

# THE NIGERIAN INSOLVENCY LAW AND THE RIGHTS OF CREDITORS AND ACCOUNT HOLDERS OF INTERMEDIATED SECURITIES **VIS-À-VIS THE INSOLVENT INTERMEDIARY**

By

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With the revolution caused by Information Technology, there has been a serious paradigm shift from traditional company & securities law to the law of securities accounts also known as intermediated (i.e. **indirectly** held) securities law. This has in turn seriously impacted on the rights of trade and secured creditors to the company as well as those of investors who deal in the company's securities through intermediaries. New legal risks resulting from increased efficiency and speed in business transactions on an electronic and virtual platform need to be addressed by way of legislative reform or subsidiary legislative action when a basic existing framework pre-exists.

In Nigeria, our basic framework is a now rather obsolete; the Companies and Allied Matters Act Cap. C20 LFN 2004 (hereafter CAMA) only deals with issues arising from the direct holding system of company securities and fails in many respects to provide certainty in new areas of corporate, capital market and insolvency practice.<sup>2</sup> The development and growth of the banking and capital market sector in the Nigerian economy –and the resulting need for a robust enforcement framework for secured credit through insolvency laws- has increased the urgency of the examination of the subject of the instant paper.

The issues raised under this paper are as follows- what happens or what protection is afforded to investors when intermediaries such as custodian companies, stock broking firms, etc, become insolvent? How will the account of these investors who are holders of indirect and intangible rights in securities be treated? Shall there be special and separate treatment/priority given to those accounts or shall same be diluted into the intermediary's pool of intangible/tangible assets available to a gamut of institutional, non institutional and statutorily protected creditors in a set order of priority.

We will firstly in this paper give a general overview of Insolvency in Nigeria, the treatment of diverse creditors and its effect on secured credit and capital market investments in Nigeria. We shall thereafter examine special national laws interfacing same with the loopholes existing in the general law and end with a comparative analysis with the international and cross-border approach of the (UNIDROIT) Draft Convention on Substantive Rules regarding Intermediated Securities.

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<sup>2</sup> The Investments & Securities Act 2007 has principally wrestled capital market matters from the Companies and Allied Matters Act.

## PART I: SECURED CREDIT AND GENERAL INSOLVENCY FRAMEWORK

**What is insolvency?** How is the term understood in Nigeria?

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Section 650 of CAMA defines corporate insolvency as follows -

*"insolvent person" where used in this Decree means any person in Nigeria who, in respect of any judgment, decree or court order against him, is unable to satisfy execution or other process issued thereon in favour of a creditor, and the execution or other process remains unsatisfied for not less than six weeks;"*

This definition requires the grant of a **court order** as a means to establish insolvency, but the truth is that corporate insolvency relates simply to the inability of a debtor company to meet up with its **commercial** commitments; that is to say, financial obligations arising from trade with third parties or secured lending. In financial accounting jargon on the other hand, "balance sheet insolvency" arises where the liabilities of the company exceeds the assets of the company<sup>3</sup>. It follows that the definition of corporate insolvency in the Act is not only inadequate but inefficient

Secured Credit on the other hand relate to lending and the process of enforcement of securities created as collateral to the loan transaction. To paraphrase the words of the UK Cork Committee, 1982 and other renowned experts in security rights such as Professor Sir Roy Goode, the importance of credit –and more particularly secured credit- in modern day economies cannot be over-emphasized as it is almost impossible for a national economy to develop without an adequate secured credit law regime. It is the lifeblood of economy. Indeed, it is pertinent to point out in company law context that equity and debt capital provision by investors as well as supply of goods on credit **are all premised on a credit transaction with the company with different maturity period and level of collateralization based on the assets of the company**. This in turn means rules of priority for the purpose of redistribution of these assets to various stakeholders when the company is insolvent are crucial.

Thus, there is a very important connect between the law of Secured Credit and Insolvency Law as typically the issue of enforcement of securities (whether in the form of transfer of rights in personal, real, tangible or intangible property) and the ranking of those securities arises only when the borrower is unable to meet with its commercial

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<sup>3</sup> From a practical point of view of insolvency practice, we venture to think that the process of mergers & acquisition under the ISA 2007 is a type of insolvency process which involves a voluntary dissolution of the existing company(s) –and absorption of its liabilities- into a new entity **without a voluntary formal process of winding-up (S122 (6) (d) ISA 2007)**. The scheme is given sufficient publicity so that the interests of various creditors in a broad sense are protected. See also S34 of the Nigeria Deposit Insurance Corporation Act, 1990 (as amended)

and contractual obligations. This means that the other side of the coin of the law of secured credit is the existence of an efficient and clear insolvency regime for the purpose of credit risk management through the enforcement of securities.

Now, the Nigerian corporate insolvency framework (hereafter referred to as the general or normal/ordinary law) is captured by Part XIV, XV and XVI of CAMA on receivership, winding-up and arrangement & compromise respectively and envisages different levels of commercial difficulty, failure or insolvency of a going concern. In this context, dealings in securities are within the context of a Direct Holding or Certificated Securities System where an investor deals directly in the securities of the issuer company and is recognized either as a member or a secured creditor of the debtor company in the relevant registers (Ss. 151, 152) of the company with the attendant rights attached to his class of securities.

For instance, aside from the subscribers to the memorandum of a company, S79(2) CAMA defines a member of a company as one *“who agrees in writing to become a member of a company, and whose name is entered in its register of members”*, whilst S151(2) on transfer of shares states that *“it shall not be lawful for the company to register a transfer of shares in the company unless a proper instrument of transfer has been delivered to the company”*, again S151(3) provides that once the instrument of transfer is executed between the parties *“... the transferor shall be deemed to remain a holder of the share until the name of the transferee is entered in the register of members in respect of the share”* (see also Ss 91 and 152(2)). The same idea goes for debenture holder under S169.

Now then, under the normal law, the administration and management of the undertaking may be subjected either to a temporary takeover of control, a joint management by the secured creditor for the purpose of liquidation of the secured obligation of the company, or a restructuring of the undertaking and the rights of (classes of ) members, debenture holders and creditors: these best case scenarios of business recovery of the vulnerable undertaking are the ones contemplated by Part XIV and XVI with the appointment of a receiver/manager and the concept of arrangement/compromises with (classes of) members and or secured creditors. To a relatively large extent, these scenarios entail the collaboration of the insolvent company with several other stakeholders such as institutional creditors or regulators, secured creditors, trade creditors and employees and a balancing act as per these several interests.

The normal law also envisages instances where those stakeholders would compulsorily or voluntarily put the insolvent company to death and has established priority rules (see Ss. 484, 494 and 495 primarily but also see Ss. 393(1), 402 to 404, 413, 414 and 448) to guide redistribution of the proceeds realized from the assets of the failed company.

By virtue of these provisions, preference is given to secured creditors holding either a legal mortgage or debenture on company's specific assets, followed by the costs, expenses and remuneration of the liquidators arising from insolvency administration (receivership/winding-up/liquidation), followed by state revenue (tax and other fiscal

deductions and dues, labour debts which rank equally). Trade creditors and holders of floating debentures are at the bottom of the pyramid, followed by contributories.

This means that under general corporate insolvency law, usually where the assets of the insolvent company are insufficient to meet its liabilities general creditors are greatly at risk. The implication of priority rules under the ordinary law is that both the account (i.e. **indirect**) holders or intermediaries (i.e. **direct holders**) of securities (i.e. classes of shares) will mostly be treated as **trade creditors** with the attendant frailties attached to their position if the insolvent company is not asset-rich. This outcome contradicts the special nature and role of the capital market and the expectations of capital market investors as capital providers. The general law could therefore be construed as capable of undermining the integrity of the capital market, and the role of the Securities and Exchange Commission (SEC) in avoiding systemic risks in the capital market could be greatly hampered if there are no assurances for these special breed of investors who may then not be attracted to the seamless flow of capital in and out of the capital market. Indeed, for public companies, it is this mischief (the special nature and role played by the capital market in dealings in company securities of publicly quoted companies) that was sought to be cured by the repeal of the entire Part XVII of CAMA on "Dealings in companies securities" by virtue of section 263 (1)(d) of the Investments and Securities Act (ISA) No 45 of 1999 now amended. In other words, the intention of the law maker was to transfer regulation of public company securities to SEC. it follows that SEC ought to regulate priority rules for those securities.

The same idea applies to account holders in banks for the banking industry. Indeed, under the Nigeria Deposit Insurance Corporation (NDIC) Act, 2006, Section 20 NDIC Act provides for immediate payment of the sum of N200,000 upon failure of a bank, whilst section 41(3) provides that the Corporation liquidation expenses enjoy priority over all other liabilities<sup>4</sup> including over legal mortgage or crystallized debenture.

The role of these sectors in the Nigerian Economy in the development of investments created an imperative for special protection, leading to promulgation of specialized statutes such as ISA 2007, NDIC Act, 2006 and the Banks and Other Financial Institutions Act (BOFIA) 1991 as amended.

These special laws derogate from the rules created by the direct holding system under CAMA and create a special protection for account holders through the twin technique of prevention of insolvency of the intermediary and special preferential treatment accorded to the account holders in the event of insolvency of the intermediary. But they also, especially in the capital market sector, create a conflict with the general law (CAMA) which requires registration of securities by its holders in order for legal rights to be attached to same. Dealings in company securities in the capital market on the other hand are premised on a dematerialized environment wherein securities are indirectly

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<sup>4</sup> The section provides in case of liquidation that the corporation shall pay itself first liquidation expenses and then pay **depositors and other creditors net amount available for distribution. The provision is however in direct conflict with Ss.54 and 56 of BOFIA which give priority to local deposits over all other claims.** By S56 BOFIA, it is submitted that BOFIA prevails.

held by account holders through the intermediaries (custodians, stock brokers, etc). We shall examine later how and whether this conflict is resolved under ISA and SEC regulations.

## **PART II: THE SPECIAL PROTECTION AFFORDED TO ACCOUNT HOLDERS IN THE EVENT OF INSOLVENCY OF INTERMEDIARIES.**

Although the scope of our paper puts emphasis on intermediated (i.e. indirect or uncertificated holding system) in the context of the capital market, we shall borrow a leaf or two also from the special protection afforded to account holders in the context of the banking sector with the BOFIA and NDIC Act as amended,

Under the provisions of ISA 2007 and SEC regulations on intermediaries, depositories and systems of clearance settlement, we shall particularly examine -

- a) The provisions of ss. 39 to 43 of the ISA 2007 on segregation of accounts by capital market operators.
- b) the provisions of Ss. 197 and 198 in Part XIV relating to the Investors Protection Fund
- c) SEC's regulations on registration and regulation of custodians as well as other securities intermediaries (custodian, brokers, banks, clearing corporate bodies), all participants in Central Securities Depositories (CSDs).<sup>5</sup>
- d) Rule 207C on Regulation of securities clearing and settlement.
- e) Rule 226 on Depository receipts by Nigerian entities

Also in ISA 2007, under Part VIII, electronic and other means of issuing and transferring securities is allowed (S55).

*“(1) Securities registered by the Commission including securities issued pursuant to part XIII of this Act, may be issued or transferred electronically or by any other means or system approved by the Commission under such terms and conditions as the Commission may prescribe, through a securities exchange or capital trade point or any other self regulatory organization.*

*(2) the Commission shall prescribe the documents and information to be provided by the issuer, an issuing house, stockbroker or any other person authorized by the Commission to offer securities for sale or subscription to the public.”*

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<sup>5</sup> See Rules 26, 27 and 207 (on custodian of securities and on Depository and other related parties as the case may be) of SEC Rules & Regulations.

Essentially, the above provisions reflect two perspective of protection of the account holders--

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- 1) Prevention of the insolvency of intermediaries participating in an intermediate holding system;
- 2) Failing same, special treatment and priority ranking afforded to account holders of intermediated securities over and above the remedies available to insolvency administrators, secured creditors and other general creditors of the insolvent intermediary.

However, it would seem that section 55 of ISA 2007 which allows electronic and other means of issuing and transferring securities is in direct conflict with various provisions of CAMA which require entry into the register of members or charges etc.

### **Prevention of Insolvency of intermediaries in Nigerian capital Market**

There are several provisions aimed at providing safeguard and assurance to investors regarding the credit risk of insolvency of the intermediary.

These are four- fold-

- The stringent provisions requiring capitalization of an intermediary company which assets would serve as safety net distributable to investors, general creditors etc in the event of the intermediary's insolvency<sup>6</sup> The reference to capitalization requirements for banks is encapsulated under the BOFIA older provisions regarding minimum paid-up share capital for banks (S9), minimum capital ratio and minimum holding of cash reserves (Ss. 13 to 16 BOFIA) as well as under the NDIC Act with the provision of fidelity bond coverage (S33).
- The provisions of the ISA regarding the creation of an Investors Protection Fund (IPF) as a safety net to cater for losses suffered by independent capital market investors as a result of the insolvency, bankruptcy, negligence or defalcation committed by the intermediary.<sup>7</sup> A similar provision which is however subject to a ceiling under the Act is the compulsory insurance of banking deposits with the NDIC (Ss. 16 and 21 NDIC Act)

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<sup>6</sup> See Rules 27(1)(vii), 27(2)(a)(c) of SEC regulations on Custodian of Securities, and Rules 26B(1)(v) & (viii), (3) SEC Rules on Depositories and related parties essentially requesting that intermediaries meet up with capital and other requirements for banks duly licensed by CBN or SEC's capital requirement, and requiring as well for the provision of a fidelity bond of a value of no less than 25% of the paid up capital of the intermediary.

<sup>7</sup> See Sections 197 and 198 in Part XIV of ISA 2007.

- The provisions of the ISA empowering SEC to intervene before an intermediary becomes insolvent or even when effectively insolvent.<sup>8</sup> The BOFIA vests the similar powers on the CBN (Ss. 7, 31 to 35 BOFIA) and to a lesser extent the current NDIC Act 2006 vests same (Ss. 27 to 32, 37, 38 and 40 to 43 NDIC Act) subject to BOFIA (S.54 BOFIA).
- The general provisions of the ISA concerning civil and criminal liability of professionals and capital market operators particularly when combined with relevant Code of Conduct drafted in rules pertaining to such participants.<sup>9</sup>

### **Treatment of Investors when the intermediary becomes insolvent under Nigerian Capital Market**

Aside from the IPF, ISA 2007 also develops a special protection for account holders in the event of insolvency of intermediaries. Apparently, ISA 2007 seeks to create a special rule which derogates from the general rule of priority under the normal law but as we shall find out later through a comparative analysis with the special treatment of account holders in banks, there are still loopholes in the special law regarding account holders of intermediated securities in the capital market.

The underlying basis for priority given to investors lies in the **segregation provisions** in ISA and SEC Rules on intermediaries that impose on the intermediaries an obligation to keep separate accounts<sup>10</sup>.

S39 starts with an obligation for the Capital Market Operator (CMO) to keep detailed accounts and records distinctly showing the financial standing of his business (S39(1)), detailed particulars of all monies received or paid, assets and liabilities of the CMO, purchase and sale of securities -both those that are the property of the CMO and those that are not-, (S39 (2) a) to d)),

It further imposes expressly on the CMO in S39 (3) an obligation to-

*“... keep records in sufficient detail to show particulars of all transactions by the capital market operator with or for the account of:*

- a) Clients of the capital market operator;*
- b) The capital market operator himself; and*

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<sup>8</sup> See Sections 48 to 51 that dealing with SEC’s powers to examine the affairs of capital market operators and intervene before they go insolvent and give written directives or orders regarding restrictions on receipt of funds/assets by the intermediaries, suspension or removal of certain of its officers, revocation of registration, self appointment as or appointment of an insolvency administrator to take over the management/ of the insolvent intermediary or even wind-up same **subject to** court sanction, etc.

<sup>9</sup> See for example R207A(3), R207B(37) of the rules for custodians and intermediated market participants in Depositories and Schedule IX of same which imposes on these participants a duty to adhere to a specialized code of conduct.

<sup>10</sup> See ss. 39 to 43 of the ISA 2007.

c) *Employees of the capital market operator.*<sup>11</sup>

S40 further expressly deals with the obligation to maintain separate accounts and seeks to regulate payment into certain trust accounts-

Page | 8 *S40 (1) a capital market operator shall maintain separate accounts for transactions carried on behalf of different clients.  
(2) No capital market operator shall mix the proceeds of the account of a client with other accounts whether belonging to the capital market operator or its clients.  
(3) a capital market operator shall establish and keep in a bank or banks one or more trust accounts to be designated or evidenced as trusts accounts...*

The CMO is required to pay not later than the next banking business day following date of receipt all amounts (less any brokerage and other proper charges) resulting from dealings in securities of account holders (S39 (3) a) & b), (4)).

Financial criminal penalties are also attached to failure to comply with this provision so as to achieve enforcement of the segregation provisions and protection of the monies and securities assets of the investor.<sup>12</sup>

Section 42 thereafter states the general rule subject to lawful claim and right of lien that money in trust account is not available for the payment of intermediary's debt.<sup>13</sup>,

This can prima facie be interpreted to mean that account holders are seen as secured creditors for a certain category of assets (securities and or cash) being held on behalf of the account holder to the exclusion of all others including insolvency administrators in the context of winding-up under the general law (Ss. **484 and 494 of the CAMA supra**).

### **Critical analysis of the special rule sought to be created under ISA**

The problem with all the above provisions and particularly S42 of ISA 2007 does not lie in the concept of segregation but rather in the fact that there is **no specific protective provision on priority** under the Act, which raises a concern that the accounts kept with the intermediaries may just be viewed as trade debts and not enjoy priority over other creditors.

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<sup>11</sup> S39 (4) creates a criminal offence for contravention of this provision with a deterrent fine of a minimum of N500,000 and/or minimum of 2 years term of imprisonment whilst S39(5) gives SEC powers to sanction the CMO by way of imposition of additional financial per diem penalties for continued violation.

<sup>12</sup> Please see S40(5) as well as S41 which creates an offence for withdrawal of money from a trust account without authority.

<sup>13</sup> Please see also R207A (8) on segregation of accounts by custodians; R207B (18) on segregation of accounts by market participants

There is on the other hand a clear and specific protection and priority in ranking for account holders/depositors in failed banks by virtue of the combined provisions of Ss. 20, 21 of NDIC Act and S54 of BOFIA on ranking in priority. Firstly, **all** account depositors are entitled to receive upfront a maximum claim of N200,000<sup>14</sup> based on the insured deposits of the failed bank. Secondly, Section 54 of BOFIA provides that the assets of the failed bank in the Federation shall be available to meet all the deposit liabilities of the bank **and such deposit liabilities shall have priority over all other liabilities of the bank**. Finally, S55(2) BOFIA clearly provides that in case of conflict with CAMA and particularly winding up of insolvent companies, the BOFIA provisions prevail.

There is no such resolution of conflict in ISA 2007, nor clear specific provisions, which is a loophole which should be cured for the purpose of achieving certainty of protection of account holders.

Moreover, despite all the ISA provisions earlier cited, it must be noted that without clear rules as to **time** of transfer of securities to an investor or from his account to buyer or another intermediary's account, the above rules of segregation will not be effective to protect account holders in the event of the intermediary's insolvency and prevent the commingling of investors assets with intermediary's assets which will be made available to general or other creditors for distribution. In other words, certainty on time of transfer of interests in securities is therefore crucial in determining whether applicable rules of priority is under ordinary or special law.

The various SEC rules related to custodian (R207A (1)), depositories and market participants (R26B (1) xiii, R207B (8)), securities clearing settlement (R207C (4)) all deal with the issue of securities transfer as **being subject to** effective funds transfer. This is otherwise known as the **delivery versus payment** rule. This means that Nigeria operates a non-matching system of transfer different from the simpler rule of matching credit with debit which allows for easy apportionment of loss.

Our comment in this regard is that whilst the present position on time when transfer is deemed valid is clear, it does not seem to us to be the ideal solution for our capital market intermediated system if the objective of the ISA and SEC regulations is to create a very conducive environment for foreign investors to deal in the capital market and help Nigerian Capital market access international capital market funds. It increases the credit risk taken by the investor-speculator and the risk of legal uncertainty for him to recoup his losses at little or no costs. It raises issues between the investor and the intermediary as the former may be robbed of his profit and further expose himself vis a vis third parties when he assumes that he has proprietary rights in securities and disposes of same or uses them as collateral for other transactions when in truth, he merely has a promise from the insolvent intermediary to carry out his instructions which may be caught up adversely with the delivery versus payment rule.

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<sup>14</sup> Under the NDIC Act 2006, the Corporation has a discretion to increase the said amount.

It will be recalled also that in analyzing the intermediated system and solving the problems of the respective rights of the account holders and intermediaries, note must be taken of the fact that Nigeria has a common law system approach to intermediated holding system as it grants its legal protection to account holders as a result of the account holder receiving a proprietary interest in the securities through a trust. Here again, a conflict arises stemming from the requirement of registration (certification) of securities<sup>15</sup> under CAMA for evidentiary purpose; only with registration is a legal right acquired. Further CAMA does not recognize the concept of trust in sharholding or membership of company. We therefore have to rely on the tortious rules of equity such as *equity regards as done that which ought to have been done* to create recognizable interest in intermediated securities.

For account holders dealing in a dematerialized environment, this is a fundamental loophole which must be addressed either by way of amendment of CAMA or more importantly and ideally the creation of a parallel statute on Uncertificated Securities which would deal with the peculiar issues of rights and obligations of account holders and intermediaries in an intermediated holding system characterized by dematerialization. Typically, in such a case, just as in the case of BOFIA, ISA etc, certain aspects of CAMA provisions would be modified, amended and or repealed by the new statute. This goes beyond SEC's subsidiary legislation as there is no general and proper framework for the intermediated holding system addressing specific legal issues pertaining to-

- a) certainty of the rights of the investor in the securities,
- b) sufficient protection of investor from the claims of an insolvent intermediary's general creditors,
- c) ability of investor to recover all of its intermediated securities in the event of loss of securities in circumstances where the intermediary is unable to disclaim responsibility for the loss,
- d) ability of investor to recover all of its intermediated securities in the event of shortfall in the pool of securities available to account holders, or
- e) restricting ability of intermediary to set-off its obligations owed to the issuer against the securities of investors in the event of the issuer's insolvency, etc..

These are issues that other participants of this seminar would have dealt with and they affect also the treatment of account holders in the event of insolvency of the intermediary. We shall now turn to examine the Draft Convention and see what we can gain from it.

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<sup>15</sup> Please see generally for instance ss. 79, 83, 84, 85, 91, 94 to 97, 146, 147, 151, 152, 156 etc of CAMA. As a result of the above requirements of the general law, our present traditional certificated system of securities and secured credit presents several challenges in terms the efficiency and speed required in today's modern transactions (**cumbersome formalities, prohibitive perfection costs, physical risks of loss, destruction or defacing of the securities which in turn result in delays and affect the legality of the lender's title and the protection of his interests in the event of insolvency of the borrower (debtor company), particularly in relation to rules of priority, fraudulent preference earlier mentioned.**

### **PART III: THE UNIDROIT FUNCTIONAL APPROACH TO THE ISSUE- A SUMMATION OF PRINCIPLES OF BEST INTERNATIONAL PRACTICE**

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The International Institute for the Unification of Private Law (UNIDROIT) Draft Convention on Substantive Rules regarding Intermediated Securities is the result not only of six years of international harmonization work towards the creation of a substantive framework for dealings in intermediated securities in international capital markets, and the influence of other parallel efforts from other European or national expert groups on the issue (the Giovanni Group, CESAME, FISCO, the UK Law Commission under the chairmanship of Professor Sir Roy Goode, and the Legal Certainty Group or LCG).

The Draft Convention deals on several occasions with issues touching on insolvency<sup>16</sup> and devotes its Chapter IV mainly on the integrity of the intermediated securities system and the incidence of insolvency of the intermediary in the system.

Article 7 establishes the general principle that the Convention –except expressly provided for- does not affect procedural or substantive insolvency laws. Having regard to my earlier comments, this means that it is crucial that the lacuna in Nigeria Insolvency laws be remedied through the enactment of an Insolvency Act.

Happily however, I am pleased to say that in the context of the Nigerian Capital Market much progress has been made by the Investments & Securities Act (ISA) 2007 and SEC in this regard, which efforts complement some specialized sectorial insolvency laws in sister industries essentially for the Banking and Insurance Sector<sup>17</sup>. The missing link is to subordinate CAMA provision to the uncertified securities regime of ISA 2007.

Other UNIDROIT provisions deal indirectly with insolvency issues and the rights of the investor or account holder by reference to ranking and priority of enforcement against third parties once intermediated securities have been transferred by the intermediary on behalf of the investor (please see combined reading of art. 11, 12, 14, 19 and 20) or by reference to the rule regarding an innocent acquirer (Article 18).

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<sup>16</sup> For example, Article 7 which expressly recognizes the supremacy of national procedural and substantive insolvency laws; Article 14 dealing with effectiveness of rights of investors acquired against third parties, creditors and insolvency administrator in any event of insolvency proceedings. Article 24 dealing with measures to prevent the insolvency of an intermediary by way of the statutory imposition of an obligation to hold available or sufficient securities for the benefit of its account holders an aggregate equal amount of securities as are being held on behalf of the account holders.

<sup>17</sup>For the Banking Sector, please see the combined reading of sections 7 & 33(1) of Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended) and the provisions of the Central Bank of Nigeria Act 2007, the Nigeria Deposit Insurance Corporation Act 1990 as amended b) for the Insurance Sector, Part V and VI of the Insurance Act 1997 (as amended).

But it is Section 21 which clearly establishes the guiding principle and protects the rights of account holders and interest takers from the insolvency administrator and creditors of an insolvent intermediary. It also gives precedence over domestic insolvency rules to system rules that adjudges a transfer or transfer order to have become irrevocable or which permit top-up or substitution of collateral prior to the commencement of insolvency.

*Article 21(1) states that-*

*“Rights and interests that have become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 6.”*

The economic sense of this provision having regard to the integrity of the intermediated securities system itself cannot be ignored: an intermediary's economic interests lie in the fees that the account holder pays it when the said investor pays or is paid monetary considerations with respect to the securities being dealt with. He is an intermediary, agent, facilitator or conduit. To therefore rank the investor with general creditors of the insolvent intermediary (i.e. enjoy the value of securities the intermediary holds in trust for its customers) will undermine the whole of the intermediated holding system. To permit an insolvent intermediary's general creditors to enjoy the value of the securities that it holds for its customers would be to provide the intermediary's creditors with a windfall at the expense of the investor and to distort the economic reality of the situation. There must therefore be existing legal rules as well as accounting rules that would adequately prevent the intermediary from stating that it owns the investors securities, and estopp creditors also from claiming that they relied on the value of those securities commingled with other assets of the intermediary when entering into a creditor/debtor relationship with the intermediary. This is the justification for SEC rules on accounts segregation. We can only call for rigorous enforcement on those rules as the Convention may not give a right in this regard greater than the provision of national laws.

The legal rationale of the provision is also undeniable. Just as the title of Chapter IV of the Draft Convention suggests, the preference given to protection of the investor **first** in the event of insolvency of the intermediary is crucial to the viability of an intermediated securities system and the investor's needs to replicate the certainty of rights and protection that he ordinarily enjoys if he was the holder of acquired certificated securities of the issuer company.

If not for the functional approach of the Draft Convention, the truth is that the views vary regarding the legal basis for offering account holders the same personal and proprietary

rights as a certificated investor or better still a secured creditor vis-à-vis certain dematerialized assets in the custody of the intermediary. In some civil law jurisdictions, the investor is considered as the direct legal owner of the underlying securities despite holding the securities through an account maintained by an intermediary (France, Italy Cote d'Ivoire and other Latin jurisdiction). In other legal systems (including the English common law system and our own present system), it is impossible to view the investor strictly speaking as a legal owner of those securities, especially when it is the intermediaries that are registered in the register of the issuer company as a stakeholder in the company. The investor will not have directly enforceable rights against the issuer.<sup>18</sup> The investor will have rights only against its own intermediary. Yet because of the economic and pragmatic sense of the problem, the Draft Convention functional approach seeks to provide the investor with the legal assurance/certainty it requires.

Nevertheless, the protection of an account holder's interest in securities from the claims of its intermediary's creditors may not always be a straightforward matter. For instance, the Draft Convention acknowledges some exceptions to the above rule. For instance, it expressly states that nothing in the Convention affects any rules of domestic law relating to the avoidance of transactions at a preference or a fraud of creditors, nor affect any rules of insolvency procedure relating to the enforcement of rights to property under the control or supervision of an insolvency administrator (Art. 21 (3)(a)& (b)). It follows that the remedy of avoidance of such transaction is usually available to an insolvency administrator. Insolvency administrators are known to use this power to avoid many transactions particularly where there is conflict of interest between directors of the issuer and the intermediary or investor. Under Nigeria law Ss495 and 499(1) of CAMA empower the insolvency administrator to avoid any transaction entered with by the company within two years of the insolvency.

Again, it may be unclear at **which point in time** this protection against creditors arises. Although the Draft Convention propounds a golden rule based on debit and credit, the truth is that time of transfer and attachment of relevant rights is determined differently depending on the jurisdictions<sup>19</sup>. For instance in common law jurisdictions, the protection given to the account holder arises as a result of the account holder receiving a proprietary interest in the securities (or interests in securities) through a trust, the question that usually follows and must be determined is exactly when this proprietary

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<sup>18</sup>The relationship between the intermediary and the investor is generally perceived in terms of a trust relationship and the legal title is vested in the intermediary. The view that it may also be viewed as a bailment where an investor will have legal title and therefore direct rights against the issuer (bearer securities) cannot hold as Intermediated securities are intangible assets that cannot be held through bailment.

<sup>19</sup> As we have seen, in Nigeria, the rule of the thumb is that transfer is effective upon **payment**. See R207C(4). Until then, the investor would only be entitled to rights in the securities he instructed his intermediary to acquire **only in his imagination** as it is a mere promise from his intermediary to credit the account.

interest passes to the account holder. In the absence of clear rules, an investor that instructs his intermediary to acquire securities may think that it has obtained property rights in those securities when in fact it still has only the benefit of a personal promise from the intermediary to credit its account. Article 21 therefore establishes the necessary basis for integrity of an intermediated system.

Further, the protection of an account holder's rights from an insolvent intermediary's creditors being at the core of the intermediary/account holder relationship, the Draft Convention further states in Article 25 (2) that securities allocated to an intermediary's account holders '*shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of creditors of the intermediary*'. This could be possible in various ways: for example, with the creation of escrow accounts distinct from intermediaries account with the intermediary not having power of access to same or through segregation of the assets of the intermediary and those of the investor (securities belonging to the investor in separate sub-accounts).

It is noteworthy in this area that Nigeria needs to address more specifically in its specialized statutory framework the risk involved with issues of priority for it to take full advantage of the benefits of the Convention bearing in mind the fact that there are major loopholes in our general or ordinary Corporate Insolvency Regime.

For instance, having regard to the rule of priority stated by Article 25(2) of the Draft Convention, under the direct holding system in place under the CAMA and the principle that rights accruing to shares follow registration of the investor shareholder and possession of the certificated securities, it appears to us that the securities allocated to the account holders would be at risk as legal title in those dematerialized and immobilized securities will be in the custodian as market participant dealing with the CSD and the issuer. There is therefore the need to amend the CAMA not only to incorporate provisions regarding intermediated securities but also to amend or supplement to its provisions on priority to include -in the case of intermediated securities and insolvent intermediaries- the uncertificated securities allocated to account holders. As it stands today, the general priority provisions under the general/ordinary law are not adequate in protecting the account holder in the event of insolvency of the intermediary where creditors of the intermediary seek to have access to the securities allocated to account holders as assets of the insolvent intermediary. If not changed, they afford an investor no less than the status of trade creditors who are obliged to queue up and await a pro rated distribution of remainder of assets realized in insolvency proceedings.

On the other hand, subject to our advice for adjustment and refinement of some of its provisions it may be said that the provisions of the ISA 2007 and SEC rules on segregation of assets by custodian have to some extent achieved "damage control" with respect to the acute inadequacies of our general statutory corporate insolvency regime. These specialized laws seem to deal with the issue at hand with their several provisions on segregation aimed at "ring-fencing" the securities of the investor in the intermediary's

custody and ensuring that assets of the intermediary are distinguished from assets of account holders.

Page | 15 Finally Article 26 (2) provides for rules on loss sharing or shortfalls in the event of the intermediary's insolvency as follows-

*If the aggregate number or amount of securities and intermediated securities of any description allocated under Article 25 to an account holder, a group of account holders or the intermediary's account holders generally (as the case may be) is less than the aggregate number or amount of securities of that description credited to the securities accounts of that account holder, that group of account holders or the intermediary's account holders generally, the shortfall shall be borne:*

*(a) where securities and intermediated securities have been allocated to a single account holder, by that account holder; and*

*(b) in any other case, by the account holders to whom the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.*

The interesting aspect of this provision stems from the fact that in the instant case, the question is not as to the treatment of the investor's assets but treatment of intermediary's assets in the event of the intermediary's insolvency.

A shortfall will arise where the number of securities allocated to account holders in the records of an intermediary is less than the requisite equivalent number of securities of the same description which is actually in the account. If this happens, then when an intermediary is insolvent or otherwise unable or not required, to discharge its obligation to make up the shortfall, the innocent account holders will bear the shortfall.

The treatment of shortfalls raises a policy issue of balancing the competing interests of the investor (ring-fencing/segregation of account), the intermediary and third parties such as the general creditors vis a vis the assets of the intermediary. Should the account holders be entitled to take priority over the intermediary's other creditors? Where an insolvent intermediary holds securities of the same description for its own account, in what circumstances, if at all, should a shortfall be taken **first** from the intermediary's own securities? Does it matter whether the intermediary's securities are in a separate account or whether or not the intermediary was at fault for the shortfall?

The UNIDROIT, consistent in its functional approach has adopted a simple mode of transfer of securities based on debit/credit entries, which makes it easier to ascertain time of transfer and makes for certainty unlike the test adopted by Nigeria presently which raises potential issues which threaten to throw back account holders in the category of mere trade creditors under the general law.

## CONCLUSION

Article 28 of the UNIDROIT draft clearly and rightly gives precedence to domestic law vis-à-vis the Convention, having regard to issues such as insolvency, the obligations of the intermediary, the account agreement or the uniform rules of a securities settlement system. This means that the Draft Convention anticipates that there shall be several substantive rules and laws in place in each contracting state with its distinct legal culture, and as well, there shall be a regulator responsible for maintaining the integrity of and confidence in the intermediated holding system.

As we have however seen, the fluid transfer mechanism for intermediated securities under ISA has not been tested against the provisions of CAMA which require registration and attendant legal consequences, particularly in the event of insolvency. There is yet no law reform to reconcile these laws. Also the issues have not been tested in contentious litigation. There are still several other substantive issues, loopholes and areas of conflict that need to be addressed ranging from the aforementioned harmonization of general/special corporate insolvency, cross-border insolvency, regulation of intermediation business in the capital market, creation of a proper parallel legal framework regarding dematerialized or uncertificated securities and resulting rules of priority in the event of insolvency not only of the intermediary but also of the issuer.

We salute the efforts of SEC under ISA 2007 in driving reform as much as it can to bring Nigeria up to speed. The recent introduction of Rule 98 on Electronic Offer and Transfer of Securities pursuant to S55 ISA 2007 as well as the instant workshop challenging all stakeholders to brainstorm on these issues is illustrative of this progressive trend. It is therefore expedient that the Commission should liaise principally with the Corporate Affairs Commission and other sister regulators to initiate the urgent reform required in this area to meet with modern challenges in a deteriorating but more and more integrated global economy. Top on the list should be to push for the enactment of,<sup>20</sup> adoption or ratification of other enactments or instruments, including in the near future, the adoption and domestication of the UNIDROIT harmonized substantive rules on intermediated securities as adapted to the Nigerian context.

Thank you for listening.

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<sup>20</sup> For instance, a Nigerian Insolvency Act, Uncertificated Securities Act, Electronic Business Act to name but a few.