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Digital Assets – an emerging trend in capital markets.

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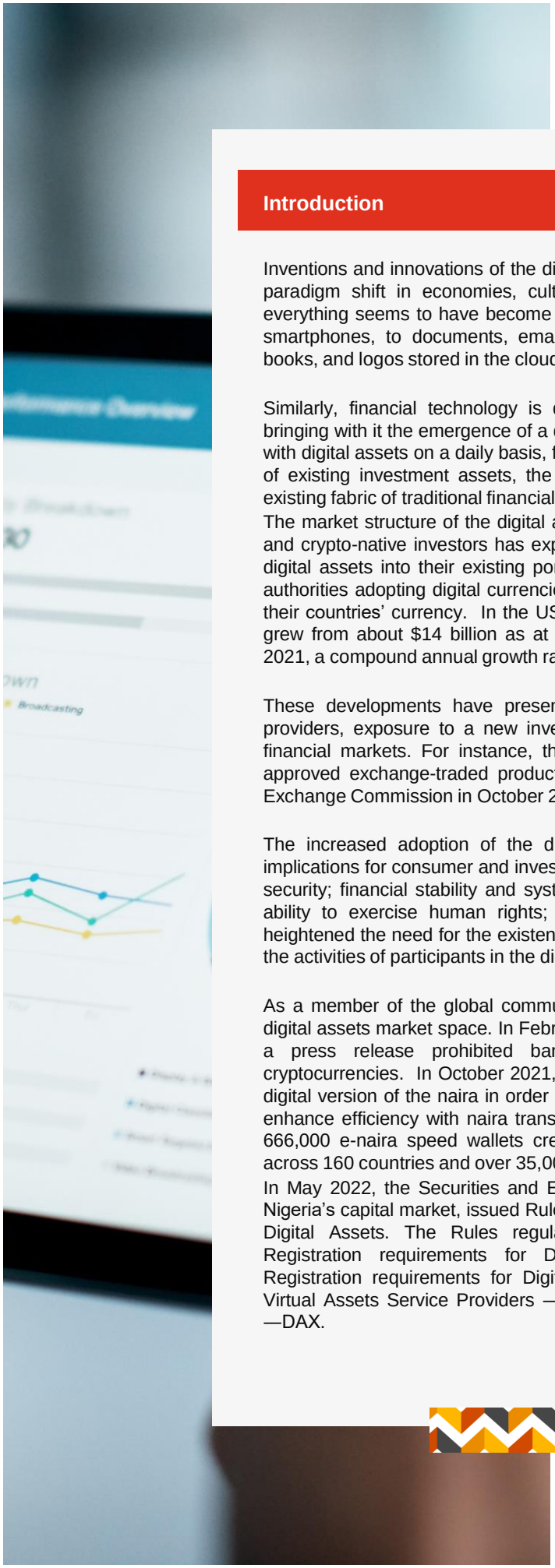

Introduction

Inventions and innovations of the digital age, which began in the 1970s, has resulted in a paradigm shift in economies, culture, work style, education, health, investing, and everything seems to have become “smarter”. From photos, music, and videos stored on smartphones, to documents, emails, illustrations, animations, social media accounts, books, and logos stored in the cloud, and more, today, we live in a digital world.

Similarly, financial technology is driving innovation in financial markets globally and bringing with it the emergence of a digital asset market. With many individuals interacting with digital assets on a daily basis, from investing in crypto as a digital asset to digitisation of existing investment assets, the digital assets market is becoming integrated in the existing fabric of traditional financial markets.

The market structure of the digital asset space initially built around retail, high-net-worth, and crypto-native investors has expanded with traditional institutional investors including digital assets into their existing portfolio of traditional investments, and some monetary authorities adopting digital currencies as a legal tender or introducing a digital version of their countries’ currency. In the US, the combined market capitalisation of digital assets grew from about $14 billion as at November 2016 to about $3 trillion as at November 2021, a compound annual growth rate (CAGR) of 193%.

These developments have presented opportunities for the entrance of new service providers, exposure to a new investor base and emergence of new asset classes in financial markets. For instance, the Ontario Securities Commission in February 2021 approved exchange-traded products for spot bitcoin ETFs and the US Securities and Exchange Commission in October 2021 approved ETFs on bitcoin futures.

The increased adoption of the digital asset market has elicited concerns as to its implications for consumer and investor protection, including issues about data privacy and security; financial stability and systemic risk; money laundering/crime; national risk; the ability to exercise human rights; and financial inclusion. These developments have heightened the need for the existence of global and domestic laws and regulation guiding the activities of participants in the digital assets market.

As a member of the global community, Nigeria is not left out of ongoing events in the digital assets market space. In February 2021, the Central Bank of Nigeria (CBN) through a press release prohibited banks from using, holding, trading or transacting cryptocurrencies. In October 2021, the Central Bank of Nigeria introduced the e-naira, a digital version of the naira in order to create an inclusive economy, foster innovation and enhance efficiency with naira transactions. As of December 2021, there had been over 666,000 e-naira speed wallets created, 700,000 e-naira speed wallet app downloads across 160 countries and over 35,000 transactions.

In May 2022, the Securities and Exchange Commission (SEC) - the apex regulator of Nigeria’s capital market, issued Rules on the Issuance, Offering Platforms and Custody of Digital Assets. The Rules regulate the following: i)Issuance of digital assets ii) Registration requirements for Digital Assets Offering Platforms —DAOPs— iii) Registration requirements for Digital Asset Custodians — DACs— iv) Guidelines for Virtual Assets Service Providers —VASPs— v) Guidelines for Digital Assets Exchange —DAX.

What are digital assets?

A digital asset is simply content that is stored digitally in any format and their associated value. They are electronic files of data that can be owned and transferred by individuals and used as a currency to make transactions or as a way of storing intangible content such as computerised artwork, videos or contracts documents. A digital asset functions in a way that makes it distinguishable and identifiable through a type of decentralized database of electronic ledger called a Blockchain. They can be in the form of digital currencies such as cryptocurrencies e.g. bitcoin or CBDC, or they maybe the underlying assets that are traded using block chain technology such as non-fungible tokens (NFTs).

One of the key features of digital assets is that they encourage fractional ownership. This means that digital assets could be created from equity, real estate, commodities or any underlying asset, which has the potential to generate future benefits and has ownership rights attached, often through tokenisation, a process which involves the creation of tokens.

Tokens help to transform sensitive information, with a unique symbol that preserves the critical data without compromising its security, into digital units or simpler forms, that can be managed without a central intermediary, through blockchain technology. Economic value is generated when units of those underlying assets represented by the digital asset in the form of tokens, exchange hands in a transfer. Thus, a digital asset can be seen to have three key characteristics; digital storage, ownership rights and probable future benefits due to those rights, and value.

Accordingly, the Securities and Exchange Commission's (SEC) New Rules on Issuance, Offering Platforms and Custody of Digital Assets, defines digital assets as "*a digital token that represents assets such as a debt or equity claim on the issuer*" while virtual assets are defined as "*a digital representation of value that can be transferred, digitally traded and can be used for payment or investment purposes*".

Digital assets issuance in other jurisdictions

The emergence of digital assets has brought about disruptions in the global financial markets and traditional financial services to the extent that various jurisdictions have recognised digital assets as a key component of the future growth of the changing financial landscape. Various governments have engaged with digital assets market stakeholders through a range of approaches as the global scrutiny for its budding market has increased. Data from Statista shows that the use of cryptocurrencies as an investment tool or means of payment is on the increase in various countries.

Fig 1: Share of respondents who indicated they either owned or used cryptocurrencies in 25 countries and territories worldwide from 2019 to 2021

Country	2019	2020	2021
Nigeria	28%	32%	42%
Thailand	23%	18%	31%
Philippines	15%	20%	28%
Vietnam	22%	21%	27%
Turkey	20%	16%	25%
Argentina	16%	14%	21%
South Africa	16%	18%	21%
Switzerland	10%	11%	16%
Kenya	10%	11%	16%
Malaysia	6%	12%	16%
Brazil	16%	11%	16%
Netherlands	9%	10%	15%
Colombia	18%	15%	15%
Czechia	10%	9%	15%
India	7%	9%	15%
Portugal	9%	8%	14%
Spain	10%	9%	14%
Chile	11%	12%	14%
Pakistan	6%	6%	14%
Ireland	8%	10%	13%
United Arab Emirates	20%	10%	13%
United States	6%	6%	13%
Peru	15%	16%	13%
Hong Kong	11%	11%	13%
Greece	11%	11%	13%

Source: Statista

The growth and adoption of digital assets and developments around the regulatory framework has been a key topic of interest globally. A look at initiatives in a number of jurisdictions is shown below:

Malaysia

- In 2019, The Capital Markets and Services (Prescription of Securities) (Digital Currency and Digital Token) Order 2019 was introduced to recognise digital assets as securities. Digital assets are categorised into two types; digital currencies and digital tokens.
- The Securities Commission Malaysia (SC) further issued the revised Guidelines on Recognised Markets to incorporate a new chapter setting out the requirements for electronic platforms that facilitate the trading of digital assets.
- Subsequently in 2020, the SC issued Guidelines on Digital Assets setting out requirements relating to fund raising activity through digital token offering, operationalisation of initial exchange offering (IEO) platform and provision of digital asset custody.
- As at April 2022, there were four Recognised Market Operators (RMOs) registered by the Securities Commission (SC) to establish and operate digital exchanges in Malaysia.
- As at September 2021, the volume of digital assets traded has surpassed a billion, with over 300,000 new accounts created since the introduction in 2019.

Mauritius

- In September 2018, the Financial Services Commission (FSC) Mauritius, recognised digital assets as an asset class for investment by expert and sophisticated investors, expert funds, specialised and professional collective investment schemes.
- The FSC introduced in 2019, a licensing framework specifically for digital assets custodian services. Persons intending to offer custody services for digital assets are required to obtain a Custodian Services (Digital Asset) license issued by the FSC.
- The FSC, in 2020, issued Guidance Notes on Security Token Trading Systems under the Financial Services Act 2007, to provide for the implementation of a common set of standards for the licensing of Security Token Trading Systems in Mauritius.
- In February 2022, the FSC, issued a communique stating that the Virtual Asset and Initial Token Offering Services Act 2021, had come into effect. It sets out a framework to regulate the business activities of virtual assets service providers (VSAPs) and initial token offerings (ITOs). It requires any person carrying out the following business activities to apply for a license or registration with the FSC:
    - a virtual asset service provider or an issuer of initial token offerings in accordance with the Act; or
    - a custodian (digital assets) in accordance with the Financial Services Act,

Thailand

- Digital asset regulations were introduced by the Emergency Decree on Digital Assets Business B.E. 2561 (2018), that regulates the issue and trade of digital assets and the Amendment to the Revenue Code (no. 19) B.E. 2561 (2018), that seeks to tax profits from digital Assets.
- The Decree requires digital asset businesses to obtain a license from the Minister of Finance and approval from the Thai Securities and Exchange Commission (Thai SEC)
- To offer newly issued digital tokens/existing digital tokens, to the public, the issuer must:
    - Be a juristic person in the categories of a limited company or a public limited company only;
    - Obtain an approval from the SEC Office;
    - File a registration statement for the offering of digital tokens and the draft prospectus to the SEC Office.

Extracts from the Rules issued by the SEC Nigeria.

The SEC rules on Issuance, Offering Platforms and Custody of Digital Assets is in 5 parts covering: (i)Issuance of digital assets; (ii) Registration Requirements for Digital Assets Offering Platforms —DAOPs; (iii) Registration Requirements for Digital Asset Custodians — DACs; (iv) Guidelines for Virtual Assets Service Providers —VASPs and (v) Guidelines for Digital Assets Exchange —DAX.

	PART A – Rules on Issuance of Digital Assets as Securities	PART B – Rules on Registration Requirements for Digital Assets Offering Platforms (DAOPs)	PART C – Rules on Registration Requirements for Digital Asset Custodians (DACs)	PART D- Rules on Virtual Assets Service Providers (VASPs)	PART E- Rules on Digital Assets Exchange (DAX)
Definitions	A digital asset is a digital token that represents assets such as a debt or equity claim on the issuer.	DAOP: an electronic platform operated by a DAOP operator for offering digital assets.	DACs: a person who provides the services of providing safekeeping, storing, holding or maintaining custody of virtual assets/digital tokens for the account of someone else.	VASPs: Any entity who conducts services such as exchange between virtual assets and fiat currencies; exchange between one or more forms of virtual assets; transfer of virtual assets; among other services specified in the Rules issued by the SEC, for or on behalf of another person.	DAX: An electronic exchange that facilitates the trading of digital assets.
Applicability	All issuers seeking to raise capital through digital asset Offerings.	Applicant seeking to register as a DAOP.	Applicant seeking to register as a DAC.	1. All platforms that facilitate trading, exchange and transfer of Virtual assets; 2. Any person, (individual or corporate) whose activities involve any aspect of Distributed Ledger Technology (DLT)-related and virtual digital asset services; 3. Issuers or sponsors of virtual/digital assets, including foreign or non-residential; 4. Foreign or non-residential operators that actively target Nigerian investors directly or indirectly.	Applicant seeking to register as a DAX Operator.

Fees	Not provided	• Filing/Application Fee – N100,000. • Processing Fee – N300,000. • Registration fee – N30,000,000. • Sponsored Individuals Fee – N100,000.	Not provided	Not provided	• Same as applicable to DAOPs.
Minimum paid-up capital and fidelity bond	Not provided	• Evidence of Required Minimum Paid up Capital – N500,000,000 Current Fidelity Bond covering at least 25% of the minimum paid-up capital.	Not provided	Not provided	Same as applicable to DAOPs.
Registration requirements (in addition to evidence of payment of applicable fees)	• Submission of assessment form and draft white paper for initial assessment; • Compliance with the Commission's minimum disclosure requirements for public offers; • Registration statement of the digital assets, • KYC procedures, disaster recovery plans and risk management protocol among other requirements.	• Payment of prescribed fees. • Submission of forms. • Minimum paid-up capital and fidelity bond; • Sponsored individuals and directors; • Corporate documents etc.	In addition to the general requirements for VASPs, the following apply: • Satisfy eligibility requirements for registration as a Custodian or Trustee, • For a custodian or registered trustee to provide DAC services, such CMO shall apply to the SEC for approval; • Foreign DACs may be registered upon meeting the requirements as set by the SEC among other requirements.	• Application filed on the appropriate SEC form • Sworn undertaking that the applicant will be able to operate an orderly, fair and transparent market in relation to the securities, • Evidence of solvency, fit and proper evidence for key officers and other requirements.	Same as applicable to DAOPs.
Exemptions	i) Securities structured to be exclusively offered through crowdfunding portals or intermediaries; ii) A judicial sale or sale by an executor, administrator or receiver in insolvency or bankruptcy; iii) Where the sale is by a pledged holder or mortgagee, selling to liquidate a bonafide debt among other exemptions.	Not provided	Not provided	Not provided	Exemptions from requirements may be granted if the Commission is satisfied that such variation is not contrary to the intended purpose of the relevant requirements in the issuance rules; and that there are mitigating factors which justify the said exemption or variation.

Potential benefits of digital assets to the domestic economy

There are lots of untapped opportunities within the domestic economy that digital assets could unlock and which would be beneficial to the entire value chain. New forms of value could be created through innovation in the digital assets market leading to a massive change in the financial landscape of the domestic economy. Some of the potential benefits include:

01 **Asset tokenisation:** The fractionalisation of high valued conventional/illiquid assets such as equity securities, real estate, commodities, loans etc., would offer retail investors greater access to a wider pool of investments which they could not normally afford to buy, as they can now purchase smaller denominations in digital token form. This has the potential to drive greater liquidity across the capital markets.

02 **Portfolio diversification**: Digital assets could provide diversification benefits when added to a portfolio of traditional assets, as digital assets have historically had low correlations with traditional assets.

03 **Convenience of payment services:** The Central Bank Digital Currencies (CBDCs), such as the eNaira, have the ability to achieve faster payments through instant settlements. This would strengthen the competition for smooth retail and cross-border payment services and help governments to accelerate digital transformation of their economies.

04 **High security and transparency:** The transactions of digital assets are recorded on transparent public ledgers that create an information flow for all transactions done. Therefore, tracking transactions and establishing audit trails is relatively easy with digital asset transactions.

05 **Advancing financial equity and inclusion:** The evolutionary technology behind digital assets makes it quite appealing to drive and possibly achieve greater financial inclusion in the economy. Digital assets can potentially expand the reach of financial institutions and close gaps by providing opportunities to reduce fees and eliminate middlemen, as well as attract foreign investors.

06 **Reduced cost and complexity:** The complexity of existing processes can be reduced with digital assets and the automation of controls and checks lead to process improvements that reduce cost.

07 **Efficiency**: Asset digitisation and blockchain technology improves existing transaction processes through reduced cost, increased transparency and asset liquidity, thereby enabling greater operational efficiency.

Conclusion

Advances in technology, low returns, in real terms, on traditional assets such as equities, fixed income instruments, real estate among others, as well as the need for greater financial inclusion has brought about increased focus on digital assets globally. Digital assets are making new investment categories possible and even accessible to retail investors. The mainstreaming of the digital asset market is an inevitable trend with the potential to transform financial markets significantly but also with attendant risk. Due to their digital nature, investors in digital assets are directly exposed to fraud, theft and cyber attacks. Similarly, the digital asset market is also prone to higher than usual risk of market manipulation, market abuse, and insider dealing by market participants due to their nascent stage. Hence, it is becoming increasingly exigent to balance the need to explore the benefits from usage of digital assets as well as protecting investors and the financial system at large. In some jurisdictions, such as Thailand, the use of digital assets has been restricted from some types of transactions so as to counteract inherent risks such as money laundering, price volatility and fraudulent activities.

The inherent risky nature of digital assets underscores the need for proper investor education on the workings of the digital asset space as well as an appropriate and robust regulatory framework to safeguard the integrity of the financial system and ensure the participation of only reputable players in the market. To this end, the Rules by the SEC are a step in the right direction towards facilitating the digital asset market in Nigeria.

The Rules by the SEC provide a clear regulatory framework for the growth of the digital asset market in Nigeria with the potential to drive financial inclusion, improve transparency, reduce transaction cost and increase the level of participation in the Nigerian capital market, while also ensuring adequate investor protection and proper regulatory oversight. However, thorough oversight would need to be done to mitigate the inherent risks.

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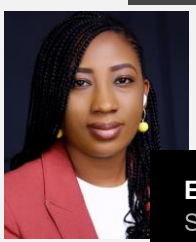

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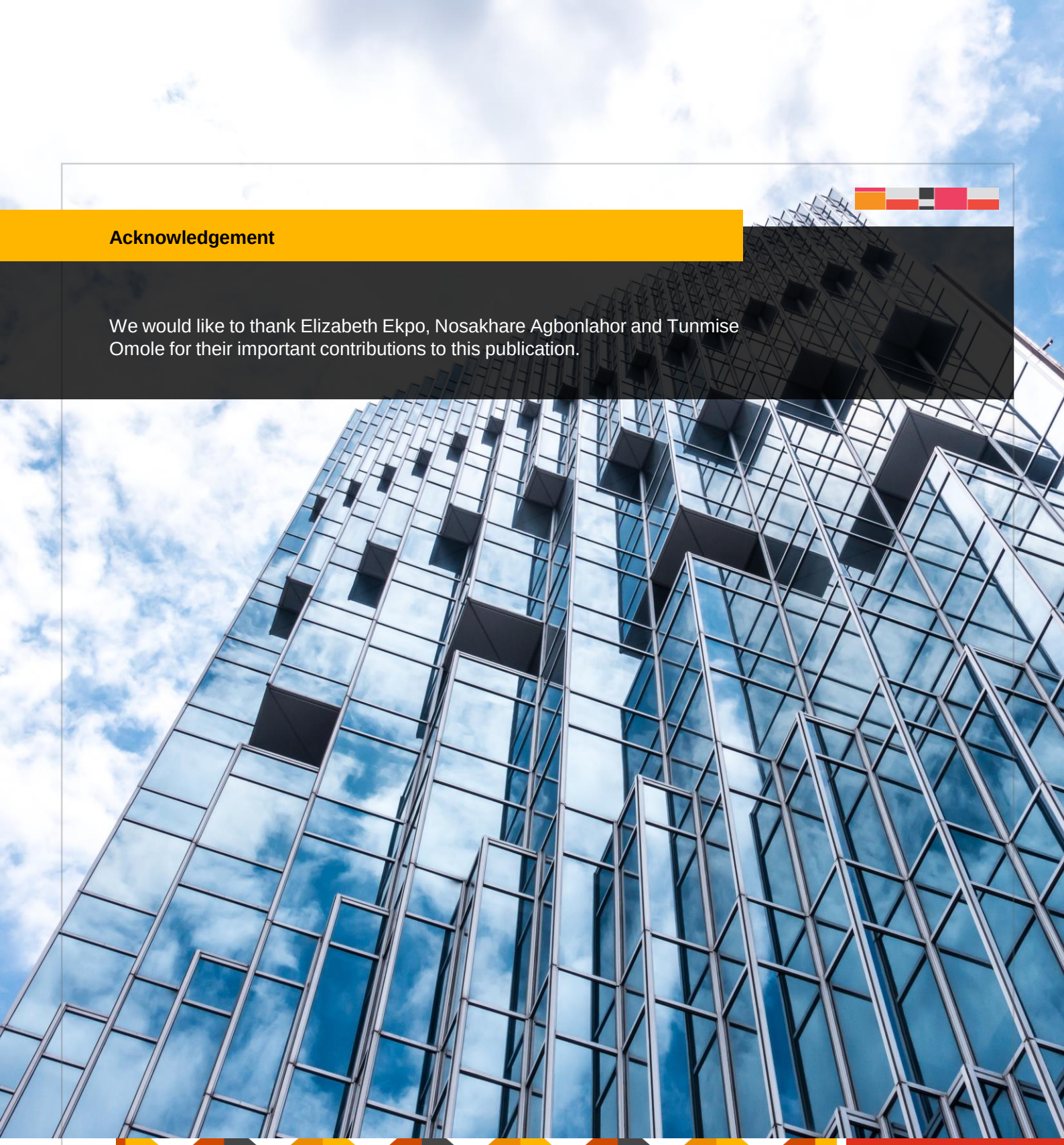

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