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Client Alert

SEC Proposes New Amendments to its Rules on Issuance, Offering Platforms and Custody of Digital Assets

Introduction

In the wake of the recent regulatory developments in the Nigerian market, the Securities and Exchange Commission (“SEC” or “Commission”) on 15 March 2024 published its proposed amendments (the “Proposed Rules”) to the existing SEC rules on issuance, offering platforms and custody of digital assets dated 11 May 2022 (the “Current Rules”).

In this client alert, we highlight some of the key proposed amendments and how the Proposed Rules could impact on the licensing process for virtual asset service providers (VASP) in Nigeria.

Changes to be Introduced by the Proposed Rules

Requirement to be registered with the SEC

Keeping in line with the SEC statement on the classification and treatment of digital assets dated 14 September 2020 (the “SEC Statement”), the Proposed Rules expressly provide that no person or entity shall provide any virtual assets service unless registered with the SEC.

Extension of the Definition of Virtual Assets

The Proposed Rules extend the description of virtual assets to include cryptocurrency such that the defined term will now be referred to as “virtual (crypto) assets” as opposed to “virtual assets” as under the Current Rules, although the ascribed definition will remain the same i.e, a digital representation of value that can be transferred, digitally traded and can be used for payment or investment purposes.

While the terms “digital assets,” “virtual assets,” and “crypto assets” are often used interchangeably, there are important distinctions, particularly from a regulatory perspective. Every crypto asset is a form of digital and virtual asset, and all digital assets are considered virtual. However, the reverse is not always true as not every digital asset is a crypto asset, and not all virtual assets are necessarily digital assets. For instance, a Non-

Fungible Token (NFT) may gain its value from representing ownership of a specific asset rather than from its blockchain foundation. Similarly, virtual assets that do not rely on blockchain technology are not considered digital assets.

Understanding these distinctions is crucial in a regulatory context, particularly when determining how an asset is classified—whether falling within the ‘securities’ category or otherwise. Securities are negotiable financial instruments that represents some type of financial value and typically include assets acquired in the anticipation of value appreciation such as equities, bonds, etc. Currencies on their own do not fall within this category. Consequently, the distinction between whether an asset is categorized as a crypto asset or a digital asset can determine its regulatory treatment, such as whether it falls under the jurisdiction of the SEC. It is important to note that the SEC Statement places the burden of proving that the crypto assets proposed to be offered are not securities and therefore not under the jurisdiction of the SEC, on the issuer or sponsor of the said assets.

Local Entity Incorporation

The Proposed Rules provide that an application for registration as a VASP can only be brought by a company incorporated and having an office in Nigeria, with such company’s Chief Executive Officer (CEO) / Managing Director (MD) or its equivalent resident in Nigeria.

Under the Current Rules, a VASP is merely mandated to have an office in Nigeria managed by a director of the company. It is not entirely clear why there is a requirement for the CEO / MD of a company applying for registration as a VASP be resident in Nigeria, especially considering that most of the activities of VASP rarely require physical interaction. Given recent events in the market though, it may be assumed that this is being introduced for ease of regulatory access to decision makers.

Business Separation Requirement

Under the Proposed Rules, the SEC may require existing Capital Market Operators (CMOs) registered to provide trading, offering platforms and custodial services but seeking to be registered as VASPs to establish a subsidiary / separate entity to take up the VASP function.

Exemptions from Registration of Digital Assets

Under the Proposed Rules, one of the requirements for exemption from registration of a digital asset is that the securities (that is, the digital asset) is structured to be exclusively offered through a SEC-registered crowdfunding portal or intermediary.

The Current Rules require that the securities be offered through any crowdfunding portal or intermediary, without specifying that such crowdfunding portal or intermediary needs to be registered with the SEC or an equivalent regulator in another jurisdiction. Therefore, whilst this may be a grey area under the Current Rules, the Proposed Rules clear up any ambiguity on the point.

Increased Fees and Minimum Paid Up Capital

The Proposed Rules introduce an increase in various regulatory fees. The application / filing fee for digital asset offering platforms (DAOPs) have been increased from ₦100,000 (One Hundred Thousand Naira) to ₦300,000 (Three Hundred Thousand Naira); the processing fee from ₦300,000 (Three Hundred Thousand Naira only) to ₦1,000,000 (One Million Naira); the registration fee from ₦30,000,000 (Thirty Million Naira only) to ₦150,000,000,000 (One Hundred and Fifty Million Naira); and the sponsored individual fee from ₦100,000 (One Hundred Thousand Naira only) to ₦300,000 (Three Hundred Thousand Naira /Individual).

In addition, the minimum paid up capital for a DAOP is now N1,000,000,000 (One Billion Naira) and the minimum paid up capital for a digital asset exchange is now N1,000,000,000 (One Billion Naira).

Account Holder Requirement

Under the Proposed Rules, a digital asset exchange (DAX) operator is required to ensure that the same account holder is not on both sides of the same transaction. This requirement potentially prevents the same entity from being the seller and buyer of digital assets in a single transaction on a DAX and is aimed at preventing money laundering amongst other financial crimes.

This, however, does not address situations where related entities (perhaps controlled by the same party) undertake the transaction as separate entities, effectively circumventing this requirement.

CBN Official Rate

The Proposed Rules require a DAX operator to ensure that investors only invest or trade in virtual or digital assets hosted on its platform using Naira. In this regard, the reference rate for conversion of foreign currency denominated assets shall be the official exchange rate as published by the CBN. This is perhaps based on the recent regulatory concerns raised by the CBN around the availability of a reference rate for the sale or purchase of stablecoins which is much higher than the CBN official rate.¹

Requirement for Registration as a Digital Asset Custodian

The Proposed Rules provide that an entity seeking to register as a digital asset custodian (DAC) must demonstrate to the SEC that it can effectively safeguard the custody of digital assets and meet other eligibility criteria as may be stipulated by the SEC from time to time.

Whereas, under the Current Rules, the requirement to demonstrate capacity is less pronounced although there is a generic requirement for a custodian to satisfy the eligibility requirements for registration as a custodian or trustee and any additional requirements which the Commission may prescribe from time to time.

The Proposed Rules do not, however, provide for the nature of evidence (i.e., whether technical, financial, or otherwise) required to demonstrate the capacity to safeguard digital assets.

¹ For further information, see our recent regulatory update: <https://www.templars-law.com/app/uploads/2024/03/NAVIGATING-THE-REGULATORY-HEADWINDS-FOR-CRYPTO-EXCHANGES-IN-NIGERIA.pdf>

Renaming and Re-arrangement of Sections

In addition to the consequential re-arrangement of the provisions of the Current Rules, the SEC is proposing to rename the Current Rules from “*Rules on Issuance, Offering Platforms and Custody of Digital Assets*” to “*Rules on Digital Assets Issuance, Offering Platforms, Exchange and Custody*”.

Though already provided for in the Current Rules, the new title specifically captures exchanges and is regulatory recognition of the significance of crypto exchanges in the digital asset ecosystem.

Conclusion

The last few weeks have been very eventful for virtual asset service providers particularly crypto exchanges in Nigeria. And as expected, the SEC is taking steps to strengthen the efforts of the CBN all aimed at tightening the perceived loopholes in the regulatory environment. However, there is a concern in the market that these regulatory efforts could also act as market barriers. For example, there are reports that over 300 companies have applied for licenses from the Financial Sector Conduct Authority in South Africa. However, the reverse is the case for Nigeria, which since the issuance of the Current Rules in 2020, (based on publicly available information) is yet to formally issue any license to VASPs. To this extent, it is important to ensure that a regulatory balance is struck so as not to inadvertently stifle innovation and growth in the digital economy.