



DIGITAL ASSETS SERIES: CHAPTER 2

LEGAL UPDATE
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Chapter 2: Initial Exchange Offering (“IEO”) and the Regulatory Framework for IEO Operators in Malaysia

In this Chapter 2 of our Digital Assets Series, we focus our discussion on initial exchange offering and the relevant regulatory framework in Malaysia.

1. What is an IEO?

- 1.1 The Securities Commission Malaysia (“SC”) had in its public consultation paper No. 1/2019 titled “Proposed Regulatory Framework for the Issuance of Digital Assets through Initial Coin Offerings” (“**Public Consultation Paper**”) sought feedback from the public on the formulation of a framework for the issuance of digital assets through initial coin offerings (“**ICO(s)**”) to mitigate the risks posed by ICOs, for purposes of investor protection and promoting confidence in the ICO market. In the Public Consultation Paper, the SC expressed its intention to adopt an approach similar to the regulatory frameworks of equity crowdfunding (ECF) and peer-to-peer financing (P2P) in Malaysia, wherein the SC shall directly regulate the operator of the platform of an ICO, who in turn shall assess the issuers on its platform.
- 1.2 The SC’s proposals in the Public Consultation Paper were then largely incorporated into the [Guidelines on Digital Assets](#) (“**DA Guidelines**”) issued on 15 January 2020 and subsequently revised on 28 October 2020, to set out, among others, the requirements relating to fundraising activity through digital token offering. Instead of the issuance of digital assets through ICOs as proposed in the Public Consultation Paper, the concept of “initial exchange offering (“**IEO**”)” was introduced and adopted in the DA Guidelines and is described thereunder as an offering of digital tokens by an issuer through an electronic platform operated by an IEO operator (“**IEO platform**”). Where an ICO involves the offering of digital asset by the issuer to the public directly, the concept of IEO is much more aligned with the intention of the SC as expressed in the Public Consultation Paper since the offering of digital tokens to the public must be made by an issuer through a regulated intermediary, i.e. an IEO platform.
- 1.3 An IEO is therefore an alternate fundraising method in the digital space where an issuer offers digital tokens to investors through an IEO platform in exchange for funds. In return, the investors shall be entitled to the rights and benefits attached to such digital tokens purchased, depending on the type and structure of the digital token offered.

2. IEO Operator

2.1 Introduction

- (a) The DA Guidelines apply to all persons intending to operate an IEO platform. “IEO operator” is defined under the DA Guidelines as “*an electronic platform operator registered under these guidelines to operate an IEO platform*”.

- (b) In a nutshell, the role of an IEO operator is to facilitate or host the issuer’s offering of digital tokens on its IEO platform to the public.
- (c) To do so, a prospective IEO operator must satisfy all the requirements set out in Part C of the DA Guidelines and be registered by the SC. A registered IEO operator shall also be deemed to be registered as a recognised market operator for the purposes of section 34 of the Capital Markets and Services Act 2007 (“**CMSA**”).

2.2 Eligibility and registration

Type of entity	Malaysian-incorporated company.
Financial requirements	Minimum paid-up capital of RM5,000,000.
Criteria for registration	<p>An applicant may be registered as an IEO operator if the SC is satisfied that all the following requirements are fulfilled:</p> <ul style="list-style-type: none"> (a) the applicant, its directors, controller and senior management are fit and proper; (b) the applicant will be able to carry out its obligations as set out under the DA Guidelines; (c) the applicant will appoint at least one (1) responsible person; (d) the applicant will be able to manage risks associated with its business and operation including demonstrating the processes and contingency arrangement in the event the applicant is unable to carry out its operations; (e) the applicant has sufficient financial, human and other resources for its operations at all times; and (f) the applicant has appropriate security arrangements, taking into account the scale of its business operations and risks, which include maintaining a secured environment pursuant to the guidelines issued by the SC for the management of cyber risk and other relevant guidelines.

2.3 Directors and Responsible Person

Independent director	Where the IEO operator is a public company, at least one of its directors must be an independent director.
Fit and proper	Directors, controller and senior management of the IEO operator must be fit and proper and are suitably qualified.
Responsible Person	<p>(a) An IEO operator must have at least one (1) responsible person ("Responsible Person") at all times appointed from its senior management, who shall be the main contact person of the IEO operator to liaise with the SC and perform any duty as may be directed by the SC.</p> <p>(b) The Responsible Person must have a minimum five (5) years' experience in carrying out due diligence, assessment on business proposals and fundraising or any other relevant experience, and must be a fit and proper person.</p>

2.4 Obligations as an IEO operator

In determining whether to approve an IEO	<p>An IEO operator must:</p> <p>(a) carry out due diligence and critical assessment on an issuer including:</p> <ul style="list-style-type: none"> (i) understanding and verifying the business of the issuer to ensure that the issuer does not engage in any business practices appearing to be deceitful, oppressive or improper, whether unlawful or not; (ii) assessing the fit and properness of the issuer's directors and senior management; and (iii) understanding the features of the digital token to be issued by the issuer and the rights attached to it; <p>(b) exercise its own judgment and carry out critical assessment on the issuer's compliance with the requirements under the DA Guidelines including as to whether the issuer will be able to satisfy the requirement to provide an innovative solution or a meaningful digital value proposition for Malaysia; and</p>
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	<p>(c) assess the issuer’s white paper furnished to the IEO operator. In approving the issuer’s white paper, the IEO operator must ensure that the contents of the white paper include the information required under the DA Guidelines and that its contents are not false or misleading, or containing any material omission.</p>
<p>Additional obligations</p>	<p>An IEO operator must, among others:</p> <ul style="list-style-type: none"> (a) ensure that the white paper and all relevant information relating to an issuer, including any material changes that are affecting the IEO project or the issuer and the issuer’s annual and semi-annual report, are available through its IEO platform; (b) take reasonable steps in monitoring the drawdowns by issuer and that it has been utilised for the purposes stated in the white paper; (c) have in place rules and procedures for IEO on its IEO platform; (d) ensure that all disclosures are not false or misleading, or containing any material omission; (e) establish and maintain policies and procedures to, among others, ensure compliance with all relevant laws, regulations and guidelines including the Anti-Money Laundering and Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 and Personal Data Protection Act 2010; (f) ensure that its processes and practices are continuously aligned to industry practices in relation to digital assets; (g) identify and manage potential vulnerabilities and cyber threats in its operating environment; (h) in the event of any systems error, failure or malfunction, take all necessary and immediate appropriate actions to mitigate any potential losses; and (i) immediately notify the SC, among others, of any material change to the IEO, the IEO project or the issuer including any of the following matters:

	<ul style="list-style-type: none"> (i) the discovery of a false or misleading statement in any disclosures in relation to the IEO, the IEO project or the issuer; (ii) the discovery of any material omission of information that may affect token holders; and (iii) any material development in the circumstances relating to the IEO, IEO project or the issuer.
Refund to investors	An IEO operator is required to effect refunds to the investors in certain events pursuant to the DA Guidelines (<i>please refer to Chapter 4 of our Digital Assets Series for more details on such events of refund</i>).

2.5 Safeguard measures and ringfence arrangements

Risk management	<p>An IEO operator must, among others:</p> <ul style="list-style-type: none"> (a) identify and manage any risks associated with its business and operations, including any possible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. (b) ensure that its systems are designed to assure a high degree of security and operational reliability, including having adequate capacity; (c) establish a robust risk management framework with appropriate systems, policies, procedures, and controls to identify, monitor, mitigate and manage all material risks; (d) have a comprehensive physical and information security policy that addresses all potential vulnerabilities and threats; (e) have a business continuity plan that addresses events posing a significant risk of disrupting operations, including events that could cause a wide-scale or major disruption; and (f) carry out periodic reviews, audits and testing on systems, operational policies, procedures, and controls relating to risk management and its business continuity plan.
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<p>Conflict of interest management</p>	<p>(a) An IEO operator, including all its directors and shareholders, must disclose to the public on its platform if:</p> <ul style="list-style-type: none"> (i) it holds any shares in any of the issuers or digital tokens issued by any issuers hosted on its platform; or (ii) it pays any referrer or introducer, or receives payment in whatever form, including payment in the form of shares in connection with an issuer hosted on its platform. <p>(b) An IEO operator is not allowed to hold more than 30% shares in any of the issuers hosted on its platform and it is also prohibited from providing direct or indirect financial assistance to investors to invest in the digital tokens of an issuer hosted on its platform.</p>
<p>Internal audit</p>	<p>An internal audit function must be established to develop, implement and maintain an appropriate internal audit framework which commensurate with its business and operations.</p>
<p>Outsourcing</p>	<p>(a) An IEO operator may engage outsourcing arrangements for some of its functions provided it selects appropriate and efficient service providers and monitors them on a continuous basis to ensure that it does not lead to any business disruption and negative consequences to token holders.</p> <p>(b) Save for any function that involves:</p> <ul style="list-style-type: none"> (i) the decision-making functions of the IEO operator; or (ii) any interaction or direct contact with the IEO issuer or token holders, <p>all other functions of the IEO operator can be outsourced subject to the requirements of the DA Guidelines.</p> <p>(c) The board of the IEO operator remains accountable for all outsourced functions.</p>
<p>Handling of investors' monies</p>	<p>An IEO operator must:</p> <ul style="list-style-type: none"> (a) establish systems and controls for maintaining an accurate and up to date records of investors and any monies or digital tokens held in relation to the investor;

	<p>(b) ensure investors' monies and digital tokens are properly safeguarded from conversion or inappropriate use by any person, including but not limited to implementing multi-signature arrangements;</p> <p>(c) establish and maintain with a licensed Malaysian financial institution one or more trust accounts, designated for the monies received from investors;</p> <p>(d) ensure that such trust accounts are administered by an independent trustee registered with the SC under the Guidelines on Registration and Conduct of Capital Market Services Providers; and</p> <p>(e) only release the funds to the issuer after the following conditions are fulfilled:</p> <p>(i) the targeted amount sought to be raised has been met;</p> <p>(ii) there is no material change relating to the IEO or the issuer during the offer period; and</p> <p>(iii) such other additional conditions precedent as it may impose which serves the token holders' interest.</p>
<p>Handling of digital tokens</p>	<p>(a) An IEO operator must:</p> <p>(i) maintain a register of initial token holders who subscribed for the digital tokens during the offer period of an IEO;</p> <p>(ii) ensure that the token holders' digital tokens are properly segregated and safeguarded from conversion or inappropriate use by any person;</p> <p>(iii) establish and maintain a sufficiently and verifiably secured storage medium designated to store digital assets from investors; and</p> <p>(iv) establish system and controls to maintain accurate and up-to-date records of client's digital assets held.</p> <p>(b) For the purpose of custody of the digital tokens, the IEO operator may either choose to appoint a registered digital asset custodian <i>(please refer to Chapter 3 of our Digital Assets Series)</i></p>

	or to provide its own custody services in compliance with the requirements set out under Part D of the DA Guidelines.
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2.6 Cessation of business or operations

Prior engagement with SC	An IEO operator shall not cease its business or operations without prior engagement with the SC and such cessation will not take effect until the SC is satisfied that all the requirements stated in the securities laws, the DA Guidelines, relevant guidelines issued by the SC and any other relevant laws or requirements have been fulfilled.
Direction by SC	To ensure an orderly cessation of the business or operations of the IEO operator, the SC may issue a direction or impose any term or condition.

2.7 Powers of SC

Additional requirements	<p>The SC may at any time:</p> <p>(a) impose additional financial requirements; and / or</p> <p>(b) vary, add or remove any requirements or terms and conditions on an IEO operator,</p> <p>that commensurate with the nature, operations and risks posed by the IEO operator.</p>
Directions	<p>The SC may, at any time, issue a direction to the IEO operator, its board of directors, any of its directors, senior management or any other person, if the SC:</p> <p>(a) is satisfied that it is necessary or expedient for the:</p> <p style="padding-left: 40px;">(i) purposes of ensuring fair and orderly markets; or</p> <p style="padding-left: 40px;">(ii) protection of the token holders, or in the public interest; or</p> <p>(b) is of the opinion that the IEO project is no longer viable or sustainable.</p>

Periodic assessment	The SC may conduct periodic assessment of an IEO operator's compliance with any or all of its regulatory obligations, and request documents or other assistance as required.
Overrule IEO operator's decision	<p>(a) The SC may, at any time before the fund raised is released to the issuer, do any or all of the following:</p> <ul style="list-style-type: none"> (i) revoke an approval granted by an IEO operator for any IEO; (ii) issue a direction to suspend the IEO; or (iii) issue a direction to defer the implementation of the IEO. <p>(b) The powers under (a) above may be exercised by the SC if it becomes aware of any of the following:</p> <ul style="list-style-type: none"> (i) the issuer has breached any requirement under securities laws, the DA Guidelines or any other guidelines issued by the SC; (ii) the issuer has failed to comply with any terms or conditions imposed by the IEO operator on the issuer; (iii) the application, including the white paper, contains any statement or information that is false or misleading or from which there is a material omission; (iv) there is a concern with the issuer's corporate governance record or with the integrity of any of the issuer's directors and senior management; or (v) the SC has reason to believe the approval of the application would be contrary to public interest.
Powers under securities laws	In addition to the above, the SC shall also be entitled to exercise its powers under securities laws.

3. Perspective

3.1 The lack of regulation for the offering and trading of digital assets in the past inevitably gave rise to scams, fraud and high risks exposure to investors. In response to such concerns, Bank Negara Malaysia and the SC had on 6 December 2018 issued a joint statement to implement a regulatory framework on digital assets.

- 3.2 The introduction of the Capital Markets and Services (Prescription of Securities) (Digital Currency and Digital Token) Order 2019 ("**Prescription Order 2019**") which essentially brings digital assets (i.e. digital currency and digital token) under the purview of securities laws in Malaysia is a significant step in regulating digital assets in Malaysia. In the same vein, the introduction of the DA Guidelines by the SC, in particular Part C, which imposes standards of conduct, duties and obligations on IEO operators, is crucial in ensuring the security, transparency and reliability of the IEO environment, which will in turn boost confidence among the general public in IEOs.
- 3.3 The DA Guidelines envisage a two-tier regulation system for the offering of digital tokens wherein issuers shall be regulated by the IEO operators, who in turn shall be regulated by the SC. While the SC will be leveraging on the expertise of IEO operators to assess potential issuers on their IEO platforms, we foresee that the SC will still be substantially involved in the assessment process of issuers, at least in the initial stage.
- 3.4 It is also apparent under the DA Guidelines that the SC has considerable powers in respect of an IEO operator, including powers to issue mandatory directions to the IEO operator, its directors or senior management and to intervene in the IEO operator's decision with regards to an issuer if it deems necessary. The powers of the SC even extend to parties who have been outsourced with certain functions by the IEO operator. In relation thereto, where an outsourcing arrangement is categorised as material under the DA Guidelines, the IEO operator is required to, among others, obtain a written undertaking from the outsourced party to provide the SC with access to all information concerning such material outsourcing arrangement. As such, while an IEO operator has the autonomy to run an IEO platform on its own terms, the DA Guidelines provides adequate checks and balances to monitor the IEO operator's conduct.
- 3.5 It appears to us that the SC has taken a relatively liberal but measured approach in facilitating a regulated and encouraging fundraising environment in the digital space in Malaysia – which in our view is strongly applaudable. For example, under the relevant laws promulgated by the SC as discussed, an issuer of digital tokens will not be required to issue a prospectus, even if the digital tokens offered will be prescribed as securities under the Prescription Order 2019. However, the DA Guidelines sets out explicitly the disclosures required by an issuer in its white paper and requires due diligence to be undertaken by an IEO operator in its assessment of the suitability of the issuer and the digital tokens to be offered. This, in our view, offers an encouraging avenue for issuers to raise funds without incurring significant costs and time (that may be present in an issuance of a prospectus within the requirements of the Prospectus Guidelines) and at the same time ensures investors' protection through, amongst others, mandatory disclosures and due diligence duties of the regulated IEO operator. This is important given fundraising via IEO will most likely invite interests from stakeholders of early-stage entrepreneurs, start-ups and small and medium enterprises (SMEs), who may not have strong resources to bear significant fundraising costs. In contrast, in other jurisdictions such as Singapore, we note that when a digital token offered carries or is prescribed as securities, the full securities laws (such

as prospectus requirements) may be triggered, which may be challenging for certain categories of issuers to comply fully.

- 3.6 Application to become a registered IEO operator has recently closed on 15 February 2021, and the SC has intimated that it has received encouraging interest from applicants. We foresee that the launch of IEO platforms under a well-regulated framework, once the assessment process by the SC is completed, will present an exciting alternate avenue to the fundraising scene through the digital asset space in Malaysia.

In the previous chapter of our Digital Asset Series (Chapter 1), we offer a brief introduction to digital assets and its regulatory framework in Malaysia. See [here](#).

In the next chapter of our Digital Assets Series (Chapter 3), we consider the regulatory framework for digital asset custodians in Malaysia.

This legal update is for general information only and is not a substitute for legal advice.

Further Information

Should you have any queries as to how these developments may affect your business, please do not hesitate to contact us.



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