



# **THE CHANGING FACE OF FINANCE IN NIGERIA - CROWDFUNDING OUR ECONOMY, PART 2**

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## INTRODUCTION

This is a follow-up article to The Changing Face of Finance in Nigeria – Crowdfunding our Economy (you can read it [here](#)), where I highlighted crowdfunding as one of the practices changing the face of finance in Nigeria. I also briefly discussed the regulatory framework for Loan-Based and Equity Crowdfunding.

In this article, I will discuss the regulatory framework in depth.

## CROWDFUNDING - REGULATORY FRAMEWORK

### *Previously...*

The Securities and Exchange Commission (“the SEC”) had warned companies in Nigeria against using Equity Crowdfunding, in light of the restrictions in the Companies and Allied Matters Act 1990 (“CAMA”) and the Investment and Securities Act 2007 (“ISA”), until such a time as the SEC can introduce a framework for its use.


### *At Present...*

The market is excited because on 28 March 2020, the SEC published its Proposed Rules on Crowdfunding (“the Rules”) and invited stakeholders to submit their comments and input. It is important to note that the rules

seek to regulate Crowdfunding through the offer of investment instruments in general, including debentures and debt securities (Investment Based Crowdfunding). As such, the Rules would have implications for both Loan-Based Crowdfunding and Equity Crowdfunding.

### *Issuing Entities*

The Rules provide that all Micro, Small and Medium Sized Enterprises (“MSME”) incorporated in Nigeria and that have been operational for a minimum of two years will be eligible to list on a Crowdfunding Portal. These Crowdfunding Portals will be registered by the SEC (as Issuers) for the purpose of raising funds through the issuance of shares, debentures and other investment instruments approved by the SEC.



Under the Rules, MSME is to be as defined by the Small and Medium Enterprises Development Agency of Nigeria (“the Agency”) in relation to total asset and annual turnover. However, a look at the definition of MSME in the National Policy for MSME published by the Agency shows that a classification based on the dual criteria of employment and asset (excluding land and buildings) has been adopted. This means there is a conflict between the definition expected by the SEC from the Agency and the definition that has actually been adopted by the Agency. This would need to be addressed/clarified in the Rules. Alternatively, the Rules may state the classification to be used and provide a clear definition of MSME.

### *Investment Instruments*

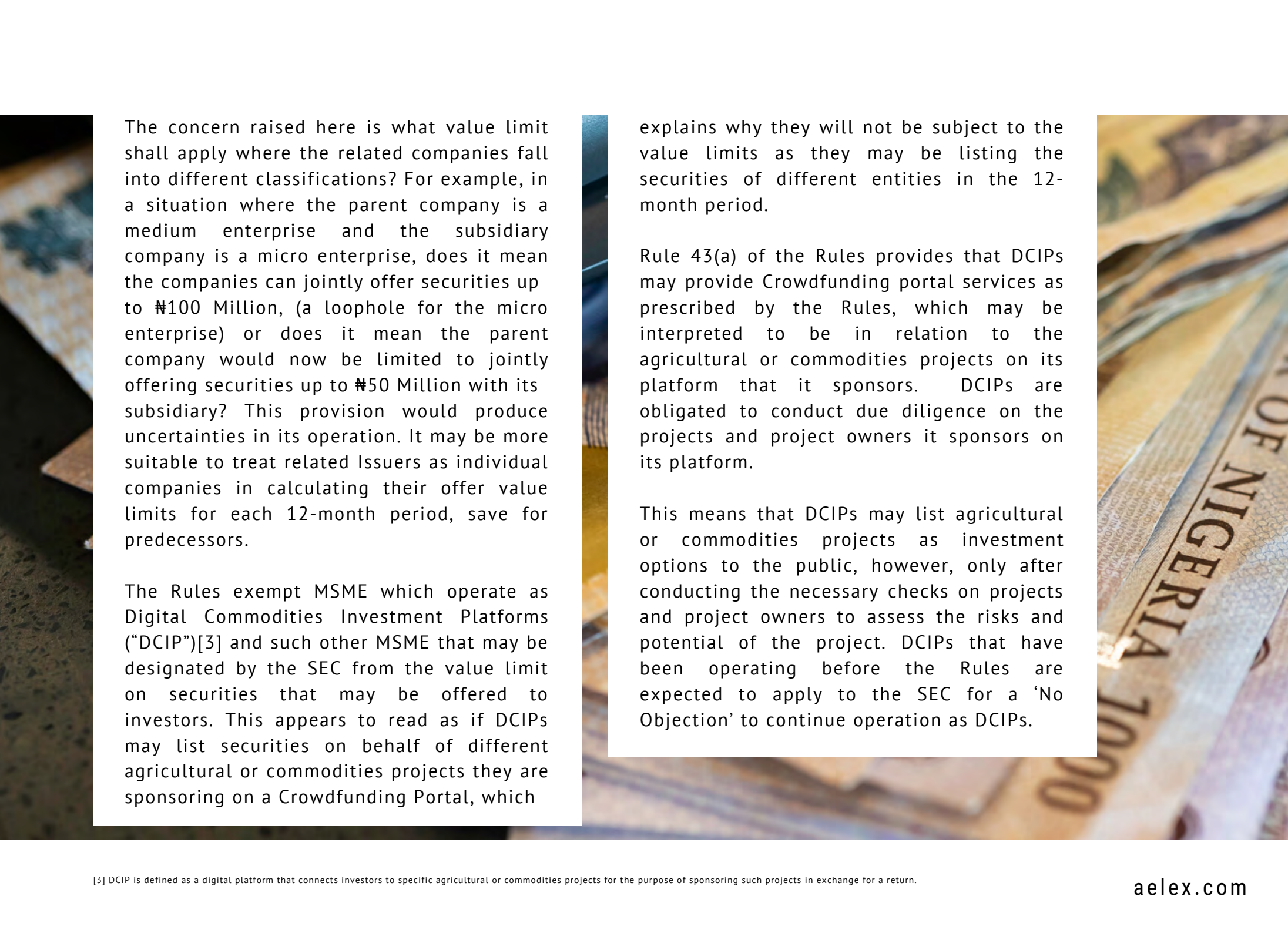
The Rules provide that securities or other investment instruments to be offered on a Crowdfunding Portal by MSME would not have to be registered with the SEC. Crowdfunding Portal by MSME would not have to be registered with the SEC.

However, this is on the provision that the aggregate value of securities or investment opportunities that may be offered and sold by the MSME does not, in a 12-month period, exceed ₦100 Million for a medium enterprise, ₦70 Million for a small enterprise or ₦50 Million for a micro enterprise. The Rules provide that only ordinary shares, plain vanilla bonds/debentures<sup>[1]</sup> or other instruments designated by the SEC may be offered on Crowdfunding Portals without being registered with the SEC.

In addition, the Rules prescribe that in calculating the aggregate value of investment instruments that have been offered by an issuing MSME within a 12-month period, all entities controlled by, under common control with the Issuer or that are predecessors<sup>[2]</sup> of the company shall also be considered. This means that the securities offered by sister companies, a parent company and its subsidiaries shall be counted together when determining whether the aggregate value limit of an issuing MSME has been reached.

[1] Debt instruments with fixed interest rates and defined maturity. Instruments are both at value, with periodic interest payments to the investor and full repayment at maturity.

[2] An entity which has been replaced by another through a merger, acquisition or other corporate action.



The concern raised here is what value limit shall apply where the related companies fall into different classifications? For example, in a situation where the parent company is a medium enterprise and the subsidiary company is a micro enterprise, does it mean the companies can jointly offer securities up to ₦100 Million, (a loophole for the micro enterprise) or does it mean the parent company would now be limited to jointly offering securities up to ₦50 Million with its subsidiary? This provision would produce uncertainties in its operation. It may be more suitable to treat related Issuers as individual companies in calculating their offer value limits for each 12-month period, save for predecessors.


The Rules exempt MSME which operate as Digital Commodities Investment Platforms (“DCIP”)[3] and such other MSME that may be designated by the SEC from the value limit on securities that may be offered to investors. This appears to read as if DCIPs may list securities on behalf of different agricultural or commodities projects they are sponsoring on a Crowdfunding Portal, which

explains why they will not be subject to the value limits as they may be listing the securities of different entities in the 12-month period.

Rule 43(a) of the Rules provides that DCIPs may provide Crowdfunding portal services as prescribed by the Rules, which may be interpreted to be in relation to the agricultural or commodities projects on its platform that it sponsors. DCIPs are obligated to conduct due diligence on the projects and project owners it sponsors on its platform.

This means that DCIPs may list agricultural or commodities projects as investment options to the public, however, only after conducting the necessary checks on projects and project owners to assess the risks and potential of the project. DCIPs that have been operating before the Rules are expected to apply to the SEC for a ‘No Objection’ to continue operation as DCIPs.

[3] DCIP is defined as a digital platform that connects investors to specific agricultural or commodities projects for the purpose of sponsoring such projects in exchange for a return.



In addition, the Rules divide investors into different categories and provides that in a 12-month period, the aggregate value of securities or investment instruments sold to a Retail Investor[4] across all Issuers must not exceed 10% of their annual income in a given year. The investments of Sophisticated Investors[5], High Net Worth Investors[6] and Qualified Institutional Investors[7] are not subject to value limits. Though it does not state how Retail Investors shall be checked and the limit imposed, it is likely that this responsibility will be that of the Crowdfunding Portal when onboarding investors that may fund MSMEs through the platform.

### *Crowdfunding Portals*

As deduced in Part 1 of this article, a key focus of the SEC is to regulate the platforms for Crowdfunding, as seen in the Rules. Every platform that facilitates interaction between Issuers and the investing public for Investment-Based Crowdfunding in Nigeria must be registered with the SEC.

A Crowdfunding Portal must be registered with the SEC where it falls under any of the following:

- it is operated, provided or maintained in Nigeria;
- it actively targets Nigerian investors even though it is located outside Nigeria; or
- the components parts of the platform when taken together are physically located in Nigeria even if any of the component parts are located outside Nigeria.

For the purposes of the Rules, a Crowdfunding Portal actively targets Nigerian investors where the operator or a representative of the operator promotes the platform directly or indirectly in Nigeria.

[4] Any investor other than a High Net Worth Investor, Qualified Institutional Investor or Sophisticated Investor.

[5] An investor whose net worth exceeds N250 Million in securities, cash or real estate estates or who earns a minimum of N25 Million annually. The investor must also have been actively investing for a minimum of three (3) years.

[6] An individual whose aggregate net worth of investment assets exceeds N100 Million and possess evident capacity, expertise and sophistication to undertake high risk investment activities.

[7] These are institutional investors who are financially sophisticated and include banks, insurance companies, fund managers, hedge funds, PE funds, stockbroking firms etc.



## *Crowdfunding Intermediary*

From the registration requirements in the Rules, a Crowdfunding Portal must be registered as a limited liability company with a minimum paid-up share capital of N100 Million. In addition, the Crowdfunding Portal must be operated by a Crowdfunding Intermediary registered with the SEC. The Crowdfunding Intermediary must be an incorporated entity whose corporate objects<sup>[8]</sup> includes the power to which can facilitate transactions for the sale of securities or investments through an online electronic platform.

However, before registering the Portal, the SEC must be satisfied that the Intermediary will operate in an orderly, fair and transparent manner in relation to the securities and investment instruments traded through its electronic platform. The SEC must also be satisfied that the company's Board of Directors, Chief Executive Officer and persons primarily responsible for the operation and financial management of the Crowdfunding are fit and proper persons.

These requirements are to ensure that the interests of the investing public and the capital market are protected.

The SEC also retains the right to revoke the registration of any Crowdfunding Portal for failure to comply with any provision of the Rules; and to suspend or revoke the registration of a Crowdfunding Intermediary who contravenes any provisions of the ISA, the SEC Rules and Regulations, the Code of Conduct for Capital Market Operators and the Rules. In addition, to protect the market, an Intermediary cannot cease the operation of a Crowdfunding Portal without the approval of the SEC.

## *Types of Intermediaries*

The Rules go on to prescribe that only an entity registered with the SEC as an Exchange, a Dealer, a Broker or Alternative Trading Facility may be registered as a Crowdfunding Intermediary.

<sup>[8]</sup> A provision in a company's memorandum and articles of association which states the range of activities the company may carry on business in.

This means that in addition to the provisions of the Rules, the Intermediary will also have to comply with the SEC Rules and Regulations for prescribed capital market operators.

A Dealer registered by the SEC for the purpose of Crowdfunding shall be limited to carrying out activities permitted by the Rules and shall be known as a “Restricted Dealer”. However, the provisions of the Rules do not apply to the following providers:

- technology service providers who merely provide infrastructure, software or system to operators,
- operators of communication infrastructure that enable orders to be routed to an approved stock market, or
- operators of financial portals that aggregate content and provide links to financial sites of service and information providers.

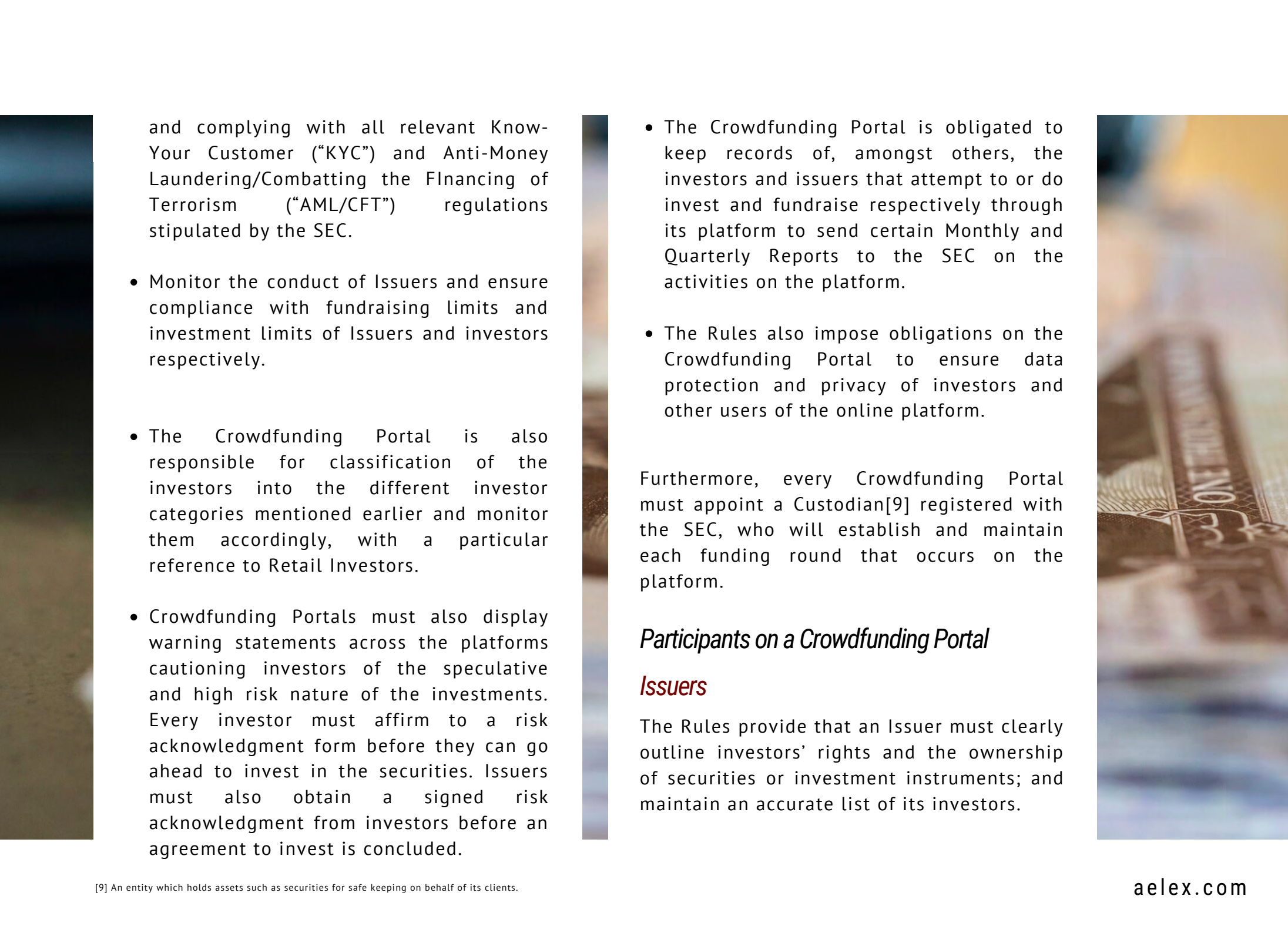
This means that technical partners of the capital market operators in the Crowdfunding space would not have to register as Crowdfunding Intermediaries.

It is pertinent to note that a Crowdfunding Intermediary cannot grant access to a Crowdfunding Portal it operates to Issuers in instances where the Portal or any of the Portal’s directors, officers, significant shareholder(s) or associated persons beneficially owns or control more than 5% of the securities of the prospective Issuer.

### *Obligations of a Crowdfunding Portal*

A Crowdfunding Portal is obligated to do the following-

- Conduct a due diligence process on all prospective Issuers, including carrying out a background check of the Directors, officers and controlling shareholder(s) of the Issuer to ensure they are fit and proper; verifying the business proposition of the Issuer;



and complying with all relevant Know-Your Customer (“KYC”) and Anti-Money Laundering/Combatting the Financing of Terrorism (“AML/CFT”) regulations stipulated by the SEC.

- Monitor the conduct of Issuers and ensure compliance with fundraising limits and investment limits of Issuers and investors respectively.
- The Crowdfunding Portal is also responsible for classification of the investors into the different investor categories mentioned earlier and monitor them accordingly, with a particular reference to Retail Investors.
- Crowdfunding Portals must also display warning statements across the platforms cautioning investors of the speculative and high risk nature of the investments. Every investor must affirm to a risk acknowledgment form before they can go ahead to invest in the securities. Issuers must also obtain a signed risk acknowledgment from investors before an agreement to invest is concluded.

- The Crowdfunding Portal is obligated to keep records of, amongst others, the investors and issuers that attempt to or do invest and fundraise respectively through its platform to send certain Monthly and Quarterly Reports to the SEC on the activities on the platform.
- The Rules also impose obligations on the Crowdfunding Portal to ensure data protection and privacy of investors and other users of the online platform.


Furthermore, every Crowdfunding Portal must appoint a Custodian[9] registered with the SEC, who will establish and maintain each funding round that occurs on the platform.

## *Participants on a Crowdfunding Portal*

### *Issuers*

The Rules provide that an Issuer must clearly outline investors’ rights and the ownership of securities or investment instruments; and maintain an accurate list of its investors.

[9] An entity which holds assets such as securities for safe keeping on behalf of its clients.




The standard Offering Document to be filed with the Crowdfunding Intermediary must include key information on the Issuer including, the proposed use of the fundraising proceeds, the nature of the Issuers' existing or proposed business, the business plan of the Issuer, the amount to be raised, the duration of the offer and the financial information of the Issuer.

Offers may only be made on a Crowdfunding Portal and the Offering documents cannot be posted on any other website. Issuers cannot host concurrent offers on multiple Crowdfunding platforms.

The Rules provide that the maximum period a Crowdfunding offer can run for is 60 days. Where the Issuer is unable to meet the minimum threshold for the target amount within the 60 days, the offer must be withdrawn and the Issuer may only commence a new Crowdfunding offer after 90 days from the expiration of the offer. The fact that the offer is withdrawn means that where an Issuer is unable to meet its prescribed minimum threshold before the end of the 60-day period, the Issuer would

be unable to cash out on any of the response it may have already received on its Crowdfunding offer. The Rules prescribe that such investors are to be refunded within 48 hours of the expiration of the offer.

After the close of a Crowdfunding offer, as prescribed by the Rules on Issuers, investors have a contractual right to withdraw an offer or agreement to invest in the securities or investment instrument by delivering a notice to the Crowdfunding Portal within 48 hours of the close of the offer. Where the Issuer's target amount has been met, the Crowdfunding Portal must pay over the funds raised to the Issuer within 24 hours of the end of the cooling-off period. Where the Issuer's target amount is not reached but the prescribed minimum threshold was met, the Issuer can provide a revised plan to the Crowdfunding Portal and investors for the use of the funds and the Portal shall pay over the funds provided the underlying project can be downscaled without negatively impacting the operations of the issuer.



The Rules impose continuous disclosure requirements on Issuers whose Crowdfunding offers were successful. These include, notification of changes in the documents prescribed by the Rules, deliverance of annual audited financial statements, notification of change of control of the Issuer or change of control of the Issuer's business, etc.

Where the Issuer is a public company or a public company by default<sup>[10]</sup>, the securities offered must be registered with the SEC before the Crowdfunding Portal can pay over the funds. It is essential to note that the concept of a public company by default contravenes the provisions of the CAMA which prescribes the steps to be taken before such a conversion (i.e. from a private to a public company) can be legally achieved consequent to an application to the Corporate Affairs Commission to that effect. The following entities are however prohibited from raising funds on a Crowdfunding Portal:

- Complex structures<sup>[11]</sup>;
- Public listed companies and their subsidiaries;

- Companies with no specific business plan or a blind pool;
- Companies that propose to use the funds raised to provide loans or invest in other entities; and
- Such other entities as may be specified by the SEC.

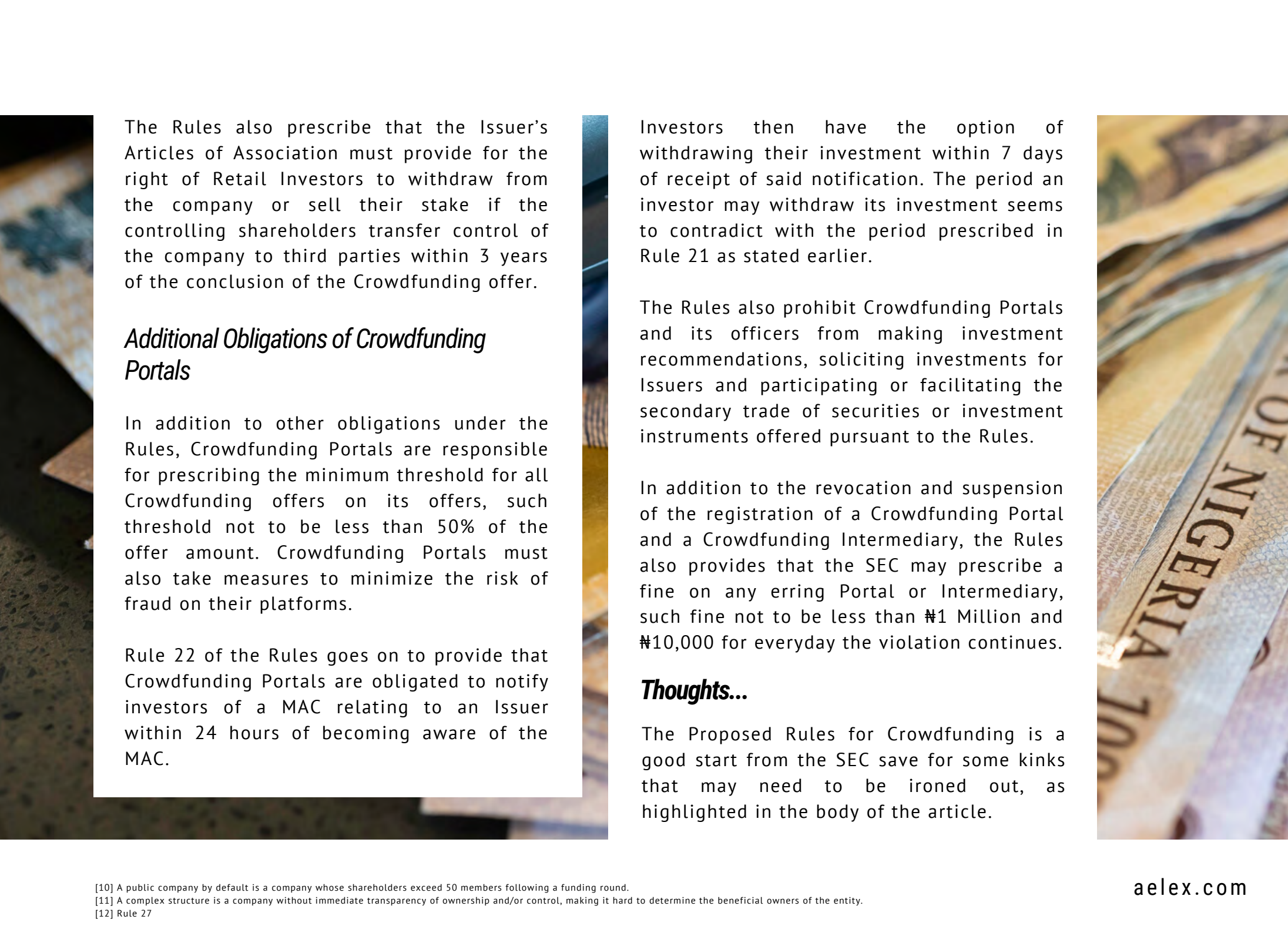
### *Investors*

Rule 20 of the Rules provide that, in addition to the cooling-off period of 48 hours after the closing of the offer, investors have the right to rescind their offer or agreement if there is a Material Adverse Change ("MAC") affecting the project or Issuer within 7 days of the MAC becoming public knowledge. After the conclusion of the investment agreement, the Rules prescribe that investors cannot transfer their interest in the securities or investment instrument for a period of one year, except where the transfer is to the Issuer, to an Institutional Investor or as part of an Offer for Sale registered with the SEC<sup>[12]</sup>.

[10] A public company by default is a company whose shareholders exceed 50 members following a funding round.

[11] A complex structure is a company without immediate transparency of ownership and/or control, making it hard to determine the beneficial owners of the entity.

[12] Rule 27



The Rules also prescribe that the Issuer's Articles of Association must provide for the right of Retail Investors to withdraw from the company or sell their stake if the controlling shareholders transfer control of the company to third parties within 3 years of the conclusion of the Crowdfunding offer.

### ***Additional Obligations of Crowdfunding Portals***

In addition to other obligations under the Rules, Crowdfunding Portals are responsible for prescribing the minimum threshold for all Crowdfunding offers on its offers, such threshold not to be less than 50% of the offer amount. Crowdfunding Portals must also take measures to minimize the risk of fraud on their platforms.

Rule 22 of the Rules goes on to provide that Crowdfunding Portals are obligated to notify investors of a MAC relating to an Issuer within 24 hours of becoming aware of the MAC.

Investors then have the option of withdrawing their investment within 7 days of receipt of said notification. The period an investor may withdraw its investment seems to contradict with the period prescribed in Rule 21 as stated earlier.

The Rules also prohibit Crowdfunding Portals and its officers from making investment recommendations, soliciting investments for Issuers and participating or facilitating the secondary trade of securities or investment instruments offered pursuant to the Rules.

In addition to the revocation and suspension of the registration of a Crowdfunding Portal and a Crowdfunding Intermediary, the Rules also provides that the SEC may prescribe a fine on any erring Portal or Intermediary, such fine not to be less than ₦1 Million and ₦10,000 for everyday the violation continues.

### ***Thoughts...***

The Proposed Rules for Crowdfunding is a good start from the SEC save for some kinks that may need to be ironed out, as highlighted in the body of the article.

[10] A public company by default is a company whose shareholders exceed 50 members following a funding round.

[11] A complex structure is a company without immediate transparency of ownership and/or control, making it hard to determine the beneficial owners of the entity.

[12] Rule 27

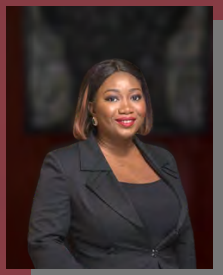
The Rules, however, may have failed to take into consideration the fact that the target Issuers, which are MSME, are likely to be private companies. Section 22(5) of CAMA provides that private companies cannot invite the public to subscribe for shares unless authorized by law. Where argument can be made that this still permits that other investment instruments may be offered to the public, there is also the provision of section 67 of the ISA which provides that no person can make an invitation to the public to acquire or dispose the securities of a body corporate unless the body corporate is a public company. This provision covers other investment instruments and so it is evident that the extant statutes prohibits private companies from offering securities to the public.

The position of the law is that a Regulation, such as the Rules, cannot amend Statutes such as CAMA and the ISA. As such, it is our view that to legally permit private companies to take advantage of Investment Based Crowdfunding as envisioned by the Rules, CAMA and the ISA would have to be amended by an Act of the National Assembly.

## CONCLUSION

Although the Rules published by the SEC are a welcome development, it seems the SEC may have missed a step in implementing a regulatory framework for Investment-Based Crowdfunding; unless, the intention is to have only public companies on Crowdfunding Portals. However, it appears from the Rules that private companies are also contemplated.

For Rules, Guidelines or Regulations issued by the regulatory body to be valid, they have to be authorised by the body's empowering legislation. In this instance and in relation to Investment-Based Crowdfunding, the ISA and the CAMA must authorise any Regulations issued by the SEC. Therefore, for private companies to take advantage of the proposed Rules for Crowdfunding, the respective statutes would have to be amended.



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