests of market participants and the economy. This has inevitably contributed to an overall environment of diminished public trust in the financial system.

2.2 Two of the largest scandals involved the manipulation of key financial market benchmarks, namely the London Interbank Offered Rate (Libor), an interest rate benchmark, and the WM/Reuters exchange rate fix. These benchmarks were considered among the most reliable and widely used in its class, having a significant role in pricing an estimated USD450 trillion[1] and USD5.3 trillion[2] (trade per day volume for foreign exchange market) market respectively, prior to the uncovering of the scandals. Both cases highlighted a series of flaws that had gone unchecked, which opened it to abuse by irresponsible market participants:

2.3 **Weaknesses in the design of key financial benchmarks**

(a) Following these scandals, independent reviews into the structure of major financial benchmarks have revealed important weaknesses that could have led to the creation of adverse incentives and the manipulation of key benchmark rates. According to the Wheatley Review of Libor[3], "the highest risk of misconduct occurs in the contribution of submissions to Libor", which were at the time unregulated under any prevailing laws, not independent as it relied too heavily on participating banks and their own industry organisation[4] and were not transparently supported by actual transactions data.[5] These structural deficiencies have inadvertently given the opportunity for traders of participating banks to collude by submitting false rates to artificially inflate or deflate the final Libor rate to their own advantage.

---

[1] The Libor figure is based on the Wheatley Review (2012).

[2] The FX figure is based on trade volume per day in the FX market. "Currency Trade Reaches $5.3 Trillion a Day Amid Yen Turnover". Bloomberg, 6 September 2013.

[3] The Wheatley Review (2012).

[4] Prior to the Wheatley reforms, the Libor were administered by the British Bankers Association, a trade association for the UK banking and financial services sector. This administrative role has since been transferred to Intercontinental Exchange (ICE).

[5] Libor submissions were instead based on a panel of banks estimates of funding rates.

(b) Similarly related are the opportunities for market malpractice linked to the structure of trading around benchmark FX rates. This was highlighted in the Final Report on Foreign Exchange Benchmarks by the Financial Services Board (FSB), focusing particularly on the WM/Reuters (WMR) 4pm London fix. The findings of the report showed that the calculation methodology of the WMR benchmark rate, which is based on actual trades captured within a 30 second window on either side of the fixing time, could create incentives for dealers to influence the exchange rate – by collusion or inappropriate sharing of information – to try to ensure that the market price at the fix generates a rate which ensures a profit from the fix trading. This practice was widely reported in the media when the FX fixing scandal surfaced, where FX traders colluded to concentrate their orders around the fixing window so that they could influence the benchmark rate higher or lower.[6] To overcome this issue the FSB recommended the fixing window be extended from its current width of one minute to five minutes to incorporate an adequate number of observations and reduce the chances of manipulation, which has since been taken aboard by WM Company.

2.4 **Poor internal governance structures and lack of surveillance**

(a) Banks and firms that were involved in these scandals were also reported to have displayed a serious lack of professionalism and revealed weaknesses in the governance structure such that the trading desks were allowed to pursue profits at their own discretion without having in place proper checks and balances. The Fair and Effective Markets Review[7] reported that senior managers became increasingly remote and unaccountable for the maintenance of standards in day-to-day trading operations while facing few apparent consequences for failing to ensure that teams upheld best market practices. In addition, the high profitability of trading desks also seemed to have caused a shift in power from management teams towards trading staff in terms of risk management.

(b) The review also highlighted that these trends were apparent in many of the investigations by the Financial Conduct Authority (FCA):

"For example, FCA enforcement notices in relation to the attempted manipulation of Libor identified weak or non-existent oversight of trading staff in banks and brokers, and a lack of clearly defined individual responsibilities. FCA enforcement notices on misconduct in foreign exchange (FX) markets showed that voluntary codes in FX and other markets had not been translated into meaningful internal guidance within firms. And trading staff in different firms attempted to collude in order to manipulate markets, against the interests both of the markets at large and, in some cases, their firms"

[6] "Traders Said to Rig Currency Rates to Profit Off Clients." Bloomberg, 11 June 2013.

[7] Fair and Effective Markets Review (2015). *Bank of England, HM Treasury and the Financial Conduct Authority UK*

(c) One final enforcement notice by the FCA to Barclays Bank PLC dated May 2015 stated that Barclays relied primarily on front-office FX business to identify, assess and manage risks, leading to attempts to manipulate the WMR and the ECB fix rates in collusion with other traders.[8]

2.5 **Disregard of best market practices and culture of impunity**

(a) Transcripts of dealers' instant messages in electronic chatrooms underlined a problem beyond just the fact that this medium of communication was being abused. More serious in nature was the fact that there exists a culture of impunity among those involved in benchmark manipulation, where dealers / had knowledge that they were indeed acting against best market practices but without fear of detection or punishment. Transcripts from chatrooms named 'The Cartel', 'The Mafia' and 'The A team' revealed that dealers adopted an array of strategies to manipulate the FX fixing rate, including transferring orders in a particular currency pair to co-conspirators to increase 'ammo' to maximise their impact on the fix.[9]

(b) Excerpts from documents published by the US Commodity Futures and Trading Commission (CFTC) and the Department of Financial Services New York, exemplify these behaviours:

Manipulation of Libor	Manipulation of FX benchmark
"*If you need something in particular in the libors i.e. you have an interest in a high or a low fix let me know and there's a high chance i'll be able to go in a different level. Just give me a shout the day before or send an email from your blackberry first thing*." **-USD Libor Submitter-** **March 2005** [10]	*"I saved 500* for last second"* *"I had 500 to jam it."* **Referring to the €500m he had to unload at the time of the fix, in an attempt to manipulate the ECB reference rate.* **-Head of Barclays' FX spot desk-** **January 2012**[11]

8 Final Notice to Barclays Bank PLC (2015), *Financial Conduct Authority UK*

9 "'Cartell' Chat Room Traders Boasted of Whacking FX Market." Bloomberg, 12 Nov. 2014.

10 Examples of Misconduct from Written Communications. *US Commodity Futures Trading Commission*

11 "NYDFS Announces Barclays to Pay $2.4 Billion, Terminate Employees for Conspiring to Manipulate Spot FX Trading Market". New York Department of Financial Services, 20 May 2015

2.6 Possible lack of regulatory oversight and action

(a) Certain evidences were brought to light during the height of the Libor scandal that suggested regulators may have been made aware of the potential manipulation as early as 2007, raising controversy and public outcry. Transcripts released by the Federal Reserve Bank of New York (NY Fed) on 13 July 2012 in response to a congressional request for information on Barclays' involvement in the scandal was summarised in a press release and includes:

(i) Suggestions that some banks could be underreporting their Libor in order to avoid appearing weak were present in anecdotal reports and emails, including a December 2007 phone call with Barclays noting that reported Libor appeared unrealistically low.

(ii) A Barclays' employee explained to the NY Fed that Barclays was underreporting its rate to avoid the stigma associated with being an outlier with respect to its Libor submissions, relative to other participating banks. The Barclays employee also stated that in his opinion other participating banks were also under-reporting their Libor submissions.

(iii) Briefing notes on these developments were produced and was circulated to senior officials at the NY Fed, the Federal Reserve Board of Governors, other Federal Reserve Banks, and US Department of Treasury.

(iv) On 1 June 2008, Tim Geithner, at the time President of NY Fed, emailed Mervyn King, the Governor of the Bank of England, a report, entitled "Recommendations for Enhancing the Credibility of LIBOR." Mr. King then confirmed to Mr. Geithner that he had brought the recommendations to the attention of the British Bankers Association.

2.7 While some form of action had evidently been taken by the authorities back then, it was perceived by the media and public as slow in resolving the problem.[12,13] In any case, despite the revelations that occurred since 2007, legal action and proper reforms only started in 2012.

2.8 Given the sheer size of the global interest rate and FX markets, as well as the financial contracts linked to Libor and the FX fixing rate, the losses arising from these scandals were financially substantial and could have also spilled over to a diverse set of market participants. Global banks involved in Libor manipulation were estimated to have paid up to USD9 billion in fines while the six banks involved in the FX fixing scandal were fined in total USD5.6 billion as at 2015.[14]

---

[12] LIBOR Rigging: What the Regulators Saw (but Didn't Shut Down)." Time, 16 July 2012.

[13] "Insight: Fed Knew of Libor Issue in 2007-08, Proposed Reforms." Reuters, 10 July 2012.

[14] "This Is the First Person to Be Tried in The Libor-Rigging Case." Bloomberg, 06 May 2015.

2.9 The financial fallout experienced by other participants as a result of Libor and FX rigging is hard to estimate. Class action lawsuits were taken against banks by a range of plaintiffs, including investors, municipal governments and home-owners – all citing large losses as their Libor-linked financial contracts were affected by the artificial rates. Large US municipalities that issued bonds, most of which used interest rate swaps to hedge against interest rate movements[15], have claimed that the Libor manipulation have caused their interest rate swaps payments that they were supposed to receive to be smaller. This loss is estimated to be at USD6 billion not including the USD4 billion needed to unwind their position following the scandal.[16] Homeowners filed charges claiming that they had to pay higher mortgages as banks pushed the Libor higher on days when the mortgage were readjusted. In the FX market, the losses caused by the FX rigging for Britain's pension holders is estimated to be at USD11.5 billion a year.[17]

3 The Regional and Domestic Context

3.1 The region itself is not isolated from market participants' behaviours that pose risks to the integrity and well-functioning of the financial market. The most notable case that caught global attention occurred in June 2013, where a year-long review into the activities of banks and traders conducted by the Monetary Authority of Singapore (MAS) over the period of 2007 to 2011 revealed market behaviours that compromised the interest rate and foreign exchange benchmarks used in Singapore.[18] This involved the Singapore Interbank Offered Rate (SIBOR), Swap Offered Rate (SOR) and the foreign exchange spot benchmarks that were used to settle non-deliverable forward (NDF) contracts.

3.2 While the review found no conclusive evidence that these benchmarks were successfully manipulated, it led to the censure of 20 banks that were found to have "deficiencies in the governance, risk management, internal controls, and surveillance systems for their involvement in benchmark submissions". It also led to the enforcement of disciplinary actions, taken on a total of 133 traders that have "engaged in attempts to inappropriately influence the benchmarks". MAS, on its part, proposed a new regulatory framework for financial benchmarks that involved specific civil and criminal sanctions on benchmark manipulation incorporated into the Securities and Futures Act and subjected key financial benchmarks to regulatory oversight.

---

[15] Municipalities issuing variable interest bonds hedge these using the interest rate swap. When the interest rate rises, causing an increased cost on these bonds, the swap sellers would pay the increased cost. These swaps are however, linked to LIBOR and when banks submitted artificially low rates, payments received by these municipalities artificially decreased causing them a loss.

[16] "Rigged libor hits states-localities with $6 Billion." Bloomberg, 8 October 2012.

[17] "New Banking Scandal Could Cost Savers Billions." *The Bureau of Investigative Journalism*. The Bureau of Investigative Journalism, 4 Dec 2014.

[18] Monetary Authority of Singapore (2013)

3.3 Malaysia's financial markets were also impacted by the manipulation of financial benchmarks. Formal investigations conducted by the Australian Competition and Consumer Commission (ACCC) that came to light in late 2016 charged two Australian banks with severe fines of up to USD11 million for collusive activities to manipulate the offshore Association of Banks in Singapore (ABS) ringgit fixing rate for forward contracts. The investigations revealed that there were several attempts by traders at Macquarie Bank Ltd. and the Australia and New Zealand Banking Group Ltd. (ANZ) communicating via private online chat rooms to make high or low submissions to the ABS with the purpose of influencing the rate to benefit from their positions taken in the financial market.

Fixing rate manipulation on ringgit market transactions

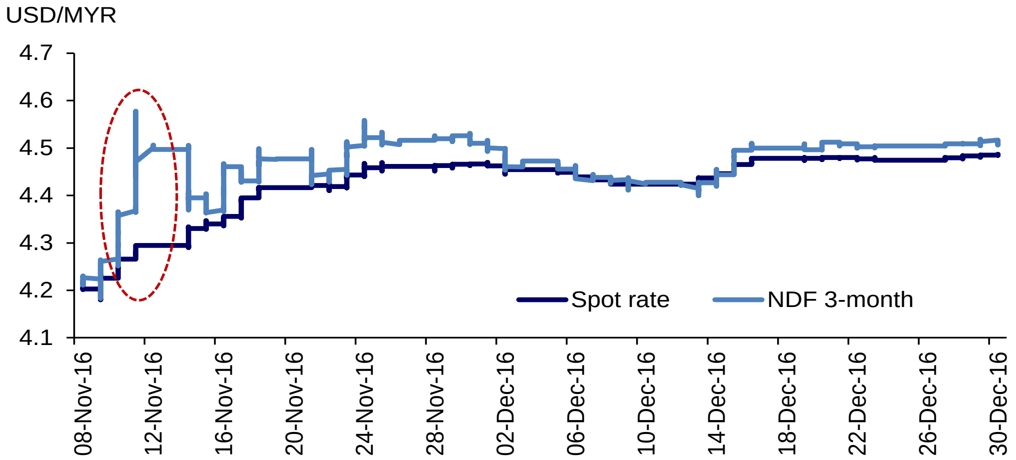
Prior to August 2015, offshore banks would typically execute their offsetting or arbitraging of their ringgit non-deliverable forward book in the onshore market with onshore banks. Such orders would be instructed to be undertaken at the 11 a.m. fixing rate, which at the time was an offshore rate that some of these banks were able to influence via their own or friendly parties submissions. Onshore banks would execute the orders in the onshore market near or around the fixing time but would be caught by surprise when the offshore fixing rate turned out to diverge regularly due to the manipulation.

In view of this uncertainty surrounding the integrity of this offshore fixing, Bank Negara Malaysia had instructed all onshore banks to execute orders based on onshore rates and the onshore reference rate only, which is under the oversight of Bank Negara Malaysia.

3.4 The Malaysian case highlights a rather prominent feature of some regional financial markets where adverse incentives are created and speculative activities take place in offshore markets, with the potential of affecting the onshore financial market environment. These activities manifest in the offshore currency non-deliverable forward (NDF) market, where it has been estimated that 60-80 percent of the volume are generated by speculative interest.[19] These activities tend to intensify during periods of ringgit depreciation, observable through the large divergence between the offshore and onshore pricing of the MYR/USD rate. The speculative activities were particularly evident following the outcome of the US elections in November 2016 where the offshore rate was pricing in a weaker rate by as much as 7% compared to the onshore spot rate (Chart 1). Furthermore, during the period, much of the trading activities and volatility in the ringgit were concentrated prior to the offshore USD/MYR rate fixing time, indicative of position-squaring by FX traders, driven by NDF transactions.

[19] Lipscomb, Laura. "An Overview of Non-Deliverable Foreign Exchange Forward Markets." (2005). Bank for International Settlements.

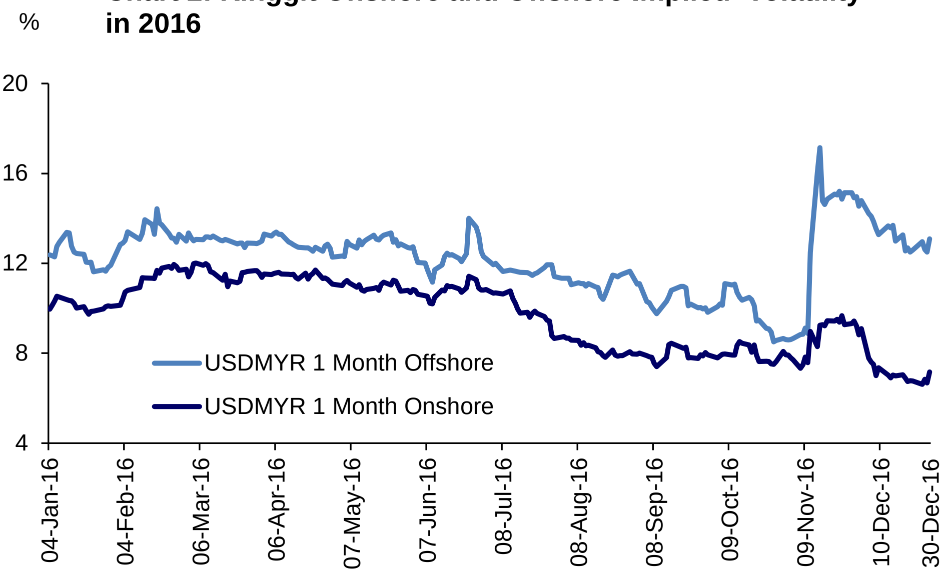
Chart 1: Ringgit Intraday Prices in the Offshore and Onshore Market



Source: Bloomberg

3.5 The spillovers from the offshore NDF market onto the domestic foreign exchange market were pervasive. The large deviation of the ringgit offshore rate from the onshore spot rate highlighted a broken pricing mechanism that was becoming out of sync with the real trade and investment activities of the economy and was instead driven by investor sentiments. Domestic players were also observed to have taken cues from the offshore rate in determining the opening price of the ringgit, causing heightened volatility in the onshore FX market and further distorting the price discovery process. The 1-month historical volatility of the ringgit peaked at 23.1 percent and was the highest among regional currencies in 2016, moving in line with the volatility in the offshore NDF market (Chart 2).

Chart 2: Ringgit Onshore and Offshore Implied Volatility* in 2016



*Based on 1 Month Options Contract
Source: Bloomberg

3.6 Developments in the offshore NDF market had compromised the fairness and effectiveness of the domestic FX market. Furthermore, these activities were able to find its way via domestic players, in spite of Malaysia's long-standing policy of non-internationalisation of the ringgit and non recognition of the offshore NDF market. In response to this, Bank Negara Malaysia took steps to reinforce its non-internationalisation of the ringgit policy, improve the onshore pricing mechanism and further develop the domestic FX market. Domestic financial institutions were reminded against quoting onshore ringgit opening prices that were referenced against offshore prices, and were required to conduct a robust due diligence and know-your-customer process to enable them to better detect transactions that could be NDF-related. The domestic price fixing mechanism was enhanced with the introduction of the KL USD/MYR reference rate, which uses transaction data in the determination of the reference rate. Furthermore, the Financial Markets Committee (FMC), a regulator-industry committee under the central bank, have been mandated to develop strategies to further develop and deepen the domestic financial market, including reviewing the policy frameworks, recommend flexibilities and new financial instruments to facilitate trade and investment transactions onshore.

Financial Market Committee (FMC)

A high level committee formed in May 2016 comprising Bank Negara Malaysia, industry and the key stakeholders to serve as a platform to broaden industry engagement in discussing strategies, issues and challenges affecting the onshore financial market development.

Financial Market Association of Malaysia, Malaysian Association of Corporate Treasurers, Life Insurance Association of Malaysia and Malaysian Association of Assets Manager are represented at the Financial Market Committtee and the subcommittees for the FX and bond market.

Following its formation, the FMC has introduced a number of initiatives for the onshore financial market development.

In protecting the integrity and promoting stability in the onshore foreign exchange market, FMC introduced a new reference rate, called KL USD/MYR reference rate that uses transaction data, instead of based on quotation under the previous fixing methodology. While the new methodology adopted global best practices, it also helps to address pervasive impact of offshore speculative activities on the onshore FX market and ringgit exchange rate stability. In particular, it reduced the vulnerability of the onshore reference rate from speculative transactions arising from the offshore NDF market. It was observed that such influence at times were heavily one sided which made the reference rate subjected to significant volatility from the NDF market activities. NDF market, in contrast to the transparent and well regulated onshore financial markets, is opaque and unregulated that allow speculative interest driving the market and the ensuing disruptive market behavior caused negative spillover effect on the onshore financial market.

FMC also focused on other aspects of the onshore financial market with the introduction of new series of market development initiatives in December 2016.

The initiatives aimed to broaden and deepen the onshore financial market by allowing greater hedging flexibilities for both residents and non-residents under the current Foreign Exchange Administration (FEA) rules, while at the same time seek to rebalance the onshore foreign demand and supply in the market. These initiatives are intended promote a deeper, more transparent and well-functioning onshore financial market where genuine FX market participants can effectively hedge their market risk with greater flexibility to hedge in the onshore market.

FMC will continue to monitor the development in the financial markets and engage the members and others stakeholders to introduce further measures, consistent with the aspiration of the Committee to create a highly developed, liquid and deep financial market in Malaysia that commensurate with the growth of the economy and increasingly sophisticated needs of the users.

4 Global Responses to Restore Integrity and Trust in Financial Markets

4.1 The uncovering of serious market malpractices and offences that had sizeable impact and spillovers which comes from financial markets has deeply eroded public trust in the financial system. Given that an environment of trust is crucial to the well-functioning of financial markets, it led to significant efforts at the global level to not only identify and correct the structural flaws that made it conducive for these malpractices to take place, but to also review and set new standards of professionalism and best market practices while enhancing regulatory powers.

4.2 Major initiatives at the global level are coordinated by the Financial Stability Board (FSB) and involve various groups such as the International Organisation for Securities Commission (IOSCO), the Bank for International Settlements (BIS), central banks and various market and industry players. The FSB periodically issues progress reports that keep track of efforts to address emerging vulnerabilities from misconduct, which mainly cover the areas of market incentives and compensation structures, major financial benchmarks and improving standards of market practice. The FSB itself has produced reports on reforming major FX and interest rate benchmarks, which proposed recommendations to improve the structure and robustness of the benchmark to avoid manipulation and abuse.

Enhancing KLIBOR rate setting standards in line with global standards

In December 2016, following a review of the KLIBOR rate fixing process, Bank Negara Malaysia had issued enhanced standards to further strengthen the integrity of the KLIBOR reference rate setting process. The new enhanced standards, effective beginning 1st January 2017, have been aligned with the latest international best practices under the Principles of Financial Benchmarks issued by the International Organization of Securities Commission (IOSCO Principles).

4.3 The Fair and Effective Markets Review by the Bank of England takes a holistic approach in identifying the root causes of misconduct in the Fixed Income, Currency and Commodity (FICC) markets and subsequently provides recommendations to address them[20]. The recommendations, which covers issues surrounding regulatory perimeter, market structures, individual accountability and use of market power, is directed at the UK authorities and government, international standard-setting bodies like the FSB and IOSCO and finally to firms themselves. These recommendations were also constructed around six key principles aimed at enhancing the fairness and effectiveness of FICC markets, thus restoring confidence towards the FICC markets.

4.4 Important progress has also been made to formulate global principles for the FX market in an effort to harmonise the various FX codes of conduct across different jurisdictions and promote universal adoption and consistent application. In 2013, eight FX committees from major global financial centres adopted the Global Preamble[21], aimed at providing a common set of reference principles for the various individual codes of conduct in these different jurisdictions.[22] Further work is being carried out by the Foreign Exchange Working Group (FXWG), established by Bank for International Settlements (BIS), to come up with a more comprehensive FX Global Code that will eventually supersede the Global Preamble. It will cover market conduct in the areas deemed important to preserve trust in the FX market such as ethics, information sharing, governance, risk management and execution practices. The first phase of the FX Global Code was completed in May 2016[23] and the final phase is expected to be completed in May 2017. *Refer to Appendix I for further information*

[20] Fair and Effective Markets Review (2015). *Bank of England, HM Treasury and the Financial Conduct Authority UK*

[21] The Global Preamble (2015), *Various FX Committees*

[22] The FX Committees include Australian Foreign Exchange Committee, Canadian Foreign Exchange Committee, ECB's Foreign Exchange Contact Group, Hong Kong Treasury Markets Association, London Foreign Exchange Joint Standing Committee, New York Foreign Exchange Committee, Singapore Foreign Exchange Market Committee, and Tokyo Foreign Exchange Market Committee.

[23] FX Global Code: May 2016 Update (2016), *Bank for International Settlements*.

PART B THE PRINCIPLES FOR A FAIR AND EFFECTIVE FINANCIAL MARKET

5 The Way Forward: Five Universal Principles and Specific Actions to Anchor the Evolution to a Fair and Effective Financial Market

5.1 Cases of market failure and malpractice in the international and regional financial markets highlight the pressing need to review the current environment and find weaknesses that enable or facilitate the creation of adverse incentives and improper conduct in the financial market. For Malaysia, a key outcome of this is to establish a set of universal principles that will not only serve as an anchor for market conduct but also any activities related to promoting the fair and effective functioning of financial markets, including development initiatives and regulatory oversight.

5.2 There are good reasons for establishing principles as the overarching ideals for the more specific and rules-based guidelines and regulations. First, a principles-based approach can be dynamic and can adapt well to changing market structures or financial market conditions. Second, it allows flexibility in coverage and application. Being broad in nature allows universal adoption by many parties. It also allows the flexibility for market participants to use their own judgement in applying these principles according to their own internal practices and circumstances. Third, principles are harder to circumvent compared to more specific rules-based code. Most of these reasons have been outlined by other global initiatives that take a similar principles-based approach.[24]

5.3 This paper proposes five universal principles for a fair and effective financial market (Principles) as follows:
(a) Professionalism and Integrity
(b) Transparency and Accountability
(c) Competitive Environment
(d) Good Internal Governance and Structure
(e) Compliance to Rules and Regulations

6 The Outcome of a Fair and Effective and Financial Market

6.1 The overarching objective of the Principles is to have a financial market environment that is trusted, competitive, resilient and best positioned to support the sustainable growth of Malaysia's economy.

6.2 A fair financial market is where
(a) There is universal adoption and application of best practices and codes of conduct by all participants

[24] See for example, the Fair and Effective Market Review (2015) and a speech by Guy Debelle (2017) on "The FX Global Code of Conduct – The Final Phase" at FX Week (Australia) 2017 Conference.

(b) There are high degrees of transparency in pricing and activity, including volume and participants
(c) The market is open and accessible, where all market participants are equal and able to fulfil their intended roles and responsibilities
(d) The market is competitive and free of collusion, rigging and manipulative practices
(e) There is an environment of trust among participants to actively participate in the market with confidence

6.3 An effective financial market would ensure
(a) Investment, funding, risk management and other transactions to be conducted in a predictable manner
(b) Market participants source available liquidity at a cost commensurate with the risk being undertaken
(c) A state of balance between different interest groups, industries and real and financial sectors
(d) Market resilience, where it is able to adjust to changing global circumstances and perform its economic functions even during periods of stress
(e) Consistent reporting to and engagement with authorities to support the well-functioning of the financial market

6.4 The Principles are consistent with global standards and is drawn from the various established international codes of conduct, guidelines and rules. In addition to this, the Principles also take into account Malaysia’s economic and financial market environment. These elements are embedded into the Principles and the specific actions that accompany it.

7 Recommendations for the Adoption of the Principles

7.1 The Principles have been adopted by the Financial Markets Committee (FMC), in line with its mandate to develop the domestic financial market and uphold the highest level of standards and integrity. The Principles are recommended to be adopted at the national level as it touches all aspects of financial market activities.

7.2 The Principles should be universally applied and fully internalised by all parties that have engagements with the Malaysian financial market.

7.3 While it does not seek to replace any existing framework or structure of market best practices, these Principles should act as an anchor for the various internal codes of conduct or ethics, governance structure and the expected behaviour of market participants. As of now, these internal guidelines and codes exist independently without any anchor guidelines. The Principles provide a broad guidance that serves as a reference and therefore streamline all the internal codes of conduct issued by market participants.

Table 1

Financial Market Ecosystem in Malaysia

Acts	Regulatory Bodies	Market Associations		Ratings, Accreditation and Training Bodies	Financial Market Participants
Financial Services Act (2013)	*BNM*	*Financial Market Association (FMA)*	*Association of Islamic Banking Institutions Malaysia (AIBIM)*	*Asian Institute of Chartered Bankers (AICB)*	*Any entity participating in the wholesale financial market, which includes banks, development financial institutions, money-brokers, insurance companies, corporations, fund management companies, platform providers, etc.*
Securities Commission Act (1993)	*FMC*	*Malaysian Association of Corporate Treasurer (MACT)*	*Federation of Investments Managers Malaysia (FIMM)*	*Financial Market Association Malaysia (FMA)*	
Capital Markets and Services Act (2007)	*SC*	*Life Insurance Association Malaysia (LIAM)*	*Malaysia Money Brokers Association*	*Asian Banking School (ABS)*	
	Anchor Guidelines **Principles for a Fair and Effective Financial Market**	*Malaysian Association of Asset Manager (MAAM)*	*Malaysian Investment Banking Association (MIBA)*	*Rating Agencies (RAM, MARC)*	
	Code of Conduct for Wholesale Malaysia Financial Markets	**Governed by various internal guidelines, codes and best practices**			

7.4 Going forward, these Principles should be fully assimilated into the culture and behaviour of market participants. Any new guidance, codes, rules and regulations that will be issued in the future should be in full accordance with these Principles.

7.5 The Principles will also evolve alongside the Malaysian financial market. Hence, the Principles will be periodically reviewed and updated accordingly. The Principles will effectively be treated as a 'live document'.

7.6 The Principles are also supplemented by more specific actions, which are by no means exhaustive and merely acts as guidance to market participants' implementation of these Principles and the behaviour expected under these Principles.

PART C ELABORATION ON THE PRINCIPLES

8 Principle 1: Professionalism and Integrity

Universal adoption of best market practices by all participants to uphold the highest standards of expertise, independence and conduct

8.1 The foundation of every financial market is the ethical and professional behaviours of its market participants. The way market participants behave in their engagements in the financial market would ultimately reflect the integrity, reliability and the level of trust for the financial market to perform its functions in a fair and effective manner. Best market practices should be universally adopted by all market participants at the institutional and individual levels.

8.2 At the institutional level, internal best practices or codes of conduct should be established based on internationally accepted standards. It is also the duty of the institution that their employees receive practical guidance and exhibit a requisite level of expertise, familiarity and understanding of the regulations, codes and best practices that apply to their profession. Supporting these institutions, industry associations and accreditation and training bodies can play a major role as standard setters and drivers of best practices.

8.3 At the individual level, the standards of best practices set by the institution should be internalised and reflected in their day-to-day activities. Individuals participating in the financial market should always conduct their activities in a professional, fair, honest and transparent manner and avoid activities that could damage the reputation of their profession, institution and the integrity of the financial market as a whole.

8.4 **Specific actions to Principle 1**

(a) Market participants should create or update their own internal code of conduct and guidelines, drawing from the Principles, codes of conduct issued by regulators and relevant rules and regulations, to be disseminated to employees at all levels.

(b) Market participants should ensure that its employees meet a minimum standard of training and qualification and exhibit a requisite level of familiarity and understanding of current regulations, rules and codes of conduct.

(c) All individuals participating in the financial market should ensure that their conduct is carried out professionally and honestly, including performing the necessary due diligence and regularly updating their skill sets, qualifications and understanding of best practices.

(d) Industry associations and accreditation and training bodies should play key roles as drivers of best practices and standard setting for their industries.

9 Principle 2: Transparency and Accountability

Full transparency and accountability in all aspects of market participation

9.1 Full transparency and accountability in financial market activities is a crucial feature of a fair and effective financial market. Transparency in trading activities, prices, positions and purposes would allow market participants to make clear assessments on market conditions as well as sound judgements and decisions in a predictable manner. This, in turn, allows the financial market to play its intermediation role more effectively.

9.2 A clear picture of the various components of market activity is also an effective tool to detect anomalies, emerging vulnerabilities and potential breaches in market conduct. This requires market participants to have robust information and processing systems to collect, analyse and disseminate information from back- to front-office operations. To preserve the integrity of the system, it is critical to ensure that this sharing of information is conducted within the boundaries of confidentiality and non-disclosure agreements.

9.3 Market participants should also be fully aware that they are accountable for all their actions and decisions when engaging in financial market activities. This awareness should be universal and present among the board, senior management, dealers, analysts and all related personnel. Any actions by any employee of the institution that break fair market practices and damage the profession and the integrity of the financial market will face reputational, regulatory and personal consequences without fear or favour.

9.4 **Specific actions to Principle 2**

(a) Market participants should require employees to sign a document stating their understanding that they will be accountable for all their actions and decisions in the financial market.

(b) Any cases of misconduct or lack of transparency should be reported to the board of directors and senior management of the market participant immediately and remedial actions, penal if necessary, should be swiftly taken to resolve the problem.

(c) Market participants should practice truthful and transparent communications, including the disclosure of actual and potential conflicts of interest and risks arising from their engagement with the financial market.

10 Principle 3: Competitive Environment

Market outcomes result from a competitive environment, and are not driven by collusive and manipulative activities

10.1 Enabling a competitive environment should be a priority as it allows equal opportunities for all market participants. Without competition, incentives are distorted and the price discovery process disrupted, affecting the well-functioning of the financial market. A financial market that is free from anti-competitive behaviours such as collusion and price manipulation is one that engenders an environment of trust and inspires the confidence of market participants to transact, characteristic of a fair and effective financial market.

10.2 There are several key elements to ensure that market outcomes result from a competitive environment, arising from the responsibilities of not just the market participant but also regulators.

(a) Markets should be open and accessible by having in place policies and best practices that are supportive of this.

(b) Market participants' pricing strategies should be in line with underlying economic fundamentals and commensurate with the risks being borne; and should eliminate factors that could result in price distortions.[25]

(c) Market participants should strive for higher standards of confidentiality and non-disclosure, and not seek to profit from the unlawful sharing or misuse of confidential information and other non-public information.

(d) Communication strategies and technologies of market participants should be secure from potential confidential information leakages and be conducted in a way that respects the boundaries of confidentiality and non-disclosure agreements.

(e) Market participants should act in a way that is in the best interest of their clients and the integrity of the financial market as a whole, avoiding activities that can be constituted as manipulation, abuse, fraud and anti-competitive.

10.3 **Specific actions to Principle 3**

(a) Market participants should ensure that prices are referenced to benchmark onshore rates and always reflect its true and fair value, based on underlying economic fundamentals.

(b) Market participants should establish high standards of confidentiality and non-disclosure while ensuring that no leakages of confidential information could occur through employees' communication or the information technology used at the institution.

(c) Market authorities to issue rules and regulations that promote fair-play

(d) Market authorities and participants should have in place strong deterrents of misconduct in the form of legal repercussions, penalties, revocation of licenses or employment and other deterrents.

11 Principle 4: Good Internal Governance and Structure

Good governance and due diligence are in place, supported by robust internal surveillance and reporting mechanisms

11.1 The good governance and due diligence practices embedded within an organisation is critical in ensuring that market participants act in accordance with the principles. This includes having board members that act and decide

[25] This is in line with Principle 6 of the IOSCO Principles which underlines that benchmarks should "seek to achieve, and result in an accurate and reliable representation of the economic realities of the interest it seeks to measure, and eliminate factors that might result in a distortion of the price, rate, index or value of benchmark".

independently of the market participant, robust and clear policies and internal controls, and a sound organisational structure in place to promote responsible engagement in the financial market.

11.2 Market participants should always ensure that at every level, a due diligence process is in place and followed to maintain objectivity, identify conflicts of interest, appropriately assess a potential client's background and intentions, and apply the necessary regulatory requirements.

11.3 Supporting this internal governance system is a robust internal surveillance and reporting mechanism that allow the detection and reporting of any potential misconduct or conflict of interest. There should be in place proper escalation procedures and whistle-blowing provisions that serve to highlight misconduct while protecting those who report them.

11.4 **Specific actions to Principle 4**

(a) Market participants should formalise a robust governance and due diligence process at every level of the institution, from board approval processes to front- and back-office operations.

(b) Market participants should immediately work towards having in place efficient and robust data capture systems for surveillance and monitoring purposes to assist in the pro-active identification of risks.

(c) Market participants should establish proper escalation procedures, such as whistleblowing policies, to better detect misconduct or conflicts of interest in a way that protects the anonymity of the reporter.

12 Principle 5: Compliance to Rules and Regulations

Adherence to prevailing rules, regulations and market codes while extending full cooperation to the authorities

12.1 Market authorities play an important role in ensuring that the financial market performs its role fairly and effectively. Where the financial market is deficient with respect to the principles of fair and effective and is not self-correcting, authorities and regulators should take the lead in enforcing regulations and catalysing reforms to maintain the resilience and well-functioning of the financial market.

12.2 In order for market authorities to do so effectively requires the full cooperation of market participants. This includes adhering to the rules, regulations and directives issued by market authorities and providing all the necessary assistance and information that allows market authorities to conduct their duties.

12.3 Two-way communication and regular engagements between regulators and market participants are important to strike a balance between regulation and allowing the market to operate efficiently. This cooperation should intensify during periods of financial market stress to swiftly address problems and issues that could affect the well-functioning of the financial market.

12.4 **Specific Actions to Principle 5**

(a) Market authorities to issue rules, regulations and guidelines pertaining to market conduct, and should stand ready to enforce regulations and catalyse reforms in a way that spurs financial market development and preserves the integrity and trust in the market.

(b) Market participants should fully comply with prevailing rules and regulations, as well as rules that are introduced during periods where the fairness and effectiveness of the financial market is deemed compromised by market authorities.

(c) Market participants should meet all the reporting requirements of market authorities and ensure the timeliness and accuracy of the information.

(d) Formation of regulator-market platforms for effective engagement on topical issues, challenges and development strategies for the financial market.

APPENDICES

Appendix 1 Global Efforts to Restore Trust and Intergrity in Financial Markets

1. Financial Stability Board (FSB)

The FSB was established in 2009 with the purpose of promoting financial stability through the coordination major initiatives globally. Since the members of FSB consists of policy makers from G20 countries and four other key financial centres, initiatives from FSB tend to garner support across sectors and jurisdictions, thus creating the necessary momentum required for the advancement of a coherent standard amid an interconnected global financial system.

In addressing the risks of misconduct in the financial markets, FSB, with the collaboration with other international standard-setters, have agreed on a list of measures to reduce misconduct risks[26] by:

(a) Supporting the role of incentives (including compensation, corporate governance frameworks and enforcement) in reducing misconduct
(b) Addressing issues with benchmarks
(c) Improving global standards of conduct in the fixed income, commodities and currency (FICC) markets

FSB issued two reports on benchmarks to improve the standards of market practice, both of which have had worthy impact on the financial market.

2. Foreign Exchange Benchmarks

In early 2014, FSB established a Foreign Exchange Benchmarks Group (FXBG) in order to assess market structure around FX benchmark fixing and associated market practices. In order to analyse market structure and incentives related to trading around benchmark fixings, the FXBG engaged with a range of market participants. Consequently, the group proposed a set of recommendations aimed at enhancing structures and behaviour around FX benchmark trading[27].

The most successful recommendation so far has been the enhancement of the WM's calculation of the London fix. FSB has evaluated the impact of the widening of the calculation window from one to five-minutes and found that there is an "increasing trend towards dealer driven algorithmic execution during the fixing window and away from manual trading"[28]. They also found that "trading volume around the fix is now more concentrated in the actual fixing

[26] Measures to Reduce Misconduct Risks: Second Progress Report (2016). *Financial Stability Board*

[27] Final Report on Foreign Exchange Benchmarks (2014). *Financial Stability Board*

[28] Foreign Exchange Benchmarks: Report on progress in implementing the September 2014 recommendations (2015). *Financial Stability Board*

window, with much less activity either side of the window, potentially as a result of both increased scrutiny around trading at the fix and the move towards algorithmic execution"[5]. This is in contrast to when the fixing window was one-minute wide, where trading volume was front-loaded and spiked at the beginning of the fixing window.

3. Reforming Major Interest Rate Benchmarks

In the same year (2014), FSB proposed several recommendations to enhance benchmarks for key interbank offered rates and promote the development and adoption of nearly risk-free benchmark rates. The report is an extension of the set of principles forwarded by IOSCO in 2013 to improve the robustness and integrity of financial market benchmarks, which were endorsed by the FSB as the global standard for financial market benchmarks[29].

Consequently, three major interest reference rates – the EURIBOR, LIBOR, and TIBOR have initiated plans to consult various stakeholders in order to enhance the methodology and expand the number of transactions involved in rate setting, all in the hope of revamping their rates and tackling shortcoming in the design and governance of benchmarks.

4. The Global Preamble

The Global Preamble is the product of a collaborative effort by eight central-bank-sponsored foreign exchange committees[30], which aims at providing a common basis from which their individual codes of conduct for the FX market follow. The Preamble highlights that market participants are expected to have systems and controls in place to[31]:

(a) Develop and promote a strong culture of ethical behaviour and standards of conduct.
(b) Promote awareness and use of general dealing practices, procedures, and conventions.
(c) Ensure accurate and timely pre-trade preparation and trade capture.
(d) Support robust and efficient back office operations including confirmation, netting, payment, and settlement.
(e) Mitigate risk in FX transactions from the point of initial discussion regarding a potential transaction to settlement.

The publication of the Global Preamble is an important step towards a consistent global framework for national level code of conduct.

[29] Principles for Financial Benchmarks: Final Report (2013). *IOSCO*

[30] The FX Committees include Australian Foreign Exchange Committee, Canadian Foreign Exchange Committee, ECB's Foreign Exchange Contact Group, Hong Kong Treasury Markets Association, London Foreign Exchange Joint Standing Committee, New York Foreign Exchange Committee, Singapore Foreign Exchange Market Committee, and Tokyo Foreign Exchange Market Committee

[31] The Global Preamble (2015), *Various FX Committees*

5. The Fair and Effective Financial Markets Review (FEMR)

FEMR was announced by the UK government to restore confidence towards the Fixed Income, Currency and Commodity (FICC) markets. The review, which was launched in response of the LIBOR scandal, found six categories of causes of misconduct[32]:

(a) Market structures, such as the design of LIBOR, presented opportunities for abuse.
(b) There is a lack of well understood and followed standards in certain unregulated markets.
(c) The systems of internal governance and control at firms have been placing too much reliance on compliance staff and lawyers to get the right outcomes.
(d) The competitive forces in the financial market are not working as well.
(e) The design of remuneration and incentive structures that encourages short-term pursuit of profit.
(f) The culture of impunity' in the financial markets which led to an 'ethical drift' – where unacceptable behaviour had become the norm.

The review made a total of 21 recommendations to fix the root causes of the misconduct in FICC markets. The recommendations, which covers issues surrounding regulatory perimeter, market structures, individual accountability and use of market power, is directed at the UK authorities and government, international standard-setting bodies like the FSB and IOSCO and finally to firms themselves.

6. The Bank for International Settlements (BIS) Global FX Code

The central bank governors of BIS established a Foreign Exchange Working Group (FXWG) to facilitate the development of a single global code of conduct or the FX market. The BIS Global FX code lays out a list of principles that encourages good practices in the wholesale foreign exchange market through the promotion of integrity and effective functioning of the wholesale FX market. Since the FX market is globally interconnected, the work to develop the Global Code is based on existing codes of best practices by various regional Foreign Exchange Committees. This incorporation of the existing codes of best practices worldwide will ensure that the practices have a global consistency and are adhered by a wide range of market participants from all around the globe.

[32] Fair and Effective Financial Markets Review (2015), *Bank of England, HM Treasury and the Financial Conduct Authority UK*.

The Global Code has six leading principles that cover[33]:

(a) **Ethics**: Market participants are to behave professionally to encourage the integrity and fairness of the financial market.

(b) **Governance**: Market participants are to have clear policies and structure in place to ensure appropriate activities in the FX market.

(c) **Information Sharing**: Market participants are expected to communicate clearly and protect confidential information.

(d) **Execution**: Market participants should exercise the utmost care in order handling and execution.

(e) **Risk Management and Compliance**: Market participants are to promote a robust compliance environment to ensure a pre-emptive identification and effective management of the risks associated with activities in the FX market.

(f) **Confirmation and Settlement Process**: Market participants must establish an efficient, transparent and risk-mitigating post trade process to promote an effective settlement of transactions in the FX market.

The Global Code is expected to be released in May 2017.

[33] FX Global Code: May 2016 Update (2016), *Bank for International Settlements*.

Appendix 2 Glossary of Terms

Data capture refers to data collection activities through available information and processing systems

FX benchmark is the standard FX reference rate commonly used by market participants as a quoted price in financial contracts, obtained from 'fixing' activities. An example of this is the WM Reuters FX benchmark.

LIBOR: Libor is calculated using a data collection service by Thomson Reuters (submission at 11am every morning),

Fixing is the process of deriving a benchmark rate based on orders or trades taking place during a specified time window. For example, in the FX market, the WM Reuters fixing time is set at 4pm London time, where WM takes 5 minute snapshots of FX trades on either side of the fixing time as part of the process of determining the fixing rate.

Market participants refer to any entity participating in the wholesale financial market, which includes banks, development financial institutions, money-brokers, insurance companies, corporations, fund management companies, platform providers, etc.

Management committee refers to a group of people which manages an organisation's affair, taking into consideration existing laws and good practices.

Market authorities and regulators refer to institutions and governing bodies responsible for the oversight of the financial market.

Onshore rates refer to prices that are the outcome of domestic financial market activities.

Price misalignment refers to the deviation of price from its fair value, or the value at which it reflects the underlying fundamentals in an economy.

Price discovery refers to the process where market participants are able to determine the price of an instrument based on the demand and supply environment.

LIST OF REFERENCE

Code of Conduct and Practices (2014). *Hong Kong Treasury Markets Association*.

Examples of Misconduct from Written Communications. *Commodity Futures Trading Commission.*

Global Preamble (2015), *Various FX Committees*.

Fair and Effective Markets Review (2015). *Bank of England, HM Treasury and the Financial Conduct Authority UK*.

Final Notice to Barclays Bank PLC (2015). *Financial Conduct Authority UK.*

Final Report on Foreign Exchange Benchmarks (2014). *Financial Stability Board*.

Financial System Inquiry (2014). *Commonwealth of Australia*.

Foreign Exchange Benchmarks: Report on progress in implementing the September 2014 recommendations (2015). *Financial Stability Boar*d.

FX Global Code: May 2016 Update (2016). *Bank for International Settlements*.
Guidelines for Foreign Exchange Trading Activities (2010). *New York Foreign Exchange Committee.*

Lipscomb, Laura. "An Overview of Non-Deliverable Foreign Exchange Forward Markets." (2005). *Bank for International Settlements.*

Measures to Reduce Misconduct Risks: Second Progress Report (2016). *Financial Stability Board.*

Principles for Financial Benchmarks: Final Report (2013). *IOSCO.*

Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions (2013). *Bank for International Settlements*.

The Model Code (2015). *ACI The Financial Markets Association*.

The Non-investments Product Code (2011). *Bank of England*, *Foreign Exchange Joint Standing Committee, the Sterling Money Markets Liaison Group and the Management Committee of the London Bullion Market Association.*

The Singapore Guide to Conduct & Market Practices for Treasury Activities (2011).

Singapore Foreign Exchange Market Committee.

The Wheatley Review of Libor (2012). *Commissioned by the HM Treasury.*