

### A note on the wholesale nature of OTC derivatives

Over the counter (OTC) derivatives are a predominantly wholesale product, used and traded by large, sophisticated entities with (in absolute terms) large financial risks to manage. Direct retail use of these products is currently not significant and is likely to remain so, given the nature and rationale of the market. Many financial services firms experience no retail participation at all.

OTC derivatives are not just a 'bigger version' of retail products. Their defining characteristic is that they are tailored financial products, transacted on a truly bilateral basis. It is this flexibility that makes OTC derivatives especially useful to wholesale market users. Any given deal may well be unique, reflecting the specific financial-risk-management needs of individual entities at a given moment.

(By contrast, markets with high levels of retail customer participation will tend to function more efficiently when significant product standardisation predominates, allowing for aggregation of order flows and for maximisation of transactional liquidity.)

This is not to say that OTC derivatives markets are completely lacking in standardisation. Inevitably in a market that has grown as large as OTC derivatives have, there is now a certain amount of product standardisation. Thus, it is possible to get a wide range of price quotes for certain types of interest rate swap (these products originally having been transacted as one-off deals). Standard-form documentation further supports liquidity in OTC derivatives more generally, including newer products such as credit derivatives. But this standardisation is related to liquidity (and thus efficient risk-transference) in certain products among wholesale participants, rather than making those products accessible to retail customers.

OTC derivatives are commonly referred to as a 'market' and, in the case of some products, trading is a significant element. But OTC derivatives are still a financial *service*, as the key impetus remains the transactionally specific needs of end-users. And, even with the existence of more heavily traded instruments, there is a significant inter-relationship between the more liquid instruments on the one hand and the more tailored ones on the other. The more liquid instruments act as 'building blocks' from which more tailored products can be constructed.

By way of comparison, listed (ie, exchange-traded) derivatives perform a somewhat different function. In such futures markets, standardisation is more rigid, in the interests of concentrating transactional liquidity and, in the case of some contracts, attracting retail participation. So, while OTC and listed derivatives may have certain characteristic economic features in common, they are not functionally synonymous.

It is true that retail investors can benefit *indirectly* from OTC derivatives. By investing in funds that make use of OTC derivatives, they can achieve precisely that result. However, it is the intermediary that is making direct use of these instruments and, in line with the characterisation above, these intermediaries will be large and sophisticated entities with their own particular risk-management requirements. The minimal direct retail participation that does occur will come from high-net worth individuals, who will themselves be relatively sophisticated.

In the terms of FSA rules, the market is almost exclusively made up of 'market counterparties' and 'intermediate customers'. As such, rules whose purpose is to protect retail customers will for the most part constitute an unnecessary complication. Rules for the protection of retail customers should, therefore, only apply to OTC derivatives to the limited extent that such customers are actually involved in transactions.

OTC derivatives transactions will take the form of swaps / forwards and various forms of option too, and exist in relation to a wide range of 'underlying' subjects. Those most commonly found relate to:

- interest rates (eg, swaps, FRAs, swaptions, caps, floors, collars);
- foreign exchange (eg, currency options, [cross-] currency swaps);
- equities (both on individual shares and on indices or baskets);
- bonds/bond indices (eg, bond options);
- credit (eg, credit default swaps);
- a range of commodities (including power and bandwidth as well as raw materials and even weather).

It is, however, in the nature of the market – bilateral transactions in tailored products – that OTC derivatives can be applied to almost any conceivable underlying subject matter or combination thereof. Ultimately each deal remains unique and, as such, economically distinct from every other deal. To the extent that transactions in OTC derivatives (involving entities other than retail customers) may be considered for exemption from the Rulebook, it therefore makes most sense to adopt as wide a definition as possible of OTC derivatives.

Moreover, because of the existence of 'hybrid products' (securities with 'embedded' derivatives) note needs to be made of all possible applications of OTC derivatives, again bearing in mind that customers/counterparties for such transactions will typically be large sophisticated entities.