

# SEC Proposes New Rules on Regulation of Derivates Trading

These proposed changes affect **derivatives trading** and registration requirements for **commodity brokers**.

All comments and input should be forwarded to the Secretariat, Rules Committee of the Commission via [rulescommittee@sec.gov.ng](mailto:rulescommittee@sec.gov.ng) or through the Ag. DG, SEC, not later than two (2) weeks from the date of this post.

## 1. **New Rule**

### **Rules on Regulation of Derivatives Trading Outline**

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## 1. Definition of Terms

**Additional Margin** means additional collateral required by Derivatives Clearing Members and Derivatives Trading Members to protect themselves against default by clients.

**Call Option** is a right but not an obligation to buy an underlying asset at a pre-agreed price, time and quantity.

**Call-Put Ratio** is the ratio of traded call options to traded put options at a pre agreed price, time and quantity.

**CCP** means the Central Counterparty appointed by an exchange to clear its derivatives contracts.

**Client** means any person to whom a participant provides securities services in Exchange Traded Derivatives Market

**Close out** means the cancellation of a position in one direction with an equal and opposite position

**Contract** means Exchange Traded Derivatives Contract

**Contract Code** means a unique code given to every Exchange Traded Derivatives Contract

**Contract Life/Tenor** means the period between when a contract is issued and when it expires or reaches maturity.

**Cost of Carry** means the cost of carrying the underlying asset until the contract expires.

**Default Fund** is fund managed by the CCP, contributed to by Derivatives Clearing Members and the CCP to protect against exposures resulting from default.

**Derivatives** means any financial instrument or contract that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, or a measure of economic value or on a default event.

**Derivatives Clearing Member** means an entity authorized by a CCP to perform clearing services either on its own account or on behalf of Derivatives Trading Members or clients

**Derivatives Trading Member** means an entity registered by the Commission to trade in derivatives for its account and on behalf of clients but is not authorized to clear trades through a CCP.

**Exchange Traded Derivatives Contract** means standardised derivatives contracts traded on a recognized exchange and cleared through a CCP.

**Expiry Day** means the last day after which the contract expires and is no longer available for trading.

**Expiry Month** mean the months in which the contract is expected to expire.

**Initial Margin** means margin provided by participants and clients before taking position in derivatives.

**Hedging** means taking position in derivatives by participants or clients who have exposure to the underlying in order to manage risk.

**Leverage** means total outstanding position of a participant in derivatives in relation to its net liquid capital.

**Listing Day** means the first day on which the contract is listed and made available for trading

**Mark to Market** means daily calculation of gains and losses of outstanding positions as a result of actual changes in the underlying or market prices of the underlying.

**Mark to Market Model** means the methodology used for marking to market outstanding positions of participants and clients.

**Multiplier** is the number of underlying contained in a single derivatives contract.

**OTC Derivatives** means derivatives contracts agreed between parties directly without going through an Exchange.

**Option** means a contract where a holder has a right but not an obligation to buy or sell an underlying at a pre-agreed price, time and quantity.

**Participants** refer to Derivatives Trading Members and Derivatives Clearing Members.

**Position** means an obligation or right of a person arising from derivatives trading.

**Position Limit** means level of ownership or control of derivative contracts that a participant, group of participants, client or group of clients shall not exceed.

**Put Option** is a right but not an obligation to sell an underlying asset at a pre-agreed price, time and quantity.

**Settlement Style/Method** means medium of settlement e.g. cash settlement, physical delivery etc.

**Speculation** means taking position in derivatives by participants or clients who do not have positions in the underlying in order to make profit.

**Strike Price** means a price at which an option holder can exercise his option.

**Termination of Trading** means the exact day and time when the contract will stop trading.

**The Commission** means Securities and Exchange Commission

**The Exchange** refers to Securities, Commodities or Futures Exchange where derivatives are listed and/or traded

**Trading Hours** means period of the day within which the contract will be traded on an exchange.

**Trading System** means the infrastructure to be deployed by the Exchange to trade the contracts.

**Underlying** means the financial instrument, commodities, index, exchange rate, interest rate and other products or components in which a derivative is based.

**Variation margin** means margin that is transferred between participants and clients with open positions to reflect current exposures resulting from actual changes in the underlying or market prices of the underlying.

## **2. Applicability**

These Rules shall apply to Exchange Traded Derivatives and OTC Derivatives

## **3. Registration Requirements**

(1)The Commission's approval shall be sought and obtained prior to the introduction of any contract.

(2)An application for registration of a contract shall be filed with

the Commission by or on behalf of an exchange with the following documents:

1 SEC Form.....

2 Information Memorandum – An information memorandum shall provide the following:

3 Contract specification – Any contract filed with the Commission shall where applicable, have the under listed specifications:

- Name of the Contract
- Name and specification of the underlying
- Type of Contract
- Contract Code
- CCP that will clear the contract
- Trading Hours
- Termination of trading
- Settlement Style/Method
- Multiplier
- Listing Day
- Expiry Day
- Expiry Months
- Contract Life/Tenor
- Mark to Market model
- Actions to be taken on single stock derivatives where there are corporate actions
- Any other specification applicable to the contract.

1 The safeguards and the risk protection mechanisms adopted by the Exchange to ensure market integrity, protection of investors and smooth and orderly trading.

iii. The trading infrastructure and surveillance system to be deployed by the Exchange to effectively monitor trading.

1 Target investors.

2 Any other documents/information required by the Commission from time to time.

(3) The contract must pass an economic test that will be determined by the Commission from time to time. The test shall

be designed to ensure that the contract is structured:

1 To solve a particular problem.

2 In such a way that market forces will determine its price and the price of the underlying.

3 In such a way that it is not susceptible to market manipulation.

(4) The Exchange shall have a framework for the regulation of the derivatives segment separate from the framework governing the cash market.

(5) All contracts must be assigned a Legal Entity Identifier code

(6) Once the Commission approves a contract, it shall become the intellectual property of the originating exchange.

#### **4. Trading And Investing In Derivatives**

(1) No participant or any capital market operator shall trade in Exchange Traded Derivatives without the prior registration by the Commission.

(2) Funds shall only invest in derivatives if it is expressly stated in their Trust Deeds.

(3) Where an underlying security is suspended from trading or delisted, contracts on such underlying shall cease to trade.

(4) Exchange Traded Derivatives can only be traded on Exchanges recognized by the Commission.

#### **5. Clearing And Settlement**

(1) All Exchange Traded Derivatives Contracts shall be cleared by a recognized CCP.

(2) All standardized OTC Derivatives Contracts shall be cleared by a recognized CCP

(3) The Commission shall issue guidelines on standardized OTC Derivatives Contracts from time to time.

(4) Clearing derivatives shall be in line with the provisions of the Act, SEC Rules and Regulations, and the rules of the relevant CCP.

(5) Where physical delivery is required, the Exchange and/or the

CCP shall make adequate arrangement for such delivery and ensure compliance with specification.

(6)The arrangements referred to in number 5 above shall include place, time, quantity and quality and any other specificationsas contained in the contract.

## **6. Participants**

(1)No persons shall trade on Exchange Traded Derivatives either for proprietary accounts or on behalf of clients except entities registered as Derivatives Trading Members and/or Derivatives Clearing Members.

(2)No persons shall clear Exchange Traded Derivatives or OTC Derivatives except entities registered as Derivatives Clearing Members.

(3)Participantsshallpromptly provide complete and accurate information about clients and their trading activities to the Commission as the need arises in accordance with the Act and SEC Rules and Regulations.

(4)Participantsshallcomply with all relevant provisions of the Act and SEC Rules and Regulations, whether or not expressly stated in these regulations.

## **7. Surveillance**

(1)The Exchange shall have the responsibility for market surveillance to ensure derivatives prices reflect demand and supply and that all forms of market manipulations are prevented.

(2)The surveillance systems shall be designed to detect:

1 Open positions, cost of carry, volatility and closing prices of the underlying.

2 Activities in the derivatives market vis-à-vis the spot market.

3 Timing of disclosure by issuer of the underlying where applicable shall be monitored.

4 Strike prices with large open positions.

5 Large trades, call-put ratios and exercise patterns.

(3)The surveillance systems shall be able to:

- 1 Capture and process client details.
  - 2 Develop databases of trading activity by participants and clients.
  - 3 Generate trading pattern in individual contracts or group of contracts by participants and clients over a period.
  - 4 Generate the pattern of trading in a contract over a period giving such details as the purchases, sales, positions and open interest held by different participants and clients.
  - 5 Detect any form of breach of the laid down rules and regulations
- (4)Where the underlying is traded in more than one exchange or the participants are members of more than one exchange, the relevant exchanges shall share relevant information to avoid supervisory arbitrage.

## **8. Position Limits**

(1)The Exchange shall:

- 1 Set position limits to prevent participants and clients from holding positions large enough to control and/or manipulate the underlying.
  - 2 Set stringent position limit on participants and clients related to issuers whose securities represent the underlying or determines price of underlying.
  - 3 Notify the Commission on position limits prescribed, methodologies and rationale used for determining the limits.
  - 4 Monitor compliance with position limits and sanction any defaulting participants.
  - 5 Report to the Commission participants or clients that owns up to 5% or more of total open interest of a particular contract.
- (2)Position limits shall be set for each contract based on the quantity of the underlying and trading volume.

## **9. Leverage**



(1)The Exchange shall:

- 1 Require participants to limit aggregate derivatives exposure from their proprietary positions to a percentage of their net liquid asset.
  - 2 From time to time determine the maximum exposure applicable to participants.
  - 3 Liaise with the CCP to determine the applicable leverage.
  - 4 Provide the market with the methodology for calculating net liquid asset from time to time.
- (2)A Derivatives Clearing Member may limit the aggregate exposure arising from the proprietary positions of its Derivatives Trading Members.

## **10. Disclosure**

(1)Participants and registered capital market operators shall disclose their outstanding derivatives-exposures to the Commission on a periodic basis as may be determined by the Commission. The disclosure shall include but not be limited to the following information:

- 1 List and description of proprietary and clients' outstanding positions.
- 2 Outstanding derivatives exposure from proprietary and clients' positions.
- 3 Profit or loss resulting from proprietary positions.
- 4 Proprietary and clients outstanding positions as a percentage of net liquid capital, where applicable.
- 5 Estimated maximum loss that could be incurred from proprietary outstanding positions and its effect on the financial position.

(2)Participants and other registered capital market operators shall disclose their outstanding derivatives exposure from proprietary positions in their quarterly and annual financial statements.

(3)The outstanding exposure shall be determined in accordance

with International Financial Reporting Standards (IFRS).

(4) Participants shall provide full disclosure of contract specifications and accompanying risks to clients before accepting orders from the clients.

(5) Participants shall provide statements with the following information to their existing clients on monthly basis:

1 Outstanding position of the clients.

2 Outstanding balance in the clients' margin account.

3 Profit made or loss incurred by clients.

4 Closed out or liquidated positions of the client.

### **5 Risk Management**

(1) Participants shall:

1 Have risk management units within their organizations.

2 Have comprehensive risk management frameworks for managing derivatives related risks.

3 Include risk management report in their annual financial statements.

## **12. Default of Clients**

(1) A client shall be in default if it fails to fulfil any of its contractual obligations.

(2) Where a client is unable to meet its obligation, its Derivatives Trading Member or Derivatives Clearing Member shall within 24 hours notify the exchange and/or CCP.

(3) The Exchange and/or CCP shall take appropriate step to close out, auction or liquidate the position of the defaulting client.

(4) The CCP shall use the initial margin deposited by the client to bear the cost of auctioning, closing out or liquidating the position of the defaulting client.

(5) The cost of closing out, auctioning or liquidating the position of defaulting clients shall be directly related to or reasonably expected to have resulted from the process.

### **13. Default of Derivatives Trading Members**

(1) A Derivatives Trading Member shall be in default if it fails to fulfil any of its contractual obligations

(2) Where a Derivatives Trading Member is unable to meet its obligation, its Derivatives Clearing Member shall within 24 hours notify the Exchange and/or the CCP.

(3) The Exchange and/or CCP shall take appropriate steps to closeout, auction or liquidate the proprietary position of the defaulting Derivatives Trading Member.

(4) The CCP shall use the initial margin deposited by the Derivatives Trading Member to bear the cost of auctioning, closing out or liquidating the position of the defaulting member.

(5) The cost of closing out, auctioning or liquidating the position of a defaulting Derivatives Trading Member shall be directly related to or reasonably expected to have resulted from the process.

(6) The Exchange shall provide guidelines or procedures for the transfer of client's account of defaulting derivatives trading member.

### **14. Default Of Derivatives Clearing Members**

(1) A Derivatives Clearing Member shall be in default if it fails to fulfil any of its contractual obligations.

(2) Where a Derivatives Clearing Member is unable to meet its obligation, the Exchange and/or the CCP shall take appropriate steps to closeout, auction or liquidate the proprietary positions of the Derivatives Clearing Member.

(3) The CCP shall use initial margin deposited by the Derivatives Clearing Member to bear the cost of auctioning, closing out or liquidating the position of the defaulting Derivatives Clearing Member

(4) The cost of auctioning, closing out or liquidating shall be directly related to or reasonably expected to have resulted from the process.

(5) The CCP shall open a separate trust account with a bank into

which shall be paid all margins held by the CCP on behalf of the defaulting Derivatives Clearing Member.

(6)The CCP shall appoint a trustee to manage the trust account based on instructions of the CCP

(7)The trustee shall after settling all liabilities and cost arising from default of the Derivatives Clearing Member pay the residual funds to the defaulting Derivatives Clearing Member.

(8)If funds and assets of the Derivatives Clearing Member are not sufficient to meet up with its obligations and liabilities, the default management procedure of the CCP shall apply.

## **15. Margin And Collateral**

(1)A CCP shall:

- 1 Receive initial margin from participants and clients immediately before contracts are consummated.
- 2 Pay to or receive from participants and clients, variation margins for gains or losses resulting from mark to market of positions.
- 3 Hold initial margin posted by participants and their clients
- 4 Have adequate arrangements to segregate its own resources from collateral of participants and clients.
- 5 At least once every business day, mark to market outstanding positions and make margin calls if need arises.
- 6 Not create or permit to exist any lien or other encumbrance on initial margin posted by participants and clients.

(2)Participants may request for additional margin from clients to protect themselves against default.

(3)A Derivatives Clearing Member shall:

- 1 Not use margins posted by clients and Derivatives Trading Members to finance its own trade or operate its own business.
- 2 Segregate its resources from additional margin posted by clients and Derivatives Trading Members.

## **16. Transaction Fee**

(1)The Commission shall:

1 Charge fees for registration of contracts

2 Issue guidelines on fees for trading and clearing of contracts in the secondary markets.

## **17. Reporting of OTC Derivatives**

(1)Participants and other registered capital market operators shall report all OTC Derivatives transactions to a Trade Repository or an Exchange as the case may be in accordance with guidelines issued by the Commission from time to time.

(2)For the purposes of these Regulations and any guidelines issued by the Commission, a person that reports details of a derivatives transaction on behalf of a counterparty shall not be considered to be in breach of any restriction on disclosure of information imposed by any contract or by any legislative, regulatory or administrative provision. Where that person is a corporate entity, no liability resulting from that disclosure lies with it or its directors or employees.

(3)Participants shall keep records that demonstrate compliance with the requirements of these Rules.

## **18. Sanctions**

Any person who violates any provision of these rules and regulations shall be liable to a penalty of not less than N1,000,000 and a further sum of not more than N25,000 for every day of default

## **2. Sundry Amendments**

### **Proposed Registration Requirements For Commodity Brokers**

#### **1. Definition Of Terms**

**Commodity Brokers** – These are entities registered by the Commission to trade commodities on spot commodities exchange market on behalf of clients only.

**Commodity Dealers** – These are entities registered by the Commission to trade commodities on spot commodities exchange market for proprietary accounts only.

**Commodity Broker Dealers** – These are entities registered by the Commission to trade commodities on spot commodities exchange market for proprietary accounts and on behalf of clients.

## **2. Payments/Fees**

(1) Evidence of Payment of Filing/Application Fee- N10,000 (Ten Thousand Naira)

(2) Evidence of Payment of Processing Fee- N20,000 (Twenty Thousand Naira)

(3) Evidence of Payment of Registration Fee- N50,000 (Fifty Thousand Naira)

(4) Evidence of Payment of Sponsored Individual Fee- N10,000 (Ten Thousand Naira)

(5) Duly Executed Form SEC 3- For the Company

## **Justification**

*The filing, processing and registration fees payable were deliberately reduced to attract participants*

## **3. Forms**

(1) Form SEC 2 and 2D – Sponsored Individual and Compliance Officer (To be completed in duplicates); (Note that every applicant is to have at least one sponsored individuals who shall be the Compliance Officer and who shall be responsible for monitoring compliance with the ISA 2007, Rules and Regulations, notifications, guidelines, instructions, etc. issued by the Commission or the Federal Government)

(2) Form SEC 2 and 2D – Directors of the company (To be completed in duplicates)

## **Justification**

*Participants do not require companies with formal structures and*

*huge number of staff. A company with 1 or 2 employees can perform the function of spot commodity brokerage.*

#### **4. Minimum Paid-Up Capital And Fidelity Insurance Bond**

(1) Evidence of required minimum paid up capital – Commodity Broker -N3,000,000 (Three Million Naira); Commodity Dealer N3,000,000 (Three Million Naira); Commodity Broker/Dealer – N10,000,000 (Ten Million Naira)

(2) Current Fidelity Insurance Bond covering at least 20% of the minimum paid-up capital as stipulated by the Commission's Rules and Regulations.

#### **Justification**

*Commodity brokers are expected to play in the spot market and as such, they do not require much capital. In addition, the nature of the market is such that it does not require professionals with huge capital base.*

#### **5. Sponsored Individuals And Directors**

(1) Minimum of one Sponsored Individuals, who shall be the Compliance Officer

(2) Managing Director of the Company to be among the Sponsored Individuals where applicable

(3) Full postal addresses of immediate previous employers, bankers (with current account number) and nominated referees of sponsored individuals

(4) Detailed curriculum vitae of Sponsored Individuals and Directors (all gap in employment and educational history should be explained)

(5) Copies of credentials of sponsored individuals, originals will be required for sighting by the SEC

(6) Police clearance report for each sponsored individual. Each sponsored individual is to report at the SEC office in Abuja or the Lagos zonal office with two recent passport photographs to commence the process

(7) Copy of means of identification of the directors and the Sponsored Individuals of the company (International passport, tax or utility payment documents)

### **Justification**

*Participants do not require companies with formal structures and huge number of staff. A company with 1 or 2 employees can perform the function of spot commodity brokerage.*

*The existing requirements for credentials and post-graduation experience including police clearance reports were removed because the market do not require educational/professional qualifications. Participants should simply have basic knowledge to be able to read, write and understand instructions.*

### **6. Applicant Company**

(1) A copy of license from an Exchange

(2) Profile of the company, where applicable, shall include among others brief history of the company, organizational and shareholding structure, principal officers as well as details of past and current activities

(3) The name(s) and address(es) of the company's subsidiaries/associated companies, type of business and percentage holding, if any

(4) Evidence of payment of shares allotted to the shareholders, where applicable

(5) Commodities owned by such broker or dealer or in which the broker or dealer has an interest shall be listed in a separate schedule and valued at the current market price

(6) Operational manual or organizational chart of the company, if any

(7) Business plan, if any

(8) Bank statement of accounts

### **Justification**

*The existing requirements for company profile and history, organizational and shareholding structure, principal officers as*



*well as details of past and current activities were removed because participants do not require companies with formal structures and huge number of staff. A company with 1 or 2 employees can perform the function of spot commodity brokerage.*

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