



# Regulated FX Derivatives Trading Venues: Promoting Fair and Orderly Markets<sup>1</sup>

## I. Introduction

Trading venues serve as the cornerstone of global currency markets, and as regulatory frameworks adapt to evolving markets, trading venues must continue to evolve as well. The current foreign exchange (“FX”) derivatives market is comprised of both regulated trading venues, which are licensed or permitted to operate pursuant to permission from global regulatory bodies (“regulated FX derivatives trading venues”), and unregulated trading venues, which may engage in activity that requires registration and regulatory oversight, but do not currently operate under the auspices of a regulatory body of any jurisdiction (“unregulated FX derivatives trading venues”).<sup>2</sup>

While unregulated FX derivatives trading venues may, in some cases, offer higher leverage, lower deposit requirements to trade, lower fees for customers and less onerous onboarding requirements, when compared to regulated FX derivatives trading venues, those benefits may come at the expense of reduced customer protections resulting from lack of comprehensive regulatory oversight. The presence of unregulated FX derivatives trading venues also introduces the possibility of regulatory arbitrage for FX markets. These dynamics raise concerns about fairness and market integrity around the operation of unregulated FX derivatives trading venues. Market participants should be aware of the regulatory status (or lack thereof) and attendant protections and risks of the platforms on which they decide to trade. The presence or absence of regulatory oversight can impact a range of issues, including the role of affiliated market makers, permitted trading practices, market surveillance, and overall market integrity.

This FXPA white paper aims to explore the network of trading venues in over-the-counter (“OTC”) FX derivatives markets, focusing on the varying structures of trading venues, the potential impacts on market integrity, and the benefits of regulatory oversight for these venues.<sup>3</sup> Further, by understanding the implications of unregulated OTC FX derivatives trading venues, the FXPA aims to provide regulators, policymakers, and market participants with helpful insight into the industry and promote informed decision-making.

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<sup>1</sup> The Foreign Exchange Professionals Association represents the collective interests of the institutional FX market to advance a sound, liquid, transparent, and competitive global currency market to policymakers and the marketplace through education, research, and advocacy. This white paper and the recommendations made herein do not represent the specific individual opinion of any one particular member. For more information about the FXPA, please see [www.fxpa.org](http://www.fxpa.org).

<sup>2</sup> This white paper does not address single-dealer (or “one-to-many”) systems or platforms, on which the sponsoring entity is the counterparty to all swap contracts executed through the system or platform, and which it does not consider for purposes of this discussion to be “unregulated venues”.

<sup>3</sup> This white paper does not cover spot FX trading or spot FX trading platforms. Spot FX activities have traditionally been overseen by banking regulators of applicable jurisdiction. Spot FX transactions are sale transactions at a negotiated price that represent immediate delivery; extensive regulation of the market could prevent efficient market functioning and inhibit market liquidity. Accordingly, exemptions for spot FX market transactions and venues from oversight by prudential regulatory regimes are common across jurisdictions. See, e.g., Further Definition of “Swap,” “Security-Based Swap”, and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48207, 48256-58 (Aug. 13, 2012).

## II. Structure of Trading Venues

Regulated FX derivatives trading venues and unregulated FX derivatives trading venues differ significantly in their structure and oversight. As a general matter, regulated trading venues, such as stock exchanges, alternative trading systems and regulated futures exchanges, are subject to comprehensive oversight by regulatory bodies and must adhere to certain governance requirements. Such venues operate under strict rules and standards designed to promote market integrity, transparency and investor protection. In addition, regulated trading venues employ rigorous risk management practices and mechanisms to mitigate systemic risks and ensure orderly trading. Both US and EMEA regulations require trading venues to demonstrate adequate governance, including a formal framework for risk management. With respect to OTC FX derivatives, for example, regulated FX derivatives trading venues must adhere to disclosure requirements to ensure market transparency. The participants on regulated FX derivatives trading venues, such as brokers and traders, must also meet specific registration and compliance standards.

Unregulated FX derivatives trading venues include informal trading platforms that do not fall under traditional exchanges or regulatory oversight. Depending on the jurisdiction, unregulated FX derivatives trading venues operate with minimal or no formal regulation. Without direct regulatory oversight, unregulated FX derivatives trading venues may lack the structured rules and standards mandated for regulated FX derivatives trading venues. There are generally fewer onboarding requirements for participants and customers compared to regulated FX derivatives trading venues and such venues have fewer, if any, reporting requirements. For example, regulated FX derivatives trading venues require transparent reporting of trades, allowing for efficient price discovery and market efficiency. Unregulated FX derivatives trading venues can operate with less transparency, which may lead to price distortion. Moreover, unregulated FX derivatives trading venues rely on internal risk controls rather than a dual risk reduction structure of internal risk controls and external regulatory oversight.

Further, under the current framework, unregulated multi-lateral platforms have been able to present themselves as single-dealer platforms, by way of a central counterparty bank that acts as principal to each trade. However, multi-lateral platforms and single-dealer platforms serve different functions and compete differently in the market.<sup>4</sup> Single-dealer platforms provide a stand-alone service for trading specific products within one asset class, while multi-lateral platforms aggregate products and services across multiple firms, bringing together multiple third parties to buy and sell trading interests.<sup>5</sup>

## III. Fairness and Market Integrity Considerations

After the financial crisis, global regulators convened in Pittsburgh to develop a financial reform framework. Among its core values, the G-20 Pittsburgh Framework states: “We have a responsibility to ensure, through appropriate rules and incentives, that financial and other markets function based on propriety, integrity and transparency and to encourage businesses to support the efficient allocation of resources for sustainable economic performance.”<sup>6</sup> At that time, global market regulators agreed to establish a coherent legal and

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<sup>4</sup> See *infra* note 2.

<sup>5</sup> See ESMA, Final Report on ESMA’s Opinion on the Trading Venue Perimeter, 7-16 (Feb. 2, 2023), available at <https://www.esma.europa.eu/sites/default/files/library/ESMA70-156-6383%20Final%20Report%20on%20ESMA%27s%20Opinion%20on%20the%20trading%20venue%20perimeter.pdf>.

<sup>6</sup> G20 Leaders, Leaders’ Statement: The Pittsburgh Summit (Sept. 24, 2009), available at [https://home.treasury.gov/system/files/206/pittsburgh\\_summit\\_leaders\\_statement\\_250909.pdf](https://home.treasury.gov/system/files/206/pittsburgh_summit_leaders_statement_250909.pdf).

regulatory framework for swaps trading, bringing the unregulated swaps market into the fold through transparency and oversight. Specifically, the G20 leaders agreed, “All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”<sup>7</sup> However, it is difficult to reconcile these principles with the flourishing nature of unregulated FX derivatives trading venues, which often compete with and sit alongside highly regulated competitors and counterparties.

Unregulated FX derivatives trading venues can have a substantial customer base, and often offer services that are similar to regulated FX derivatives trading venues. However, as noted above, unregulated FX derivatives trading venues might not adhere to the same standards as regulated FX derivatives trading venues, raising concerns about elements of market fairness and integrity. We explore some of these concerns below.

## A. Transparency of Regulated Status

In some cases, unlicensed and unregulated FX derivatives trading venues will purport to operate as a technology intermediary or will use a central counterparty and function in similar ways to a US-registered designated contract market, swap execution facility, EU-recognized multilateral trading facility (“MTF”), organized trading facility, or Singaporean recognized market operator. These unregulated FX derivatives trading venues compete directly with regulated FX derivatives trading venues, but do not always disclose that they are not regulated, introducing the risk that consumers will choose unregulated FX derivatives trading venues in light of some of the benefits they can provide without complete knowledge to evaluate the attendant risks.

## B. Operational Costs

Regulated FX derivatives trading venues face higher operational costs, such as those associated with market surveillance, reporting and investor protection. Regulated FX derivatives trading venues must adhere to regulatory requirements, which involve costs such as licensing fees, audits, and other administrative compliance expenses. Regulators are focused on heightened transparency and reporting, which results in ongoing costs related to technology, personnel and risk management. For example, the Financial Conduct Authority (FCA) has published consultations aimed at enhancing transparency in derivatives and equities markets.<sup>8</sup> Consultation Paper (CP) 23/32 aims to revise the transparency framework for derivatives markets in the UK by extending transparency to OTC markets.<sup>9</sup> Establishing and maintaining the necessary infrastructure to collect, process and report data in a compliant manner is a large ongoing cost for regulated FX derivatives trading venues. CP23/32 acknowledges the operational costs imposed on firms to comply with transparency requirements, stating, that “[t]o comply with pre- and post-trade transparency requirements, firms must access and ingest the results of our calculations from [the Financial Instruments Transparency System]. Given the outcomes of the transparency calculations, this is disproportionately costly

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<sup>7</sup> *Id.* at 9.

<sup>8</sup> See e.g., FCA Consultation Paper CP23/32: Improving transparency for bond and derivatives markets, 99 (Dec. 2023) (discussing how the FCA’s proposals seek to address the harms that are driven by externalities, asymmetric information, market power and regulatory failure).

<sup>9</sup> Within OTC derivatives, all underlying asset classes are in scope: foreign exchange (FX), credit, commodities, interest rates and equities. See *Id.* at 14.

for firms and for the FCA.”<sup>10</sup> Maintaining the necessary infrastructure to collect, process, and report data imposes an ongoing cost for regulated FX derivatives trading venues. These reporting obligations are not only costly, but an area of potential risk for regulated FX derivatives trading venues, where non-compliance can result in fines, penalties and reputational damage.

Further, regulated FX derivatives trading venues invest in robust surveillance systems to monitor trading activities, detect irregularities to safeguard market integrity, prevent cybersecurity risks, and ensure business continuity and operational resilience. Regulated FX derivatives trading venues bear the additional costs of implementing compliance measures and prioritizing investor protection, such as providing real-time market monitoring to promote market integrity. This includes monitoring for signs of disorderly trading across markets and products. In addition, regulated FX derivatives trading venues that engage in algorithmic trading are subject to specific requirements such as resilience and capacity testing.<sup>11</sup>

These types of costs can be expansive and burdensome. For example, regulatory requirements for MTFs require registered venues to adhere to strict rules regarding required headcount and seniority of oversight staff engaged in compliance duties. In some cases, this has resulted in obligations to relocate offices and further expand funding for office staff. Regulated FX derivatives trading venues have also invested considerable time and resources to comply with system safeguard requirements, including through hiring compliance staff and building T+1 settlement surveillance systems. A financial services regulatory consultancy recently reported that to be “fully compliant and to undertake all the investment and work that registration entails” could “cost as high as GBP 3 million.”<sup>12</sup> An internal analysis conducted by one FXPA member estimates that operating a single regulated FX derivatives trading venue costs between \$1.3 million to \$1.5 million US dollars per year, and costs would be higher for an entity operating more than one regulated FX derivatives trading venue.

Unregulated FX derivatives trading venues, on the other hand, operate with fewer regulatory constraints, resulting in substantially lower compliance or oversight-related expenses. Unregulated FX derivatives trading venues generally enjoy the flexibility of designing their operations to reduce administrative costs, and also lack the regulatory oversight that would impact operating expenses.

### C. Impartial Access

Regulated FX derivatives trading venues are expected to demonstrate adequate governance across trading activities, and impartial access is crucial to market fairness and competition. Promoting equal access to regulated FX derivatives trading venues ensures a level playing field amongst all market participants. For example, regulated FX derivatives trading venues have single rate cards for market participants rather than bespoke arrangements that reward larger players. These rate cards are published, whereas unregulated FX derivatives trading venues have the ability to benchmark and maintain the flexibility to undercut rates. Regulated FX derivatives trading venues do not pay connectivity vendors and fully disclose market maker programs; standards that may not be upheld among unregulated FX derivatives trading venues.

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<sup>10</sup> *Id.* at 4.

<sup>11</sup> Under the Markets in Financial Instruments Directive 2 (MiFID2) regulations, trading venues that allow or enable algorithmic trading must monitor all algorithmic trading activity in real time.

<sup>12</sup> See “The Ultimate Risk-Reward: To MTF or Not?”, The Full FX (May 22, 2024), available at <https://thefullfx.com/the-ultimate-risk-reward-to-mtf-or-not/>.

The fairness imported to the markets through adherence to standards of impartial access promotes healthy competition and market stability. The diversity of participants accessing regulated FX derivatives trading venues contributes to market stability. Imbalanced access could lead to concentration risk and potentially destabilize the market. When a limited number of participants have exclusive access to a trading venue, trading activity will inevitably become concentrated among those participants, which may then lead to the market becoming more dependent on both the activity and the stability of those participants. Regulated FX derivatives trading venues are also required to implement rules that aim to prevent discriminatory practices, thereby allowing market participants to trade on equal terms. Such regulatory obligations promote transparency and reduce the risk of market abuse.

## IV. Implications of Regulatory Gaps on Competition Between Venue Types

Regulated FX derivatives trading venues are bound by certain requirements and obligations designed to promote customer protection through transparency, accountability, and risk management, and global regulators regularly assess and adjust the standards of compliance to protect market participants and promote market integrity. For example, the European Securities and Markets Authority (ESMA) published a consultation paper on the review and development of a package of regulatory technical standards under the Markets in Financial Instruments Regulation (MiFIR), focusing on pre- and post-trade transparency issues.<sup>13</sup> ESMA acknowledges, and has requested input from stakeholders, as to the level of financial resources and ongoing costs that would be required to implement and comply with the amended regulatory technical standards.<sup>14</sup>

As recognized by ESMA and discussed above, regulated FX derivatives trading venues will continue to endure these costs of compliance, while unregulated FX derivatives trading venues, to date, have proliferated and appear to generally operate free of regulatory requirements and expectations. The barriers to entry to compete are largely tilted against regulated FX derivatives trading venues in favor of unregulated FX derivatives trading venues. As markets are generally efficient and react predictably to incentives, the costs of regulatory adherence for regulated FX derivatives trading venues acts as a negative incentive for unregulated FX derivatives trading venues. Instead, such venues are incentivized by the large cost savings associated with not complying with transparency and reporting obligations, and the ability to, in some cases, offer benefits to customers including higher leverage, lower deposit requirements to trade, lower fees for customers and less onerous onboarding requirements.

Moreover, the uneven playing field between regulated FX derivatives trading venues and unregulated FX derivatives trading venues can also have knock-on impacts to overall market liquidity. Many customers are price sensitive (taking into account liquidity) and as a result, cost savings are material to the market. As volumes on unregulated FX derivatives trading venues grow, a cycle of liquidity draws more volume in and away from regulated FX derivatives trading venues. These liquidity draws, in turn, reduce price discovery and price fairness for market participants.

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<sup>13</sup> ESMA, MiFIR Review Consultation Package (May 21, 2024), available at [https://www.esma.europa.eu/sites/default/files/2024-05/ESMA74-2134169708-7241\\_CP\\_Package\\_on\\_the\\_MiFIR\\_Review\\_-\\_RTS\\_2\\_RCB\\_and\\_Reference\\_Data.pdf](https://www.esma.europa.eu/sites/default/files/2024-05/ESMA74-2134169708-7241_CP_Package_on_the_MiFIR_Review_-_RTS_2_RCB_and_Reference_Data.pdf).

<sup>14</sup> *Id.* at 63.

A regulatory framework that treats functionally similar market participants differently does not promote a fair and orderly market. Accordingly, it is imperative to find a balance between regulatory oversight and market efficiency. The longer regulatory gaps between regulated FX derivatives trading venues and unregulated FX derivatives trading venues can be exploited by unregulated FX derivatives trading venues, the more other FX trading venues will seek to replicate their success.

## V. Considerations for Policymakers

Global regulatory bodies and policymakers should continue to support and promote the use of regulated trading venues for FX trading that can act as the “first line of defense” to crowd out or expose unregulated entities that may act in ways that do not promote market fairness or integrity. Absent consistent treatment of similar trading venues, regulators may be unable to effectively oversee markets, mitigate systemic risk, and protect customers. Regulators of jurisdiction should evaluate the effects of unregulated FX derivatives trading venues providing services, (e.g., liquidity formation and trade execution) that are mandated to be subject to oversight. Unregulated FX derivatives trading venues that obfuscate their services by describing themselves as technology platforms or as relying on other market operation structures, such as single-dealer platforms, single prime brokerage, or bilateral trading, should be considered comparable to their market competitors regardless of their market-facing presentation.

When considering the regulation of FX trading venues, policymakers should take into account how the operational structures of unregulated FX derivatives trading venues impact systemic risk management, market development, and global competitiveness. Regulated FX derivatives trading venues adhere to stringent rules and oversight to ensure market integrity and investor protection, whereas unregulated FX derivatives trading venues operate with more flexibility, but heightened risks due to limited oversight and transparency. As indicated in the discussion above, the benefits of regulated FX venues include the following:

- Regulated FX derivatives trading venues must provide transparency by disclosing important information to their customers such as financial standing and operations. Unregulated FX derivatives trading venues do not have these same requirements, and therefore might not provide the same information, making it difficult for customers to evaluate the validity of the platform.
- Regulated FX derivatives trading venues are subject to conflicts of interest requirements, including establishing policies and procedures that mandate disclosure of any actual or potential conflicts of interest by officers or board members to ensure fairness in market operations.<sup>15</sup>
- Regulated FX derivatives trading venues adhere to robust Know-Your-Customer and Anti-Money Laundering processes and procedures. Unregulated FX derivatives trading venues may not have such stringent controls, which may negatively impact market integrity and heighten the risk of enabling bad actors to participate in the market.

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<sup>15</sup> We note that the CFTC has proposed substantially more prescriptive conflicts of interest requirements. See CFTC, Notice of Proposed Rulemaking, “Requirements for Designated Contract Markets and Swap Execution Facilities Regarding Governance and the Mitigation of Conflicts of Interest Impacting Market Regulation Functions”, 89 FR 19646 (March 19, 2024), available at <https://www.cftc.gov/sites/default/files/2024/03/2024-04938a.pdf>.

- Regulated FX derivatives trading venues follow strict rules for protecting customer funds. Unregulated FX derivatives trading venues do not necessarily adhere to the same requirements for customer funds, which can result in greater risk of financial loss to customers.
- Regulated FX derivatives trading venues promote innovation while ensuring new trading technologies and practices comply with regulatory standards. Unregulated FX derivatives trading venues can more freely foster innovation, but without the insurance of regulatory oversight.
- Regulated FX derivatives trading venues must comply with costly audit trail requirements for regulatory oversight. The relevant data must be maintained in compliance with certain recordkeeping obligations and reported to regulators. This includes, from time to time, building new reporting fields within trading systems to fulfill reporting requirements. Comprehensive audit trails enable regulators and policymakers to engage in more effective oversight and to clearly understand and reconstruct past market events.

Market participants may not fully appreciate the risk of trading on an unregulated FX derivatives trading venue. In fact, some participants may believe that risk is borne by the trading venue and not the market participant. While unregulated FX derivatives trading venues may offer certain perceived benefits to customers, customers should be aware of the significant risks involved.

Policymakers and regulators should also consider supporting regulated entities by enabling decreased regulatory cost burdens through normalizing regulatory norms amongst jurisdictions and allowing greater equivalence or substituted compliance for entities operating in multiple jurisdictions. These efforts have a supplemental benefit of making it easier for customers to understand the regulatory standards of the marketplace and how they can participate in the market on a multi-jurisdictional basis.

Absent formal guidance or action from regulators, the regulatory gap between compliant and non-compliant activities could continue to widen, further increasing the risk to market participants and weakening market integrity. By taking into account the considerations discussed in this paper, policymakers can develop a regulatory framework for OTC FX derivatives markets that promotes an efficient and fair-trading environment while balancing the need for market innovation and development.