

**MALAYSIAN ASSOCIATION  
OF ASSET MANAGERS**

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**CODE OF CONDUCT AND CORPORATE  
GOVERNANCE**

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The recent issues of corporate and accounting shenanigans have highlighted the need for better corporate governance, the need for stronger oversight of listed issuers and the need for better oversight of the accounting and auditing profession. The unfolding of the debacles has brought investor confidence in the US to its all time low, wiping trillions of dollars off people's wealth. While all eyes have turned questioningly to corporations and the accounting profession, it is also timely to take stock of how Malaysia's asset management industry, a business that is built on confidence and trust, keeps risks and other dangers at bay.

**CODE OF CONDUCT FOR ASSET MANAGERS**

The asset management business is a trust business. Clients must have confidence that their moneys are in safe hands, in persons who they trust will help them multiply the value over time. It is thus critical that there should be a comprehensive infrastructure and regulatory framework in place to ensure that those in the business adhere to best practices. This is necessary in order to promote and maintain the integrity of the industry, safeguard the interest of clients and ensure sound operations of the asset management companies.

Since its establishment in 1996, The Malaysian Association of Asset Managers ("MAAM") has undertaken various initiatives to promote the development and the standard of business conduct of the asset management industry in Malaysia. Particularly note worthy was MAAM's revision of a Code of Conduct for its members in 2001.

The MAAM Code of Conduct represents the best practices that MAAM expects its members to observe in the conduct of their asset management business. The Code covers the following principal areas:

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- i) Compliance with laws and regulations;
- ii) Risk management;
- iii) Management of conflict of interests;
- iv) Safeguarding clients' interests; and
- v) Duty to exercise due care and skill

The central theme that underlies these best practices is that asset managers shall conduct their business with due care and skill, and in a way that will be in the best interest of their clients. Protection of clients' interest should be the paramount consideration. Unless we, as asset managers can convince our clients that we have their interest at heart, and that we are capable of adding value, we will have difficulty persuading doubters and detractors to entrust their moneys with us.

Let us now take a look at what are some of the essential provisions of the Code of Conduct.

### **Compliance with laws and regulations**

In the area of compliance with laws and regulations, the requirements are straightforward but important. First, asset management companies have to meet the relevant financial requirements. Second, asset management companies have to meet other regulatory requirements laid down in the Securities Industry Act, the Securities Commission Act and Guidelines on Money Laundering. These include licensing requirements, and certain conduct of business rules, such as disclosure of interest in securities, accounts and record keeping, and auditing.

### **Risk Management**

Asset management companies are exposed to a number of risks that may impact on clients adversely. These risks may also, directly or indirectly, threaten the financial stability of asset management companies. It is therefore imperative that asset management companies should have good understanding of the risks they and their clients are subject to, and have in place an adequate system of procedures and controls to control such risks.

Asset management entails a number of risks, but the principal ones include regulatory risk, operational risk, counter-party risk and market risk. Regulatory risk is defined as a failure to comply with the law and regulations. One cannot over emphasize the importance of ensuring

compliance with law and regulations. Failure to do so can expose an asset management company to possible criminal or civil actions.

Operational risk comes about as a result of a loss arising from having inadequate internal procedures and controls, or from failure to comply with internal procedures and controls. Instances of massive, and sometimes debilitating, financial and reputational losses suffered by financial institutions as a result of failure to detect unauthorized trades underscore the need for financial institutions to have a robust internal risk control system. The story of how unauthorized trading brought down Barings serves to remind us that this scenario is all too real.

Counter-party risk arises as a result of potential losses caused by the default of counter parties, while market risk arises due to fluctuation in the market prices of investment positions undertaken for clients' or for the company's account. To minimize operational, counter party risks, asset management companies should have procedures and controls in place that include:

- Trading only through approved brokers that meet specified criteria;
- Allowing trades to be executed only by authorized dealers;
- Requiring approved brokers to accept trade instructions only from authorized dealers;
- Imposing trading limits for each authorized broker and for each authorized dealer;
- Avoiding concentration of trades in one or a small number of counter-parties;
- Setting appropriate concentration limits;
- Requiring segregation of dealing and back-room functions; and
- Applying dual control principle where appropriate.

### **Conflicts of Interests**

Asset management companies and their staff owe a fiduciary duty to their clients. There may be situations when their duties to their clients will conflict with their own interest. Best practices require that asset management companies and their staff should avoid putting themselves in a position of conflict of interest. If conflicts of interest cannot be

avoided altogether, they should be mitigated and controlled. The company or its fund managers should not offer or accept any inducement that is likely to put it in a position that would significantly conflict with its duty to clients. If the company engages in proprietary trading, there should also be controls to ensure that clients' trades should be given due priority and that trades are not done against clients' interest. If staff dealings are permitted, then the company should have in place controls, such as a restricted list/black out period, requirement for approval prior to dealing, and documentation of approval.

### **Safeguarding clients interests**

If an asset management company receives rebates on brokerage or other soft commissions (such as research, price information service) from brokers, special care must be taken to ensure that clients' interest is duly safeguarded. If there is any arrangement on receipt of soft commissions, full disclosure of it should be made to the clients.

It is common for asset management companies to manage funds for a number of clients. Where trades in the same securities are made for two or more clients at the same time, established policy and procedures should be in place to ensure that trades will be fairly allocated to the different clients. This is to ensure that no favoritism is given to one client to the detriment of another. Procedures should require proper documentation and review of pre-trade allocations and the basis of allocation of trades that are partially executed. Cross trades should only be permitted only under restrictive conditions. To safeguard the interest of both clients, the asset management company must ensure that the trades are executed on an arm's length basis at current market prices, and that they are in the best interest of the clients. The company must also document the reasons for the cross trades, and disclose the basis of the trades to the clients.

To provide added comfort to clients, asset management companies should ensure that the clients' assets are entrusted to a custodian that is appointed by the client or with the authority of the client.

### **Internal procedures and controls**

A company should also have an adequate system of internal procedures and controls to ensure that daily routines are carried out systematically, consistently and in accordance with laid down policies and requirements. The policies, procedures and controls should be documented in an Operations Manual to provide easy reference by staff. This Operations Manual should be up-dated regularly to reflect changes

in regulations, business and operating environment. The procedures would also ensure that an audit trail is possible.

### **Compliance Function**

A diligent and effective compliance function is essential for the long-term well being of an asset management company. The compliance function should be independent of other functions and should report directly to senior management. It ensures that all regulatory requirements are observed and that policies, procedures and controls have been adhered to. Unfortunately, all too often, compliance function tended to be relegated to relative unimportance, and its role is given the attention it deserves only when the company has found itself in trouble. However, the financial debacles that come to light from time to time around the world do serve as reminders, even if temporarily, of the need to have a robust compliance that can keep pace with business growth.

### **Essentials for success**

Having a good system of internal procedures and controls, and a robust compliance function are necessary, but insufficient, ingredients for sustained growth in business. They provide the framework and foundation from which a sound business can be built. To be successful, an asset management business must also have three P's: People – good people who are diligent, hard working, capable, knowledgeable and whose integrity is beyond reproach; Philosophy – investment philosophy that works; and Process – investment process that is rigorous and consistent and objective. By building the 3P's onto a strong framework of internal controls and compliance, I believe we will be better able to enhance the integrity and reputation of the asset management industry, thereby foster its long-term development in Malaysia.

### **CORPORATE GOVERNANCE**

Corporate Governance is about putting in place governance structures, processes and controls that would promote long-term performance, thereby enhancing shareholder value. Increasingly, markets are coming to the view that companies would benefit from higher standard of corporate governance. Two surveys from McKinsey have lent support to this belief. McKinsey's Survey of Institutional Investors in 2000 revealed that the majority of respondents indicated that they are prepared to pay a premium for shares of companies with good corporate governance. In McKinsey's 2001 Survey of Private Equity Investors, the

respondents indicated that they considered the following factors, among others, to be highly relevant:

- Distinction between company and family interests;
- Clearly defined governance arrangement;
- Accuracy of financial reporting;
- Legally enforceable minority shareholder protection;  
and
- Use of performance-related pay for top management.

More and more markets have promulgated their own Code of Corporate Governance, setting out the best practices, which their listed companies are required to observe. Malaysia issued its own Code of Corporate Governance in 2000. The Malaysian Code covers four main areas: Board matters, Remuneration matters, Audits, and Communication with shareholders.

In the Board area, the Code advocates having a balanced Board that is capable of exercising effective supervision of the company, and directing its strategic development. Among other things, it makes recommendations on composition of the Board and of sub-committees, including the audit committee, the nominating committee and the remunerations committee, emphasizing balance of power and avoiding concentration of power on any one person. It also recommends instituting a formal and more transparent process for the selection of Board members, and the appraisal of their performance as well as that of senior management team. The Code emphasizes on the need to have appropriate core competencies and experience on the Board, and that directors should be selected on account of their expertise and experience.

The Code considers it desirable that members of the Board and management should be “incentivized” to perform better by linking compensation to company and job performance. However, the Board and management should be accountable to the company and shareholders for their performance. Indeed, this issue has recently been the subject of considerable debate in Malaysia. Some companies have, without sanction by shareholders in general meeting, substantially boosted their executive directors’ compensation without commensurate improvement in company performance. That has aroused considerable criticisms from investors.

In the area of auditing and communication with shareholders, the Code highlights the need to institute an effective process to review the adequacy of internal controls and risk management systems, and to

ensure accuracy, transparency and timely disclosure of information to shareholders and other stakeholders. Fair and equitable treatment of shareholders, large or small, is also emphasized.

Malaysia has taken the important step of promulgating a Code of Corporate Governance, and requiring directors to attend courses to familiarize themselves with the duties and obligations of directors under the law, Listing Manual and Code of Corporate Governance. That is a crucial first step, and while many listed companies in Malaysia are now more conscious of the need to improve their governance practices, there is a lot of room for improvement.

Malaysian Association of Asset Managers  
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<sup>i</sup>The contents of this article was based on a class delivered By Dr Tan Chong Koay, Chief Executive Pheim Asset Management Sdn Bhd at the Securities Commission's SIDC CAPITAL MARKET WORKSHOP SERIES, Fund Management Industry, 23 – 26 April 2002