DERIVATIVES TRADING IN NIGERIA: THE NEW SEC RULES AMENDMENT

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1. Introduction

The Nigerian Securities and Exchange Commission (**SEC**) has decided to develop a derivatives trading market in Nigeria. To this end, the SEC issued an amendment to its Rules and Regulations in December 2019, providing for new rules on the regulation of derivatives trading and on central counter party (**CCP**).[2] In February 2020, the Central Bank of Nigeria (**CBN**) in collaboration with FMDQ Holdings Plc offered its first long-term Naira settled OTC FX Futures Contracts to hedge against foreign exchange (**FX**) risk, with a maximum tenor of 5 years and to be traded on the FMDQ OTC Securities Exchange.[3] This combination of new rules and products is opening up derivatives trading in Nigeria to new investors and participants as both regulators seek to bolster the market and offer new risk management products.

This article will consider derivative contracts and its different forms as well as the provisions of the newly issued SEC Rules on derivatives trading in Nigeria.

2. Derivative Contracts

A derivative is a bilateral contract whose value is derived at a future date from an underlying asset, such as a commodity, currency, interest rate, property value, company share, etc.[4] Derivatives are financial instruments used for hedging and risk management. Through a derivative contract, the value of an underlying asset is locked[5] for a future date (settlement date) to protect the risk of price fluctuation and speculate the future value of the asset. This locked price, known as the strike price, is the value reference or consideration upon which the contract will be settled and the underlying asset will be transferred to the buyer on the settlement date.[6] A derivative contract may be cash settled or physically settled. Under a cash

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1 **Brooks & Knights Legal Consultants (BKLC)** is a law firm established in Lagos, Nigeria to provide bespoke legal advisory and policy consulting services to individuals, corporates, government agencies and NGOs.

2 SEC, New Rules and Amendments to the Rules and Regulations of the Commission, 23 Dec 2019, available at https://sec.gov.ng/wp-content/uploads/2019/12/SEC-New-Rules-and-Ammendments-23-December-2019.pdf

3 Lolade Akinmurele, *In Boost to Foreign Inflows, CBN, FMDQ Launch Long-Term Naira Contract*, Business Day, 14 Feb 2020 at p.1.

4 Practical Law Finance, *Derivatives: Overview (UK)*, <Practical Law>, accessed on 24 February 2020.

5 A strike price is the value of the underlying asset fixed at the time the contract is entered into. *Id*.

6 The Nigerian Stock Exchange, *Glossary of Common Derivatives Terms*, available at http://www.nse.com.ng/investors-site/becoming-an-investor/FAQs/NSE%20Glossary%20Of%20Common%20Derivatives%20Terms.pdf, accessed on 25 February 2020.

settled derivative contract, settlement of the derivative is completed through a cash payment, usually the difference between the strike price and the market value at the settlement date.[7] In the case of a physically settled derivates contract, the underlying asset is physically transferred to the buyer on the settlement date in consideration for the strike price.[8]

Derivatives may be used by trading companies to protect them from risks that are peculiar to their business interests (e.g. currency risk, interest rate risk, commodity risk), by lenders to redistribute their risk exposure on a transaction or by institutional investors to manage their investment portfolios.[9]

3. Forms of Derivatives

Vanilla Derivatives vs. Exotic Derivatives

Derivative products may be vanilla or exotic. A vanilla derivative is a standard derivative product whose features are well defined and traded actively.[10] They are commonly encountered derivatives with basic features such as strike price and settlement date, and having no special features.[11] An exotic derivative is an unusual derivative, structured and developed to meet the specific requirements of the parties to the contract.[12] They contain more complicated features as they are usually structured to meet a particular transaction's requirements.

OTC Derivatives vs. Exchange Traded Derivatives

Derivative contracts may be privately traded over-the-counter (**OTC**) or exchange traded through specialized exchanges. An OTC derivative is a privately negotiated derivate contract, which is structured according to the requirements of the contracting parties.[13] The contracting parties do not go through any intermediary or exchange and thus, each party takes on the counter party's credit risk by entering into the contract. Exchange traded derivatives are standardized derivative contracts entered into through an exchange, which acts as an intermediary between the parties. The Exchange's clearing house acts as the central counterparty and takes on a limited credit risk from each counterparty. As exchanges are regulated entities, parties trading exchange traded derivatives are usually registered members licensed to trade on the exchanges. Credit risk is managed under exchange traded derivatives, through margin payments[14] deposited by the contracting parties, making them less risky than OTC derivatives.

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7 Practical Law Finance, *Derivatives: Overview (UK)*, <Practical Law>, accessed on 24 February 2020.

8 *Id*.

9 *Id*.

10 'Vanilla Option', *The Financial Encyclopedia*, 8 Novemberr 2017, available at https://www.investment-and-finance.net/derivatives/v/vanilla-option.html, accessed on 25 February 2020.

11 Practical Law Finance, *Derivatives: Overview (UK)*, <Practical Law>, accessed on 24 February 2020.

12 *Id*.

13 *Id*.

14 A Margin is a good faith collateral deposit, specified as a percentage of the value of the financial instrument in question. It is usually paid in cash and held by the central counterparty in order to manage counterparty risk associated with every position and ensure the integrity of the derivatives market. 'Margin' Nigerian Stock Exchange, *Glossary of Common Derivatives Terms*, Supra at note 6.

4. Types of Derivatives Instruments

Forwards and Futures

A forward is a classic derivative contract, where a buyer agrees to purchase an underlying asset at a future date for a fixed price.[15] Forwards are OTC derivatives where each counterparty bears the credit risk of the other. Futures are standardized forwards that are exchange traded.[16] Buyers under forwards and futures are obligated to purchase the underlying asset at the strike price, irrespective of the market price of the asset on settlement date.[17]

Swaps

Swaps are OTC derivative contracts under which parties agree to exchange future cash flow obligations from different financial instruments.[18] The most common form of swap derivatives are currency swaps and interest rate swaps.

Options

Option derivatives grant an option holder the right but not the obligation to buy or sell the underlying asset.[19] The option may either be a call option, which grants the option holder a right to buy the underlying asset at the strike price on the settlement date, or a put option, which obligates the option holder to sell the underlying asset to the option writer (party granting the option) at the strike price on the settlement date. Depending on the timing for the exercise of the option, the option may be either be a European style option, where the option holder may only exercise the option on a particular date; an American style option, where the option holder may exercise the option at any point during the term of the option; or a Bermudan style option, where the option holder may only exercise the option on certain dates during the term of the option.[20]

Equity and Credit Derivatives

An equity derivative is a financial instrument whose value is referenced from the price performance of an underlying equity asset or index unit.[21] Examples of equity derivatives include equity options, equity futures, equity swaps or other structured equity products. A credit derivative is a financial instrument that protects a party against the credit risk inherent in the debt obligations of a third-party borrower, by transferring that risk to a counterparty.[22]

5. Framework for Derivatives Trading in Nigeria: New SEC Rules Amendment

In December 2019, the SEC issued amendments to its Rules and Regulations to include:

a. Rules on the Regulation of Derivatives Trading (**Derivatives Trading Rules**); and

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15 'Forward Contract', Nigerian Stock Exchange, *Glossary of Common Derivatives Terms*, Supra at note 6. See also Practical Law Finance, *Derivatives: Overview (UK)*, Supra at note 7.

16 *Id.*

17 *Id.*

18 James Chen, *Swap*, Investopedia 4 February 2020, available at https://www.investopedia.com/terms/s/swap.asp,accessed on 25 February 2020.

19 Practical Law Finance, *Derivatives: Overview (UK)*, <Practical Law>, accessed on 24 February 2020.

20 *Id.*

21 James Chen, Equity Derivative, Investopedia 20 April 2020, available at https://www.investopedia.com/terms/e/equity_derivative.asp, accessed on 25 February 2020.

22 Practical Law Finance, *Derivatives: Overview (UK)*, <Practical Law>, accessed on 24 February 2020.

b. Rules on Central Counterparty (**CCP Rules**).

The Derivatives Trading Rules

The SEC Derivatives Trading Rules apply particularly to exchange traded derivatives, however, some reporting requirements exist for OTC derivatives.[23] The Derivatives Trading Rules require that a Derivatives Contract be registered with the SEC in the prescribed manner, and its approval granted before such contract is introduced on any exchange.[24] The SEC shall charge fees for the registration of derivatives contracts and shall issue guidelines for the trading and clearing of contracts in the secondary market.[25] An exchange must have a regulation framework for its derivatives trading.[26] The rules shall include provisions for general requirements, membership requirements, reporting requirements, risk management requirements and any other requirements determined by the SEC.[27]

The Rules provide for the participants in the derivatives trading markets. Under the Rules, no person shall trade on exchange traded derivatives for proprietary or client accounts except they are registered with a recognized exchange and/ or a CCP as a dealing member or a derivatives clearing member.[28] Only CBN-licensed commercial and merchant banks are eligible to register as derivatives clearing members under the Rules.[29] A derivatives clearing member is defined as an entity authorized by a CCP to perform clearing services either on its own account or behalf of dealing members or clients. [30] A dealing member is a SEC registered entity who is also a registered member of an exchange and has obtained a dealing licence to execute trades for proprietary accounts or on behalf of its clients.[31]

Exchange traded derivatives may only be traded on exchanges that are recognised by the SEC[32] and shall only be cleared by a CCP registered and recognised by the SEC.[33] All standardized OTC derivatives contracts shall be traded on an exchange.[34] The SEC shall issue guidelines from time to time on the trading, clearing and settlement of OTC derivatives.[35] The Rules further provide that only registered derivative clearing members may clear exchange traded or OTC derivatives.[36] The clearing of derivatives shall comply with the provisions of the Investments and Securities Act, 2007 (**ISA**), the SEC Rules and the rules of the relevant CCP.[37]

Exchanges shall be responsible for market surveillance to ensure that derivatives contract prices reflect demand and supply and deter market manipulations.[38] Market surveillance shall include the sharing of relevant information where an underlying asset is traded in more than one exchange or participants are members of more than one exchange.[39] Exchanges shall set position limits to prevent participants and clients from holding positions large enough to control and/ or manipulate the underlying asset

23 Rules 2 and 15 of the Derivatives Trading Rules.
24 Rule 3(1) and (2) of the Derivatives Trading Rules.
25 Rule 14 of the Derivatives Trading Rules.
26 Rule 3(4) of the Derivatives Trading Rules.
27 Rule 5 of the Derivatives Trading Rules.
28 Rule 7(1) of the Derivatives Trading Rules.
29 Rule 4 of the Derivatives Trading Rules.
30 Rule 1 of the Derivatives Trading Rules.
31 *Id*.
32 Rule 5(3) of the Derivatives Trading Rules.
33 Rule 6(1) of the Derivatives Trading Rules.
34 Rule 6(2) of the Derivatives Trading Rules.
35 Rule 6(3) of the Derivatives Trading Rules.
36 Rule 7(2) of the Derivatives Trading Rules.
37 Rule 6(4) of the Derivatives Trading Rules.
38 Rule 8(1) of the Derivatives Trading Rules.
39 Rule 8(4) of the Derivatives Trading Rules.

and shall notify the SEC on its prescribed position limits, as well as the methodologies and rationale used to determine the limits.[40] A position limit is a level of ownership or control of derivative contracts that a participant or group of participants, client or group of clients shall not exceed.[41]

A CCP is required to receive and maintain an initial margin[42] from participants before accepting to clear contracts from them. They shall also pay variation margins to participants and clients for gains resulting from mark to market of positions and receive variation margins from participants and clients for losses resulting from mark to market of positions.[43]

The Rules make general provisions for leverage,[44] disclosure and risk management. Exchanges are required to liaise with CCPs to determine the applicable leverage relevant to each type of derivatives contract and such leverage shall be disclosed to the SEC within 24 hours.[45] Participants are mandated to make certain disclosures to the SEC and to develop risk management units and frameworks within their organizations.[46]

The accompanying sanctions for breach of the Rules provide that a person in violation shall be liable to a penalty of not less than NGN1 million and a further sum of not more than NGN25,000 for every day of default.[47]

Generally, the Derivatives Trading Rules provide for the registration, membership and reporting requirements by exchanges, derivatives clearing members, CCPs and dealing members. The Rules anticipate that the exchanges will provide a further direct framework to regulate their derivatives trading.

The CCP Rules

The CCP Rules provide for a more detailed regulation framework for central counterparties. They are required to register with the SEC[48] and must have sufficient assets, resources and effective and reliable infrastructure to perform their functions including their clearing operations.[49] The Rules provide for the development of governance procedures by CCPs[50] and the composition of a CCP Board.[51]

The Rules provide for the functions of a registered CCP[52] which includes acting as intermediary between counterparties through a process of novation, a legally binding agreement or an open offer system. The CCP is also expected to facilitate post trade management functions and implement a margin system that establishes margin levels commensurate with the risks and attributes of each product, portfolio and the market. The CCP shall collect and manage collateral held for the due performance of the obligations of clearing

40 Rule 9(1) of the Derivatives Trading Rules.
41 Rule 1 of the Derivatives Trading Rules.
42 An initial margin is the collateral collected upon the execution of an order to buy or sell a derivatives contract to cover potential changes in the value of each participant's position over the appropriate close-out period in the event that the participant defaults. Rule 1 of the Derivatives Trading Rules.
43 Rule 13 of the Derivatives Trading Rules.
44 A leverage is the total outstanding position of a participant in derivatives in relation to its initial outlay. Rule 1 of the Derivatives Trading Rules.
45 Rule 10 of the Derivatives Trading Rules.
46 Rules 11 and 12 of the Derivatives Trading Rules.
47 Sanctions, Derivatives Trading Rules.
48 Rule 3 of the CCP Rules.
49 Rule 4 of the CCP Rules.
50 Rule 7 of the CCP Rules.
51 Rules 8 and 9 of the CCP Rules.
52 Rule 6 of the CCP Rules.

members[53] and maintain a default fund[54] to mitigate the risk of default by a clearing member and ensure that the obligations of that clearing member continue to be fulfilled where possible.

CCPs are required to make rules to govern their operations and clearing members.[55] They are also required to develop a framework for the comprehensive management of risks.[56] They are mandated to manage their liquidity risks by, among other things, having highly liquid resources and a committed line of credit to enable them meet their financial obligations and ensuring that they have a diversified portfolio of liquid resources to avoid undue concentration with respect to any relevant asset class and issuer.[57] They are also required to develop frameworks, policies and procedures to manage their operational, business and credit risks.[58]

The CCP Rules provide collateral requirements for a CCP,[59] including that they shall only accept highly liquid assets with low credit and market risks; and they shall avoid concentrating collateral in one class of asset with the exception of Federal Government Securities. They are also expected to develop a collateral management system that complies with the requirements of the CCP Rules.[60]

CCPs shall have a system that stipulates margin requirements proportionate to the risks and attributes of the relevant products and markets. They shall also have a reliable source of timely price data for exchange traded and OTC derivatives. They are to adopt more conservative margin models for OTC derivatives. They are to ensure that market conditions are considered when setting initial margin requirements.[61]

CCPs have reporting requirements to the SEC[62] including daily transaction reports on clearing activities, monthly reports, quarterly financial statements and operational reports, annual reports and audited financial statements, quarterly assessments of risks from its operations and any other SEC required information. They are also expected to maintain records of all activities and services and all contracts cleared for a period of not less than 10 years.[63] Other required records to be maintained include transaction records, position records, business records and record of reports made to a trade repository.

6. Conclusion

The recently issued SEC Rules amendment for derivatives trading provide a framework for the trading of derivatives products in Nigeria. Parties and participants are clearly defined and the responsibilities of central parties like exchanges and CCPs are detailed with further expectations that they will develop rules to govern their operations. The Rules are an important step in the right direction for the expansion of the Nigerian financial markets and

53 A clearing member is an entity authorized by a CCP to perform clearing services either on its own account or on behalf of other dealing members or clients. Rule 1 of the CCP Rules.

54 A default fund is a fund established and administered by a CCP to protect against exposure resulting from default of a clearing member.

55 Rule 10 of the CCP Rules.

56 Rule 15 of the CCP Rules.

57 Rule 17 of the CCP Rules.

58 Rules 18, 19 and 20 of the CCP Rules.

59 Rule 21 of the CCP Rules.

60 *Id*.

61 Rule 22 of the CCP Rules.

62 Rule 32 of the CCP Rules.

63 Rule 33 of the CCP Rules.

the diversification of portfolio options in favour of derivative products. While its implementation is yet to be seen, the rules clearly anticipate issues of arbitrage and important risks that undermine the market such as credit and operational risks and provides for reporting requirements to watch for and prevent those risk events.

Going forward, it is expected that specialized derivative exchanges will be developed and rules issued to further define the derivatives trading market in Nigeria. It is also expected that more products beyond CBN FX Futures will be introduced and traded in the market as a framework for trading has been developed. The Rules provide for more detailed provisions for Exchange traded derivatives than for OTC derivatives, which are the riskier derivatives products. They however imply the development of more detailed regulations for OTC derivatives.