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ETHIOPIA'S DRAFT COLLECTIVE INVESTMENT SCHEME RULES: BUILDING THE FOUNDATIONS FOR A DOMESTIC PRIVATE CAPITAL MARKET

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Introduction

Ethiopia's financial sector reform programme continues to gather momentum. Following decades of a predominantly state-led and bank-centric financial system, policymakers are gradually laying the foundations for a more diversified financial architecture intended to mobilise long-term capital, deepen domestic markets and broaden investment opportunities.

Recent reforms have included the enactment of the Capital Market Proclamation and the establishment of the Ethiopian Capital Market Authority ("ECMA"), the licensing of the country's first securities exchange, the adoption of directives governing public offerings and securities trading, the liberalisation of the banking sector to permit foreign participation, reforms to the insurance and payments sectors, the introduction of a modern Real Estate Proclamation, and ongoing efforts to strengthen pension and institutional savings frameworks. Taken together, these measures reflect a deliberate shift towards creating market-based channels for savings and investment.

Following decades of a predominantly state-led and bank-centric financial system, policymakers are gradually laying the foundations for a more diversified financial architecture intended to mobilise long-term capital, deepen domestic markets and broaden investment opportunities

Against this backdrop, ECMA's recently issued Draft Directive on Collective Investment Schemes (the "Draft Directive") represents another significant milestone. While the Draft Directive is designed to regulate a broad range of investment products, its implications for private equity and venture capital may prove to be particularly consequential.

Establishing Ethiopia's First Comprehensive Fund Framework

To date, Ethiopia has lacked a dedicated regulatory framework governing pooled investment vehicles. As a result, private equity and venture capital transactions have typically been structured through offshore funds, direct investments, co-investment arrangements, or bespoke contractual structures.

This regulatory gap was identified in the World Bank Group and IFC's 2020 diagnostic study on Ethiopia's private equity and venture capital ecosystem as one of the principal constraints limiting industry development, mobilisation of institutional capital and the establishment of locally domiciled investment vehicles.

The Draft Directive seeks to address this gap by introducing Ethiopia's first comprehensive framework governing collective investment schemes.

The proposed regime establishes a wide spectrum of regulated investment products, including: Mutual Funds; Money Market Funds; Exchange Traded Funds; Real Estate Investment Funds; Alternative Investment Funds ("AIFs"); and Special Designation Funds.

The framework contemplates different legal forms through which funds may be established, including share companies, private limited companies, unit investment schemes and, importantly for private capital investors, limited partnerships.

The Directive also introduces governance standards commonly associated with mature fund jurisdictions, including licensing requirements for operators, mandatory custodial arrangements, board oversight obligations, conflict management rules, periodic reporting obligations, valuation requirements, disclosure standards and investor protection mechanisms.

In several respects, the framework draws upon internationally recognised concepts and practices. Of particular significance is the proposed recognition of the International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines), which should provide greater comfort to institutional investors accustomed to globally accepted valuation methodologies.

Alternative Investment Funds: The Missing Piece for Private Capital

From a private capital perspective, the provisions governing Alternative Investment Funds are arguably the Draft Directive's most important innovation.

The Ethiopian private equity industry has existed for more than fifteen years and has attracted a number of regional and international fund managers. Nevertheless, investment activity has largely remained dependent on offshore structures due to the absence of an enabling domestic legal framework.

The Draft Directive proposes to change this dynamic.

By expressly permitting AIFs to be constituted as limited partnerships, private limited companies or share companies, the proposed regime aligns Ethiopia more closely with international private capital practices. Limited partnerships remain the preferred structure for private equity and venture capital funds globally because they enable passive participation by investors while delegating investment decisions and portfolio management to professional fund managers.

Equally important, the Directive recognises that private capital strategies differ fundamentally from retail investment products. Unlike traditional mutual funds, which are often subject to strict diversification requirements, AIFs may pursue concentrated investment strategies and may be offered primarily to qualified investors. This approach reflects commercial realities. Venture capital funds typically invest in a relatively small portfolio of high-growth businesses, while private equity funds often seek significant ownership positions that allow them to influence governance, operational performance and strategic direction.

The introduction of a regulated vehicle capable of accommodating these investment approaches could therefore represent a significant evolution in Ethiopia's investment ecosystem.

Tax Neutrality: An Important Signal for Investors

The emerging tax treatment of collective investment schemes is another noteworthy feature of Ethiopia's evolving investment framework. Recent amendments to the Income Tax Proclamation provide that collective investment schemes are exempt from corporate income tax at the fund level. This effectively allows investment income to be accumulated, reinvested and managed within the fund without being subject to the standard 30 percent corporate income tax ordinarily applicable to companies.

For private equity and venture capital investors, fund-level tax neutrality is a particularly important consideration. Internationally, investment funds are generally designed to operate as pass-through or tax-neutral vehicles to avoid an additional layer of taxation that could otherwise diminish investor returns and reduce the attractiveness of pooled investment structures. In this respect, Ethiopia's approach appears broadly aligned with international market practice.

The exemption, however, does not eliminate taxation altogether. Income generated by portfolio companies in the form of dividends, interest or other distributions may remain subject to applicable withholding taxes, while gains or distributions realised by investors at the point of exit may also attract tax liabilities depending on the nature of the investor and the applicable tax rules. Although certain implementation questions are likely to require further clarification, the introduction of a tax-efficient CIS regime should be viewed as an encouraging signal for sponsors considering the establishment of locally domiciled investment funds.

Beyond Fund Formation: Mobilising Long-Term Capital

The importance of the Draft Directive extends beyond the establishment of fund structures.

Ethiopia continues to experience a shortage of patient growth capital despite increasing entrepreneurial activity and expanding opportunities in sectors such as financial technology, healthcare, logistics, agribusiness, manufacturing and renewable energy.

A credible domestic fund framework has the potential to facilitate capital mobilisation from a wider range of investors over time, including development finance institutions, family offices, diaspora investors, high-net-worth individuals and potentially domestic institutional investors such as pension funds and insurance companies as regulatory reforms continue to evolve.

Private capital also brings more than financing. Fund managers frequently provide strategic guidance, governance support, management expertise and access to international networks. The development of a regulated private funds industry may therefore contribute not only to increased capital formation but also to broader improvements in corporate governance, business resilience and enterprise growth.

An Important Beginning

The Draft Directive should not be viewed as the culmination of Ethiopia's private capital reforms.

Rather, it establishes an institutional foundation upon which a domestic alternative assets industry may begin to emerge.

Important questions remain, including: the treatment of foreign participation; taxation of carried interest and fund distributions; the ability of pension and insurance assets to allocate capital to alternative investments; foreign exchange considerations; and the practical licensing requirements applicable to fund managers.

Nevertheless, the proposed framework signals a notable policy shift. For the first time, Ethiopia appears poised to offer a regulated pathway for establishing locally domiciled private equity and venture capital funds.

For investors monitoring Ethiopia's gradual financial sector liberalisation, the Draft Directive may prove to be one of the most important building blocks in the country's transition from an investee market served largely by offshore vehicles to a jurisdiction capable of originating, hosting and managing private capital on its own terms.

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