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Capital Markets: Derivatives 2024

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Contributing Editor
Carl E. Kennedy
Katten Muchin Rosenman LLP

MALAYSIA

Law and Practice

Contributed by:
Deepak Sadasivan and Jerry Tiew
Adnan Sundra & Low

Contents

Adnan Sundra & Low was established in August 1975 under the name Mutalib Sundra & Low and has operated under its present name since June 1982. The firm operates solely out of Kuala Lumpur, Malaysia. The firm's experience in derivatives work is backed by two partners, Mr Deepak Sadasivan and Mr Jerry Tiew, together with a managing associate, Mr Rishen Nadarajan. The firm regularly advises on derivatives under the International Swaps and Derivatives Association, Inc. (ISDA) 2002 Master Agreement (ISDA MA) and the ISDA/International Islamic Financial Market Tahawwut Master Agreement (ISDA/IIFM TMA), as well as on various types of structured products transactions (both conventional and Shariah-compliant), with underlying reference assets ranging from equity to currency and credit. The firm also regularly advises on the Global Master Securities Lending Agreement, the Global Master Repurchase Agreement and its Shariah-compliant equivalents in the domestic Malaysian market.

Authors

Deepak Sadasivan began his career as a legal assistant at Adnan Sundra & Low in January 1995, working thereat until December 1999 before becoming a partner in January 2000. Since the initial years of his practice, he has been primarily involved in capital markets and finance work, and he has advised extensively on numerous transactions involving project finance, Islamic finance, derivatives, structured finance and securitisation, being a key member of the firm advising on all derivatives transactions described in the firm profile. Deepak is also a member of the Bar of England and Wales, Lincoln's Inn (1993) and the Malaysian Bar (1994).

Jerry Tiew was called to the Malaysian Bar in 2009 and has been a partner at Adnan Sundra & Low since 2017, specialising in banking, finance and capital markets transactions. He has worked on financing deals with a variety of structures, including perpetual securities, asset-backed securities and project financing in both conventional and Islamic forms. Jerry is a key member of the firm, advising on most of the firm's ISDA MA, ISDA/IIFM TMA and structured products transactions in the past decade.

Adnan Sundra & Low

Level 25
Menara Etiqa
No. 3
Jalan Bangsar Utama 1
59000 Kuala Lumpur
Malaysia

Tel: +603 22793288
Fax: +603 22793288
Email: enquiry@adnansundralow.com
Web: www.asl.com.my

1. General

1.1 Overview of Derivatives Markets

Governing Statute and Regulator

The governing statue for the derivatives markets in Malaysia, dealings therein and requirements/duties/powers of a derivatives exchange is the Capital Markets and Services Act 2007 (CMSA). The regulator of the derivatives market in Malaysia is the Securities Commission Malaysia (SC).

Over-the-Counter (OTC) Derivatives

Derivatives are classified as a "capital market product" under the CMSA, and any offerings of OTC derivatives are subject to authorisation by the SC unless the derivatives are offered to sophisticated investors identified by the SC. Such sophisticated investors include persons/entities licensed or registered under the CMSA, corporations/partnerships with total net assets exceeding MYR10 million (or the equivalent in foreign currency) and individuals whose gross annual income exceeded MYR300,000 (or the equivalent in foreign currency) in the preceding 12 months.

The SC has also published guidelines on contracts for difference ("CFD Guidelines"), which may only be offered in respect of the following underlying instruments:

- shares – units of a real-estate investment trust or an exchange-traded fund listed on *Bursa Malaysia Berhad* ("*Bursa Malaysia*") or a stock exchange outside Malaysia;
- commodity derivatives listed on *Bursa Malaysia Derivatives Berhad* (BMD); or
- indices.

These must meet the various criteria for such instruments specified in the CFD Guidelines, which, where applicable, range from market capitalisations to public shareholding spreads and accessibility of information.

The CFD Guidelines further provide for an offering based on the above to be made together with a disclosure document and product highlights sheet, for which the minimum content requirements range from the background of the contracts for difference (CFD) provider to the product features of the CFD, hedging activity that may be undertaken by the CFD provider to mitigate risk, fees and charges in relation to the investment, the operations and systems of the CFD provider and risks associated with trading in the CFD.

The SC additionally has guidelines in place that regulate the conduct of analysts and investment analysts, professions that require the holding of a capital markets services licence, for the purpose of providing investors with insight and information to assess particular investment opportunities. Accordingly, the analysts and investment analysts are held to high standards of integrity and are expected to exercise reasonable care and diligence in providing research-related services.

Standardised Derivatives

The CMSA governs a variety of matters relating to standardised derivatives, ranging from the establishment of derivatives markets to derivatives exchange, approved clearing houses, checks and balances of the SC in connection with the rules of a derivatives exchange and a derivatives clearing house, the dealing in derivatives of holders of a capital markets services licence and offences relating thereto or the repercussions of non-compliance. The derivatives exchange in Malaysia is operated by BMD, whilst the approved clearing house for the same is operated by *Bursa Malaysia Derivatives Clearing Berhad* (BMDC).

1.2 Historical and Forward-Looking Trends

SC's Capital Market Masterplan 3

The SC has strived to achieve an optimal balance between innovation and regulation in connection with derivatives clearing and trading. For this purpose, the SC has adopted the principle of proportionality for liberalisation measures and the rationalisation of regulatory frameworks. The SC also seeks to explore, in collaboration with market operators, the possibility of improving the domestic-equity product range catering to the developing needs of investors globally, which ultimately allows investors wider access to adjacent or derivative equity products.

This includes the SC's consideration of facilitating the "electronification" of OTC derivatives trading, bearing in mind the value propositions for the Malaysian market. Additional technologically influenced growth in the Malaysian market is also anticipated to occur via non-traditional data and analytics service providers, including algo-based brokers and digital services with automated back-office operations.

Given that crude palm oil futures (FCPO) are a major asset class of derivatives traded in Malaysia, global players who demand a faster trading speed and more efficient cost management are looking for more direct access to exchange-traded commodities. To facilitate this, the SC is seeking to explore a framework enabling remote membership of the Malaysian derivatives market for trading participants. To further facilitate exchange-traded derivatives and thus complement the main OTC derivatives described in **2.5 Predominant Asset Classes**, the SC is also seeking to implement new interest rate futures, aiming to provide lower-cost alternatives and lower counterparty credit risks.

In 2023, as one of the measures to foster greater inclusivity and a more competitive derivatives market, the SC approved a mini-United States dollar and Chinese futures contract (FCNH) and a soybean oil futures contract (FSOY) for inclusion in BMD's exchange. The FCNH is based on a licensing agreement with the Hong Kong Futures Exchange (HKFE) for the settlement price of Hong Kong's USD/CNH currency contract, whilst the FSOY is based on a licensing agreement with the Dalian Commodity Exchange (DCE) for the settlement price of the DCE's soybean oil futures contract.

Discretionary Trading Framework

Given the need to diversify the local intermediation landscape to improve investors' participation in the derivatives market, Bursa Malaysia introduced a discretionary trading framework in 2021, which allows clients to appoint participating organisations to run trading strategies backed by agreed mandates. A Shariah-compliant version of the framework was subsequently introduced in 2022.

Financial Sector Blueprint 2022–26 of Bank Negara Malaysia (BNM)

BNM is also increasing efforts towards the development of the Malaysian onshore derivatives market to increase the market's liquidity and volume of transactions, where the intention is to promote the development and application of a transaction-based alternative reference rate for Malaysia. In June 2024, BNM also published a policy document on Islamic collateralised funding governing the scope of sell and buy back transactions and collateralised-commodity murabahah transactions. The Shariah Advisory Council of BNM has also recently issued a ruling on the permissibility of anticipatory hedging. BNM's continued efforts to review and improve the structure of Islamic instruments is anticipated to contribute further to Malaysia's share of Islamic finance, which is already widely regarded as a global hub of Islamic finance.

2. Types of Derivatives

2.1 Futures and Options

The key types of futures and options trading in Malaysia from the perspective of standardised derivatives are as follows:

- agriculture contracts such as FCPO and options thereon;
- equity contracts such as FTSE Bursa Malaysia Kuala Lumpur Composite Index futures contracts and options thereon;
- metal contracts such as gold and tin futures contracts;
- interest rate contracts such as the three-month Kuala Lumpur Inter-Bank Offered Rate (KLIBOR) futures contract and the three-, five- and ten-year Malaysian government securities futures contracts; and
- currency contracts such as the FCNH described above.

As for cryptocurrency futures, there are none yet. Notwithstanding this, cryptocurrencies under Malaysian legislation are prescribed as securities, which do not fall under the ambit of derivatives and would instead be governed by provisions relating to securities under the CMSA, separate from provisions relating to derivatives.

2.2 Swaps and Security-Based Swaps

Swaps in the Malaysian jurisdiction are traded as OTC derivatives and not on the exchange. As such, there are no regulations pertaining to cleared and uncleared swaps, which are instead mainly governed by bilateral contracts typically adopting the International Swaps and Derivatives Association, Inc. (ISDA) 2002 Master Agreement (ISDA MA) or the ISDA/International Islamic Financial Market Tahawwut Master Agreement (ISDA/IIFM TMA). As an alternative to the foregoing documentation, commercially, swap-transaction parties may also choose to adopt long-form confirmations in place thereof.

2.3 Forwards

Joint Public Consultation Paper and the CMSA

There are no specific regulations on forwards under Malaysian law. However, as OTC derivatives, forwards would be subject to the regulations governing OTC derivatives in general. Regulation under Malaysian law concerning OTC derivatives is currently quite limited, leaving counterparties with the freedom to contract commercial provisions between themselves (although of course always being subject to Malaysian contract laws).

A joint public consultation paper was issued by BNM, the SC and the Malaysia Deposit Insurance Corporation in 2013, which sought to increase the availability of granular data on the terms of trades, market valuations and collateral. Following therefrom, the current provisions in the CMSA in connection with OTC derivatives cater for trade repositories to be approved by the SC, which in turn would subject players dealing in derivatives to reporting obligations to such trade repositories (with exemptions for BNM and the government of Malaysia). Notwithstanding this, there are currently no approved trade repositories in Malaysia.

Dynamic Hedging Programme

BNM introduced a dynamic hedging programme for institutional investors in 2016 as one of the initiatives to provide flexibility in the active management of foreign-currency risk exposure via forward-hedging activities involving financial institutions.

2.4 Listed v Over-the-Counter

OTC

As described briefly in **2.3 Forwards**, OTC derivatives are contractually negotiated in Malaysia, so requirements in respect thereof are mainly commercially determined. A key difference with OTC derivatives traded in Malaysia is that they are largely offered to sophisticated investors, as described in **1.1 Overview of Derivatives Markets**, to ensure that any such offering would not need to be authorised by the SC.

Listed

As for standardised derivatives, the trading and clearing of the same are mainly governed by the Rules of BMD ("BMD Rules") and the Rules of BMDC ("BMDC Rules"), where the BMDC Rules cater for various clearing and settlement procedures in connection with trades on BMD's exchange. Additionally, further directives are issued pursuant to the BMD Rules and BMDC Rules to provide guidance for the relevant participants in relation to adhering to their obligations thereunder.

Only entities that have applied to BMD to be a participant under the BMD Rules may trade in the derivatives available on BMD's exchange, which is effected through BMD's automated and computerised trading system. The BMD Rules cater for various administrative and operative provisions pertaining to the placement and execution of trades on the exchange, including reporting and other governance requirements.

2.5 Asset Classes

Predominant Asset Classes

As Malaysia is the global benchmark for the crude palm oil price, FCPO is the largest traded derivatives product in Malaysia. As for OTC derivatives, the active players for which are mostly financial institutions, the predominant derivatives products are those with an underlying reference asset of equity, currency and interest rates.

Prohibition of Asset Classes

Whilst there are currently no specific prohibitions for asset classes of derivatives in Malaysia, the SC, in exercising its powers under the CMSA to issue directions to a derivatives exchange, may terminate or suspend trading on a derivatives exchange, where considerations of the SC in relation to issuing such directions will be based on ensuring fair and orderly markets, protecting investors or acting in the public interest. Under the CMSA, the SC has the power to prohibit the trading of particular securities or a particular class of securities, but this is not extended to derivatives.

Generally, if a particular underlying reference asset class is deemed illegal under Malaysian law, any contracts in relation thereto would similarly be deemed illegal under the Malaysian Contracts Act 1950. Accordingly, no contracts in respect of such asset classes can be formed as a derivative instrument.

New Asset Classes

In line with climate action awareness, Bursa Malaysia set up voluntary carbon markets in 2022 to support the financing of projects and solutions that reduce, remove or avoid greenhouse gas (GHG) emissions, allowing companies to offset their carbon emission footprint. To this end, Bursa has established the Bursa Carbon Exchange (BCX), which has adopted the Verified Carbon Standard from Verra. The BCX currently has the Global Technology-Based Carbon Contract and the Global Nature-Based Plus Carbon Contract available for trading, which represent standardised contracts for the delivery of units issued by Verra and feature global technology/nature-based GHG-reduction projects. However, information on trades is currently limited, so liquidity trends cannot be ascertained.

2.6 Exemptions, Non-derivative Products and Spot Transactions

Exemptions and Spot Commodities

There are currently no derivative products that benefit from an exemption from regulation in the Malaysian jurisdiction.

Spot commodities are typically traded via contractual sale-and-purchase OTC transactions and, as such, they are not currently regulated under the Malaysian jurisdiction, nor are there any unique rules governing the same.

Retail Foreign Exchange Transactions and Leveraged Retail Spot Commodities

Retail foreign exchange transactions are governed under the Malaysian Financial Services Act 2013 and its Islamic equivalent legislation, in which there is a general prohibition on the buying or selling of foreign currency in Malaysia without written approval from BNM. Notwithstanding this, to effectuate commercial efficacy of transactions and transactions with licensed money-changers, BNM has a foreign exchange policy in place that contains pre-set approvals from BNM for the purpose of trading foreign currency in accordance with the notices issued thereunder, essentially catering for most typical transactions pertaining to retail forex that are to be carried out.

The position under Malaysian law in relation to leveraged retail spot commodities is the same as that described in respect of spot commodities earlier in this section.

3. Regulation of Derivatives

3.1 National

3.1.1 National Regulators

Under the Malaysian jurisdiction, there is only one regulator set up for the purpose of regulating transactions pertaining to derivatives, and that is the SC.

3.1.2 Clearing

Further to the brief description of the BMDC Rules above, the provisions thereunder cater for the admission of clearing participants thereunder (being persons who are party to a subsisting contract with BMD or BMDC and are bound by their rules). In connection therewith, there are, amongst others, standing, capital, financial, licensing, risk management and audit requirements for such clearing participants, as well as provisions for inspection regarding compliance with the BMD Rules and BMDC Rules.

There are further deposit requirements relating to margins and the contributions by the clearing participants to BMDC's clearing fund, for the purpose of indemnifying BMDC against losses attributable to a failure of clearing participants or financial institutions to discharge their obligations when due.

Under Malaysian law, no derivatives are currently exempt from clearing requirements.

3.1.3 Mandatory Trading

Under Malaysian law, save for order sizes and prices that are subject to the tick sizes specified in the derivatives contract, there are no mandatory trading requirements pertaining to standardised derivatives and, as such, no exemptions are applicable. Please refer to **3.1.4 Position Limits** in respect of the trading and position limits of derivatives in Malaysia.

3.1.4 Position Limits

Under Malaysian law, BMD and BMDC have the power pursuant to the BMD Rules and BMDC Rules, respectively, to impose limits on open positions, the number of options that can be exercised and (by BMD only) the minimum and maximum price in a derivative contract concerning a participant on BMD's exchange.

3.1.5 Reporting

Under Malaysian law, there are reporting requirements under the CMSA, BMD Rules and BMDC Rules. In addition to the obligation to report to a trade repository for OTC derivatives, as described in **2.3 Forwards**, a holder of a capital markets services licence is required under the CMSA to maintain records of the instructions of its client for trading in standardised derivatives.

Under the BMD Rules, there are also requirements for the retention of records in relation to transactions pertaining to the exchange of a derivatives position for another similar position, negotiated large trades and off-balance-sheet transactions. There are further requirements regarding the maintenance of accounts and provision of financial statements thereunder by the participant to BMD.

3.1.6 Business Conduct

Among the conduct requirements imposed under the CMSA in connection with derivatives transactions is the assumption that a holder of a capital markets services licence dealing in derivatives trades as an agent, and not as a principal, unless they inform the person in writing that they are acting as a principal and not an agent in respect of a particular transaction. Additionally, "a holder of a capital markets services licence who carries on the business of dealing in derivatives shall not instruct another holder to carry out the instructions of the first-mentioned holder's client unless the consent of that client has been obtained". Briefly, the CMSA also imposes obligations on the holders of a capital markets services licence pertaining to the sequencing and execution requirements of instructions received.

The BMD Rules and BMDC Rules provide various requirements for conduct by participants, including conflict and risk management, the placement of policies/procedures/controls, advertising, and publicity regarding the accuracy and adequacy of information. Generally, participants are required to show professional conduct, uphold standards of integrity, engage in fair dealing and exercise proper skill, care and diligence.

3.1.7 Commercial End Users

For the purpose of dealing in derivatives transactions in Malaysia, and based on the legislation and regulations currently in place, there do not seem to be any particular unique issues affecting financial institutions or holders of a capital markets services licence. There are also no specific exemptions or relief measures in place for the aforementioned entities.

3.2 Local

Derivatives in Malaysia are not specifically regulated at the local level.

3.3 Self-Regulatory Organisations, Independent Authorities, and Exchanges

Whilst BMD and BMDC have the authority under the CMSA to create industry standards pursuant to the BMD Rules and BMDC Rules, they nonetheless remain regulated by the SC at the national level. There are no other relevant organisations in Malaysia from the perspective of derivative transactions.

4. Documentation Issues

4.1 Trading Documentation

4.1.1 Industry Standards and Master Agreements

The industry standards for the documentation of derivatives in Malaysia are the ISDA MA and the ISDA/IIFM TMA (for the purpose of governing derivatives transactions). Notwithstanding this, and as mentioned in **2.2 Swaps and Security-Based Swaps**, commercially, transaction parties may also choose to adopt long-form confirmations in place thereof.

There have been instances where, commercially, parties have decided to adopt a master confirmation agreement with more specific terms and conditions pertaining to a "Confirmation" issued under the ISDA MA or the ISDA/IIFM TMA. Notwithstanding this, a supplement to the master confirmation agreement is still issued for a trade and acknowledged by the counterparty to constitute an exchange of the Confirmation issued under the ISDA MA or the ISDA/IIFM TMA. This approach has been adopted for derivatives transactions with an equity underlying the reference asset, although it is feasible for its application to be extended to other asset classes.

4.1.2 Margins

Procedures for Variation Margin

All standardised derivatives in Malaysia cleared based on the BMDC Rules, for the purpose of meeting margins, require an initial deposit (in cash or collateral, as may be specified by BMDC) to be lodged with BMDC. In the event of a settlement variation, the BMDC Rules do not specify any particular form of document or communication that may be adopted by BMDC for such an increased amount of deposit. The BMDC Rules allow for flexibility by BMDC in specifying the manner in which such a request is made to the clearing participant.

The parameters under the BMDC Rules for a settlement variation may be triggered by BMDC after considering various factors, such as performance risk, market volume, price volatility, or even other matters BMDC may consider relevant. Due to the generic nature of the requirements, the existing documentation for derivatives contracts mirrors the requirements and would mainly be subject to change in the event that further amendments are made to the BMDC Rules and/or further directives are issued in respect of such additional amounts.

Uncleared derivatives in Malaysia would then be OTC derivatives and, whilst there are no regulatory requirements for the provision of margin, the contracts for such OTC derivatives have evolved over time such that it is now market practice that such contracts also include provisions for margin requirements.

In-Scope Assessment

Under the BMDC Rules, all clearing participants are subject to the margin requirements for the purpose of the performance of obligations under all open contracts (which in turn necessitates margin contributions from the clients whose account is carried in the books of the clearing participant). As such, there are no separate determinations to be made pertaining to in-scope assessments, and the margin requirements would be reflected in all standardised derivatives contracts.

As noted above, whilst there are no regulatory requirements for uncleared OTC derivatives contracts to provide for margin requirements, they are typically included, and the determination of whether such requirements would be imposed is made on a case-by-case basis, taking account of commercial considerations.

4.1.3 Other Agreements

The main types of trading agreements used in Malaysia for the purpose of repurchase transactions range from the Global Master Repurchase Agreement to the Shariah-compliant equivalent, being the Master Collateralized Murabaha Agreement, and the Buy/Sell-Back Annex.

For securities borrowing and lending transactions, there is the Global Master Securities Lending Agreement and the Shariah-compliant equivalent, being the Islamic Securities Selling and Buying – Negotiated Transaction Agreement of Bursa Malaysia.

4.2 Clearing Documentation

The BMD Rules prescribe contract specifications in relation to the standardised derivatives traded on the BMD exchange, which are to be adhered to in all such standardised derivatives. The specifications range from stipulating provisions on minimum price fluctuations, price limits, tick values, specific settlement procedures and, depending on the underlying reference asset used, the grade of underlying assets delivered (where applicable), including disputes in relation thereto.

As the contract specifications are fairly standard provisions under the BMD Rules, no significant issues are encountered by clearing brokers or their customers in negotiating the same, which is coupled with the availability of directives by BMD and a trading manual in connection with the transactions available.

4.3 Opinions and Other Documentation Issues

Malaysian Market Standards

The types of trading agreements that typically, from a Malaysian market standards perspective, require legal opinions to be issued are the trading agreements stipulated in **4.1.3 Other Agreements**.

As for the types of counterparties to be addressed by such opinions, ISDA has commissioned a Malaysian law firm to issue an enforceability opinion on, amongst others, the ISDA MA, which predetermines the capacity of the counterparties specified therein to enter into the ISDA MA and the enforceability of the close-out netting provisions against those counterparties in non-insolvency and insolvency scenarios. Financial institutions typically request a top-up opinion on specific counterparty types not otherwise covered in the commissioned opinion, and such top-up opinions similarly cover the items in the commissioned opinion pertaining to such counterparties.

Regulatory Requirements

As there are no specific regulatory requirements pertaining to the issuance of legal opinions for derivative contracts, the ambit of the opinions would be in accordance with the Malaysian market standards, as described earlier in this section.

5. Enforcement Trends

5.1 Regulator Priorities and Enforcement Trends

There has not been any significant enforcement activity in Malaysia over the past year. Typical enforcement actions by the SC are in respect of entities trading without the requisite licences.

Generally, Bursa Malaysia focuses on the prioritisation of enforcement actions relating to serious or material breaches that have had a significant or material impact on the market, and where it is possible to increase the transparency of the enforcement. Penalties in connection therewith are then determined in accordance with the nature and impact of the breach, the disciplinary history of the defaulting party, the circumstances of the breach, mitigating factors and public interest considerations.

In addition to the priorities listed above, Bursa Malaysia and SC also organise forums with the relevant market participants from time to time, for the purpose of communicating expectations of compliance from a practical perspective.

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