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Dear Mr Adenugha,

Thank you for the NSE’s public invitation to provide comments on its draft rules for the exchange traded derivatives market (the “Rulebook”).

As you may know, Pottery Research is an organization that uses knowledge of law and financial markets to assist investment and business stability. In this letter, I outline proposals which may serve the Nigerian financial markets better in its aims at ensuring a robust derivatives market.

In the event that you would like to discuss the issues raised in this letter, please do not hesitate to contact me. I would be happy to provide further information or assistance.

**Definition of Cleared Trade**

Proposal to include a definition

The Definitions in the Rulebook use the term “Cleared Trade”. However, this is not defined. To remedy this, Pottery Research suggests that the Rulebook incorporates a definition of “Cleared Trade”.

This will clarify the status of rights and obligations. In particular, it will make it clear that the rights of Members, upon novation, are against the DCH. Although the Rulebook at 4.3 explains the operation of a Cleared Trade, its implications are not obvious to the market participant, in that it does not explain where rights and obligations are situated upon novation of a derivative trade.

The implication of a Cleared Trade, as drafted, may suggest an intention to discharge rights and obligations of Clearing Members against the DCH, as opposed to rights and obligations against Clearing Members that have submitted these trades.
Pottery Research understands that if these trades are accepted, the transaction is novated to the DCH and the DCH assumes the position of seller to the buyer and buyer to the seller. The Rulebook however indicates that Clearing Members cease to have rights and obligations upon novation of the particular trade.

On this basis, Pottery Research suggests the following definition. It clarifies that the rights and obligations of the parties after novation are not only against the DCH, but are subject to the DCH’s Rules.

"Cleared Trade"  
(a) the Transaction or Transactions which may result from the process of acceptance set out in the Designated Clearing House Rules, upon or following execution;  
(b) any other Transaction or Transactions which may be created between the Designated Clearing House and a Clearing Member in relation to a transaction by operation of the Designated Clearing House Rules, including, without limitation, any Transaction that results from any process under the Designated Clearing House Rules that varies, modifies, transfers, replaces, novates or ports any Transactions within (a) above or any Transaction that results from any netting or settlement-to-market process under the Designated Clearing House Rules.
Application of Rules to Cleared Trades
Proposal to clarify

Rule 4.3.2 of the Rulebook states:

“The validity of a Cleared Trade is determined pursuant to these Exchange Derivatives Rules and the Designated Clearing House Rules. Each Cleared Trade is subject to The Exchange Derivatives Rules and the Designated Clearing House Rules as applicable.”

Pottery Research believes that some form of clarity is necessary here. In asserting rights and performing obligations, it will be important for Members to know which Rules supersede. Otherwise, if this level of clarity is difficult, it is worth explaining the interaction between the DCH Rules and the Rulebook to market participants.

This is the opposite, for example, when it comes to the application of the NSE default rules. Rule 6.1.1 of the Draft Rulebook states that in the event of any conflict between The Exchange Default Rules and the Rulebook, The Exchange Default Rules shall take precedence. This clarity would also be useful for Cleared Trades if the benefits of clearing are to be realized.

One of the key concerns of investors will be the legal placement of their rights and obligations. To allow the mechanism of central clearing to benefit markets – through multilateral netting and centralization of default - Pottery Research would suggest these amendments are taken into consideration.
The Exchange Default Rules
Proposed amendment to Rule 6.1.3 – Event of Default

An Event of Default is an agreement between the NSE and a Clearing Member. Pottery Research understands that in the event that there is a default by a Clearing Member, the NSE can terminate the agreement allowing the Clearing Member to enter trades on behalf of clients.

It is Pottery Research's view that the operation of Events of Default should be considerably more extensive than currently drafted.

This will enable the NSE to have broader enforcement powers. This is also necessary to ensure that participants do not treat the rules unfairly. On this basis, we suggest the following amendment to Rule 6.1.3. We have redrafted Rule 6.1.3. Our changes can be seen in red below.

"6.1.3 The Exchange may take the actions set out in the remainder of these Exchange Default Rules in respect of a Member in the event of any of the following circumstances (each an Event of Default):

a. the Member fails to discharge any obligation or margin liability in respect of a Trade, whether under the Membership Agreement, The Exchange Derivatives Rules, any Trade or otherwise;
b. the Member notifies The Exchange that it is, or is likely to be, unable to discharge any obligation or margin liability in respect of a Trade, whether under the Membership Agreement, The Exchange Derivatives Rules or otherwise;
c. the Exchange believes that a Member is, or is likely to be, unable to discharge any obligation or margin liability in respect of a Trade, whether under the Membership Agreement, The Exchange Derivatives Rules or otherwise;
d. the Member being (or capable of being, deemed by law or a court to be) insolvent or unable to pay his debts,
e. beginning negotiations or taking any other step with a view to the deferral, rescheduling or other readjustment of all of (or all of a particular type of) the Member’s debts for of

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any part which the Member will or might otherwise be unable to pay when due),
f. stopping, suspending or threatening to stop or suspend payment of all or a material part of the Member’s debts,
g. proposing or making a general assignment, or an arrangement or composition with or for the benefit of the relevant creditors,
h. suffering a moratorium to be agreed or declared in respect of or affecting all or a material part of (or of a particular type of) the Member’s debts or
i. taking any step, or any step being taken by any other person, with a view to the administration of the Member;

j. an execution, distress, sequestration, attachment or other legal process being levied or enforced or sued out against any substantial part of the Member’s revenues or assets and not being discharged or stayed within seven days of being so levied, enforced or sued out or any security over any such substantial part becoming enforceable and any step (including the appointment of a receiver, administrative receiver, manager or similar person) being taken to enforce the same;
k. any step being taken (either by the Member or by any other person) with a view to the winding-up or dissolution of the Member except for the purpose of and followed by a reconstruction, amalgamation, merger, reorganisation or consolidation on terms previously approved by the Exchange;
l. that person, being a Member, failing to satisfy the Exchange or any relevant designated agency or self-regulating organisation at any time that the Member meets any minimum net worth or other financial requirement for Membership or continued authorisation from time to time stipulated by the Exchange or any such designated agency or self-regulating organisation;
m. that person, being a Member, becoming or being declared in default under the default rules of any recognised investment exchange or recognised clearing house.
Membership

The NSE Member Rules: Interaction with the Exchange Derivatives Rulebook

Trading securities on the NSE is conducted by Members. They may act for themselves or on behalf of investors. Likewise, with derivatives: They may act in this manner as Dealer, Broker, or Dealer-Broker. They must satisfy the ‘Minimum Criteria’ in the Rulebook. Amongst others, this criteria requires compliance with operational procedure, due diligence, law and regulations, in order that transactions involving derivatives are properly conducted.

Pottery Research observes that it is not clear how the Minimum Criteria for Membership in the Rulebook is different from the Exchange’s membership regulations. In this respect, it may be appropriate to clarify whether membership of the Exchange includes or excludes membership to conduct trading in derivatives provided on the Exchange.

Taking the NSE’s rules for membership as a dealing member as an example, the NSE requires that potential members are duly incorporated limited liability companies in Nigeria under the Companies and Allied Matters Act 1990. On the other hand, the Rulebook has a simple requirement that a person must at all times be incorporated as a body corporate in Nigeria. Presumably then, satisfaction of the initial membership of the NSE should allow dealing members to satisfy the Minimum Criteria.

Similarly, taking another example, one difference between the two criteria for membership seems to be that in the Rulebook, there is a requirement that potential members not be subject to Insolvency Events or Events of Default.
Our recommendation at Pottery Research is that the operation between the Minimum Criteria and the NSE’s rules of membership should be clarified. Considering the early stages of the market, stakeholders are likely to consider conflicting requirements problematic. This is also something which could be rectified with a simple statement from the NSE clarifying how the rules apply.

As mentioned above, please do not hesitate to contact me, in the event that the issues highlighted in this letter warrant a discussion. We are looking forward to the development of the derivatives market in Nigeria. Pottery Research will continue ensuring that the interaction between the legal and financial market issues are engaged with at the highest of standards.

Yours sincerely

Mr Omotola Ariyo
Director at Pottery Research