

Crypto OTC Markets: Primer & Insights

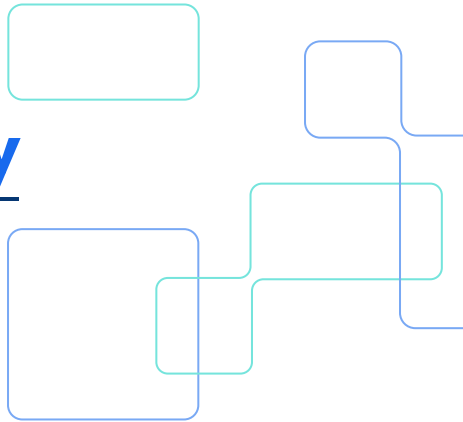
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Contents

1. Executive Summary	2
2. Market Infrastructure	3
3. Liquidity Providers	5
4. Technology & Infrastructure	9
5. Counterparty Risks	11
6. Deep Technical Dive into Trading	13
7. Speed Bump in Trading	18
8. Scope of Market Research	21
9. Results of Research	23
10. Conclusion	30
11. Participants (or full list of LPs) & Partners	31
12. Questionnaire	32
13. Glossary	34
14. Sources	36

Executive Summary



This report offers an in-depth look at the Over-The-Counter (OTC) crypto market. Unlike traditional exchanges, OTC trading involves direct transactions between parties. The report covers several key aspects:

Market Structure: We examine how these markets are set up, including the types of orders traders can place (like immediate or at a specific price), and how much information about trades is available to participants. This includes understanding different market models, from those driven by orders to those driven by quotes from sellers.

Technology's Role: Technology is crucial in today's trading environment. It ensures trades happen quickly and securely. The report evaluates various trading platforms and tools, highlighting their importance in executing trades efficiently and safely.

Liquidity Providers: These entities ensure that there's enough activity in the market for buying and selling. The report explains why they are crucial for efficient trading, helping traders get better prices and execute trades more rapidly.

Risks and Management: Trading, especially in the crypto world, involves risks like regulatory changes and market volatility. We discuss these risks and suggest ways to manage them, including best practices like thorough risk assessment and having strong security measures.

Market Research Findings: Our research gives insights into the duration of organizations' involvement in crypto trading, the estimated size of the OTC market, client trends, and the impact of regulatory changes.

The findings indicate that the OTC crypto market is dynamic, with a growing client base and optimistic projections for future trading volumes.

2. Market Infrastructure

In order for markets to function effectively, they should be designed to meet the needs of both institutional and individual investors, as well as traders and professional market participants. A successful market should allow investors to trade whenever and wherever they want, while minimizing the costs associated with placing trades.

There are several key characteristics that define the architecture of a market:

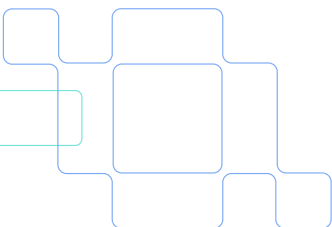
2.1 Market Type: Markets can be classified as order-driven, quote-driven, or a combination of both (hybrid).

2.2 Order Types: Different types of orders can be placed in a market, such as market orders (executed at the prevailing market price), limit orders (executed only at a specified price or better), or a combination of both (hybrid).

2.3 Trading Protocols: Markets have specific protocols that determine how trades are executed. These protocols include considerations such as price-time priority (the order in which trades are executed based on the time they were placed), price-size priority (the order in which trades are executed based on the size of the order), minimum lot size (the minimum quantity of shares that can be traded), and minimum price increments (the minimum price difference between trades).

2.4 Transparency: The level of transparency in a market refers to the visibility of information before and after trades are executed. This can include the amount of pre-trade information available to participants and the level of post-trade information provided. Additionally, markets can offer anonymous or non-anonymous trading, depending on whether the identities of the participants are disclosed.

By considering these key characteristics, different participants can benefit from efficient and fair trading using various market architectures.



There are various types of execution venues available to digital asset players, each with different characteristics in terms of market type, order type, trading protocols, and trading transparency:

- Centralized cryptocurrency exchanges
- Decentralized exchanges
- Bilateral off-exchange trading with liquidity providers
- Multilateral execution venues

It is important to understand that the market structure for executing trades in various asset classes does not follow a "winner takes it all" setup. Instead, it is designed to accommodate the different needs of market participants. For instance, in the foreign exchange (FX) market, customers have access to liquidity through more than 30 multi-dealer platforms, various electronic communication networks (ECNs), over 20 single-dealer platforms (primarily banks), and price streams from numerous proprietary trading firms.

For the purpose of this report, we will be focusing on different over-the-counter (OTC) setups. This is because the dynamics and performance of trading on centralized exchanges and decentralized finance (DeFi) platforms are more transparent and well-covered in terms of analytics.

3. Liquidity Providers

In the context of financial markets, including the cryptocurrency OTC market, a liquidity provider (LP) refers to an entity that facilitates trading by providing liquidity, typically in the form of buy and sell quotes.

This stands in contrast to market makers (MMs), who actively make markets on exchanges by quoting both buy and sell prices for specific assets, looking to profit from the spread between the two. Though both liquidity providers and market makers contribute to market liquidity, market makers have a more specialized role in creating and maintaining a market for specific assets and have direct access to the exchange or trading platform and are subject to specific rules and obligations.

Although market makers (MMs) can be considered a subset of LPs, for the purpose of this report, we'll focus solely on the broader concept of LPs. Liquidity providers can offer quotes on exchanges, multilateral OTC trading platforms, or via direct relationships with their clients. These can range from individual retail investors and high-net-worth individuals to other liquidity providers, institutional investors, and businesses engaged in the digital asset industry.

3.1 Key Reasons for Using Liquidity Providers

The characteristics mentioned in section 1 can have a significant impact on liquidity, execution speed, and overall trading costs. However, the goals of market participants can vary greatly, depending on their investment objectives, time horizon, and trade size. Some may prioritize optimizing execution speed, while others may focus on achieving the best execution price. Depending on the unique needs of each market participant, there are several reasons why they might choose to use liquidity providers for trading:

Asset Coverage: LPs typically have access to multiple exchanges and trading venues. As such, their clients can access a wider range of markets and assets, including less liquid assets, allowing them to execute trades more efficiently. Licensed liquidity providers can offer support for fiat-to-crypto trading, providing an alternative to crypto exchanges and DeFi platforms that lack access to traditional banking systems.

Price Stability: LPs can offer more stable and consistent prices. This is especially beneficial during periods of high volatility, reducing the impact of large buy or sell orders on the price.

Lower Costs: The competitive spreads offered by LPs can substantially reduce the cost of trading.

Speed and Efficiency: With high-speed trading infrastructure and APIs, LPs facilitate rapid execution of trades.

Regulatory Compliance: Institutions often prefer working with LPs that adhere to stringent regulatory guidelines, mitigating counterparty risks.

Tailored Services: Some LPs offer bespoke services like risk management solutions, algo trading, and direct market access, which can be advantageous for specialized trading activities.

Risk Mitigation: Liquidity providers often act as reliable counterparties to trades, mitigating the risks of failure to deliver assets, default on payments, or even fraudulent activities.

Confidentiality: OTC markets facilitated by LPs can offer a level of anonymity that may be preferable for certain traders and institutions.

3.2 Categories of Users of Liquidity Providers

- **Institutional Traders** use liquidity providers to execute large trading orders without significantly impacting market prices on venues with visible liquidity and take advantage of competitive spreads.
- **Retail Traders** seek the services of liquidity providers to leverage competitive spreads and lower transaction costs.
- **Exchanges and Trading Platforms** rely on liquidity providers to ensure uninterrupted trade execution for their customers, even in less liquid markets.
- **Fund Managers and Asset Managers** engage with liquidity providers to execute trading strategies and manage portfolios efficiently, aiming to minimize slippage.
- **Market Makers** depend on liquidity providers to balance their books and manage their risk exposures effectively.
- **OTC Trading Desks** act as intermediaries for clients who wish to place large orders without affecting market prices, using liquidity providers for this purpose.
- **API Traders and Algorithmic Traders** utilize liquidity providers to facilitate the effective implementation of high-frequency trading strategies with minimal latency.
- **Arbitrageurs** use liquidity providers to quickly and efficiently exploit price discrepancies across different trading platforms.

3.3. Main Factors When Choosing an LP

Asset Coverage: Crypto markets are diverse, with a wide range of coins and tokens available for trading. An effective LP should offer a broad range of assets, including major cryptocurrencies like Bitcoin and Ethereum. This breadth in asset coverage allows traders to diversify their portfolio without having to switch between different LPs.

Regulatory Compliance: It is important to note that regulatory requirements vary across jurisdictions. Choosing an LP that complies with the specific regulations of your target markets can simplify compliance reporting for traders, resulting in reduced administrative overhead. Liquidity providers that strictly adhere to regulatory guidelines offer enhanced security and an added layer of protection against fraud and market manipulation.

Post-trade settlement: In the context of fiat-to-crypto trading, post-trade settlement occurs on both blockchain rails and through traditional banking transfers. It is crucial to ensure that traders and liquidity providers have banking access that enables smooth post-trade settlements.

Spread Size: The spread is the difference between the buying and selling price of an asset. In the context of liquidity providers, tighter spreads are generally more advantageous for traders. Tight spreads mean that the cost of entering and exiting a position will be lower, thereby reducing total transaction cost. Larger spreads can eat into trading profits and make trading strategies less viable. Therefore, evaluating the average spreads offered by an LP is critical.

Depth of Order Book: The order book depth is a real-time, continually updated list of buy and sell orders in a particular market. A deeper order book indicates that there is a significant amount of buy and sell orders at various price levels.

The benefit of a deep order book is twofold:

Price Stability: A deep order book helps to buffer against market volatility. When large orders are executed, they are less likely to move the market price significantly.

Reliability: The reliability of an LP is measured by its historical uptime, performance, and response to market crises. Liquidity providers that frequently experience downtimes or lags, especially during periods of high volatility, can be hazardous for market players and traders who may find themselves unable to execute trades or manage positions effectively. Therefore, reviewing historical data, third-party reviews, and uptime guarantees can be useful in assessing an LP's reliability.

Integration and Support: Finally, the ease of integration with a trader's existing systems is an important consideration. Liquidity providers usually offer API (Application Programming Interface) access that allows for seamless integration with trading platforms and other financial systems. Moreover, robust customer support can aid in troubleshooting, provide quick resolution to queries, and even offer market insights. Thus, it's worthwhile to consider both the quality of the LP's technical infrastructure and their customer support services.

4. Technology & Infrastructure

4.1 Importance in OTC Trading

In today's fast-paced trading environment, technology plays a vital role in OTC trading, offering several key advantages:

Speed and Efficiency: Modern trading systems rely on high-speed data feeds, low-latency communication, and rapid order execution. In a market where milliseconds can make a significant difference, technology is critical.

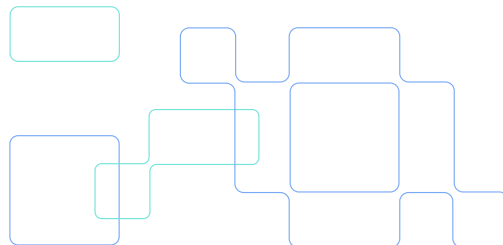
Scalability: As trading volumes and data streams grow, scalable technology is essential to handle the increased load without affecting performance.

Security: With the increasing number of cyber threats, a robust technological framework is necessary to secure sensitive data and financial transactions.

Algo-Trading and Automation: Advanced algorithms can execute complex trading strategies more efficiently than human traders, doing so with mathematical precision.

Transparency and Compliance: Regulatory requirements demand a high level of reporting and transparency, achievable through advanced technological systems that can track, record, and report trades in real-time.

Global Reach: Technology allows for a global trading environment, where trades can be executed 24/7 across different markets worldwide.



4.2 Evaluation of various trading platforms and tools

ECNs, multilateral and bilateral trading platforms and their trading mechanisms can be categorized (with a degree of simplification) based on two factors: (1) anonymity and (2) the "firmness of liquidity."

(1) **Anonymity:** When trading on a bilateral basis or using multilateral systems with request-for-quote (RFQ) or streaming prices, the trading is fully disclosed. On the other end of the spectrum, Central Limit Order Books (CLOBs) offer full pre-trade anonymity. Some ECNs have even created separate matching mechanisms for specific pools or tiers of participants with shared characteristics.

(2) **Firmness of liquidity:** The second factor to consider is the level of certainty in execution, also known as the "firmness" of liquidity. This is influenced by a practice called "last look.", which is discussed in section 5 of the report.

When considering technology solutions for OTC trading, various factors must be considered:

User Interface: A clean, intuitive interface can significantly improve the user experience, making it easier to execute trades efficiently.

Reliability: Platforms need to be stable, with minimal downtime, to ensure continuous trading.

Customization: The ability to customize the platform according to specific needs—like specialized trading algorithms or risk assessment tools—can offer competitive advantages.

Cost: The total cost of ownership, including initial setup and ongoing maintenance fees, should align with expected benefits.

Data Analysis Tools: Platforms equipped with advanced analytical tools can offer crucial insights into market trends, allowing for more informed decisions.

Regulatory Compliance: Ensure that the platform adheres to relevant regulations and standards to mitigate legal risks.

5. Counterparty Risks

5.1 Evaluation of risks involved in OTC trading

The collapse of FTX exposed the potential systemic risks that can stem from inter-connectedness and reliance on a centralized exchange. As a result, market players have been seeking a greater emphasis on risk management and robust safeguards. Shifting towards OTC setups is one way to mitigate counterparty risks, as OTC markets allow for direct bilateral or multilateral agreements between parties, reducing reliance on centralized intermediaries and minimizing the exposure to potential defaults or insolvencies.

Despite this, the crypto OTC market presents its own set of counterparty risks, distinct from those in centralized exchanges or traditional financial systems:

Regulatory Ambiguity: The unclear or rapidly changing regulatory environment for cryptocurrencies increases the risk of abrupt policy changes that could affect trades.

Identity and Fraud Risks: The pseudonymous nature of blockchain transactions makes it easier for bad actors to disguise their identity, increasing the risk of fraud.

Wallet and Custody Risks: The need to move large amounts of cryptocurrency to and from wallets exposes traders to the risk of hacking or internal fraud.

Price Manipulation: The relative lack of oversight and reporting requirements can make the crypto OTC market susceptible to price manipulation schemes.

Settlement Risks: In a market where transactions are often finalized quickly, the risk of one party defaulting on their commitments is heightened.

5.2 Best practices for risk management

Managing counterparty risks in crypto OTC markets requires a tailored approach, given the unique risks involved. This includes:

Regulatory Alignment: Stick to counterparties and platforms that strive to align with both local and international regulations, even if not explicitly required.

Credit Risk: Assess credit risks and conduct thorough due diligence of the OTC LPs for effective risk management, focus on the healthy balance sheet and financial statements, collateral requirements/evaluation and proven track record.

KYC/AML Procedures: Choose trading platforms and counterparties that implement robust Know Your Customer (KYC) and Anti-Money Laundering (AML) protocols.

Multi-Signature Wallets: When possible, use multi-signature wallets that require multiple approvals before funds can be moved, enhancing security.

Price Verification: Use multiple data sources to verify pricing information to safeguard against manipulation.

Settlement Procedures: Clearly define and agree upon settlement procedures and timelines in advance to reduce settlement risk.

Insurance: Consider using platforms or custodial services that offer insurance on digital assets to mitigate potential loss from hacks or fraud.

By understanding the unique counterparty risks in the crypto OTC market and applying these best practices, traders and institutions can better safeguard their assets and trading operations.

6. Deep Technical Dive into Trading

Understanding the underlying mechanics of trading systems is pivotal for traders and investors alike. Our 'Deep Technical Dive into Trading' section aims to elucidate the complexities of different market structures and practices that govern asset pricing, trade execution, and risk management.

In this section, we will explore the nuances of order-driven and quote-driven markets, exploring how they impact liquidity, price determination, and transparency. Additionally, we will examine the controversial yet commonly employed practice of 'Last Look,' focusing on its implications for both liquidity providers and traders. This deep dive aims to equip you with the knowledge to navigate the trading environment more effectively, illuminating the pros and cons of each system and practice.

6.1 Order-Driven Market

Bid and Ask: Traders place 'bid' orders to buy and 'ask' orders to sell. The highest price a buyer is willing to pay is the bid, and the lowest price a seller is willing to accept is the ask.

Order types: Market structure tends to differentiate orders both by their liquidity-effect and by their associated risks. Two main types are market orders (direction to trade immediately at the best price available) and limit orders (have inbuilt price limits that must not be breached).

Order Matching: Orders are matched based on these bids and asks. When a bid matches an ask, a trade occurs. Orders can be matched based on either price-time priority or price-size priority. In price-time priority, the order in which orders are received at a specific price level is the main factor determining trade execution. On the other hand, in price-size priority, the size or quantity of the orders takes precedence over the time they were received.

Price Discovery: Prices are set organically through supply and demand. A price shift occurs when new bids or asks are placed that don't match existing asks or bids, respectively.

Liquidity & Slippage: Liquidity in this market comes from the orders themselves. High liquidity generally reduces slippage—the difference between the expected price and the executed price.

Transparency: One of the primary advantages of order-driven markets is that they are often more transparent as more pre-trade and post-trade information is available to traders. Traders can see the depth of market interest at various price levels.

Impact of Large Orders: In this type of market, large orders can significantly affect the price. Traders need to be mindful of how their orders could move the market.

6.2 Quote-Driven Market

A quote-driven market is characterized by market makers who provide liquidity by continuously quoting buy and sell prices, with trades executed directly between investors and these market makers. This system is especially suitable for less liquid markets, as market makers ensure continuous trading by always being available to buy or sell.

That being said, quote-driven market operates as follows:

Liquidity Providers Quotes: Market makers or LPs quote the prices at which they are willing to buy or sell an asset. These quotes often include both a bid and an ask price.

Negotiation: Unlike in an order-driven market, participants negotiate directly with liquidity providers rather than placing orders into a public order book. This means quotes are indicative rather than firm.

Liquidity: Here, liquidity is provided by the market makers or liquidity providers, not by the trading crowd.

Price Determination: Prices are set by these market makers based on their own inventory, risk tolerance, and market perception.

Transparency: This type of market tends to be less transparent than an order-driven market, as traders do not have full visibility into the range of bid and ask prices available.

6.3 Last Look

The crypto market is fragmented and lacks a centralized system for recording quotes and trades. This lack of consolidation makes it difficult to determine historical or current price levels, which can create opacity in the market. As a result, liquidity providers face the risk of latency arbitrage. This means that they may receive orders from market participants who have better information about future prices, creating an information asymmetry. Additionally, the fragmented and high-speed nature of the market can lead to "relativistic prices," where prices at any given time are uncertain.

"Last Look" is a trading protocol in which a liquidity provider (LP) reserves the final right to accept or reject a trade request after a client has committed to a specified price and trade size. This essentially creates a review or "pause" window during which the LP may examine various factors, including risk factors, market conditions, price movements, etc.

Originally, the Last Look mechanism has its roots in the FX market and was primarily designed as a risk management tool for liquidity providers, as it enables LPs to ensure that the pending transaction aligns with their risk parameters and operational capacities before finalizing the trade.

While the practice provides LPs with added security against market anomalies and toxic flows, it can also result in trade delays or rejections, causing some controversy particularly among traders who might view it as a potential point of unfair advantage.

Risk Management: From a technical standpoint, Last Look functions as a safeguard for Liquidity Providers (LPs). It acts as a final validation step in the trade lifecycle, often implemented as a software-controlled delay or manual override within the LP's trading system. During this time-window, risk management algorithms can reassess market conditions, manage exposure, and balance the LP's portfolio, effectively preventing toxic flow, latency arbitrage and ensuring that the trade aligns with the LP's risk parameters.

Slippage & Rejections: Slippage occurs when the executed price of a trade differs from the expected price. In a Last Look window, various factors such as risk parameters, even a small delay in market data feeds, technical errors, pricing errors, and market fluctuations can lead to a rejection. This, in turn, can result in slippage for traders, as their orders will need to be rerouted, leading to delays in trade execution. Algorithms and high-frequency trading strategies, which depend on low latency, can be severely impacted by such delays

Market Conditions: The Last Look window allows LPs to technically evaluate the real-time market conditions—often by employing machine learning algorithms to analyze order book depth, volatility, and other market metrics. Should a sudden and significant market movement occur, the LP can back out of fulfilling the trade, thus saving themselves from potential losses.

Transparency: Transparency in the Last Look process can be increased through technical means such as time-stamping orders at various stages, including pre and post-Last Look, providing a reason code for rejections. These technical layers of transparency can be built into trading platforms and can be audited by third-party agencies, providing more confidence in the fairness of the trading process.

Controversy: The practice becomes controversial, especially when LPs engage in what is called 'order fishing.' Technically, this involves LPs capturing client orders to assess the market direction before making a decision. Critics argue that this essentially allows LPs to game the system by rejecting orders that would be disadvantageous to their positions. This behavior, although difficult to prove, could be monitored using advanced order tracking and auditing algorithms.

Impact on Liquidity Takers

In the OTC market, liquidity takers might face challenges due to the Last Look practice. This is because:

- 1. Price Uncertainty:** Takers may agree to a trade, but due to Last Look, the final execution can be uncertain if the market maker decides to reject the trade after the quote is accepted.
- 2. Strategy Disruption:** Timing is crucial in trading. Any delays or uncertainties can disrupt takers' trading strategies, especially those reliant on prompt execution.
- 3. Market Impact:** Frequent Last Look rejections could make takers more cautious, potentially impacting their willingness to engage in the OTC market, which could indirectly affect market liquidity.

Impact on Makers

Makers, typically the liquidity providers in the OTC crypto market, use the Last Look practice for several reasons, each with its benefits and drawbacks:

- 1. Risk Management:** The primary benefit for makers is the ability to manage risk. Given the volatile nature of cryptocurrencies, Last Look allows makers to back out of a trade if market conditions change drastically between the time a quote is given and when the trade is executed. This can protect them from significant losses due to sudden market movements.
- 2. Preventing Toxic Flow:** Last Look enables makers to avoid trades that might be based on asymmetric information or speed advantage or advanced knowledge of market movements (often associated with high-frequency trading strategies), which can be detrimental to the maker's position.
- 3. Price Optimization:** Makers can use the Last Look window to ensure that the agreed-upon trade price is still aligned with current market conditions. This can help in maintaining profit margins and mitigating risks.

However, there are notable drawbacks:

1. Reputational Risk: Overuse or perceived misuse of Last Look can harm a maker's reputation. Market participants may view them as unreliable if they frequently reject trades, leading to a potential loss of business.

2. Market Integrity Concerns: Excessive use of Last Look can raise questions about the fairness and integrity of the OTC market. It might discourage participation, especially from those who value transparency and certainty in trade execution.

3. Operational Complexity: Implementing and managing a Last Look policy can add complexity to the trading operation, requiring sophisticated systems and algorithms to make real-time decisions.

Back in 2015 FX market participants started to develop “The FX Global Code”, a set of guidelines and principles developed by market participants to promote fair and transparent practices in the FX market. It aims to enhance the integrity and effectiveness of the market by establishing standards for behaviour, execution, and risk management. The code covers areas such as ethics, governance, information sharing, execution, risk management and compliance, confirmation and settlement practices.

Given the similarities between the FX market structure and the cryptocurrency market structure, players in the crypto industry may consider adopting a similar code to ensure the integrity and stability of their market and build trust among participants.

7. Speed Bumps in Trading

As discussed in Section 6, last look practice was established by LPs to reduce the risk of latency arbitrage and information asymmetry in a fragmented, high-speed marketplace with no centralized price discovery.

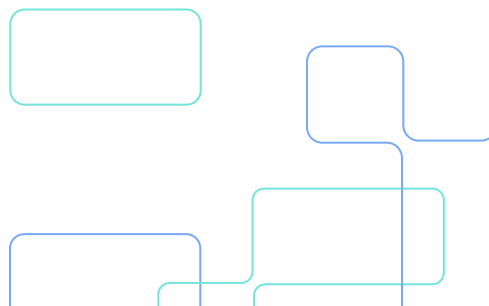
The benefits and costs of high-frequency trading are currently under debate, with some experts suggesting that the speed at which trades are executed may be reaching a point of diminishing returns. The goal is to shift the focus from speed-based competition to price-based competition by reducing the comparative advantage of high-frequency traders and decreasing the possibility of trading on information asymmetry and latency arbitrage.

One possible method to reduce risks for LPs, even without implementing the controversial "last look" practice, is by introducing asymmetric speed bumps.

A Speed Bump in trading is a deliberately introduced latency, typically a few milliseconds, during order execution. Its main purpose is to mitigate the advantage of high-frequency traders (HFTs) who rely on ultra-low latency systems to outpace other market participants. By slowing down the order execution process slightly, speed bumps aim to level the playing field and prevent HFTs from exploiting market-moving information or price changes before others can react.

In trading of traditional asset classes, speed bumps can take on various forms. One type is symmetrical speed bumps, where all order types and market participants experience the same minimum delay between two orders. For example, the American IEX platform implemented this mechanism for equities trading to slow down trading speed. Another type is asymmetric speed bumps, which may or may not impose a delay depending on the order type. These mechanisms are used for certain instruments in Europe (Euronext, Eurex) and the US (ICE) to protect liquidity providers by specifically targeting high-frequency arbitrage strategies.

There are also random speed bumps, which aim to prevent market participants from predicting the impact of the slowdown. This particular mechanism, which is only found in foreign exchange markets, can lead to duplicate orders and reduced market participation.



Reduced Market Manipulation

By negating the speed advantage of HFTs, speed bumps can reduce instances of market manipulation like 'front-running,' where traders capitalize on advanced market information.

- 1. Improved Market Stability:** Slight delays in order execution can lead to a more stable trading environment by reducing the intensity of rapid price movements often exacerbated by HFT strategies.
- 2. Enhanced Fairness:** Speed bumps can make the trading environment more equitable for all participants, including those who do not have access to high-speed trading infrastructure.
- 3. Better Price Discovery:** By preventing HFTs from instantly reacting to market information, speed bumps can contribute to more accurate price discovery, as prices reflect a broader range of market participants.
- 4. Protection Against Volatility Spikes:** In volatile market conditions, speed bumps can help in smoothing out sudden price spikes, providing LPs with a more controlled environment for managing their quotes and orders.

Implementation and Effectiveness

The implementation of speed bumps varies across different trading platforms, but the underlying principle is consistent. **Key aspects include:**

- 1. Duration of the Delay:** The typical duration of a speed bump is a few milliseconds, enough to dampen the advantage of HFTs without significantly impacting other traders.
- 2. Selective Application:** Some platforms apply speed bumps only to certain types of trades or market conditions, such as during periods of high volatility or for trades that exceed a certain size.
- 3. Transparency and Predictability:** Effective implementation requires transparency about when and how speed bumps are applied, so traders can adjust their strategies accordingly.
- 4. Customization for Different Markets:** The design and impact of speed bumps can vary based on market specifics, such as asset type and typical trade size.

Effectiveness and Market Response

The effectiveness of speed bumps is subject to ongoing debate:

1. Proponents' View: Advocates argue that speed bumps enhance market integrity and fairness, benefiting a wider array of market participants, not just those with the fastest technology.

2. Critics' Perspective: Opponents contend that speed bumps introduce artificial inefficiencies and can lead to unintended consequences, such as reduced liquidity or distorted market signals.

3. Regulatory Considerations: The use of speed bumps in traditional asset classes also involves regulatory scrutiny to ensure that they align with broader market fairness and efficiency objectives.

In summary, speed bumps in trading are designed to create a more equitable trading environment by mitigating the advantages of high-frequency trading. Their benefits for liquidity providers include improved market stability and fairness, even without the controversial “last look” mechanism. However, the effectiveness of speed bumps and their broader impact on market dynamics remain subjects of active discussion and analysis within the financial community.

8. Scope of Market Research

The objective of the market research component of this report is to gauge various aspects of liquidity providers' operations, market activity, and sentiment in the crypto OTC space. We aim to gather comprehensive data that will shed light on market dynamics, volume, client behaviour, and the impact of regulatory changes among other key metrics. The questionnaire, designed to be answered by 80+ Liquidity Providers, serves as the primary tool for collecting this data.

8.1 Elements of Market Research

Duration in the Market: Understanding how long liquidity providers have been involved in trading digital assets will help assess their expertise and market understanding.

Types of Crypto Instruments: This aims to determine the diversity of trading instruments offered by liquidity providers, such as Spot, Futures, Options, etc.

Market Size and Share: This crucial metric will offer an understanding of the average daily trading volume, which in turn helps assess the size and potential of the Spot OTC market.

Volume Comparison: Comparing trading volume on Centralized Exchanges (CEXs) to OTC platforms will provide insights into market preference and liquidity.

Trading Volume Ratios: Distinguishing between Spot and Derivative trading volume will help understand the risk profile and market activities better.

Year-On-Year Growth: This data aims to gauge the market's direction and pace by looking at the six-month year-on-year growth rate in trading volumes for the Spot OTC market.

Projected Growth: The aim here is to understand how liquidity providers perceive market growth for the year 2023 compared to 2022.

Client Base: Knowing whether the number of clients is increasing, decreasing, or staying the same will help assess market saturation and adoption rates.

Asset Preference: By breaking down the trading volume into BTC, ETH, and other assets, we can identify market trends and investor preferences.

Investment Focus: Understanding where liquidity providers are planning to invest to increase their client base gives an idea of emerging market trends and priorities.

Regulatory Impact: This will help gauge the overall sentiment towards regulatory changes and their impact on business operations.

Legal and Domicile Information: This is important for classification and segmentation of the data.

Consent for Disclosure: Understanding whether the companies are comfortable being listed as respondents will govern how the report can present its data.

8.2 Methodology

Data Collection: The primary mode of data collection will be through the questionnaire.

Data Analysis: Responses will be analyzed both quantitatively and qualitatively.

Segmentation: Data will be segmented based on various parameters like company size, years in operation, and geographic location.

Visualization: Key findings will be presented in graphical format for easier interpretation and comparison.

Confidentiality: Respondents' privacy will be maintained, and data will be aggregated to ensure that individual responses cannot be identified.

Expected Outcomes

The research is expected to yield valuable insights into the current state and future trends of the crypto OTC market, thereby aiding stakeholders in making informed decisions.

9. Results of Research

9.1. Executive Summary of Findings

The report on Over-The-Counter (OTC) crypto markets reveals some insightful trends, despite certain limitations in data capture. A significant portion of organizations, about 40%, have been involved in digital asset trading for over six years, indicating a strong and established presence in the market. This is complemented by those with medium-term engagement of 4 to 6 years, making up 33% of the respondents. Although the intention was to gather more extensive data for deeper insights, the responses for some questions were inconclusive. Therefore, the report focuses on the conclusive data available.

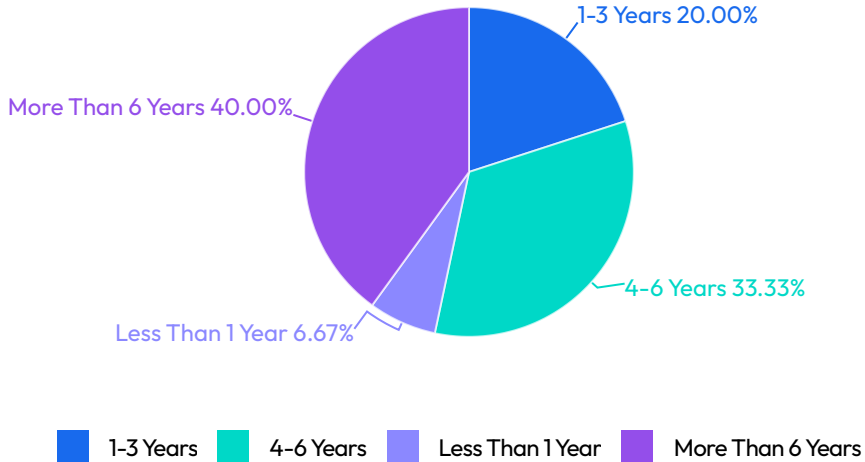
The spot OTC market size during the first three quarters of 2023, has an average daily trading volume of \$1.44 billion, based on responses from market participants who were willing to disclose their trading volumes. This highlights robust market activity. Looking forward, the majority of respondents are optimistic about the market, expecting an increase in trading volumes in the future period.

Client engagement also appears to be growing, with 80% reporting an increase in their client base in 2023 over the previous year. However, the impact of regulations on these businesses is mixed, with 40% reporting no change, 33.33% feeling a positive impact, and 26.67% experiencing a negative impact in 2023 compared to 2022.

9.2. Tenure in Digital Assets Trading

The tenure of organizations in digital assets trading varies, with a notable 40% having over six years of experience in the field. This long-term involvement is a testament to the established nature of almost half of the players in the market. Additionally, a substantial segment of 33.33% has been trading digital assets for a period of 4 to 6 years, indicating a strong medium-term presence. The market also includes newcomers, with 20% of organizations having a tenure of 1 to 3 years and a small minority of 6.67% being involved for less than a year.

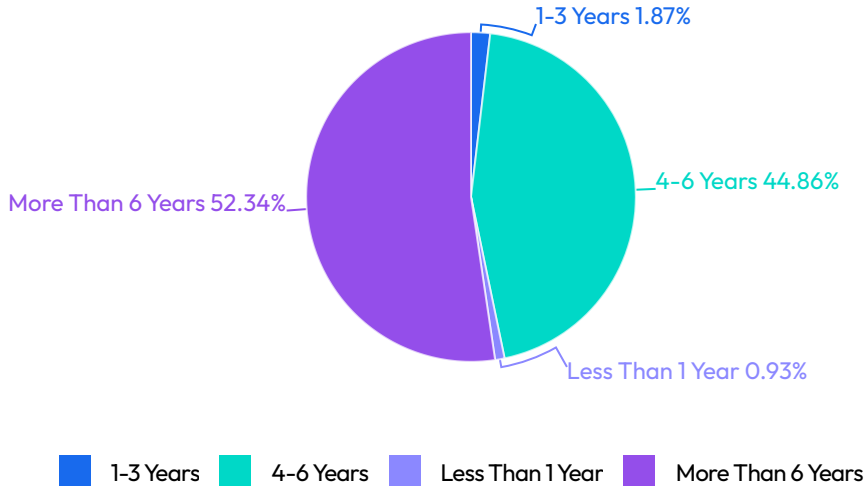
How Long Has Your Organisation Been Involved in Trading of Digital Assets - Over The Counter (OTC) Trading



Utilizing CCData’s Exchange Benchmark dataset, we can investigate the key differences of 107 centralized exchanges, against the results seen within the OTC market. Based on this data, 52% of centralized exchanges integrated into the Benchmark have been involved in Digital Assets for over 6 years, suggesting that the majority of key providers in the industry have established a reputation since at least 2017, being present in the space for 2 previous cycles, going on a third. Additionally, exchanges with a presence for 4-6 years make up around 45%, meaning that in total, 97% of exchanges in CCData’s dataset have existed for at least 4 years.

This may show that most reputable exchanges have had to withstand the test of time, building trust from participants over a long period. It may also signal the difficulty in breaking into the top 100 exchanges due to the counterparty risk associated with new or untrustworthy exchanges, exacerbated by hacks, exit scams and exploits omnipresent across the CEX landscape. Additionally, OTC providers do not require the same level of trust due to off-exchange settlement and strong integration with self-custody and reputable custody providers being standard practice across the OTC marketplace. It may also indicate that institutionalization of the industry may still be in its infancy, inferring that higher growth should be expected amongst OTC providers as they continue to build reputation in the market and facilitate a growing institutional audience.

How Long Has Your Organisation Been Involved in Trading of Digital Assets - Centralised Exchanges

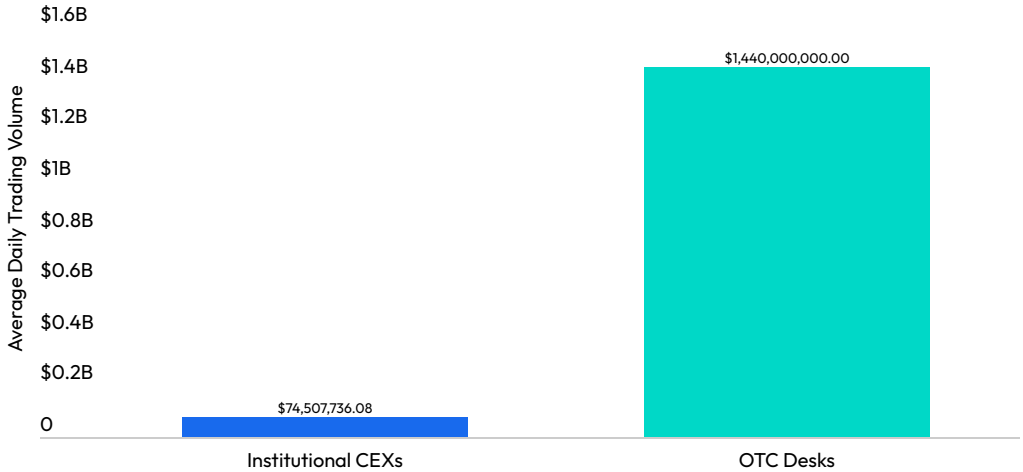


9.3. Spot OTC Market Size and YoY Growth

The spot OTC market size, as reported from a limited yet significant set of responses, averages a substantial \$1.44 billion in daily trading volume. This figure underscores the considerable scale of market activity in this segment, especially taking into consideration that this estimate was made during bear market. Additionally, there's a general sentiment of optimism about future market growth, with most respondents expecting an increase in trading volumes compared to the previous year.

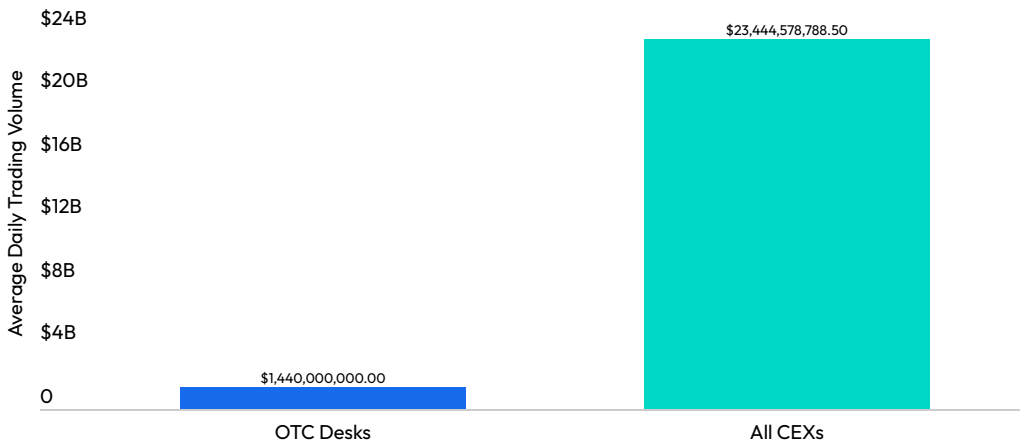
When comparing average daily trading volumes with centralized exchanges, some large differences are observed. According to CCData's comprehensive market data set for CEXs, institutional-only exchanges, LMAX and ErisX, have in total generated around \$75 million in average daily spot trading volume throughout 2023. Although most CEXs are retail-facing and tend not to reserve access to only institutions, LMAX and ErisX maintain high entry requirements and as such are proxies for institutional volumes. Based on these results, observable differences are displayed, with OTC Desks capturing ~1800% more volume on average every day. This shows a high level of preference currently shown to an institutional OTC provider versus CEX throughout 2023.

Average Daily Trading Volumes, 2023 - Institutional CEXs vs OTC Desks



Factoring in full coverage of CEXs within the industry, OTC average daily volumes remain small in comparison, with average spot volume for CEXs being recorded at \$23.4 billion per day. This suggests that spot volumes are still dominated by CEXs in general, due to their ease of accessibility and convenience to retail traders. However, it also shows the large capture that may be possible by OTC providers, as the space matures and more sophisticated players enter the market due to regulatory clarity and improved accessibility.

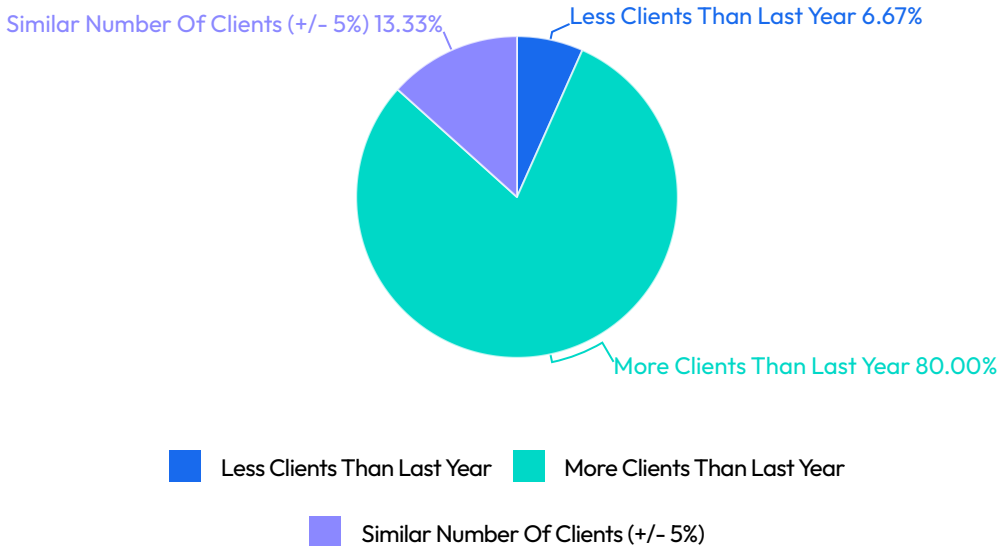
Average Daily Trading Volumes, 2023 - OTC Desks vs All CEXs



9.4. Client Base Metrics (Q8)

The client base in the OTC crypto markets appears to be expanding significantly, with 80% of the respondents reporting an increase in their client numbers in 2023 compared to 2022. This growth is indicative of a rising interest and engagement in the market, reflecting a positive trend in market participation. Conversely, 13.33% of the organizations reported maintaining a similar client count, suggesting stability for a segment of the market, while a small fraction of 6.67% experienced a decline in their client base. Overall, these figures collectively point towards a generally healthy and growing OTC crypto market, despite a few instances of stagnation or reduction in client numbers.

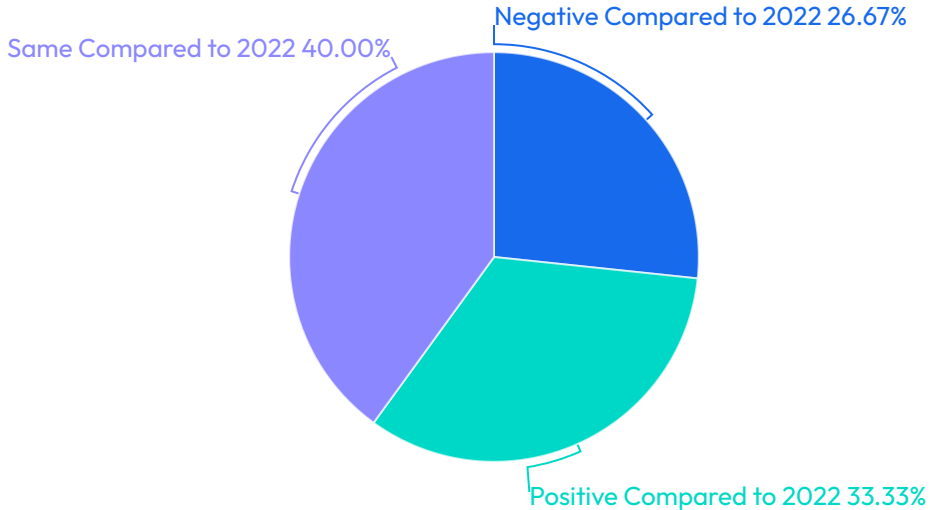
OTC Desks: Number Of Clients in 2023 Compared to 2022



9.5. Regulatory Impact

The impact of regulations on businesses in 2023 has been diverse. While 40% of the respondents observed no significant change compared to the previous year, a notable 33.33% reported a positive impact of regulations on their operations. However, 26.67% of the respondents felt a negative impact, illustrating the varied effects of regulatory changes in the OTC crypto market.

OTC Desks: How Would You Describe the Impact Of Regulation In 2023 On Your Business Compared to 2022?



9.5. Spreads in OTC Markets vs Centralized Exchanges

As explored in earlier explanations and analysis, there are many advantages to utilizing an OTC provider when looking for best execution in high volumes. Compiling trade data to cover a period of high volatility, on both the upside and downside, we observe and analyze the March 2023 banking crisis regarding Silicon Valley Bank, which was the largest banking failure since 2008, with \$42 billion of withdrawals being processed in a single day. As a result of this crisis, the markets immediately sold off due to fears of systemic risk within the banking sector, with knock-on effects such as a USDC depegging causing major concern within the industry. Assessing how best execution occurred during this highly volatile event will provide insight into how average spreads were affected by uncertainty.

Looking into the data, we selected the BTC-USDT pair on both OTC and select CEXs due to its high liquidity across all venues. For OTC execution, we considered all trades executed through Finery Markets during the selected time period, looking at all trades executed at both 1 BTC and 10 BTC. For CEXs, we considered top-of-book spreads regardless of size during the same period. The comparison was done by evaluating the standard deviation of spreads throughout the selected time period across multiple CEXs, with the trade data collected by Finery Markets.

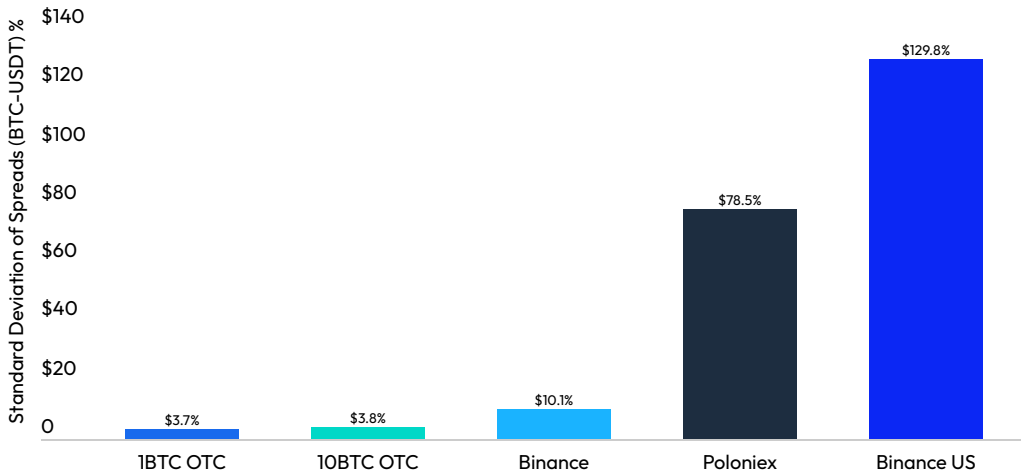
The results show significantly tighter spreads during the period on OTC, regardless of the trade size. In fact, both standard deviations were incredibly close, with just 0.1% difference between

1BTC and 10BTC executions. In comparison, Binance maintains a 10% standard deviation, with Poloniex seeing 78.5% and Binance US significantly worse off, with 130%. These stark differences highlight the consistency of OTC market execution regardless of size and volatility, beating Binance who maintain the tightest spreads amongst the CEXs within the market.

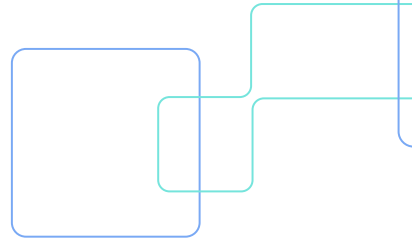
These results underscore the execution benefits felt by OTC clients in comparison to CEXs during highly volatile periods (regardless of up or downside volatility).

It must be noted that OTC providers, as explained in previous sections, have the right of ‘last look’ and can therefore decline trades which may form part of toxic flow or unprofitable setups. This differs from CEXs who operate a closed order book (COB) model where market orders are always filled (with some slippage incurred) without need confirmation or approval.

Standard Deviation of BTC-USDT Spreads on Selected Exchanges During Banking Crisis, 9-12 March 2023



10. Conclusion



In concluding this research on the Over-The-Counter (OTC) crypto market, the analysis presents a market characterized by dynamic growth and complex regulatory interactions. The observed increase in the client base in 2023, relative to the previous year, indicates a significant expansion of the market. This expansion is not merely quantitative; it reflects a broader trend of increasing engagement and confidence in the OTC crypto trading environment.

The anticipation of growth in trading volumes, as indicated by a majority of respondents, suggests a positive market outlook. This sentiment points towards an underlying robustness within the market structure, potentially driven by evolving trading strategies and an increasing diversification of market participants.

Regulatory impacts, however, present a more heterogeneous picture. The data indicates diverse responses to regulatory changes, with some entities experiencing positive impacts, others negative, and a notable portion observing no significant change. This variation underscores the multifaceted nature of regulatory influences on the OTC crypto market and highlights the importance of contextual and nuanced analysis in understanding these impacts.

Technological advancements in trading platforms and infrastructure emerge as critical factors in this market. They play a pivotal role in enabling efficient, secure, and adaptable trading mechanisms, which are essential for maintaining market integrity and fluidity.

Liquidity providers are identified as key contributors to market efficiency. Their role in facilitating trading, providing competitive pricing, and managing risks is crucial in the functioning of the OTC crypto market.

This research contributes to a comprehensive understanding of the OTC crypto market, its dynamics, and the factors influencing its growth and stability. It provides a foundation for future research and analysis in this field, emphasizing the need for continuous monitoring and adaptation to evolving market conditions, technological advancements, and regulatory landscapes.

In summary, this paper highlights the OTC crypto market as an evolving ecosystem, shaped by a confluence of technological, regulatory, and market participant-driven factors. Understanding these dynamics is essential for stakeholders navigating this space, and for formulating strategies that align with the market's growth trajectory and regulatory environment.

11. Participants

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12. Questionnaire

Question #1

How long has your organization been involved in trading of digital assets?

- A Less than 1 year
- B 1-3 years
- C 4-6 years
- D More than 6 years

Question #2

What Crypto Instruments does your company trade?

- A Spot
- B Futures
- C Options
- D ETFs / ETNs / ETPs
- E CFDs / NDFs

Question #3

Market Size and Share:

What is your estimate of the Spot OTC market average daily trading volume in 2023?

Please enter the numerical value in \$bln (e.g., \$2bln)

Question #4

Please provide your estimate of the ratio for Trading volume on CEXs compared to OTC.

Please specify the ratio (e.g., 20/80)

Question #5

Please provide the ratio for Spot / Derivatives Trading Volume in your organization in 2023.

Please specify the ratio (e.g., 20/80)

Question #6

Please provide the year-on-year growth rate in trading volume for the Spot OTC market for the 6-month period of 2023, expressed as a percentage.

For example, "25%" in the case of volume increase or "-25%" in the case of volume decline.

Question #7

What is your projected growth rate for Spot OTC trading volumes for 2023 compared to 2022?

Please enter a numerical value as a percentage (e.g., 10%)

Question #8

Compared to the same period last year, how does the number of your clients you have today measure up?

- A More Clients than last year
- B Similar number of Clients (+/- 5%)
- C Less Clients than last year

Question #9

Please provide the ratio for BTC / ETH / Other Trading Volume in your organization in the H1 2023.
Please specify the ratio (e.g., 60/25/15)

Question #10

Please provide the ratio for BTC / ETH / Other Trading Volume in your organization in 2022.
Please specify the ratio (e.g., 60/25/15)

Question #11

What are the key areas in which you are planning to invest in order to increase number of Clients?
e.g., geographical expansion, new asset classes, HR, technology, new product features, etc.

Question #12

How would you describe the impact of the Regulation in 2023 on your business compared to 2022?

- A Positive compared to 2022
- B Negative compared to 2022
- C Same compared to 2022

Question #13

What is the full legal name of your company?

Question #14

In which country is your company domiciled?

Question #15

Do you give us consent to use the Name of your company in the section List of respondents?
Individual companies will not be linked to any specific comment or data point.

- A Yes
- B No

13. Glossary

API (Application Programming Interface)

A set of rules and protocols that allow different software entities to communicate with each other.

Arbitrageurs

Traders who exploit price differences of the same asset across different markets for profit.

Asset Managers

Professionals or firms that manage investments on behalf of clients.

CEX (Centralized Exchange)

A platform where assets like cryptocurrencies are bought and sold in a centralized environment.

Derivatives

Financial contracts whose value is derived from an underlying asset, such as futures or options.

Fund Managers

Individuals or entities responsible for implementing a fund's investment strategy and managing its portfolio.

High-Frequency Trading

A type of algorithmic trading characterized by high speeds and high turnover rates.

Institutional Traders

Entities like mutual funds, pension funds, and endowments that trade in large volumes.

Latency

The delay between the initiation and execution of a process, often used in the context of trading systems.

Liquidity

The ability to buy or sell an asset without causing significant impact on its price.

Liquidity Providers (LPs)

Entities that provide buy and sell quotes in a market, facilitating smoother and more efficient trading.

Market Makers (MMs)

A subset of liquidity providers who commit to buying and selling specific assets to ensure market liquidity.

OTC (Over-the-Counter)

A decentralized marketplace where trading of financial instruments, including cryptocurrencies, occurs directly between parties without a centralized exchange.

Portfolio

A collection of financial investments such as stocks, bonds, and cryptocurrencies.

Retail Traders

Individual traders who buy and sell financial instruments, typically in smaller quantities compared to institutional traders.

Slippage

The difference between the expected price of a trade and the actual price at which the trade is executed.

Spot Market

A financial market where assets are traded for immediate delivery and payment.

Trader

An individual or entity engaged in the buying and selling of financial instruments for profit, typically with a focus on short-term market movements.

Volatility

The degree of variation in the price of an asset over time, often used as an indicator of risk and market stability.

14. Sources

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