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Retail derivative products – Investor protection, regulatory and prudential risks and issues

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How's this for a market?



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- Only the market maker able to make prices
- All other users of the market only able to trade at the bid or offer price as determined by that market maker
- Market maker able to quote different prices to different users; and
- Market maker knows positions, bids and offers of every other user in the market

Agenda



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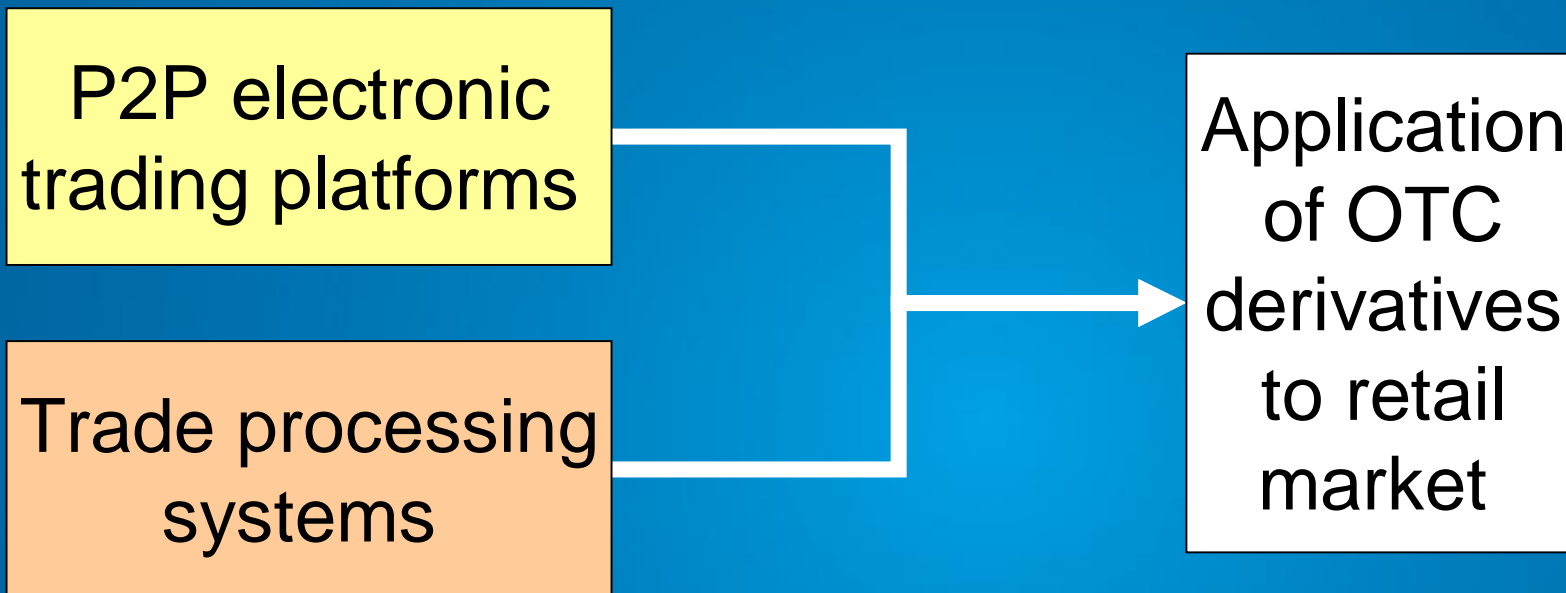
- How has this situation come about?
- What are the retail investor protection issues that arise from the emergence of this model?; and
- What are some of the possible consequences of this development?

1. How has this situation come about?



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2. Retail Investor protection issues



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ODE	OTC
Supervisory oversight of front line regulatory team	Non-regulated trading environment
Standardised contract specifications	Customisation
Transparent, consistent operating model	Opaque activity
Compliance with approved rules	Unequal pricing power
Central counterparty clearing	Internalisation of risk

3. Possible consequences



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- OTC incentives
- Customer constraints
- Internalised activity
- Reduced central market liquidity
- Decreased transparency
- Weakened centralised price formation

Prudential risk



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- OTC providers:
 - Are not required to keep prudential security to support the risks inherent in the positions held by its customers
 - Tendency to ‘under margin’ the risk in order to grow their business
 - Typically have neither the prudential background nor the separation of function between clearing risk and business development

Prudential and systemic risk



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- OTC providers of financial products, in the absence of prudential or regulatory constraints, will reduce the level of security they require from customers as competition in their product increases

Conclusion



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- Retail OTC derivatives particularly OTC CFDs, present regulators with a completely new set of regulatory, investor protection and systemic risk issues and challenges