Tope Adebayo LLP
Legal Practitioners and Arbitrators

LEGAL MECHANISM FOR INVESTOR PROTECTION IN PRIVATE EQUITY TRANSACTIONS IN NIGERIA

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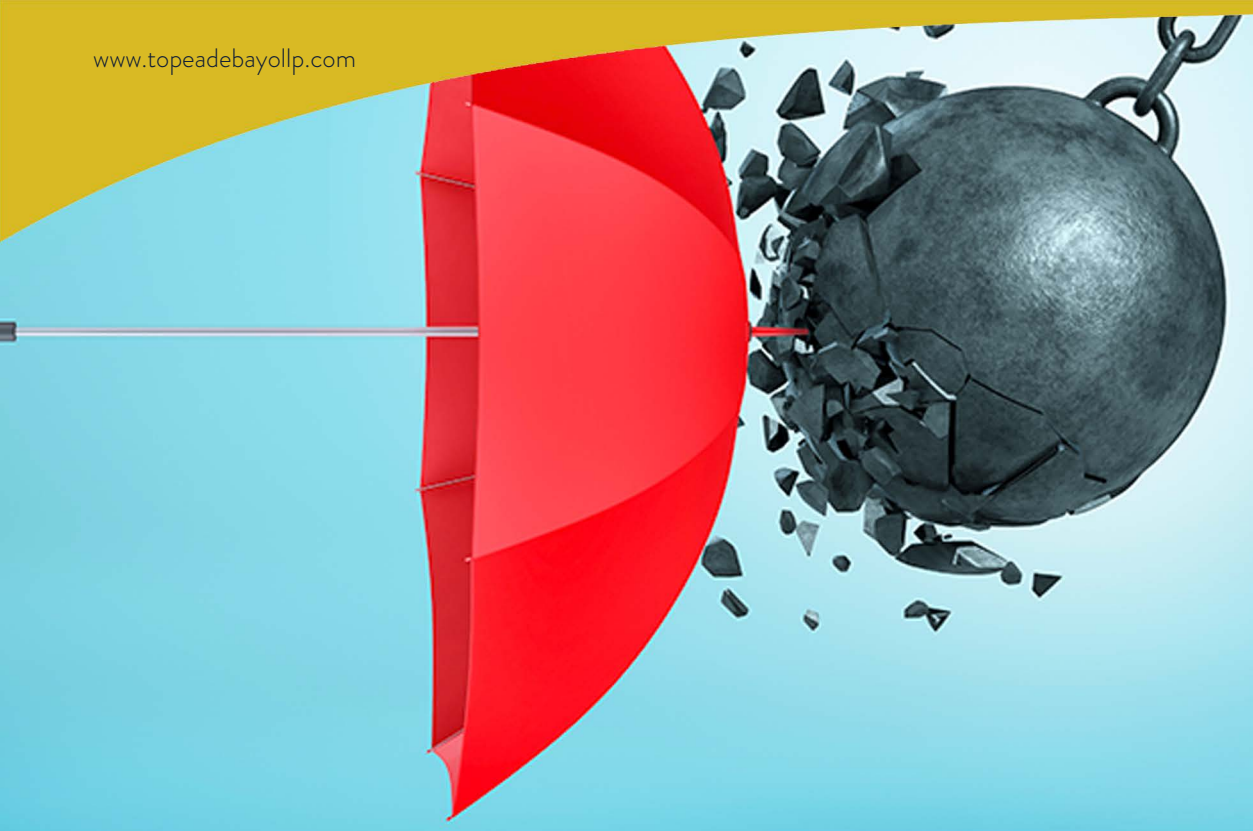
INTRODUCTION

According to the African Private Equity and Venture Capital Association, 73 percent of the total value of private equity deals in West Africa between the years 2013 to 2018 were recorded in Nigeria. This trend continued into 2019 and 2020 with a high volume of deals recorded in the financial services, information technology and real estate sectors. In recent years, the Nigerian private equity industry has grown exponentially with the establishment of a number of indigenous private equity funds, however deal activity continues to be dominated by international funds. Established indigenous fund managers include African Capital Alliance which was established in 1997, Sahel Capital Agribusiness Limited, Synergy and Verod. The Nigerian government has recognized private equity as a catalyst for growth, accordingly it has passed laws and made regulations to encourage investor confidence in the Nigerian private equity market despite obvious limitations and risks. This article examines available legal mechanisms to guarantee investor protection.

LEGAL AND REGULATORY PROTECTION

In 2013 the Securities and Exchange Commission (SEC) introduced rules for the registration and regulation of private equity funds. The Sec Rules 2013 define Private Equity Funds (PEF) as a type of collective investment scheme that invests primarily in private companies and unlisted companies, whether or not in an attempt to take control of the business. The rules apply to PEF's with a minimum commitment of N1 billion investor funds. The implication is that PEF's with less than N1 billion in investor funds are not subject to the rules. The rules mandate the fund manager of a PEF to have a minimum paid up capital of N150million to qualify for registration. PEF's may only privately source for funds from Qualified Investors alone, they are not permitted to source funds from the public. Qualified investors include institutional investors and high net worth individuals. The rules prohibit fund managers from putting all their eggs in one basket, accordingly, a PEF shall not commit more than 30% of the funds in a single investment. This is a common sense provision aimed at minimizing risk exposure and diversifying investment. The rules establish and promote a regime of transparency on the part of fund managers. Fund managers must disclose detailed information on the risks and potentials of the fund to investors by way of an information memorandum. The information memorandum must contain specific particulars and must be filed with the Commission.

The SEC rules on PEF's are skeletal and lacking in essential detail. This is very evident when the SEC rules are compared with the provisions of the PENCOM Regulation on Investment of Pension Fund Assets (Pencom regulations) which are more detailed. The Pencom regulations allow Pension Fund Assets to be invested in PEFs. Amongst other requirements, the regulations mandate the PEF to publish and publicize annual financial statements audited by two independent firm(s) of chartered accountants registered by the Financial Reporting Council. The regulations also prescribe that the PEF Vehicle shall have satisfactory pre-defined liquidity and exit routes such as IPO's, Dividends, sale to industry buyers etc. This implies that at the commencement of the investment, the PEF must have a well-defined and detailed exit strategy, after all, the ultimate aim of the fund is to make substantial gain upon the liquidity event. The regulations stipulate that key principals of the fund manager should have at least ten (10) years' experience in investments and management of third-party funds. The regulations also incorporate an important local content provision which provides that 60% of the fund shall be invested in companies or projects within Nigeria.



In 2015, the SEC established the National Investment Protection Fund which is incorporated as a legal entity. The fund is set up as a type of insurance scheme for investors in the event of losses suffered as a result of insolvency, bankruptcy, negligence or misappropriation of the funds by fund managers. However, subject to certain eligibility criteria, payment is made by the board to satisfy claims subject to the rules and provisions of ISA. However, the maximum amount paid out by the board to a single investor in the event of a claim is determined by the Board from a written policy from time to time. By the National Investment Protection Fund Rules 2017, the maximum amount payable to an investor who has suffered loss is Two Hundred Thousand Naira (N200, 000.00) or its equivalent in form of shares/units. It must be said that the N200, 000 Cap hardly scratches the surface. Unsuccessful investments usually lead to losses in millions, if not billions of Naira by individual investors. If the SEC is serious about insuring investor funds, then the cap must be increased substantially.

In terms of structure, a PEF may be set up either as a limited liability company registrable under the Companies and Allied Matters Act, or general or limited partnerships. However, most PEF's in Nigeria are structured as limited partnerships where the General Partner who is the fund manager is liable for all the debts and obligations of the fund, while the limited partners are the investors whose liability is restricted to the value of their respective contributions. As it stands, no federal law recognizes and regulates limited partnerships as a corporate structure in Nigeria, recourse is had to the Partnership Law of Lagos state which is extensive on limited partnerships. However, the applicability of the law is limited to the precincts of Lagos. Fortunately, the current efforts of the National Assembly to amend the CAMA incorporates and makes detailed provisions for partnerships as corporate structures. It is expected that the new CAMA will be passed by the National Assembly and receive the requisite presidential assent very soon.

CONTRACTUAL PROTECTION

It is customary for private equity funds which acquire equity stakes in portfolio companies to insist on certain controls to guarantee the protection of their investment in the process of consummating the requisite investment agreements. The investments agreement is usually a tripartite agreement amongst the PEF, the Founders and the Company. In most cases, the agreement obligates the company to amend its Memorandum and Articles of Association in order to give the PEF control sufficient to protect their investment.

The PEF may insist on the power to veto certain decisions at the board or shareholders level so that such decisions cannot be taken by the Portfolio company without its consent. For this purpose, the PEF would reserve the right to appoint a nominee-director to occupy key positions on the Board such as CEO and or CFO or even the Chairmanship of the Board (depending on the volume of investment). An investor appointed director maintains a fiduciary duty of care towards the company.

Section 280 of the Companies and Allied Matters Act binds the director to put the interest of the company above his personal interest, including that of the investor. Accordingly, the nominee-director must not fetter his discretion to the detriment of the company. The PEF may also insist on having some level of supervisory rights over the finances of the company, which would give the right to examine the books and account of the business. The fund may further reserve the right to establish a finance, audit and strategic committee with powers to inspect the books of the portfolio company at any time. By the investment agreement, the management team of the company may also be put under obligation to obtain consent of the PEF before making borrowings or expenditure above certain limits. In some other cases, the PEF will reserve the right to appoint key ocers of the business, such as the chief financial officer or chief operating officer, in view of the critical role they will play in achieving the investment objectives.

Depending on the deal structure, the PEF's investment in the target entity may be an outright acquisition, merger, takeover, leveraged buyout, capital raising etc. Where the PEF assumes control of the company as defined under Section 119 of the Investment and Securities Act, and Section 92(2) of the Federal Competition and Consumer Protection Act, 2018, then the respective provisions of those laws must be complied with. However, where the PEF only acquires a minority stake in the target company, then as stated above, necessary clauses must be included in the Investment Agreement to secure and protect the investment.

In the early 2000's African Capital Alliance sponsored a fund which invested in MTN (the company was private at that time) through a vehicle. Through the vehicle, ACA acquired minority stake in MTN which at the time of entry was worth $400 million and by the time of exit the telecoms giant was worth $13 billion. Another example is the London based investment firm Acts, which has been very active in Nigerian private equity space. The firm has equity investments in Diamond Bank, UAC, Heritage Place, Ikeja City Mall, and a host of others.

CONCLUSION AND RECOMMENDATIONS

In recent times, the government has undertaken reforms to encourage and guarantee investor protection within the country. In 2016, the Federal government established the Presidential Enabling Business Environment Council (PEBEC) with the mandate of removing bureaucratic constraints to doing business in Nigeria. Today Nigeria is ranked 131 out of 190 economies in the 2019 World Bank Ease of Doing Business ranking, a significant improvement from its 146th position in the 2018 rankings. Through the Finance Act, 2020 the country has also made extensive reforms to its tax administration, in some cases eliminating incidences of double taxation and removing the burden of Companies Income Tax from small companies whose annual gross turnover is less than N25 million. Also, the country has also confronted the problem of money laundering, financial and investor fraud within the country by strengthening its regime of criminal legislation in this regard. Today there is the Economic and Financial Crimes Commission established by the EFCC Act, the Independent Corrupt Practices and Other Related Offences Act, the Cybercrimes (Prohibition, Prevention, Etc.) Act, 2015, Money Laundering (Prohibition) Act, Advance Fee Fraud and Other Related Offences Act etc. However, more must be done to promote investor confidence in the country's private equity market. We make some suggestions in the following paragraphs-

Whistle Blower Policy: Following the 2008 global financial crisis, the United States introduced new reforms to the entire spectrum of its financial and investment landscape through the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010. Aside introducing a system of registration for US based Private Equity Firms and advisers, the Act incorporated a whistle blower provision which encourages whistleblowers to report fraudulent dealings of companies to the US SEC. Whistleblowers are entitled to financial reward in the region of 10% to 30% of the governments total monetary recovery, they are also adequately protected under the act from retaliation. It is recommended that similar whistleblower provisions should be incorporated into Nigeria's financial and investment laws and regulations with adequate incentives and protection provided for whistleblowers.

Credit Rating: By the Dodd Frank Act, the United States tightened regulations of Credit Rating Agencies with the establishment of the Office of Credit Ratings (OCR). The mandate of the office is to support the US SEC's in enhancing the regulation, accountability and transparency of Nationally Recognized Statistical Rating Organizations (NRSRO). Accordingly, the office monitors and regulates the activities of these NRSRO's to ensure the accuracy of ratings issued by them and to prevent ratings fraud. In Nigeria, Credit Rating Agencies (CRA) are required to be registered with SEC, but their activities are not closely monitored by the commission. It is recommended that stricter measures should be put in place by SEC to monitor the activities of the CRA's in other to ensure accuracy of their ratings and protect investors.

Disclosure: Ultimately, the decisions of investors are guided by the accuracy of disclosures made by PEF's. The SEC rules mandate PEF's to make detailed disclosure of their investment profile to potential investors by their information memorandum, as this is in line with international best practices. However, SEC must do more to validate the information provided by the PEF in their filed information memorandum. Accordingly, the commission must conduct extensive due diligence on all PEF's prior to registration. This would reduce incidences of fraudulent misrepresentation by PEF's domiciled in the country.

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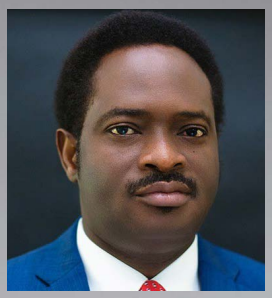

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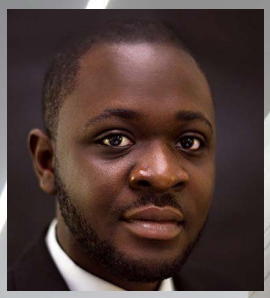

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