

ARTICLE SERIES

**THE NIGERIAN SECURITIES AND EXCHANGE COMMISSION
CROWDFUNDING RULES -
ITS IMPACT ON STARTUPS AND SMES**



INTRODUCTION

On 12 January 2021, the Nigerian Securities and Exchange Commission (“SEC”) released its Rules on Crowdfunding (“the Rules”), pursuant to section 13(a) of the Investment and Securities Act 2007 to regulate investment-based crowdfunding in Nigeria.

SEC set a deadline of **30 June 2021** for the implementation of the Rules. It is therefore important to consider the activities and entities required to be registered with the SEC per the Rules.

The SEC has mandated that all existing portals/platforms that facilitate investment-based crowdfunding comply with the requirements of the Rules and register with the SEC or cease their operations by the 30th of June 2021. Failure to comply with the foregoing would render any operation by an unregistered entity illegal and they will be subject to regulatory sanctions as provided by the Rules. It is important to note that entities do not need to term their activities crowdfunding before they fall under the purview of the Rules; this is determined by their structure and product offerings

In May 2020, we considered the provisions of the Exposure Draft of the Rules released by SEC (read [here](#) [1])

Scope of the Rules

The Rules only apply to investment-based crowdfunding [2]. To understand the Rules, there are a number of definitions that are important to note -

- **investment-based crowdfunding** - ‘the process of raising funds from the public through an online portal in exchange for shares, debt securities or other investment instruments approved by the Commission’,
- **investment instruments** - ‘ordinary shares, plain vanilla bonds or debentures, and simple investment contracts approved by the SEC for issuance through a crowdfunding portal from time to time’,
- **simple investment contract** - ‘a contract or scheme for the placing of capital in way intended to secure income or profit from its employment and includes participation in any profit-sharing agreement by virtue of which the investors provide the capital, the promoters manage, control and/or operate the enterprise, and the investors share in the earnings and profits’.

[1]<https://www.aelex.com/the-changing-face-of-finance-in-nigeria-crowdfunding-our-economy-part-2/>

[2] Paragraph 2 of the Rules

- **crowdfunding intermediary** – ‘an entity organized and registered as a corporation to facilitate transactions involving the offer or sale of securities or investment instruments through a Crowdfunding Portal’,
- **crowdfunding** – ‘the use of small amounts of money, obtained from a large number of individuals or organizations, to fund a project or, a business through an online web-based platform’,
- **fundraiser** – ‘refers to the originator, maker or obligor of the investment instrument to be issued pursuant to the Rules’, and
- **crowdfunding portal** – ‘a website, platform, portal, intermediary portal, application or other similar module that facilitates interaction between Fundraisers and the investing public’.

To simplify the above definitions, investment-based crowdfunding involves many people (the public) investing various amounts of money to fund a project or an entity in exchange for interest or return on their investment. Entities who receive contributions/capital from its users, manage this capital and then distribute profits to the users will also fall under the scope of the Rules as they are seen to be entering into **simple investment contracts** as defined under the Rules. Now, per the Rules, entities who facilitate investment-based crowdfunding via online platforms (Crowdfunding Portals) are required to be registered with the SEC as Crowdfunding Intermediaries.

FUNDRAISERS AND INVESTMENT-BASED CROWDFUNDING

Before the Rules, there were no limits on the types of issuers that may participate in investment-based crowdfunding; however, with the passage of the Rules, the SEC has set a limit. Entities that are eligible to raise funds through a Crowdfunding Portal operated by a Crowdfunding Intermediary by the issuance of investment instruments are:

- MSMEs incorporated as a company in Nigeria with a minimum of two-years operating tracking record; and
- MSMEs incorporated as a company in Nigeria with less than 2 years operating track record but with a strong technical partner that has a minimum of 2 years operating track record or has a core investor.

MSMEs are defined by the Rules as micro, small and medium enterprises as prescribed by the Small and Medium Enterprises Development Agency of Nigeria (“SMEDAN”) in relation to total asset annual turnover or number of employees. This shows that SEC clarified one of the conflicts highlighted in our earlier article in terms of the definition of MSMEs in the National Policy for MSME published by SMEDAN adopting the dual criteria of employment and asset (excluding land and buildings).

In addition, it is interesting to note, the Rules differ from the Exposure Draft in terms of the eligible MSMEs. The Exposure Draft had been much stricter by providing that only MSMEs with a minimum of two-years operating track record were eligible to raise funds through a Crowdfunding Portal, but the Rules are more flexible as it permits MSMEs with a technical partner or a core investor to crowdfund.

INVESTMENT INSTRUMENTS - EXEMPTIONS FROM THE INVESTMENT AND SECURITIES ACT 2007 ("THE ISA")

Now investment-based crowdfunding which involves the offering of securities to the public would typically be subject to restrictions under the Nigerian securities regulation. Section 67 of the ISA provides that no person can make an invitation to the public to acquire or dispose any securities of a body corporate unless the body corporate is a public company.

Paragraph 4 of the Rules provides that a Fundraiser may offer or sell investment instruments without prior registration of the investment instruments as required under ISA provided that the fundraiser is incorporated in Nigeria and accredited by a Crowdfunding Intermediary to utilize its portal, the

instruments are offered through a Crowdfunding Portal, and the aggregate amount of investment instruments offered and sold by the Fundraiser within a 12-month period does not exceed N100Million for a medium enterprise, N70 Million for a small enterprise, and N50Million for a micro enterprise. Also, the aggregate amount of investment instruments sold to retail investors during the 12-month period shall not exceed 10% of their net annual income in a calendar year.

In addition, the Rules prescribe that in calculating the aggregate amount of investment instruments offered and sold by a Fundraiser within a 12-month period, all entities controlled by, under common control with the Fundraisers or that are predecessors of the Fundraiser 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.

We note that the final issue of the Rules does not address one of the concerns raised following the Exposure Draft, which is, what value limit shall apply to the aggregate amount of investment instruments offered by a Fundraiser where one of its related companies falls into different classifications?

For example, in a situation where the parent company is a medium enterprise and the subsidiary company is a micro enterprise, would the N100 Million limit apply or would the N50 Million apply? This appears to be a grey area that the SEC would need to clarify.

Fundraisers and Crowdfunding Intermediaries must also note that any equity-based crowdfunding remains subject to provisions of the Companies and Allied Matters Act 2020, especially on restrictions on the shareholding of private companies.

CROWDFUNDING PORTALS

The Rules mandate that every portal that facilitates, operates, provides or maintains interactions between Fundraisers and the investing public in Nigeria for any investment-based crowdfunding must be operated only by Crowdfunding Intermediaries [3]. The type of Crowdfunding Portals that fall under the scope of the Rules remains the same as in the Exposure Draft and highlighted in our previous article [4].

It can be deduced from the Rules that the SEC has placed emphasis on the regulation of websites, apps, etc (portals) that offer investment-based crowdfunding to Nigeria and regulation of the entities that operate these portals.

CROWDFUNDING INTERMEDIARIES – REQUISITE TO RUN A CROWDFUNDING PORTAL

While the registration requirements are similar to the requirements in the Exposure Draft, there are key changes – which we shall highlight below.

Registration as a Crowdfunding Intermediary

An interesting change is that the final issue does not include the requirement that a Crowdfunding Intermediary must be registered with the SEC as an Exchange, a Dealer, a Broker or Alternative Trading Facility; however, this has occasioned additional registration requirements such as registration of at least 3 principal officers of the Crowdfunding Intermediary as sponsored individuals, requirement for a fidelity insurance bond, minimum cash assets ratio of 30% liquid assets to 70% fixed and other assets, etc.

The SEC may register a Crowdfunding Intermediary if it is satisfied that, amongst others, the board of directors, the chief executive officer, and any other officer primarily responsible for the operations or financial management of the Crowdfunding Portal are fit and proper persons and that the Intermediary will be able to operate an orderly, fair and transparent system concerning the offering of investment instruments on its portal [5]

[3] Paragraph 5 of the Rules.

[4] <https://www.mondaq.com/nigeria/securities/930000/the-changing-face-of-finance-in-nigeria--crowdfunding-our-economy-part-2>

[5] Paragraph 7 of the Rules

Cancellation or Suspension of Registration as a Crowdfunding Intermediary

On the flip side, SEC may cancel or suspend 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, or is guilty of fraud, repeated defaults or had been convicted of an offence involving moral turpitude [6].

Where the registration of an Intermediary is suspended, cancelled, or revoked or where an Intermediary voluntarily ceases business, SEC may issue directives concerning the former operations of that Intermediary in the interest of investors, including on ongoing issuances on the portal, repayments to its investors, interim management of the operations of the Intermediary, funds held by custodians on behalf of Fundraisers, etc.

OBLIGATIONS OF CROWDFUNDING INTERMEDIARIES

The regulation of Crowdfunding Portals and Crowdfunding Intermediaries is focused on investor protection, considering the popularity of investment-based crowdfunding amongst retail investors.

To that end, the SEC has set certain obligations Crowdfunding Intermediaries are required to comply with in their operation of Crowdfunding Portals, including:

- Disclose and display prominently on its portal, information relating to the use of the portal including disclosures on the Fundraiser such as details of ownership, management, overall controls structure at the time of the offering, etc.
- Display of investor education materials, appropriate risk disclosures, fees, charges and other expenses that may apply to Fundraisers and investors, information about complaints handling and dispute resolution.
- An attestation by the Intermediary that it has verified the legitimacy of the Fundraiser's business and the operations of the Fundraiser agree with the disclosed objectives and will continue to do so.
- Comply with the provisions of the Nigerian Data Protection Regulations and other applicable laws, ensuring the safety and confidentiality of information collected from investors.

[6] Paragraph 8 of the Rules

- Display warning statements on the home page of the portal, subscription landing page of each Fundraiser and application forms for investing through the portal. The warning statement must include, amongst others, a caution to investors that investment in the businesses hosted are speculative and high risk, that investing through an online portal is risky, and that investment limits of investors are being monitored by the Crowdfunding Intermediary. 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.

Investors must properly appreciate the risk they take in participating in an investment-based crowdfunding and must note that the risk acknowledgement forms they sign, amongst others, mean that they will not have the benefit of protections associated with an investment made under a prospectus and they will not be entitled to claim from the national investor protection fund [7].

Crowdfunding Intermediaries are required to carry out due diligence investigation on Fundraisers applying to use its portal and must ensure that these Fundraisers comply with the provisions in the Rules [8], including monitoring their conduct on the portal [9].

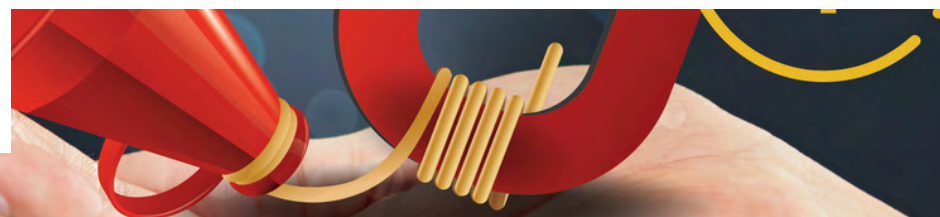
Further, Crowdfunding Intermediaries are required to appoint a Custodian registered with SEC, who will be charged with establishing and maintaining a separate interest yielding trust account for each funding round on the portal. The Custodian may only release the funds raised to Fundraisers if the targeted amount sought has been raised or the minimum threshold has been met, there is no material adverse change relating to the offer during the offer period and any applicable requirements for registration of securities has been met.

Cross Ownership by a Crowdfunding Intermediary

Except with the approval of the SEC, a Fundraiser cannot raise funds on a portal that is operated by a Crowdfunding Intermediary who (or any of its officers, directors, significant shareholders or associated persons) beneficially own or control more than 5% of the securities of the Fundraiser.

The Rules also go on to state the obligations of crowdfunding participants, including fundraisers, investors, and intermediaries. The Rules are a lot and will clearly change the operation of previously unregulated crowdfunding in Nigeria.

[7] Paragraph 16 (C) of the Rules
[8] Paragraph of the Rules
[9] Paragraph 13 of the Rules



IMPACT OF THE RULES ON THE OPERATION OF CROWDFUNDING IN NIGERIA

In Nigeria, the typical investment-based crowdfunding we have seen is an app listing investment opportunity to its users, who can co-invest for unit prices. In exchange, they get returns after a stated time. Investors who are looking to liquidate their investment before maturity are encouraged to sell to other users at an agreed price and prospective investors have the opportunity to make offers on sold out opportunities to current investors via the app. Most apps offer investment opportunities in various sectors such as agriculture, real estate, transportation, etc.

With the Rules, such apps must consider how their operations must change to ensure compliance with the Rules. To start, as highlighted above, the Crowdfunding Portals must now have certain disclosures and warning statements displayed across the platform.

In addition, the Rules now prohibit Crowdfunding Intermediaries from intermediating or facilitating secondary trades between buyers and sellers for investment instruments issued pursuant to the Rules. With this, existing Crowdfunding Portals who facilitate these secondary trades on the investment opportunities on the platform/app would have to stop offering that service to their users.

The biggest change to the operation of investment-based crowdfunding following the Rules is likely the introduction of 'Commodities Investment Platforms' and the additional requirements that apply to the operation of one.

Commodities Investment Platforms

A Commodities Investment Platform "CIP" is defined by the Rules as an electronic platform that connects investors to specific agricultural or commodities projects for the purpose of sponsoring such projects in exchange for a return. Existing crowdfunding intermediaries that list agricultural or commodities projects as investment opportunities on their portals must note that there are now restricted as follows:

- they cannot also be registered as a fund manager with the SEC;
- they cannot use the portal for any other crowdfunding or marketing purpose save for crowdfunding for investments in agriculture or other commodities;
- they cannot host other crowdfunding portals for investment-based crowdfunding for non-agricultural or commodities projects; and
- there is a limit of N1,000,000,000 (One Billion Naira) on funds that may be raised on a CIP within a 12-month period (subject to approval by the SEC on application to exceed the specified amount).

What this means is that a Crowdfunding Intermediary which offers investment-based crowdfunding opportunities for agricultural/commodities projects cannot offer investment opportunities in projects in other sectors [10].

This certainly limits a few of the 'Crowdfunding Intermediaries' currently operating in Nigeria and will necessitate a restructuring of their operations. Further, the Rules stipulates certain requirements to be met before crowdfunding transactions are hosted by a Crowdfunding Intermediary.

Crowdfunding Transactions

Before hosting an eligible Fundraiser on its platform, a Crowdfunding Intermediary must send information on the Fundraiser's promoters, directors, shareholders, area of business, etc., to the SEC [11]. Following the notification, the SEC may (within 2 working days) direct an Intermediary to prohibit an offering if it considers it necessary and in the interest of the capital market [12].

In addition, the Rules stipulates that crowdfunding offers shall not be open for more than 90 days (a 60-day initial period, and an extension of 30 days subject to the portal's conditions). A target amount must be set for each offering and the Portal must be set to reject additional subscriptions once target has been met, while, if an offer fails to meet the minimum threshold for the target in the approved period, the offer must be withdrawn, and investors refunded.

A Fundraiser will only receive funds if the minimum threshold was met.

Investment instruments acquired following an investment-based crowdfunding are also subject to certain restrictions under the Rules, such as a lock-in period of one year save for transfers to certain persons, equity offers must include tag-along rights for retail investors and debt offers must include an early redemption (put) option for all investors, in the event that controlling shareholders transfer control of the Fundraiser to third parties within 3 years from the conclusion of the offer.

Entities currently operating crowdfunding portals that offer investment-based crowdfunding must review the Rules, restructure their operations to comply with the Rules and must apply to be registered with the SEC within 90 days of the effective date of the Rules – 30 June 2021 to avoid sanctions by the SEC.

CONCLUSION

The Rules are a huge change for a previously unregulated type of financing. Operators would likely have to significantly restructure their operations to ensure compliance with the Rules. However, it is our view that with proper engagement with the SEC and stakeholders in the market, parties can stay compliant with SEC's regulations while remaining competitive.

[10] Paragraph 40 of the Rules

[11] Paragraph 24 of the Rules

[12] Paragraph 25 of the Rules



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