



## OVERVIEW OF SEC PROPOSED RULES ON CROWDFUNDING

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On 28 March 2020, the Securities and Exchange Commission (**SEC**) exposed its draft Rules on Crowdfunding (**Rules**). The Rules is expected to regulate crowdfunding platforms located within Nigeria, and those outside Nigeria as long as the crowdfunding activities are targeted at investors in Nigeria.

In a market where only public companies are permitted to offer securities to the public, the Rules aim to regulate raising finance from the public being carried out online by entities other than public listed companies or companies regulated by SEC.

Under the Rules, Crowdfunding is defined as “*the process of raising funds to finance a project or business from the public **through an online platform***”. This definition is wide enough to catch all forms of ‘digital’ crowdfunding - including equity, debt, project and donation based forms of crowdfunding but will not extend to ‘offline’ crowdfunding. Whilst the risks associated with equity-based crowdfunding such as illiquidity, fraud, scope of disclosure, or regulatory oversight makes the Rules a welcome development in protecting investors, it is still unclear whether the Rules effectively consider the typical forms of crowdfunding prevalent in this market and the impact it may have on the issuers who typically rely on these alternative mode of raising finance.

### ***The Participants***

According to the Rules, the key participants in crowdfunding include:

- (a). Issuers seeking to raise capital via crowdfunding;
- (b). Crowdfunding portals used to crowdfund; and
- (c). Investors investing in crowdfunding investment instruments.

### ***Issuers***

Under this head, the Rules permit medium, small and micro enterprises (MSMEs)<sup>1</sup> to be Issuers. However, such entities are now required to have a minimum paid up share capital of at least N100 million and been operational for at least 2 years. The following entities are prohibited from being issuers:

- (a). Complex structures;
- (b). Public listed companies and their subsidiaries;
- (c). Companies with no specific business plan or a blind pool;

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<sup>1</sup> MSMEs are defined as prescribed by the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) in relation to total asset and annual turnover.

- (d). Companies that propose to use the funds raised to provide loans or invest in other entities;
- (e). Such other entities as may be specified by the SEC.

Private limited liability companies, public unlisted companies would still be eligible to be Issuers.

It is important to mention that the definition of an “Issuer” under the Rules may effectively “lock-out” issuers seeking alternative financing as they may not be able to meet the registration requirements for an issuer prescribed by the Rules. This is because in addition to the requirement to be a private or an unlisted public company limited by shares, the issuer needs to have been operational for at least 2 years and needs to have a minimum paid up capital of at least N100 million. Considering that the Rules are targeting corporate MSMEs, this minimum paid up requirement contradicts the classification of MSMEs by Small and Medium Enterprises Development Agency of Nigeria (**SMEDAN**) and may lock out small, micro and certain medium enterprises (whose classification fall below N100 million<sup>2</sup>) from eligibility based on capital requirements.

From the list of eligible issuers highlighted above, it follows that a private company (or public unlisted company) subsidiary of a public listed company may not be eligible due to such affiliation and similarly, complex structures used in holding shares in Nigerian entities could result in other entities being excluded from being registered as issuers. A ‘complex structure’ is *“an entity without immediate transparency of ownership and/or control thereby making it difficult to immediately ascertain the beneficial owners of the entity”*.

An eligible Issuer seeking to raise funds through a crowdfunding portal would have to submit the following to the crowdfunding portal:

- (a) information that explain the key characteristics of the issuer;
- (b) information that explains the purpose of the listing and the targeted offering amount;
- (c) audited financial statements of the issuer;
- (d) issue an offering document.

### **Crowdfunding Portals**

Under the Rules, a Crowdfunding Portal is defined as a *“website, portal, intermediary portal, application, or other similar module that facilitates interaction between fundraisers and the investing public”*. The Rules provide that only “Crowdfunding Intermediaries” (*intermediaries*

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<sup>2</sup> The SMEDAN National Policy on Micro, Small and Medium Enterprises classifies MSMEs in terms of employment and assets. For assets, micro enterprises have less than N5 million; Small enterprises have between N5million and N50million; and Medium enterprises have between N50million and N500million.

*organized and registered as a corporation to facilitate transactions involving the offer or sale of securities or investments through an online electronic platform*) may register and operate Crowdfunding Portals.

The Rules require Crowdfunding Portals to be registered with the SEC. The registration requirement is applicable to crowdfunding portals located within and outside Nigeria. For platforms within Nigeria, the Rules will apply if:

- (a). The platform is operated, provided or maintained in Nigeria; or
- (b). The component parts of the platform when taken together are physically located in Nigeria even if any of its component parts, in isolation, is located outside Nigeria.

For platforms outside Nigeria, the Rules apply if these portals are “targeting Nigerian investors” by the operator or representative promoting the platform directly or indirectly in Nigeria.

The Rules provide additional obligations for digital commodities investment platforms. A digital commodities investment platform is “*a digital platform that connects investors to specific agricultural or commodities projects for the purpose of sponsoring such projects in exchange for a return*”. For digital commodities investment platforms already in existence prior to the Rules, they would have to apply to the SEC for a “No objection” to continue to operate as a digital commodities investment platform and cannot be registered as a fund manager. The Rules also require that such digital commodities investment platforms only host commodities investment projects on crowdfunding platforms it does not directly or indirectly control.

In addition to regulating the registration of Crowdfunding Portals, SEC also extensively regulates the operation of and the discontinuation of business of a Crowdfunding Portal. In relation to operation, the obligations range from conducting due diligence on issuers, monitoring and reporting obligations, data protection and privacy, record keeping, compliance matters, to the operation of trust account for each funding round.

Under the Rules Crowdfunding Portals are prohibited from:

- (a) soliciting investments or making recommendations, which extends to both Crowdfunding Portals and or their managers and officers;
- (b) acting as intermediary or facilitator of secondary trades between buyers and sellers for securities or crowdfunding investment instruments.

Penalties apply for non-compliance with the Rules, which could be a fine of not less than N1 million plus a N10,000 for every day of non-compliance. In addition to fines, SEC may revoke their registration if:

- (a). the portal fails to meet the requirements under the Rules;
- (b). the Crowdfunding Intermediary fails or ceases to operate or maintain the portal for a consecutive 6 months period;
- (c). there is a failure to pay SEC fees.

## ***Crowdfunding Intermediaries***

Crowdfunding Intermediaries play an integral role in the crowdfunding process as they own and operate the Crowdfunding Platforms and are thus required to be registered with the SEC. A Crowdfunding Intermediary is required to have a minimum paid up capital of N100 million.

The Rules clarify that entities eligible to apply for registration as Crowdfunding Intermediaries include “an Exchange, Dealer, Broker, Dealer/Broker, alternative trading facility” registered with the SEC. Thus, such capital market operators registered for any of these functions would qualify for registration as Crowdfunding Intermediaries under the Rules.

It is important to note that a Dealer seeking to be registered as a Crowdfunding Intermediary would be considered to be a “Restricted Dealer” upon registration and will be restricted to only carrying out crowdfunding activities prescribed under the Rules. This means that such Dealers will not be able to simultaneously carry out other capital market activities.

Crowdfunding Intermediaries are prohibited from:

- (a). allowing an issuer to access the crowdfunding portal if the portal or any of its officers, directors, significant shareholders or associated persons own or control more than 5% of the securities of that issuer;
- (b). providing financial assistance to investors for the purpose of investing in an offer hosted on its platform or for which it has provided a service;
- (c). paying a finders’ fee for a person who connects them with potential investors<sup>3</sup>.

The registration of a Crowdfunding Intermediary may be cancelled or suspended, where the Crowdfunding Intermediary:

- (a). breaches the provisions of:
  - i. the Investment and Securities Act,
  - ii. SEC Rules and Regulations 2013 (as amended),
  - iii. Code of conduct for capital market operators;
- (b). is guilty of fraud;
- (c). repeated defaults;
- (d). convicted of an offence involving moral turpitude; or
- (e). fails to comply with obligations under the Rules such as periodic returns or reports, amongst others.

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<sup>3</sup> Similarly, issuers are also prohibited from paying finders’ fee, referral fees, commission or similar payments to any person in connection with an offering other than to the crowdfunding portal. This would mean advisory firms stand to lose potential fees for connecting such intermediaries and issuers with retail investors, sophisticated, high net worth qualified investors or crowdfunding platforms particularly considering the cap on fees introduced by the SEC for acting for parties to the issue. The SEC caps transaction fees at a maximum of 2% of the total funds raised.

The Rules prescribes fines for non-compliance by Crowdfunding Intermediaries similar to those imposed on Crowdfunding Portals. This amounts to a fine of not less than N1 Million plus a N10,000 daily fine for each day the violation continues.

### **Investors**

The Rules define Investors as “*any person or entity that seeks to make, are making, or have made an investment in an investment vehicle with the expectation of achieving returns*”.

Investors are permitted to invest in companies hosted on a Crowdfunding Portal subject to the prescribed limits for Retail Investors<sup>4</sup>, which include non-professional investors purchasing securities or investment instruments for their own personal account and usually in smaller quantities. The Rules limit such Retail Investors to an aggregate investment of not more than 10% of their annual income in such investment instruments in a calendar year. There are however no prescribed limits for Sophisticated Investors<sup>5</sup>, High Net Worth Investors<sup>6</sup> and Qualified Institutional Investors<sup>7</sup>.

### **Permitted Crowdfunding Investment Instruments**

The permitted crowdfunding investment instruments that can be issued under the Rules include plain vanilla bonds/debentures, shares and simple investment contracts. A simple investment contract is “*a contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profit from its employment and includes participation in any profit-sharing agreement by virtue of which:*

- (a). The investors provide the capital;
- (b). The promoters manage, control and/or operate the enterprise; and
- (c). The investors share in the earnings and profits”

This widens the scope of what would ordinarily have been viewed as a limited pool of investment instruments.

Issuers are however prohibited from hosting an offer concurrently on multiple Crowdfunding Portals.

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<sup>4</sup> Retail Investors are defined as any investor other than High Net worth, Sophisticated Investor or Qualified Institutional Investors.

<sup>5</sup> This refers to an Investor with net worth in excess of N250 million in securities, cash or real estate assets or earns N25 million annually and provided the investor have been actively investing for a minimum period of 3 years.

<sup>6</sup> This refers to an individual with a net worth of at least N300 million, excluding automobiles, homes and furniture.

<sup>7</sup> This refers to a purchaser of securities that is financially sophisticated.

### ***Limit on Capital Raising***

Under the Rules, SEC has defined the threshold for capital raising for different categories of issuers. The categories and thresholds are as follows:

- (a) Medium enterprise = N100 million
- (b) Small enterprise = N70 million
- (c) Micro enterprise = N50 million

These thresholds are expected to apply to the issuer and its affiliates - entities controlling it or one under common control.

As highlighted above<sup>8</sup>, the minimum paid up capital requirement under the Rules already vastly limit the pool of eligible MSME issuers.

In terms of medium enterprises who may be better positioned to meet the minimum paid up capital requirement, such issuers would be unduly limited in their ability to crowdfund, particularly through the use of investment instruments where no shares in the issuer are being offered, by these prescribed caps. Furthermore, when taking into account the cumulative range of entities SEC considers for the purposes of calculating the annual limit for issuers, the extent of the limitation on the amount certain MSME issuers can raise through crowdfunding becomes more apparent, as these thresholds are not directed at how much the issuer can raise per offer but aggregates the total capital that can be raised in a year, whether independently or jointly with affiliated entities.

It is however important to note that the aforementioned thresholds do not apply to MSMEs operating as digital commodities investment platforms or such other MSMEs designated by SEC from time to time, and as such they may raise funds above the prescribed limits for MSMEs.

### ***Other Crowdfunding Requirements***

The Rules provide other extensive provisions around the offer process, some of the salient provisions are as follows:

- (a) an offer period for an issue cannot be more than 60 days;
- (b) if the issuer fails to raise the minimum threshold within the offer period, the issuer is required to withdraw the offer, refund the funds received to the investors within 48 hours and may not crowdfund for 90 days after the withdrawal;
- (c) offering documents are to be made available to potential investors through the Crowdfunding Portal;
- (d) offering documents are to be short, easy to read, standardised for compatibility and digital friendly;

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<sup>8</sup> Ibid at paragraph 0.

- (e). admission of an offer to a crowdfunding portal is subject to existence of tag along rights for retail investors.
- (f). offering documents are to comply with disclosure requirements specified by the SEC;
- (g). investors have a 48-hour window from the date of close of the offer to withdraw their investment;
- (h). investors cannot transfer securities or crowdfunding investment instruments purchased for a period of one year except if to the Issuer/institutional investor/part of an offer for sale registered with SEC;
- (i). issuers are required to notify investors within 24 hours of becoming aware of a MAC affecting the project and investors have 7 days to withdraw investment from receipt of such notice;
- (j). crowdfunding portals are required to implement measures to verify use of proceeds comply with the stated purpose.

### **Conclusion**

These long awaited Rules set out clear provisions on who the permitted participants for the purposes of digital crowdfunding are, the registration requirements for such participants as well as on the crowdfunding process. The Rules however fail to align its provisions on the registration requirements for issuers with the target enterprises the rules are intended to cater to. They also fail to align the prescribed limits to fund raising for such issuers with the classification of MSMEs. Such provisions could effectively mean that (i) a vast number of MSMEs may be locked out from being eligible to register as issuers and (ii) eligible issuers may be significantly limited in how much they can actually raise through these alternative means.

The Rules authorise only Crowdfunding Intermediaries to operate crowdfunding portals as well as to register such portals. As the operators of Crowdfunding Portals, the Rules also subject such Crowdfunding Intermediaries to a minimum paid up capital of N100 million. Furthermore, Dealers seeking to be registered as crowdfunding intermediaries would be considered to be “Restricted Dealers” and accordingly, limited to only carrying out crowdfunding activities.

To ensure compliance, the Rules prescribed penalties that would apply to both crowdfunding platforms and crowdfunding intermediaries.

Considering the impact the Rules may have on key participants, we welcome comments from clients interested in crowd funding on the reviewed provisions of the Rules as well as any other specific questions on the Rules.

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