

# CROWDFUNDING:

## An Overview of SEC Proposed Rules

Regulating crowdfunding became inevitable in the bid to protect investors and boost public confidence to invest in startups and MSMEs, which would further deepen the nation's capital market and enable it to provide capital development for MSMEs. However, there is the need for regulatory caution, to avoid over-regulation which may hinder the intended access of MSMEs to capital.

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## Introduction and Definition

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Crowdfunding is a form of crowdsourcing and alternative means of financing businesses and ventures, whereby a small amount of money is raised from a large number of people in exchange for a later reward or equity (except for charity/donation-based crowdfunding). It is the collective effort of individuals, pulling funds together to promote a particular course or object. It is “the process of raising funds to finance a project or business from the public through an online platform”.<sup>1</sup>

Crowdfunding comes with many merits and benefits to the initiator, aside from the funding/financing benefits, it serves as a great marketing tool, a means to promote an idea or business before launch, imprinting brand awareness in the mind of the public. It also serves as a market survey tool, giving clues as to the extent of public appreciation of an idea, product, and/or service, as well-subscribed crowdfunding suggests easy market penetration of the brand. Crowdfunding also serves as a channel for peer-to-peer promotion of a venture, subscribers/investors to a particular crowdfunding venture, would be interested in the profitability of the venture, hence, subconsciously becomes an advocate and evangelist of such venture.

A well-subscribed crowdfunding scheme, boost the profile and reputation of the initiator of such a

scheme, provides market feedback, enables audience engagement as well as the financial benefit to fund and promote a business venture.

The relevant provisions of ISA<sup>2</sup> and CAMA<sup>3</sup>, excludes private limited companies from the operations of the capital market, hence, prohibited from inviting the public to subscribe or invest into their business either by way of equity (shares) or debt instruments (debentures) or deposit into the business. Likewise, Section 22 of CAMA forbids private companies to have more than fifty (50) shareholders, by implication, limiting such business from accessing a larger pool of funds from subscribers exceeding fifty. The ISA<sup>4</sup> also prohibits all companies and businesses except for public companies from making any invitation to the public to acquire or dispose of any security of a corporate entity for a fixed period or payable at call, whether bearing interest or not.

The above exclusion and corporate restriction have made crowdfunding popular amongst MSMEs, particularly, for those who seek to survive in their competitive industry. It could be safely concluded that crowdfunding is the gateway for MSMEs<sup>5</sup>, private companies, and startups to access the benefit of the capital market. It is to the MSMEs, what IPO<sup>6</sup> and SPO<sup>7</sup> is to the publicly traded company, thereby

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<sup>1</sup> Rule 1 “crowdfunding” – SEC proposed rules on crowdfunding

<sup>2</sup> The Investments and Securities Act, 2007

<sup>3</sup> Companies and Allied Matters Act Cap C20, LFN 2004

<sup>4</sup> Section 67 ISA

<sup>5</sup> Micro, Small and Medium Enterprises

<sup>6</sup> Initial public offering

<sup>7</sup> Subsequent public offering

enabling MSMEs access to publicly raise funds to promote business ventures, foster their corporate sustainability, and enabled their competitive power and chances in the competitive market.



### **Risk and dangers of crowdfunding**

Before crowdfunding gained the attention of the SEC, it was alien to the Nigerian corporate law and practice, hence, it possesses a regulatory risk to parties. The scheme lacked regulatory protection and framework to help secure the investments of the subscribers to the scheme as well as guarantee the expected Return on Investment (ROI) as and when due. The lack of legal protections and rights, as well as regulatory instruments exposed the parties in the scheme, particularly, the investors to irreparable damages and irredeemable loss.

Parties to a crowdfunding scheme face risks such as failure of the business venture, loss of investment, fewer or no legal protection and rights, as well as unguaranteed return amongst many other risks. The Crowdfunding scheme also became an instrument of fraud, whereby subscribers/investors are deceived by the initiator of the crowdfunding scheme to fund bubble business.

It, therefore, became imperative to put in place a regulatory framework to check the operations and activities associated with crowdfunding, particularly as it relates to the interest of investors who suffers the brunt of a failed or fraudulent scheme.

### **SEC proposed rules and the implication of same**

Regulating crowdfunding is founded on the need to protect investors and boost confidence to invest, which would further deepen the nation's capital market and enable it to provide capital development for MSMEs<sup>8</sup>. However, there is the need for regulatory caution, to avoid over-regulation which may hinder the intended access of MSMEs to capital.

SEC therefore released draft rules in March 2020, which would serve as a regulatory framework to check the operations of players in a crowdfunding scheme. These rules as released by SEC provides for and entails the following implications:

#### **1. Eligibility:**

By the SEC rules, all MSMEs incorporated as a company in Nigeria with a minimum of two (2) years operational track record shall be eligible to raise funds through the registered portal in exchange for the issuance of shares, debentures or other approved investment instruments.<sup>9</sup> In essence, incorporation becomes an essential tool to access public funds, hence, ruling-out the fraudulent activities of bubble companies by further demanding for a two-year operational track record. That a company is two years old or more does not qualify it, rather, the years of incorporation must evidence corporate growth and advancement of its corporate objectives, which the requested funding has become inevitable for the furtherance of those objectives. It should be noted that the SEC provisions exclusively make eligible

<sup>8</sup> [www.vanguardngr.com/2020/03/sec-to-regulate-companies-use-of-crowdfunding-platform/](http://www.vanguardngr.com/2020/03/sec-to-regulate-companies-use-of-crowdfunding-platform/)

<sup>9</sup> Rule 2

companies and not registered names or incorporated trustees.

To further ensure the eligibility of issuers and to guarantee the investment of subscribers, an issuer in addition to being incorporated may only utilize the crowdfunding platform via SEC accredited portals.<sup>10</sup> These accredited portals on their end, are required to conduct due diligence on every prospective issuer intending to use their platform, as well as monitor and report the conduct of issuers on their platform.



## 2. Capital mobilization and the investment cap

The rules set an aggregate amount of securities or investment instruments that can be offered or sold by the issuer within 12 months at a maximum of One Hundred Million Naira (N100,000,000.00) for medium enterprises; Seventy Million Naira (N70,000,000.00) for small enterprises; and Fifty Million Naira (N50,000,000.00) for micro-enterprises.<sup>11</sup>

It is believed that this capital mobilization cap may be detrimental to and hamper the prompt growth of MSMEs that are capital intensive in the provisions of machinery and running cost of their enterprise. It handicaps the competitiveness of the MSMEs where the aggregated mobilization cap has been reached, yet more funds are required to become fully operational and profitable. It is envisaged that the cap placed on capital mobilization may have a detrimental effect on the growth of such capital intensive MSMEs and may likely occasion corporate death as timely and sufficient funding remains the life wire of most startup. Also, Key Performance Indicators (KPI) of a particular issuer in the utilization of the initial or previous funds raised via

the crowdfunding portal was not considered by the SEC rules as a cogent factor in determining the investment cap for such an issuer in subsequent founding rounds on the crowdfunding portal.

It is also imperative to note that since all issuers must go through SEC accredited portals to be able to utilize the crowdfunding platform, some fees would have to be paid by the issuers to the portals, which further eats into the raised fund that may originally be insufficient to see through the issuer's business object.

The rule makes an exception for MSMEs operating as digital commodities investment platforms and for those as may be designated by SEC. It further defines a "digital commodities investment platform" 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". This exception is only allowed to investment intermediaries and not the businesses of the MSMEs that are in dire need of the funds for growth. The question remains whether these capital mobilization caps would not do more harm than good to the growth of the MSMEs.



## 3. Protection of investment

Regulating crowdfunding is founded on the need to protect investors and boost public confidence to invest, hence, the need to deny the use of the platform for fraud or to promote bubble companies, guarantee the credibility of the Issuers, ensure the security of investors' investments as well as the return on same. The SEC rules thereby mandate all accredited portal to carry out due diligence on prospective issuers

<sup>10</sup> Rule 3 (a)

<sup>11</sup> Rule 3 (b)

intending to use its platform<sup>12</sup>. The portals are obligated to conduct background checks to ensure the issuers' credibility, the business plan, their board of director, officers and controlling shareholders, verify the business of the issuers and ensure it complies with all relevant know-your-customer (KYC) and AML/CFT<sup>13</sup> regulations as well as verify the financial conditions of the issuer and disclose relevant information on the portal.

To further ensure the security of investment, portals are mandated to monitor the conduct of issuers and file relevant reports<sup>14</sup>, ensure security and confidentiality of investors' information, identify operational risk, and take adequate steps to avoid operational disruption. The portal shall also take all reasonable steps and establish measures by which it can verify that the proceeds raised from its platform are utilized for the stated purpose<sup>15</sup> and take measures to reduce the risk of fraud.

The protective rules as laid down allows the investors to make informed investment decisions, calculate the risk involved, and withdraw from an investment within a window period of 48 hours after the close of the offer. The rules also afford investors the opportunity, in the event of a material adverse change affecting the project or the issuer to rescind the investment made within seven (7) days of such adverse change been made public<sup>16</sup>.

However, the portal shall not be responsible if the investor loses all or part of the invested fund, hence, investors bear the risk associated with each investment made. It is required of the portals to warn investors of the risk associated with each investment and the likelihood of losing the entire or part invested.



#### 4. Participants for crowdfunding

##### a. The crowdfunding portal

Every platform that facilitates interaction between the issuers and the investors for any investment-based crowdfunding is required to be registered with the SEC as a Crowdfunding Portal, however, the registration and operation of such portal may only be done through operators registered with SEC<sup>17</sup> as a Crowdfunding Intermediary<sup>18</sup>

To operate as a crowdfunding portal, the applicant must be an incorporated body with a minimum of One Hundred Million Naira (N100,000,000.00) as paid-up capital aside other requirements for registration such as the sworn undertaking of compliance, organizational structure, and profile of management, application for registration by at least three (3) principal officer, a written declaration of competence amongst others.<sup>19</sup>

The portals are also obligated to:

- i. Ensure compliance with the rules and educate investors by availing them with necessary information<sup>20</sup>;
- ii. Conduct due diligence on prospective issuers intending to use its platform<sup>21</sup>;
- iii. Monitor the conducts of issuers and file appropriate reports to SEC<sup>22</sup>;
- iv. Ensure investors privacy and data protection<sup>23</sup>;
- v. Establish and maintain a separate trust account for each funding round on its platform with a financial institution registered by the SEC as a Custodian<sup>24</sup>;

<sup>12</sup> Rule 10

<sup>13</sup> Anti-Money Laundry / Combating the Financing Terrorism

<sup>14</sup> Rule 11

<sup>15</sup> Rule 31

<sup>16</sup> Rule 20 (b)

<sup>17</sup> Rule 4 (d) and (e)

<sup>18</sup> An intermediary organized and registered as a corporation to facilitate transactions involving the offer or sale of securities or investments through an online electronic platform. That

is, entities registered with the Commission as an Exchange, Dealer, Broker, Broker/Dealer, or Alternative Trading Facility.

<sup>19</sup> Rule 5 and 6

<sup>20</sup> Rule 9

<sup>21</sup> Rule 10

<sup>22</sup> Rule 11

<sup>23</sup> Rule 12

<sup>24</sup> Rule 13

- vi. Issue investment warning to investors and ensure every investor affirms the risk acknowledgement form<sup>25</sup>;
- vii. Ensure proper book keeping<sup>26</sup>;
- viii. verify the financial condition of the issuers and disclose relevant information on the portal;<sup>27</sup>
- ix. Take measures to reduce the risk of fraud;<sup>28</sup>
- x. Review the information presented by the issuer on its website to ensure that the information adequately sets out satisfy the stated requirements<sup>29</sup>

It is feared that the bureaucracy built around crowdfunding by the SEC rules may defeat the attractiveness of its use by MSMEs and even portals who must operate through intermediaries. While the rules seek to encourage investing, it may, on the other hand, starve MSMEs the requisite fund necessary for growth or even midwife the failure of other MSMEs.

### b. The issuer

This is the initiator or creator of the crowdfunding scheme. By the provision of the SEC rules on crowdfunding, it must be an incorporated company in Nigeria with a minimum of two (2) years of operating track record who seeks alternative sourcing to fund MSMEs by soliciting funding from the public through a SEC accredited crowdfunding portal in exchange for security or investment instruments as may be approved by SEC.

To utilize the platform, an intending Issuer is required to file a standard offering document with the crowdfunding intermediary, stating:<sup>30</sup>

- i. Particulars as to key information on the issuer;
- ii. The use of the proceeds; nature of its business;
- iii. The business plan;
- iv. The offering amount to be raised as well as the duration of offer;
- v. A signed certificate of truth;
- vi. Issuers financial information;
- vii. Two years audited financial statements amongst others.

The issuer shall avail the investors the offering document through the funding portal before the investors agree to purchase the securities or investment instrument. It shall provide an investor with the contractual right to withdraw an offer or agreement to purchase the securities or investment instrument by delivering a notice to the funding portal within 48 hours after the close of the offer.



### c. The investors

The rules categorized investors as retail investors; sophisticated investors; high net investors; and qualified institutional investors<sup>31</sup>. A retail investor is an individual with an aggregate net worth not exceeding One Hundred Million Naira (N100,000,000.00), lacks requisite knowledge, expertise, skill, experience and sophistication for investment management, possess low to moderate risk tolerance threshold and undertakes investments for own beneficial account or on behalf of a minor as a parent or guardian.<sup>32</sup> A sophisticated investor, High net investor, or qualified institutional investor is an individual other than a retail investor.

While retail investors are restricted to an annual cap of 10% of their annual income, the other kinds of investors are not subject to investment limits. The question then is, how will the portals determine the annual income of each retail investor as to be able to restrict their investments to the prescribed limit; or since the threshold for retail investors is 100 Million Naira, will the portal make a uniform restriction of 10% of the threshold being 10 Million Naira for all the retail investor? Another concern is how would the portals determine the net worth of and/or the capacity in which an investor acts?

<sup>25</sup> Rule 14

<sup>26</sup> Rule 16

<sup>27</sup> Rule 21 (c)

<sup>28</sup> Rule 21 (e)

<sup>29</sup> Rule 21 (f)

<sup>30</sup> Rule 19

<sup>31</sup> Rule 3(3)

<sup>32</sup> Rules and Regulations of Security and Exchange Commission

Investors are expected to economically absorb the complete or partial loss of their investment, as the crowdfunding portal will not be responsible for the investors' loss. Investors under the crowdfunding portal are also excluded from the benefits of protection associated with an investment made under a prospectus<sup>33</sup> and neither would such investors be entitled to claim from the National Investor Protection Fund.<sup>34</sup>

The National Investor Protection Fund is a fund instituted by SEC to compensate investors to with genuine claim of pecuniary loss against dealing member firms, resulting from:<sup>35</sup>

- i. insolvency, bankruptcy or negligence of a dealing member firm of securities exchange or capital trade point; and
- ii. defalcation committed by a dealing member firm in relation to securities, money, or any property entrusted to or received by the dealing member firm in its course of business as a capital market operator.

This compensation is to bring succor and restore the confidence of retail investors in the capital market. It is, however, a concern, the rationale behind the exclusion of crowdfunding investors from such protection and compensation. It would ordinarily be expected that since SEC has absorbed the operation of crowdfunding under its regulatory ambience and as part of the capital market, that the investors under the crowdfunding scheme would enjoy protections and compensation available in the capital market or at best set-up custom protection and compensation for such crowdfunding investors.

It should also be noted that by the very nature of MSMEs, mostly being a private limited company, investors might never be able to sell their security or investment instrument, hence, making the market unattractive. If an investor desires to sell his/her security or investment instrument in an issuer company, such a sale or transfer would be prohibited if initiated within a period less than one year of the

issue of such security or investment instrument except if such sale or transfer is:<sup>36</sup>

- i. To the issuer of the securities or investment instrument;
- ii. To an institutional investor; or
- iii. Part of an offer for sale registered with the Commission.



## 5. Funding round and penalties

A funding round is the period within which a specific project, business, or venture is hosted on a crowdfunding platform to raise funds from a large number of people in exchange for shares, debt securities or other investment instruments as may be approved by SEC. It is the lifespan of an offering, the period between the opening and the closing of an offering made to the public and by the SEC crowdfunding rules, an offering shall not remain open for more than 60 days.<sup>37</sup>

At the offshoot of an offering, it is required of the issuer to state the target amount to be raised in a funding round as well as state the minimum threshold that must be subscribed to sufficiently accomplish the business objectives,<sup>38</sup> which shall not be lesser than 50% of the targeted amount.<sup>39</sup> If upon the close of a funding round or the expiration of the 60 days lifespan prescribed for a funding round, the indicated minimum threshold is not reached, the issuer must withdraw the offer, and would not be unable to initiate a new crowdfunding offering until the expiration of 90 days after the said withdrawal.<sup>40</sup> Upon the withdrawal of an offer on grounds that the minimum threshold is not reached, the portal must refund all investors within 48 hours of such withdrawal.<sup>41</sup>

<sup>33</sup> Rule 14(vi)

<sup>34</sup> Rule 14 (vii)

<sup>35</sup>

<http://www.sec.gov.ng/files/New%20rules%20April%202015/Rules%20on%20National%20Investor%20Fund.pdf> – last accessed 01/06/2020

<sup>36</sup> Rule 29

<sup>37</sup> Rule 19 (e)

<sup>38</sup> Rule 32

<sup>39</sup> Rule 21 (d)

<sup>40</sup> Rule 19 (f)

<sup>41</sup> Rule 24

However, where the indicated threshold is reached but falls short of the targeted amount, the issuer shall be required to furnish the portal and the investors with a revised plan for the use of the funds raised to sufficiently accomplish its business objects. Provided such a project can be economized and accommodated within the raised funds, as well as satisfactorily executed without a detrimental impact on the issuer.<sup>42</sup>



The rules prohibit concurrent listing on multiple crowdfunding portals by issuers<sup>43</sup> and further prohibits certain entities from utilizing the crowdfunding portal to raise funds. The prohibited entities include:<sup>44</sup>

- a. Complex structures<sup>45</sup>;
- b. Public listed companies and their subsidiaries;
- c. Companies with no specific business plan or a blind pool;
- d. Companies that propose to use the funds raised to provide loans or invest in other entities;
- e. Such other entity as may be specified by the Commission.

The rules in a bid to ensure conformity spells out penalties for defaulting portals and intermediaries by imposing a fine of One million Naira (N1,000,000.00) and an additional Ten Thousand Naira (N1,000.00) for each day such violation persists.

### Concluding issues and conflicts

- a. The SEC rules provide that an issuer shall offer its securities or investments to the public through a registered crowdfunding portal and further mandates such Issuers to maintain an

accurate list of investors. It is safe to conclude that where investors invest in exchange for equity in the issuer's company, such an investor becomes a shareholder of the company. It should also be noted that the SEC rules only set restrictions as to the amount to be raised and not the number of investors. The issue that comes to mind, juxtaposing the above with Section 22 of CAMA, that prohibit private limited companies from having more than 50 shareholders is "how would such conflict be resolved, if an issuer, being a private limited company engaged in a crowdfunding scheme and have more than 50 investors, investing for equity?"

- b. The relevant provisions of ISA and CAMA prohibit private limited companies from inviting the public to subscribe or invest in their business either by way of equity (shares) or debt instruments (debentures) or deposit into the business. On the other end, the SEC crowdfunding rules have given access to such private limited companies to invite the public to invest in their business either by way of equity (shares) or debt instruments (debentures) or deposit into the business without referring to how the conflicting provisions may be resolved. It is pertinent to bring to our minds that both the ISA and the CAMA are legislative documents that take preeminence and is superior to the SEC rules on crowdfunding. In light of the existing unresolved conflicts, it may be concluded that as far as private limited companies are concerned, the SEC crowdfunding rules remain empty words void of life.

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### Caution

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**We hope you find this article informative, however, please note that this article is not legal advice and must not be considered as such. For further enquiries, please contact Samuel Tosin Matthew at [matthewtosam@gmail.com](mailto:matthewtosam@gmail.com)**

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<sup>42</sup> Rule 28

<sup>43</sup> Rule 41(2)

<sup>44</sup> Rule 42

<sup>45</sup> an entity without immediate transparency of ownership and/or control thereby making it difficult to immediately ascertain the beneficial owners of the entity