

Assessing a Legal Framework for Malaysian Stock Option Plans

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Abstract

The objective of this article is to analyze the legal structures which governing Malaysian stock option plan. Based on the assessment of the relevant legal sources, the study produces some evidence of the legal frameworks find that the Malaysian law has modeled on the Anglo-Saxon system. Furthermore, it produces evidence that the law as it is currently adopted in Malaysia is slightly similar with the law operated in most of developed markets. To date, however, the law reforms carried out is not enough to revamp certain provisions. As consequences, some parts of the law enforced for stock option plans are not strongly applied in Malaysia. This study also emphasizes the following reasons which contribute to this issue as the existing legal system is unable to provide clear guidance although the main laws underpinning executive stock option plans like company and securities law have reformed comprehensively. The finding has found that law reform in Malaysia's legal structure is not sufficient to ensure strong practices by the firm. Therefore, the Malaysian government should put in place a strong legal system by taking an immediate response to enforce new initiative. This could solve problems of amending provisions from being superseded.

Keywords: Stock Option plans, Law Reforms

Introduction

A growing body of literature offers evidence for the widespread use of stock option plans in Anglo-Saxon countries. Developments in this area as spilled over into other regions as an increasing number of companies develop interest in equity sharing as part of a compensation package. The commonly cited examples for the use of stock option plans have by Sharma (2006) points out that the trend for stock option plans at this level has reduced in size from \$119 billion in (2000) to \$71 billion in (2002). The efficient functioning of legal frameworks has a substantial impact for the shaping, design and operation of stock option plans, however the legal practice adopted in guiding stock option plans might vary from country to country. In consequence, the associated legal and regulatory frameworks usually require a series of amendments that should be in place before stock plans are established. In respect to this, the objective of this paper is to assess the legal and regulatory frameworks governing stock option

plans in Malaysia through the process of coherent review. This paper examines the basis and jurisdiction with respect to how the regulatory framework operates within the capital market, as well as to appraise the legal aspects that guiding the use of the stock option plans in Malaysia.

The regulatory frameworks governing Malaysian stock option plans

The use of stock option plans in Malaysia has a very short history as the first used of stock option plan was announced as recent as 1989. However, there is still a lack of discussion about the practical use of stock options in the corporate sector of Malaysia. At present, most applications emphasize the accounting treatment of stock options, and because of this there has been no real need to devise a complex legal framework to govern the use of such instruments. Moreover, the presence of cash-based payments could be one of the reasons for why there has been limited discussion regarding the legal effects of stock options. However, and given the growing popularity of stock options, the trend for an employee compensatory system has changed towards share-based payments. In this respect, the present legal structure requires to a coherent review and update in order to cope with both current and future needs. As a result, updating the laws is likely to produce clearer guidelines for Malaysian companies and ultimately achieve a higher standard for practice.

During the process of creating the structure for the legal and regulatory framework governing compensation pays, a crucial part of the process has been to consider the dimensions that facilitate the business stakeholders. In this context, there is no single source of regulations governing the operation of stock option plans which are commonly controlled by two types of law: company law and securities law. Both laws serve as a principle of the regulatory frameworks that establishes a standard system for adoption by all companies which contain the law for, among others, administration, directors' duties and company audits. Other than that, the law function to regulate the issuance of securities and to protect the rights and interests of stakeholders. Therefore, both legal sources function simultaneously to prevent inequitable and unfair practice on the stock exchange. Together with the legal structures underpinning stock option plans, the specific guidelines in the frameworks play a vital role in setting boundaries that guide the duties of directors'. This therefore enables stock option plans to operate in an efficient way. In addition, stock option plans usually require the issuance of new shares that would have dilutive effect on the existing wealth of shareholders', which suggests that the process of establishing a stock option plan involves a series of business activities that requires changing the company's capital and information disclosure, and financial management practices. Hence, a different set of corporate activities is seemingly applied to a different stage of jurisdiction.

In the establishment of a stock option plan also relates to the issue of corporate governance within the company, particularly when the agency problem is widespread in the company. For that reason, the legal and regulatory frameworks would seem to play an important role in helping to solve potential corporate governance issues that may arise. On this particular issue, it worth to mention that the corporate governance literature presents mixed results on the actual relationship between corporate governance practice and stock option plans. For example, a positive association could be found when the stock option plans appear to align the interest of managers with those of the shareholders of the company. This gives the impression that the corporate governance framework in place is functioning well.

However, the contrasting effect could also be generated if the corporate governance framework fails to exercise its core functions.

Investigation on the existing legal frameworks for stock option plans reveal that the U.S. and U.K are often cited as a main source of reference. This is because the main features of corporate law and exchange regulations governing the use of stock option plans in both countries appear not to be too restrictive. However, this differs from the laws applied to stock option plans in Malaysia, where the focus is on the stock option plan disclosure and procedural guidance. This implies that the law as currently applied is overly restrictive. Moreover, in the U.S., the design of the regulatory frameworks for compensatory methods is shared between the judicial system and the tax authorities. In this way, the regulatory framework designed may prevent excessive compensation at the top management level. Furthermore, the demand for information disclosure is given the highest priority by the regulatory body in order to overcome the issue of insufficient information. In addition, some interaction between the strict law enforcement of the regulatory bodies and the Companies Acts with the non-mandatory provisions of the Corporate Governance Code, which makes it very clear that provision in the main statute. Responding to this a process of updating needed to meet current and changing needs.

With regard to the effect of stock option plans on the listed duties of directors are clearly indicated in the Acts. Among other things, it might discourage corporate risk-taking so that directors become more risk averse when making judgments. Other instances of duties, as stated, might also produce the effect of discouraging non-executive director from holding multiple directorships. Therefore, the Acts note the extent of the changes that might prevent behavior that conflicts with the interests of the corporation in the same way. At this point the process of modernizing regulatory frameworks and practices could serve for major reform in other jurisdictions that would benefit as they move closer into line with international standards¹.

As indication, stock option plans are not a new phenomenon to Malaysia, since they were used as early as 1989. Throughout the 1990s, it is indicated that Malaysian public listed companies (PLCs) on the Kuala Lumpur Stock Exchange began to use stock option plans as part of a compensation package for employees (Ariff, Shamsheer and Nassir, 1998). However, the development of stock option plans did not foresee the Asian financial and economic crisis in 1997. Although the impact of the crisis did not affect the Malaysian economy as deeply as other Asian countries the grant size of Malaysian PLCs with stock option plans were significantly affected. The practice of setting up eligibility criteria for stock option plans in Malaysian companies indicate that the value of stock option plans are heavily allocated to employees, instead of top management levels. This showing that top management are no longer the predominant holders of stock option plans within the listed companies. And the view of that Malaysian corporate sector is dominated by a significant involvement of owners in management, as represented by family owned firms, which give rise to potential agency problems and raises a number of corporate governance issue. One way to prevent such a problem is through the establishment of stock option plans in the spirit of regulatory and public policy as set out in local laws.

¹ For example, Japanese provides a major reform in 1997 on the Japanese Commercial Code to allow companies offer stock option plans to directors and it also moves closer into line with the US and Europe. See a study discussed by Junko Mori of Asahi Law Offices, Tokyo.

Taking into consideration the role of law in other countries, this seems that an exhaustive regulatory framework would be the best cure for the problems in Malaysian corporate governance. And although Malaysian law has developed organically, it is physically structured on the basis of the Anglo-Saxon model of the U.S. and U.K.² This is consistent with the present law is largely borrowed from the U.K. and the reforming in the corporate and securities laws have been recently, the actual reforms are widely viewed as not going far enough in overhauling particular provisions. Unlike U.S. and U.K. corporate and securities law, some parts of Malaysian corporate and securities law are not applied as strongly and at times are not equally enforced. As a result, the system in place gives the impression of being unable to provide very clear legal guidance and is often quite slow in making progress towards law enforcement. Also, the corporate and securities law has undergone a comprehensive reform programme, the reforms are not sufficient to ensure the delivery of strong corporate governance practices. For example, although the report on Corporate Governance Country Assessment for Malaysia undertaken by the World Bank indicates that Malaysia is one of the best ranking countries in Asia, terms of legal frameworks for corporate governance, in reality this is not reflected by its achievements³. Therefore, the new initiatives have to put in place by the regulatory bodies in order to reap the perceived benefits from the changes; although such initiatives are always implemented on 'a piecemeal basis'. While the lack of a coherent review process often means there is a lag in the process of legal reform. As response, Pascoe (2008) suggests that the main reason for these failings is due to weaknesses in the rule of law in Malaysia and the degree of political influence on corporate control.

Returning to the framework governing stock option plans in Malaysia, the main focus and attention of the underdeveloped legislative mechanism suggests that reforming the main statute is not sufficient to ensure exclusive legislation to guide the operation of stock options. In fact, the existing regulatory framework only considers three factors worth noting with respect to its usefulness. This includes the basic conditions, approval procedures and disclosure of stock option plans. As a result, a different source of laws is required aimed at providing a more comprehensive legal structure; one with clear directions on how to successfully implement such plans. Other than the Companies Act and the Securities Industry Act of 1983, which was later repealed, there are four legal sources governing corporate activities: the Securities Commission Act of 1993, the Capital Market and Services Act of 2007, the Bursa Malaysia Listing Requirements and the Common Law. Instead of reviewing the existing regulatory framework for the purpose of devising regulation that can accommodate the requirements of developments in the use of stock options, the authorities have always opted to push through initiatives which invariably are not consistent with current needs. On this issue, Sheehan (2009) points out that despite the piecemeal approach, the Malaysian government are willing to allow sufficient room for the market to shape the practice of stock option plans without imposing any legislative constraints.

The Asian financial crisis of 1997 provides a useful starting point in helping to identify what is precisely the true picture of weak governance practices among Malaysian PLCs. Although the Malaysian government had already put in place a reliable corporate legal framework, it has been argued that the reason for the crisis in Malaysia was due to the existence of fragile financial structures, ineffective boards, audit committees, and poor quality disclosure of

² In the Anglo-Saxon countries apply a common law system in which more freedom in formulating incorporation acts.

³ Corporate Governance Country Assessment: Malaysia, June 2005, World Bank. Available at <http://www.worldbank.org/ifa/ro>

information. Thus the corporate collapse and scandals that resulted were primarily due to a lack of effective laws to protect investors, combined with a lack of transparency in the regulatory processes (Gonzalez, 2007). In response to the inherent weaknesses in Malaysian corporate and securities regulatory framework, the Malaysian government was forced to put in place a comprehensive law reform programme directed towards enforcing the Capital Market Master plan, the Code of Corporate Governance and a revamping of the Bursa Malaysia Listing Requirements. To a degree these initiatives had the desired effect in helping to improve corporate governance practices in Malaysia, though the evidence reveals a less impressive governance culture, since Malaysia remain in 6 position in corporate governance rankings.⁴ However, it is noteworthy to note that the evidence indicates that Malaysian corporate governance improved in terms of the form rather than in substance of corporate governance arrangements.

Regulatory initiatives on employee stock option plan (ESOP) in Malaysia

In essence, the Malaysian regulation applied for stock option plans is very similar to that in the U.K., except that some parts of the law tends to be enforced in a preferential ways. Table below provides a brief guide on the degree to which the Malaysian government is pushing through with plans to update the regulatory framework in line with international standards. Among the initiatives, the Companies Act of 1965 has been passed more than 30 times with amendments. However, some of the approaches taken have often been on a piecemeal basis and without their being a coherent review, leading to the establishment of the Malaysian Corporate Law Reform Committee (CLCR).

Table 1

Regulatory initiatives on employee stock option plan (ESOP) in Malaysia

	Subject	Action taken	Steps	Adequacy
Supervision	Supervisory framework	Legislative proposal	Legislative proposal	High restrictive and involve jurisdiction enforcement
Regulatory gaps	Formulating Malaysian corporate Governance Frameworks	Corporate Governance Code	Code of Practices	Mandatory to listed companies and it has to be applied as a part of the listing obligation.
Degree of confidence	Establish a capital market framework to protect the interest of minority	The Minority Shareholder Watchdog Group (MSWG)	The Malaysian Corporate Governance (MCG) Index	Clearly revealed a selection score and criteria for achievement.

⁴ CLSA/ACGA: "Stray not into perdition: Asia's CG momentum slows", Available at http://www.acga.org/public/files/CG_Watch_2010_Extract_Final.pdf.

	Subject	Action taken	Steps	Adequacy
	shareholders through shareholder activism.			
Risk management	Company Rating	Approved an independent credit research and advisory – Rating Agency Malaysia	Rating Criteria	Highly adequacy and it has been conducted with collaboration of international agencies such as Standard & poor.
Market application	Strategic framework Corporate Law Reform Programme of the Companies Commission of Malaysia	Established the Malaysian Corporate Reform Committee (CLCR)	Working Group – Working Group A on Company's Formation, Private Companies and Alternative Forms of Business Vehicles Working Group B on Capital Raising & Capital Maintenance Rules Working Group C on Corporate Governance and Shareholders' Rights Working Group D on Corporate Securities and Insolvency Working Group E on Sanctions and Enforcement	Corporate Law Reform Programme

The CLCR serves as the starting point in the modernization of current practices in Malaysian corporate law and other jurisdictions, which allows it to determine important benchmark for changes and to decide on how far reaching reforms to the law in Malaysia should be made. To date the CLCR has produced 12 consultation papers with some recommendations for core provision. Some of the recommendations have come into force via

the Companies Act.⁵ And as Pascoe (2008) points out, although other significant recommendations for core provision have yet to be incorporated in the Act, this may cause the law reform to become overdue.

Another issue surrounding the regulatory framework that has received attention in connection with stock option plans relates to tax concessions. Although tax benefit has not been clearly introduced under the Malaysian regulatory framework, however, it has received the attention of the Malaysian government which has taken steps to promote the growth of such plans. As an indication on how far developments have reached, stock option plans may now be considered as a tax shelter when it defers tax obligation until employees exercise the options. The benefit is liable for tax in the year the option is exercised. Thus the timing of exercise is important and employees must decide on when they prefer to exercise their options. Therefore, the major changes to the tax rules on stock option plans in Malaysia began in 2006 when the tax ruling on stock options changed. But before the year in effect, any benefits received from stock options by employees were deemed as gross income and therefore subject to income tax. And, the value of income from each share was determined based on the difference between the market price of the share on the date of the offer and the discounted price for each share. It should be noted that this does not take account of the market value of the stock on the date when the stock option was exercised. Thus no tax was imposed if the exercise price of the stock option was set at the market price on the grant date. However, and given the new tax ruling which came into effect in 2006, the value of the benefit of each stock option is now determined based on the difference between the market price on the date the stock option is exercised or exercisable, whichever is lower, and the discounted price offered by the employer.⁶ Although there are no capital gains tax on equities, except on gains from the disposal of shares in a real property company incorporated in Malaysia. With regard to a company's costs on the arrangement of compensatory stock options, the deductibility of such expenses will only be permissible if the cost is incurred by the offshore parent company and is incurred 'wholly and exclusively' in the production of business income.⁷ The allowable cost also covers the maintenance of the stock option plan or reimbursement to the parent company.

Concluding remarks

The motivation in this paper was to investigate the legal and regulatory frameworks governing stock option plans in Malaysia and to appraise the regulatory framework governing stock option plans in the U.S., U.K., Japan and Singapore to emphasize the differences in regulatory arrangements. In this respect I have provided evidence that confirms that stock option plans in Malaysia do not produce incentives to the target groups which suggests that the role of the regulatory mechanisms is to accomplish that goal. I also noted that the regulatory aspects governing stock option plans in Malaysia involved a series of amendments which enabled the Malaysian government to respond to current needs. It was noted that since Malaysian laws are differ from developed countries that parts of the law currently in place is not as strong or as equally enforced in Malaysia. As a result, the legal framework governing stock option plans would appear not to provide clear guidelines, while only making slow progress towards law enforcement. As noted in our discussion, the regulation applied to stock option plans is quite

⁵ "High Level Finance Committee, Report on Corporate Governance, February 1999.

⁶ Exercisable date means the date when the right shall be exercised, assigned, released or acquired if the right is exercisable on a specified date or otherwise.

⁷ Section 33 (1) of the Income Tax Act 1967.

similar to that practiced in the UK, though some part of the law as enforced varies in a preferential way. As a result, the Malaysian government is always preoccupied with updating the regulatory framework in line with international standards.

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