The New Player in Town: Pension Fund Administrators as Institutional Investors in Nigerian Securities Lending Market

Introduction

The Pension Reform Act, 2014 ("**PRA**") and the Regulation on Investment of Pension Fund Assets 2019 ("**Regulation**") stipulate the mode for investing pension fund assets. While pension fund administrators ("**PFAs**") are responsible for the management of pension funds and assets[1], pension fund custodians ("**PFCs**") hold pension funds and assets in safe custody and on trust[2].

Prior to February 14, 2023, neither the PRA nor the Regulation permitted PFAs to invest in securities lending transactions. The permitted investments were largely bonds, sukuk, treasury bills, ordinary shares of public companies, asset-backed securities, specialist investment funds registered with the SEC, and global depositary receipts. Post February 14, 2023, the Business Facilitation (Miscellaneous Provisions) Act, 2022 (the "**Business Facilitation Act**") has now amended Section 89 of the PRA. The amendments permit the (a) use of pension assets for securities lending and (b) application of a percent of pension assets for the purpose of securities lending, subject to guidelines issued by the National Pension Commission ("**PENCOM**"). Thus, the current position of the law is that pension assets can now be applied in securities lending transactions.

This article considers the regulatory framework governing securities lending in Nigeria, the prospects of securities lending by PFAs, and the tax implications of utilizing pension assets for securities lending. The new changes are welcome as far as they go, but there is still some work to be done regarding making new rules.

The Legal Framework for Securities Lending in Nigeria

Securities "lending" is actively transferring the possession or title to securities with a power in the transferor to buy back equivalent securities rather than through "lending". It involves selling a financial instrument to a buyer (in this context called the borrower). The borrower will provide collateral which can be in the form of cash, bonds, shares, or letters of credit.[3] As of December 2021, more than $36.2 trillion of assets were available for securities lending globally, with over $2.5 trillion on loan on an average day.[4]

The value of the collateral is higher than the value of the securities lent. In a securities lending transaction, the lender gets collateral and is paid a fee for facilitating the transaction while the borrower agrees to return the securities to the lender either on-demand or at the end of the agreed loan term.[5] Such securities to be returned by the borrower will be the equivalent number of securities of the same type and class borrowed within the time specified in the agreement along with the income and capital proceeds which may have accrued on them during the period of borrowing.[6]

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[1] Sections 54 and 55, the Pension Reform Act 2014.

[2] Sections 56 and 57, the Pension Reform Act 2014.

[3] Corporate Finance Institute Team, 'Securities Lending' (11 January 2023). "https://corporatefinanceinstitute.com/resources/equities/securities-lending/" accessed April 28, 2023.

[4] iShares by BlackRock, 'Securities Lending' https://www.ishares.com/uk/professional/en/education/securities-lending?switchLocale=y&siteEntryPassthrough=true#what-is-security-lending last accessed October 30, 2023.

[5] Nigerian Exchange, 'Securities Lending' "https://ngxgroup.com/exchange/trade/equities/securities-lending-shortselling/ " accessed May 8, 2023.

[6] Rule 389 (10) of the Securities Exchange Commission Rules 2013.

Securities lending enables dynamic trading activities, thus improving liquidity in the capital markets, which in turn reduces the cost of trading and promotes price discovery and transparency. [7] In Nigeria, securities lending is primarily regulated under the Investment and Securities Act 2007 (as amended) (the **"ISA"**) and the Securities Exchange Commission Rules, 2013 (as amended) (Part G3 - Securities Lending and Borrowing) ("**SEC Rules**"). Also, the Nigerian Exchange Limited[8] ("**NGX**") recognizes the Global Master Securities Lending Agreement ("**GMSLA**") as the market standard agreement for securities lending transactions on its platform.[9] While parties to a securities lending transaction are allowed to define the terms of their agreement to suit the circumstance of their transaction, it is strongly recommended that parties adopt the provisions of the GMSLA which embodies international best practice for securities lending. [10]

Under the SEC Rules, the securities lender is not allowed to enter directly into an agreement with the borrower for the lending and borrowing of securities. The lender is required to enter into an agreement with a lending agent for the purpose of depositing the securities for lending and the borrower will enter into a separate agreement for the purpose of borrowing the securities.[11] Under the lending agreement, the lender retains the beneficial interest in the deposited securities and gets any accrued income on capital proceeds, although there is an absolute transfer of title of the securities. [12] The borrower, however, can deal with it or dispose of it in any manner.[13]

This will mean that PFAs as securities lenders or borrowers are not allowed to enter into direct agreements with their counterparties in securities lending transactions. This also implies that parties to the securities lending agreement in this regard will include the PFA (as a lender) and the lending agent, or the lending agent and the PFA (as a borrower) as the case may be.

Under the SEC Rules, only quoted securities qualify for lending and borrowing purposes.[14] However, securities of unlisted public companies may be bought, sold, or transferred only by means of a system approved by the SEC and under such terms and conditions as the SEC may prescribe from time to time.[15] Thus, until the SEC prescribes the terms for using unquoted securities in securities lending, only assets that are listed on an exchange are eligible for securities lending.

Additionally, the rules of the exchange on which such securities are listed will also apply to the securities lending transaction in addition to statutory rules and regulations. For instance, the NGX issued the Securities Lending Guidelines of the Nigeria Stock Exchange 2017 ("**NGX Guidelines**"). The NGX Guidelines makes provision that guides lenders, borrowers, and participants like the lending agents, intermediary agents, and professionals, involved in lending securities listed on the exchange.

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[7] Nigerian Exchange, 'Securities Lending' "https://ngxgroup.com/exchange/trade/equities/securities-lending-shortselling/ " accessed May 8, 2023.

[8] Formerly called the Nigerian Stock Exchange.

[9] Rule 4.2, Securities Lending Guidelines of the Nigeria Stock Exchange 2017.

[10] Rule 4.3, Securities Lending Guidelines of the Nigeria Stock Exchange 2017.

[11] Rule 389 (1) of the Securities Exchange Commission Rules 2013.

[12] Rule 389 (2) of the Securities Exchange Commission Rules 2013.

[13] Rule 389 (9) of the Securities Exchange Commission Rules 2013.

[14] Rule 389 (4) of the Securities Exchange Commission Rules 2013.

[15] Rules on Trading in Unlisted Securities April 13, 2015.

"Eligible Investments" and Investment Principles under the PRA and the Regulation

The PRA[16] sets out the principles for investing pension fund assets, as well as eligible and ineligible investments for pension funds and pension assets. The eligible investments listed in the PRA are stated to be subject to "guidelines issued by PENCOM".[17] Some of the investment principles are that PFAs can invest the pension funds in units of any investment outside Nigeria so far as it is within the categories of investments allowed under the PRA and subject to a limit set by PENCOM and approved by the President of the Federal Republic of Nigeria.[18]

Under the PRA, PFAs cannot invest pension assets in any securities issued by the PFA or its Pension Fund Custodian ("**PFC**"). PFAs cannot sell pension assets to themselves, their shareholders or related parties, employees, affiliates of any shareholder, the PFC, and its related party.[19] Additional investment guidelines and principles are set out in the Regulations.

By a combined reading of the PRA and the Regulation, "eligible investment" options for pension assets and fund include: (a) bonds, bills, and other securities issued by the Federal, States, and Local Governments and the Central Bank of Nigeria; (b) bonds, debentures, redeemable preference shares and other debt instruments issued by corporate entities and listed on a Stock Exchange; (c) ordinary shares of listed public limited companies; (d) bank deposits and bank securities; (e) investment certificates of listed closed-end investment fund or hybrid investment funds; (f) units sold by registered open-end investment fund or specialist open-end investment funds; and (g) real estate development investments.

Other eligible investment options include (a) special investment funds[20]; (b) bonds, Sukuk, Treasury Bills, Global Depository Notes and other securities issued by the Federal Government and CBN or their agencies or Special Purpose Vehicles and Companies owned by the Federal Government or by States or Local Government; (c) asset-backed securities like mortgage bonds, mortgage-backed securities, infrastructure bonds/sukuk; (d) money market instruments of banks and commercial papers issued by eligible corporate entities[21]; and (e) any other securities or instruments that may be approved by the PENCOM from time to time.

Prior to the enactment of the Business Facilitation Act, however, section 89(1)(c) of the PRA prohibited PFAs from applying "pension fund assets under [their]… management by way of loans and credits or as collateral for any loan taken by a holder of retirement savings account or any person whatsoever". PFAs were thus effectively prevented from participating in securities lending. The Commission's then attitude of prohibiting PFAs from lending pension assets or using them as collateral may be said to have been influenced by the nascent stage of securities lending in the Nigerian capital markets. [22]

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[16] Part XII, Section 85 – 91 of the Pension Reform Act 2014.
[17] The National Pension Commission. Section 86 of the Pension Reform Act.
[18] Section 87(2), Pension Reform Act 2014.
[19] Section 88, Pension Reform Act 2014.
[20] Section 86, Pension Reform Act 2014.
[21] Regulation 4.0, Regulation on Investment of pension fund assets, 2019.
[22] Securities Finance Times, " Nigeria abandons securities lending dream" (May 22, 2013) "https://www.securitiesfinancetimes.com/securitieslendingnews/industryarticle.php?article_id=218712&navigationaction=industrynews&page=&newssection=industry" last accessed 18 May 2023.

The Business Facilitation Act

On February 14, 2023, the Business Facilitation Act was passed into law. This law now makes it possible for PFAs to use pension assets for securities lending. The Business Facilitation Act[23] amends the PRA by substituting for subsection 89(2), a new subsection as follows:

"Notwithstanding the provisions of subsection (1)(c)-

a. *pension assets are eligible for securities lending as the Commission may approve; and*
b. *Pension Fund Administrator may, subject to guidelines issued by the Commission, apply a percentage of the pension assets in the retirement savings account-*
    i. *towards payment of equity contribution for payment of residential mortgage by a holder of Retirement Savings Account, and*
    ii. *for the purpose of securities lending."*

The PRA defines "Pension Assets" as "all assets set aside as retirement benefits"[24]. Pension assets include all cash contributions, the allowable investments made by PFAs in securities, investment fund and real estate and the accrued profits from these investments.

Implication of and Prospects for Securities Lending for Pension Funds in Nigeria

This 2023 change in the law has now empowered PFAs to use pension assets for securities lending, following the guidelines set out by PENCOM. Thus, the provisions of this section will be fully enforceable when the Commission issues guidelines setting out the (a) principles for PFAs to consider before applying - assets under their management to securities lending and (b) the percentage of the assets that can be invested in securities lending (the "**Proposed Securities Lending Guidelines**"). An official of PENCOM revealed that the commission is working towards publishing the Proposed Securities Lending Guidelines by the end of 2023.[25]

Consequently, PFAs who undertake securities lending transactions must also comply with the SEC Rules and the rules of the applicable exchanges (for instance, if the securities are listed on the NGX, the NGX Guidelines). PFAs would also be required to enter separate contracts with lending agents, and not directly with the lender (or borrower, as applicable).

Second, PFAs must, in addition to the Proposed Securities Lending Guidelines, undertake securities lending transactions subject to extant investment principles in the PRA and the Regulation. That is, to the extent that the Proposed Securities Lending Guidelines do not expressly provide otherwise.

Third, in preparing the Proposed Securities Lending Guidelines, PENCOM should also consider the extant investment principles contained in the PRA and the Regulations. We say so because pension assets eligible for securities lending include those listed on an exchange. If PFAs will invest in listed securities ordinarily and further to securities lending transactions, then the

[23] Section 64(2)(a) of the Business Facilitation Act.
[24] Section 120, Pension Reform Act, 2014
[25] The Cable, 'PENCOM were working on regulations to enable PFAs partake in securities lending', https://www.thecable.ng/pencom-were-working-on-regulations-to-enable-pfas-partake-in-securities-lending, last accessed October 26, 2023.

Proposed Securities Lending Guidelines should incorporate a revision of the investment limits established for listed securities as an eligible asset class. This adjustment would incentivize PFAs to maintain adequate holdings of listed securities while also actively participating in securities lending activities.

Fourth, it would appear that for now, PFAs can only function as lenders in securities lending transactions. It is unclear how a PFA can function as a borrower of securities as the extant regulations on investment of pension fund assets only authorize PFAs to carry out investment activities such as purchase and sale of assets, investments in securities, sales of securities, etc., but not trading activities such as hedging, speculating, arbitrage, etc.,(which form the bedrock of the activities of borrowers in a securities lending transaction). Ideally, the Proposed Securities Lending Guidelines should thus set out the parameters for PFAs engaging in securities lending whether as borrowers or lenders. The PENCOM can also take a cue from the securities lending guidelines in other jurisdictions like South Africa[26].

For robust and effective regulation, PENCOM should ensure that the Proposed Securities Lending Guidelines are harmonious with the PRA, the Regulation, and SEC Rules. If there will be a point of divergence, then the same must be expressly spelt out, with the ambit of such divergence clearly provided for. The SEC Rules have provisions that seek to mitigate the usual risks securities lending transactions expose parties to.[27] In any event, we expect that the Proposed Securities Lending Guidelines would present a more robust protection framework for pension assets such as setting a standard minimum credit rating for borrowers of securities forming part of pension assets.

Tax Implications for Securities Lending Transactions by PFAs

On the subject of disposal and repurchase of the assets, SEC Rules[28] provide that the lending of securities under the rules and the return of the equivalent securities shall not be treated as a disposal of the securities. It would thus appear that the transfer of assets would not be deemed as a disposal and capital gains tax would not be applicable.

In 2020, The Federal Inland Revenue Service (FIRS) issued a circular on the tax implications of the operation of Regulated Securities Lending Transactions ("SEC Lending") in Nigeria. The circular governs securities lending transactions that are conducted pursuant to SEC rules and reiterates the position of the existing tax laws on the extent of applicability of Company Income Tax, Withholding Tax, Stamp Duties, and Personal Income Tax.

However, the PRA specifically stipulates that all interests, dividends, profits, investments, and other forms of income accruable to pension funds and assets shall not be taxable.[29] As a result, the prevailing tax regime governing securities lending transactions in Nigeria would also not be applicable to the PFAs. This exemption underscores the distinctive tax treatment accorded to PFAs in relation to their pension-related activities.

[26] For instance, South Africa's Pension Funds Act, 1956: Regulation 28 of the Regulations made under Section 36 of the Act: Conditions for Securities Lending Transactions.
[27] Rule 389 of the Securities Exchange Commission Rules, 2013.
[28] Rule 389 (5) of the Securities Exchange Commission Rules 2013.
[29] Section 10(2) of the Pension Reform Act 2014.

Conclusion

The idea of engaging pension assets in securities lending has been a topic for discussion between the Securities and Exchange Commission and the PENCOM since 2019.[30] Now that this idea has received a legal stamp, the Nigerian Capital Markets and PFAs stand to benefit from its implementation.

In 2020, the CEO of the NGX Group, Oscar Onyema, predicted an “exponential growth” in Nigeria’s budding securities lending market in part due to regulatory changes in the Finance Bill. By the end of 2020, the number of securities lent was 7.38 million units compared with 61,435 units in 2019 and the value of securities lent was ₦97.18 million compared to 2019 which was ₦344,000[31]. The introduction of PFAs, a large class of institutional investors, to securities lending, is set to propel this market to new heights as we await an implementation framework and guidelines for securities lending from the PENCOM.

PFAs as participants in the securities lending market are encouraged to become familiar with the rules, procedures, and conventions of the securities lending market in which they will operate in order to fully comprehend the business and its associated risks. PFAs should also ensure that they have established and fully understood their tax position in relation to securities lending transactions.

[30] NAN-The Guardian, “SEC engages PENCOM, AMCON on Securities Lending” (November 22, 2019), https://guardian.ng/business-services/sec-engages-pencom-amcon-on-securities-lending/ accessed May 9, 2023.

[31] Securities Finance Times (24 November 2020) ”https://www.securitiesfinancetimes.com/countryfocus/country.php?country_id=168&navigationaction=countryprofiles&newssection=countryprofiles” accessed 28 April 2023.

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