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TEMPLARS ThoughtLab

Navigating the Regulatory Headwinds for Crypto Exchanges in Nigeria

In the past few weeks, the Central Bank of Nigeria (CBN) appears to have taken several steps to defend the continuous devaluation or rather rapid free fall of the Naira since its floatation in June 2023. Through a mix of regulatory actions, the CBN has issued at least ten circulars / guidelines since 1 January 2024 primarily aimed at sanitising the FX ecosystem.

In what is widely considered to be an intensified effort to reduce the pressure on the Naira which has suffered an over 100% devaluation since last year,¹ the CBN through the Nigerian Communications Commission (NCC) has reportedly ordered mobile network operators (MNOs) and internet service providers (ISPs) to block the domains of several global crypto exchanges on the grounds of alleged forex market manipulation which the CBN and other government agents have variously referred to as the blatant fixing of the exchange rate for Nigeria.² We note however, that despite these allegations at this time there have been no publicly reported formal legal proceedings instituted against these institutions.

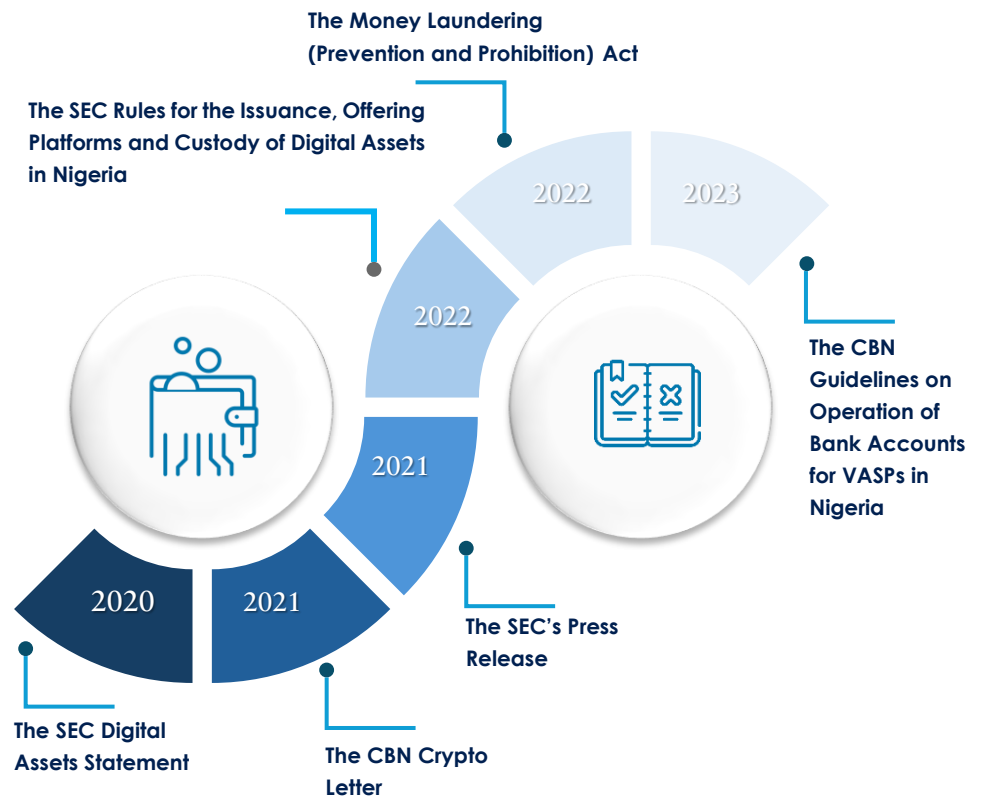
There have also been reports of arrests and the planned imposition of fines in record amounts of up to US\$10 billion to be levied against at least one crypto exchange.

In this client alert, we discuss the recent market developments and how crypto exchanges, and related businesses can navigate the currently rough Nigerian regulatory waters.

¹ The Naira traded at approx. N641/\$US1 as of 19 June 2023 and N1538/\$1 as of 1 March 2024 in the official market.

² These allegations have been made publicly on numerous occasions including by the Governor of the CBN on 27 February 2024 during a press conference.

The Chronology of Cryptocurrency Regulation in Nigeria



- **The SEC Digital Assets Statement 2020**

On 14 September 2020, the Securities and Exchange Commission (SEC) published its first categorical statement on the classification and treatment of digital assets in Nigeria (the “**SEC Digital Assets Statement**”).

The SEC’s position is that unless otherwise proven, digital assets will be treated as securities. As a result, the SEC Digital Assets Statement mandates the filing of an initial assessment and thereafter a registration where the digital assets in relation to which an initial assessment filing was made qualify as securities.

- **The CBN Crypto Letter 2021**

On 5 February 2021, the CBN in a letter addressed to all deposit money banks (DMBs), non-bank financial institutions (NBFIs) and other financial institutions (OFIs) (the “**CBN Crypto Letter**”), reminded DMBs, NBFIs and OFIs that they are prohibited from dealing in cryptocurrencies and/or facilitating payments for cryptocurrency exchanges. As a result, bank accounts identified as belonging to cryptocurrency exchanges, custodians or used in facilitating cryptocurrency transactions were closed.

From a practical standpoint, the CBN Crypto Letter which effectively prohibited cryptocurrency transactions from passing through the Nigerian banking system operationally rendered the SEC Statement redundant given that Nigerians could no longer (at least indiscreetly) use their bank accounts, debit cards or wallets to undertake cryptocurrency transactions.

- **The SEC's Press Release 2021**

On 11 February 2021, the SEC issued a press release (the "**SEC Press Release**") to clarify the perceived conflict between the SEC Digital Assets Statement and the CBN Crypto Letter promising to engage with the CBN on the matter.

To put things in perspective, the CBN and the SEC are two independent regulators with distinct regulatory mandates, albeit with the CBN having a wider reach as the apex regulator of financial institutions. However, given the critical role of the Nigerian banking system in cryptocurrency transactions, the SEC Press Release provided that it would put on hold the admittance into the SEC Regulatory Incubation Framework of all persons and products affected by the CBN Crypto Letter until such persons are able to operate bank accounts within the Nigerian banking system.

- **The SEC Rules for the Issuance, Offering Platforms and Custody of Digital Assets in Nigeria 2022**

By a regulation issued on 11 May 2022, the SEC issued its rules for the Issuance, Offering Platforms and Custody of Digital Assets in Nigeria ("**SEC Digital Asset Rules**"). Amongst other things, the SEC Digital Asset Rules prescribe the various licensing and operational rules for digital assets in Nigeria and require Virtual Asset Service Providers (VASPs) to be registered with the SEC.³

Despite the existence of the SEC Digital Asset Rules since 2022, the CBN's stance on cryptocurrency effectively prevented VASPs from obtaining licenses from the SEC or at least made the requirement to obtain a license less attractive. For many crypto exchanges, there was limited commercial value in obtaining a license from the SEC if cryptocurrency transactions could not pass through the Nigerian banking system.

- **The Money Laundering (Prevention and Prohibition) Act 2022**

The Money Laundering (Prevention and Prohibition) Act 2022 (the "**AML Act**") was signed into law on 12 May 2022. Amongst other things, the AML Act expanded the definition of financial institutions to include virtual asset service providers and the definition of funds to include virtual assets in order to subject VASPs to various AML compliance obligations such as customer due diligence (CDD) and the filing of suspicious transaction reports and cash transaction reports.

- **The CBN Guidelines on Operation of Bank Accounts for VASPs in Nigeria 2023**

On 22 December 2023, the CBN through the Guidelines on Operation of Bank Accounts for VASPs in Nigeria 2023 (the "**CBN VASP Guidelines**") lifted the ban on banks and other financial institutions from operating bank accounts for VASPs although banks and other financial institutions are still prohibited from holding, trading and/or transacting in virtual currencies on their own account.

Amongst other things, one of the key objectives of the CBN VASP Guidelines was to provide for effective monitoring of the activities of VASPs within the Nigerian banking

³ A virtual asset service provider (VASP) is defined under the SEC Digital Asset Rules to mean any entity that conducts one or more of the following activities or operations for or on behalf of another person: **(a) exchange between virtual assets and fiat currencies; (b) exchange between one or more forms of virtual assets; (c) transfer of virtual assets;** (d) safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets; and (e) participation in and provision of financial services related to an issuer's offer and/or sale of a virtual asset.

system by operationalising the SEC's licensing regime for VASPs, which until the issuance of the CBN VASP Guidelines, was effectively redundant.

It was therefore expected that VASPs such as crypto exchanges and custodians would be in a better place to decide on whether to obtain a license from the SEC.

Risk Factors

From a Nigerian law perspective, the offering of a cryptocurrency exchange in Nigeria poses certain legal risks – some of which have been cited by both the CBN (and the Securities and Exchange Commission (SEC) in the past) as the basis for their regulatory actions.

- **Permanent Establishment Risk**

Under Nigerian law, a foreign company (i.e., a company registered or incorporated outside Nigeria) with the intention to carry on business in Nigeria is required to take all steps necessary to incorporate a separate entity in Nigeria for that purpose.

There is limited statutory guidance on the interpretation of 'carrying on business in Nigeria'. However, the Nigerian courts have interpreted this to include conducting or continuing a particular vocation or business as a continuous operation or permanent occupation. To this extent, depending on what is considered as 'carrying on business in Nigeria', there is sufficient legal basis to argue that a locally incorporated entity is required to do business in Nigeria.

That said, the interpretation of doing business in Nigeria is could potentially be viewed as lacking in certainty particularly within the context of digital services. To this end, digital service providers such as crypto exchanges often rely on the principle of reverse solicitation (which allows offshore service providers to serve individuals of a particular country if the products and services have been requested at the individual's own exclusive initiative) to provide their services on an offshore basis without setting up a local entity or obtaining any in-country licenses.

Relatedly, there is also the risk of being liable to companies' income tax on the profits derived from the provisions of services in Nigeria based on the principle of significant economic presence.

- **Licensing Risk**

The combined effect of the SEC Digital Assets Statement and SEC Digital Asset Rules is that entities that qualify as VASPs are required to apply for and obtain a license from the SEC to operate in Nigeria.

Similar to the local entity incorporation requirement, VASPs often rely on the principle of reverse solicitation to offer their products and services in Nigeria. That said, the jury is still out on whether this argument is sufficient to circumvent the requirement for obtaining a license from the SEC.

- **AML Risk**

Under the AML Act, VASPs are required to undertake CDD and file various reports with the Nigerian Financial Intelligence Unit (NFIU). The extent to which this applies to VASPs without any local entity or license, however, remains unclear. As a practical matter, it

is difficult to imagine how VASPs that provide their services on a reverse solicitation basis i.e., purely on an offshore basis without a local entity would comply with these requirements.

- **FX Regulation Risk**

The buying and selling of foreign currencies in Nigeria are heavily regulated by the CBN. As a result, products and services that relate to the foreign exchange regime in Nigeria are constantly under the CBN's regulatory radar.

Based on publicly available information, the CBN and by extension the Nigerian Government appears to be concerned with the availability or otherwise quoting of reference rates (which to date have been much higher than the official rate) by crypto exchanges for the sale of stablecoins such as USDC and USDT which has become a profitable venture of speculators and a safety net for Nigerians looking to hedge against the continuous devaluation of the Naira.

From all indications, the CBN considers the availability of such reference rates to have contributed to the rapid fall of the Naira.

Options Available to Crypto Exchanges

Crypto exchanges affected by the recent CBN regulatory actions or those looking to lower the risk of coming under the radar of the CBN and the Nigerian Government by extension may consider the following practical risk mitigation options:

- **Suspending Stablecoin Trades**

One option would be to suspend the availability of stablecoins to Nigerian users on the crypto exchange such that users will be unable to buy or sell stablecoins in Naira given that the CBN's concern seems to be around the fact that stablecoins provide speculators with an avenue to profit from FX arbitrage.

- **Using the CBN Official Rate as the Reference Rate**

As noted, it is generally understood (at least based on publicly available statements attributable to the Nigerian Government), that one of the major concerns seem to be the availability of a reference rate for the sale or purchase of stablecoins which is much higher than the CBN official rate.

To this extent, an alternative would be to consider using the CBN official rate as the reference rate for transactions on the platform although crypto exchanges would need to assess the commercial viability or otherwise of this option particularly within the context of customer acquisition.

- **Disabling Naira Based Payment Methods**

Disabling Naira based payment methods i.e., the use of bank transfers and wallets is also another possible option to consider, in which case, there would be no need for the use of a reference rate as users will have to buy or sell stablecoins using foreign currency denominated payment instruments. Alternatively, where there is significant concern around the recent CBN measures, as a temporary measure, there is the option to suspend the availability of the crypto exchange in Nigeria pending when

there is some degree of clarity with respect to the recent actions of the Nigerian Government.

- **Engaging with Regulators**

Under the appropriate circumstances, a VASP could also engage with the regulators such as the CBN and the SEC to provide clarity on their operations and product offerings which runs the risk of being misunderstood.

Conclusion

Given the current regulatory climate for crypto exchanges, a re-evaluation of their operations in Nigeria is now critical. Due consideration must be given to the recent developments *vis-a-vis* the existing regulatory and licensing regime as well as the risks of relying on the principle of reverse solicitation to provide services in Nigeria. It is important to note that the options above are non-exhaustive and may need to be evaluated by the VASP against its Nigerian customer base, profitability, and ease of implementation. In the short term at least, it seems clear that the regulatory headwinds for crypto exchanges in Nigeria will remain strong, however, the circumstances could change with continued developments in the FX regulatory framework and in all likelihood these recent measures do not portend the end of crypto exchanges in Nigeria.