The Policy and Regulatory Response to Private Equity and Venture Capital in Nigeria[1] : The Consolidation Play.

One of the key issues that should form part of the ongoing debate around increasing private equity interest in Africa is the question of what Africa's legal and policy response should be to the growing interest of private equity advisers within the continent. It is important to debate this issue at the highest policy decision making levels given, on the one hand, the need for the Nigerian government to create cheap, sustainable, *off-balance sheet* financing alternatives for social and infrastructure projects for its rapidly growing population and on the other hand, the benefits of private equity as a development finance tool. Currently, there is overwhelming data to support the proposition that the private equity and venture capital industry can deliver significant social, infrastructural and economic returns. With the benefit of intelligent regulation, African governments can benefit from this growing interest to achieve strategic infrastructural and economic objectives.

The combination of capital and management support and illiquidity that typifies private equity investments stand it out from other equity linked investments/assets as a tool for development finance. The features of the asset class which combine capital and human capacity is particularly useful for Nigerian businesses especially in the context of the current state of economic and infrastructural development in Sub-Saharan Africa. As competition builds in the industry and global firms build capacity and expand geographically, the Nigerian Government via the regulatory authorities, as a matter of priority, should take steps to deepen the private equity and venture capital market in Nigeria. To achieve this, a number of changes in regulatory approach as well as amendments to existing laws will be very useful. Although PE firms will regardless, *follow the money*, intelligent policy and regulation can significantly drive growth and deliver sustainable infrastructural and policy objectives for African economies.

Moving away from what currently obtains, which could easily be described as a disjointed approach to regulation and policy in the private equity and venture capital industry in Nigeria, a convergence between regulators on the one hand and another convergence in policy/regulatory approach on the other hand, is critical to the consolidation of the growing interest of PE in Nigeria. First off, there is a need, from a regulatory and policy standpoint to view the industry holistically. Although, there is a marked difference between the motivations and risk appetite of venture capital and private equity investors, there is a lot more that holds both streams together than apart, so much so from a regulatory/policy point of view. Consequently, policy and regulation must recognize and reflect the importance of the interdependence of the parts of the industry, and further acknowledge that regulation and policy directed at venture capital or at building the start-up ecosystem for instance, must be conceived with the private equity industry in mind. In the same vein, there is a need to painstakingly identify all the ministries, department and agencies of Government that have direct impact on the industry and promote a greater degree of cohesion and collaboration between these agencies of government. The Ministry of Trade and Investment is particularly, of primary relevance to the consolidation of the gains of private equity and venture capital interest in Nigeria. The Corporate Affairs Commission, the Trademarks Registry, the Nigeria Immigration Service the Securities and Exchange Commission, the Nigerian Stock Exchange, SMEDAN are also very key Ministries, Departments and Agencies which all have to work together consistently, as a team in developing an appropriate regulatory and policy response. The need for convergence on these levels is a critical baseline factor which must form part of the overall policy and regulatory strategy/response to global private equity interest in Nigeria.[2]

In terms of what the trajectory of regulatory and policy response should entail, the first port of call has to be in the area of corporate law. Corporate law reforms are central to the efficiency of the asset class and a

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2 The absence of convergence is prevalent in common law legal systems in Sub-Saharan Africa and will also be a useful approach in driving strategic reforms even on a sub-continental level.

re a recurrent feature in the evolution of private equity markets all over the world. A number of provisions from Nigeria's Companies Act come to mind. The first of these has to be the Financial Assistance Rules. Clearly, exemptions can now be made, in accordance with the growing trends in developed markets, to allow the assets of target companies be used as security without necessarily risk to capital. If the mischief which the financial assistance rules seeks to guard against is the erosion of capital in the interest of creditors, sanctioning a transaction by way of resolutions and proof of solvency at the time of the transaction could well provide the required comfort.

The other point to be made relates to the need to consider creating separate and or additional legal forms that are adaptable to current commercial realities. It is instructive to note that the current forms of business association are not cast in stone and there are certainly other legal structures that can be created by mixing and matching the benefits and or deprivations of incorporation vis-a-vis partnerships to achieve significant advantages for the start-up ecosystem in Nigeria. This point is particularly relevant in light of the fast evolving start-up space in Nigeria and the relevance of an active start-up ecosystem to both the growth of Nigeria's economy and to the expansion of the industry in Nigeria. The current corporate regulatory framework in the author's view imposes onerous responsibilities on start-ups/early stage companies and is unfit for companies at that stage. For instance, the requirement that only atleast 2 shareholders and two directors can form and operate a company, the provisions relating to mandatory meetings and length of notice for meetings, provisions relating to the business transacted at meetings, amongst others, cannot only significantly increase set-up and compliance costs for early stage companies but also deprive early stage companies of the flexibility required for scaling up. Another area of review that comes up for mention are the provisions relating to weighted and non-voting shares. The re-introduction of weighted shares and non-voting shares into Nigeria's corporate law for instance will give investors greater choice and also provide issuers with greater flexibility for raising capital. The point should be made that minority shareholding is not necessarily a *disadvantage* in the content of a private equity/venture capital investment. Perhaps, Nigeria is due for close corporation-type legal entity[3], effectively giving entrepreneurs the choice to elect between a close corporation or a standard corporation depending on own requirements.

The last point that must be made in relation to corporate law reform in the context of corporate law has to do with the centralization of company regulation in Nigeria. It is the view of the author that companies' regulation is not of any special importance as to be a matter for the exclusive list. Nigeria should really consider decentralization of company law regulation. In many ways, decentralization presents a simple revenue generation case for the Federal Government. In addition to the prospect of reducing federal government spending by way of allocation, decentralization of companies' regulation will create competitive tension between state governments, a development which will be very useful for the growth of the industry.[4]

In the area of securities regulation, the question for Nigeria is no longer whether private equity should be regulated as the extent to which private equity should be regulated would seem to have been answered as Nigeria's private equity regulations which are basic and largely non-interfering. The regulatory strategy adopted by Nigeria's Securities and Exchange Commission is to require that fund managers apply for authorization and registration of a private equity fund by submitting an application and a copy of the proposed fund's information memorandum. The Regulations stipulate a minimum paid-up capital for private equity fund managers and a threshold for exemption of PE funds from regulatory oversight. There are also marketing/ investment restrictions as well as reporting, valuation and governance obligations on a private equity fund manager. Overall, what the Regulations do is to set the tone and minimum standards for LP engagement.[5]

Although there exists a legal framework for the set-up of private equity and venture capital funds locally, the vast majority of local private equity funds are set-up in offshore centers, with the effect that such local

[3] *an entity that is generally entitled to operate without the strict formalities required in the operation of standard companies*

4 If company regulation is deregulated for instance, Lagos state, for instance, might decide in addition to being the only state in Nigeria which allows business to associate as a limited partnership, to also be the hub for company set up in Nigeria by affording issuers and investors with different opportunities/ legal structures for associating for the purpose of business.

5 Protection of LPs have been justified on the basis of the relatively nascent nature of private equity investments in Nigeria ly-sponsored funds can easily fall outside the scope of SEC's regulatory purview, except of course where such funds aim to target Nigerian based LPs. At present, there is no separate contemplation or regulation for foreign venture capital or private equity investors operating in Nigeria and consequently no requirement for offshore funds PE/VC funds to register with the SEC.[6] On the other end of the spectrum, emerging regulatory trends suggest the usefulness of ensuring non-intrusive regulations for offshore funds operating locally. This approach can be used to achieve a number of regulatory objectives, one of which is the provision of industry specific data that can be deployed to measure growth and to drive intelligent regulation across key sectors. Regulators must be able to obtain specific data and monitor the flow of illiquid investments across critical sectors to achieve strategic infrastructural and social objectives. In addition, such regulations can also be used to extend the regulatory powers of the SEC in relation to offshore funds as it relates to the ability of the SEC to demand sundry obligations relating to the maintenance of books and records and calling for information. The entrenchment of SEC's investigative powers and its powers to call for information in relation to offshore funds operating locally will be very useful in the protection of investors and in the regulation of the *strip and flip* tendencies of private equity firms, thereby putting in place a self-generating structure that ensures the creation of operational value for Nigerian companies. It is also typical for such a regulation to exact positive declarations from offshore funds in respect of Nigeria's negative investment list. In many ways, some form of light, incentive-based regulation for Nigeria focused offshore funds operation in Nigeria will also help address what could possibly be the unfair advantages that offshore funds have over local funds and also, possible even out whatever imbalances exist between benefits derived by offshore fund managers relative to local managers.

On a broader level it would be useful to consider policies that will promote the development of substantive onshore management activities in Nigeria. Given the breadth of our human resources and the influence Nigeria wields in sub-Saharan Africa as a gateway country, Nigeria could easily be the first choice location for funds domiciliation and serve as the hub of onshore management activities in the Sub-Saharan region. This may boil down to incentivization as there is little that can be done from a regulatory angle to compel onshore management activities.

Issues relating to excessive and hidden management fees are on the front-burner globally and can potentially hamper LP activity and by extension the growth of the local LP market especially in developing markets. Despite regulations freeing pension funds for private equity in Nigeria, pension exposure to the private equity asset class is still remarkably low. Although, a fund manager is required by law to state in the information memorandum, the fees and charges connected with investment in its fund, the challenge for the regulator is the need to develop regulatory/monitoring intelligence in relation to the market-facing structures put together by PE Firms. This will greatly help in boosting investor confidence and encourage LP activity.

Industry players certainly also have a role in the growth trajectory of the industry. A lot remains to be done around educating stakeholders about the mechanics of the asset class as well as promoting an understanding of the precise and peculiar requirements of the Nigerian market for private equity investments. In the author's view, there is an urgent need to create more credible platforms, for both LPs and GPs to facilitate debates around emerging trends, to driving policy reform and to building consensus. The Africa Venture Capital Association has done remarkably well since 2002 representing the private equity and venture capital industry in Africa. In the view of author, the trajectory of PE investments in Nigeria justifies the need for a similar professional association for both LPs and GPs in order to provide education, research and drive policy at a more granular level. Without a doubt the industry is very different from 14 years ago when the AVCA was established.

[6] *The regulation of foreign investment and cross border securities under the SEC Rules relate primarily to capital market operation. The Investment and Securities Act itself contains provisions relating to the requirements to be fulfilled by collective investment schemes administered in a foreign jurisdiction who wish to solicit investment in such scheme from investors in Nigeria*

Whist the foregoing does not exhaust all the issues relevant to this topic, represent all the factors relevant, to the topic[7], it is important to note that regulation and policy in this space must be data driven. Regulation must also demonstrate a precise understanding of the motivations of global PE firms in Africa, the limitations of local PE funds and the real challenges of Pension fund managers and other limited partners.

[7] *There are still pertinent issues with regards to taxation, and particularly, policies relating to the supply of start-ups/companies to the economy,.*