

Proposed Crowdfunding Regulations in Kenya, & Cytonn Weekly #32/2021

Focus of the Week

The Cabinet Secretary for the National Treasury and Planning, through the Capital Markets Authority (CMA), recently published the **Draft Capital Markets Investment Based Crowdfunding Regulations, 2021**. The proposed rules seek to regulate the raising of funds through online platforms by licensing and approving all persons who operate or intend to operate an investment-based crowdfunding platform. Given that these are new regulations in the capital markets, we found it necessary to demystify the proposed regulations and give our insights on them. We shall do this in five sections, namely:

1. Introduction to Crowdfunding,
2. Review of the draft regulations,
3. Case Study - Australia,
4. Recommendation, and,
5. Conclusion

Section 1: Introduction to Crowdfunding

Crowdfunding is the act of raising small amounts of money obtained from a large number of individuals or entities to either finance or re-finance a project or business through a website, application or internet-based portal operated by a crowdfunding platform operator. Crowdfunding can be majorly categorized into two; investment-based crowdfunding and donation-based crowdfunding. With investment-based crowdfunding, the issuer raises funds on the crowdfunding platform in exchange for shares, debt securities or any other investment instruments approved by the Authority. Donation-based crowdfunding, on the other hand, involves non-profit projects such as charity, philanthropy, health or social work raising funds from a large number of donors who receive no financial or material return. Examples of crowdfunding platforms locally include *M-changa* and *M-pesa's* Paybill platform which have been mainly used for charitable courses such as fundraising for medical bills and *Pezesha* a debt-based crowdfunding platform that got approval from CMA in 2020. Internationally, we have examples of Kickstarter and *IndieGogo* which have been used to raise funds for start-ups.

Investors invest through crowdfunding since it allows them to invest small amount of funds, share risks and diversify their investments into multiple campaigns and companies. Issuers, on the other hand, are able to access larger pools of accredited investors faster and at a lower transaction cost. The main issuers for crowdfunding investments are Micro or Small Enterprises and Start-ups who issue financial instruments such as shares, loans or other approved investments instruments so as to raise funds for their businesses.

Section 2: Review of the draft regulations

The draft CMA regulations on investment crowdfunding are meant to control the raising of finances

through the crowdfunding platforms and protect the investors using the platforms. The regulations are aimed at ensuring that crowdfunding platforms are operated by licensed persons only and participation on the platform will only involve eligible issuers and investors. The draft CMA regulations focused on the following:

- i. **Issuers** - Issuers eligible to raise funds through a crowdfunding platform are startups with good operating track record and a good corporate governance record and micro or small enterprises incorporated in Kenya with a minimum of two years' operating track record and a good corporate governance record. According to the **Micro and Small Enterprises Act, 2012**, a micro enterprise is defined as a firm, trade, service, industry or a business activity whose turnover does not exceed Kshs 500,000.0 annually, which employs less than ten people and whose total assets be as determined by the Cabinet Secretary from time to time. A small enterprise, on the other hand, means a firm, trade, service, industry or a business activity whose annual turnover ranges between Kshs 500,000 to Kshs 5.0 mn, employs 10 to 50 people and whose total assets and financial investment shall be as determined by the Cabinet Secretary from time to time. Within a twelve-month period, an eligible issuer can offer a maximum aggregate amount of investment as follows:
 - a. Kshs 100.0 mn for Medium Enterprises,
 - b. Kshs 50.0 mn for Small Enterprises, and,
 - c. Kshs 5.0 mn for Micro Enterprises.

However, a crowdfunding platform operator may apply to CMA for a no-objection whenever an issuer seeks to raise more than the set limit within 12 months. Issuers prohibited from raising funds through the crowdfunding platforms include public listed companies and their subsidiaries, entities with a poor governance record, entities that propose to use the funds raised to provide loans or invest in other entities and any other such entity as may be specified by CMA,

- ii. **Investors** - Eligible investors for crowdfunding include sophisticated investors and/or individual retail investors subject to an investment limit as prescribed by the platform operator and up to a maximum of Kshs 100,000. Investment instruments allowed for purposes of crowdfunding include shares, bonds or debentures or any other instruments as shall be approved by the Authority,
- iii. **Platform Operators** - Anyone who operates or intends to operate a crowdfunding platform in Kenya must obtain an approval and licensing from CMA. To be eligible for licensing, the crowdfunding platform operator should be a company limited by shares with a minimum paid up capital of Kshs 10.0 mn. The license will be issued to the eligible operator once they meet all the requirements including an application fee of Kshs 10,000 as well as an annual regulation fee of Kshs 200,000. A platform operator will be deemed operating in Kenya if:
 - a. The crowdfunding platform is established in Kenya,
 - b. The platform is located outside Kenya but actively targets Kenyan investors, or,
 - c. The key components of the platform are physically in Kenya even if any of its components are located outside Kenya.

The CMA may suspend, restrict or revoke a crowdfunding platform operator license in accordance with Section 26 and 26A of **The Capital Market Act**. According to CMA, a person operating a crowdfunding platform in Kenya without a license commits an offence under these regulations and is liable for a penalty under section 34A of the Act. The platform operator will be responsible for ensuring the funds raised through the platform are used for the stated objective. The crowdfunding platform operator is also mandated to appoint a financial institution duly registered by CMA as a custodian, who shall establish and maintain a separate trust account for each funding round on its platform, and,

- iv. **Crowdfunding Transactions** - A crowdfunding offering shall not remain open for more than sixty days and where an issuer is unable to meet the prescribed minimum threshold for the targeted amount, the offer shall be withdrawn and the crowdfunding platform operator shall effect a refund

of the monies to the investors within 48 hours. The issuer may only commence a fresh crowdfunding offering not earlier than ninety days after the said withdrawal. However, where the crowdfunding transaction is successful, the crowdfunding platform operator shall make the funds available to the issuer within 24 hours after the close of the offer. Moreover, investors are granted a 'cooling off' period of 48 hours, which is the period within which the investor can withdraw an offer or agreement to purchase the securities or investment instrument by delivering a notice to the crowdfunding platform operator. A platform operator is expected to prepare and display a warning statement on the crowdfunding platform to all visitors using the platform, investors and on all application investment forms. Investors must then sign the risk acknowledgement form to confirm that they understand that the proposed investment is risky, they can never be able to sell the security, they will be provided with minimal disclosure and they will not have benefits of protection associated with the investment.

The regulations are a commendable move by the National Treasury and the CMA as they will ensure that investors using crowdfunding platforms are protected and raising of finances on crowdfunding platforms is controlled. These regulations will also enhance accountability and transparency of operations in the crowdfunding platforms and will ensure supervision of crowdfunding operations by the CMA. The regulations are also aimed at ensuring investors' funds are used for the stated purpose by holding the platform operator responsible for ensuring the funds raised through the platform are used for the outlined objective. The other key advantage is the fact that this provides another avenue for businesses to seek funding and diversify the funding sources from banks.

Section 3: Case Study - Australia

According to **The 2nd Global Alternative Finance Market Benchmarking Report** by Cambridge Centre for Alternative Finance (CCAF), Australia ranked 11th amongst the most active crowdfunding countries globally with crowdfunding volumes of USD 1.2 bn as at 2020. In 2020, its equity-based crowdfunding was worth USD 39.5 mn, a 1.0% increase from USD 39.1 mn in 2019. We have chosen Australia for our case study since the Australian Securities and Investments Commission (ASIC) has provided clear and comprehensive regulation guidelines that control and monitor raising of investment funds through crowdfunding in the country, having in mind most countries have no specific legislations governing crowdfunding.

The Crowd-Sourced Funding (CSF) regime in **Pt 6D.3A of the Corporations Act 2001 (Corporations Act)** of Australia provides a regulatory framework for investment-based crowd-sourced funding by small unlisted public companies and proprietary companies, enabling them to make offers of ordinary shares to retail clients, through a licensed intermediary's platform, using a CSF offer document. The eligibility and roles of the different players in investment crowdfunding in Australia as discussed in the Act include:

- i. **Investors** - Both institutional and retail investors are eligible to invest into companies making an offer on the crowdfunding platforms. Retail investors have an investment cap of USD 10,000 per company in any 12-month period and a 'cooling-off' period allowing them to withdraw from a CSF offer up to 5 days after making an application. Additionally, all investors have 14 days to withdraw their application and be repaid their application money, if a supplementary or replacement CSF offer document is published to correct a defective offer document, and the defect is materially adverse from the point of view of an investor. The investors must also acknowledge that they have read and understood the risk warning statement provided on the platform before applying for shares,
- ii. **Issuers** - Unlisted public companies and proprietary companies with less than USD 25.0 mn in assets and annual revenue can make offers of ordinary shares to retail clients, through an Australian Financial Services (AFS), a licensed CSF intermediary's platform, using a CSF offer document. Eligible companies can raise up to USD 5.0 mn in any 12-month period under the CSF regime. Public companies and proprietary companies that have completed a successful CSF offer

must comply with certain financial reporting and corporate governance obligations such as consent of directors to the publication of CSF document, lodging of financial statements and audit of financial statements if the company raises over USD 3.0 million through CSF offers,

- iii. **Investment crowdfunding intermediary** - The Investment crowdfunding intermediary (platform operator) must be licensed by the AFS to be able to offer investment crowdfunding services to companies, SMEs and investors. The intermediary has to demonstrate adequate human and technological resources to prove capacity to carry out financial services in full compliance with the Corporations Act. Surplus Liquid Funds (SLF) of USD 50,000 must be maintained if the intermediary holds clients assets of at least USD 100,000. Cash flow projections will also be required to indicate that the intermediary will hold, at all times covered by the projection, a cash buffer of at least 5.0% of projected 12-month cash outflows or, if higher, the cash outflows of the previous year. This way, the intermediary will demonstrate adequacy of cash and financial resources. The crowdfunding intermediary must lodge annual financial statements and an audit report on those statements with ASIC. The investment crowdfunding intermediary's platform must provide the following facilities:
- **Application facility** - All applications must be made through this facility and the intermediary must, as soon as practicable, reject and refund any money paid for any applications made other than through the application facility. This ensures that investors are protected from fraud since the application facility must only be available while the relevant CSF offer is open, and,
 - **Communication facility** - This facility allows potential investors, the company making the CSF offer and the intermediary to communicate with each other about the offer to enhance transparency and help investors make an informed decision.

A CSF intermediary is obligated to suspend a CSF offer if it contains a misleading or defective statement, if it omits relevant information or if new circumstance arises and needs to be included in this document. However, the offering company can prepare a supplementary or replacement CSF offer document to correct the defect. When dealing with retail investors, the intermediary must provide:

- i. **Unconditional cooling-off rights** - All retail investors who make an application in response to a CSF offer have an unconditional right to withdraw their application within five business days of making the application,
- ii. **Risk acknowledgement** - Similar to Kenya, retail investors need to complete an applicant risk acknowledgement containing the exact wording in the Corporation Regulations,
- iii. **A cap on investment** - The intermediary must reject an application from a retail client where it would breach the USD 10,000 cap in respect of applications for CSF offers made by a particular company via the same intermediary over a 12-month period, and,
- iv. **Restrictions on financial assistance** - The CSF intermediary must not financially assist a retail client in relation to a CSF offer, or arrange financial assistance for a retail client to acquire shares under a CSF offer, that it is hosting or intending to host.

Lessons Kenya can borrow from Australia's Investment Crowdfunding Regulations:

- i. **Increased cooling-off period rights for investors** - Australia's CSF regulations require intermediaries to provide retail investors the right to withdraw their application within five business days from day of making the application, compared to Kenya where investors have only 48 hours to reconsider their investment. ASIC also gives all investors the right to withdraw their application within 14 days and be repaid their application money if a supplementary or replacement CSF offer document is published to correct a defective offer document, and the defect is materially adverse from the point of view of an investor,
- ii. **Audit requirements** - Audit obligations apply only when a company raises over USD 3.0 million through CSF offers in Australia. In Kenya, issuers are supposed to provide two years audited financial statements during application. This could limit startups from raising funds having in

mind the CMA has provided that only Micro and SMEs ought to have been in operation for two years. The intermediaries in Australia are also obligated to lodge annual financial statements with ASIC and an audit report on those statements while here in Kenya, the CMA has not obligated platform operators to hand in audited financial statements,

- iii. **Guidance on crowdfunding platform structure** - As discussed above, the ASIC has clearly stated the most essential facilities to be provided by intermediaries such as a communication facility that will enable investors to make informed decisions and an application facility that will protect investors by ensuring investments are only made on open and viable offers,
- iv. **Conflict of Interest management** - The ASIC has clearly laid down roles of the intermediaries in managing conflict of interest compared to Kenya's draft that only states that the platform operator ought to manage any conflict of interest that may arise. In Australia, the intermediary is obligated to have a conflicts of interest policy written down. The policy should contain appropriate measures to identify, document and manage conflicts of interest and should be prepared following general guidance provided by the ASIC on conflicts of interest. The key conflict of interest specific to CSF intermediaries is the conflict that could arise between their various obligations under the CSF regime and the financial benefits they derive from publishing CSF offers and ensuring the success of those offers,
- v. **Computation of the issuer cap** - The ASIC has provided a clear formula of calculating issuer cap that is, a sum of:
 - a. The maximum amount sought to be raised by the company under the current CSF offer,
 - b. All amounts raised by the company and its related parties under any other CSF offers made in the last 12 months, and,
 - c. All amounts received in the last 12 months by the company and its related parties under small scale personal offers and offers made via an AFS licensee.

The CMA should also set a clear and standard way of calculating the maximum aggregate funds, that is, the Kshs 100.0 mn for Medium, the Kshs 50.0 mn for Small and the Kshs 5.0 mn for Micro enterprises to be raised or state some ratios on which amounts raised can be pegged on.

Section 4: Recommendation

While the proposed draft regulations are a step in the right direction towards enhancing efficiency in the capital markets, we believe the regulations could offer more clarity to facilitate growth of investment-based crowdfunding and boost investor confidence. In regard to the observations, we recommend the following improvements before having the final regulations;

- i. **Enhanced due diligence and KYC disclosures on investors** - The guidelines should be expanded to include an enhanced due diligence on investors, more so on their sources of funds. The disclosure will assist in enhancing Anti-Money Laundering and terrorism financing activities that might be carried out using such platforms,
- ii. **Clarity on the issuer cap** - The amounts to be raised should be pegged on some ratios or metrics as opposed to absolute numbers. This will enable SMEs to raise enough financing and will also reduce chances of over-funding some startups,
- iii. **Definition of a medium enterprise** - Although the CMA refers to the Micro and Small Enterprises Act that defines the two types of enterprises, the Act as well as the draft on investment-based crowdfunding do not define a Medium enterprise that is eligible to raise up to Kshs 100.0 mn through investment crowdfunding platforms. The CMA ought to provide a clear framework of classifying an enterprise as a medium enterprise, and,
- iv. **Clarity on the startup track record** - The CMA should provide guidelines on evaluation of Micro and SME's track records. This could be done through clarifying financial or corporate governance metrics to be used in evaluating the track record.

Section 5: Conclusion

For economies to grow, there is need for companies to be in a position to access capital to finance their businesses and Investment Crowdfunding platforms provide access to an alternative source of finance. However, according to CMA's Capital Markets Soundness Report Q4, 2020, 95.0% of capital in Kenya is sourced from banks, meaning that the other sources of capital such as investment crowdfunding platforms remain untapped. In our view, the move of proposing investment crowdfunding regulations is commendable since it will not only control the raising of finances on crowdfunding platforms but also protect investors using such platforms through licensing, regulating and authorizing crowdfunding platforms and the operators. This will ensure that the Investment Based Crowdfunding platforms are managed well and within a legal and regulatory framework, therefore ensuring investor protection and a standardized investment crowdfunding system. However, more clarity should be provided in regard to key issues such as startups' track record evaluation and issuer cap computation.

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