

# ENTRY, EXIT, OWNERSHIP STRUCTURE AND THE EFFICIENT MARKET HYPOTHESIS: A CASE STUDY OF THE KUALA LUMPUR STOCK EXCHANGE

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## Abstract

The objective of this paper is to provide a new theoretical perspective on testing the Efficient Market Hypothesis in the Kuala Lumpur Stock Exchange (KLSE). Previous studies have shown that the KLSE is weak form efficient or at most semi strong form efficient. However, an adequate explanation has not been provided as to why the KLSE is not strong form efficient. The paper suggests that this is because the KLSE does not approximate the neoclassical competitive model in terms of entry, pricing and exit. There are barriers to entry and exit and hence to the free flow of accurate and complete information in the KLSE. The securities offered for sale are also underpriced as there is extensive government intervention to ensure adequate returns to investors. The market is also dominated by large government owned and family owned conglomerates. This together with a segmented market for three classes of investors, that is, the bumiputras, the other Malaysians and foreigners ensures that resources are not allowed to flow to their most value users and hence prices are not competitively set. The paper ends by noting that the KLSE is moving from a government dominated exchange for securities to a market system as a result of recent reforms and policy changes.

**Keywords:** Kuala Lumpur Stock Exchange, Efficient Market Hypothesis, Competition, Concentration of Ownership, Entry, Exit, Initial Public Offer, Pricing of Securities

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## I. Introduction

In studying stock markets, researchers have been faithful in testing Fama's justly famous Efficient Market Hypothesis (Fama, 1970) as laid out in his seminal paper of 1970 as to whether the stock market is informationally efficient or inefficient. Refinements of informational efficiency have also been presented in Fama's 1970 seminal paper and they relate to whether the market is efficient in a weak form, a semi-strong form or a strong form. A market is considered "weak form efficient," if prices reflect historical information. In other words, since historical information cannot be concealed, no one investor will be able to benefit at the expense of other investors by using historical information because no one investor will have a comparative advantage in terms of information. So it will then be obvious that all stock markets are weak form efficient as long as historical information about prices are easily available to all investors at very low transaction costs. Several studies of the Kuala Lumpur Stock Exchange have also come to the conclusion that the KLSE is weak form efficient (Annuar and Shamsher, 1993; Kok and Goh, 1995).

However, very few markets in the emerging markets have been described as semi-strong form efficient or strong form efficient. A market is considered semi-strong form informationally efficient if stock prices reflect all historical as well as all published information and if these historical and

published information are easily available to all investors at very low or zero transaction costs. A market is considered as strong form informationally efficient if stock prices reflects all historical and published information and insider information. Considering the fact that emerging markets are informationally poor it is not surprising that they are not strong form efficient. They are also not semi-strong efficient because public information becomes available after the event and is therefore historical information and not current information.

Considering the fact that emerging markets are at most only semi-strong efficient and very often weak form efficient, prices would not reflect all information and therefore would not be competitively set and the prices quoted in the KLSE do not reflect the scarcity value of the assets that are traded. In the neo classical perfectly competitive market model, a key assumption is that complete and accurate information is available to all participants in the market and there is a free flow of information implying that the transaction costs of obtaining information is zero or near zero. The perfectly competitive model also assumes that there is ease of entry and exit into the market and industry and there are no barriers to entry. There are no artificial obstacles to prevent new firms from entering or existing firms from leaving the industry in the long run. Firms and the resources they employ are shiftable, or mobile. The purely competitive industry is composed of a large number of independent sellers and

buyers. The firms offer a standardized product. No individual or firm supplies enough of the product to influence its market price noticeably. As a result of this structure, prices are set competitively as no firm can benefit from concealing information as all information is available to all buyers and sellers in the market. A good explanation of why the stock market in emerging economies is only weak form efficient in the Fama sense is because the structure of the stock market is not competitive.

In this study we attempt to study as to whether the KLSE approximates the neo classical perfect competition model in terms of (i) entry conditions; (ii) price determination, that is, is price determined by supply and demand; (iii) whether the market is dominated by a few firms and exercise undue influence on the market and (iv) the ease of exit. In describing the structure of the stock market in terms of entry and exit conditions, price determination and dominant position of some actors in the industry or market, we also throw light on the free flow of accurate information, that is crucial to ensure transparency, good corporate governance and efficiency as postulated by Fama's Efficient Market Hypothesis. It is not sufficient to test the EMH by using stock prices but also to describe the institutional structure of the stock market to determine whether the structure facilitates the free flow of information or inhibits it or whether there are opportunities to benefit from asymmetrical information, moral hazard and adverse selection. However, before that we give a short history and describe the structure of the KLSE to put the discussion in perspective.

## **II. Structure of the KLSE**

The KLSE was established in 1973 but was linked to the Singapore Stock Exchange, from which it was separated in 1990. The KLSE is a public limited company incorporated under the Companies Act 1965. It is not demutualized and has no shareholders or share capital but only two classes of members, that is, voting and non-voting members. The voting members as defined in KLSE's Articles of Association are the executive directors of stockbroking firms, whereas non voting members may either be stockbrokers or others, which may include individual and corporate shareholders and non executive directors of the stockbroking firms. The KLSE has about 56 voting members and 313 nonvoting members.

The KLSE is managed by a nine member committee, who are either appointed by the Minister of Finance or elected by the voting members of the exchange. Article 9.2(a) of the Securities Industry Act, 1983, provides that the Executive Chairman and three other members of the KLSE would be appointed by the Minister of Finance, whereas the remaining five members would be elected by the voting members of the KLSE. The Chairman of the Securities Commission that regulates the KLSE is also appointed by the Minister of Finance. The Chairmen of the

KLSE and the Securities Commission and all other appointed members serve at the pleasure of the Minister of Finance. The elected members are eligible to serve for a maximum of six years.

About 942 companies were listed in the KLSE as of July 2004. Of these 613 were listed in the Main or First Board and 280 were listed in the Second Board. The total market capitalization of the KLSE was RM653.02 billion in May 2004. The Second Board, which is for smaller companies, is miniscule in comparison to the First Board in terms of capitalization. The only other exchange is MESDAQ, which has listed 49 companies and started operations in 1997 and which is dedicated to high growth and technology stocks is also owned by the KLSE. The Labuan International Financial Exchange (LFX) an offshore financial exchange is also owned by the KLSE. Besides these the KLSE also owns MDEX, which offers equity derivatives, financial derivatives and commodity derivatives (Bursa Malaysia, 2004).

The President of the Exchange is responsible for the day to day operations of the fully computerized order driven market. A group of companies has been set up by the KLSE to disseminate real time information; to operate the central depository type of electronic settlement system; to register shares; to clear shares and to conduct research and disseminate research findings. The companies that have been set up are respectively KLSE-Bernama Real-Time Information Services (KULBER), Malaysian Central Depository (MCD), Malaysian Share Registry Services (MSRS) and Securities Clearing Automated Network Services Sdn Bhd (SCANS) and the Research Institute of Investment Analysis Malaysia (RIIAM).

The regulator of the KLSE under the Securities Commission Act (SCA), 1993, the Securities Industry Act (SIA), 1983 and the Futures Industry Act (FIA), 1993 is the Securities Commission. The Securities Commission is the sole regulatory authority of the Malaysian Capital Market and the SCA empowers the SC to supervise and monitor the activities of exchanges and the SIA and FIA empowers the SC to approve the business rules of the exchanges in Malaysia. The SC however does not have any shareholding or MOU with the exchanges and the SC does not regulate the solvency of the exchanges. The SC is responsible to the Minister of Finance for the supervision of the securities industry together with Bank Negara Malaysia (Central Bank of Malaysia), the Foreign Investment Committee and the Registrar of Companies, who are also responsible to the Minister of Finance. The government is not only the regulator of the KLSE but is actively involved as a participant as its investments in the KLSE account for more than a third of the market capitalization of the KLSE (Claessens, et.al., 1999:3).

The KLSE has also in place some risk management measures including ensuring that the stockbroking firms have adequate capital adequacy ratios (CARs). It has also incorporated internal procedures to deal with default risk, settlement risk

and market disruptions. To protect investors against default risk, the KLSE has set up a Compensation Fund and licensed members under the SIA are required to make contributions to the Compensation Fund every year. A standby facility has also been established by the KLSE and SC in the eventuality any stockbroking firm is unable to meet its obligations to the clearing house. The maximum amount a stockbroking firm may borrow per day is RM10 million. In the case of market disruptions the KLSE is expected to inform the SC, which is expected to take appropriate action.

Under the Capital Market Masterplan released in 2001, there is expectation of that all the exchanges will be consolidated into one and that the single Malaysian exchange would be demutualized and would be listed by 2003. However, to date the consolidation and demutualization has not occurred as progress has been slow.

### III. Entry Conditions into the KLSE

If entry into the stock market is costless the number of firms listed in the exchange would equal the number of firms registered with the Registrar of Companies. However, the number of companies registered with the Registrar amounts to more than 626,000 (Government of Malaysia, 2004) whereas the number of firms listed in the exchange is only slightly more than 940 (KLSE, 2004). This is a very small percentage. However, this small percentage is not entirely due to the regulations or restrictions imposed or erected by the KLSE or Bursa Malaysia. The majority of firms in Malaysia are small family owned firms that may not find listing in the KLSE to seek equity financing as advantageous as they may lose control over the firm. Some may not want to be subjected to new regulations and disclosure requirements of the exchange. Similarly, some of the larger firms like the government owned Commerce Bumiputra bank may also not want to be listed for strategic reasons and in the national interest. The large multinationals may also not want to seek listing with the KLSE because they may not be familiar with the rules and regulations in a new culture and they may find local definitions of transparency and good corporate governance as being different. They may also face an information environment that is asymmetrical and so they would prefer to avoid problems of moral hazard and adverse selection. However, some of the corporations may find it difficult to gain listing because the probability of being listed is not 1. For example, of the 122 firms that sought listing in the First and Second Board of the KLSE between 1999 and 2001, only about 65% were successful (Mustapha Mohamed, 2002:2). This may be due to the inability of applicants to meet the stringent listing requirements set by the KLSE.

The KLSE has set both quantitative and qualitative requirements that a firm must comply with to be listed in the Stock Exchange. The quantitative requirements refer to the minimum paid up capital and profit record of firms seeking listing in the First and

Second Board respectively. The qualitative requirements refer to the issuance of prospectus, corporate governance, listing fees, disclosure, compliance with the New Economic Policy and Bumiputera equity participation rules and restrictions on foreign investment.

#### (i) Quantitative Requirements

The minimum paid up capital for main board companies has been set at RM60 million, comprising ordinary shares of RM1 each. In the case of Second Board companies, the minimum paid up capital has been set at RM40 million comprising also of ordinary shares of RM1 each. Firms are also required to have an uninterrupted profit track record of between three to five years to qualify to be considered for listing in either the Main or Second Board of the KLSE. They are also required to show a minimum after tax profit of RM8 million for the most recent year if they are seeking listing in the Main Board and RM4 million if they are seeking listing in the Second Board.

**Table 1.** Listing Requirements for the Main Board and the Second Board, KLSE

	Main Board	Second Board
Uninterrupted Profit Record	3 to 5 years	3 to 5 years
Aggregate After Tax Profit	Minimum RM30 million over 3 to 5 year period	Minimum RM12 million over 3 to 5 year period
Minimum After Tax Profit Per Year for most recent year	RM8 million	RM4 million
Minimum Issued and Paid Up Capital	RM60 million	RM 40 million

Source; Bursa Malaysia, 2004

**Table 2.** Shareholding Spread for Initial Public Offers

Nominal Value of Issued and Paid-Up Capital	Minimum number of shareholders
RM40-60 million	750
RM60-100 million	1,000
More than RM100 million	1,250

Source: Bursa Malaysia, 2004

It appears clear from Table 1 that the listing requirements are biased towards reducing risk in the KLSE and to provide protection to investors against firms that are not sustainable. It is also noticeable that small and medium firms with a low capital base of below RM40 million and a low profit record but sustainable are excluded from being eligible for listing in the KLSE. The shareholding spread has also been set to discourage concentration in the shareholding structure so as to avoid expropriation by majority shareholders.

It is obvious from Table 2 larger companies are required to have a greater number of shareholders than smaller companies.

*(ii) Issue of Prospectus*

A firm seeking listing in the KLSE needs to provide a prospectus or introductory statement that complies with the Securities Commission's Prospectus Guideline for Public Offering. The prospectus has to be widely circulated through the main English or Malay newspapers in Malaysia. The information that should be revealed through the prospectus include (i) the issued and paid up capital; (ii) the shareholding spread; (iii) the names of directors and substantial shareholders; (iii) the historical profit and loss statement and (iv) the audited profit and dividend record for the past few years.

*(iii) Corporate Governance Requirements*

In the case of directors a stipulation has also been made that at least two or one third of the directors, whichever is higher, should be independent and the audit committee should be made up of independent directors (Securities Commission, 1999). The categories of person ineligible to act as independent directors include major shareholders, relatives of executive directors or major shareholders or professional advisors to public listed companies (PLCs). This is to prevent conflicts of interest. The Independent Director is expected to be independent of management and free from any business or other relationship which could interfere with the exercise of independent judgment or the ability to act in the best interest of an applicant or listed issuer (Bursa Malaysia, 2004). The directors are also expected to attend at least 50% of all meetings. The KLSE is also empowered to grant exceptions to this rule (Asia Law Profile, 2002). The listed firms are also required to disclose on a continuous basis quarterly reports inclusive of balance sheet components (Bursa Malaysia, 2004).

*(iii) Listing Fee*

While the information requirements may seem immense, the listing fee is modest relative to the paid up capital of the firm. It is in fact miniscule because it ranges from RM100 to a maximum of RM 750 for companies with a paid up capital ranging from RM2 million to RM100 million.

*(iv) Merit Based to Disclosure Based Listing*

The criteria for being listed are not always clear as the listing decision is merit based and until today has not been completely transformed to being disclosure based. Under the merit based regime, a judgment on whether to approve the listing can differ from company to company. This is what is meant by the merits of the case. The decision may not be transparent and the criteria used and the information used to make the decision may not be disclosed to the public. The regulators could also arbitrarily dictate the initial price

of each share of the firm, whose listing it has approved. However, in sharp contrast under the disclosure based regime, which is as yet not fully operational, the powers of the regulators, are curtailed and brought into check, as the quality of public disclosure plays an important role in listing decisions.

On commenting on the move to disclosure based regulations, the APEC Secretariat has noted that the new provisions to securities laws in Malaysia would "enhance transparency and investor protection. These amendments are intended to strengthen the regulatory framework for good ethical practices, transparency and corporate governance by requiring accurate and timely disclosures, fair dealing by directors and good corporate governance" (APEC Secretariat, 1999:3).

*(v) New Economic Policy and Bumiputra Equity Participation*

Government regulations under the New Economic Policy (NEP) of 1971, require that at least 30% of the new shares under Initial Public Offers (IPOs) should be reserved for the Bumiputra community as part of affirmative action to redress economic imbalances among the major races of the country. This may represent share market segmentation as there are three major classes of investors in the country, that is, the Bumiputeras, the non-Malays and the foreigners. After 1990, when the New Economic Policy was replaced by the National Development Policy (NDP), the government continued to require that a minimum of 30% of the shares offered should be allocated to Bumiputera investors upon listing. It appears that companies seeking listing that did not comply with this requirement would not be considered for listing (Bursa Malaysia, 2004).

Despite the criteria governing listing or entry into the stock exchange, the Bursa Malaysia retains powers, to exercise discretion over the admission and continued listing of securities on its Official List and may approve or reject applications as it deems fit. The company applying for listing has to get prior approval from the Securities Commission, the Registrar of Companies, the Foreign Investment Committee, the Licensing Officer in the Ministry of Finance and other relevant authorities before listing and quotation.

*(vi) Restrictions on Foreign Firms*

Prior to September 2003, foreign firms that are controlled by foreigners were not allowed to be listed in the KLSE. There has been some liberalization of entry requirements for foreign firms in an attempt to make the KLSE globally competitive (Tiem Ker Wei, 2004). Four types of companies that were previously barred from seeking listing in the KLSE are now allowed to list themselves. These categories of firms include: (i) Malaysian owned locally incorporated companies with substantial overseas operations; (ii) Malaysian and foreign owned overseas incorporated companies with substantial local operations; (iii) Malaysian owned overseas incorporated corporations

with substantial foreign operations (The Star, September 20, 2003). These new rules replaced guidelines that restricted KLSE listings to Malaysian incorporated companies with the majority of operations located in the country. However, under the new rules, foreign corporations can only seek listing to the Main Board and must obtain the prior approval of the domestic regulatory authorities. The foreign firms must also be incorporated in centers with “comparable corporate laws and enforcement” (The Star, September 20, 2003).

In other words the foreign firm must be incorporated in a jurisdiction acceptable to the Securities Commission. The jurisdiction should be subject to similar laws and regulations in reference to the constitution of a corporation, composition of directors, rights and obligations of shareholders and minority interest protection; conduct of meetings and proceedings; accounts and audits; file keeping of notices, returns, registers and other company records and regulation of takeovers and mergers; enforcement of laws involving fraud and dishonesty and the existence of relevant laws, treaties in the foreign jurisdiction that could facilitate the enforcement of criminal and civil actions taken in Malaysia. Foreign equity participation in Malaysia is governed by the FIC Guidelines for the Regulation of Acquisition of Assets, Mergers and Takeovers and Section 4(4) of the Industrial Coordination Act, 1975. The application usually takes nine months to approve.

#### IV. Initial Pricing of Securities

Before a company is listed in the KLSE, its share price has to be determined in what is called an Initial Public Offer (IPO). It is quite common in most countries for the IPOs to be underpriced as information as to the intrinsic value of a share that has not been traded is not available but what is more important is that an undervalued asset is more tradable. However, it has been found that IPOs in Malaysia are generally underpriced to a greater extent than IPOs in other countries.

It is clear from Table 3 that except for China, the level of underpricing of IPOs in Malaysia is the highest. One plausible reason for the underpricing is to ensure that all informed and uninformed investors, including the bumiputera community, who are allocated 30% of all new equity shares, receive a very favorable return. Another plausible reason is that given asymmetrical information, the average uninformed investor will only be induced to subscribe to an IPO if he is guaranteed a very high return. Asymmetric information increases the risk of the IPO and unless IPOs have a relatively high return, investors will not be persuaded to invest in an IPO.

It has been postulated that the three major parties to an IPO, that is, the underwriter, the issuing company and the investors do not have access to the same information. Rock (1986) has assumed that there are two classes of investors, that is, the informed and the

uninformed investor and the latter is assumed to have superior information in relation to the former. The informed investor will only compete for good issues, whereas the uninformed investor may be left with lemons and so his investment decision is more risky. Without a discount or underpricing, the uninformed investor will withdraw from the market. While Rock has a plausible model, it is in reality difficult to differentiate between an informed and uninformed investor.

It is possible that underwriters have an incentive to undervalue an IPO to ensure that all the shares offered are sold for otherwise the underwriter will be liable for unsold shares.

**Table 3.** Summary of Evidence of Underpricing of IPOs in Emerging and Developed Markets

Country	Study	Sample Size	Time Period	Average Initial Returns
Malaysia	Dawson (1987)	21	1976-1983	166.7
	Yong (1991)	33	1983-1988	167
	Ku Ismail et.al (1993)	63	1980-1989	114.6
	Nasir et.al. (1998)	112	1990-1995	78
Singapore	Dawson (1987)	29	1979-1983	37.5
	Koh and Tee (1985)	62	1973-1984	33.8
	Wong and Chiang (1986)	64	1975-1984	36.8
	Lee et.al. (1996)	132	1973-1992	31.4
Thailand	Wethyavivorn and Koo-Smith (1991)	32	1988-1989	56.7
Hong Kong	Dawson (1987)	21	1978-1983	13.8
China	Su and Fleisher (1999)	308	1987-1995	948.6
Turkey	Kymaz (2000)	163	1990-1996	13.1
Greece	Kzantzis and Levis (1995)	79	1987-1991	48.5
Brazil	Aggarwal et.al. (1993)	62	1980-1990	78.5
United States	McDonald and Fisher (1972)	142	1969	28.5
	Logue (1973)	250	1985-1989	41.7
	Stoll and Curley (1974)	205	1957-1963	60.6
	Ibbotson (1979)	771	1960-1969	11.4
	Ritter (1984)	5126	1960-1982	18.8
	Ibbotson, Sindelar and Ritter (1994)	8668	1977-1982	16.37
	Chalk and	649	1975-	21.65

	Peavy (1987)		1982	
	Miller and Reilly (1987)	510	1982-1983	9.87
United Kingdom	Merritt et.al (1967)	149	1959-1963	13.7
	Buckland, Herbert and Yeomans (1981)	297	1965-1975	9.6
	Lewis (1990)	123	1985-1988	8.6
Australia	Noti and Hadjia (1983)	47	1972-1980	20.8
	Finn and Higham (1988)	93	1966-1978	29.2
Canada	Jog and Riding (1987)	100	1971-1983	11.5

Source:

<http://www.sm.umist.ac.uk/dissertation/dissertations/SuanchinOngSections%201-5.pdf>

Work done by Carter and Manaster (1990) show that the reputation of an underwriter also determines the extent of underpricing. The role of the underwriter has also been downplayed in Rock's model. They report a negative relationship between the prestige or credibility of the underwriter and the extent of underpricing. The uninformed investor will trust the share price valuation of the credible underwriter and would not perceive the investment as being risky and so would not demand such a high discount. Similarly Beatty and Ritter (1986) also found that the reputation of an investment bank, which may act as an underwriter, was inversely related to the level of underpricing. The level of underpricing is also related to the uncertainty before the stock is listed. This ex ante uncertainty can be reduced by the size of the firm. IPOs of larger firms are not as underpriced as IPOs of smaller firms (Miller and Reilly (1987) and Ritter (1991)). A similar finding for Malaysia was reported by Othman Yong (2004).

The time to market also has an effect on ex ante uncertainty. It has been found that the offer price of an IPO has been set on an average of 119 days before listing. In other words the lag time between the release of an IPO prospectus and the listing of an IPO has been 119 days or nearly 4 months. This has, however, been reduced over time. The underwriter cannot predict the listing time required and so fixes the offer price without adequate information. Because the lag is quite long, the market valuation of an IPO share may change after the offer price has been set. However, without prior information, the probability is that underwriters will be more concerned to fix the price very low in case the market valuation decreases during the 119 days. The longer the time to market, the larger the information leaks and the greater the probability that uninformed investors will require a larger compensation for bearing ex ante uncertainty.

Under the merit based listing process currently practiced, the offer price is set by the regulator with a

P/E ratio of 3.5 to 15.5 times of the forecasted earnings per share of the IPO. The P/E ratio also differs by sectoral classification and the merits of the proposed investments. Although the limits on offer price levels were withdrawn in 1996, the Securities Commission still retains the final authority to approve the offer price. There is no competition to the KLSE and as a result the KLSE and the Securities Commission have a monopoly position in setting prices. In the case of the New York Stock Exchange Demsetz (1968) has argued that competitive pressures from related and rival markets will avoid excessive spreads (Gehrig and Jackson, 1998:89-119). According to Demsetz (1968:43), "competition of several types will keep the observed spread close to cost. The main types of competition emanate from (1) rivalry for the specialist's job, (2) competing markets, (3) outsiders who submit limit orders rather than market orders, (3) floor traders who may bypass the specialist by stressing buy and sell orders themselves, (5) and other specialists." In the case of the KLSE, the IPOs may be underpriced because of lack of competing markets. The number of underwriters are also limited in Malaysia.

The general tendency is not only for all IPOs to be underpriced but also to fall within a narrow range so that they are affordable to the general public. The underwriters and the listing committee have to ensure the sales of the shares offered and to play safe they tend to operate on the low conservative side. When this happens a world class Multinational Corporation (MNC) may be valued at the same price as a Second Board local small company. This is not surprising if one is familiar with the literature on the "market for lemons."

The market for lemons suggests that all goods that appear alike will get the same price. For example, a 1997 Toyota will sell in the second hand market for the same price regardless of the condition of the car or the accessories that the car carries. Will then the owner of a good second hand 1997 Toyota offer his car for sale? Obviously not because he is only going to get the average price, which does not reflect the true market value of the car. So he will not offer his car for sale and hence only bad 1997 Toyotas will be offered for sale. The buyer in the second hand car market will then have the dilemma of paying an average price for an inferior second hand car. If he makes an adverse selection then he will have the moral hazard that the car will not perform.

Similarly an MNC will not want to be underpriced and be compared to a lemon or put on the same shelf as a lemon. The MNC will not want the problem of making the adverse selection of seeking to be listed on the KLSE (Bursa Saham) and later finding out that there is a moral hazard that the KLSE (Bursa Saham) will not value its shares appropriately and the low price assigned to the shares will make it easier for the local speculators to gain control of the MNCs. The MNCs also worry that the rules of the game may suddenly change that may make them vulnerable to

takeovers or mergers by local entrepreneurs eager to create new synergies and wealth. The MNC in seeking listing is entering a new terrain, which he is unfamiliar with and which is still evolving systematic rules for dealing with share ramping and insider trading and to improve corporate governance.

**V. Ownership Concentration and Efficient Equity Markets**

In the extreme case of a single issuer of stocks, the investor will have access to very little information as the monopolist would have an incentive to conceal information. Similarly, in the case of an equities market that is characterized by ownership concentration in a few hands, the investor will not have access to all the relevant information as there are no competitors with an interest to generate more complete and accurate information. Furthermore, there is the danger that the regulators, that is, the Securities Commission and the Bursa Malaysia may be captured by the regulated as postulated by Stigler (1966).

In a recent study, Khatri et.al., have noted that “Malaysia like the other crisis countries is characterized by insider system of corporate governance, with high levels of ownership concentration, crossholding and significant participation of owners in management. A few large corporations own a significant proportion of financial assets and productive capacity in Malaysia; stock ownership is concentrated in the hands of a relatively few institutional and corporate investors; and cross-holding of share ownership, or pyramiding, magnifies the actual control of a few individual entities well beyond their level of ownership in each company” (Khatri, et.al, 2004:7).

In a different study, Claessens et.al., found that more than 84% of the publicly traded companies in Malaysia, were either family owned or state owned. Of these about 43% were family owned and about 34% were state owned. In the case of the largest 20 corporations, about a third of the largest 20 corporations were owned by the state and about a third were owned by families indicating a high concentration of ownership (Claessens et.al., 1999:33).

The state has acquired assets in the KLSE through its various investment arms including Permodalan Nasional Berhad (PNB), Khaznah Holdings and Ministry of Finance (MoF) Incorporated, the Employees Provident Fund (EPF) and other government assisted institutional investors including the Armed Forces Fund (LTAT), the Pilgrim’s Fund (LUTH).

The Ministry of Finance (MoF) Inc has substantial shareholdings in Telekom Malaysia, Malaysian Airport Holdings, Commerce Asset Holdings, DRB Hicom, Bintulu Port, Malaysian Airlines System and Tenaga Nasional Berhad. These are all large firms in terms of capitalization. Forty GLCs account for 34% or RM232 billion in market capitalization of the KLSE (Bursa Malaysia, 2004). The government has also majority ownership of 7 of the

top 10 companies listed in the KLSE. These include Telekom Malaysia, Malayan Banking, Tenaga Nasional, Petronas Gas, Sime Darby and Commerce Asset Holding. The rest of the top ten companies are majority owned by Chinese families and these include Resorts World, Genting and YTL Corporation.

As a result of the enabling environment created by the government, the KLSE or Bursa Malaysia is dominated by SOEs or privatized SOEs over which the government has control because it has a Golden Share in these privatized entities and the Golden Share gives it veto rights. The KLSE is dominated by Telekom, Tenaga Nasional Berhad and other Government Linked Corporations (GLCs) that constitute more than a third of the capitalization of the KLSE (Claessens, et.al., 1999). These companies are not entirely efficient as there is no incentive to lower costs as they are not regulated and they are monopolies. Their profits are guaranteed by the government.

Being dominant in the market and in the composition of the main Kuala Lumpur Composite Index (KLCI) they can easily influence the outcome of the Index and the market. As large monopolies requiring lumpy investments they are unlikely to have competition as the set up costs are too high in an essentially uncontestable market.

Furthermore, the government fund managers that is MoF Inc and Khazanah adopt a long term strategy and do not buy and sell to make profits. As a result there is not much trade in government held securities and this has led J.P Morgan to remark that the government provides the floor of the market and the peaks and troughs are accounted for by the flow of foreign portfolio investments. To quote JP Morgan, “while Government linked funds provided a floor to share prices, foreign funds flow were the key catalyst in determining bull and bear markets” (J.P. Morgan, 2003:8).

**Table 4.** Control of Publicly Traded Corporations in Malaysia (weighted by market capitalization)

Number of Corporations in Sample	238
Widely held	1 %
Family held	42.6%
State held	34.8%
Widely held financials	1.1%
Widely held corporations	5.3%

Source; Claessens, et.al; 1999:32

**Table 5.** Percentage of Shares owned by Ministry of Finance Inc and Khaznah (Government Holding Company) in several listed companies in the KLSE

Name of Firm	Ministry of Finance (Inc)	Khazanah	Ranking in terms of market capitalization

Telekom Malaysia	19%	32%	1
Malaysian Airport Holdings	49%	23%	
Commerce Asset Holdings	8%	13%	8
DRB-Hicom	5%	5%	
Bintulu Port	42%		
Malaysian Airlines	69%		
Tenaga Nasional Berhad	17%		2

Source:

[http://www.jefooi.com/archives/2004/05/how\\_to\\_short\\_cha.php](http://www.jefooi.com/archives/2004/05/how_to_short_cha.php)

**Table 6.** Substantial Shareholdings (%) of Key Domestic Public Institutional Investors in Public Companies Listed in the KLSE, 1998

% of Shareholdings	EPF	KH	LTAT	LUTH	PNB
Main Board					
5-10	40	4	9	16	22
10-15	10	-	3	6	10
15-20	2	1	-	4	3
20-30	2	-	4	2	2
30-50		1	1	-	5
>50		1	2	-	2
Second Board					
5-10			1	4	28
10-15			-		5
15-20			-		12
20-30			1		4
30-50					1
>50					

Source; SBC Warburg Dillon Read, Malaysian Connections, January 1998

EPF-Employees Provident Fund

KH – Khazanah Holdings

LTAT- Armed Forces Fund

LUTH-Pilgrim's Fund

PNB – Perbadanan Nasional Berhad

The Malaysian government has performed its custodial role in the market by acting as a money pump to correct what it perceives to be incorrect prices or market failure. It formed a firm called ValueCap with a market capitalization of RM10 billion to correct for market failure in the KLSE. According to the then Economic Advisor to the Government, "ValueCap will not be used to prop up the market beyond its fundamental value nor bail out distressed government linked companies... ValueCap's objective is to buy shares that have fundamental values but were underpriced"

(<http://www.geocities.com/CapitolHill/3939/IKs2041.html>). According to the Malaysian Institute for Economic Research (MIER), "ValueCap was formed with funds amounting to RM10 billion with the intention of buying undervalued stocks that have good prospects" and "to boost confidence in the sagging stock market" (MIER, 17 April, 2003).

However, others see a political motive in the government injecting funds into the stock market. According to the Asean Focus Group in Australia, "A RM10 billion state controlled fund, ValueCap Sdn., has been established to buy stocks deemed 'undervalued'. Since 10 January this year (2003), when it started operations, the KLSE Composite Index has gone up at least two percent. Anecdotal evidence from past elections indicates a direct link between a healthy stock market with a healthy vote for the government" (Asean Focus Group, 2003). According to the Asia Times, "In the aftermath of the 1997 Asian financial crisis, Nor Mohamed (Economic Advisor to the Government of Malaysia) was tasked with rescuing firms that were regarded as strategic to the state's interests. Among those he was involved in restructuring were politically well-connected firms such as Malaysian Airlines, the UEM Group and Malaysian Resources Corporation Berhad" (AsiaTimes Online, January 9, 2004). The Economics Intelligence Unit (EIU) has commented that Khazanah's RM3.8 billion takeover offer of a politically connected firm, that is, United Engineers (M) Bhd. as a first step to restructuring the Renong Group has the support of the Prime Minister (Economist Intelligence Unit, June 25, 2001). However, the government has defended its intervention in the market to ensure that the ethnic ownership targets of the New Economic Policy are achieved.

However, the government's intervention in the market has also been seen as not helpful in attracting foreign investments. According to BizAsia, "ValueCap, which was designed to prop up Malaysian government related companies, could drive off foreign investors. ValueCap spent RM10billion (USD2.6billion) on shares of state owned companies, that is, Tenaga Nasional Berhad (TNB) and Telekom Malaysia. ValueCap is jointly owned by Khazanah Nasional and Permodalan Nasional Berhad (PNB), two state owned investment arms" (BizAsia.com, 2003). Khazanah Nasional is owned by the Ministry of Finance Incorporated, which is controlled by the Ministry of Finance. The PNB is also government owned and invests on behalf of bumiputeras. ValueCap represents 2% of stock market capitalization. The government has taken note of the tradeoff between wanting to distribute assets and jump start the economy.

Standard and Poor (S and P) had also expressed concern that the purchase of undervalued stocks may delay the quest for a balanced budget by diverting funds to the stock market. The government, according to S and P was also setting up an unsustainable asset bubble. S and P also warned that "a continuance of



ValuCap policy could result in a downgrade of Malaysia's rating by S and P" (BizAsia.com, 2003).

## VI. Exit Policy of the KLSE (Bursa Malaysia)

Table 7 shows that the number of companies listed in the KLSE has grown steadily over the period between 1973, when the KLSE was established, and 2004. In fact the growth rate has been positive in all years except a few. In only eight years of the thirty one years of the existence of the KLSE have firms been delisted from the KLSE and as a result the growth rate of firms listed has been negative in the years immediately after those eight years. The delistings occurred in 1990 and before. In 1990, about forty firms were delisted accounting for more than half the total number of firms delisted between 1973 and 1990. However, after 1990 the delisting policy appears to have changed as no firms were delisted after 1990.

The current policy reaction is to list the companies that are insolvent or distressed or in poor financial condition or in violation of the rules and regulations of the KLSE as PN4 companies. It is estimated that there are in total 100 companies that are classified as PN4 companies and only one is expected to be delisted (The Star, September 13, 2003). The PN4 companies are either (i) given time to restructure their finances while their shares are still being traded or (ii) given time to restructure and satisfy the listing requirements of the KLSE while their shares are suspended.

Restructuring firms have value as long as they are not delisted because they may be the target of predators and merger partners or friendly acquirers of their businesses. The listing status of an insolvent company is valuable to firms wanting to raise equity capital because under the merit based listing system, it is costly and time consuming to get listed. In view of these, the number of companies listed in the KLSE has not declined since 1990 and, in fact on the average, the total number of companies listed in the KLSE has grown at a healthy average rate of more than 9% since 1990.

The Government has also a vested interest to keep distressed companies listed by allowing them to work out their deficiencies because the government itself has investments in companies listed in the KLSE and it wants to prevent bankruptcies and retrenchments to avoid the economy wide repercussions of widespread corporate bankruptcies. There is also no investor protection program and as long as firms are listed, the investor has the opportunity to still regain his investment. This motivates the government to keep the firms listed.

After the 1997 East Asian financial crisis several large corporations were in financial distress as a result of the sharp fall in their share prices. The Government set up the Corporate Debt Restructuring Committee (CDRC) to get the large corporations and banks to restructure corporate debt.

**Table 7.** Total Firms, New Firms, Rate of Growth of Firms in the KLSE and the Number of Firms Delisted in the KLSE (Bursa Malaysia), 1973-2004

Year	New Entrants	Total Firms	Total Firms Less New Entrants	Rate of Growth (%) of Total Firms Less New Entrants	Number of Firms Delisted
2004	23	937	914	5.29	0
2003	38	906	868	5.33	0
2002	44	868	824	4.04	0
2001	20	812	792	4.62	0
2000	38	795	757	2.85	0
1999	21	757	736	3.95	0
1998	28	736	708	14.19	0
1997	88	708	620	17.20	0
1996	92	621	529	10.66	0
1995	51	529	478	16.01	0
1994	66	478	412	11.65	0
1993	44	413	369	13.88	0
1992	45	369	324	13.68	0
1991	39	324	285	12.20	0
1990	31	285	254	-13.60	40
1989	13	307	294	5.37	0
1988	6	285	279	-2.44	7
1987	5	291	286	1.06	0
1986	5	288	283	1.07	0
1985	4	284	280	4.47	0
1984	14	282	268	2.68	0
1983	10	271	261	3.16	0
1982	8	261	253	2.01	0
1981	5	253	248	-0.008	2
1980	-	250	250	0.8	0
1979	5	253	248	-0.008	2
1978	3	253	250	-0.007	2
1977	4	256	252	-2.32	6
1976	6	264	258	-2.27	6
1975	4	268	264	3.12	0
1974	8	264	256	-2.29	6
1973	-	262	262		

Source: Bursa Malaysia (2004)

Only corporations that owed more than RM 50 million to 5 banks were invited by the CDRC to meet the banks in an informal manner akin to the "London Approach." The CDRC aims to facilitate voluntary corporate debt restructuring by coordinating voluntary negotiations and workouts between creditors and corporate debtors. The CDRC intends to minimize losses to creditors, shareholders and other stakeholders, preserve viable businesses and implement a comprehensive framework for debt restructuring. For smaller public listed companies, interest rates were reduced through measures to increase liquidity and the provision of soft loans through the Small and Medium Enterprises (SMEs) loan schemes administered by the Central Bank with the assistance of commercial banks.

## VII. Regulation of the Stock Market

The stock market in Malaysia is regulated by the Securities Commission, the Registrar of Companies, the Kuala Lumpur Stock Exchange, the Foreign Investment Committee and the Licensing Officer (Securities/Futures Trading) of the Ministry of Finance and the Foreign Investment Committee of the Prime Minister's Department. The Securities Commission was set up on March 1 1993 to be the main regulator of the capital market including the stock market. The Chairman and members of the Board of the Securities Commission are appointed by the Minister of Finance.

The main functions of the KLSE Board are to advise the Minister of Finance on all matters related to the KLSE; to ensure that there is compliance with the securities laws; to regulate takeovers and mergers; to regulate unit trusts; to supervise and monitor the operations of the KLSE including the clearing house and the central depository; to ensure adequate protection of investors; to issue licenses; to promote self regulation of market participants and to make recommendations on reform. The KLSE under the Securities Industry Act, 1983, is required to assist the Securities Commission in the administration of the securities laws.

The KLSE is regulated by a Board under the supervision of the Securities Commission and the Minister of Finance. As noted earlier, the Executive Chairman and three other members of the Board are appointed by the Minister of Finance. The other five members are elected from among the stockbroking firms that are members of the KLSE. It is a curiozum as to how the stockbrokers sitting on the board are to regulate themselves. The KLSE has its own Memorandum and Articles of Association as well as a set of rules governing the conduct of its members including the stockbroking companies. The KLSE is responsible for the enforcement of its Listing Requirements, which spell out the criteria for listing, disclosure and standards to be maintained by public listed companies.

The Registrar of Companies (ROC), who is also appointed by the Minister of Finance, is responsible for administering the Companies Act, 1965. There are more than 620,000 companies, including those listed in the KLSE. However, neither the KLSE nor the ROC is able to provide timely and accurate information on the financial statements of the companies listed on the KLSE. The two agencies are however doubling their efforts to monitor the companies and to enforce regulations requiring timely dissemination of information.

The Foreign Investment Committee (FIC) in the Economic Planning Unit (EPU), Prime Minister's Department was formed soon after the implementation of the New Economic Policy in 1971 to regulate the acquisition of substantial national assets by foreigners as the policy then was to use the market to increase the bumiputera share of the national wealth and reduce the foreign share. The FIC's approval has to be obtained

for any proposed acquisition of 15% or more of the voting power of any corporation by any one foreign interest. On the whole, no more than 30% of the voting power of a Malaysian incorporated company can be owned by foreigners.

The FIC is made up of senior civil servants appointed by the Minister of Finance. Given the tight control the Minister of Finance has on the appointments to the regulatory agencies, it is unclear as to how independently these agencies can operate and execute their functions. The FIC has been criticized in the case of the exemption given by the FIC to Renong Corporation from making a general offer. It is within these regulatory environment that international pressure was brought to bear on the government to introduce reforms to make the Malaysian capital market internationally competitive after the 1997 East Asian financial crisis.

## VIII. Conclusion

However, with the substantial withdrawal of foreign portfolio investments after the 1997 East Asian financial crisis and the abolishment of the exit tax on foreign investments, and the downgrading of the equity market, the Government has been forced to introduce reforms. The main reforms are in listing, corporate governance, transparency and investor protection. On all these fronts there has been slow progress in terms of implementation and enforcement. One plausible reason for the slow progress is that the Malaysian government has been and is sympathetic to the needs of the corporate sector under the Malaysia Incorporated concept introduced in 1983.

The KLSE cannot be considered as semi strong form or strong form efficient as there is no easy of entry and exit into the market and prices of IPOs are subsidized to ensure that would be investors receive an attractive return. Furthermore, the market is dominated by conglomerates and the Government accounts for a large share of the stocks that comprise the Kuala Lumpur Composite Index (KLSCI). However, with reforms it is expected that the stock market will function effectively as a market in the medium to long run.

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