



## **PUBLIC CONSULTATION PAPER**

**NO. 1/2019**

### **PROPOSED REGULATORY FRAMEWORK FOR THE ISSUANCE OF DIGITAL ASSETS THROUGH INITIAL COIN OFFERINGS (ICOs)**

The Securities Commission Malaysia (SC) invites your written comments in this consultation paper. Comments are due by 29 March 2019 and should be sent to:

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This Public Consultation Paper is dated 6 March 2019

# CONTENTS

<b>Overview .....</b>	<b>3</b>
<b>1. Introduction .....</b>	<b>3</b>
<b>2. What is an Initial Coin Offering .....</b>	<b>6</b>
<b>3. Risk associated with ICOs .....</b>	<b>7</b>
<b>4. The need for regulation .....</b>	<b>8</b>
<b>5. Proposed regulatory framework .....</b>	<b>8</b>

## OVERVIEW

### Introduction

- 1.1 With the advent of innovation in technology, the SC notes a growing interest in the use cases of blockchain, blockchain-based digital assets and investing in such digital assets, both domestically and globally. These digital assets are known by a variety of terms including crypto assets, digital tokens and coins.
- 1.2 The purpose of this consultation paper (CP) is to provide some background as to the nature of digital assets, some of the risks involved in investing in such digital assets and the proposed regulatory framework for Initial Coin Offerings (ICO).
- 1.3 Blockchain technology is based on the concept of a distributed ledger. The distributed ledger is maintained and updated by independent nodes within a network and is secured by cryptography. It provides an ecosystem where the network participants can confirm and create ledger entries without the need for a centralised party or intermediary. The ledger entries are then recorded in “blocks” and the blocks are “chained” together in sequence providing an auditable and *tamper-proof* history.
- 1.4 Despite the arguably nascent stage of the technology, its rapid development has resulted in many use case applications. Examples of such applications include being used as a form of proof of ownership and provenance (for example land titles or the sourcing of ethical goods), record-keeping (for example storing university certificates and medical records) and in the case of finance, to facilitate remittances and trade finance, or to effect clearing and settlement activities. The technology is applicable across industries and is not limited by sector.
- 1.5 More relevant to this CP however, is the emergence of a new fundraising mechanism hosted on a blockchain platform known as an ICO. While ICOs are a relatively recent phenomenon, this new fundraising mechanism has become increasingly popular. An

ICO issuer would create and issue digital assets to investors in exchange for investors funding a typically early stage business idea or project. Further details of the basic structure of an ICO can be found below.

- 1.6 Notwithstanding the well-publicised interest on ICOs, the digital asset industry is also still a relatively nascent market. The total global market capitalisation of digital assets is valued at approximately US\$130 billion. This figure when put into context, is much smaller than the size of the overall Malaysian capital market.
- 1.7 Digital assets issued through an ICO often contain unique or bespoke characteristics. As such, the structure of the digital asset can take multiple forms and have multiple usages. For example, a single digital asset may be structured as a medium of payment, be tradable at a digital asset exchange or crypto-exchanges while promising dividend-like returns to a token holder. As a result, a single issuance may potentially trigger regulatory requirements and compliance with multiple regulators based on the use case of the digital asset.
- 1.8 In view of the above, global and regional regulators have applied various approaches in responding to the growing interest in digital assets. The approaches range from imposing an outright ban on all forms of digital asset related activities to introducing new regulation to cater specifically to the offer, issuance or trading of such digital assets.
- 1.9 The SC recognises the potential use cases of blockchain and digital assets in enhancing efficiencies in the capital market including lowering post trade latency and counterparty risks, and enabling seamless regulatory reporting and compliance. Digital assets also have the potential to act as an alternative asset class for investors. As such, in line with the SC's mandate to promote the development of the capital market, the SC seeks to develop a regulatory framework that will balance promoting innovation with ensuring proper safeguards to protect the integrity of the capital market and investors' interest.

1.10 In this regard, the SC has taken a phased approach in developing the regulatory framework for digital assets–

(i) on 15 January 2019, the ***Capital Markets and Services (Prescription of Securities) (Digital Currency and Digital Token) Order 2019*** (PO) came into force;<sup>1</sup> and

(ii) on 31 January 2019, the SC issued the revised ***Guidelines on Recognized Markets*** to incorporate a new chapter setting out the requirements for electronic platforms that facilitate the trading of digital assets.<sup>2</sup>

1.11 The SC is mindful of the various types of digital assets that are currently being offered. With the coming into force of the PO, digital assets which meet the requirements under the PO are prescribed as securities under the securities laws.

1.12 The PO provides that a digital asset must be recorded on a distributed ledger. As such, discount cards, e-money or e-payment etc. will not be considered as securities unless it is recorded on a distributed ledger and satisfies the PO's requirements.

1.13 In this regard, digital assets which display the characteristics below will be considered as securities:

- (i) In the case of a digital currency–
- A. when it is used as payment to purchase goods, services or other digital assets **and** is traded on a digital asset platform; and
  - B. a person who trades such currency on the platform expects to benefit from a return or appreciation in the value of the digital currency.

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<sup>1</sup> <https://www.sc.com.my/api/documentms/download.ashx?id=8c8bc467-c750-466e-9a86-98c12fec4a77>

<sup>2</sup> <https://www.sc.com.my/api/documentms/download.ashx?id=eb8f1b04-d744-4f9a-a6b6-ff8f6fee8701>

- (ii) In the case of a digital token, which is issued through an ICO, the token will fall under the definition of securities if–
- A. investors pay monies<sup>3</sup> in exchange for the token received;
  - B. investors' monies are pooled and managed by the issuer; and
  - C. investors who purchase the token expect a return or appreciation in value from their investment. The returns to investors may be derived from either the buying or selling of assets of the issuer or from any business activities carried out by the issuer.

1.14 The issuance or offering of digital assets described in paragraph 1.13 above, to the public, will require prior approval or authorisation from the SC and compliance with the relevant laws and regulations.

1.15 Given the above, the SC is issuing this CP with a view to obtain feedback on the proposed requirements relating to the offering of ICOs in Malaysia. The SC is mindful that any regulation imposed must be proportionate to the risk posed to the investors investing in an ICO.

1.16 This CP does not seek to address the issue of trading of digital assets on electronic platforms nor is it targeted to address the underlying blockchain technology.

## **2. WHAT IS AN INITIAL COIN OFFERING**

2.1 In an ICO, an issuer who is typically an early-stage venture, creates and issues its own digital assets in exchange for established digital currency (for example Bitcoin or Ether) or fiat currency. The proceeds from the ICO are then purportedly used to build and develop its venture.

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<sup>3</sup> Can also include digital currencies

- 2.2 The digital asset received by the investors is often representative of their interests, rights or benefits in the ICO issuer or the product or services of the ICO issuer. Examples of such rights and returns could include rights to monetary returns, projected returns from trading, access to facilities or discount entitlement on products.
- 2.3 The ICO is normally accompanied by a disclosure document known as a Whitepaper. The Whitepaper contains basic information about the ICO including the underlying business or project, the technology and processes employed and the investors' entitlements (if any) from participating in the ICO. Although the Whitepaper is commonly used to attract the investors to invest in an ICO, the varied and unregulated content and format of the Whitepaper poses a potential risk to the investors. The risks are discussed below.

### **3. RISK ASSOCIATED WITH ICOs**

- 3.1 The dynamic characteristics of digital assets when coupled with factors such as the nascent stage of the technology, risk of business failure, cross border structures and media interest in a largely unregulated space makes investing in such digital assets susceptible to certain inherent risks.
- 3.2 Some of these potential risks include–
- (i) an ICO issuer not having a physical presence in Malaysia – it would be difficult to verify the authenticity of the ICO and the recovery of invested monies may be subject to foreign laws or regulations;
  - (ii) the involvement of unregulated/unlicensed individuals and activities – heightened risk and exposure to fraud including pump and dump schemes, money laundering and terrorism financing;

- (iii) the ICO may be structured in such a way as to limit the legal protection and recourse for the investors against an ICO issuer;
- (iv) the general risk of investing in a start-up or early venture company; and
- (v) cyber-security risks including hacking and stealing of online personal information.

#### **4. THE NEED FOR REGULATION**

- 4.1 The lack of a regulatory framework for ICOs currently, exposes investors to the above risks and makes them vulnerable to fraud and manipulation. Regulation is therefore required to mitigate the risks posed by ICOs for purposes of investor protection and promoting confidence in the ICO market.
- 4.2 Therefore, the SC is seeking public feedback on the formulation of a framework for the issuance of digital assets through ICO.

#### **5. PROPOSED REGULATORY FRAMEWORK**

- 5.1 This framework seeks to balance the business needs of the industry while ensuring that adequate investor protection measures are in place taking into account the proposed benefits and risks posed by ICO activities.
- 5.2 To mitigate incidences of fraud while protecting market integrity, the SC is adopting a two-pronged approach. This approach entails an authorisation for the offering or issuance of the ICO and the registration of a disclosure document (Whitepaper) which complies with prescribed minimum requirements set by the SC.



## Proposed Requirements Applicable to an ICO Issuer

### *Assessment of the ICO*

- 5.3 Since the launch of the equity crowdfunding framework (ECF) and peer-to-peer financing framework (P2P) in February 2015 and April 2016 respectively, both avenues have shown good progress in meeting the financing needs of micro, small and medium enterprises (MSME). As at December 2018, a total of RM261.52 million has been raised by issuers.
- 5.4 Under the ECF and P2P frameworks, the SC directly regulates the platform operator. The responsibility of carrying out the assessment of issuers on the platform is borne by the platform operator. Furthermore, the platform operator is under an obligation to ensure that any disclosure made by the issuer to the investors on its platform is fair and accurate. A specific obligation is also imposed on the issuer to ensure that disclosures made to the investors on the platform are not misleading.
- 5.5 The platform operator in carrying out its assessment of an issuer is required to comply with the requirements imposed by the SC. This includes amongst others, taking reasonable steps to conduct background checks on the issuer with a view to ensure the fit and properness of the issuer, its directors, senior management and controller. Furthermore, the platform operator must also verify the business proposition of the issuer.<sup>4</sup>
- 5.6 Leveraging on the approach adopted in respect of ECF and P2P financing frameworks, the SC intends to apply a similar approach for ICOs.
- 5.7 The SC proposes that an ICO issuer be required to approach a third party to agree to “host” the ICO and assess its Whitepaper. In this regard, the ICO issuer will be required to undergo an assessment conducted by an independent third party

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<sup>4</sup> See Chapter 12 *Guidelines on Recognized Markets*

authorised by the SC, prior to it submitting a formal application to the SC. The assessment criteria will be further discussed in paragraph 5.10.

- 5.8 The above approach will enable the SC to leverage on the expertise and experience of persons who wish to participate and contribute to the development of this industry. It is proposed that the third party “host” is a recognised market operator or alternatively any other person recognised by the SC as having the necessary skills and expertise. In this regard, the SC will be introducing a separate framework in relation to the authorisation of the third party who will carry out this role.
- 5.9 Notwithstanding a third party’s agreement to host the ICO, the ICO issuance is subject to the SC’s approval or authorisation.

**Consultation question 1**

Do you agree that the SC should leverage on a recognised market operator or a qualified third party to conduct an initial assessment of an ICO, given their experience and expertise in either hosting MSME’s on their platforms or their involvement in the digital or crypto industry? If yes, do you agree that the application to the SC for authorisation should be conditional on the ICO being hosted by the said recognised market operator or third party?

**Consultation question 2**

Other than a recognised platform operator, should other qualified parties also be allowed to conduct the initial assessment of the ICO? Please provide reasons for your answer.

### *Criteria for assessment of the ICO*

5.10 The evaluation and assessment of the ICO would be guided by requirements specified by the SC. The specified assessment criteria may include–

- (i) the fit and properness of an ICO issuer, its board of directors, its senior management and controller.<sup>5</sup> Management must also possess the appropriate experience and track record demonstrating that it is capable of carrying out and completing the business/project and is able to manage the company sustainably based on the strategy outlined in the Whitepaper;
- (ii) a determination of the ICO's underlying business/project is able to demonstrate an innovative solution or a meaningful digital value proposition for Malaysia;
- (iii) sufficient safeguards to protect the interests of existing shareholders as well as token holders;
- (iv) an evaluation of the business/project including risks and mitigating measures and an assessment of the business/project plan of the ICO issuer;
- (v) adequate processes are in place to manage related party transactions and conflict of interest issues;
- (vi) satisfactory processes in place to monitor anti-money laundering requirements;
- (vii) the valuation methodology and assumptions for price determination of the digital tokens issued are reasonable; and
- (viii) an evaluation of the protocol/code, platform or any other application for the

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<sup>5</sup> This would include among others, that the person has not been convicted for offences relating to fraud, dishonesty or breaches of securities laws, has engaged in any business practices appearing to the SC to be deceitful or oppressive or otherwise improper or has engaged in or has been associated with any conduct that cast doubt on his ability to act in the best interest of the investors.

technology, as the case may be and its cyber risk management framework.

**Consultation question 3**

Do you agree with the assessment criteria above? Are there any other assessment criteria that should be included in the above list?

*ICO issuer eligibility*

5.11 It is proposed that only a company that–

- (i) is locally incorporated, with its main business operations carried out in Malaysia;
- (ii) has a minimum paid up capital of RM500,000; and
- (iii) is not a public listed company

may undertake ICOs.

5.12 In this initial phase of the ICO framework, the SC is proposing not to allow public-listed companies to undertake ICOs given the potential impact it may have on the pricing and valuation of listed shares as well as the impact on the rights of existing shareholders. However, public listed companies may establish a separate entity to carry out an ICO.

5.13 In addition to the above, the SC is proposing for the board of directors (BOD) and senior management (SM) team to collectively hold 50% equity holding in the ICO issuer. The BOD and SM team will not be able to dispose of their equity holding for a period of 18 months. This is to ensure that the BOD and SM team are committed in ensuring the success of the ICO.

**Consultation question 4**

Do you agree with the proposed eligibility requirements set out above? Please provide your reasons. Are there any other eligibility requirements that should be imposed?

*Governance requirement*

- 5.14 The SC is proposing that an ICO issuer must ensure that any individual appointed to its BOD or its SM team is fit and proper. In addition, the SC is proposing that at least half of the BOD comprises of Malaysians. This would enable the ICO issuer to demonstrate its value proposition for Malaysia as well as promote the development of local talent including through knowledge transfer and training on new technologies and expertise.
- 5.15 The ICO issuer is also required to appoint a responsible person which will be the main contact point for the SC. The responsible person must be a member of the BOD or of the SM team and is responsible for, among others, identifying and reporting to the SC any breach of the requirements, relevant laws or material adverse change relating to the ICO or the ICO issuer.
- 5.16 In addition, an ICO issuer is required to establish processes to effectively manage conflict of interest and risk management issues. The ICO issuer must also have in place business continuity management and a cyber-resiliency framework.

**Consultation question 5**

Do you agree with the requirements listed above? If you do not agree, please provide reasons for your answer. Are there any other requirements that should be included in the list above?

*Limit on amount of funds to be raised through an ICO*

5.17 The SC is proposing to impose a limit on the amount that can be raised through an ICO.

5.18 In this regard, it is proposed that an ICO issuer may raise funds calculated as a multiple of 10 times the shareholders' funds and subject to a ceiling of RM100 million.

**Consultation question 6**

Do you agree with the fund-raising limit and calculation proposed above? If you do not agree, what is your proposed alternative and why?

*Requirements relating to ICO proceeds*

5.19 The SC is proposing that subject to Bank Negara Malaysia's exchange controls, at least 50% of the proceeds of the ICO must be utilised in Malaysia, and if the ICO is asset-backed, to ensure that at least 50% of the assets are based in Malaysia. This would enable the ICO issuer to demonstrate its value proposition for Malaysia.

5.20 To safeguard investors' interest, the SC is of the view that an ICO issuer should only be permitted to withdraw or utilise investors' monies, based on milestones disclosed in the Whitepaper. In this regard, the trustee may only allow for draw-downs pursuant to a confirmation from a third party auditor that the relevant milestones have been achieved. The issuer will also be required to provide confirmation to the

SC that the draw-downs have been utilised for the purposes stated in the Whitepaper.

**Consultation question 7**

Do you agree with the proposal that the main business operations or assets of the ICO should be based in Malaysia? If you do not agree, please provide your reasons.

**Consultation question 8**

Do you agree with the proposal that any drawdown of ICO funds must be in accordance with the milestones disclosed in the Whitepaper? If you do not agree, please provide your reasons.

**Consultation question 9**

Do you agree with the proposal that an auditor must be appointed to provide certification for the monies that have been drawn down?

*Other ongoing obligations for an ICO issuer*

5.21 In addition to the above, there are other obligations imposed on the ICO issuer for purposes of safeguarding the investors' interest and promoting confidence in the ICO industry. These obligations include—

- (i) having processes in place to monitor anti-money laundering requirements, including carrying out the requisite know your client and customer due diligence on investors;
- (ii) a prohibition against third party endorsement, promotion and publicity of the ICO; and
- (iii) annual and quarterly reporting to the SC and to its investors in relation to information as may be specified by the SC.



**Consultation question 10**

Do you agree with the proposed obligations listed above? If you do not agree, what are your suggestions? Are there any other requirements that should be included in the list of obligations above?

*Trust Account*

5.22 The SC is proposing that an ICO issuer be required to deposit all funds raised through the ICO in a separate trust account with a licensed bank. The trust account must be maintained by an independent custodian, escrow agent or entity acting in the capacity of a trustee that is registered with the SC for carrying out capital market activities.

*Requirements for Whitepaper*

5.23 As discussed briefly above, the Whitepaper is the disclosure document which typically accompanies an ICO offering. It will normally include details of the underlying business/project which the ICO issuer is seeking finance for, the technology and processes employed and investors' entitlements (if any) for participating in the ICO. The challenge however is that there is no standardized disclosure requirement or best practice guidance for the preparation of the Whitepaper.

5.24 As such, it is proposed that under the ICO framework, any offering of an ICO must be accompanied by a Whitepaper. An ICO issuer will be required to submit the Whitepaper to the SC for registration. In deciding whether to register the Whitepaper or otherwise, the SC may take into consideration the pre-approval evaluation and assessment carried out by a recognised market operator or third party service provider.

5.25 To ensure some consistency, the SC proposes that the Whitepaper must contain, among others, the following information:

- (i) Brief description of the ICO issuer including, where applicable, the group structure and details of material entities within the group;
- (ii) Details and profile of the board of directors/ senior management team/ promoters;
- (iii) Brief description of the shares and/or digital token held by the board of directors/ senior management team/ promoters;
- (iv) Objective or purpose and timeline of the ICO, including detailed information on the underlying business/project to be managed and operated by the ICO issuer;
- (v) Business plan, including detailed description of the sustainability and scalability of the underlying business/project, and the targeted date for each major phase in the business/project;
- (vi) Targeted amount to be raised through the ICO and a scheduled timeline for utilisation of the proceeds including the details of each utilisation;
- (vii) Any rights, conditions or functions attached to digital tokens issued from the ICO including any specific rights/privileges/benefits attributed to a digital token holder;
- (viii) Details of the independent custodian, escrow agents or entity acting in the capacity of a trustee;
- (ix) Discussion on the determination of the price per digital token including the valuation methodology and reasonable assumptions adopted in such calculation;
- (x) Financial information including audited financial statements or management

accounts (where applicable);

(xi) A detailed technical description of the protocol, platform and, or application, as the case may be, and the associated benefits of the technology; and

(xii) Details of the associated challenges and risks including any conflict of interest and related party transactions.

5.26 To mitigate instances of fraud, ease of comparability and to facilitate understanding of the SC's assessment process, the SC may publish the list of approved and rejected ICO applications with the relevant Whitepapers on a dedicated microsite.

**Consultation question 11**

Do you agree with the proposed minimum content requirements above? Is there any other information that should be included in the list above? Please provide reasons for your answer.