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The Capital Markets (Investment-Based Crowdfunding) Regulations, 2022

Introduction

The Capital Markets (Investment-Based Crowdfunding) Regulations, 2022 (the "Regulations") have been gazetted. The Regulations enable start-ups and growing businesses to raise money from individuals or entities to either finance a project or business through crowdfunding platforms. We set out below a summary of the key highlights in the Regulations.

Scope of the Regulations

While crowdfunding may take a variety of forms including donation based crowdfunding popularly done in Kenya through *M-changa,* the scope of the Regulations is investment-based crowdfunding which involves raising of funds in exchange of investment instruments such as shares and bonds.

Crowdfunding in other jurisdictions

The regulation of crowdfunding is a mixed bag across jurisdictions. For example, while there is no specific legislation for regulating crowdfunding in South Africa, crowdfunding activities may be subject to the general financial services regulatory frameworks. In countries like Nigeria and Ghana there is a specific legal framework to regulate crowdfunding and there are regulatory approvals required. Closer home in East Africa, Kenya is the first to develop a regulatory framework governing crowdfunding.

Licencing as a Crowdfunding Operator

The Regulations apply to investment based crowdfunding platforms established, maintained or operated in Kenya, platforms operated outside Kenya but actively targeting Kenyan investors, or those whose key components when taken together are physically located in Kenya. An institution may be deemed to target Kenyan investors where it uses agents or cold selling tactics such as emails and phone calls to target Kenyan investors even though it is based in a different territory.

Eligibility to operate a crowdfunding platform

A crowdfunding platform operator must be licensed by CMA and the platform approved by CMA. An applicant for a crowdfunding platform operator licence must be a company limited by shares with a minimum paid up capital of Kenya Shillings Five Million (KES 5,000,000) and a minimum liquid capital of Kenya Shillings Ten Million (KES 10,000,000) or 8% of its liabilities, whichever is higher. The licence application will be accompanied by details of the principal office of the operator as well as information of the platform to be used including system capacity, security and functionality and evidence of adequate human resources with knowledge and competence on crowdfunding business. Other requirements that apply to Capital Markets licencees such as the shareholders, directors and key personnel being fit and proper also apply. Given the nature of their business, the operators will also need to comply with the Data Protection Act, 2019 and the Proceeds of Crime & Anti-Money Laundering Act, 2012.

Eligible Issuers

Eligible Issuers include:

1. Start-ups with a good operating track record of two years and a good corporate governance record. A start-up under the Regulations is an entity that has not been existence for more than 10 years and is established for developing an innovative and scalable product or service;
2. Medium enterprise which is a company whose annual turnover ranges between KES 5,000,000 and KES 50,000,000 and employs between 50 to 300 employees; and

3. Small and micro enterprises registered as such under the Micro and Small Enterprises Act, 2012. These enterprises must additionally be two years in operation and have a good corporate governance record.

Prohibited Issuers

Prohibited Issuers include:

1. Public listed companies and their subsidiaries which may not raise funds on a crowdfunding platform. This is in keeping with the objective of the Regulations, to provide funding for start-ups and micro or small enterprises.
2. Entities in the business of lending or financing other entities cannot raise funds on a crowdfunding platform to avoid them being classified as Deposit Taking Entities and therefore falling under the Central Bank's jurisdiction.
3. Entities with a poor governance record are also prohibited issuers for the purposes of the Regulations.

Eligible Investors

These include sophisticated investors being high-net-worth investors with significant knowledge on capital markets investment products and individual retail investors who are only allowed to invest up-to a maximum of Kenya Shillings One Hundred Thousand (KES 100,000).

Fundraising Limits

The maximum amount of investment instruments that can be raised by an issuer on a Crowdfunding platform within a twelve-month period is Kenya Shillings One Hundred Million (KES 100,000,000). Where the business seeks to raise an amount higher than the set limit, the platform operator may apply to CMA for a no-objection.

Cooling Off

The Regulations provide for a cooling off period of forty-eight (48) hours being the period within which an investor may withdraw their investment without penalty. The Regulations also require that the funds debited from or blocked in the account of the investor be refunded or released within forty-eight hours of the withdrawal request.

Handling of Investor Funds

The Regulations require the platform operator to appoint a custodian.

If a funding round is successful, the crowdfunding operator will release the funds to the issuer within 5 business days after the close of the offer. This takes into account the cooling off period. Where the issuer is unable to meet the prescribed threshold for the targeted amount within the offer period, the offer shall be withdrawn and the platform operator shall refund the monies to the investors within forty-eight (48) hours. A fresh offer may only be issued after 90 days from the date of withdrawal of the offer.

The Regulations additionally provide that an operating platform can be created to transfer investment instruments previously offered on another crowdfunding platform.

Duties and Obligations of Crowdfunding Platform Operators

Over and above ensuring the platform displays relevant information such as user rights, complaints and dispute handling procedures, fees charged for use of the crowdfunding platform, among others, a Crowdfunding Operator is also required to perform the following functions:

a. To display on its platform, users' rights and responsibilities, information relating to issuers and investors hosted on the platform, investor education material and programs, disclaimers and limitation of liability.

b. To carry out due diligence on its prospective issuers intending to use its platform and ensure that the disclosure documents lodged by each issuer is verified for accuracy and made accessible to investors through the platform.

c. If crowdfunding is successful, to make the funds available to the issuer within five days after close of the offer.

d. To take reasonable steps to ensure that the funds raised through its platform are used for the stated purpose.

e. To maintain a register of all investors and issuers including records on holdings by investors.

f. To disclose all the risks associated with the crowdfunding including warnings on investment risk and restrictions on investment cancellations.

g. To submit to CMA monthly reports with information including details of the issuers, offers made through the platform and use of the funds, details of the investors and the amounts invested and any other information that CMA may request from time to time.

h. To submit to CMA quarterly management accounts and audited accounts within four months following the end of each financial year.

Penalties

Individuals shall be liable upon conviction to a fine not exceeding Kenya Shillings Five Million or to imprisonment for a term not exceeding two (2) years and shall pay two times the amount of any gain made or loss avoided as a result of the contravention. Companies shall be liable upon conviction to a fine not exceeding Kenya Shillings Ten Million and shall pay two times the amount of any gain made or loss avoided as a result of the contravention.

Key Considerations

The Companies Act 2015 restricts the number of members in a private company to fifty. Additionally, a private company is prohibited from inviting the public to subscribe to its shares or debentures. This would limit private companies from taking part in equity-based crowdfunding activities. The Companies Act, 2015 may need to be streamlined with the crowdfunding regulations.

To resolve this issue, Australia through the *Corporations Amendment (Crowd-Sourced Funding for Proprietary Companies) Act 2018* amended its Corporations Act 2001 to provide that shareholders connected with crowdfunding will not count when considering the fifty-member limit for private companies in the same way employee shareholders are not.

Another key consideration for the Regulations is the applicability of other capital market laws to crowdfunding activities. Regulation 38 requires a crowdfunding Platform Operator to comply with the Capital Markets (Conduct of Business) (Market Intermediaries) Regulations, 2011, Capital Markets (Corporate Governance) (Market Intermediaries) Regulations, 2011, the Regulations on the Prevention of Money Laundering and Terrorism Financing in the Capital Market, 2015 and any other existing capital market laws and regulations.

Conclusion

The *Crowdfunding in East Africa* report by FSD Africa in 2017 indicated that bespoke regulation was not recommended given the relatively small size of the market. It recommended regulators to advise industry stakeholders to implement self-governing rules and regulations. Since then, African countries including Kenya have seen a significant growth in their capital markets. Ghana and Zambia had crowdfunding volumes of USD 528 Million and USD 297.64 Million respectively as at 2020, and South Africa recorded a volume of USD 23.79 Million according to the 2nd Global Alternative Finance Market Benchmarking Report. In 2020, CMA approved the *Pezesha* platform after a one-year testing period in a regulatory sandbox. It remains to be seen whether the better path was to allow the industry grow organically as was the case for mobile money transfer services and digital credit and implement a self-regulatory regime as opposed to a regulator-led approach. The former does have its risks but has proven a more effective approach. The Regulations are however a welcome move and we look forward to enhanced crowdfunding activities in the market.

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