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DIGITAL SECURITIES OFFERINGS IN MALAYSIA (PART 2)

Malaysia Lawyer's Perspective on Digital Assets[1] Offering

*The following Q&A is between Ian Fong, Director of Marketing & PR, Propine Technologies Pte. Ltd. and our Serina Abdul Samad, Partner and Head of Capital & Debt Market practice group, Azmi & Associates, in Q1 2020 and is the second of our two-part series on the topic of Digital Assets Offerings (“**DAO**”) in Malaysia. Some parts of the answer have been updated.*

Ian: Do you think that DAO is going to take off in Malaysia and the APAC region in 2020, especially with the current COVID-19 pandemic going on?

Serina: In Malaysia, an issuer must only carry out an offering of digital tokens through an Initial Exchange Offering (“**IEO**”) platform and not through any other means and the trading of a digital asset must be done on electronic platform called Digital Asset Exchanges (“**DAX**”), operated by a DAX operator duly registered under the Guidelines on Recognized Market.

On 4th June 2019 the Securities Commission Malaysia (“**SC**”) had registered three (3) Recognized Market Operators (“**RMOs**”) to establish and operate DAX in Malaysia. These three (3) RMOs, namely Luno Malaysia Sdn. Bhd., SINEGY Technologies (M) Sdn. Bhd., Tokenize Technology (M) Sdn. Bhd., are IEO operators as well and have been given nine months to fully comply with all regulatory requirements.

To date, there has been no news report on any one of the three (3) IEO operators processing application for offering of digital tokens by potential issuers.

Although December 2019 saw LuxTag raising a pre-series A funding through pitchIN, a Malaysian licensed equity crowdfunding operator which obtained approval from the SC to accept considerations in crypto tokens for the LuxTag ECF campaign, LuxTag emphasized that its crypto-equity-crowdfunding campaign through pitchIN is not an initial coin offering (“**ICO**”) nor security token offering).[2] For simplicity, the term security token offering, digital security offering and digital assets offering are used interchangeably to describe the same thing.

The current COVID-19 pandemic would contribute to the lack of news on potential DAOs from the IEO operators or the issuers themselves.

As for the APAC region, in the Q1 Ernst & Young ("EY") averred that given the COVID-19 outbreak and its negative impact on global economic activities, IPO markets are not expected to quickly rebound in Q2 2020 and that while Q3 is typically a slower time of the year, there may be increased IPO activity as the market attempts a reset and the global pipeline looks for the next IPO window.

This is indeed the case. Q2 2020 saw no IPO in Malaysia whilst Q3 saw almost the same number as Q1 2020.[3]

So far, there has been no DAO activity.

Ian: Why do you think the growth of DAO for the past two years doesn't seem to match up to the hype around DAOs?

Serina: In the past two (2) years, the regulation for DAO was still being developed by our local authority. Apart from the three (3) DAX operators mentioned above, SC on 4th July 2019 instructed that no other online platforms are permitted to establish and operate a DAX in Malaysia currently and all other DAX operators are required to immediately cease all activities related to the trading of digital assets and return all monies and assets collected from investors.

The bad reputation of some ICOs may have affected the potential DAO too. According to some local news reports, prior to having the issuance of DAO and trading of digital assets regulated and monitored by the local authority, there were concerns on unvetted, risky schemes and potentially fraudulent ICOs, and there had been some money game schemes that claimed to leverage blockchain technology to entice investors. As ICOs emerged at a time when the cryptocurrency space was largely unregulated, the space gained a bad reputation for various problems related to scams and fraud, on top of insufficient disclosures and inadequate investor protection.

Besides, financial advisors have cautioned their clients from investing in early stages of DAO as well. For an example, Felix Neoh, a director of financial planning at Finwealth Management Sdn Bhd, advised that investors should not just jump on the bandwagon simply because the space is now regulated as they need to assess carefully whether digital assets are suitable to complement their portfolios, considering their risk appetite and goals. He further elaborated that digital assets are still very new in the country, so they will most likely be considered as riskier assets and recommended only small investment on such assets and due to the uncertainties that are still clouding the space, investors will benefit from taking a back seat and becoming an active observer instead of immediately investing in the first IEO issued, at least in the early stages.

Ian: Do you think that capital markets lawyers should play a more active role in pushing digital securities adoption to the issuers? Who do you think is the weakest and strongest link in the determination of its success?

Serina: Capital markets lawyers can play more active role in pushing for digital securities adoption by the issuers. They are familiar with the listing criteria for companies in the various markets of the Malaysian Stock Exchange and can bring the attention of their existing corporate clients who are seeking to raise funds but will not make the cut for the stock exchange, to consider raising funds via DAO through IEO platform and trading of the digital assets via DAX.

The strongest links in determining the success of the DAO would be the DAX operators and also the issuer itself. The role of the DAX operators in selecting and approving the best or most viable DAO that can be presented by an issuer would be very important. According to Hong Qi Yu, founder and CEO of DAX operator, Tokenize Technology (M) Sdn. Bhd., only selected IEO projects will be introduced to investors, this reduces investment risk among the mass market and raises the industry's standards, apart from safeguarding investors from scams, which have happened in ICO projects.

Hong further added that exchanges mainly select their prospective issuances based on several key factors. First, the exchanges evaluate the project idea presented on its whitepaper. Then, they assess the entire economics of the project's solution and how it flows through the token. The project's management and team members are also assessed. The exchanges try to determine whether they can demonstrate their capabilities to ensure the project's success, how they intend to deliver the results.

A well-managed issuer also will ensure the success of DAO as they would be able to present a strong business model, a working product and its potential for undergoing development, the ability to prepare the necessary documentation, the token growth justification (in economics sense), strong existing community or client-base, reputable management team and advisors, strong social media and public relations for marketing. Lack of these vital components may result in underperformance of the DAO project and the subsequent reputational damages for the relevant DAX operator. Therefore, a DAX operator shall have an interest in the quality companies offering digital assets on its platform.

Hence, well-managed issuer, reputable, credible and responsible DAX operator and regulated IEO platforms and DAX are important in determining the success of the DAO.

While the weakest link in determining the success of the DAO would be the issuers as well. The tokens issued to the investors represent a share of an underlying asset. These can be shares of a company or any asset that is expected to turn into a profit, including a share in the ownership of a property, fine art, investment funds, etc., therefore the issuers must be able to convince the investors that the expected profit, dividend and/or any return

are attractive enough for the investors to subscribe for the tokens. If there is lack of any vital components on the part of the issuer which has been discussed in the paragraph above, it will reduce the attractiveness of the DAO or the ability the issuer or DAX operator to persuade investors to subscribe for the issuer's DAO.

Ian: What is the current state of DAOs and have you seen more interests from your clients / issuers towards exploring DAO in raising funds during the recent months?

Serina: As at today, there is no publicly available information on any DAO having been launched by the said three (3) DAX operators in Malaysia.

We also do not have any corporate clients enquiring or exploring DAO to raise funds in recent months.

Ian: Are we consciously exaggerating the potential liquidity for DAOs today, from peer-to-peer private markets, broker syndicates, and digital assets/security token exchanges that supposedly have a supply of interested buyers of digital assets/security token based assets?

Serina: So far there has been no publicly available information on any DAO having been launched in Malaysia by the DAX operators. It is still too early to say whether there has been an exaggeration of the potential liquidity for DAO in Malaysian market.

In financial markets, liquidity is not something that just happens, it is something that market players and regulators have to build for. As trust is the most significant element in investing, issuers and exchange operators need to address the security concerns of potential investors and regulators have to put in place regulations of such market. In essence, the challenge is to create a professional investment ecosystem, having regulated exchanges and operating in jurisdictions that provide legal certainty.

The introduction of the Guidelines on Digital Assets and registration of the three (3) DAX operators by SC would address the above concern as angel investors and sophisticated investors that will bring the bulk of the liquidity to the DAO market are hesitant to participate in unregulated DAO. Under the said Guidelines, retail investors can invest up to RM2,000 per issuer with a total investment limit not exceeding RM20,000 within a 12-month period, angel investors are subjected to a maximum of RM500,000 within a 12-month period whereas sophisticated investors have no restriction on investment amount.

Furthermore, to achieve the desired liquidity, the issuers and exchange operators must (i) raise awareness of fund raising by way of DAO to those companies that possess projects having the capability to (a) provide a solution or address an existing market need or problem; or (b) improve the efficiency of an existing process or service undertaken by the

company or the industry, through the application of distributed ledger technology, and its expected returns to the investors and (ii) help to create the pool of interested and potential investors for the DAO. It will require an industry effort as well as for the issuers themselves to promote their products and to create real demand for their assets, which in turn will create liquidity for their digital assets/security tokens.

Ian: To what extent do you think that Blockchain will disrupt the legal industry as legal documents can be changed, but smart contracts are immutable.

Serina: A smart contract is an agreement between two (2) parties in the form of computer code run on blockchain, stored on a public database and cannot be changed. The transactions that happen in a smart contract are processed by the blockchain, which means the transactions can be sent or done automatically without a third party involved. The transactions only happen when the conditions in the agreement are met.

One of the examples given by many articles advocating for smart contract is a sale and purchase agreement (agreement) between two parties, Individual A buying a house from Individual B, and the agreement is formed on blockchain using a smart contract. This smart contract contains an agreement between Individual A and Individual B and in the simplest terms, will look like "*WHEN A pays B 300 coins, then A will receive ownership of the house*". Once this smart contract agreement has been put into place, it cannot be changed, meaning A can feel safe to pay B 300 coins for the house.

But in reality, this kind of smart contract will only work for transaction of subject matter of small value and not regulated by laws. Taking the above example, a property transaction in Malaysia may be subject to consent to transfer by State authority, has to be stamped, the transfer forms and loan documents have to be prepared, stamp duties have to be paid and relevant forms to be registered with the relevant local authorities for the transfer of the property to be valid under the laws.

The novelty of the technology still brings a lot of questions to the table. How will the government decide to regulate such contracts? How will they be taxed? What happens if the contract cannot gain access to the subject matter of the agreement or transaction, or anything unexpected happen to it? If this were to happen to a traditional legal contract, it could be enforced or rescinded in court of law.

It remains to be seen whether the usage of cryptocurrencies, blockchain or smart contract will gain traction among the local population and if so, how prevalent. Therefore it is still too early to predict whether blockchain or smart contract will disrupt the legal industry.

Ian: Any other last words to encourage digital assets adoption among the players in the ecosystem?

Serina: DAO can provide another alternative fundraising avenue for early stage entrepreneurs. It allows a company with an innovative business proposal to raise capital before it is able to do so through venture capitalists, without selling their equity or taking out a debt while developing their innovative ideas.

Therefore, companies that cannot afford or want to avoid the abovementioned can consider DAO offerings to raise funds in the future.

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1. Digital asset refers collectively to a digital currency and digital token which have been prescribed as securities under the Capital Markets and Services (Prescription of Securities)(Digital Currency and Digital Token) Order 2019
 2. Malaysian LuxTag's Equity-Crowdfunding Campaign Now Open for Bitcoin and XEM From Worldwide Contributors, 3 December 2019 (<https://www.luxtag.io/blog/luxtag-equity-crowdfunding-campaign-now-open-for-bitcoin-and-xem/>)
 3. IPO Summary (https://www.bursamalaysia.com/listing/listing_resources/ipo/ipo_summary?per_page=50&page=1)

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