



SECP's Regulatory Sandbox & Startup Focused Changes to Companies Law

with Barrister Ahmed Uzair

As the Startup Ecosystem in Pakistan continues to evolve, a need for startups to be recognized and protected through a regulatory framework has been identified by the SECP.

Startups, in this still nascent ecosystem, face many legal hurdles, ranging from company registration, to issues pertaining to stock options, to filing of returns, and many more. The SECP, realizing the need for startups to be recognized and protected through the regulatory regime, stepped forward and introduced amendments to the Company's Act 2017, under the Companies (Amendment) Ordinance 2020, and for the first time, the definition of a Startup as a separate entity has been recognized and incorporated in the law. This and other major amendments were introduced by the SECP to provide an enabling regulatory framework to facilitate startups in Pakistan.

To discuss the changes implemented, and to create awareness on how the regulatory framework is facilitating startups to operate in Pakistan, the National Incubation Center invited Barrister Uzair Ahmed in its Leadership Talk Series, 'SECP's Regulatory Sandbox & Startup Focused Changes to Companies Law.' Key questions addressed in the discussion, are presented below:

According to Companies Act, what is the definition of a startup?

An entity shall be considered as a Startup:

- Up to a period of 10 years from the date of incorporation/registration.
- Turnover of the entity for any of the financial years since incorporation/registration is not greater than 100 million rupees.
- The entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

How is the Companies (Amendment) Ordinance, 2020 incorporating the use of Employee Stock Options for Startups, and what benefits can startups derive from this?

Company's Act 2017 incorporated Employee Stock Options in law, for use by Public Limited Companies. The Companies (Amendment) Ordinance, 2020 allows Private Limited Companies to also avail Employee Stock Options.

Employee Stock Options enable startups to stay lean, yet keep employees motivated, without burning a lot of cash. Having ESOs allows startups to attract high quality human resource from the market, while giving employees a sense of ownership, and a hook to contribute towards growth of the company.

For cash strapped startups, owners and employees often draw salaries less than their market value, in return for a stake in the company known as 'Sweat Equity'. How is Sweat Equity addressed in the law?

There is a certain amount of overlap in sweat equity and employee stock options. Sweat Equity is generally given to consultants, who are necessarily NOT employees of the startup. The Law has now made it easier to issue sweat equity- while previously, the worth of Sweat Equity to be issued, had to be verified by an SECP-approved valuator, the current law removes this obligation, making the founders the sole decision makers for the amount of sweat equity to be issued to a consultant.

How does 'Share buy-backs/ share repurchase' Policy work for startups, and at what stage does a startup become eligible for buy backs?

Many startups fail and a major reason is co-founder dispute. This tool allows the company to buy back shares from the exiting

co-founder. If the startup does not have money to pay dividends to the exiting cofounder, it can use funds to buy back stock.

How do all the above-mentioned policies open doors for international investors. How does law protect rights of investors, and create potential for startups to seek investment?

As a regulator, SECP has taken a proactive approach in understanding the problems of startups and finding solutions to them. These policies bring us in line with what is standard across the world. Employee stock options, for example, is a very common practice for early stage startups across the world. However, the other two regulators SBP and FBR need to put their foot forward and only then collaboratively we can create that ecosystem that will enable startups to thrive.

SECP recently launched a 'Sandbox'. What is it and what is the rationale behind it? What objectives have been achieved so far?

Sandbox is a strategy, designed as a mutual understanding between the regulator, and regulatee, to resolve regulatory hurdles, not explicitly defined under law. Startups having innovative solutions to real-world problems, and faced with regulatory challenges, can join the Sandbox, where the regulator sits with the founders as their partner, and helps them navigate the challenges for a certain period. E.g. in the case of equity crowd funding which is not permitted under law, but is a very popular tool for attracting investment from the market, startups can work under regulatory sandbox for a period of 6 to 12 months, giving the regulator, in this case the SECP, a good window to understand what exactly the startup is doing, and design and further improve its regulatory regime.

For details on the SECP Sandbox, visit:

https://www.psx.com.pk/psx/themes/psx/uploads/SEC_Regulatory_Sandbox_Guidelines,_2019.pdf

COVID-19 has affected many existing contracts for startups. How does 'Force Majeure' come into play for such unforeseen crisis situations?

Force Majeure only comes into play when it has been incorporated in contract, with exact representation of event. If the contract language does not incorporate the specific force majeure event being claimed, then the startup will not be able to derive benefit from it.

Some other changes to the Company's Law to facilitate startups:

1. Removing the requirement of having a Company Seal
2. Removing the requirement of depositing share deposit money within 30 days of incorporation
3. Removing the requirement to engage a chartered accountant as soon as a company is registered.

Audience Q & A:

1. What are SECP requirements for registration of Limited Liability Partnership (LLP)?

LLP is only advisable if you are in a services business, or in a business where you are unlikely to attract equity injection, for instance, a consultancy business. Tax liability and reporting requirements are the same as in case of Private Limited Companies.

2. Can a company or a startup use a convertible note for raising investment in Pakistan? Has a clause for this been added in the Companies (Amendment) Ordinance, 2020?

You can certainly raise investment by issuing a convertible note. The Security Act specifically calls a convertible note as a kind of security. Many local and foreign investments are currently being made in the form of convertible notes.

3. Is equity crowdfunding prohibited under the ambit of Section 84 of Companies Act, which prohibits acceptance of deposits from the public?

Acceptance of deposits from the public is definitely prohibited, which means you cannot use public media like newspapers, for this purpose. However, an accredited investor, can invest through the website, where his identity can be verified through credentials.

4. Does a consultancy firm become eligible for funding on projects in development sector for community work?

Yes, some donors or NGOs require you to be a non-profit, while many contracts or opportunities do not have such a clause. For requirement of non-profits, you can always partner with someone.

Watch the video here:

