

THE NIGERIAN DERIVATIVES REGULATORY FRAMEWORK AND THE DEVELOPMENT OF AN EFFICIENT DERIVATIVES MARKET IN NIGERIA

By

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1. Introduction

Over the past decade, Nigeria has steadily developed its derivatives regulatory framework. In 2011, the Central Bank of Nigeria (CBN) issued its Guidelines for FX Derivatives and Modalities for CBN FX Forwards which was shortly after replaced by the Guidelines for FX Derivatives in the Nigerian Financial Markets (CBN FX Derivatives Guidelines).² Recently, the Nigerian Securities and Exchange Commission (SEC) also issued its Rules on Regulation of Derivatives Trading and on Central Counterparties (SEC Rules on Derivatives Trading).³ This progressive development shows the intention on the part of the Nigerian financial and securities regulators to develop this important financial market and properly regulate the activities within it. In addition to this, the SEC noted, its intention, in January 2020, to develop 'an efficient derivatives market'.⁴ This desire to develop an efficient derivatives market is commendable and requires the development of proactive regulation and market structures that will drive efficiency within the market.

Market efficiency is an important concept in derivatives regulation. It generally describes the relationship between information and cost when pricing products in a derivatives market. The concept of efficient markets is based on the hypothesis that prices within a market will fully incorporate all available information.⁵ This concept was initially developed for stock markets, but its application has been expanded to financial markets in general. For derivatives markets, efficiency involves the relationship between information and cost. This relationship also underscores the extent to which risk is effectively managed, priced, and distributed in derivatives contracts. Derivatives markets are specialized markets that trade on the speculation of the future value of underlying assets. An efficient derivatives market is generally marked by low trading costs and appropriate distribution of risk. The cost of acquiring, processing, and verifying information is an important value note embedded in derivatives trading costs and a relevant marker of an efficient derivatives market. To encourage competition and appropriate distribution of risk, a derivatives market must develop and implement certain regulatory standards that

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² Central Bank of Nigeria, Guidelines for FX Derivatives in the Nigerian Financial Markets, March 2011, available at <https://www.cbn.gov.ng/OUT/2011/CIRCULARS/FMD/GUIDELINES%20FOR%20FOREIGN%20EXCHANGE%20DERIVATIVES%20IN%20THE%20NIGERIAN%20FINANCIAL%20MARKETS.PDF>

³ In that time, the CBN also issued the Revised Guidelines for the Operation of the Nigerian Inter-Bank foreign Exchange Market (June 2016). The FMDQ OTC Securities Exchange which is the market for OTC FX Futures, also issued its Market Operation Standards (August 2018) and its Market Framework (February 2020) regulating the trading in OTC FX Futures.

⁴ Iheanyi Nwachukwu, *Nigeria's SEC says derivatives trading one of its top priorities in 2020*, (Jan 6, 2020), available at <https://businessday.ng/markets/article/nigerias-sec-says-derivatives-trading-one-of-its-top-priorities-in-2020/>, accessed on 13 June 2020.

⁵ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), Oxford Legal Studies Research Paper No. 51/2015, available at <http://dx.doi.org/10.2139/ssrn.2660939>, p.7.

ensure ease of access to information across market participants and maintain a level playing field in the market.

Building an efficient derivatives market in Nigeria is an important step in the development of our derivatives market infrastructure, especially as the volume of activity within the market continues to grow. Derivatives contracts have always been a part of large project or syndicated financings in Nigeria, where they are usually used to hedge against currency and interest rate risk. Derivatives trading has been ongoing for at least 5 years, especially with the trading in OTC FX Futures on the FMDQ Exchange since the CBN introduced the products in mid-2016. Since that time, CBN has sold over \$34 billion in futures contracts⁶ and over \$25 billion of those contracts have been successfully cleared and settled with no defaults occurring in the market.⁷ In addition to FX Futures, swaps and forwards are regularly traded OTC by Nigerian banks. The CBN FX Derivatives Guidelines approved FX options, forwards (outright and non-deliverable), swaps and cross-currency interest rate swaps as hedging products in the market and allows dealers to offer European-style FX call and put option contracts to their customers and in the inter-bank market.⁸

This activity makes it important to consider how efficient the Nigerian derivatives markets are and what regulatory reforms are necessary to encourage efficiency within the market. In furtherance of the SEC's stated objective to

develop an efficient derivatives trading market this year, this article will consider the mechanisms that support efficient derivatives market in Nigeria and recommend any reforms necessary to ensure the implementation of an efficient market. It will also analyze the present regulatory structure⁹ for derivatives in Nigeria and consider how they support market efficiency.

2. Regulatory Mechanisms that Support Efficient Derivatives Markets

Efficient derivatives markets are grounded by certain regulatory standards that ensure proper dissemination of information across the market, efficient risk management and proper clearing and settlement of transactions. These standards also consider some of the lessons learned from the global financial crisis and cover the regulation of certain participants in the markets. The standards which are generally considered below are: the regulation of dealers, information dissemination, centralized clearing, exchange trading of derivatives, the use of standardized contracts and the implementation of netting and collateral regimes.

Regulation of Dealers and Informational Transparency

Dealers are important participants in derivatives transactions. They are usually banks, who originate and trade these products on behalf of clients and where permitted, may also engage in proprietary trades. Dealers sit in a significant position information-wise because they usually

⁶ Kayode Tokede, *OTC FX Futures Contracts: CBN sold \$34.3bn in over 44 months – FMDQ*, (17 February 2020), available at <http://nigeriannewsdirect.com/otc-fx-futures-contracts-cbn-sold-34-83bn-in-over-44-months-fmdq/>, accessed on 13 June 2020.

⁷ FMDQ, *CBN, FMDQ Introduce Long-Dated OTC FX Futures Contracts for up to 5 years*, (14 February 2020), available at <https://www.fmdqgroup.com/cbn-fmdq-introduce->

[long-dated-otc-fx-futures-contracts-5-years/](#), accessed on 13 June 2020.

⁸ Paragraph 2.0 of the CBN FX Derivatives Guidelines.

⁹ The article will consider the provisions of the CBN FX Derivatives Guidelines, the CBN Inter-bank FX Revised Guidelines, the FMDQ OTC Market Operating Standards, February 2020, the FMDQ OTC FX Futures Market Framework, August 2018, the SEC Rules on Derivatives Trading and the SEC Rules on CCP.

have or can procure the counterparty and market information necessary to price risk in a derivatives contract. This may range from universally available information to information that is specially available to them as a function of their business as bankers, such as the corporate, financial and such other requirements of counterparties. This places them in a very advantageous position and may deter other participants from engaging in the market if the cost of sourcing the kind of price sensitive or price determining information that a bank would normally have or acquire in the ordinary course of their business, is deleteriously high. This in turn would restrict access to derivatives market for other participants if this information is not readily available. It may also result in dealers acting in ways that are detrimental to the rest of the market to protect their positions.

Following from the global financial crisis, a number of regulatory mechanisms were introduced in global derivatives regulation to address some of the informational and risk concerns related to dealers. These include trade reporting and disclosure requirements, price and position transparency, imposition of speculation limits and prudential requirements on dealers. The essence of these mechanisms and the forms in which they appear or are applied in the Nigerian derivatives regulatory space are discussed below.

a) Trade Reporting and Disclosure Requirements¹⁰

Trade reporting and disclosure requirements in securities markets

generally come in the form of pre- and post-trade transparency. Pre-trade transparency mechanisms connect, and match ask and bid orders/ prices from different participants in a central market place. The ready availability of prices from different buyers and sellers in a central market place generates competition in the market and drives efficiency. Post-trade transparency involves disclosures of all information regarding executed trades including information on price, volume, counterparty, collateral, maturity, and termination. This information should be publicly available to give a clear picture of any counterparty's derivatives contract exposures and the trading volumes in the market.

Trade Reporting and Disclosure Requirements under Nigerian Derivatives Law

Trade reporting and disclosure requirements are provided for under Nigerian derivatives law with then imposition of different forms of reporting and disclosure requirements. The initially issued CBN FX Derivatives Guidelines of January 2011 provided for pre-trade transparency.¹¹ Under those Guidelines, CBN would sell its FX forward contracts to authorized dealers¹² using a multi-price Dutch Auction system¹³. Authorized dealers were required to submit bids on an

¹⁰ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), Oxford Legal Studies Research Paper No. 51/2015, available at <http://dx.doi.org/10.2139/ssrn.2660939>, pp.48-53.

¹¹ Paragraph 6, CBN FX Derivatives Guidelines.

¹² An authorized dealer is a Nigerian bank that is licensed by the CBN to deal in foreign exchange under the provisions of the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act, F34 Laws of the Federation of Nigeria (LFN) 2004.

¹³ Paragraph 6.3 of the CBN FX Derivatives Guidelines.

electronic trading platform¹⁴ along with the submission of hard copies to CBN's offices in Abuja or Lagos.¹⁵ However, those Guidelines were superseded by the CBN FX Derivatives Guidelines of March 2011 which make no provision for pre-trade transparency. However, FMDQ's FX Futures Market Framework makes some provision for pre-trade transparency by adopting a request-for-quote (RFQ) module in its inter-bank trading. Its order book is however, not anonymized and provides information on the banks quoting bids.¹⁶

The SEC Rules on Derivatives Trading do not expressly provide for any pre-trade transparency disclosures. However, the Rules impose several reporting and disclosure requirements for post-trade transparency. The Rules require that all derivatives contracts be registered with the SEC before they are introduced on an exchange.¹⁷ This registration involves the filing of certain disclosures including an information memorandum that provides information on the specifications of the contract¹⁸, the risk protection mechanism, the target investors and the trading infrastructure or surveillance to be deployed by the exchange to monitor trading. An application for the

registration of a derivatives contract under this rule will also require the disclosure of the following information: general information on the underlying, susceptibility to manipulation, protection of market participants and investors, trading and pricing information and any information required by the SEC.

Market participants are required to promptly disclose complete and accurate information on their trading and clearing activities to the SEC, as the need arises.¹⁹ They are also subject to quarterly disclosures to the SEC regarding their outstanding derivatives exposures. This includes information on proprietary²⁰ and clients' outstanding positions, outstanding derivatives exposures from these positions, all of a participant's outstanding positions as a percentage of its net liquid capital, where applicable, and the estimated maximum loss that could be incurred from a participant's proprietary outstanding positions along with its effect on the participant's financial position.²¹ Outstanding derivatives exposures from proprietary positions are to be disclosed in participants' quarterly and annual financial

¹⁴ The Guidelines prescribe for the use of Reuters Dealing 3000 Xtra System. Paragraph 6.6 of the CBN FX Derivatives Guidelines of January 2011.

¹⁵ *Id.*

¹⁶ Paragraph 3.1 of the FMDQ FX Futures Market Framework.

¹⁷ Paragraph 3 of the SEC Rules on Derivatives Trading.

¹⁸ This includes, among others, the name of the contract, name and specification of the underlying, the type of contract, contract code and the CCP that will clear the contract.

¹⁹ Paragraph 7 of the SEC Rules on Derivatives Trading. The provision that these disclosures be

made 'as the need arises' is ambiguous and may be interpreted as making those disclosures in line with other disclosure requirements required in the SEC Rules and the Investment and Securities Act of 2007 (ISA).

²⁰ It is important to note that proprietary trading is disallowed under the CBN FX Derivatives Guidelines, as authorized dealers are only required to bid for FX Forward contracts on behalf of customers and to show evidence of existing trade transactions before bidding for the contracts. Paragraph 6.2 of the CBN FX Derivatives Guidelines.

²¹ Paragraph 11 of the SEC Rules on Derivatives Trading.

statements.²² The Rules also provide for certain pre- and post-trade disclosures that participants are to make to their clients when trading on their behalf.²³

Finally, the Rules impose reporting requirements for OTC derivatives.²⁴ Market Participants and other registered capital market operators are required to report all OTC Derivatives transactions to a trade repository or an exchange. This reporting is to comply with guidelines to be issued by the SEC from time to time. The reports are required to include information on the entry into an agreement to sell or purchase a derivatives contract or product, any change in the beneficial ownership of derivatives contract between parties where one of the parties is a market participant, and any modification, assignment or termination of a contract to sell or purchase a derivatives contract or product.

Analysis of the Trade Reporting and Disclosure Requirements under Nigerian Derivatives Law

The combination of all the available derivatives rules will generally elicit transparency and open access to information in FX Forwards and Futures markets. This is because while the SEC Rules on Derivatives Trading apply to all tradable products, the FMDQ rules particularly govern the trading in OTC FX Futures. Other derivative products will therefore only be subject to the SEC's post-trade transparency

provisions as well as any trade reporting requirements of any exchange or market for those products. This in turn may mean that other non-FX derivatives products are not subject to the pre-trade transparency disclosures and will consequently elevate dealers trading in those products to an unduly advantageous position over other market participants due to them possessing the most information in the market. This dearth of regulation imposing pre-trade disclosures is not in line with international regulatory best practices and impedes pre-trade efficiency in derivatives markets. Furthermore, the OTC contracts disclosures will allow for a clearer view of the volumes in the market as well as make publicly available, all information on a counterparty's derivatives contracts exposures for contracts that are not actively traded on an exchange. However, these disclosures are subject to guidelines which are yet to be issued by the SEC. It is important that the SEC promptly issue guidelines on the form of this reporting requirement since the majority of derivatives transactions are privately concluded bilateral contracts and these disclosures will bring some transparency to that area of the market.

Disclosure is a major bedrock of derivatives regulation and efficient derivatives markets. As more derivatives exchanges are developed, pre- and post-trade disclosures should be instituted to encourage a level playing field among participants and

²² These statements are publicly available documents and may be retrieved from either the SEC or the Corporate Affairs Commission (CAC).

²³ Paragraph 11(4), (5) of the SEC Rules on Derivatives Trading.

²⁴ Paragraph 15 of the SEC Rules on Derivatives Trading.

allow for a fair assessment of counterparty risk when entering into a derivatives contract.

b) Price and Position Transparency²⁵

As noted above, imposing trade reporting and disclosure requirements encourages transparency. Heightened transparency will increase informational efficiency and enhance the disclosure of financial risk.²⁶ An efficient derivatives market must foster price and position transparency and afford market participants access to all information that drives a counterparty's ask or bid price, shows the extent of a counterparty's risk exposure in the market and provides a full picture of the pricing on all trades, contracts and products in the market.

Trading over exchanges and other electronic trading platforms encourages price and position transparency and market efficiency as these financial infrastructures aggregate information about supply and demand and disseminate this information to participants in the market²⁷. This makes information on market conditions readily available to market participants and enhances competition within the market. The cost of sourcing, acquiring and verifying information on products and counterparties is largely reduced,

thereby enhancing efficiency in derivatives markets.

Price and Position Transparency under Nigerian Derivatives Law

Price and position transparency are reflected in the SEC Rules on Derivatives Trading. Derivatives contracts are required to be registered with the SEC before they are introduced on an exchange and the purpose of this registration is to provide the trading and pricing information.²⁸ Disclosure requirements imposed on market participants are centered on exposing outstanding positions.²⁹ Participants are required to disclose to the SEC and in their financial statements, information on their outstanding derivatives exposure from their proprietary positions. Further disclosures are to be made to the SEC regarding participants' outstanding proprietary and client positions, the profit and loss resulting from their proprietary positions, their outstanding positions as a percentage of their net liquid capital and an estimation of the maximum loss that could be incurred from their proprietary outstanding positions as well as its effect on their financial position.

Analysis of the Price and Position Transparency Provisions under Nigerian Derivatives Law

²⁵ Darrell Duffie, *How Should We Regulate Derivatives Markets?* (2009), The Pew Economic Policy Department Financial Reform Project Briefing Paper #5, available at <https://www.pewtrusts.org/-/media/assets/2009/08/25/pewduffiederivativesregulation.pdf>, pp.11-14.

²⁶ Piero Cinquegrana, *The Need for Transparency in Commodity and Commodity Derivatives Markets*, (December 2008), ECMI Research Report No. 3,

p.17. available at https://www.files.ethz.ch/isn/94947/003_The%20Need%20for%20Transparency.pdf

²⁷ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), pp.38-40.

²⁸ Paragraph 3 of the SEC Rules on Derivatives Trading.

²⁹ Paragraph 11 of the SEC Rules on Derivatives Trading.

Price transparency is very limited under Nigerian derivatives law. Beyond the post-trade pricing disclosures under the SEC Rules, none of the other existing rules provide for pre-trade price transparency. The OTC derivatives contract disclosures do not impose price disclosures and leave the pricing of non-exchange traded derivatives contracts and products shrouded in secrecy. However, the SEC is to issue further guidelines on the form of this reporting which may consider price disclosure and provide an overview of the volumes of contracts in the market. The position disclosure requirements for market participants allows both the regulator and potential counterparties an overview of risk concentrations of any participant which in turn enhances informational and market efficiency within derivatives markets.

The SEC should further consider imposing requirements on trade repositories and exchanges to provide information on market-aggregated position sizes for different products available in the markets as well as the frequency of such reporting.

c) Imposition of Speculative Position Limits³⁰ and the Prudential Regulation of Dealers³¹

Along with hedging, one major reason why parties enter into derivatives contracts is to speculate³² on the price fluctuation of the underlying. Speculation in the derivatives market was one the main causes of the global financial crisis of 2007/08. Counterparties, especially dealers, holding large speculative positions are linked to systemic risk because of their potential to manipulate pricing, create a bubble in the market, and where those positions result in losses, the occurrence of a run on the markets.³³ Therefore, imposing speculative position limits on OTC derivatives, to curb a counterparty's exposure in the markets, works toward protecting the integrity of the market and enhancing efficiency.

In a similar vein, international regulators have also instituted prudential regulations on dealers in OTC derivatives. International prudential regulation and supervision has been led by the Basel Committee on Banking Supervision's (BCBS) Basel III framework. The Basel III reforms were instituted to strengthen the regulation, supervision and risk management of banks.³⁴ Basel III provides for capital, risk coverage and liquidity reforms that manage market and systemic risks.³⁵ Its prudential regulations prescribe for the

³⁰ Darrell Duffie, *How Should We Regulate Derivatives Markets?* (2009), pp.15-18

³¹ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), pp.59-64.

³² Speculation involves trading a financial instrument involving high risk in expectation of significant returns with the motive of taking maximum advantage of fluctuations in the market price of the instrument. The Economic Times, *Definition of Speculation*, available at <https://economictimes.indiatimes.com/definition/speculation>, accessed on 11 June 2020.

³³ Darrell Duffie, *How Should We Regulate Derivatives Markets?* (2009), pp.6-7.

³⁴ Bank of International Settlements, *Basel III: International Regulatory Framework for Banks*, available at <https://www.bis.org/bcbs/basel3.htm?m=3%7C14%7C572>, accessed on 16 June 2020.

³⁵ Bank of International Settlements, *Basel Committee on Banking Supervision Reforms – Basel III*, available at https://www.bis.org/bcbs/basel3/b3_bank_sup_reforms.pdf, accessed on 16 June 2020.

quality and level of capital/ equity banks should hold against their risk-weighted assets; revisions to the standardized approaches for calculating credit, market, operational and credit valuation adjustment risk; more stringent requirements for measuring counterparty credit risk exposure and the introduction of capital incentives to use central counterparties; reforms in risk management and supervision as well as to contain leverage; and new liquidity standards emphasizing high-quality liquid assets.

Speculative Position Limits and Prudential Regulation of Dealers under Nigerian Law

The CBN FX Derivatives Guidelines proscribe speculative trading in the FX derivatives market. The Guidelines impose a trade-backed requirement on all FX trades noting that the CBN's objective in boosting liquidity in the market is to offer FX risk management support to bank customers. Therefore, authorized dealers are required to ensure that their customers are hedging trade-related FX exposures in their obligation and not speculating on the Naira.³⁶ The CBN Revised Guidelines for the Operation of the Nigerian Inter-Bank Foreign Exchange Market, June 2016 (**CBN Inter-Bank FX Revised Guidelines**) restricts authorized dealers to holding a FX trading position maximum limit of +0.5%/-10% of their shareholder funds unimpaired by losses to support their obligation as liquidity

providers at the end of each business day.³⁷

The SEC Rules on Derivatives Trading requires that exchanges impose position limits on participants and clients to prevent them from holding large enough positions to control or manipulate the underlying as well as set stringent position limits on participants and clients related to issuers whose securities represent the underlying or determine the price of the underlying.³⁸ Exchanges are to monitor compliance with position limits and inform the SEC on participants holding up to 5% or more of the total open interest on a particular contract.³⁹

No prudential regulations are provided by CBN or the SEC on the activities by dealers, especially those in the OTC derivatives market. The CBN FX Derivatives Guidelines state that the CBN's Financial Policy and Regulation Department and its Banking Supervision Department will develop detailed prudential guidelines on FX Options which will cover quality criteria, limits, capital adequacy charge, spot-hedge position limits, accounting, returns, staffing requirements, market risk management standards, internal controls standards, etc. These potential guidelines, though ambitious, are yet to be issued, since 2011 when the CBN FX Derivatives Guidelines were issued and despite

³⁶ Paragraphs 6.0 of the CBN FX Derivatives Guidelines and 2.4.3 of the CBN Inter-bank FX Revised Guidelines .

³⁷ Paragraph 2.3 of the CBN Inter-Bank FX Revised Guidelines.

³⁸ Paragraph 9 of the SEC Rules on Derivatives Trading.

³⁹ *Id.*

trading activity in OTC FX Futures market beginning in 2016.

Analysis of Speculative Position Limits and Prudential Regulation of Dealers under Nigerian Law

The trade backed requirement and the trade position limits for FX Derivatives are regulatory steps in the right direction to prevent undue speculation on the Naira. However, position limits for other products and contracts are only mandated under the SEC Rules, where they are exchange traded and are subject to the position limits set by the exchange. No position limits are imposed on non-exchange traded derivatives. The absence of prudential guidelines on dealers is of great concern when assessing systemic risk in the market. Regulations on liquidity, capital quality and counterparty credit risk management and supervision protect against systemic risk and allow participants effectively manage stress tests.

Both the CBN and the SEC should consider issuing and implementing prudential guidelines and imposing position limits on OTC derivatives, to make the market attractive to investors and in turn drive market efficiency.

Centralized Clearing and the Central Counterparty

As previously stated, market efficiency in derivatives requires that all counterparties have sufficient information to adequately price products in light of all the risk components

involved in a derivatives contract. OTC derivatives contracts usually require that each counterparty bear the other counterparty's credit risk or the risk that they may default and be unable to meet their financial obligations under the contract. This risk was one of the reasons for the global financial crisis of 2007/08 and since that time, regulators have sought to relieve its reoccurrence by moving to centralized clearing of derivatives contracts.

For the purposes of market efficiency, dealer counterparties, being usually banks, are more likely, given their ordinary business, to source, acquire and verify information on counterparty credit risk and they are able to price products efficiently. The cost of undertaking this process for non-dealers may be deleterious enough to deter their participation in the markets and in turn, drive down efficiency. In order to level the informational playing field, both counterparties contract using a central counterparty (CCP) whose functions protect each counterparty from the other's credit risk and largely reduces the need to source this information in derivatives contracting. The CCP is a financial institution regulated by the SEC and adequately capitalized and governed to preserve the integrity of the trade and the market. In Nigeria, two clearinghouses have received their approvals-in principle from the SEC to operate as CCPs in the Nigerian derivatives markets. These are the clearinghouses of the Nigerian Stock Exchange (NG Clearing Ltd) and the FMDQ (FMDQ Clear).⁴⁰

How Centralized Clearing and CCPs work in a Derivatives Contract

A CCP is an intermediate party that novates itself between the buyer and the seller in a

⁴⁰ Two Nigerian CCPs, set to Launch Following Approval from the Securities and Exchange Commission, 14 Oct, 2020, available at <https://ccp12.org/regulatory-updates/two-nigerian->

ccps-set-to-launch-following-approval-from-the-securities-and-exchange-commission/, accessed on 14 Oct. 2020.

derivatives contract. In the colloquial maxim, the CCP is the buyer to every seller and the seller to every buyer. CCPs also have clearing responsibilities and are usually clearinghouses. In this way, the CCP ensures and maintains liquidity in derivatives trades. Counterparties posts collateral for their derivatives contract positions to the CCP, in the form of initial margin.⁴¹ As positions are marked-to market⁴² each day, they pay or receive variation margin⁴³ in recognition of any reductions or increases in the market values of their positions⁴⁴ or the credit rating of a counterparty, depending on the contractual triggers for variation margin in the contract.⁴⁵ Margin is usually posted using highly liquid securities such as cash and treasury securities.⁴⁶ Margin collateral is designed to reflect each counterparty's exposure to the default of the other counterparty over the duration of the contract.⁴⁷

CCPs and centralized clearing mechanisms are beneficial to market efficiency for a number of reasons including: (i) their use of multilateral netting⁴⁸ to offset exposures and thereby reduce overall counterparty exposure to each counterparty's default; (ii) their requirement of

collateral which further minimizes net exposures; and (iii) the loss sharing mechanisms they employ to mitigate the defaults or dealers and clearing members.⁴⁹

Centralized Clearing and CCPs under Nigerian Derivatives Law

CBN OTC FX Futures are traded on the FMDQ Exchange which clears and settles the trades.⁵⁰ Derivatives traded on exchanges are generally centrally cleared and the Exchange ostensibly acts as CCP for derivatives traded on its platforms. The CCP⁵¹ ensures that collateral is posted by counterparties and acts as trustee of the securities that are margined for the trades.⁵² The CCP also ensures that risk management structures are put in place and are adequately implemented.⁵³

The SEC Rules specifically regulate CCPs in their centralized clearing and their counterparty functions.⁵⁴ All exchange traded derivatives contracts are required to be cleared by a CCP registered or recognized by the SEC. All standardized OTC derivatives contracts are required to be traded on an exchange and consequently cleared by a CCP. As regulated

⁴¹ Initial margin is the collateral collected upon execution of an order to buy or sell a derivatives contract to cover potential changes in the value of each counterparty's position over the appropriate close-out period in the event the participant defaults. Rule 1 of the SEC Rules on Derivatives Trading.

⁴² Marked-to-market means the daily calculation of gains and losses of outstanding positions as a result of actual changes in the underlying or changes in the market prices of the underlying or the derivatives contract. Rule 1 of the SEC Rules on Derivatives Trading.

⁴³ Variation margin is the margin required from counterparties with open positions to reflect current exposures resulting from actual changes in the market prices of the derivatives contracts or the underlying or collateral. Rule 1 of the SEC Rules on Derivatives Trading.

⁴⁴ Darrell Duffie, *How Should We Regulate Derivatives Markets?* (2009), pp.7-8.

⁴⁵ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), p.41

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ To be discussed in the section on Netting Collateral Requirements.

⁴⁹ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), p.56. A Clearing Member is an entity authorized by a CCP to perform clearing services either on its own account or on behalf of other counterparties. The SEC Rules only allow CBN-licensed commercial and merchant banks to act as clearing members. Rules 1, 4 of the SEC Rules on CCP.

⁵⁰ Rule 3.5 of the FMDQ OTC Foreign Exchange Market Framework, February 2020.

⁵¹ The CCP is designated as the Clearing Agent under the FMDQ OTC FX Futures Market Operational Standards, August 2018.

⁵² Rule 10.1 of the FMDQ OTC Foreign Exchange Market Framework, February 2020.

⁵³ *Id.*

⁵⁴ Rule 6 of the SEC Rules on Derivatives Trading and Rule 6 of the SEC Rules on CCP.

entities, CCPs have the following designated functions:⁵⁵ (i) to interpose itself between counterparties to contracts traded in one or more financial markets through the process of novation, legally binding agreement or open offer system; (ii) to facilitate post trade management functions; (iii) to implement a margin system that establishes margin levels commensurate with the risks and particular attributes of each product, portfolio and market; (iv) to collect and manage collateral held for the due performance of the obligations of clearing members; (v) to establish and maintain a default fund⁵⁶ to mitigate the risk of default by a clearing member and to ensure that such clearing member's obligations continue to be fulfilled; (vi) to have a clearly defined default management system and waterfall where the obligations of the defaulting clearing member, other clearing members and the CCP are legally and clearly managed.

The capitalization, risk management and corporate governance structure of CCPs are also regulated by the SEC Rules on CCP. Registered CCPs are required to have, among others, sufficient assets and resources, including financial, management and human resources with appropriate experience to perform its functions, an effective and reliable infrastructure to facilitate its clearing operations, and a comprehensive risk management process.⁵⁷ For the purposes of corporate governance, CCPs are required to have rules and procedures that support the financial stability, safety and efficiency of their clearing activities, a charter for the Board and Management that clearly stipulates responsibilities and accountabilities which

should be made publicly available, standard operating procedures that stipulate entire business processes and operations and which is duly approved by the Board and process which identify, assess and manage potential conflicts of interest of Board members, principal officers, employees or any person directly or indirectly linked to the Board.⁵⁸

CCPs are also expected to institute comprehensive risk management framework that cover policies and procedures for comprehensive management of risks including the legal basis of its operations, its credit exposures to clearing members and those arising from its payments clearing and settlement processes, its collateral and margin management requirements that are adequate and risk based, its maintenance of adequate liquid resources to ensure timely fulfilment of payment obligations with a high degree of confidence, risk management tools that effectively manage systemic risks, and information management systems that allow it to promptly acquire information necessary to comprehensively manage risks.⁵⁹

CCPs are required to have a diversified portfolio of highly liquid resources and committed lines of credit to enable them to meet their financial obligations.⁶⁰ They are also required to only accept highly liquid assets with low credit and market risks as collateral.⁶¹

Analysis of Centralized Clearing and CCPs under Nigerian Derivatives Law

Centralized clearing and CCPs are of central importance to derivatives regulation under Nigerian law. The regulators effectively consider

⁵⁵ Rule 6 of the SEC Rules on CCP.

⁵⁶ The Default Fund is the fund managed by the CCP, contributed to by clearing members and the CCP to protect against exposures resulting from default of a clearing member. Rules 1 of the SEC Derivatives Rules and the SEC Rules on CCP.

⁵⁷ Rule 4 of the SEC Rules on CCP.

⁵⁸ Rule 7 of the SEC Rules on CCP.

⁵⁹ Rule 15 of the SEC Rules on CCP.

⁶⁰ Rule 17 of the SEC Rules on CCP.

⁶¹ Rule 21 of the SEC Rules on CCP.

managing informational and counterparty credit risk by ensuring the interposition of CCPs not only in exchange traded contracts but also in standardized OTC contracts.

However, a gap in regulation exists – what amounts to a standardized OTC derivatives contract? The SEC Rules note that the SEC will issue guidelines on standardized OTC derivatives contracts from time to time.⁶² In the case of the CBN OTC FX Futures, the CBN Inter-bank Revised Guidelines prescribe that OTC FX Futures be *non-standardized* with fixed tenors and bespoke maturity dates.⁶³ Despite being non-standardized, these contracts are traded on the FMDQ exchange and its Market Framework notes that one of the functions of the exchange is to promote market standards by standardizing the agreements for all contracts with stakeholders.⁶⁴ However, its Market Operating Standards states that the OTC FX Futures contracts shall be bought and sold in non-standardized amounts.⁶⁵

The sum of these rules paints a picture of derivatives contracts that are non-standardized with regard to amounts and maturity date. This means they are standardized in some respects and non-standardized in others. Therefore, the respects in which they are standardized makes them tradeable on an exchange and thereby subject to the exchange's central clearing system. This is why it is necessary for the SEC to promptly issue guidelines for the standardization of OTC derivatives contracts.

The SEC may also consider, beyond mandating the central clearing of standardized OTC contracts, that certain contracts be centrally

cleared because of their proclivity to result in market and systemic risk, especially credit default swaps.

Implementation of Netting and Collateral Requirements⁶⁶

An efficient derivatives market requires that the price of products and contract adequately reflects all relevant information in the market. Relevant information includes an analysis of a counterparty's risk exposure including market, credit and operational risk. Risk exposure differs from counterparty to counterparty and requires that each party sources information about their counterparty's ability to fulfil their obligations under the contract. Sourcing this information may be costly to other non-dealer market participants and thereby reduce competition in the market. To reduce this cost and still protect against counterparty default, derivatives contracts contain collateral requirements that reflect each counterparty's exposure to the default of the other counterparty over the duration of the trade and netting provisions that allow counterparties to offset their exposures to one another across multiple transactions. Netting and collateral provisions ensure market efficiency and liquidity in derivatives markets by acting as a substitute in investment in information.

Collateral

Counterparties are required to post collateral for their financial obligations under derivatives contracts, usually in highly liquid securities or cash. The requirement for collateral manages the risk exposure of each counterparty to the other's default. It usually takes the form of

⁶² Rule 6 of the SEC Rules on Derivatives Trading.

⁶³ Paragraph 2.2.2 of the CBN Inter-bank FX Revised Guidelines.

⁶⁴ Paragraph 2.2 of the FMDQ OTC Foreign Exchange Market Framework, February 2020.

⁶⁵ Paragraph 1.10 of the FMDQ OTC FX Futures Market Operational Standards, August 2018.

⁶⁶ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), pp.40-42 and Darrell Duffie, *How Should We Regulate Derivatives Markets?* (2009), pp.3-5.

margin requirements, i.e. initial and variation margins.⁶⁷ Initial margin is an amount paid at the outset of the contract or trade which reflects exposure to the default of the other counterparty over the duration of the contract or trade. As counterparty positions are marked-to-market daily or some other predetermined contractual trigger occurs, counterparties will be required over the duration of the contract or trade to also post variation margin, which is designed to reflect changes in the market price of the underlying asset or the credit rating of the counterparty.

The posting of collateral is especially relevant in the occurrence of a termination or default event under the contract. Such event will usually entitle the non-defaulting party to seize and administer the collateral to fulfil any outstanding obligations under the close-out netting provisions of the contract. However, the enforceability of this provision and the ability of a non-defaulting counterparty to administer this collateral in the event of insolvency will depend on the set-off, stay and fraudulent preference provisions of applicable insolvency laws as well as any applicable carve-outs or exceptions. This is discussed further in the *Netting* section.

Collateral Requirements under Nigerian Derivatives Law

The different rules and guidelines for derivatives trading provide for collateral requirements. Counterparties trading OTC FX Futures on the FMDQ exchange are required to post eligible collateral, in the form of cash, Federal Government of Nigeria (FGN) securities (including FGN bonds and treasury bills), CBN

open-market-operation bills and any other security determined as eligible by CBN and the FMDQ exchange.⁶⁸ The SEC Rules on Derivatives Trading and CCP also provide that the CCP shall receive and maintain initial and variation margin, which shall be in the form of highly liquid assets with low credit and market risks.⁶⁹

Netting

Netting under a derivatives master agreement,⁷⁰ allows counterparties to adjust their existing risk exposure positions by offsetting their receivables and payables exposures to one another. It is one of the foundational contractual principles in derivatives trading and is an important part of a counterparty's rights and obligations upon termination of the derivatives contract. The 2002 International Swaps and Derivatives Association (**ISDA**) Master Agreement, the global standard for derivatives contracts, specifies events of default and termination events. Events of default include any failure of a counterparty to make any payment when due, to perform any obligation under the agreement, to comply with the provisions of any credit support document, as well as the occurrence of a counterparty's default or bankruptcy. Termination events include specified force majeure events or the occurrence of any event that makes performance of any payment or delivery obligation under the agreement unlawful. The occurrence of any of these events grants the non-defaulting party the right to terminate the agreement, resulting in the closing-out of positions and the settlement of

⁶⁷ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), p.41

⁶⁸ Paragraph 3.2 of the FMDQ OTC FX Market Framework and paragraph 5 of the FMDQ OTC FX Futures Market Operational Standards.

⁶⁹ Paragraph 13 of the SEC Rules on Derivatives Trading and paragraph 21 of the SEC Rules on CCP.

⁷⁰ ISDA uses a master agreement (the 2002 ISDA Master Agreement) to provide general terms that govern all transactions between two counterparties and schedules or confirmation letters/ agreements to govern specific transactions under the master agreement.

obligations. The ISDA Master allows for single and multiple transaction payment netting, depending on the number of transactions engaged by the counterparties under the master agreement.

Close-out netting involves 4 (four) major events: (i) the termination of the agreement;⁷¹ (ii) the acceleration of outstanding payment obligations; (iii) the valuation of counterparties' positions using a mark-to-market model or other determination formula; and (iv) the offsetting of counterparties' obligations against each other (netting) to arrive at a final amount and the settlement of this amount. Where close-out netting results in the non-defaulting party being a net-creditor (being in the money), it becomes the general creditor of the final amount and is entitled to seize any collateral posted by the defaulting party to settle the amount. Where close-out netting results in the non-defaulting party being a net debtor (being out of the money), the final amount is paid to the defaulting party or its trustee.⁷²

Enforceability of Close-out Netting under Nigerian Law

The enforceability of close-out netting provisions in a derivatives contract depends on the set-off, stay and fraudulent preference provisions of applicable insolvency law as well as any applicable carve-outs or exceptions.⁷³ In July 2020, the Nigerian Federal Government passed the Companies and Allied Matters Act (CAMA) of 2020, a law to repeal and replace the formerly existing CAMA enacted in 1990. The new CAMA

2020 contains provisions on netting that revolutionize the formerly existing insolvency provisions under Nigerian law and make close-out netting applicable under Nigerian law. The new netting provisions are modeled against the ISDA Model Netting Act, 2018.⁷⁴

We discuss below the former and new positions of Nigerian law on netting and the importance of the new provisions on netting on the Nigerian derivatives market.

a. The Former Position of the Law – Old CAMA.

The formerly existing provisions of Nigeria's corporate insolvency laws impeded the enforceability of close-out netting provisions in derivatives contracts. These provisions of the law were absolute and required statutory carve-outs or safe-harbor exceptions to protect against settlement risk and enhance market efficiency. In the event of a counterparty's insolvency under the old regime, the set-off provisions of Nigeria's bankruptcy law⁷⁵ required that mutual credits, mutual debts and mutual dealings must exist between the insolvent counterparty and the non-defaulting party before any set-off could occur. This provision would be satisfied by the existence of a derivatives contract between the 2 (two) parties. The set off provisions further provided that an account be made of all claims due from one

⁷¹ For executory forwards where no payment has occurred, or exchange traded derivatives which are settled daily, this termination ends the contractual obligations between counterparties with no further requirements.

⁷² Robert R. Bliss and George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral and Closeout* (10 May 2005), FRB of Chicago Working Paper No. 2005-03, available at

<http://dx.doi.org/10.2139/ssrn.730648> accessed on 16 June 2020, pp.4-6.

⁷³ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), p.40.

⁷⁴ The ISDA Model Netting Act is available here: <https://www.isda.org/2018/10/15/2018-model-netting-act-and-guide/>.

⁷⁵ Section 33 of the Bankruptcy Act, B30, Laws of the Federation of Nigeria (LFN) 2004.

counterparty to the other in respect of the mutual dealings⁷⁶ and a set-off administered between the amounts and the balance paid to the counterparty with a credit on the account after the set-off.⁷⁷ These set-off provisions were analogous in essence to netting provisions under derivatives contracts. Therefore, in the event of insolvency of one counterparty, the solvent counterparty was allowed to net-off its claims against the insolvent counterparty. However, its ability to seize posted collateral to settle any net credit amount it may have been entitled to was restrained by the stay and fraudulent preference provisions of the Nigerian insolvency laws.

The former stay provisions under Nigerian insolvency laws provided that any disposition of property, attachment, sequestration, distress or execution against the estate of a company being wound up by the court shall be void.⁷⁸ However, the court may allow the continuation of any execution or other legal proceedings on such terms as it may deem fit.⁷⁹ This meant that a solvent counterparty with a netting claim against an insolvent counterparty was unallowed under Nigerian law to use posted collateral to settle its claims under the derivatives contract, unless such counterparty had obtained a writ of execution from a Nigerian court to use the collateral in such fashion and the court in charge of

the winding-up process had granted such counterparty leave to enforce its execution. This constituted a serious hindrance to close-out netting and effectively increased settlement risk in the market.

A solvent counterparty would also have been concerned with the provisions of fraudulent preference under the old Nigerian CAMA. The former fraudulent preference provisions stated that any payment made by an insolvent counterparty in favour of any creditor (in the case of a derivatives contract, the solvent counterparty), with a view to giving such creditor a preference over other creditors, shall be deemed fraudulent and void if made within 3 (three) months prior to the institution of bankruptcy proceedings.⁸⁰ However, the solvent counterparty is protected from the transaction being adjudged as fraudulent preference, where the payments were made before a receiver was appointed by the court and if the solvent counterparty was unaware of bankruptcy proceedings against the insolvent party when the transactions were executed.⁸¹

b. The New Position of the Law – CAMA 2020.

The new CAMA 2020 has provided for a more pro-derivatives regime by amending the previous law to include netting provisions that specifically apply

⁷⁶ These mutual dealings may reflect more transactions between the counterparties than those under the derivatives contract

⁷⁷ This provision is subject to the non-defaulting counterparty being unaware of the bankruptcy proceedings against the insolvent counterparty. Section 33 of the Bankruptcy Act.

⁷⁸ Sections 413, 414 and 497 of the Companies and Allied Matters Act, C20, LFN 2004.

⁷⁹ Section 12 of the Bankruptcy Act.

⁸⁰ Sections 46 of the Bankruptcy Act and 495 of the Companies and Allied Matters Act.

⁸¹ Section 47 of the Bankruptcy Act

to derivatives contract and acts as statutory carve-outs to the stay and fraudulent preference provisions of Nigerian corporate insolvency laws. The netting provisions are modeled against the ISDA Model Netting Act, 2018.

Under the CAMA 2020, the provisions of a netting agreement are enforceable against an insolvent party, and against a guarantor or any other person providing security for such insolvent party, are unavoidable by any action of a liquidator, any other provision of law relating to bankruptcy, reorganization, composition with creditors, receivership or any other insolvency provision that the insolvent party may be subject to.⁸² The netting provisions in CAMA 2020 also provide that upon the commencement of insolvency provisions, any obligation to make or receive payments under a netting agreement shall be the net obligation of those payments in favour of the credit party.⁸³ The power of a liquidator to assume or repudiate any contracts or transactions of an insolvent company will not prevent the acceleration of payment or delivery obligations and entitlements under a netting agreement.⁸⁴ CAMA 2020 explicitly excludes the applicability of any provision of insolvency law which seeks to limit the rights of set off or any netting obligations owed between an insolvent party and another party, except where any payments or transfers made are so made with intent to hinder,

delay or defraud any entity to which the insolvent party is indebted to.⁸⁵

Close-out netting provisions intend to give a counterparty preference with regard to collateral, over all other creditors of an insolvent counterparty and place derivatives contracts outside the normal bankruptcy process. Enforcement of close-out netting provisions under the old regime conflicted with the stay and fraudulent preference provisions of the old Nigerian corporate insolvency laws and restrained a solvent counterparty from settling netted obligations. This increased settlement risk and impedes market efficiency. Statutory carve-outs or safe harbor statutes were necessary to exclude derivatives contracts from the provisions of Nigerian insolvency laws. The netting provisions of the new CAMA 2020 have effectively created this carve out and ostensibly work to increase efficiency in the Nigerian derivatives market.

Other Mechanisms of Market Efficiency in the Derivatives Market

It is important to note 2 (two) other mechanisms that are important to developing an efficient derivatives market in Nigeria: the use of standardized derivatives contracts and increased exchange trading of derivatives.

⁸² Section 721(1) CAMA 2020.
⁸³ Section 721(2) and (3) CAMA 2020.

⁸⁴ Section 721(4) CAMA 2020.
⁸⁵ Section 721(5) and (6) CAMA 2020.

The Use of Standardized Derivatives Contract⁸⁶

The legal heterogeneity of derivatives contracts impedes derivatives market efficiency as it heightens the importance of counterparty credit risk and emphasizes issues of replacement risk in contractual arrangements. The cost of managing these risks works against implementing an efficient derivatives market. However, heterogeneity may be managed using standardized contracts.

The preparation of standards for derivatives contracting and interpretation has been spearheaded by the International Swaps and Derivatives Association (ISDA). ISDA has developed master agreements and amendment protocols for different derivatives products that standardizes derivatives market practice and ensures that contractual terms adequately reflect all jurisprudential, practical and commercial developments. ISDA has also developed a Model Netting Act to guide, support and homogenize legislative enactments across jurisdictions that enforce closeout netting and collateral arrangements for derivatives, in addition to developing legal guidelines to explain core principles of ISDA documentation.⁸⁷ ISDA's master agreements standardize legal terms, thereby making it easier for participants and counterparties to understand their contractual arrangements and effectively hedge their risk exposures. Standardization also encourages exchange trading of derivatives, which is another mechanism that supports efficiency in the market.

In Nigeria, OTC FX Futures transactions are contracts using the Nigerian Master FX Agreement.

Exchange Trading of Derivatives⁸⁸

Exchange trading ensures price transparency and central clearing of derivatives contracts, which enhances market efficiency. This is why ongoing support for increased derivatives trading on exchanges has been a major pillar of the regulatory response to the global financial crisis of 2007/08. In Nigeria, OTC FX Futures issued by the CBN are traded on the FMDQ exchange. The SEC Rules on derivatives trading emphasize the regulation of exchange traded derivatives and mandate that standardized OTC derivatives contracts are to be traded on exchanges.⁸⁹

3. Conclusion

Derivatives are important financial instruments to hedge against risk exposure and protect against price volatility in the market. An efficient derivatives market will increase activity within the market, boost liquidity and enhance proper pricing across different underlying products. Therefore, developing an efficient market is an important regulatory mandate. The Nigerian SEC, the Federal legislature and all market participants are encouraged to consider all necessary means toward implementing these mechanisms and driving competition and investment in the Nigerian derivatives market.

⁸⁶ Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, (November 5, 2016), p.42-47

⁸⁷ ISDA Legal Guidelines for Smart Derivatives Contracts: The ISDA Master Agreement. Retrieved from <https://www.isda.org/a/23iME/Legal->

[Guidelines-for-Smart-Derivatives-Contracts-ISDA-Master-Agreement.pdf](#) accessed on 28 June 2020.

⁸⁸ Darrell Duffie, *How Should We Regulate Derivatives Markets?* (2009), pp.14-15.

⁸⁹ Rule 6 of the SEC Rules on Derivatives Trading.