ALUKO & OYEBODE

An Overview of the Trading and Settlement of Derivative Contracts in Nigeria

January 2024

Introduction

Among other things, the derivatives market is essentially about mitigating financial market risk, and derivative contracts are the financial instruments used for that purpose. A derivative contract derives its value or price from an underlying asset such as currency, commodities, stocks, or bonds. Derivative contracts provide opportunities for financial market participants to capture value from anticipated price movements of the underlying assets they may not directly own. In a derivative contract, the parties take positions based on their expectation of future market movements, aiming to take advantage of price fluctuations. The party that contemplates that the price of the underlying asset will rise is described as holding the long position, while the party that contemplates that there will be a decline in the price of the underlying asset is described as holding the short position. The differences in the positions of the parties can either be cash-settled or settled by physical delivery. For cash-settled derivatives, if there is an increase in the price of the underlying asset, the party holding the short position has the obligation to make payment to the party holding the long position. When there is a decrease in the price of the underlying asset, the party holding the long position has the obligation to make payment to the party holding the short position.

As an illustration, company A which trades cross borders and seeks to mitigate the risk relating to foreign currency exposure may do so through a derivative contract. The company needs to import some materials for production from the United States and will procure foreign currency at a rate of ₦750 (Seven Hundred and Fifty Naira) to USD 1. Company A envisages that in some weeks, USD will appreciate against the Naira, and it executes a derivate contract with company B to hedge the risk of fluctuating foreign currency rates. The maturity date of the contract is September 2024. In October 2023, the dollar appreciates, and the exchange rate is ₦1000 (One Thousand Naira) to USD 1. company B therefore has the obligation to pay company A the difference in their positions, that is, the difference between USD 750 and USD 1000. If the US dollar depreciates against the Naira, it is company A that has the obligation to pay Company B the difference in the rates.

The advantage of utilising a derivative is that Company A is assured of access to foreign currency at ₦750 to USD 1, irrespective of whatever fluctuations may occur in the foreign currency market in that period. The obligation to pay the difference between the long and short positions on the derivative contract will be due at maturity. Upon maturity, the obligations can be settled either by cash or by a physical delivery, if the underlying asset is a commodity.

The core components of a derivative contract therefore are: (a) the underlying asset; (b) the positions of the parties involved; and (c) the maturity date of the contract. Derivative contracts are a vital part of the financial markets because they can be used for several purposes such as hedging a position, risk management, and creating easy access to liquidity, etc.

There are four major types of derivatives contracts: forwards, futures, swaps, and options. For forwards and futures, the parties agree to trade an asset and settle at a future date at a pre-agreed price. The main difference between forwards and futures is that forwards are non-standardised contracts traded over-the-counter (**"OTC"**), while futures are standardised contracts traded on an exchange. Options are contracts that give investors the right but not the obligation to buy or sell an underlying asset at an agreed price and date, while swaps are derivatives where counterparties exchange cash flows or liabilities from two different financial instruments. The most common forms of swap derivatives are currency swaps and interest rate swaps.[1]

This article will consider how derivative contracts are traded and settled in the derivatives market in Nigeria.

THE FRAMEWORK GOVERNING THE TRADING OF DERIVATIVE CONTRACTS IN NIGERIA

Derivative contracts can be traded in two ways, OTC or an exchange (organised trading venues). OTC derivative contracts are usually customised contracts negotiated privately or through a broker-dealer. OTC contracts are private contracts and there is no public information on the counterparties' positions and exposures. This presents credit and operational risks that can arise from poor monitoring of the contractual rights and obligations of the parties.[2] Exchange-traded derivative contracts are standardised contracts traded on a formal, organised, and regulated exchange.

The legislation that governs the trading and the settlement of standardised derivative contracts in Nigeria are the rules on the Regulation of Derivatives Trading, 2019 (**"Derivatives Trading Rules"**) and the rules on Central Counter Party (**"Rules on CCPs"**), 2019, both issued by the Securities and Exchange Commission (**"SEC"**). Derivatives Trading Rules highlight the requirements for derivatives trading in Nigeria, including a framework to guide risk management procedures and back-office operations of exchanges, while the Rules on CCPs highlight requirements for the establishment and operation of Central Counter Parties[3] (**"CCPs"**) in Nigeria. According to the Derivative Trading Rules, all derivatives contracts must be registered and approved by the SEC prior to their introduction on any exchange. These two rules, in addition to the pre-existing Guidelines for Foreign Exchange Derivatives and Modalities for CBN Foreign Exchange Forwards released in 2011 by the CBN are the fulcrum of the regulatory framework for the trading and settlement of derivative contracts. Nigeria's derivatives regulatory framework has evolved alongside the growth of the market. The recent developments and regulations in the Nigerian derivatives market were discussed in our previous article which can be accessed here.

There are also rules that govern the trading of derivative contracts on specific exchanges in Nigeria. In 2022, the Rulebook on Derivatives Market (the **"Rulebook"**) issued by the Nigerian Exchange Limited (**"NGX"**) became effective. It applies to all the members and users of the NGX derivatives platform. FMDQ Securities Exchange Limited (**"FMDQ"**) also released its Derivative Market Rules in 2021, and its exchange-traded derivates platform went live in July 2023.

Commodities derivatives are financial instruments whose underlying assets are physical commodities such as wheat, cotton, gold, etc., and the value of these contracts is derived from the value of the commodities. Commodities exchanges such as Nigeria Commodity Exchange Plc, Lagos Commodities and Futures Exchange Limited, and AFEX Commodities Exchange Limited have specific rules and regulations that govern the trading of commodities derivatives on their respective platforms.

[1] A currency swap is a derivative transaction in which two parties exchange an equivalent amount of money with each other but in different currencies, while an interest swap is a derivative contract in which parties exchange one stream of interest payments for another, over a period of time.

[2] Edmund Parker and Marcin Perzanowski 'Practical Derivatives; A Transactional Approach' (4th edition), Globe and Business Limited, 2023, 11.

[3] Sometimes referred to as Clearing Houses.

THE CLEARING AND SETTLEMENT OF DERIVATIVE CONTRACTS IN NIGERIA

Parties Relevant to the Clearing and Settlement of Derivative Contracts

An important component in the settlement of derivative contracts is the parties and their unique functions. For OTC derivative contracts, the necessary parties are usually the buyer and the seller; however, on some occasions, the clearing of such contracts may involve a CCP or clearing agent, to mitigate counterparty credit risk, which is the risk that one party may fail to meet its obligations under the contract. The CCP acts as an intermediary between the buyer and seller to guarantee the performance of the contract.

Exchange-traded derivative contracts involve multiple parties to ensure the proper settlement and performance of the contract. Below are the different roles played by the parties in Exchange-traded derivatives.

1. *Buyer:* this is the counterparty who purchases the derivative contract at an agreed price;

2. *Seller:* this is the counterparty who sells the derivative contract at an agreed price;

3. *Trading or Dealing Members (also known as derivative brokers):* these are SEC-registered members of an exchange, matching the buyers and the sellers, and facilitating the trade of the derivative contracts on the platform of an exchange. They can execute trades for themselves as counterparties (as long as they have a dealing license) but are not authorised to clear trades through a CCP. Every trading member will have to appoint a clearing member;

4. *Clearing Members:* Clearing Members are members of a relevant exchange, authorised to clear derivative contracts executed on the trading platform of the exchange. Typically, clearing members are prohibited from trading for themselves or on behalf of a counterparty. In Nigeria, only commercial and merchant banks can function as clearing members;

5. *Nigerian Inter-bank Settlement System Plc ("NIBSS"):* provides an infrastructure for inter-bank payments. Every clearing member is expected to issue an irrevocable debit mandate to NIBSS authorising NIBSS to debit or credit the account of the Clearing Member further to any instruction for settlement from the CCP;

6. *Central Clearing Parties (CCPs):* CCPs are responsible for the clearing and settlement of derivative contracts.

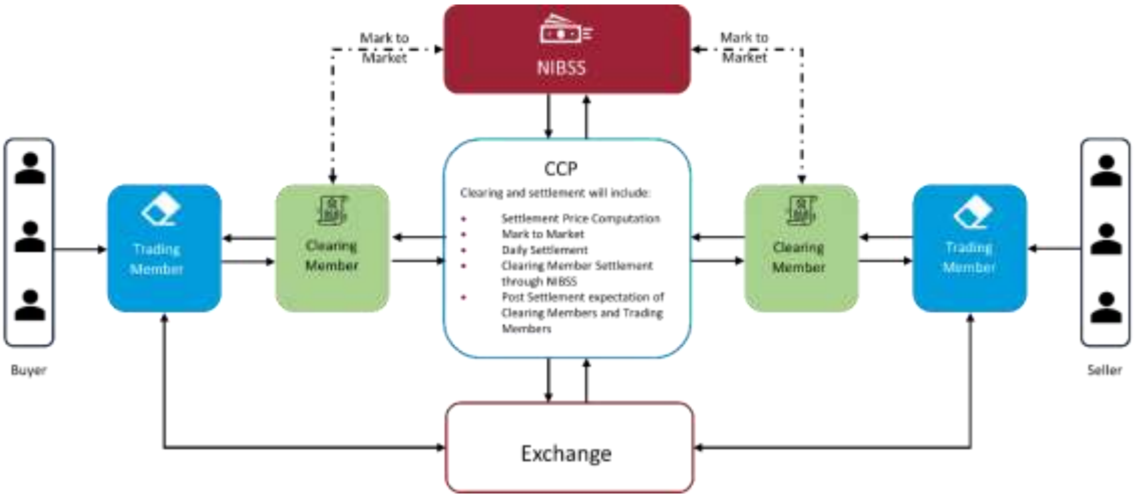
7. *Collateral Management Companies:* these are SEC-registered companies engaged in the business of managing commodities as collateral, by providing and enabling arrangements for collateral commodity financing, preservation of commodities, and issuance of credible warehouse receipts and other necessary arrangements for commodity financing;

8. *Collateral Managers:* these are companies registered by the SEC to act as third-party holders for commodities in a warehouse, owned or controlled by a collateral management company;

9. ***Warehouse Operators:*** these are persons or companies responsible for managing warehouses used for the storage of commodities.[4]

Every party's role is important to the clearing and settlement process of the derivative contracts and the optimal functioning of the derivatives market.

The diagram below outlines a typical flow in a clearing and settlement process of a derivative contract.


Mark to Market
NIBSS
Mark to Market
CCP
Clearing and settlement will include:
Settlement Price Computation
Mark to Market
Daily Settlement
Clearing Member Settlement through NIBSS
Post Settlement expectation of Clearing Members and Trading Members
Trading Member
Clearing Member
Clearing Member
Trading Member
Buyer
Seller
Exchange

The Process of Clearing and Settlement

Clearing is the post-transaction process that ensures that transactions on the exchange will be settled, and no party will default in its obligations set out in the derivative contracts. Settlement is the actual exchange of money, securities, or commodities between the parties to a trade on the settlement date.

The introduction of CCPs was predicated by the global financial crisis of 2008 which exposed the deficiencies of the OTC derivatives market. As a result of this crisis, it was discovered that most financial institutions had complex exposures from OTC derivative contracts, as the lack of standardisation made it difficult to assess and manage the risks when some major counterparties defaulted, and this led to a liquidity crunch in the global financial markets. To address these issues, the G20 leaders committed, amongst other things, that standardised OTC derivative contracts should be traded on exchanges and cleared through the CCPs. The history and operationalisation of CCPs in the Nigerian financial markets Nigeria were discussed in our previous article which can be accessed here.

In Nigeria, there are only two CCPs, FMDQ Clear Limited and NG Clearing Limited. These CCPs guarantee the successful execution of derivatives trades or contracts from various trade points in the Nigerian capital markets while managing all the risks associated with such derivative transactions.

[4] The registration and operational requirements of warehouses and collateral managers are regulated by the SEC's Rules on Warehousing and Collateral Management released March, 2021.

A CCP in performing its clearing function is responsible for aggregating, computing, and establishing the parties' obligations, interposing itself between the parties by netting,[5] and updating the accounts of clearing members.

In order to prevent any defaults in the settlement of a derivative contract, the CCP would become a party to the derivative contracts through a process called novation[6] and take on the responsibility of the counterparty. The CCP thus manages this exposure by obtaining margins (collateral/security)[7] from clearing members. A margin is a percentage of the value of a derivative contract that the CCP has computed as the largest possible loss that can occur if any of the parties were to fail to perform their obligations under those derivative contracts when they fall due. Before a CCP allows a trade, it will have to assure itself that an initial margin[8] has been deposited on behalf of the trading member by a clearing member and this allows a trading member to trade on the back of its margins. The CCP will not allow a trading member to trade a transaction that exceeds its margin. This is part of the risk and collateral management functions of a CCP.

The clearing function of a CCP also involves 'marking to market' each transaction. 'Marking to market' means the CCP constantly tracks the value of the derivative contract purchased on the exchange to ensure that the value of the derivative contract reflects the current market value of the underlying asset. This also helps the CCP determine whether a buyer or seller has made a profit or loss. At the end of every trading day, the CCP will identify the settlement price[9] of the derivative contract and the derivative contract must be marked to align with the settlement price for the day.

CONCLUSION

Derivatives trading are not the typical buy and hold type of investments like stocks, but they can offer numerous benefits towards hedging and preventing potential losses for institutional investors or businesses seeking to lock in the price of an interest rate, currency exchange rate, or a commodity in an unstable market. A CCP performing its clearing and settlement functions guarantees the fulfilment of obligations in a derivative contract. Enhancing the regulatory and operational frameworks of CCPs will bolster the confidence of investors in the credibility and viability of derivatives as a financial instrument in the Nigerian capital markets.

[5] Netting is an aggregation of all open positions or obligations and reducing them into a single net obligation. For more information on the concept of Netting under Nigerian law, please refer to our article on the recent developments and regulations in the Nigerian derivatives market which can be accessed here.

[6] Novation is the replacement of an original derivative contract with 2 (two) separate contracts, between each counterparty and the CCP.

[7] This can be cash and other highly liquid, low-risk securities or other contributions by a Clearing Member of an Exchange provided pursuant to the rules and regulations of a CCP.

[8] An initial margin is the collateral obtained to cover current and potential future exposures over a minimum 10-day business period. This is different from a variation margin which is collateral obtained to cover the changes in the market value of the derivative contract due to the changing market value of the underlying asset.

[9] Settlement price is the price of a derivative contract at the end of each trading day or at the maturity of the contract.

Contact Details

Ajibola Asolo
Partner

M +234 810 216 4161
E Ajibola.Asolo@aluko-oyebode.com

Tomilola Tobun
Senior Associate

M +234 913 939 0669
E Tomilola.Tobun@aluko-oyebode.com

Ofure Odia
Associate

M +234 906 298 1757
E Ofure.Odia@aluko-oyebode.com

Further information about the firm, its practice areas, client briefing notes and details of seminars/events are available at www.aluko-oyebode.com. This is a publication of Aluko & Oyebode and is for general information only. It should not be construed as legal advice under any circumstances. For further information, please contact us at ao@aluko-oyebode.com.

1 Murtala Muhammed Drive
Ikoyi, Lagos, Nigeria
P.O. Box 2293, Marina, Lagos

T +234 1 462 8360
E ao@aluko-oyebode.com