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INSIGHTS

Commentaries on the new SEC rules on issuance, offering platforms and custody of digital assets.

Introduction

In exercise of the powers conferred by Section 13 of the Investment and Securities Act, 2007; the Securities and Exchange Commission of Nigeria (SEC or the Commission), as the apex regulator of the Nigerian Capital Market on 14th September, 2020; released a circular titled "*Statement on Digital Assets and their Classification and Treatment"*, to provide clarification on digital assets while categorizing such assets under the purview of its regulation.

Pursuant to the circular, the Commission will regulate digital assets whether crypto-token or crypto-coin investments as long as the character of the investment qualifies as securities transactions. The circular stretches the scope of its coverage to encompass virtual crypto assets as securities, subject to its regulation, unless proven otherwise by an issuer by making an '*Initial Assessment Filling*".

Prior to the referenced SEC circular, the Central Bank of Nigeria (CBN) in January, 2017 had earlier released a statement classifying digital currencies such as Bitcoin, Litecoin, and others as a means to aid the funding of terrorism and money laundering considering their anonymity.
In furtherance of the statement, the CBN released another circular in February 2021 prohibiting financial institutions in Nigeria from dealing in cryptocurrencies or facilitating payments for cryptocurrency exchanges. The CBN went further to direct banks to close all accounts associated with cryptocurrency.

The Federal High Court of Nigeria in the case of ***CBN Governor v Rise Vest Technologies*** cleared the misconception and put it correctly that cryptocurrency is not illegal and that the CBN has no authority to criminalize an action[1]. However, undeterred by the Ruling, the CBN imposed a fine of ₦800,000,000.00 on five Nigerian banks for processing crypto-related transactions.

Interestingly, the SEC on 13th May, 2022 released its guidelines for digital asset related activities titled "New Rules on Issuance, Offering Platforms and custody of Digital Assets"; thereby bringing hope to players in the digital market. The Rules comprises five parts numbered A to E.

[1] FHC/ABJ/CS/822/2021

Part A
Issuance of Digital Assets as Securities

Part A of the New SEC Rules regulates the issuance of digital assets that qualify as securities. It applies to all issuers seeking to raise capital through digital asset offerings which has been defined to include Initial Coin Offering (ICO). The Rules define Digital Asset as "*a digital token that represents assets such as debt or equity claim on the issuer*" while ICO is the issuance of tokens to the public for cash, cryptocurrency or other assets through a distributed ledger technology. Some of the core provisions of the Rules in respect to digital assets issuance are as follows:

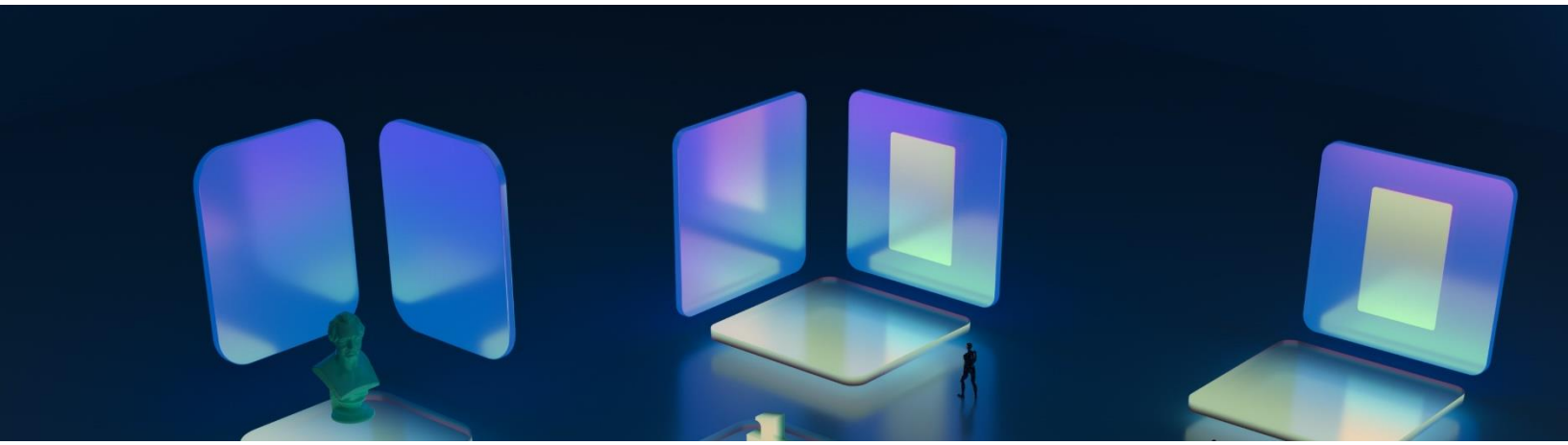
1. Promoters, entities or businesses proposing to conduct initial coin offering in Nigeria or targeting Nigerians are mandated to file an assessment form and the draft white paper for the project with the SEC. This is to help the SEC ascertain whether the offering qualifies as security or otherwise. The white paper to be filed must contain information regarding the project to be backed by the offer, the description of the business of the issuer, the issuer's business plan and a feasibility study on the project, how the project will benefit investors, etc. The SEC is to make a review within thirty (30) days and communicate its decision to the issuer within five (5) days of the conclusion of the review.

2. Issuers of Initial Asset Offerings in Nigeria or within Nigeria are mandated to file an application for registration with SEC. The application for registration is required to contain certain information including the particulars of the digital asset, Know Your Client (KYC) procedures, risk management and security protocol for the platform, opinion of the solicitor to the offering; confirming that applicable permits and licenses has been obtained, corporate governance disclosures and an escrow agreement with an independent custodian/trustee registered with SEC. The SEC has the power to reject an application for registration if, in its opinion, the project backed by the issue infringes on public policy, is injurious to investors or violates the law.

3. The Rule requires that the directors and senior management of an issuer must collectively own not less than 50% shares in the issuer at the time of the issuance. They are permitted to sell, transfer or assign not more than 50% of the said aggregate required holding provided that an individual director or senior manager does not sell, transfer or assign more than 50% of his holding in the issuing company until the end of the offering project. This is necessary to give the investor some level of assurance and confidence in the project. Based on the provision, the directors of an issuer also have their holdings tied to the project and will be adversely affected if the project fails.

4. An ICO issuer can only raise twenty (20) times the money the shareholders invest in the project, provided that the total funds to be raised does not exceed 10 billion naira or any limit introduced by the SEC. Before the ICO can be registered by SEC, the issuer must show that the gross proceeds to be raised from the offering would be enough to complete the project in accordance with what is contained in the whitepaper. If the amount raised is below the amount required for the project as contained in the project's whitepaper, the issuer is mandated to refund all monies collected from token holders to them within five (5) months.

5. A retail investor cannot invest more than ₦200,000.00 per issue and ₦2 million within a 12-month period. No restriction is placed on institutional and high net worth investors.
6. The Act exempts digital assets exclusively offered though crowdfunding portals or intermediaries; judicial sale of digital assets by an executor, administrator or receiver; sale by a mortgage or pledgor for the purpose of liquidating a debt; and a one-time sale of digital asset by an individual owner through his account from the requirements under the Rules.



Part B
Digital Assets Offering Platforms (DAOPs).

Part B of the Rules regulates **Digital Assets Offering Platforms (DAOP**) in Nigeria. It defines DAOP as electronic platforms for offering of digital assets. The Rules mandates DAOPs to manage all risks associated with its business. The Rules makes the following provisions concerning DAOPs:

1. The applicable fees for the registration of a DAOP includes a filing fee of ₦100,000.00 (One Hundred Thousand Naira) a processing fee of ₦300,000.00 (Three Hundred Thousand Naira) a registration fee of ₦30,000,000.00 (Thirty Million Naira) and a sponsored individual fee of ₦100,000.00 (One Hundred Thousand Naira).

2. The Minimum paid up capital for a DAOP is ₦500,000,000.00 (Five Hundred Million Naira).

   A DAOP is also mandated to provide a current fidelity bond covering at least 25% of the minimum paid up capital of the company.

3. The Rules mandates every DAOP to have a Board of Directors. However, the membership of the board must be approved by SEC before it is registered at the CAC. The tenor of a CEO of a DAOP is five years and the CEO can only be re-appointed for another term of five years. The SEC must approve the appointment of such CEO.

4. The Rules mandates a DAOP to carry out due diligence and critical assessment of an issuer before approving a digital asset offering through its platform. A DAOP has numerous obligations under the Rules, including making a project's whitepaper accessible to investors, uploading vital information relating to the issuer on the platform, notifying the SEC of any breach of the ISA or its guidelines and granting SEC access to the platforms or register maintained by the DAOP.

5. The Rules mandates DAOPs to maintain a record of investors and assets held by it. A DAOP is also mandated to establish and maintain a trust account with a receiving bank for proceeds realized from investors. The trust account is to be administered by a trustee of Central Securities Depository registered with SEC. The DAOP may decide to personally maintain custody of token but must comply with the requirements for Digital Asset Custodian under the Rules or may appoint a digital asset custodian registered with the SEC. However, DAOP must maintain a register of the token holders who subscribed during an offer period.

6. A DAOP is authorized to outsource but must notify the commission of such arrangement within two weeks before entering into the outsourcing arrangement as well as submit an undertaking from the service provider outsourced stating that SEC will have access to its records.

7. An issuer can only be hosted on a single DAOP. Also, an issuer cannot be hosted on a DAOP and an equity crowdfunding platform at the same time.

8. Before a DAOP can cease its business, it must notify the SEC for approval. In the same vein, the SEC has the power to cancel the registration of a DAOP.

Part C
Digital Assets Custodians (DACs)

Part C of the Rules regulates Digital Asset Custodians (DAC). As provided under the Rules, a DAC is a person who provides services such as safekeeping of digital tokens, storing, holding and maintaining custody of digital tokens. The following are the major regulations for DACs:

1. A DAC must be registered with the SEC. The Rules allows a foreigner to be registered as a DAC in Nigeria but the foreigner must be authorized to render similar service in his country of origin. The foreigner's country of origin must have regulatory arrangement on enforcement, supervision and information sharing with Nigeria.

2. A DAC is obliged to act in the best interest of clients, ensure unrestricted access to clients' token, submit accurate information to SEC when requested, and notify SEC in the case of breach of any law or guideline.

3. The Rule mandates DACs to perform regularly internal checks on its operation through an auditor who will report directly to the board. A DAC is allowed to outsource its services, including internal audit requirement but with the consent of the SEC.

4. Similar to a DAOP, a DAC cannot cease its business without the approval of SEC. SEC also has the power to cancel the registration of a DAC.

Part D
Rules on Virtual Assets Service Providers (VASPS)

Part D of the Rules regulates all Virtual Asset Service Providers, including Digital Asset Exchange, Digital Asset Custodian, Digital Asset Offering Platforms. The part also regulates the issuance of digital assets. This part of the Rules extends to all platforms or persons that facilitate crypto trades, exchange and virtual transfer of assets; or connected to distributed ledger technology. Pursuant to the Rules, all VASPS must be incorporated as a corporate body. In addition to the requirements under part A, B, C and E of the Rules, a VASP is required to submit to the SEC an undertaking to abide by the Rules, together with an undertaking that the transaction documents submitted are not false. The Rules mandates VASPs to have an office in Nigeria.

Part D
Digital Assets Exchange (DAX)

Part E of the Rules regulates Digital Assets Exchange in addition to part D of the Rules. The salient provisions of the Rules are as follows:

1. A DAX must be registered with the SEC before it can operate in Nigeria. To be registered it must pay an application fee of ₦100,000.00 (One hundred Thousand Naira), a processing fee of ₦ 300,000.00 (Three Hundred Thousand Naira) and a registration fee of ₦30,000,000.00(Thirty Million Naira) together with a sponsored individual fee of ₦100,000.00 (One Hundred Thousand Naira).

2. A DAX is prohibited from providing direct or indirect financial assistance to investors, including its officers and employees to invest or trade in a virtual asset on its platform.

3. Before a DAX can facilitate the trading of any virtual asset, it must be issued a "No Objection" by SEC.

4. All requirements for the registration of a DAOP applies to a DAX.

Commentary

It is apt to state that the proposed Rules is an innovative measure worthy of commendation. It is the first step towards exploiting the opportunities available within the digital market space. However, a surface glance at the provisions of the Rules would reveal the lack of in-depth understanding of the Digital Asset space and its fundamental operations.

Consequently, we believe that the crux of the Commission's role should center on understanding the intricacies of the market and the best regulatory approach for the sector. This is owing to the fact that from our review of the proposed Rules, we envisage a challenging outcome regarding the enforcement of some of the provisions, unless a clearcut enforcement mechanism is introduced.

For instance, the Rules requires that ICOs, DAXs and DAOPs should be registered with the Commission. Unfortunately, there is no means of ensuring compliance with the requirement, especially by offshore entities. This challenge defeats the entire purpose of the Rules as the Commission can only exercise its supervisory role over a digital asset related entity if the entity can be brought under its regulatory net. Due to the peculiarity of digital assets compared to other securities, sticking with the existing regulatory approach would seem counter-productive.

The commission has a duty to broaden its research into the sector just as other jurisdictions are currently doing. We recommend that similar to the UK's Securities and Exchange Commission, the Nigerian Securities and Exchange Commission should set up a FinTech hub made up of key players in the financial and technological sector to understanding the market by carrying out expansive research and critic of the digital asset market and crypto currency.

Furthermore, the Commission failed to provide a yardstick for determining whether a digital asset qualifies as security. This means that the Commission has an arbitrary power to describe a digital asset as security notwithstanding the features. It would be vital for key industry players and investors to have full information before approaching the SEC for the registration of a digital asset; hence, the need for clear cut parameters in determining what qualifies a digital asset as a security.

In a similar breath, SEC cannot act ultra vires the provisions of the Investment and Securities Act 2007 from which it derives its power. Section 315 of the Investments and Securities Act makes an elaborate provision as to what amounts to securities. It defines securities as follows: "*(a) Debentures, stocks or bonds issued or proposed to be issued by a government; (b)Debentures, stocks, shares, bonds or notes proposed to be issued by a corporate body;* (c) *Any right or option in respect of any such debentures stocks, shares, bonds or notes;* (d) *Commodities futures,* ***contracts,*** *options and other derivatives…"* This definition is akin to the provisions of the US Securities Act of 1933, albeit not as comprehensive. The US Securities Act defines securities to mean: "*any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share,* ***investment contract****…"*. It is obvious that what was intended by the Investment and Securities Act as "Contract" is an "investment contract" similar to the US Securities Act.

In the US jurisdiction, the Howey test is applied in determining whether a transaction, including transactions relating to digital assets, qualify as an "investment contract" and therefore categorized as a security and subject to the regulation of the Securities and Exchange Commission.

The Test recognizes a transaction as investment contract if the transaction involves the investment of money in a common enterprise with a reasonable expectation of profit to be derived from the efforts of others. Thus, a transaction that meets the above requirements qualifies as security and will be subject to the regulation of the Securities and Exchange Commission.

The application of the Howey test in defining investment contract to determine whether a token qualifies as securities is necessitated by the fact that not all tokens have the nature of securities within the purview of the Rules. Some securities by their nature operate as currency that can only be regulated by the Central Bank of Nigeria. A typical example of this kind of token is the Bitcoin which unlike other tokens, is not associated with a particular project but operates as a digital currency. Also, Non-Fungible Tokens (NFTs) are digital assets linking to certificate of authenticity of a real time asset with the aid of blockchain. By their nature they do not qualify as securities, although fractionalized NFTs which allow investors to purchase a fraction of an expensive large collection of NFTs could be classified as securities; thus, subject to the regulation of the SEC.

Considering the similarities between the two jurisdictions regarding what amounts to securities, we recommend that the Securities and Exchange Commission should adopt a similar yardstick in determining whether a digital token amounts to securities capable of being regulated by the commission or otherwise.

We further note that the CBN circular prohibiting financial institutions from allowing transactions associated to crypto assets is a setback on the application of the SEC Guidelines. Notwithstanding the Rules, without the financial institutions, the digital asset market cannot successfully progress. Also, with the evolvement of web 3.0, new dimensions of digital assets have also evolved, some of which may be categorized as securities. Clearly the task of providing a proper regulatory framework extends beyond the Securities and Exchange Commission, the Central Bank of Nigeria and other regulatory bodies including Corporate Affairs Commission and the Federal Inland Revenue Service.

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