THE CENTRAL DEPOSITORY SYSTEM

Malaysian Central Depository

Malaysian Central Depository Sdn Bhd (MCD), a subsidiary of Kuala Lumpur Stock Exchange (KLSE), was incorporated on 14 April 1990, to operate the Central Depository System (CDS) in Malaysia.

KLSE is the premier stock exchange in Malaysia. As at 31 December 1993, it had a market capitalisation of RM 619 Billion (US$ 238.1 Billion) easily making it the largest bourse in the region.

In 1984, KLSE set up a centralised Clearing House called Securities Clearing Automated Network Services Sdn Bhd (SCANS), doing away with the clearing and settlement of scrip on an inter-broker basis. KLSE replaced the traditional open-outcry system of trading with a semi-automated trading system called System on Computerised Order Routing and Execution (SCORE) in 1989.

SCORE was further enhanced into a fully automated system and implemented for all securities on 30 November 1992. In an effort to improve the clearing and settlement system, the Daily Netting System (DNS) and the Fixed Delivery and Settlement System (FDSS) were introduced from 1 January 1990 and 12 February 1990 respectively.

In line with developments in the securities industry worldwide and in the wake of the increasing trading volume on the local bourse, there is a need to replace the existing clearing and settlement system which involves physical movement of scrip with a Central Depository System or a "scripless trading" system.

MCD has been authorised by the Minister of Finance to run the only central depository in Malaysia.

Objectives

The main objectives of MCD are

* to establish and operate a system for the central handling of securities, whether or not listed on any stock exchange
* to increase the capacity of clearing and settlement of securities
* to reduce the costs and risks of settlement of securities
* to enhance the liquidity and efficiency of the Malaysian capital market
* to promote Malaysia's competitiveness, by complying with the latest international standards for settlement and clearing of securities

System Overview

The following are the proposed functions of the CDS :

* Immobilisation of securities
* Book-entry accounts
* Confidentiality
* Detailed listing of investor holdings by security types
* Handling of corporate actions
* Distribution of dividends, interest and redemption monies
* Handling of all types of securities, both debt equity and their derivatives
* Delivery versus Payment (DVP)
* Links to other depository systems around the world

These functions are in line with the recommendations made by various international committees and task forces such as the Federation Internationale de Bourses De Valeurs (FIBV) and the Group of Thirty (G30), in improving and standardising the clearance and settlement process.

The implementation of these facilities will establish Malaysia as a leader in terms of securities clearance and settlement. However, these reforms which create a totally new environment, are being implemented in phases. The first phase has covered the first five (5) functions stated above. The rest will be covered in subsequent phases.

The CDS is a new clearing and settlement system. Under the CDS, the current practice of holding and moving scrip of quoted shares, is replaced by a safe and dependable computerised book-entry system. When investors trade in CDS shares, there is no more need for delivery and receipt of scrip. Instead, a seller's account is debited and a buyer's account credited. All shares of companies listed on KLSE whose investors have CDS accounts, are consolidated into a few jumbo certificates and stored centrally. The investors' CDS accounts will show their holdings. Listed companies are gradually being brought into the CDS.

Until all securities on KLSE are taken in, the CDS will be running side-by-side with the existing scrip-based system.

Benefits

The CDS brings benefits to all parties involved in the stock market and securities industry. Investors, both individual and corporate, benefit as follows:

* No risks of misplaced, lost or forged scrip
* No more delivering and collecting volumes of scrip to and from brokers
* No need to send scrips for registration as registration is automatic. Entitlements to benefits and rights on shares held are automatic
* Investors save time, stamp duty and registration fee

Public listed companies and their registrars have the following benefits:

* Savings in registration cost
* Being able to know at any point of time, their actual shareholders as well as their holdings
* When dividends, bonus, rights, etc are declared, there will be no rush to register entitlements because registration is automatic

Banks and large institutional investors benefit by saving time, manpower and space utilised in processing, tracking and storing scrip. Banks may also offer better custodian services and pledging facilities, to their customers through the CDS.

With the establishment of the CDS, KLSE and Malaysia offer a more attractive investment environment for investors, both foreign and local. *This is in line with KLSE's vision of becoming a world-class stock exchange. It will also realise the Government's objective of making Kuala Lumpur, an important financial centre in the Asia Pacific region.*

Users / Participants

All investors, whether individual or corporate, are required to open CDS accounts if they wish to trade in prescribed securities. A prescribed security is a counter that can only be traded and settled through the CDS. Investors may also use the CDS for safekeeping of shares, and for custodian and pledging services. Investors may open CDS accounts through KLSE's Member Companies, which have been appointed as Authorised Depository Agents (ADAs).

Certain institutional investors, commercial and merchant banks, finance companies, insurance companies, unit trusts and other financial institutions are allowed to open CDS accounts directly with MCD. Such account holders are called Authorised Direct Members (ADMs).

The ADM facility is extended to these institutional investors because not only are these institutional investors actively involved in the capital market, they also provide custodian and pledging services to their clients. As active participants in the capital market, these institutional investors find that membership as an ADM enables them to maintain and monitor their investment portfolio and provides them with portfolio confidentiality. As ADMs, institutional investors maintain their clients and its own CDS accounts and initiate transfers of securities by using CDS terminals at their offices. ADMs may also maintain accounts for their wholly owned locally incorporated subsidiaries.

In addition, the system will be interacting with other users like the issuers, registrars, issuing houses, SCANS and KLSE.

Functions

CDS in Phase 1 provides the following six (6) functions:

- Account Management
- Deposits
- Transfers
- Withdrawals

- Trade Settlement
- Corporate Actions

Trading Under The CDS

With the CDS, it is important to note that except for a small additional procedure of providing the CDS Account No., trading practices in securities remain exactly the same as they were before. *Investors will still instruct their broker to buy or sell.* Under the CDS, trade settlement is accounted for at investor level, as opposed to broker level in the scrip based system.

The Fixed Delivery and Settlement System (FDSS) will continue except that delivery will now be replaced by book-entry. Settlement is still carried out on T+5, where 'T' is defined as the day of trade and '5' represents five market days. Seller will get paid by brokers on T+6 and buyers shall pay brokers no later than T+7. It is also important to note that *as the CDS is being implemented security by security, it will co-exist with the scrip based system until all securities listed on KLSE are immobilised.*

Trade Settlement

Trade settlement in the CDS does not refer to cash settlement. *Under the CDS, the cash settlement arrangements remain as they are.* For that reason, the CDS accounts show the quantities of shares and not the values.

Buyer Settlement

A buyer of securities prescribed in the CDS will have his CDS account credited on T+5. However, as he has not paid his broker for the shares on that date, his credit will be under "lien", meaning these shares cannot be utilised for transfer or withdrawal, until they have been paid for.

When the investor pays for the shares by T+7, as he should, the broker will release the lien.

On the other hand, where a broker indicates that its client has *failed to make payment by T+7, the shares will be automatically transferred to a special account of the broker known as the "Stock Clearing Account"*. This is to protect the broker as he has already paid SCANS on T+6 in respect of the purchase. The broker will then sell out the shares to recover its outlay on T+8.

Seller Settlement

In line with the current FDSS, a seller's CDS account is debited on T+5. In other words, to settle a sell trade he transacted on T day, he must have shares to the credit of his account on T+5. If not, the trade will fail.

The system carries out the task of trade settlement in a batch run at the end of the day. Thus, the seller's CDS account will be debited and buyer's account credited on T+5 night.

This also means that a seller's account does not have to be in credit, at the point when he trades. To settle such a trade, he can transfer the required shares into his account on T+5 day itself. During the Prescribed Period, he can deposit shares on the day of trade settlement before 12.30 pm. The Prescribed Period (which is no less than a month) is a special length of time which allows the seller to utilise deposits that have not been given good value by the registrar, to settle trade.

Buying-In

If a seller fails to have shares in his CDS account to settle a trade on T+5, his trade will fail and a buying-in will be instituted against him on the next market day.

While selling through the normal mode can be done without having shares in the seller's CDS account, selling through a buying-in can only be done if there is a "free" balance or a "bought lien" balance in the seller's account as the shares will be debited when the order is matched. 'Free' balance means that the shares in the CDS account have been given good value and are good for all CDS transaction. 'Bought lien' on the other hand applies when the shares are pending payment by the buyer and is under a lien to the broker. Bought lien shares cannot be transferred or withdrawn.

Trade Netting In The CDS

Trades are netted at client level under the CDS, as opposed to SCANS Daily Netting System (DNS) of netting at broker level.

To put it simply, under a scenario where three of the four investors of a broker sell 1000, 2000, 3000 shares of Security A respectively and the fourth investor buys 10,000 shares of the same security, then under CDS there will be debiting of 1000, 2000, 3000 shares of Security

A from the respective accounts of the selling investors and crediting of 10,000 shares into the account of the buying investor. Whereas under the SCANS Daily Netting System there will be a net buy of 4000 shares (10,000 - 1000 - 2000 - 3000) for the broker without going into details at individual investor level.

The following example would further clarify the netting at client level.

If an investor purchases 2000 shares of Security A and sells 1000 shares of the same security on the same day, then only 1000 shares of Security A will be credited into his CDS account on T+5. However, the statement of the accounts will show both the transactions.

Trade Settlement Fees

Investors will continue to pay the trade fees as currently practised, and no additional fees will be payable for trade settlement under the CDS. The settled trade will automatically be registered in the name of the buyer and no fees would be charged for the same.

The Computer

The central computer used in the operation of the CDS is a Tandem Cyclone mainframe. It is a fault tolerant system designed in such a way that the processors, disc controllers and disc drives work in pairs. When one unit goes down, the other unit of the pair will take over, without affecting the processing.

Data entry of transactions is carried out on-line. However, the balances are updated at the end of the day. This is to enable MCD to perform adequate checks on deposit, withdrawals and transfers, even after they have been verified by the ADAs. This is an additional important security measure taken before the updating of balances are carried out.

Compensation Fund

MCD has set up a Compensation Fund to meet possible claims from investors, if they suffer losses arising out of its own staff's infidelity, professional negligence and computer crimes. All Authorised Depository Agents and Authorised Direct Members are required to have sufficient insurance covers, and indemnify MCD against any losses as a result of neglect at their end. The Compensation Fund, is separate from the Fidelity Fund operated by KLSE as mandated by the Securities Industry Act, 1983.

Legal Structure

To ensure investors are protected the Securities Industry (Central Depositories) Act, 1991 was passed by Parliament in early 1991. This Act governs the operations of the CDS to ensure maximum protection for the investor.

In addition, MCD has a set of rules, known as the Rules of the Malaysian Central Depository Sdn Bhd, which complement the Act and complete the legal framework.

Current Developments

MCD has been carrying out a re-engineering of the computer system of the CDS since early 1994. The re-engineering project is now nearing completion and the proposed implementation of the new system, i.e. **CDS-2** is scheduled for mid-1995.

The objective of the exercise is to improve the processing efficiency of the CDS to cater for far greater transaction volumes associated with the conversion of Main Board companies list on KLSE and subsequent trading of shares in these companies. In brief, the re-engineering exercise involves a more extensive use of on-line processing where the current CDS-1 is more batch oriented.

The re-engineering process essentially does not alter the functionalities of the current CDS-1. Opportunities have been taken to make a few cosmetic improvements to the system to make it more user friendly with more extensive use of on-line processing and faster processing time.