

Digital Capital Markets and SMEs

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Presentation Plan

- SMEs Finance: Introduction
- Capital Markets and SME Finance
- Digital Capital Markets for SMEs

SMEs and Financing Gaps

- Small and medium enterprises (SMEs) play important role in the economy
 - Constitute 90% of the businesses
 - Provide 50% of the employment
 - Contribute to 40% of the national income
- Annual finance gap for formal MSMEs in emerging and developing countries
 - Total—US\$ 5.2 trillion (World Bank and IFC 2017)
 - Equity financing gap—US\$ 3.92 trillion (World Bank 2020b: 73).



Reasons of financial exclusion from financial institutions

- Involuntary (supply side issues)
 - Acute asymmetric information—increases risks
 - Lack of acceptable collateral
 - High transactions costs
 - Cumbersome and opaque processes
- Voluntary (demand side)
 - Due to religious cultural reasons





Capital Markets

- Capital markets can be used to raise funds directly from investors in the form of
 - Equity (shares and private equity placements)
 - Debt (minibonds, securitization and private debt placements)
- Mechanisms and Processes
 - Issuance and Listing
 - Trade and Post-trade Mechanisms

Capital Market Processes: Issuance and listing

- Issuance of securities in capital markets is a complex process involving different types of processes and stakeholders (investment banks, lawyers, etc.)
- Companies issuing securities are subject to disclosure and reporting requirements
- **'Prospectus'** provide essential information of the security to the investors
 - Detailed information on the company, financials, sales, risks, etc.



Capital Market Processes: Issuance and listing costs

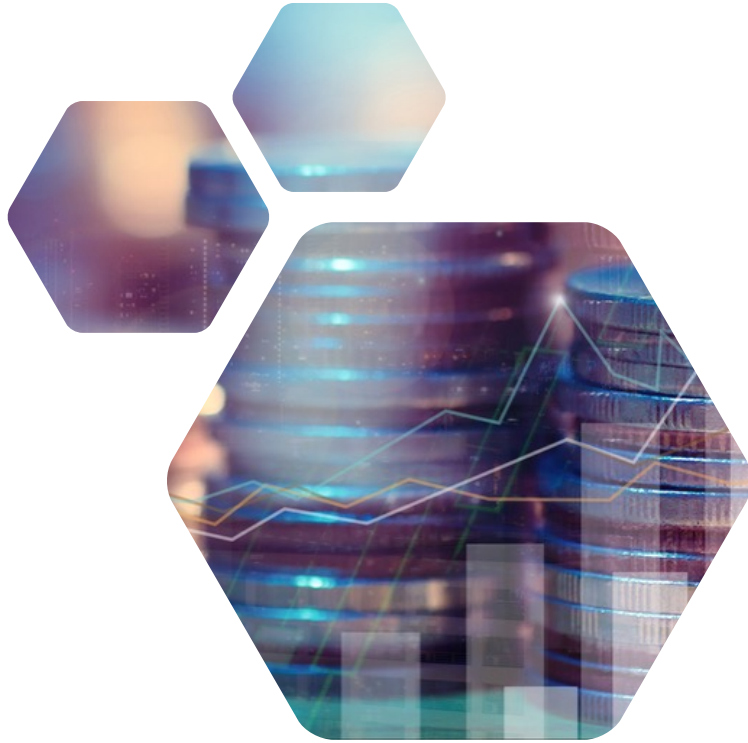
- Direct costs include expenditures for preparing the documentation for listing and admission
 - Fees paid to sponsor, advisor, accountants and lawyers involved with the issuance and listing processes
 - Charges for listing include application fee, vetting fee and admission or trading fee
- Ongoing fees paid to exchanges and for audit and ongoing compliance



Capital Market Processes: Trade and Post-Trade Mechanisms

- Well-functioning capital market enables smooth trading of securities among different parties
- Execution of a trade goes through a process of clearing, settlement and custody
- Services provided by
 - Market infrastructure entities—Central Counterparties (CCPs), Clearing Houses, Central Securities Depositories (CSDs)
 - Intermediaries such as banks and brokers help in buying/selling of securities





Capital Markets for SMEs: Constraints and issues

- Underdeveloped capital markets in emerging economies
- Higher costs of issuing and listing securities
- Onerous disclosure and reporting requirements
- Lack of liquidity due to lack of depth and small trading sizes

Solution—Use Digital Technology

- Crowdfunding platforms—lack liquidity features
- Cryptoassets and exchanges
- Cryptoassets and initial coin offerings (ICOs)
 - *Exchange tokens*: Exchange or payment tokens (cryptocurrencies) do not give any rights, but can be used as means of exchange or for investment
 - *Utility tokens*: Tokens providing consumptive rights and access to some specific service, product or platform
 - *Security tokens*: Investment tokens representing rights of ownership in some specific underlying assets such as bonds, stocks or other assets
 - Non-fungible tokens (NFTs) representing ownership of a specific non-fungible asset such as digital art





Shariah Views on Cryptoassets

- Many national level Shariah bodies (including Indonesia) have prohibited cryptocurrencies
- Security tokens with underlying assets of economic activities are Shariah compliant (digital securities)
 - Equity based—ownership of companies
 - Asset based—ownership of assets



Security Tokens and Crypto-Exchanges

- A ‘whitepaper’ published before launching provide basic information on the ICO/STO
- Due to lack of regulations, accuracy of information in the whitepaper cannot be ensured
- Many ICOs turned out to be scams and fraud that result in loss of investors’ funds
- Crypto-exchanges—key issue relates to governance
 - Some crypto exchanges have decided to close down trading limiting access to crypto-assets by owners

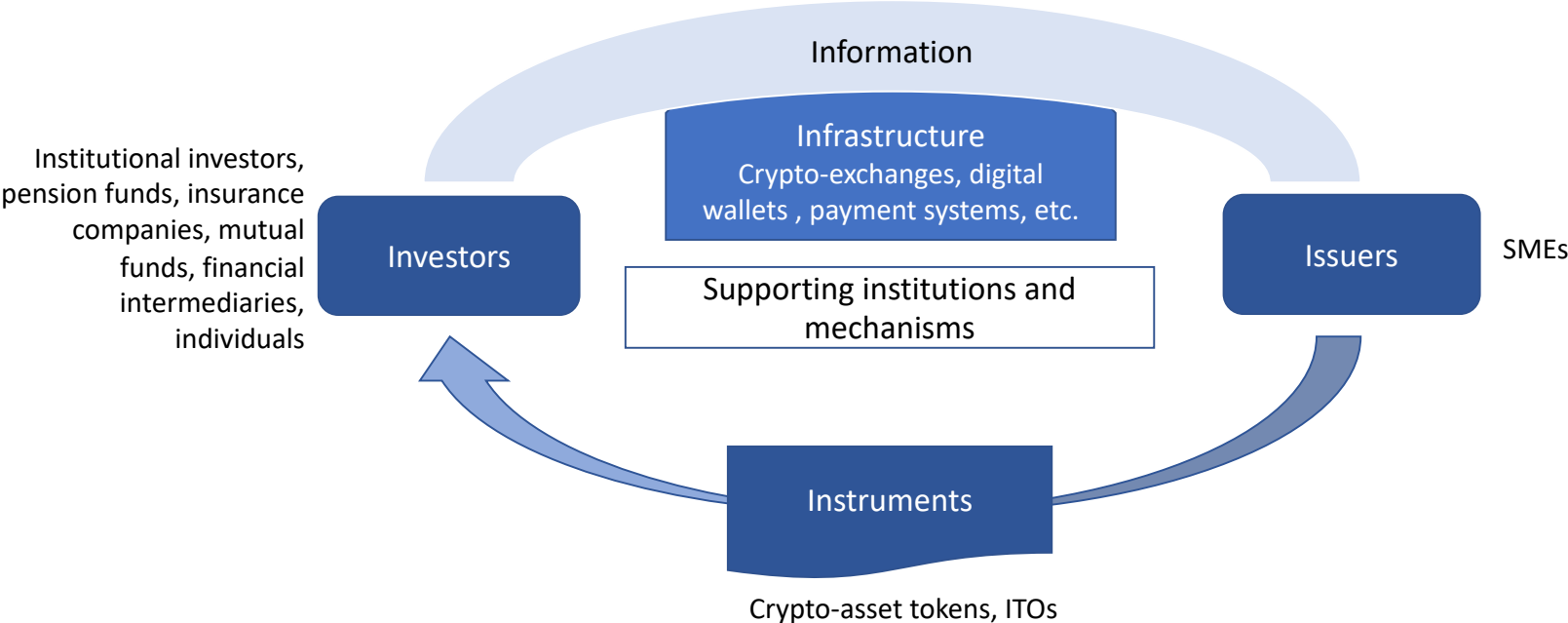
Digital Capital Market (DCM) for SMEs: Rationale

- DCM for SMEs can mitigate the constraints existing in traditional capital markets and crypto exchanges
- Security token offerings (STOs) will represent ownership of shares in the firms or assets by start-ups, growth companies and SMEs
- Regulated exchanges will improve governance and increase trust among investors

Digital Capital Market (DCM) Ecosystem for SMEs

Regulations/Regulators

Laws, regulations, listing & disclosure standards, supervision, etc.



Crypto-Exchanges—Basic Features

Settlement and Asset Layers

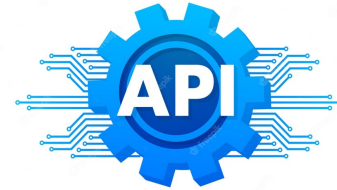
Tokens are created and ownership recorded on blockchain



Any exchange of tokens verified and recorded on blockchain

Protocol and Application Layers

Application Programming Interface (APIs) enable interaction with end-users (such as display of market prices, digital wallets, buying and selling of tokens)



DCMs for SMEs: Issuance and Listing

- Issuing security tokens remove the need for involving intermediaries and reduce costs of issuances significantly
- SMEs seeking to raise funds using STOs have to issue a **'whitepaper'** (to mitigate the asymmetric information problems)
- Regulatory guidelines on what should be disclosed in a 'Whitepaper' providing Information on the firms, their assets and operations that can be used to rate the firms
- Using the concept of proportionality, disclosure requirements less stringent than 'Prospectus' in IPOs



DCMs for SMEs: Trade and Post-Trade Mechanisms

- Once issued and listed, STs can be held in **digital wallets** (plays the role of depositaries)
 - Blockchain can also reduce the chain of custody arrangements and hence reduces costs
- While intermediaries can be used to trade on the exchange, investors will be able to buy/sell directly on the **digital exchange**
- Settlement process can be done directly on the **blockchain ledger** which record transactions and resolve clearing and settlement without the involvement of CCP





Questions