AN OVERVIEW OF THE CBN FX CODE AND CIRCULAR ON THE ELECTRONIC FOREIGN EXCHANGE MATCHING SYSTEM



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Introduction

The Central Bank of Nigeria ("CBN") has consistently been expressing its policy drive to deepen the Nigerian autonomous foreign exchange market ("FX Market"), and to promote transparency and the efficient functioning of the FX Market. In this regard, the CBN released two circulars on 2nd October, 2024, announcing policy changes aimed at strengthening and providing guidance for participants in the FX Market. The CBN, through the circular titled "Nigeria Foreign Exchange Code Book: Draft Exposure" ("FX Code Circular") released a draft of the Nigeria Foreign Exchange Code (the "FX Code"). Although the FX Code is still indicated to be a draft, it appears the CBN has commenced its implementation. This is because the CBN has, in its subsequent guidelines regarding the operations of the FX Market, mandated participants in the FX Market to comply with the FX Code in conducting transactions in the FX Market. The FX Code seeks to enhance transparency, integrity ,and improve the efficiency of the wholesale FX market by setting clear guidelines for market participants to adopt.

In addition, the CBN issued a circular titled "Introduction of the Electronic Foreign Exchange Matching System ("EFEMS") in the Interbank Foreign Exchange Market" (the "EFEMS Circular") to introduce an electronic matching system, which will serve as the platform for conducting all FX transactions in the FX Market. This was followed by the release of Frequently Asked Questions ("FAQs") on 21st October, 2024 to provide clarity on the implementation of the EFEMS.

These initiatives come off the back of recent measures introduced by the CBN to enhance operations in the FX Market, including the unification of the various pre-existing FX windows in Nigeria into a single window, which is currently the FX Market for all official dealings in FX in Nigeria. Please refer to our publication on the unification circular in June, 2023 using this link for context.

This publication provides insights on the measures introduced by the CBN in the EFEMS Circular and the FX Code, their potential impact on FX Market activities, and the broader implications for the Nigerian economy.

Highlight of the EFEMS Circular

The EFEMS Circular introduced the EFEMS to align with the provision of Principle 43 of the FX Code relating to automated trade confirmation matching systems for market participants. The implementation of the EFEMS commenced on 1st December, 2024 following a two-week test run in November, 2024. Authorised dealers are required to conduct all FX transactions in the FX Market on the EFEMS, including trades with clients. This development is expected to reduce speculative activities and eliminate market distortions in the FX Market and enable the CBN to exercise regulatory oversight over and to effectively regulate the FX Market.

The EFEMS is meant to provide real-time pricing and visibility of buy/sell orders, reduce opacity in the FX Market and enhance market oversight, and allow for better regulation and monitoring of FX activities. Authorised dealers in the FX Market are required to transition from Refinitiv FXT (which was the operational FX trading platform in Nigeria) and use the EFEMS to place buy and sell orders in real-time. In that case, the system will automatically match corresponding orders based on predetermined operating rules. Refinitiv FXT and any other existing platforms may still serve as supplementary tools for conversational dealings.

Authorised dealers are mandated to comply with the Nigerian FX guidelines and regulations and ensure that relevant documentation, training, and systems integrations are in place for the implementation of the EFEMS.

Highlights of the FX Code

The FX Code aims to foster a robust, liquid, competitive, and transparent FX market for market participants, which are banks licensed by the CBN and operating within the wholesale FX market in Nigeria (including their personnel) ("Market Participants"). The FX Code is modelled after global best practices of the FX Global Code introduced in May 2017, which has been adopted in over 51 countries.

The FX Code is structured around six core principles covering ethics, governance, execution, information sharing, risk management and compliance, and confirmation and settlement processes. It sets clear expectations for Market Participants to operate in a professional and transparent manner, upholding the integrity of the FX Market.

Market Participants are required to conduct periodic self-assessments and submit quarterly compliance reports to the Financial Markets Department of the CBN within 14 days after the end of each calendar quarter, with the first report due by 31st December, 2024. Market Participants are also required to submit to the CBN a detailed compliance implementation plan approved by the board of such Market Participant by 31st December, 2024.

The key aspects of the core principles introduced by the FX Code are discussed below.

(a) Ethics

Under this leading principle, Market Participants are mandated to have internal mechanisms to ensure that both the Market Participants and their personnel conduct their respective affairs in an ethical, professional, and experienced manner that promotes fairness and integrity in the FX Market. The FX Code emphasises three sub-principles which, among other things, require Market Participants to strive towards maintaining the highest ethical standards in relation to their operations, dealing with clients, and with other Market Participants.

Market Participants are also required to strive for the highest degree of professionalism and standards of business conduct in the FX Market. The FX Code further highlights certain factors that underpin professionalism, which include having sufficient knowledge of applicable laws in the industry, possession of relevant experience and application of professional judgment among personnel.

In addition, Market Participants are also indulged to device internal mechanisms to identify and avoid conflicts of interest in relation to dealings with clients, activities involving other Market Participants, personal dealings, etc. This may be achieved by, among other things, the provision of relevant training for their personnel, segregation of duties and reporting lines, establishing clear declaration policies for potential conflicts of interest.

(b) Governance

The FX Code emphasises the need for Market Participants to implement sound and effective governance frameworks which promote responsible engagement in the FX Market and encourage compliance with the principles set out by the FX Code. The FX Code also acknowledges that these frameworks may vary depending on the size, stage and complexity of the Market Participant’s activities within the FX Market.

The underlying sub-principles for governance under the FX Code range from the implementation of business strategies and appropriate structures, which provide appropriate oversight, supervision and control of the activities of Market Participants in the FX Market to the implementation of appropriate checks and balances to ensure that the relevant personnel carry out their duties in line with best practices under the FX Code.

(c) Execution

Market Participants are required to exercise due diligence when executing transactions in the EFEMS to ensure fairness and transparency. Market Participants must also have clear policies on how client orders are handled and ensure that clients are informed about transaction terms and conditions. There are also specific provisions relating to the manner of discharging disclosure obligations and exercising duties, which include transaction risk management, for Market Participants acting in different capacities such as agents, interdealer brokers, or those operating e-trading platforms for FX.

Specifically, Principles 12, 13 and 14 contain provisions which prohibit Market Participants from engaging in unfair trade practices which are capable of hindering effective market functioning or compromising market integrity. Such unfair practices may include acts that are capable of resulting in artificial price movements, delayed transaction turnaround, the application of outrageous mark-up towards client transactions, etc.

(d) Information Sharing

This principle relates to the standards for clear and unambiguous communication of relevant information to intended recipients such as clients. It also covers the exercise of adequate discretion towards protecting confidential information which the FX Code defines to include FX trading information not already available in the public domain, and other categories of information designated by the relevant Market Participants to be confidential. Such confidentiality may be contained in formalised confidentiality or non-disclosure agreements between Market Participants and their clients, service providers, or with other participants within the FX Market.

(e) Risk Management and Compliance

Market Participants are required to establish appropriate risk management and compliance frameworks that help identify and prevent risks associated with their operations within the FX Market, as well as manage such risk exposures effectively. Market Participants are also required to carry out periodic independent reviews of their risk and compliance control measures to ensure that these are up to the required standards for their operations at every point in time. Some of the key risks identified in the FX Code for consideration by Market Participants include counterparty credit risks, which the FX Code recommends could be managed by the use of master netting agreements and other credit support agreements that can reduce exposure from counterparty party credit risks. Others include operational risks, legal and compliance risks, risks associated with technology, as well as market risks arising from changes in FX prices or rates, which could adversely impact Market Participants.

(f) Confirmation and Settlement

This principle dwells more on post-trade risk mitigation and settlement processing. Market Participants are encouraged to establish consistency between their operating practices, documentation, monitoring and management and transmission of trade data. It also underscores timeliness in account reconciliation and settlement of any likely discrepancies arising from transactions and encourages the use of Standing

Settlement Instructions (SSIs). SSIs are standardised instructions that provide pre-programmed information/procedure on how particular transactions should be settled between Market Participants.

Under Principle 43 of the FX Code, trade confirmations must be conducted promptly using secure and efficient automated trade confirmation matching systems where such systems are available. While the FX Code suggests that the use of such systems is optional, this principle seems to have informed the CBN’s decision to introduce the EFEMS. However, unlike the FX Code which offers flexibility in using automated systems, the implementation of EFEMS mandates its use for all FX transactions, making it a compulsory platform for trade confirmations.

The Implications of the New Measures Introduced

The primary objectives of the FX Code and the EFEMS are the introduction of necessary mechanisms for effective governance, professionalism, and transparency in the FX Market. These are to further address the underlying FX illiquidity issue and its impact on the larger Nigerian economy. The EFEMS will allow for real-time buy/sell order matching and FX price transmission by the CBN, aimed at improving market efficiency and reducing speculative activities.

By requiring Market Participants to incorporate efficient mechanisms for timely settlement and confirmation of orders (such as the use of SSIs and the live transmission of real-time transactions on the EFEMS), the possibility of price speculation and manipulation in the FX Market will be minimised. In addition, by eliminating the usual forms of market-disrupting activities, the CBN will effectively be able to ensure that the FX Market, although liberalised, is not subjected to untoward price manipulation and absence of integrity and transparency.

Conclusion

The measures introduced by the FX Code and the EFEMs Circular are aimed at fostering a robust, liquid, and transparent FX Market environment. This is to empower Market Participants, underpinned by resilient infrastructure, to engage in open, efficient and effective FX transactions in Nigeria. By promoting competitive pricing that accurately reflects available market information, the FX Code and the introduction of the EFEMS align with established global standards of best practices in FX dealings.

The effective implementation of the FX Code and the EFEMS, particularly the live transmission of prices and orders, would enhance market efficiency and transparency, allowing exchange rates to be more reflective of actual market forces. The adoption of SSIs for certain categories of transactions may also be an efficient way of ensuring that orders are processed timeously, with reduced exposure to market and operational risks. It is essential that Market Participants put in place measures for compliance, especially regarding governance structures, ethical practices, and risk management frameworks, to ensure a smooth transition into this new regime in the FX Market.

We hope that the implementation of the FX Code and the operations of the EFEMS will yield the desired results of the CBN to have an open, transparent, efficient and effective FX Market.

This publication has been provided by Joseph Eimunjeze, Itoro Uwemedimo Etim, and Fortune Ihator of the Banking & Finance team at Udo Udoma & Belo-Osagie. For more information about our Banking & Finance practice group offerings, please visit our website at www.uubo.org or email us at uubo@uubo.org.

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