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SEC'S DRAFT RULES FACILITATE PENSION FUNDS' INVESTMENT IN COMMERCIAL PAPERS

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Background

On December 3, 2024, the National Pension Commission ("**PenCom**"), in a circular referenced "PenCom/TECH/ISD/2024/403", addressed to managing directors and chief executive officers of licensed Pension Fund Administrators in Nigeria ("PFAs"), **announced the removal of the restriction earlier placed on investment of pension funds in commercial papers.**

PenCom had directed all PFAs, in an earlier circular dated October 23, 2024, to immediately suspend further investment in commercial papers where non-bank capital market operators act as Issuing and Placing Agents ("**IPAs**"). The directive by PenCom was based on the fact that the Securities and Exchange Commission ("**SEC**"), the apex regulator of the capital market, did not have any established rules and regulations governing the issuance of commercial papers.

According to the recent PenCom circular, the restriction has now been lifted following an exposure draft of rules developed by SEC ("**Draft Rules**") and a consequential amendment to existing SEC rules, pursuant to which SEC posits that it will be in a position to "exercise adequate oversight over commercial papers, in line with the provisions of the Investments and Securities Act of 2007 ("**ISA**"), to ensure transparency, an orderly market and maintain the investor protection mandate of the Commission". Notwithstanding the removal of the restriction, PFAs are required to undertake the prescribed legal and financial due diligence on all prospectus/offer documents as appropriate, before investing pension fund assets.

Power of PenCom to restrict investment by PFAs

Section 315 of ISA defines securities to include "debentures, stocks, shares, bonds or notes issued or proposed to be issued by a body corporate". This definition is adopted in section 1 of the PenCom's Regulation on Investment of Pension Fund Assets of 2019 ("Investment Regulation") made pursuant to section 115 of the Pension Reform Act of 2014 ("PRA"). Commercial papers are short-term debt instruments issued generally in the nature of a promissory note and are therefore a form of securities under the ISA and the Investment Regulation.

Essentially, money market instruments of banks and commercial papers issued by eligible corporate entities are an allowable instrument for PFAs under section 4 of the Investment Regulation. However, PFAs are not permitted to take unbridled risks in investing pension funds in just any allowable instrument without qualification. In the specific case of commercial papers, PFAs are mandated under section 5 of the Investment Regulation to invest only in instruments with a minimum credit rating of 'BBB' issued by at least two rating agencies, one of which must be a rating agency incorporated in Nigeria and registered with SEC.

Additionally, by their nature as provident funds, pension assets, typically the largest investment blocks in most markets and economies around the world, require adequate regulation to ensure their protection from investment risks and potential abuses, in order to secure their primary purpose of providing retirement benefits to the contributing employees. It is in line with this philosophy that PenCom reserves powers under section 90 of the PRA to impose additional restrictions on investments by PFAs, with the aim of protecting the interest of beneficiaries of Retirement Savings Accounts. Further to the foregoing, and in the context of the global inclination toward strict regulation, the hitherto restriction on investment of pension funds in commercial papers for the absence of an established regulatory framework for the asset class in Nigeria, represented an appropriate regulatory intervention.

Protective provisions from the proposed SEC Rule

The Draft Rules reflect provisions which collectively act as a screening mechanism, aiming to ensure that only companies with demonstrated financial stability and a strong track record are eligible to issue CPs, thereby safeguarding investor interests. Some of these provisions include:

- **Minimum Operational History**: The issuer must have been in operation for at least five years. This indicates the company has demonstrated a track record of sustained operations.
- **Audited Financial Statements:** Issuers need to provide three years of audited financial statements, with the latest being no older than nine months from the last financial year-end. This requirement ensures transparency and allows investors to assess the company's financial health.

- **Minimum Shareholders'** Funds: The issuer's shareholders' funds, unimpaired by losses, must be at least ₦500,000,000 and maintained at that level while any CPs are outstanding. This provision ensures a significant financial buffer, protecting against potential losses.
- **Debt-to-Equity Ratio:** The issuer's total indebtedness, including the new CP issuance, cannot exceed 400% of its net worth (a gearing ratio of 4:1). This limits excessive borrowing and ensures the company can manage its debt obligations.
- **Investment Grade Credit** Rating: Issuers must have a credit rating of investment grade from a SEC-registered rating agency. This independent assessment signifies the company's strong creditworthiness and ability to meet its financial commitments.
- **No Default History:** Issuers cannot offer CPs if currently in default of interest or principal payments on previous issuances. This ensures only companies with a good repayment history can access the CP market.
- **Compliance with all relevant laws and regulations:** All issues shall be governed by the draft Rules, general provisions of SEC's Rules and Regulatory Guides, as well as the provisions of the ISA.

The Draft Rules also contain provisions on conditions for issuance, subscription level, tenor and rollover of issues, credit enhancement and guarantees, registration requirements, execution of issue documents, maturity and redemption, allotment, listing requirements on a registered securities exchange, summary report on completion of offer, utilization of proceeds, reporting & disclosure requirements, and sanctions & penalties for non-compliance.

Conclusion

Since its establishment in 2004, Nigeria's pension fund has grown exponentially. According to a recent report by PenCom, total assets under management by PFAs hit N21.92 trillion at the end of October 2024, with total investment of N2.29 trillion in corporate debt securities and N2.20 trillion in money market instruments like commercial papers, in the last one year.

With the pension fund's growing profile and influence as an institutional investor, amidst potential and existential risks in the market, inter-agency collaboration across relevant regulators is crucial to strengthening the investment regime for PFAs. The PenCom circular signifies a new level of confidence in the market, and it is expected to buoy capital raising activities, enhance market stability and further deepen the capital market in Nigeria.

However, it must be considered whether PenCom has acted prematurely in lifting the restriction, given that the Draft Rules are yet to come into force and there is no certainty as to when same will be in force or what form the final version will take.

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