



REGULATING CRYPTOCURRENCY AND INITIAL COIN OFFERINGS: THE NIGERIAN PERSPECTIVE (PART 1)

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HUMBLE BEGINNINGS

On 31 October 2008, Satoshi Nakamoto (a person or a group of people) sent a white paper titled “Bitcoin: A Peer-to-Peer Electronic Cash System.”[1] to the subscribers of a cryptography mailing list. The document, described a decentralized system that would allow peer-to-peer payment of money without the interference of a third party (banks and financial institutions) and the government.

That white paper which introduced block chain based-cryptocurrency, has revolutionised the global monetary system and today, the cryptography-based currency has evolved into a \$267,000,000,000 (two hundred and sixty-seven billion Dollars) industry[2]. Cryptocurrency has disrupted finance as we know it and with the usage of it to create new methods of achieving financial goals and targets for businesses, cryptocurrency is slowly evolving into a viable legal tender.

This article is divided into two parts. The first part will discuss what cryptocurrencies are, how digital coins and digital tokens make up the ecosystem of cryptocurrency and the Nigerian legal framework on cryptocurrency. The second part will explore Initial Coin Offerings (ICOs), how it is used to raise funds, the Nigerian legal framework on ICOs, and the pros and cons of ICOs.

WHAT IS CRYPTOCURRENCY?

To understand what cryptocurrency is, there has to be an understanding of the technology that cryptocurrency is built on. The technology includes:

CRYPTOGRAPHY

Rivest Ronald defines cryptography as the practice and study of techniques for secure communication in the presence of third parties[3]. It can also be described as the art of writing and solving codes[4].

[1] Bitcoin: A Peer-to-Peer Electronic Cash System by Satoshi Nakamoto <https://bitcoin.org/bitcoin.pdf>

[2] Market Insider for Business Insider <https://markets.businessinsider.com/currencies/news/bitcoin-price-crypto-market-grows-billions-breaks-threshold-value-total-2020-5-1029182471#> accessed 25 June 2020

[3] “Cryptography” by Rivest, Ronald L.. (1990). In J. Van Leeuwen (ed.). Handbook of Theoretical Computer Science.

[4] The Oxford English Dictionary, Third Edition, published by the Oxford University Press.

These definitions are central to modern cryptography as computer codes and algorithms are written in such a way around computational hardness assumptions[5], making such algorithms and codes hard to break by third parties therefore making them computationally secure.

DECENTRALIZED NETWORKS

Decentralized networks or decentralized computing is a computer network where the nodes (computers) within the network function as a separate authority with independent decision-making power regarding how it interacts with other systems[6]. The network shares data and processing power among nodes through connected servers. The fundamental principle of a decentralized network is that all nodes are independent and connected. Since each node is independent, every one of them can set their own rules regarding data and workload availability[7].

BLOCKCHAIN TECHNOLOGY

Blockchain is a decentralized ledger of all transactions across a peer-to-peer network[8]. With blockchain, various transactions can be carried out without the interference of a third party, regulatory body or clearing party. Blockchain technology is being considered for use in a number of sectors, from encrypting patient information in the health sector, to voting during elections to ensure votes are not duplicated. With the brief explanation above of the technology that drives cryptocurrency, it can be defined as a digital currency secured by cryptography[9]. It is a medium of exchange, created and stored electronically in the blockchain, using encryption techniques to control the creation of monetary units and to verify the transfer of funds[10].

With the blockchain technology, transactions of cryptocurrency can be made from one person to another. However, no physical currency moves under this transaction.



[5] Computational hardness assumptions is a hypothesis that a particular problem will not be able to be solved efficiently by a computer.


[6] Centralized vs Decentralized Network: Which One Do You Need? by Alan Seal for Vxchnge. Accessed 25 June 2020

[7] Centralized vs Decentralized Network: Which One Do You Need? by Alan Seal for Vxchnge. Accessed 25 June 2020

[8] Making sense of bitcoin, cryptocurrency and blockchain by PWC United States. Accessed 25 June 2020

[9] Jake Frankenfield, reviewed By Michael Sonnenshein, 5 May 2020 "Cryptocurrency" on Investopedia <https://www.investopedia.com/terms/c/cryptocurrency.asp> Accessed 25 June 2020

[10] Making sense of bitcoin, cryptocurrency and blockchain by PWC United States Accessed 25 June 2020.



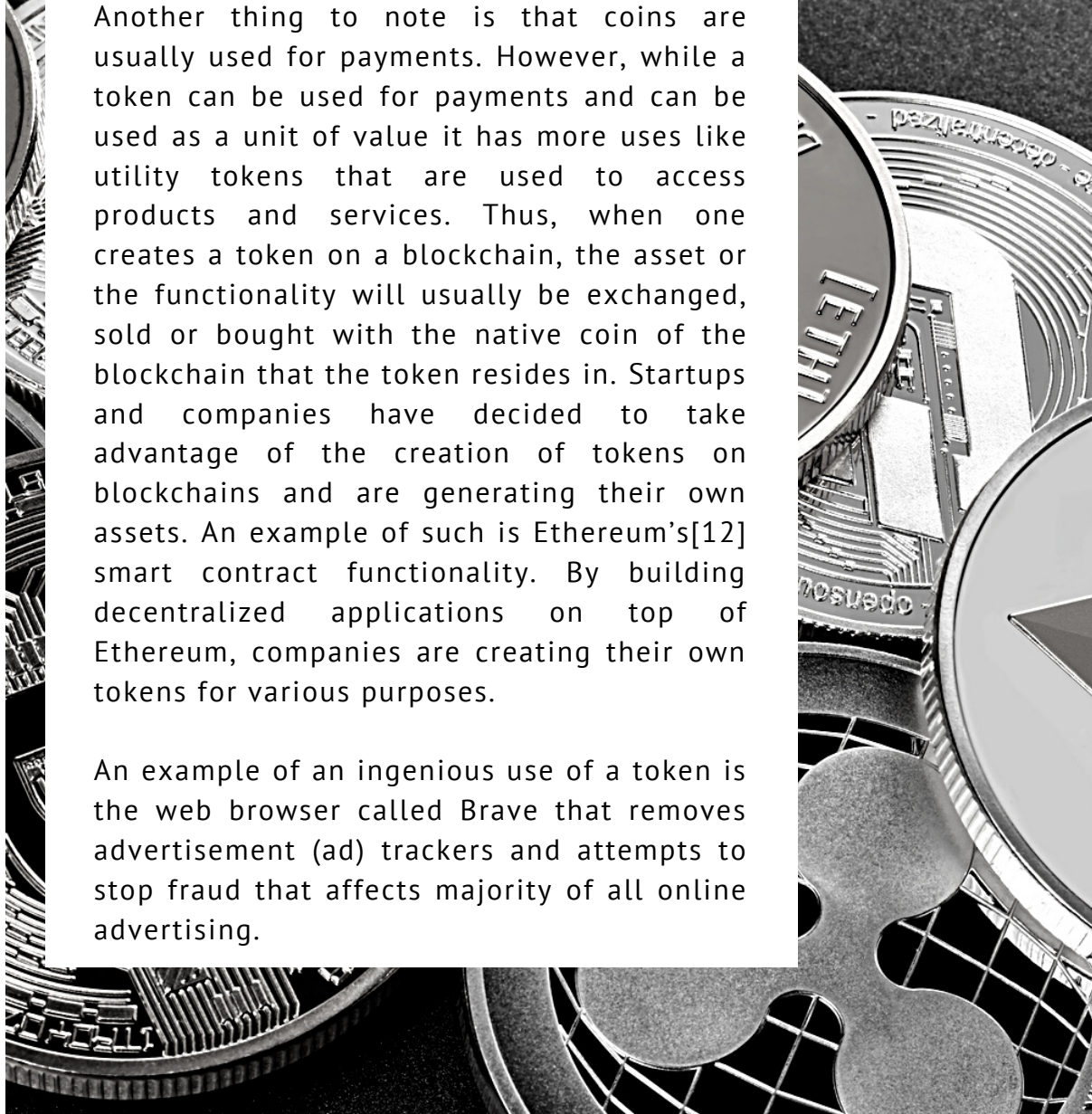
All the “currency” exists as data on a global database (blockchain). This blockchain keeps track of all the transactions and is checked and verified by computers around the world.

COINS AND TOKENS

In the cryptocurrency ecosystem, cryptocurrency is referred to as a coin or token. Although these names are sometimes used interchangeably, they are two different types of the cryptic currency.

A coin is a unit of value or digital asset that is native to a blockchain[11]. It is a means of exchange used within a blockchain to enable the participants exchange value. So, for example, a cryptocurrency like Bitcoin operates and functions on the Bitcoin blockchain for the purpose of exchanging value. Coins function like regular money and are used solely for monetary purposes like purchasing goods and services.

A token on the other hand does not have its own blockchain. Rather it is an asset built on top of an existing blockchain, which has the ability to replicate such functionality or assets.

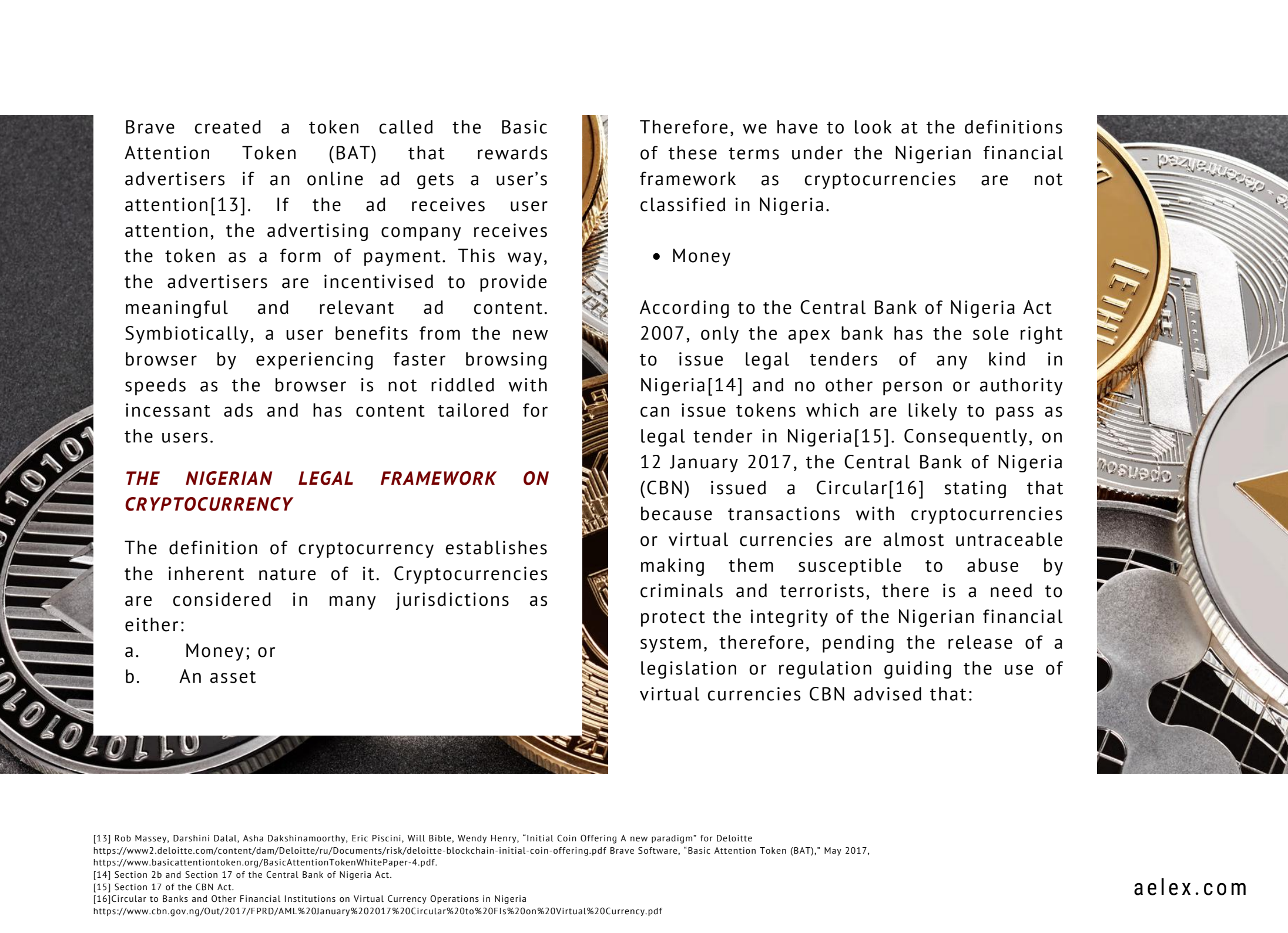


Another thing to note is that coins are usually used for payments. However, while a token can be used for payments and can be used as a unit of value it has more uses like utility tokens that are used to access products and services. Thus, when one creates a token on a blockchain, the asset or the functionality will usually be exchanged, sold or bought with the native coin of the blockchain that the token resides in. Startups and companies have decided to take advantage of the creation of tokens on blockchains and are generating their own assets. An example of such is Ethereum's[12] smart contract functionality. By building decentralized applications on top of Ethereum, companies are creating their own tokens for various purposes.

An example of an ingenious use of a token is the web browser called Brave that removes advertisement (ad) trackers and attempts to stop fraud that affects majority of all online advertising.

[11] Rob Massey, Darshini Dalal, Asha Dakshinamoorthy, Eric Piscini, Will Bible, Wendy Henry, "Initial Coin Offering A new paradigm" for Deloitte <https://www2.deloitte.com/content/dam/Deloitte/ru/Documents/risk/deloitte-blockchain-initial-coin-offering.pdf>

[12] Ethereum is a cryptocurrency platform (native blockchain) that allows users to create smart contracts. It is an open source decentralized cryptocurrency platform that is programmable meaning the blockchain can be modified for various purposes from financial services to applications. The coin used on the Ethereum blockchain is called Ether.



Brave created a token called the Basic Attention Token (BAT) that rewards advertisers if an online ad gets a user's attention[13]. If the ad receives user attention, the advertising company receives the token as a form of payment. This way, the advertisers are incentivised to provide meaningful and relevant ad content. Symbiotically, a user benefits from the new browser by experiencing faster browsing speeds as the browser is not riddled with incessant ads and has content tailored for the users.

THE NIGERIAN LEGAL FRAMEWORK ON CRYPTOCURRENCY

The definition of cryptocurrency establishes the inherent nature of it. Cryptocurrencies are considered in many jurisdictions as either:

- a. Money; or
- b. An asset

Therefore, we have to look at the definitions of these terms under the Nigerian financial framework as cryptocurrencies are not classified in Nigeria.

- Money

According to the Central Bank of Nigeria Act 2007, only the apex bank has the sole right to issue legal tenders of any kind in Nigeria[14] and no other person or authority can issue tokens which are likely to pass as legal tender in Nigeria[15]. Consequently, on 12 January 2017, the Central Bank of Nigeria (CBN) issued a Circular[16] stating that because transactions with cryptocurrencies or virtual currencies are almost untraceable making them susceptible to abuse by criminals and terrorists, there is a need to protect the integrity of the Nigerian financial system, therefore, pending the release of a legislation or regulation guiding the use of virtual currencies CBN advised that:

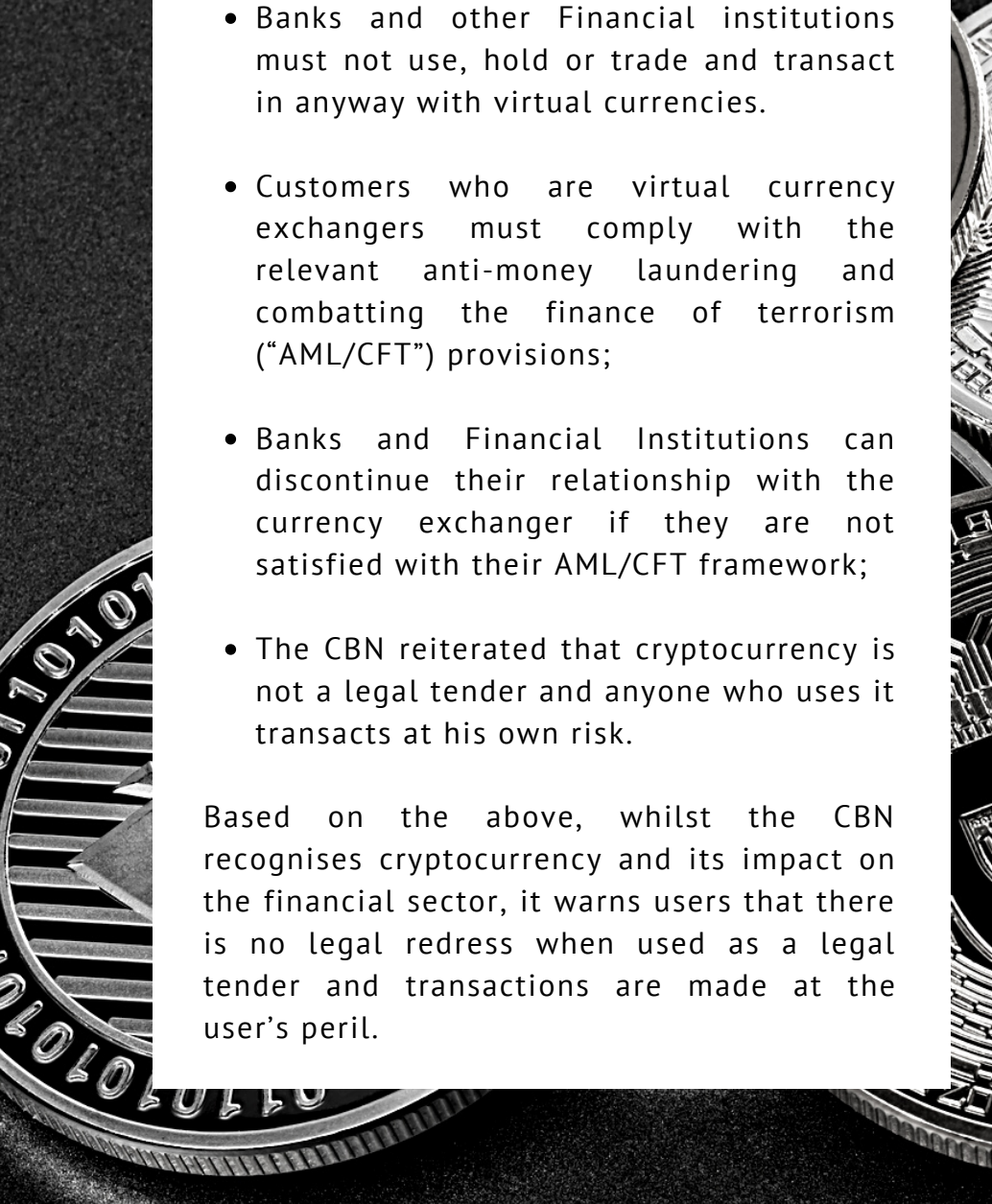
[13] Rob Massey, Darshini Dalal, Asha Dakshinamoorthy, Eric Piscini, Will Bible, Wendy Henry, "Initial Coin Offering A new paradigm" for Deloitte <https://www2.deloitte.com/content/dam/Deloitte/ru/Documents/risk/deloitte-blockchain-initial-coin-offering.pdf> Brave Software, "Basic Attention Token (BAT)," May 2017, <https://www.basicattentiontoken.org/BasicAttentionTokenWhitePaper-4.pdf>.

[14] Section 2b and Section 17 of the Central Bank of Nigeria Act.

[15] Section 17 of the CBN Act.

[16] Circular to Banks and Other Financial Institutions on Virtual Currency Operations in Nigeria

<https://www.cbn.gov.ng/Out/2017/FPRD/AML%20January%202017%20Circular%20to%20FIs%20on%20Virtual%20Currency.pdf>

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- Banks and other Financial institutions must not use, hold or trade and transact in anyway with virtual currencies.
 - Customers who are virtual currency exchangers must comply with the relevant anti-money laundering and combatting the finance of terrorism (“AML/CFT”) provisions;
 - Banks and Financial Institutions can discontinue their relationship with the currency exchanger if they are not satisfied with their AML/CFT framework;
 - The CBN reiterated that cryptocurrency is not a legal tender and anyone who uses it transacts at his own risk.


Based on the above, whilst the CBN recognises cryptocurrency and its impact on the financial sector, it warns users that there is no legal redress when used as a legal tender and transactions are made at the user’s peril.

• Assets

In finance, a financial asset is a non-physical asset that derives its value from a contractual right or an ownership claim[17]. Therefore, securities such as shares and bonds are regarded as financial assets. The regulatory framework for securities in Nigeria is governed by the Investment and Securities Act 2007 (“ISA”) and the Rules and Regulations of the Security and Exchange Commission 2013. The ISA defines ‘security’ to mean:

- debentures, stocks or bonds issued or proposed to be issued by a government;
- debentures, stocks, shares, bonds or notes issued or proposed to be issued by a body corporate;
- right or option in respect of any such debentures, stocks, shares, bonds or notes; or
- commodities futures, contracts, options and other derivatives.





The definition of securities in the ISA includes those securities which may be transferred by means of any electronic mode approved by the Securities and Exchange Commission (SEC) and which may be deposited, kept or stored with any licensed depository or custodian company as provided under the ISA[18].

The inference that may be drawn from the foregoing provisions may be that cryptocurrency can be used freely as a form of security in Nigeria but this appears not to be the case. In 2017, the SEC as the apex regulatory body for investments and securities in Nigeria, took the position that none of the persons, companies or entities promoting cryptocurrencies had been authorised or recognised by it to provide any investment in Nigeria and it warned the general public of the risk in investing in cryptocurrencies.

However, although it appeared that regulatory bodies were not so keen to accept the use of cryptocurrency in Nigeria, the SEC established the Fintech Roadmap Committee in 2019 to analyse the impact of fintech on securities and investments in Nigeria.

Part of the findings[19] of the Committee was on the regulation of crypto currencies and virtual financial assets. The Committee recommended that cryptocurrencies be expressly classified as securities or commodities in the SEC regulations. Currently the SEC is also working to ensure that a framework for the regulation of virtual currencies is being put in place in Nigeria[20].

THE EXISTING REALITY IN NIGERIA

Though the Nigerian regulators have warned that there are no existing frameworks to protect consumers from the risks of cryptocurrency, Nigeria is rife with cryptocurrency users. According to Bitcoin.com, 11% of connected Nigerians use cryptocurrencies[21] and Coinmarketcap, a platform for tracking the price of cryptocurrencies, reports that the tracking of the prices of cryptocurrency in Nigeria grew to 211%. Binance research also highlights that there has been an increase in interest in cryptocurrency and Nigeria leads the pack of the countries who are showing interest in cryptocurrency[22].




[18] Section 315 of the Investment and Securities Act.

[19] <https://sec.gov.ng/report-of-the-fintech-roadmap-committee-of-the-nigerian-capital-market/>

[20] <https://diutocoinnews.com.ng/sec-will-release-cryptocurrency-regulations/07/32/> accessed 26 June 2020.

[21] <https://news.bitcoin.com/south-africa-leads-crypto-revolution-in-africa-challenges-spur-and-slow-adoption/> accessed 26 June 2020.

[22] <https://nairametrics.com/2020/03/29/nigerians-the-attractions-to-bitcoin/> accessed 26 June 2020.



Also, cryptocurrency exchange platforms and apps are on the rise in Nigeria. Buycoins, an exchange platform for cryptocurrency processed over N500,000,000 (five hundred million Naira) worth of cryptocurrency in the space of 3 months[23] while other platforms such as Patricia, Binance and Quidax record cryptocurrency transactions daily in Nigeria.

One of the major reasons why Nigerians seem to use cryptocurrency more than ever is because cryptocurrency is a seamless way for them to instantly exchange value during cross-border transactions as international money transfer services may delay transfers. Also, some Nigerian start-ups are using cryptocurrency as an innovative way to raise funds through Initial Coin Offerings (ICO)[24] which will be discussed in the second part of this article.

CONCLUSION

The Nigerian finance regulators constantly warn consumers about the inherent risk of using cryptocurrency and their fears are not wrongly misplaced. Cryptocurrencies have led to one of the biggest fraudulent activities of 2019.

Two ICOs, run by the same company operating out of Vietnam, are believed to have swindled around 32,000 investors of a combined \$660,000,000 (sixty-six million Dollars)[25]. But risk is always inherent in business and it is the job of the regulators to worry.

The above notwithstanding, given the increased use of cryptocurrency by Nigerians, it can be argued that there is a need for the Central Bank of Nigeria and the Securities and Exchange Commission to establish regulations guiding the use of digital currency in Nigeria and clearly define what cryptocurrency is under the Nigerian financial regime.



[23] <https://technext.ng/2018/10/19/nigerian-cryptocurrency-app-buycoins-hits-milestone-processes-over-n500-million-worth-of-cryptocurrency-in-9-months/> accessed 26 June 2020.

[24] <https://disrupt-africa.com/2018/01/nigerias-sureremit-raises-7m-via-ico/> accessed 26 June 2020.

[25] <https://cointelegraph.com/news/vietnam-pincoin-ifan-icos-exposed-as-scams-that-allegedly-stole-660-million> accessed 26 June 2020.



Oluwapelumi
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