UDO UDOMA & BELO-OSAGIE

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A Review of H1 2024 Exposure Drafts of New and Sundry Amendments to the SEC Rules on Private Equity Funds, Venture Capital Funds, and Collective Investment Schemes.

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OVERVIEW

Recent industry reports track a discernible shift in the African private capital industry towards smaller deals and a dominance of venture capital deals, reflecting a cautious yet active investment landscape. Despite consistent exit volumes in East Africa, however, regional disparities persist, with Southern and West Africa experiencing fluctuating deal values and significant declines in deal volumes. Nigeria's potential as a leader in private capital activity, driven by digital transformation and numerous startups, especially in technology, healthcare, and financial services, remains to be realised, with stakeholder surveys reporting high operational costs, funding difficulties, and regulatory uncertainties.

Against this backdrop, in H1 2024, the Nigerian Securities and Exchange Commission (SEC) released two exposure drafts proposing amendments to its rules on funds and collective investment schemes (CISs). The 4th January 2024 amendments address green, social, sustainability, sustainability-linked, and transition bonds[1], as well as registration requirements for commodity brokers, CISs, and private equity funds. The 20th June 2024 draft defines VC funds and prescribes requirements for SEC authorisation and prospectus contents.

Generally, the amendments appear to aim to address longstanding issues by providing clearer guidelines, which can improve operational efficiency, and enhance investor protection. While fund managers and investors may initially face an adjustment period, innovations such as extended submission timelines and standardised fee structures align with global best practices, potentially conferring long-term benefits to fund managers through the increased clarity and predictability of a more streamlined and transparent regulatory framework.

These changes have the potential to lead to more successful fund launches and better-managed portfolios, where investors can expect greater transparency and accountability, reducing investment risks. Striking a balance between safeguarding investors and maintaining regulatory integrity while encouraging innovation and investment and catalysing positive growth in the industry, is essential. A nuanced and dynamically responsive adaptable approach that treats private equity and venture capital as discrete asset classes, and which takes into account practical challenges and their impact on investor perspectives, is key.

In this update, Folake Elias-Adebowale, Dami Adedoyin, Aanu Odunaike, and Precious David of Udo Udoma & Belo-Osagie's Private Equity and Venture Capital team assess the SEC's H1 2024 amendments and their potential implications for the Nigerian private capital sector.

[1] Visit www.uubo.org to read UUBO updates on these other amendments.

A. RULES ON COLLECTIVE INVESTMENT SCHEMES (CIS)

A.1. Amendment of Rule 450(B) – Offer Process for Closed-Ended CIS

(1) Submission of Offer Documents

The timeframe for submitting executed offer documents of a closed-ended CISs to the SEC has been extended from five to ten working days post-SEC clearance. This extension addresses the impracticality of the previous five-day limit due to challenges like geographical distances and delays in stamping the offer documents at the Federal Inland Revenue Service (FIRS).

The extended timeframe allows for more realistic scheduling, accommodating logistical delays and reducing the pressure on fund managers to meet tight deadlines, thereby enhancing compliance and accuracy in submissions. However, further delays may still occur, necessitating additional flexibility, and the extension could prolong administrative processing, potentially delaying fund approvals and market entry.

Encouraging digital submissions through a dedicated SEC e-portal could reduce reliance on physical document transfers, minimising delays, and integrating a feedback mechanism to monitor the effectiveness of the new timeframe to help make necessary adjustments based on practical experience and stakeholder input.

(2) Exemption for Infrastructure Funds and Alternative Investment Schemes

The removal of the 28-day offer period requirement for Infrastructure Funds and alternative investment schemes targeted at qualified investors is a pragmatic adjustment. This amendment recognises the extensive capital-raising processes that these funds require, typically involving lengthy meetings, thorough due diligence, and investment committee approvals, which can extend up to two years. The amendment offers fund managers greater flexibility to align fundraising timelines with actual demands, acknowledging the practical realities of raising capital for large-scale projects. While this flexibility may encourage more investment in infrastructure and alternative schemes essential for economic development, there may be a slight risk of reduced market discipline and potential inefficiencies without a set timeframe. To address these challenges, clear guidelines and robust monitoring mechanisms may be considered for implementation to ensure efficient fund utilisation and maintain investor confidence. Regular updates to investors and performance metrics can further ensure the extended periods are justified and productive.

A.2. Amendments to Rule 450(C) – Offer Process for Open-Ended CIS

(a) Registration Requirements

A schedule of scheme set up costs" is now required to accompany the Registration Statement for an open-ended CIS. This amendment ensures compliance with the regulatory cap on setup costs, which is capped at 1% (0.2% regulatory fees and 0.8% professional fees).

(b) Filing of Executed Scheme Documents

The submission timeframe for Executed Scheme Documents for an open-ended CISs offer has been extended from three to ten working days post-approval. This change addresses the logistical challenges faced by fund managers in meeting the previous deadline.

A.3. General Rules for CISs

(a) Supplementary Shelf Prospectus

A supplementary Shelf Prospectus must state the offer period, which should not exceed 28 working days from the date of issue, unless extended by the SEC. Infrastructure Funds and other Alternative Investment Schemes for qualified investors are exempt from this provision.

(b) New Sub-rule on Capital Utilisation

A new sub-rule mandates that no subsequent series of an infrastructure fund or alternative investment scheme targeted at qualified investors shall be issued until at least 50% of the previous issuance's proceeds have been utilised according to the fund's investment objective and policy. The aim of this change is to prevent scenarios where fund managers are raising additional capital without utilising existing funds effectively.

(c) Annual Supervisory and Regulatory Fees

The basis for computing annual supervisory fees for CISs and regulatory fees for portfolio products is proposed to change from Net Asset Value (NAV) to total Assets Under Management (AuM). This amendment, which is in line with global practices, provides a more comprehensive view of the total assets that a fund manager is responsible for and addresses loopholes where fund managers could avoid fees by netting client assets and investments.

(d) SEC Fees on Market Deals

The SEC proposes a ₦50,000 fee for each submission of advert materials for CISs, distinguishing it from the higher ₦500,000 fee for companies' proxy materials. The SEC's proposal aims to reduce financial pressures on smaller funds and encourage compliance.

However, potential challenges are conceivable. First, given the current macro environment and currency volatilities, ensuring that the N50,000 fee covers administrative costs will be important in that if it is insufficient, it could potentially compromise regulatory oversight. The significant fee disparity should ideally and transparently reflect the difference in resource allocation. For small or emerging CISs (as defined by the Rules), however, even the lower fee could be burdensome, potentially deterring new funds. A tiered fee structure based on CIS size could address this, ensuring fair regulation while fostering market participation.

Comparing these fees with those in other markets is also essential for competitiveness. Excessive fees might make Nigeria less attractive to fund managers. The impact on market dynamics should be considered, as deterrence could further reduce market transparency. It might also be beneficial to conduct a detailed analysis to ensure fees are proportional to administrative efforts and consider implementing a tiered fee structure. Regular reviews based on market feedback could help keep the fees fair and effective.

B. AMENDMENTS TO RULES REGULATING PRIVATE EQUITY FUNDS

B.1. Amendment to Rule 557 – Expanded Definition of PEFs

Under the Amendments, Private Equity Funds (PEF) are now defined as a type of CIS that invests primarily in private equity/unlisted companies, whether or not in an attempt to gain control, based on a specified investment strategy and defined investment horizon. This expanded definition accommodates various fund types beyond traditional mutual funds.

By classifying PEFs as CISs, it appears that the SEC aims to create a consistent framework that applies similar standards across various investment vehicles. This helps streamline oversight, ensuring that all funds operate under comparable rules, thereby potentially enhancing investor protection through rigorous disclosure requirements and governance standards which could potentially attract more capital.

The classification could, however, lead to increased compliance costs and operational constraints for PEFs. The obligation to regularly report on activities and to adhere to specific

investment limits might reduce their flexibility, hindering the high-risk, high-reward nature of private equity investing. The stringent regulations may also stifle innovation, making it harder for PEFs to pursue unconventional strategies or support high-risk ventures.

To address these challenges, there must be discrete and specific regulations that account for the unique characteristics of private equity funds, allowing more flexibility in investment strategies and management practices. A tiered compliance approach could adjust the regulatory burden based on fund size and type, reducing costs for smaller funds. Conducting regular reviews of the regulatory framework and stakeholder engagement for feedback will help it to remain relevant and adaptable to changing market conditions and investment practices.

B.2. Amendment to Rule 558 – Increased PEF Registration Thresholds

PEFs with a target fund size of N5,000,000,000 (five billion Naira) or less will not be required to register but must file governing documents for SEC's no objection before commencing operations. This raises the threshold from the previous minimum commitment of N1,000,000,000 (one billion Naira)

Raising the registration threshold for PEFs reduces the regulatory burden on smaller funds, allowing them to operate more efficiently. In the current macroeconomic environment, however, with significant currency volatilities, testing this threshold increase to ensure that it is meaningful is crucial to avoid overregulation. The higher threshold must genuinely reflect the economic realities and fund sizes to minimise the risk of excessive regulatory overheads while still protecting investors.

B.3. Amendment to Rule 560 – Expanded Restrictions on PEFs

The expanded restrictions on PEFs include maintaining a minimum 3% investment in the fund where pension fund assets are involved, capping total management fees and expenses at 2% of the total sum raised in Nigeria, and limiting performance fees to 20% of the total sum raised.

While these changes aim to protect institutional investors, encourage diversification, and standardise fees, they may inadvertently stifle fund flexibility and innovation. High compliance costs and reduced incentives for fund managers could deter investment and limit the growth of the private equity sector, particularly in high-risk, high-reward ventures that drive economic innovation

B.4. Amendment to Rule 561 – General Requirements

(a) Conflict of Interest Policy

A policy on conflict of interest is now required for the authorisation and registration of a PEF. Requiring the policy should enhance transparency and governance, which are crucial for investor protection.

Implementing this requirement may, however, be challenging for some stakeholders. Smaller funds may struggle with the additional administrative burden, potentially increasing operational costs and compliance complexity.

Overly stringent policies might deter fund managers from taking necessary risks or making decisions that could benefit the fund's performance. While laudable and well-intentioned, however, it will be important for the policy to strike a balance between ensuring transparency and maintaining operational flexibility to avoid stifling fund innovation and efficiency.

To balance transparency with flexibility in conflict of interest policies for PEFs and ensure investor protection while maintaining operational efficiency and innovation, there may be a need to adopt scalable and proportional requirements through clear guidelines and practical examples, to offer support and build capacity through training, to refine approach through continuing stakeholder feedback, and to generally use a risk-based supervisory approach.

B.5. Amendment to Rule 562 – Enhanced Reporting Requirements

PEF Managers must issue semi-annual reports to investors, including details on total commitments, drawdowns and distributions, changes to investment strategy, current and new investments, detailed realisation summary by investment, valuation of each investment, and statements of benefits, fees, and net management fee.

Requiring PEF Managers to comply with these obligations will conceivably enhance transparency and investor confidence. The detailed reporting of commitments, drawdowns, distributions, strategy changes, new and current investments, and valuations may, however, increase administrative burdens and costs, particularly for smaller funds. Ensuring the accuracy and timeliness of such detailed information may also be difficult.

Balancing detailed reporting with operational efficiency, for instance by Implement scalable, automated reporting systems to reduce manual effort and errors, offering training for efficient reporting and compliance, and considering tiered reporting based on fund size to ease the burden on smaller funds while maintaining transparency for larger ones, however, will be key to making these amended requirements practical and beneficial.

B.6. Amendment to Rule 563 – Valuation Methodology

The amendments require that the valuation of PEF assets must be conducted "in good faith" by the PEF Fund Manager based on approved principles and reviewed annually by the statutory auditor. This amendment replaces the previous fair value regime, aiming for a standardised valuation methodology, while maintaining fairness and operational efficiency.

Subjective interpretations of the term "in good faith" may lead to inconsistencies in valuations across different funds, which could conceivably result in disputes or discrepancies in reported asset values. Annual reviews by statutory auditors can be costly, particularly for smaller funds, adding to their operational expenses and potentially reducing the capital available for

investments. Moving from a fair value regime to a standardised methodology may require significant adjustments in current valuation practices, causing temporary disruptions and necessitating additional training for fund managers.

It will be important to have detailed guidelines and examples of what constitutes "in good faith" valuations red, to reduce subjectivity and ensure more consistent application across funds. Offering government subsidies or support for smaller funds to cover the costs of annual audits may help mitigate financial burdens. Phasing in the new methodology gradually can allow fund managers to adjust without significant disruption.

C. AMENDMENTS - NEW VENTURE CAPITAL FUND RULES

C.1. New Rules

The SEC's proposed amendments to Section 555 of the SEC 2013 Consolidated Rules focus on the definition of venture capital funds (''**VC Funds**"), requirements for authorisation by the SEC and contents of a prospectus.

C.2. Definition of VC Funds

VC Funds are now defined as a type of collective investment scheme that invests primarily in early-stage companies.

C.3. Analysis

C.3.1. Inclusion of VC Funds within the CIS Framework: Implications, Potential Issues, and Overview of Comparative Approaches in 6 Jurisdictions

The modification of these rules has the potential to enhance transparency, proper governance, and compliance in the management and operation of venture capital funds. Such changes also

align with the SEC's broader regulatory framework for collective investment schemes and private equity funds. Having said this, however, potential challenges and issues could arise from classifying Venture Capital Funds within the CIS framework.

- VC Funds and traditional CISs serve different purposes and operate under different principles. While CISs typically aim for diversified, lower-risk investments suitable for a broader investor base, VC Funds usually focus on high-risk, high-reward investments in early-stage companies.

- Applying CISs regulations to VC Funds could lead to inappropriate regulatory requirements that do not match the operational realities of VC Funds. CISs generally target retail investors who expect liquidity and regulatory protections that are not suitable for VC investments.

- VC funds, on the other hand, are usually aimed at institutional or accredited investors who are prepared for higher risks and longer investment horizons. Using CIS frameworks could conceivably mislead investors about the nature of risks involved in VC investments.

- VC funds often take an active role in the management of portfolio companies, which is a key difference from the typically passive investment strategies of CISs. This active involvement is crucial for the success of early-stage investments but is not accounted for in CIS regulations, which focus more on diversified and passive investment approaches.

- Overregulation could impede the flexibility that VC funds need to effectively manage their investments. Regulations designed for CISs might impose administrative burdens that stifle innovation and reduce the attractiveness of VC funds to potential investors and entrepreneurs.

- Imposing CIS regulations on VC funds could create confusion in markets, leading to misaligned expectations about liquidity, risk, and return, which might, in turn, deter both domestic and international investors, potentially driving capital to more favourably regulated markets.

C.3.2. Comparative Overview of Regulation of VC Funds in 6 Different Jurisdictions

(a) Jurisdictions That Regulate VC Funds Under Discrete Frameworks

In jurisdictions where VC funds are regulated separately, like the United States of America, the United Kingdom, Singapore, and the European Union, there is typically more flexibility in terms of fund structure, management, and reporting requirements. This flexibility is crucial for the high-growth, high-risk nature of VC investments. In contrast, where VC funds are strictly or primarily regulated under CIS frameworks, fund managers might face constraints that hinder their ability to support startups effectively, potentially leading to a slowdown in innovation and economic growth.

UNITED STATES[2]	**EUROPEAN UNION**[3]
In the U.S., VC funds are regulated under the Investment Advisers Act of 1940 but are exempt from many of the Act's provisions if they meet the definition of a "venture capital fund" under the Dodd-Frank Wall Street Reform and Consumer Protection Act. This exemption allows for greater flexibility in fund structure, management, and reporting requirements. For example, VC funds do not have to register with the SEC if they meet certain criteria, such as not holding more than $150 million in assets under management in the U.S. This flexibility supports the high-risk, high-growth nature of VC investments by reducing regulatory burdens.	The European Venture Capital Funds (EuVECA) Regulation provides a tailored regulatory framework for VC funds in the EU. This regulation allows qualifying VC funds to market their funds across the EU with a lighter regulatory burden compared to traditional investment funds. EuVECA funds benefit from a passporting regime, enabling them to raise capital across member states without additional national requirements, which simplifies the fundraising process and supports the high-risk, high-reward investment model typical of VC funds.
UNITED KINGDOM[4]	**SINGAPORE**[5]
In the UK, VC funds can be structured as Enterprise Investment Scheme (EIS) funds, which offer tax incentives to investors and are subject to different regulatory requirements compared to traditional collective investment schemes. This structure provides flexibility in terms of fund management and reporting, making it easier for VC funds to attract investment and support early-stage companies.	Singapore provides a specific regulatory framework for VC funds, exempting them from certain requirements that apply to other types of funds. For instance, VC managers in Singapore are subject to simplified regulatory requirements under the Securities and Futures Act, which reduces the compliance burden and supports the agility needed for venture capital investments.

[2] SEC.gov
[3] European Commission - EuVECA Regulation
[4] Gov.uk - Enterprise Investment Scheme
[5] Monetary Authority of Singapore - Venture Capital Fund Managers

(b) Jurisdictions That Regulate VC Funds under CIS Frameworks

There appears to be relatively stricter regulation of VC funds in emerging markets like India and South Africa. Such jurisdictions have a rapidly developing or well-developed financial sector and strong industrial base. The classification of VC Funds within the CIS framework in such markets, however, appears to be driven by a combination of the need for market stability[6], investor protection[7], regulatory capacity constraints[8], historical financial instability[9], less developed legal and financial infrastructure[10], and goals of promoting responsible investment practices[11]. Such factors would contribute to a more cautious regulatory approach in the referenced jurisdictions to manage the inherent risks perceived or associated with VC investments in emerging markets, as indicated below, and may also inform the SECs' cautious approach.

INDIA[12]

In India, VC funds are regulated under the Securities and Exchange Board of India (SEBI) and Alternative Investment Funds (AIF) Regulations, 2012. These regulations, while providing a specific category for VC funds (Category I AIF), impose numerous restrictions and compliance requirements similar to those for traditional collective investment schemes. In such frameworks, higher compliance costs and administrative requirements can reduce the amount of capital available for actual investment in startups.

Stringent rules regarding fund structure, investment restrictions, and reporting requirements can, however, limit the operational flexibility of VC funds, making it harder to respond quickly to market opportunities. The increased regulatory burden can deter both domestic and foreign investors from participating in venture capital activities, potentially slowing down innovation and economic growth.

SOUTH AFRICA[13]

In South Africa, 'venture capital companies' (VCCs) are subject to regulations under the South African Revenue Service (SARS) and must comply with Section 12J of the Income Tax Act. Although these provisions offer tax incentives, they also come with strict compliance and operational requirements akin to CIS frameworks. Potential challenges include the dual oversight by SARS and other regulatory bodies, for instance, creates complex compliance landscapes, making it difficult for VC funds to operate efficiently.

Requirements such as minimum investment periods and specific compliance criteria can restrict the ability of fund managers to adapt their strategies as needed. Potential investors might be discouraged by the stringent regulations, affecting the flow of capital into venture capital markets and hampering the growth of innovative startups.

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[6] https://www.worldbank.org/en/topic/financialsector
[7] OECD - Investor Protection
[8] IMF - Capacity Development
[9] Brookings - Financial Crises in Emerging Markets
[10] World Economic Forum - Legal Infrastructure
[11] UN PRI - Responsible Investment
[12] SEBI AIF Regulations, 2012
[13] SARS Section 12J.

Where VC funds are regulated under stricter CIS frameworks, they might face constraints such as restrictions on fund structures and operations that may limit the ability of VC Fund managers to respond quickly to investment opportunities and manage high-risk investments effectively. In addition, the regulatory and administrative requirements and increased compliance costs may reduce funds available for investments in startups, and venture capital activities, which may ultimately impact the rate of innovation and economic growth.

C.4. Requirements for Authorisation

The SEC 2013 Consolidated Rules provide detailed requirements for the authorisation of VC funds, including the submission of a draft prospectus, trust deeds (where the fund is a trust structure) or constitutive documents (where the fund is a company or partnership or other structure), letters of consent from involved parties, and detailed information about the fund provider and manager. In addition, evidence must be present that the VC Fund manager's paid-up capital complies with SEC requirements.

C.4.1. Requirement that VC Fund Managers Must Manage the Business in which the Fund is Invested

While the SEC's 2013 Consolidated Rules aim to ensure transparency, proper governance, and investor protection, therefore, they also present several challenges for VC Funds. One key amendment and requirement is that venture capital companies are no longer required to be the general partner; instead, the fund manager of the VC Fund is required to be the general partner. In addition, the Fund Manager, for instance, is required to manage or to participate in the management of the business in which the VC Fund is invested. This requirement may introduce operational complexities. Fund managers will need to have the requisite skills and expertise to manage the relevant businesses directly. This requirement could, conceivably, lead to potential conflicts of interest, as the VC Fund manager's role as a general partner involves significant fiduciary responsibilities that may conflict with such obligations.

C.4.2. Administrative Obligations

Preparing the extensive documentation required by the SEC can be costly, especially for smaller VC funds that may not have the resources to handle these administrative tasks efficiently. Meeting ongoing compliance requirements, including reporting and maintaining updated documentation, can be challenging and resource intensive. Fund managers will need to be vigilant in staying abreast of regulatory changes to ensure continuous adherence. Prescribing detailed and stringent requirements may also increase the risk of non-compliance, which can result in penalties, delays, or the revocation of authorisations, adversely impacting VC Fund operations.

C.4.3. Capital requirements

Demonstrating that a VC Fund manager's paid-up capital complies with SEC requirements can be a significant barrier to entry, particularly for new or smaller fund managers who may struggle to meet financial thresholds. The need to maintain a certain level of paid-up capital could limit the fund manager's ability to deploy capital efficiently, potentially reducing the funds available for investment in startups and other high-growth opportunities.

C.4.4. Contents of Prospectus

The prospectus is required to include a summary of the issue, details of directors and parties involved, information on target companies (including investment opportunities, past performance and other unique factors of entrepreneurship), exit strategies, and other relevant financial and operational details. It should also include statements of assets and liabilities, profit and loss accounts, and cash flow forecasts.

The requirement to submit a draft prospectus, trust deeds, or constitutive documents, letters of consent from involved parties, and detailed information about the fund provider and manager may create a significant administrative burden for fund managers) especially for smaller VC Funds, which may delay the authorisation process and increase costs.

CONCLUSION

The SEC's H1 2024 Amendments seek to address practical challenges by simplifying regulatory requirements, ensuring compliance, and standardising processes for CISs, and Private Equity and VC funds .

These amendments are timely, given the need for a consistent, robust, and transparent investment environment to foster growth and stability in Nigeria's private equity and venture capital industry.

It will be crucial to balance investor protection and regulatory integrity with the need to support innovation and investment. A supportive and flexible regulatory framework will be key to bolstering

investor confidence and regaining positive momentum in the industry.

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