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RÉSUMÉ DU PROJET

Sources of Underutilization of Exchange Traded Derivative Products in Canada.

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Exchange-traded derivatives stand out among risk management tools for portfolio managers for their advantages vis-à-vis other instruments with respect to transparency, cost-effectiveness and low credit and default risk. They are also convenient vehicles for arbitrage and completion of markets, and hence contribute to market efficiency.

It has been estimated that the ratio of the principal amount outstanding of over-the-counter (OTC) derivatives to notional value of outstanding exchange-traded derivatives in Canada is approximately 17.93. This compares to a ratio of 4.72 in the rest of the world. This underutilisation is troubling because of the lack of transparency in OTC markets, as well as the higher level of counterparty risk associated with OTC products, among other issues.

The research proposed in this study will examine the development of the exchange-traded derivatives market in Canada, and possible factors underlying the lack of liquidity for exchange-traded products. By identifying likely factors hindering the development of the markets, we will be in a position to set forth policy changes and prescriptive mechanisms for the Exchange's stakeholders, regulators, accreditation bodies, as well as Investment Advisors, as they influence the Corporate and Retail base. This study will be in five parts.

In the first part of the study we will address the issue of liquidity of the exchange-traded markets vs. OTC markets in Canada. In addition to exploring the evolution of liquidity as measured by contract trading volumes, turnovers, and bid/ask spreads for OTC products in Canada as well as other countries, we will also study other microstructure dimensions of liquidity that have been more prominent in the literature in recent years.

In the second part of the study, we will examine the extent to which OTC products in Canada tend to substitute for, rather than complement exchange traded products. To address this issue, we will attempt for the first time to link OTC transactions to Futures Market Transactions, to determine the nature of the feedback between markets (e.g. modeling the extent to which increased trading in OTC derivatives affect the price and volatility of the exchange-traded futures).

In the third part of the study, we will examine the liquidity issues relating to screen trading vs. floor trading mechanisms, which has been of increased interest in the literature in recent years, despite the increased diffusion and adoption of electronic trading venues.

In the fourth part of the study, we will examine the extent to which exchange-traded derivative market growth has been hindered by regulations that constrain investment funds from using derivatives. We hope to identify the extent to which higher transaction costs associated with OTC derivatives serve to enhance the use of exchange-traded derivatives by investment funds in Canada, as well as the extent to which banker and investment banker opportunism serves to deter their use.

In the fifth and final part of the study, we will explore the level of knowledge and use of derivatives and risk management by the retail brokerage community in Québec, and where possible, compare this with other jurisdictions (Australia, US, Europe). A comparison will also be made of the proficiency/licensing requirements in these jurisdictions to determine whether this has an impact on levels of knowledge and use among advisors. This part of the research project will be based on comprehensive questionnaire surveys of industry participants and stakeholders. We will first develop a metric for the *level of knowledge* of derivatives and risk management strategies among investment advisors in Québec and elsewhere. In addition, we will develop a metric for comparing *certification/licensing requirements* between regulatory jurisdictions. Based on our developed metrics, we will be in a position to directly model the extent to which knowledge levels and certification requirements explain cross-country differences in option market participation rates.