

THE OTHER EXCHANGE: OVER THE COUNTER (OTC) MARKETS

The global wholesale over the counter ("OTC") markets are critical to the effective functioning of the worldwide financial system. The vast majority of financial asset classes only exist in the OTC environment and consequently the efficient functioning of these markets is essential for the free flow and availability of capital, the mitigation of risk and investor choice. OTC derivatives are a growth industry worldwide. Last year they had a total notional value of more than \$248 trillion, which was almost 13% up on 2003.

There are two basic ways to organize financial marketsexchange and over the counter (OTC). Today there are more than a hundred stock and derivatives exchanges throughout the developed and developing world. But exchanges are more than physical locations. They set the institutional rules that govern trading and information flows about that trading. They are closely linked to the clearing facilities through which post-trade activities are completed for securities and derivatives traded on the exchange. An exchange centralizes the communication of bid and offer prices to all direct market participants, who can respond by selling or buying at one of the quotes or by replying with a different quote. Depending on the exchange, the medium of communication can be voice, hand signal, a discrete electronic message, or computer-generated electronic commands.

OTC markets are unregulated markets quite often with no central market makers. They are typically the domain of financial institutions to trade with each other where the transactions do not take place on a recognized exchange. Unlike exchanges, OTC markets have never been a "place." They are less formal, although often well-organized, networks of trading relationships centered on one or more dealers. Dealers act as market makers by quoting prices at which they will sell (ask or offer) or buy (bid) to other dealers and to their clients or customers. That does not mean they quote the same prices to other dealers as they post to customers, and they do not necessarily quote the same prices to all customers. Moreover, dealers in an OTC security can withdraw from market making at any time, which can cause liquidity to dry up, disrupting the ability of market participants to buy or sell. Exchanges are far more liquid because all buy and sell orders as well as execution prices are exposed to one another. Also, some exchanges designate certain participants as dedicated market makers and require them to maintain bid and ask quotes throughout the trading day. In short, OTC markets are less transparent and operate with fewer rules than do exchanges. All of the securities and derivatives involved in the financial turmoil that began with a 2007 breakdown in the U.S. mortgage market were traded in OTC markets.

Over-the-counter (OTC) describes trading agreements that are unlisted and unregulated. Counterparties to such an agreement therefore rely on a contract negotiated between them. Moreover, in many markets around the world they have to confirm and match their trades by exchanging faxes or emails, an archaic method that creates myriad problems for confirmation, reset payments and settlement. For example, while settlement of a bond or equity trade happens within a few days, settlement of an OTC trade can take up to 30 days, depending on its complexity. During the life of the trade, too, there will be an agreed number of resets which require payments between the counterparties, and therefore need ongoing management. These resets have been traditionally been managed manually, a method which creates large backlogs of paperwork and increasingly delayed settlement.

ISDA (International Securities Derivative Association) is the global trade association representing over 650 institutions that participate in the OTC market. Its main aim is to identify and reduce sources of risk in derivatives trading. To that end, it has prescribed standards and requirements, and taken steps to advance understanding and treatment of derivatives from a risk management and settlement perspective.

Over-the-counter (OTC) transactions come as ready and easy alternative to the highly formalized and regulated futures market. It is a market that creates a window for privately negotiated transactions on a quasi-formal platform. OTC transactions have assumed quite a great dimension in the advanced economies. Its growth in the emerging markets is equally becoming quite remarkable. The growth in this market is coming with interesting features and structures that make it increasingly acceptable to investors. And the OTC transactions equally spin off derived productsjust like the more formalized exchange based transactions, thereby widening the investment space of the financial market.

OTC dealers convey their bid and ask quotes and negotiate execution prices over such venues as the telephone, mass e-mail messages, and, increasingly, instant messaging. The process is often enhanced through the use of electronic bulletin boards

MARKET UPDATE			
	15/01/13	15/12/13	14/03/14
Naira/US\$	154.1	155.2	155.75
Brent,US\$/BBL	109.78	107.84	109.9
COCOA, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	8.0
MORTGAGE RATE %	22.0	23.0	23.0

STOCKS CONSTITUTING GMA INDEX			
STOCKS	31/12/13 Price (N)	14/03/14 Price (N)	%Change in Price
OANDO	24.25	16.15	-33.40
GTBANK	27.02	23.70	-12.29
OKOMU	44.00	42.00	-4.55
STANBIC	21.35	19.05	-8.67
DANGSUGAR	11.70	9.44	-19.32
FIDSON	2.79	3.15	12.90
TRANSCORP	4.35	4.00	-8.05
CCNN	11.75	8.76	-25.45

	PRICE(N)	NAV (N)
	31/01/14	14/03/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	14/03/14	% Change
NSE ASI	41,329.19	38,171.32	-7.64
GMA Index	1.50	1.29	-14.07

Source: CBN, SEC and NSE

where dealers post their quotes. Others in the market are not privy to the trade, although some brokered markets post execution prices and the size of the trade after the fact. But not everyone has access to the broker screens and not everyone in the market can trade at that price. Although the bilateral negotiation process is sometimes automated, the trading arrangement is not considered an exchange because it is not open to all participants equally.

There are essentially two dimensions to OTC markets. In the *customer market*, bilateral trading occurs between dealers and their customers, such as individuals or hedge funds. Dealers often initiate contact with their customers through high-volume electronic messages called "dealer-runs" that list various securities and derivatives and the prices at which they are willing to buy or sell them. In the *interdealer market*, dealers quote prices to each other and can quickly lay off to other dealers some of the risk they incur in trading with customers, such as acquiring a bigger position than they want. Dealers can have direct phone lines to other dealers so that a trader can call up a dealer for a quote, hang up and call another dealer and then another, surveying several dealers in a few seconds. An investor can make multiple calls to the dealers with which they have established a trading relationship to get a view of the market on the customer side. But customers cannot penetrate

the market among dealers.

DEVELOPMENT AND STRUCTURE OF OTC AND EXCHANGE MARKETS

The OTC markets have developed in parallel to those markets traded on traditional stock, futures or commodities exchanges. The relationship between the two is often portrayed as competitive, but is in reality more often symbiotic. OTC and exchange markets each have separate, distinctive and logical reasons to exist, none of which are called into question by the current market turmoil.

Exchanges such as NYSE Euronext, NASDAQ, the London Stock Exchange, Eurex, CME Group provide a trading venue for assets that are by their nature simple, in as much as they are all based on a single key measure or parameter (such as the anticipated financial performance of a company in the case of shares, or the value of a specific interest bearing bond or commodity at a time in the future) and whose characteristics can be standardized. These markets, due to their "monolithic" structure, attract a wide range of participants who, by posting a modest amount of margin, trade standardized contracts in a single, deep and liquid marketplace. All exchange contracts are given up to a CCP/clearing house for settlement as discussed below.

In contrast, the wholesale OTC markets offer a deep and liquid trading venue for professional market participants, such as major banks and financial institutions, to execute transactions, the key terms of which are individually negotiated, rather than standardized. As such, it is no surprise that asset class innovation tends to originate within the OTC space. Some types of OTC asset class may over time become commoditized and migrate to the exchange environment; but this does not always happen. In OTC derivative markets, counterparties usually have bilateral arrangements in place to offset their contingent credit risk on each other by giving (or taking) collateral against that risk. In some of the more significant asset classes, OTC trades are either "given up" to a CCP or underwritten by a clearing house. As they have matured, several of the larger more homogeneous OTC markets have started to trade electronically as market players have recognized (as they have also on exchanges) the benefits of screen based trading.

OTC MARKETS IN NIGERIA

Formal exchanges for over-the-counter (OTC) trading have recently been set up in Nigeria to create greater liquidity for small companies and more transparency for investors looking to invest in unlisted securities.

There is also a backlog of demand to trade unlisted stocks and bonds in Nigeria. A flurry of private placements over the past few years has left many securities off the [Nigerian Stock Exchange \(NSE\)](#), hidden in investors' portfolios. These equities and bonds will be introduced to the OTC exchanges first and once they reach the desired levels of liquidity and trust has developed in the market, more complicated securities will be introduced. There are an estimated 1,000 securities in the OTC market, reflecting the scale of demand. Two OTC exchanges have recently been incorporated in the Nigerian market.

FMDQ OTC Plc was licensed by the Securities and Exchange Commission in 2012 to function as an Over-the-Counter market. The FMDQ OTC is owned by 25 banks, the Central Bank of Nigeria, Finance Dealers Association and the Nigerian Stock Exchange. The platform is also expected to enhance financial securities transactions outside of the official window under the regulatory purview. FMDQ is expected to complement existing securities exchanges and provide the governments, issuers and investors, both globally and domestically, with world class market governance for capital transfers.

The Securities and Exchange Commission (SEC) also granted the National Association of Security Dealers (NASD) Limited an Approval-in-Principle in 2001 to operate Over-the-Counter market. NASD Limited was formed on the 1st of June 1998 to promote and operate an OTC market open to all interested, registered securities dealers in Nigeria. The company is to be a provider of pricing, information and trading platform for equity and debt securities and other derivative instruments traded on an over-the-counter (OTC) basis in Nigeria. It would complement The Nigerian Stock Exchange by being the self-regulatory organization for all securities firms that conduct business on its OTC platform.

CONCLUSION

OTC markets have a crucial role to play in all national and international economies alongside and complementary to exchange markets. They have played a major role in global economic development and have been the hub of developments that benefit savers, investors, businesses and governments. The perception of OTC markets as "unregulated" overlooks that fact that all major market participants are individually regulated and codes of conduct are set by supervisors in many OTC markets. The OTC markets are not the root cause of current market problems (though the lack of transparency in some parts of the OTC world may have exacerbated some of the market reactions to current problems). OTC trading should and will continue to develop in the near future.

Disclaimer

This report is produced by Goldbank Management Associates Limited for information purposes only. Nothing in this report constitutes investment, legal or other advice, an offer or an invitation to sell any securities or to produce investment services of any description.

Goldbank Management Associates Ltd. 5th Floor Medife House, 58/60 Broad Street, Tinubu Square, Lagos. P.O. Box 2294 Marina. Tel: +234 1 4480803, 4480802. Email: info@gma.com.ng Website: www.gma.com.ng



...thinking and executing new perspectives