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MARKET MAKING, SECURITIES LENDING AND SHORT SELLING IN THE NIGERIAN CAPITAL MARKET

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INTRODUCTION

As part of its effort towards the recovery of the Nigerian capital market, the Nigerian Stock Exchange (NSE or the Exchange) implemented its Market Making Programme (“the Programme”) on September 18, 2012. To kick-start the process, the NSE appointed the following firms as Market Makers: Capital Bancorp, CSL Stockbrokers, ESS/Dunn Loren Merrifield, FBN Capital, Future View Securities, Greenwich Securities, Renaissance Capital, Stanbic IBTC, Vetiva Capital and WSTC.

The new market structure is a ‘hybrid’ market that allows Market Makers to provide two way quotes and licensed broker/dealers of the Exchange to submit orders. This new system will involve market making, securities lending and short selling.

Considering the hybrid form of the market, the Market Makers will play a central role by providing two-way quotes (comprising of buy and sell prices) for the securities that they make markets on and they will leverage on the securities lending process which will enable them to borrow securities in order to meet ‘buy orders’.

The Programme will be rolled out over a six-month period during which additional

securities will be gradually phased in on a weekly interval. The lower/upper trading limit (circuit breaker) will increase from 5% to 10% for securities that get rolled out into the Programme.¹ The Programme will be implemented within the framework of certain rules and operational guidelines.

We have set below the highlights of the Market Making and Securities Lending Framework of the NSE. And its potential impact on the Capital Market (“the Market”).

CONCEPTUAL CLARIFICATION

What is Market Making?

Under the traditional structure used in the Nigerian Market, prospective buyers issue a ‘buy order’ for the securities they want to deal in and the interplay of market forces would influence the price of the stocks being dealt in. As such, there are occasions of inequality in the demands and supply of securities in the market. This imbalance in the securities market is addressed by market making.

Market making is a trading system whereby broker-dealers provide continuous two-way quotes of the buying and selling prices with sizes of the securities they make market on during the trading day. Such broker-dealer

¹<http://www.nse.com.ng>

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licensed by the Exchange to execute such trade is called a 'Market Maker'. A Market Maker is defined in Rule 31C (2) Sec Rules And Regulations (Amendment), 2012 as: *“any specialist permitted to act as a dealer, any dealer acting in the position of a block positioner, any dealer who, with respect to a security, holds himself out as being ready to buy and sell such security for his own account on a regular and continuous basis”*.

The 'buy quote' indicates the price and size the Market Maker is willing to buy a particular security which is called the 'bid'. The 'sell quote' indicates the price and size the Market Maker is willing to sell the same security which is called the 'ask' or 'offer'. The bid and ask prices will usually differ and, the difference is called the 'bid-ask spread' which is the Market Maker's profit.

Two types of Market Makers are recognised in the Nigerian Market. These are the Primary Market Makers and the Supplemental Market Makers. The Primary Market Maker is any Market Maker who has been appointed by the NSE as the foremost liquidity provider of particular securities and has undertaken to assume the role. The Supplemental Market Makers are appointed to act as a supplementary liquidity provider.

Essentially, when the Market Makers make market for the particular security they are licensed to deal in, they literally assume the influence of the market's forces. Meanwhile this is not an absolute

authority because; the market making operation is being regulated.

The primary responsibility of a Market Maker is to maintain a fair and orderly market, in the individual securities and generally to make a positive contribution to the operation of the market.²

From the foregoing, Market Makers play an important role of maintaining market liquidity and stability. The system makes it possible for an intending buyer or seller to have his buy order executed at a moment's notice. However, each Market Maker must ensure that trading for the Market Maker's own account is practical under the circumstances, consistent with just and equitable principles of trading and not damaging to the integrity of the Exchange or the Market.³

For any person(s) to function as a Market Marker, it shall be a company duly registered with the Corporate Affairs Commission with a minimum paid up capital as specified by the supervising self-regulatory organization (SRO) with the approval of Securities and Exchange Commission (SEC or the Commission). The Market Maker shall at all times maintain sufficient liquid assets to cover its current indebtedness. Currently, a minimum net capital requirement of ₦570 million was prescribed by SEC.

What is Securities Lending?

There are occasions when a broker may have insufficient securities to meet the buy orders of prospective buyers of

² Ibid

³ Ibid

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securities. This commercial exigency can be met by borrowing securities from other broker-dealers in the Market who are readily willing to offer the securities on loan. This type of dealing in securities is called securities lending.

Securities lending is a commercial arrangement whereby securities such as stocks and bonds are lent by the lenders, who are usually pension plans, insurance companies e.t.c. to borrowers who may be Market Makers and broker-dealer firms among others. The parties to securities lending are borrowers, direct lenders and agent lenders. The borrower is a person who borrows the securities⁴ through an approved intermediary. This category of persons consists of Market Makers, broker-dealer firms, investment banks, hedge funds and intermediaries. The direct lenders are often large institutional investors such as pension plans, insurance companies, mutual funds, sovereign wealth funds, investment companies and some high net-worth individuals. While those who play the role of agent lenders are custodians, broker-dealer firms and asset managers.

It is important to note that this is not a typical lender/borrower arrangement. Despite the nomenclature-“lending” this arrangement in effect is a transfer of the title in the securities, but is not a disposal of the securities⁵. The borrower has an obligation to return the equivalent number of security of the same type and class borrowed at the end of an agreed period along with all the corporate benefits⁶ (dividend rights, bonus,

redemption benefits, and interest) which have accrued on the borrowed securities during the borrowing period⁷.

Notably, the legal title of the securities passes from the lender to the borrower⁸, but all the corporate benefits arising from corporate actions are retained by the owner⁹. In essence, the benefits accruing from the title vested in the borrower in this transaction are the right to trade with the securities, the potential profit and the right to vote and attend the company’s general meeting.

The borrower must provide acceptable collateral security¹⁰ to secure the lender against any default on the part of the borrower. The collateral would be considered with reference to the type of security, credit rating of the counterparty, margin, concentration limit and notional limit of the collateral.

In the Nigerian Market, securities lending involves two separate transactions; one is between the lender and the intermediary (Lending Agent), and the other between the intermediary and the borrower. The former is for the deposit of securities by the lender to the Lending Agent for the purpose of lending, while the latter is the lending agreement between the Lending Agent and the borrower. The SEC Rules and Regulations (Amendment), 2011¹¹ prohibits a direct agreement for lending and borrowing securities between the lender and the borrower. The borrower of the securities must enter into

⁴ SECRR (Amendment) 2011 Rule 105A
⁵ Ibid Rule 105A (e)
⁶ Ibid Rule 105A

⁷ Ibid Rule 105A (j)
⁸ Ibid Rule 105a (i)
⁹ Ibid Rule 105a (b)
¹⁰ Ibid Rule 105A (n) *Section 6.5 NSE Securities Lending Guidelines 2012
¹¹ Ibid Rule 105A (a)

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a Securities Lending Legal Agreement (SLLA) with the Lending Agent (the lending agent); who being a custodian of the securities would have entered into a separate agreement i.e. Securities Lending Authorisation Agreement (SLAA) with the lender of the security which authorises the lending agent to lend the securities to borrowers, prior to the lending of the security.

The NSE has adopted the Global Master Security Lending Agreement (GMSLA) standard for securities lending in Nigeria, and permits modifications to cater for the Nigerian Market and the peculiarity of each transaction. The agreements must be in existence prior to the lending of the securities.¹²

Recall process in Securities Lending

There is generally no time limit to the duration the short seller may remain short unless when the broker 'calls' the securities back, at which time the borrowed securities must be returned to the owner. The owner may require the securities to vote at the company's general meeting, to address a situation where there are concerns over the borrower's credit-worthiness or concerns over market volatility.

The loan agreement may be of fixed or indicative term. Under a fixed term, the date of return of the securities is fixed, as such; the borrower is not obliged to accept early return of securities or to comply if the lending agent recalls the securities. The contrary is the case under an indicative term whereby the return or

recall of the securities by the lender is permissible.¹³

The conditions and circumstances for recalling loaned securities would have been stipulated in the lending agreement.¹⁴ When the loan is recalled the borrower shall return the equivalent number of securities borrowed to the lending agent within the time specified in the agreement.¹⁵

Where the borrower fails to return the borrowed securities at the due date or when called to do so, the borrower shall be in default and the lending agent shall have the right to dispose the collateral deposited with him in order to use the proceeds to purchase the same quantity of securities from the Market to replace the loaned ones and still have a right of action against the borrower,¹⁶ coupled with other sanctions and penalties that may be imposed by the NSE and SEC¹⁷ on the recommendation of the Exchange for such default.

What is Short Selling?

One of the established principles in property law is that a person cannot give what he does not have – the 'nemo dat quod non habet' rule. Hence a party cannot effectively pass title in a property if he has no title in it or his title in the property is defective save in certain circumstances permitted by law such as

¹² NSE Securities Lending Guidelines, 2012 Section 4.1

¹³ Ibid Section 9.9.1

¹⁴ SECRR (Amendment), 2011 Rule 105A (k)

¹⁵ Ibid Rule 105A (j)

¹⁶ Ibid Rule 105A (q)

¹⁷ Ibid Rule 105A (r)

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under an agency arrangement, apparent ownership or estoppel by negligence.¹⁸

Despite this general rule, a broker can sell securities that he does not own based on the commercial practice of short selling which is recognised in Nigeria.¹⁹

Short selling is the practice of selling borrowed securities with the aim of repurchasing them at a lower price at a later day. This is done with an anticipation of making profit from a decline in price of the securities at the time of repurchasing it, because the borrowed securities were initially sold at the then prevailing high market price.

It is noteworthy to state that Naked Short Selling is prohibited i.e. the sale of securities without prior borrowing. The lending agent must obtain appropriate authority from the beneficial owners of securities to be lent or from a party suitably authorised by the beneficial owners²⁰ before lending the securities.

Brokers who short sell securities are called short sellers. The short seller as a borrower of securities obtains borrowed securities from brokers that engages in securities lending, either as a lending agent or direct lender. The lending agents get the securities meant for borrowing from the owners who would have previously approved such arrangement.

Normally, the short sellers make profit by repurchasing the same quantity of borrowed securities they initially sold at a higher price when the price goes down.

Conversely, they may incur loss if the price or the securities increase. The short seller is contractually obligated to repurchase the same quantity of borrowed securities sold in accordance with the agreement entered with the intermediary. The securities must be returned to the owners at an agreed latter day regardless of the prevailing market price of the stocks at that period.

Although securities lending complements short sale in securities, it is important to note that despite the implementation of the Market Making Programme by the NSE, there are no specific rules or guidelines for short selling in Nigeria as obtainable in other jurisdictions. However, short selling as a market technique may be accommodated by the provisions of Rule 105A of SEC Rules on Securities lending and borrowing which specifically allows a borrower of securities to dispose of the securities in any manner whatsoever.²¹ This provision is wide enough to cover short selling since it is a disposal of borrowed securities.

LEGAL & REGULATORY FRAMEWORK

For the successful execution of the Market making programme the SEC and the NSE have put in place certain legal and regulatory framework to complement the existing legal and regulatory guidelines.

The following are the legal and regulatory framework for the implementation of the Market making programme:

¹⁸ Goode on Commercial Law, 4th edition, 2010, Pg 451-452,

¹⁹ SECRR (Amendment), 2011, Rule 105A (i)

²⁰ NSE Securities Lending Guidelines, 2012, Section 2.1

²¹ Ibid Rule 105A (i)

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1. Investment and Securities Act 2007.
2. Securities and Exchange Commission Rules and Regulations(as Amended)
3. The Nigerian Stock Exchange Securities Lending Guidelines 2012.
4. Companies and Allied Matters Act CAP. C20 LFN 2004.
5. SEC Code of Corporate Governance 2011.
6. Code of Conduct of Capital Market Operators.

The Investment and Securities Act (ISA) 2007

The Investment and Securities Act (ISA) 2007 is the principal legislation regulating investment and securities business in Nigeria through the establishment²² and empowerment²³ of the SEC²⁴ as the apex regulatory authority for the Nigerian capital market.²⁵This is to ensure the protection of investors, maintain fair, efficient and transparent market and reduction of systemic risk. SEC registers and regulates securities exchange and all other recognised exchanges²⁶ as well as capital market operators.²⁷

Further, the ISA established the Investment and Securities Tribunal²⁸ having all the powers of a court in proceedings²⁹ and vested with exclusive³⁰

jurisdiction³¹ on matters provided in the ISA and disputes between the stakeholders of the Market.

The ISA³² and SEC³³ prohibits fraudulent and unfair trade practices in securities which is a punishable offence.³⁴

The SEC Rules and Regulations

The SEC Rules and Regulations made pursuant to the powers vested in the Commission by the Investment and Securities Act 2007 regulates the operations of Nigerian capital market.³⁵ The Rules and Regulations provides the participants in the Market with more precise notice of what is expected of them, the sanctionable actions and also promotes fairness and equality of treatment among all the participants.

The SEC Rules on Securities Lending and Borrowing

Rule 105A of the SEC Rules and Regulations (As Amended) 2011 makes provisions for Securities Lending and Borrowing. These include the general requirements for securities lending transactions in Nigeria, the necessary terms and conditions in a securities lending agreement; criteria for eligibility of approved intermediaries and their obligations and responsibilities; maintenance of complete record by approved intermediaries of securities deposited by the lender; circumstances of default of borrowers to return borrowed

²² Investment and Securities Act, 2007, Section 1

²³ Ibid Section 13.

²⁴ Ibid.

²⁵ Ibid

²⁶ Ibid Section 13

²⁷ Ibid Sections 38-44

²⁸ Ibid Section 274

²⁹ Ibid Section 290

³⁰ Ibid Section 294

³¹Ibid Section 284

³² Ibid Section 105-112

³³Ibid Section 13 (aa)

³⁴ Ibid Section 115

³⁵ Ibid Section 13

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securities and consequential right of intermediaries to liquidate the deposited collateral to protect himself; notification of the commission and relevant Securities Exchanges of defaulting borrowers for appropriate sanction.³⁶

The SEC Rules on Market Makers

Rule 31C of SEC Rules and Regulations (Amendment), 2012 makes provisions for Market Makers. The main highlights provided in the rules are the eligibility of Market Makers³⁷and their obligations.³⁸

The NSE Securities Lending Guidelines 2012

The NSE Securities Lending Guidelines 2012 sets the general standards of professionalism expected in the operation of securities lending in the Nigerian stock exchange; to wit; maintenance of integrity and confidentiality, observance of prudent practices and prohibition of intentional false distortion of market.

Its main features are; preliminary issues and procedures³⁹to be observed which includes prior obtaining of appropriate authority from the beneficial owners of securities to be lent, obtaining of relevant permission from regulatory authorities and prior documentation of terms of the agreement and ascertainment of the credit assessment of counterparties.It is compulsory that all securities lending agreement be written.⁴⁰Another feature is the prior proper arrangement for the

custody of the collateral.⁴¹Similarly, it is compulsory that the loan of all securities be collateralised, and the collateral and margin shall be marked to market on daily basis. Also, the participants should have a clear understanding of the nature of securities lending transaction with regards to dividends and corporate actions⁴² like voting, notices and rights issue. Lastly the parties to securities lending transaction are expected to establish a procedure for the recalling of securities⁴³and be aware of the rights and obligations of each party.

CONCLUSION

Overall, the market making programme hinged on the complementary fulcrum of short selling and securities lending is well conceived. Considering the effect of the recent crisis in the capital market, the new programme being a major milestone by the NSE will engender the trust of investors (local and foreign) in the capital market because it will demonstrate full transparency in securities market, open up liquidity to the retail market which had hitherto been absent in the Nigerian Market.

Part of the advantages expected to be derived from the programme is that it will enhance efficient price discovery as opposed to the previous trend of subjective pricing seen on the OTC. Also, it will enhance portfolio diversification, promises potential income from lending idle securities, increased activities in the capital market culminating into increased

³⁶See generally Rule 105(A)(a)-(k) SECRR (Amendment), 2011

³⁷ SECRR (Amendment), 2012, Rule 31c (4)

³⁸Ibid Rule 182C(2)

³⁹ NSE Securities Lending Guidelines 2012, Section 2

⁴⁰Ibid Section 4

⁴¹Ibid Section 5

⁴²Ibid Section 9.8

⁴³Ibid Section 9.6

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market capitalization, cheap source of funding, reduced market impact from price fluctuation, additional income and more competition in the capital market.

Moreover, the introduction of short selling into the Nigerian capital market guarantees that short sellers can still make profit even when the price of securities are crashing. This is because, short sellers profits from a decline in the price of securities when they repurchase the securities at a cheaper price for the purpose of returning them to the lender.

However, one major concern of stakeholders on the market making programme is that the process may cause the manipulation of price of securities in the Market.

Nevertheless, this fear has been allayed by the NSE as it has put in place a lower/upper trading limit (circuit breaker) which was increased from 5% to 10% for securities involved in the Programme. The circuit breaker is a threshold of the quantity of securities that can be dealt in on a trading day. It is similar to the US 'limit up-limit down' mechanism. Importantly, the ISA criminalises and sanctions market manipulation and this should serve as a deterrent to such practice. Nonetheless, only time will tell how the Market Making initiative of the NSE will impact the Market.

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