CRYPTOCURRENCY TRADING AND INSOLVENCY REGULATION IN NIGERIA

Key Contacts

Chinedu Anaje, FCIArb
Partner
chinedu.anaje@ao2law.com

Oluwasijibomi Alafe
Senior Associate
oluwasijibomi.alafe@ao2law.com

Chinemeze Eze
Associate
chinemeze.eze@ao2law.com

Imekan Essien
Associate
imekan.essien@ao2law.com

Introduction

Cryptocurrencies and the underlying blockchain technology are becoming a pervasive force in the global economy, affecting everything from cross-border retail payments to interbank transfers. The growing adoption and decentralized nature of cryptocurrencies pose unique and unprecedented challenges for financial authorities, capital markets regulators, consumer protection and privacy bureaus, and tax authorities around the world. However, cryptocurrencies also bring opportunities in terms of leveraging the internet to provide new digital pathways for individuals and micro-, small and medium-sized enterprises (MSMEs) into the global financial system.

Since the creation of bitcoin by "Satoshi Nakamoto" in 2009, the number of cryptocurrencies has exponentially increased to over five thousand. This is in spite of the cold reception from regulators in many jurisdictions including Nigeria. Since 2020, Nigeria has generated over US$400 million worth of crypto-transactions, ranking third globally in terms of volume of crypto-currency trade. A potential implication of this trend is the possibility of insolvency proceedings involving crypto-currencies or crypto-assets. The peculiar characteristics of crypto assets are likely to pose unique challenges in such proceedings. This article examines some of these potential challenges, drawing lessons from some common law jurisdictions and also steps that can be taken to resolve the underlying issues.

Cryptocurrency Basics

In simple terms, cryptocurrency is any form of currency that only exists digitally, usually has no central issuing or regulating authority but instead uses a decentralized system to record transactions and manage the issuance of new units. It relies on cryptography (computerized encoding and decoding of information) to prevent counterfeiting and fraudulent transactions.[1]

[1] https://www.merriam-webster.com/dictionary/cryptocurrency

Furthermore, a cryptocurrency[2] is a digital non-governmental asset based on a combination of cryptographic algorithms, whose existence and transfer are confirmed and recorded on a ledger that is distributed across a network of independent computers ("validators"). Before the existence or transfer of a cryptocurrency can be recorded on the ledger, the network's validators must reach agreement according to the network's consensus protocol. The decentralized architecture of the validator network is designed to create trust in the absence of a centralized authority, like a government or other central entity. In a decentralized network, multiple entities operate independently under a network-wide shared governance framework, eliminating the single point of failure or control. Cryptocurrencies constitute their own unit of account, although, in most cases, the price to acquire a unit is usually quoted in government based fiat currency. Additionally, most cryptocurrency projects allow for the issuance of account addresses and the transfer of the currency between sender and recipient, without a centralized party and without the need for personal identification typically required by such parties[3].

There are two types of cryptocurrencies: (1) traditional cryptocurrencies, which are created by a standalone blockchain such as BTC (Bitcoin) and ETH (Ethereum); and (2) cryptocurrencies that are digital representations of other assets such as those backed by fiat currency (sometimes referred to as stablecoins) such as USD Coin (USDC) issued by Circle[4].

[2] https://www.europarl.europa.eu/cmsdata/150761/TAX3%20Study%20on%20cryptocurrencies%20and%20blockchain.pdf

[3] Identity documentation may still be required to fight against illicit activity. However, it is not required for the technical transfer of cryptocurrency.

[4] The federal government has said that Nigerian banks and other fintech companies are set to launch the cNGN stablecoin on February 27, 2024. The stablecoin backed by the Central Bank of Nigeria (CBN) will be pegged 1:1 to the highly unstable naira. https://www.forbes.com/sites/digital-assets/2024/01/08/central-bank-of-nigeria-approves-naira-stablecoin-for-2024-launch/

There are currently thousands of different cryptocurrency projects and networks, many with distinct design, architectures and features. While most cryptocurrency projects rely on a distributed ledger system, there are two primary types of "access" permission:

1) permissionless, where networks are open and any entity can participate in terms of sending transactions, reading the history (ledger) of transactions, or participating in transaction verification; or
2) permissioned, where participation in these activities is limited by a governance framework that restricts participation.

Who are the players involved in the Cryptocurrency market?

The cryptocurrency market is a new playing field where different actors each play a particular role. To shed some more light on how the market works, and without attempting to be exhaustive, we will hereinafter further identify the key players[5].

a. **Cryptocurrency users:** A cryptocurrency user is a natural person or legal entity who obtains coins to use them (i) to purchase real or virtual goods or services (from a set of specific merchants), (ii) to make Peer to Peer (P2P) payments, or (iii) to hold them for investment purposes (i.e. in a speculative manner).

b. **Miners:** A Miner participates in validating transactions on the blockchain by solving a "cryptographic puzzle".
c. **Cryptocurrency exchange:** Cryptocurrency exchanges are persons or entities who offer exchange services to cryptocurrency users, usually

[5] http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf

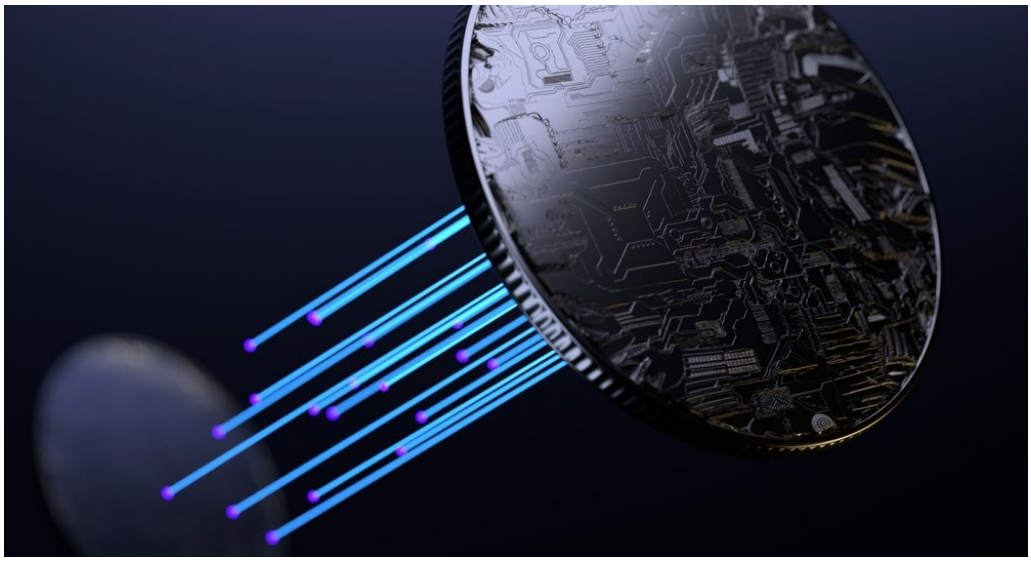
against payment of a certain fee (i.e. a commission). They allow cryptocurrency users to sell their coins for fiat currency (example Naira, Pounds, US Dollars etc.), or buy new coins with fiat currency.

d. **Trading Platforms:** Trading platforms are marketplaces that bring together different cryptocurrency users that are either looking to buy or sell coins, providing them with a platform on which they can directly trade with each other (E.g. Binance, Gemini or Cryptomat)
e. **Wallet providers:** Wallet providers are those entities that provide cryptocurrency users digital wallets or e-wallets which are used for holding, storing, and transferring coins.
f. **Coin Inventors:** Coin inventors are individuals or organizations who have developed the technical foundations of a cryptocurrency and set the initial rules for its use. In some cases their identity is known (e.g. Ripple, Litecoin, Cardano), but ever so often they remain unidentified (e.g. Bitcoin, Monero).
g. **Coin Offerors:** Coin offerors are individuals or organizations that offer coins to cryptocurrency users upon the coin's initial release, either against payment (i.e. through a crowdsale) or at no charge (i.e. in the framework of a specific (sign-up) program (e.g. Stellar – see below)), normally to fund the coin's further development or boost its initial popularity.

A brief history of Nigeria's stance on Cryptocurrencies

On 5th February, 2021, the Central Bank of Nigeria (CBN) directed banks to close accounts of persons or entities involved in cryptocurrency transactions within their systems. On 9th February, 2021, the CBN launched investigation into financial institutions offering services to cryptocurrency traders. On 11th February, 2021, the Senate of the Federal Republic of Nigeria, invited the CBN, the Nigerian Securities and Exchange Commission ("SEC"), to discuss opportunities and threats of cryptocurrencies on Nigeria's economy and security. On 18th February 2021, the International Monetary Fund said cryptocurrencies may be used for illegal activities. On 22nd February, 2021, the SEC said that there was a need to regulate cryptocurrencies usage and operations in Nigeria . On 26th February, 2021, the then Vice-President of Nigeria, Prof. Yemi Osinbajo called for a regulatory framework for cryptocurrencies rather than an outright ban. March 21st, 2021 saw the CBN clarify its position on the ban and states that individuals are not prohibited from buying and trading crypto, however, just not through any Nigerian bank or fintech. By 15th April, 2021, SEC stated that discussions were ongoing with the CBN over the regulation of cryptocurrencies. On 26th April, 2021, the Economic and Financial Crimes Commission ("EFCC") warned Nigerians to be cautious before investing in Bitcoin. On 22nd July, 2021, the CBN announced its plans to launch the e-Naira, a Central Bank Digital Currency (CBDC)- which is quite different from Bitcoin and other cryptocurrencies. 25th October, 2021 saw Nigeria become first African nation to launch a digital

currency; the e-Naira. 7th April, 2022, witnessed the CBN hit six banks with a N1.3 billion fine over alleged non-compliance with its regulation on account of "crypto" traders.



Furthermore, on 11 May 2022, the SEC approved the New Rules on Issuance, Offering Platforms and Custody of Digital Assets (the "Digital Asset Rules") to regulate digital assets and virtual asset service providers[6]. The Digital Asset Rules contain rules on the issuance of digital assets as securities, registration requirements for digital asset offering platforms (DAOPs), registration requirements for digital asset custodians (DACs) and operation as virtual assets service providers (VASPs) and digital asset exchanges (DAX). By virtue of the Digital Asset Rules, the SEC fully recognised virtual cryptoassets as securities that fall within its regulatory purview.

In addition to the SECs Digital Asset Rules, the CBN in December 2023 also issued a circular on Guidelines on Bank Accounts for Virtual Asset Providers and has lifted the ban hitherto placed on banks and other financial institutions from operating accounts for virtual/digital service providers.

Key Takeaways from the CBN's Guidelines:

Licensing: VASPs must obtain a prior license from (SEC) to get a service license from the CBN and adhere to all relevant regulations.

AML/CFT Controls: The regulation re-enforces the implementation of robust Anti-Money Laundering and Combating the Financing of Terrorism controls.

Customer Due Diligence (CDD): The identity verification process ensures the maintenance of adequate Customer Due Diligence procedures.

Reporting: VASPs are obligated to report suspicious transactions to the CBN.

[6] https://sec.gov.ng/wp-content/uploads/2022/05/Rules-on-Issuance-Offering-and-Custody-of-Digital-Assets.pdf

Consumer protections measure: Financial institutions shall ensure that appropriate consumer protection systems against risks of fraud are established.

Cooperation: VASPs are required to collaborate with the CBN in its investigations.

The CBN's guidelines represent a positive step forward for the Nigerian virtual asset ecosystem, providing the much-needed clarity and guidance. This will foster responsible innovation and growth in the sector.

Treatment of Crypto-Assets in Insolvency

At the international level, given the cross-border nature of cryptocurrency networks, a key question is who should oversee the markets for cryptocurrencies and financial market infrastructure (FMI) that interact with crypto-assets[7] in payment, settlement and other activities. These potential ecosystem risks lead to fragmentation of solutions and inconsistencies in interpretive guidance that may eventually hurt consumers and investors in the long term. Already, certain cryptocurrency market intermediaries have suffered disruptions with some frequency, most notably the bankruptcy of notable exchange platforms (e.g. Mt. Gox)[8]. And, as the Federal Trade Commission (FTC) in the United States reported in May 2021, **"Since October 2020, reports [of cryptocurrency theft] have [increased], with nearly 7,000 people reporting losses of more than $80 million".**[9]

We will examine peculiar characteristics of crypto assets which are likely to pose unique challenges in insolvency proceedings and possible solutions:

i. Cross-border and Jurisdictional Issues:

Crypto-transactions usually involve parties in different countries or jurisdictions. For example, as of 2013, insolvent Japanese crypto-currency exchange, Mt Gox Co. Ltd, had nearly 1.1 million active accounts from 239 countries[10]. The transnational nature of crypto-transactions may give rise to complex issues in insolvency. Determining the jurisdiction where crypto-assets are based may be problematic considering the virtual nature of crypto-assets. It has been mooted that crypto-currencies are located in the jurisdiction of the crypto-currency exchange hosting the crypto-currencies. Where an exchange's server is based in a different jurisdiction from the exchange, it has been suggested that the crypto-currencies are located in the server's jurisdiction. A shortcoming of these propositions is that they are premised on the flawed

[7] "Crypto-assets" and "cryptocurrencies" are used interchangeably in this Article.
[8] Frankenfield, Jake, Mt. Gox, Investopedia, 26 March 2021 (link as of 4/8/21).
[9] Consumer Protection Data Spotlight, Federal Trade Commission, May 2021 (link as of 4/8/21).
[10] https://www.investopedia.com/terms/m/mt-gox.asp

assumption that crypto-currencies have physical form(s) identifiable to a particular crypto-currency exchange or server.

Officeholders of insolvent crypto-investors may have to seek the assistance of courts in jurisdictions where crypto-currency exchanges are located to prevent crypto-assets from being dissipated or put out of reach. This is imperative considering that the insolvency provisions in the Companies and Allied Matters Act, 2020 (as amended) "CAMA" do not have extra-territorial effect.

In **Ruscoe & Moore v Cryptopia Ltd [2020] NZHC 728**[11], insolvency proceedings for Cryptopia (a crypto-currency exchange) were commenced in New Zealand. Crytopia's data was stored in servers in a US-based web services company. The US based company demanded for US$2million before granting access to data in its servers, which were required to determine owners of millions of crypto-currency tokens held by Cryptopia. Cryptopia's liquidators had to file an insolvency petition in the US for recognition of the New Zealand liquidation, so as to apply for interim relief to preserve Cryptopia's data in the US-based server.

ii. The Property Question:

Crypto-currencies are stored in digital wallets which are hosted in online crypto-currency exchanges such as Buycoins, Bundle, Luno, Quidax, Binance, Xend etc. These exchanges enable storage, purchase and transfer of crypto-currencies. Each unit of crypto-currency has a public-key and private-key. The public-key is similar to a username whilst the private-key is a unique string of alphanumeric required in accessing a user's wallet[12].

A significant issue which courts have had to address in insolvencies relating to cryptoassets is whether or not crypto-assets constitute property. The categorisation of cryptoassets will influence how they are treated in insolvencies. Where crypto-assets are categorised as property, crypto-investors would have proprietary rights in crypto-assets in an exchange's insolvency, as opposed to mere personal rights against the cryptocurrency exchange. Such categorization would also enable crypto-assets to be held on trust and for security to be created over crypto-assets. Furthermore, in the event of an exchange's insolvency, crypto-currencies would not be available for distribution to the exchange's general body of creditors. Rather, crypto-investors will be entitled to a refund of their crypto-currencies or an equivalent value.

Common law traditionally categorises property into real and personal property. Personal property may either be tangible i.e. choses in possession

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[11] https://www.nortonrosefulbright.com/en/knowledge/publications/d6ea37bd/cryptocurrencies-are-property-capable-of-being-held-on-trust-new-zealand-high-court-holds

[12] https://issuu.com/thisdaylive/docs/tdla-0601

or intangible i.e. choses in action. Crypto-currencies are not tangibles because they have no physical form and cannot be possessed. There is difficulty in categorizing crypto-currencies as intangibles considering that they do not embody any right capable of being enforced by action. Regardless of the foregoing, a number of courts in common law jurisdictions have recognized crypto-asset as a specie of intangible personnel property.

In a similar vein, in **Ruscoe & Moore v Cryptopia Ltd [supra]**, a New Zealand Court held that crypto assets are "property" within the definition in section 2 of the New Zealand Companies Act 1993 and more generally, under common law[13]. Gendall J. stated that crypto-currencies met Lord Wilberforce's indicia for property laid down in **National Provincial Bank Ltd v Ainsworth**[14] and that his conclusion accorded with UKJT's [15]position that crypto-assets possess all the characteristics of property and that their intangibility ought not to disqualify them. Gendall J. also held that the $170million worth of crypto-currencies held by Cryptopia were held in trust for account-holders of Cryptopia and were not the property of Cryptopia.

It is apposite to note that while CAMA does not define property, the above decisions from other common law jurisdictions have persuasive effect on Nigerian Courts. Save for those hinged on specific foreign statutes, they may serve as useful guides in Nigeria. The **Bankruptcy Act**[16] defines property to include "money, goods, things in action, transferable interests and every description of property. whether real or personal and whether situate in

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13 https://www.nortonrosefulbright.com/en/knowledge/publications/d6ea37bd/cryptocurrencies-are-property-capable-of-being-held-on-trust-new-zealand-high-court-holds

14 [1965] 1 AC 1175 at 1247–1248

15 UK Jurisdiction Task Force, Legal statement on cryptoassets and smart contracts, The Law Tech Delivery Panel (November 2019).

16 Cap B2. Laws of the Federation of Nigeria 2004

Nigeria or elsewhere, also obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, arising out of or incidental to property as above defined". This definition is similar to the definition of property under Section 2 of Canada's Bankruptcy and Insolvency Act[17]. It is thus arguable that it is capable of accommodating crypto-assets in the context of personal bankruptcy.

iii. The Pseudonymity barrier:

The pseudonymous and borderless nature of cryptocurrency systems and the fact that virtually anyone can create a new cryptocurrency and send it to other addresses raises potential financial integrity risks. Presently, there are no (public) registers of ownership of crypto-assets. Accordingly, an officeholder may have an uphill task ascertaining whether an insolvent entity has crypto-assets and (if it does) the exchange(s) where those crypto-assets are hosted. Even where crypto-assets and the relevant exchange(s) have been identified, an officeholder may face the challenge of ascertaining the insolvent entity's private-key to facilitate access to and control of the crypto-assets. While pseudonymity hides personally identifiable information, the strings of data representing holders' public key addresses can, with significant effort, be linked back to identifiers, thereby compromising the identity of users and their privacy.

In Quadriga Fintech Solutions Corporation's case, crypto-currencies of 115,0000 clients of crypto-exchange Quadriga CX valued at US$196 million were inaccessible. This followed the demise of Quadriga's chief executive, Gerald Cotton, who was the only person with the passkey to the off-line cold wallets holding the crypto-currencies[18].

An officeholder may have to seek for the assistance or cooperation of the insolvent's officials to make disclosures regarding crypto-assets. An officeholder may also consider searching the insolvent's books, records, bank statements, mobile applications, emails, and internet browsing history for evidence or hints of crypto-transactions and private keys. Where the insolvent's or exchange's officials are uncooperative, the officeholder may seek court orders to compel disclosure, restrain transfer of crypto-assets or a turnover of private key information.

iv. Preservation and Valuation:

After assuming control of crypto-assets via private-keys, an officeholder may have to explore ways of protecting and preserving the crypto-assets. In this regard, the officeholder may consider holding the cryptoassets in a cold storage pending their sale. A cold storage is an offline wallet for storing

[17] https://laws-lois.justice.gc.ca/eng/acts/b-3/page-1.html#h-24360
[18] https://ag-pssg-sharedservices-ex.objectstore.gov.bc.ca/ag-pssg-cc-exh-prod-bkt-ex/266%20-%20EY%20-%20Fifth%20Monitor%20Report.pdf

cryptocurrencies. This protects the cryptoassets from cyber-hacks, unauthorized access and other internet-related risks.

A notable characteristic of cryptocurrencies is their price volatility. This may form an additional layer of complexity in a valuation process. For crypto-investors, depending on the circumstances, price fluctuations may be beneficial or detrimental to their commercial interests.

Where the value of cryptocurrency is not fixed/determined on the date of the commencement of the formal insolvency proceedings, a plummet in price could result in losses. In contrast, crypto-investors could reap a windfall if prices skyrocket. In Mt Gox's case, bitcoin was priced at about $500 at the time of its insolvency filing. Four years later, when some of the sales of the insolvency estate's bitcoins were carried out, they were done at an average price of about $8,000. An officeholder may optimise returns to crypto-investors by strategically refraining from selling when prices tank, and selling when prices soar.

Conclusion:

Nigeria's restrictive approach implies imposing more broad restrictive measures that affect the cryptocurrency market generally. This may be based on a more conservative or precautionary view and/or may derive from a specific market experience or event. However, adopting definitive legislation at this early stage and in a broader manner may be premature and affect innovation which could be of interest of the nation States. The main takeaway is revealed in the fact that regulation of cryptocurrencies is an evolving and global challenge, which is primarily being dealt with on a country level but is also of importance to international bodies and regulators. While we hope that the CBN Guideline will restore the much-needed confidence and respite amongst stakeholders in the virtual/digital assets ecosystem and unlock fresh local and foreign investments in decentralized ledger technology in Nigeria, we envisage that this and further regulation of the cryptocurrency market will aid insolvency regulation in the country.

Please do not treat the foregoing as legal advice as it only represents the public commentary views of the authors. All enquiries on this Brief should please be directed to

insolvency@ao2law.com or litigationteam@ao2law.com