

ARTICLE SERIES

**VIRTUAL ASSETS -
LEGAL AND PRACTICAL CONSIDERATIONS FOR
ISSUANCE OF STABLECOINS**



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INTRODUCTION

Cryptocurrencies have been gaining momentum in recent years, notwithstanding various concerns and critiques about the use-case of cryptocurrencies. Cryptocurrencies are digital or virtual currencies built on the Blockchain, secured by cryptography and typically designed to operate as a medium of exchange.

Cryptocurrencies had a bull run in 2021 with Bitcoin, the first cryptocurrency, rising from approximately USD7,000 in 2020 to an all-time high of approximately USD69,000 in 2021. However, by July 2022, the price of Bitcoin fell to as low as USD17,800. [1] Despite its volatility, or perhaps because of it, Cryptocurrencies have gained global attention.

The volatile nature of most cryptocurrencies brought to bear the need to create a cryptocurrency that possesses the core qualities of cryptocurrencies but has a level of stability that makes it a trustworthy asset. This category of cryptocurrencies is referred to as “Stablecoins.” Stablecoins are cryptocurrencies whose value is pegged to some other assets such as fiat currency or commodities. Thus, Stablecoins are designed to avoid the volatility inherent in other cryptocurrencies whose prices are entirely market-driven. Accordingly,

Stablecoins are similar to our traditional conception of money in comparison to other cryptocurrencies and have received more acceptance than other cryptocurrencies.[2] It has been noted that, in the presence of appropriate regulatory framework, Stablecoins would have the potential to play an important role in retail and cross-border payments.[3] Nevertheless, the regulatory and licensing requirement for the issuance of Stablecoins are quite knotty and require a lot of nuances based on the manner the Stablecoin in question operates.

GENERAL OVERVIEW OF STABLECOINS

As earlier highlighted, Stablecoins are cryptocurrencies pegged to some other assets which could be a fiat currency such as Naira or US Dollars, or could be a commodity such as gold. This stability is essential to the use-case of Stablecoins, and coins that lose their peg (i.e. that are unable to maintain parity with the commodity or currency to which they are pegged) often do not survive their depegging. [4]

Issuers of Stablecoins may achieve price stability by (a) using collaterals, (b) using algorithms, or (c) merging collaterals and algorithms.

[1] CoinMarketCap, “Bitcoin” available at <https://coinmarketcap.com/currencies/bitcoin/> accessed 4 July 2022.

[2] It was reported in June 2020 that, for the first time, there was more value in transactions using Stablecoins than in Bitcoin. This trend has continued over time. See <https://medium.com/akeo-tech/complete-guide-to-stablecoins-in-2020-1f37b7e11d9d>

[3] HM Treasury, “UK regulatory approach to cryptoassets and stablecoins: consultation and call for evidence” available at <https://www.gov.uk/government/consultations/uk-regulatory-approach-to-cryptoassets-and-stablecoins-consultation-and-call-for-evidence> accessed 19 July 2022.

[4] See for example UST.

Collaterals

Where the Issuer chooses to use collaterals, such collateral may be fiat currency, commodities, or other cryptocurrencies.

Fiat collateralized Stablecoins are wholly or partly backed by a government-issued fiat currency such as the Euro, Pound or US Dollar, often with a ratio of 1:1. A central entity, acting as an independent custodian, usually manages the process and ensures that the equivalent fiat currency is held in collateral for every token that is issued. [5]

Commodity-backed Stablecoin operates in a manner similar to fiat-collateralized coins. However, instead of being backed by fiat currency, this type uses other kinds of interchangeable assets and goods, such as gold, diamonds and valuable commodities, as collateral. [6]

For the final category, the value of crypto collateralized Stablecoins is backed by other cryptocurrencies, rather than by fiat or commodities -such Stablecoins are often overcollateralized to account for the volatility of the collaterals. [7]

[5] See for example USDT.

[6] See for example PAX Gold

[7] See for example DAI.

[8] A fixed redemption value means the Stablecoin has a fixed face value at which it is initially sold and the holder can redeem the Stablecoin on demand for that amount or, in the case of commodity-collateralized Stablecoins, possibly for the fiat equivalent of the face value. An example of this is USDT which has a face value of 1 USD and is redeemed for exactly 1 USD.

[9] A variable redemption value means the Stablecoin does not have a fixed redemption amount but instead entitles users to receive an allocable portion of the reserve assets at the time of redemption. Consequently, the amount redeemable will fluctuate based on the value of the amount in the reserves. This framework was adopted by Meta's Libra.

[10] See for example Ampleforth

The essence of using collaterals is that the Stablecoin can be redeemed/exchanged for the collateral held by the Issuer. The collaterals may be redeemable at a fixed value[8] or at a variable value. [9]

Algorithms

Where the Issuer chooses to use an algorithm, the Issuer may either use a rebase system or a seigniorage system. For Rebasing algorithmic Stablecoins, otherwise called single token model, the total supply of the Stablecoin is elastic and said supply is automatically adjusted to maintain the peg of the Stablecoin. For example, where the Stablecoin is trading below its peg, the algorithm automatically reduces the supply of the Stablecoin to drive up the price. Where the Stablecoin is trading above its peg, the algorithm automatically increases the supply of the Stablecoin to reduce the price. [10]

For Seigniorage algorithmic Stablecoins, otherwise called multiple token model, the Stablecoin is issued alongside at least one Sharecoin. Typically, when the price of the Stablecoin is trading below its peg, the Sharecoins are utilized to reduce the supply of the Stablecoins and when the price of the Stablecoin is trading above its peg, the Sharecoins are utilized to increase the supply of the Stablecoins.

For example, under the UST/LUNA framework, 1 UST can be exchanged for 1 Dollar worth of LUNA regardless of the actual trading value of UST and vice versa.

Consequently, where UST is trading for less than a Dollar, Investors/Users are incentivized to purchase UST and exchange it for LUNA (this increases demand for UST and drives up the price of UST, thereby allowing it regain its peg) and where UST is trading for above a dollar, Investors/Users are incentivized to purchase LUNA and exchange same for UST (this increases the supply of UST and drives down its price thereby allowing it regain its peg).

Merging collaterals and algorithms

As earlier stated, Issuers of Stablecoins may also merge collaterals and algorithms. This merger is referred to as fractional algorithmic Stablecoins which combine the features of fully-algorithmic and fully collateralized Stablecoins. These Stablecoins avoid over-collateralization and have fewer custodial risks. In contrast to solely algorithmic designs, it seeks to enforce a somewhat tight peg with a higher level of stability. [11]

While Nigeria, like most countries of the world, does not have a regulatory framework dealing with the issuance of Stablecoins, the way and manner a Stablecoin is issued and how it maintains its peg determines the regulatory requirements the Issuer will be required to meet under the existing Nigerian Legal Framework. It must however be emphasized that this is uncharted territory in Nigeria and there are several grey areas.

CBN'S STANCE ON CRYPTOCURRENCIES

In a letter dated February 5 2021, the Central Bank of Nigeria directed all deposit money banks, non-bank financial institutions and other financial institutions to identify and close the accounts of persons and/or entities transacting in or operating cryptocurrency within their systems.[12]

This letter was issued after previous CBN statements such as a Press Release dated February 28 2018 wherein CBN warned that virtual currencies are not legal tender in Nigeria; [13] and a circular dated January 12 2017 where CBN directed banks and other financial institutions to ensure that they do not use, hold, trade and/or transact in any way in virtual currencies pending substantive regulation or decision by the CBN.[14] Consequently, it is difficult to conceive a situation where an Issuer of Stablecoins can freely operate in Nigeria.

[11] See for Example Frax which is partly backed by collaterals and partly backed by seigniorage algorithm in the form of FXS.

[12] CBN, "LETTER TO ALL DEPOSIT MONEY BANKS, NON-BANK FINANCIAL INSTITUTIONS AND OTHER FINANCIAL INSTITUTIONS" available at <https://www.cbn.gov.ng/out/2021/ccd/letter%20on%20crypto.pdf> accessed 04 July 2022.

[13] CBN, "Virtual Currencies not Legal Tender in Nigeria - CBN" available at <https://www.cbn.gov.ng/Out/2018/CCD/Press%20Release%20on%20Virtual%20Currencies.pdf> accessed 04 July 2022.

[14] CBN, "CIRCULAR TO BANKS AND OTHER FINANCIAL INSTITUTIONS ON VIRTUAL CURRENCY OPERATIONS IN NIGERIA" available at <https://www.cbn.gov.ng/out/2017/fprd/aml%20january%202017%20circular%20to%20fis%20on%20virtual%20currency.pdf> accessed 04 July 2022.

However, the Securities and Exchange Commission (SEC) on 11th May 2022 published the Rules on Issuance, Offering and Custody of Digital Assets (“the Rules”).^[15] It is expected that persons registered under the rules would be exempt from the imposition contained in the earlier referenced CBN’s Letter. Specifically, Issuers of Stablecoin may register as a Virtual Asset Service Provider (“VASP”) under Part D of the Rules^[16] to enjoy this potential exemption.

SECURITIES LAW CONSIDERATIONS

The Rules require every Issuer conducting initial digital assets offering within Nigeria or targeting Nigerians to file an Initial Assessment Filing containing, amongst others, a legal opinion on whether or not the tokens to be sold through the initial digital asset offering are security. ^[17] Where SEC determines that the Stablecoin offering constitutes a Security, the Issuer will be required to register such Stablecoin unless it falls under one of the limited exceptions. ^[18]

While SEC has not given any indication on the test it will use in determining if the digital assets to be offered are securities, ^[19] SEC will likely adopt the Howey test which is applied by the United States Securities and Exchange Commission to make similar determinations. ^[20] Under the Howey test, an offering will constitute an investment contract and therefore a security where the following conditions are met:

- An investment of money;
- In a common enterprise; and
- In which profits would be expected and derived from the entrepreneurial and managerial effort of others.

While the purchase of a Stablecoin will meet the first requirement, the existence of the other two requirements depends on the nature of the Stablecoin and the way and manner it strives to maintain its peg. For example, it is conceivable that purchasing DAI will not be regarded as a common enterprise because each User/Investor determines whether they have deposited sufficient collateral and their fortunes are not directly tied to the activity of other Users/Investors or the Issuer.

^[15] SEC, “Rules on Issuance, Offering and Custody of Digital Assets” available at <https://sec.gov.ng/wp-content/uploads/2022/05/Rules-on-Issuance-Offering-and-Custody-of-Digital-Assets.pdf> accessed 04 July 2022.

^[16] Rule 1.1(c) Part D of the Rules provide that “these rules shall be read in conjunction with all relevant and applicable laws and the Rules and Regulations of the Commission and shall apply to issuers or sponsors of virtual/digital assets, including foreign or non-residential;” while Rule 3.0(v) Part D of the Rules provides that a VASP “means any entity who conducts one or more of the following activities or operations for or on behalf of another person: participation in and provision of financial services related to an issuer’s offer and/or sale of a virtual asset.” However, whether Issuers fall under the definition of VASPs as set forth above is arguable. However, the idea that the Rules apply to Issuers but Issuers are themselves not VASP leads to an absurdity.

^[17] Rule 4.0(iv) The Rules. It must be noted that digital asset is defined under the Rules to mean a digital token that represents assets such as a debt or equity claim on the issuer. Digital tokens can be contrasted with Virtual Assets defined under the Rules to mean a digital representation of value that can be transferred, digitally traded and can be used for payment or investment purposes. It shall not include digital representation of fiat currencies, securities and other financial assets.

^[18] Rule 5 of the Rules. The Issuer will be exempted from the requirement to register where the Stablecoins are offered exclusively through crowdfunding ports or intermediaries; where the offering is a judicial sale or sale by an executor, administrator or receiver in insolvency or bankruptcy; where the sale is by a pledged holder or mortgage, selling to liquidate a bona fide debt and not for the purpose of avoiding the provisions of the rules; and where the sale is an isolated transaction in which the Stablecoin is sold for the Owner’s account and such sale or offer for sale not being made in the course of repeated and successive transactions of like manner by such owner.

^[19] Note that the principal securities law in Nigeria, the Investment and Securities Act, defines Security as “(a) debentures, stocks or bonds issued or proposed to be issued by a government; (b) debentures, stocks, shares, bonds or notes issued or proposed to be issued by a body corporate; (c) any right or option in respect of any such debentures, stocks, shares, bonds or notes; or (d) commodities futures, contracts, options and other derivatives, and the term securities in this Act includes those securities in the category of the securities listed in (a) - (d) above which may be transferred by means of any electronic mode approved by the Commission and which may be deposited, kept or stored with any licensed depository or custodian company as provided under this Act”

^[20] SEC v W.J. Howey, Co., 328 U.S. 293 (1946)

Notwithstanding the above, most Stablecoins will meet the second requirement.

Most Stablecoins are purchased for their stability and not for any expectation of profit. [21] Nevertheless, depending on the nature/structure of the Stablecoin, Stablecoins may be purchased with the expectation of profit. For instance, Users/Investors may purchase a rebasing algorithmic Stablecoin with the hopes of staking the tokens for the high APYs offered by most rebase tokens.

Similarly, Users/Investors in a seigniorage algorithmic Stablecoin may purchase the Stablecoin with expectation of using it as a warrant to mint the Sharetokens or to trade between the multiple tokens. Collateral-backed Stablecoins may also be bought (a) at a discount; (b) with the hopes of selling at a premium; or (c) with expectation of redeeming it when the collateral appreciates in value, particularly where the Stablecoin is redeemable at a Variable Redemption Value. [22]

Investors/Users in any Stablecoin may also cause arbitrage based on the slight fluctuations of Stablecoins or purchase Stablecoins with the expectation of staking them for returns. Notwithstanding the above, even where profit is made, the issuance will not be treated as a security transaction when, generally speaking, purchasers are

motivated by a desire to use or consume the Stablecoin rather than as an investment vehicle with an expectation of profit.

It must be emphasized that an Investor merely purchasing a Stablecoin with the expectation of profit will not render the transaction a Security transaction requiring registration unless the profits is expected from the activities of the Issuer or some other third party. For example, profits from increased market cap of a rebasing algorithmic Stablecoin would likely be from the activities of the Issuer in manipulating supply and profits in Seigniorage algorithmic Stablecoins will likely be from the activities of the Issuer in making decisions about the supply/value of the various tokens in the Stablecoin ecosystem.

However, where profit made/expected is incidental to the use of the Stablecoin for functionality or not based on the managerial/entrepreneurial effort of the Issuer, it is highly unlikely that such issuance will be treated as a Securities Transaction.

[21] Indeed, the point of Stablecoins is to maintain their pegs.

[22] See footnote 9

LICENSE CONSIDERATIONS

Irrespective of the security status analysis, a fixed-redemption fiat-collateralized Stablecoin would very likely be regarded as receipt of deposit. This is because the Issuer receives value[23] from the Investor/User and, in turn, gives the Investor/User of the Stablecoins the assurance that such Stablecoins can be redeemed for a specific amount of money.

This classification implies that the Issuer of such stable coins would likely be subject to the provision of BOFIA and must consequently be incorporated in Nigeria and obtain a banking license from the CBN. [24] A non-bank Issuer looking to issue such Stablecoins would likely have to treat the investment from Users/Investors as credit and deal with the same as a Capital Market Agent such as a Broker, Fund Manager etc.

Similarly, irrespective of the security status analysis of the Stablecoin itself, the Sharecoin in a Seigniorage algorithmic Stablecoin may be treated as a participatory interest in a collective investment scheme. [25] Such classification will trigger registration requirements with the SEC.

[23] Via fiat currency, cryptocurrency, commodity, etc

[24] Banking business is defined in Section 131 of the Banks and Other Financial Institution Act 2020 ("BOFIA") to mean the business of receiving deposits on current account, saving deposit account or other similar account, paying or collecting cheques, drawn by or paid in by customers; provision of finance consultancy and advisory services relating to corporate and investment matters, making or managing investments on behalf of any person whether such businesses are conducted digitally, virtually or electronically only or such other business as the Governor may, by Order published in the Gazette, designate as banking business. Pursuant to Section 2(1) of BOFIA, no person shall carry on any banking business in Nigeria except it is a company duly incorporated in Nigeria and holds a valid banking license issued under BOFIA.

[25] Section 153 Investment and Securities Act defines a collective investment scheme to mean a scheme in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which (a) two or more investors contribute money or other assets to hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; (b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed, but not a collective investment scheme authorized by any other Act,

[26] Section 22(5) Companies and Allied Matters Act 2020. See also Section 67(1) Investments and Securities Act 2007.

[27] CBN, "REGULATORY GUIDELINES ON THE eNAIRA" available at

<https://www.cbn.gov.ng/Out/2021/FPRD/eNairaCircularAndGuidelines%20FINAL.pdf#:~:text=The%20eNaira%20is%20the%20digital%20form%20of%20the,par%20with%20the%20physical%20Naira%20%28that%20is%201%3A1%29.> Accessed 4 July 2022

COMPANY TYPE CONSIDERATIONS

Private companies are prohibited from acting as Issuers of Stablecoins in Nigeria. This is because private companies are generally prohibited from inviting the public to subscribe for their securities and/or deposit money for fixed periods or payable at call. [26]

Consequently, regardless of the classification as a Security, Digital Asset, Virtual Asset or not, private companies cannot issue Stablecoins. Stablecoins are typically issued by Public Companies while most State Bodies would rather issue Central Bank Digital Currency, as was done by the Central Bank of Nigeria when it issued the e-naira in 2021. [27]

PRACTICAL REQUIREMENTS

In addition to the regulatory requirements set out above, there are various practical requirements that a prospective Issuer of Stablecoins must comply with and some of these requirements are incidental to meeting regulatory obligations.

The Issuer must publish a whitepaper alongside its tokenomics and roadmap,[28] the Issuer must also provide its Coin name, proposed ticket symbol, github link tokenomics and roadmap, provide general information such as Coin name and proposed ticket symbol, Github Link and the team behind the token.

The Issuer must also meet prudential requirements such as risk management framework, business continuity plans, security arrangements as well as orderly failure and insolvency plans.

In essence, a prospective Issuer would have to meet the listing requirements of major cryptocurrency exchange platforms in order to receive acceptance and adoptions. These requirements vary across exchange platforms and are regulated updated.

[28] The above would be scrutinize by potential investors and Exchange platforms.

CONCLUSIONS

All prospective Issuers of Stablecoins in Nigeria or targeting Nigeria are, on a preliminary note, required to register as a VASP in Nigeria and file an initial assessment filing and possibly required to register the proposed Stablecoins with the SEC.

Where the Stablecoin is backed mostly by Naira-denominated instruments and partly by other means, it is likely that the Issuer will be required to obtain a banking license and possibly register with the SEC where, for example, it is a fractional algorithmic Stablecoin.

It must be emphasized that final thoughts cannot be communicated in the absence of a draft/proposed whitepaper and even in the presence of same, there will likely be need to seek various clarifications from the Regulators.

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