

Paradigm

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Submitted via CFTC Comments Portal

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre 1155 21st Street NW
Washington, D.C. 20581

Re: Response to the Commodity Futures Trading Commission’s Proposed Rulemaking on Conflicts and Affiliations (RIN 3038-AF76)

Dear Mr. Kirkpatrick,

Paradigm Operations LP (“**Paradigm**”) appreciates the opportunity to comment on the Commission’s proposed rulemaking on Conflicts and Affiliations (the “**Proposed Rule**” or “**NPRM**”).¹ Paradigm is a frontier technology investment firm that invests and builds in crypto, AI, robotics, and across new frontiers from the earliest stages.² Paradigm supports the broad availability of regulated prediction markets and is an active participant in regulated derivatives markets, including prediction markets. As a participant in this developing field, Paradigm brings a wealth of experience to issues concerning market structure, competition, and the regulation of affiliated relationships within designated contract markets (“**DCMs**”).

Paradigm believes that flexible and principles-based rulemaking can facilitate responsible market structure innovation while simultaneously addressing the conflicts of interest that may arise in affiliated structures. To that end, Paradigm agrees with the Commission that affiliated market makers can be “especially important in the creation and maintenance of new markets”³ and that “facilitating market structure innovation and competition, subject to appropriate safeguards, advances the Commission’s mission.”⁴ Furthermore, Paradigm supports the core safeguards in the Proposed Rule—conflicts-of-interest procedures, information barriers protecting non-public information, incentive-program parity, and independent verification of controls—which generally reflect practices that responsible exchanges already follow. On both of these key metrics, we commend the Commission’s balanced framing and thoughtful reasoning.

Paradigm’s comments, however, focus on six critical areas where the Commission should ensure that its final rule preserves the conditions for markets and exchanges to form, attract capital, and grow. *First*, Paradigm strongly recommends that the Commission reject the blanket subordination approach to affiliated market making and, in its place, proposes a dual-path volume cap that addresses the same concerns without crippling market liquidity. *Second*, Paradigm urges the Commission to reconsider the mandatory independent third-party regulatory service provider

¹ Conflicts and Affiliations, 91 Fed. Reg. 50926 (Aug. 6, 2026).

² More information about Paradigm is available online at <https://www.paradigm.xyz>.

³ NPRM at 50932.

⁴ NPRM at 50927.



(“*RSP*”) requirement, including by considering unaffiliated designated self-regulatory organization (“*DSRO*”) examination for DCMs and DCOs with affiliated futures commission merchants (“*FCMs*”). *Third*, Paradigm supports the Commission’s own alternative disclosure regime over the proposed per-session click-through notice. *Fourth*, Paradigm explains why the “bona fide market making” framework and associated immediate-cessation rule require refinement. *Fifth*, Paradigm urges the Commission to narrow the proposed definition of “control” to avoid sweeping in ordinary investor governance rights. *Sixth*, Paradigm opposes the proposed capital independence condition.

I. A Volume-Based Approach to Order-Priority Subordination Is a More Effective Alternative to Blanket Subordination

The Proposed Rule would require that a DCM’s matching system fill any unaffiliated member’s bid or offer before an affiliate market maker’s order at the same price, without regard to time priority.⁵ Under this rule, the affiliated market maker would be filled last at every price level, subordinating its orders to those of all other participants. Moreover, the subordination requirement would apply to all bids and offers filled through the DCM’s “matching system,” which may include non-central-limit-order-book executed transactions.⁶ Paradigm recognizes the potential for conflicts of interest arising from affiliated market makers, but blanket subordination that applies identically at every price level and to new and mature markets alike unnecessarily risks a cure that is worse than the disease.

To be clear, the Commission’s proposed order-priority subordination would create a structural disincentive for investment in new exchanges and markets, and it would undermine the variety and liquidity that make these markets valuable hedging opportunities and information sources. In the early stages of a DCM’s life and when established exchanges launch new or innovative markets, affiliated market makers are often the primary, and sometimes the sole, source of liquidity.⁷ Under these conditions, strict subordination in every market and at every price creates a free-rider incentive for unaffiliated market makers—allowing them to price match the affiliated market maker and “skim” the desirable trades while leaving the rest for affiliates—that distorts markets, ensures that affiliates are left with only toxic flow, and disrupts the structural compromise that allows nascent markets to flourish. And, of course, as markets mature with unaffiliated liquidity, affiliated market makers are unable to hedge or recover those toxic positions, leaving them unable to seed the next round of emerging markets.

Paradigm therefore proposes a market-by-market volume trigger, above which an affiliated market maker’s volume would be capped at 5% of the market-wide, quarterly trading volume. The volume trigger for each product market would be set in advance and at a level sufficient to allow the affiliate to seed liquidity and support orderly trading in a new or thinly traded market. As unaffiliated liquidity develops in that specific market, the affiliate’s trading volume would be

⁵ See proposed § 38.852(c)(1)(i), NPRM at 50992; *see also* NPRM at 50951, 50953-50954.

⁶ See NPRM at 50951.

⁷ See NPRM at 50932 (“this market structure is particularly prominent in prediction markets and that the operators of such markets believe that an affiliated market maker can be especially important in the creation and maintenance of new markets”).



limited, but in a way that is less operationally burdensome than an order-priority subordination method. And to the extent that certain exchanges (or the Commission) find market-by-market administrability to be overly burdensome, the Commission should offer an alternative under which exchanges restrict trading by affiliated firms at 5% of exchange-wide, quarterly trading volume. This belt-and-suspenders approach would preserve the capital-raising incentives that new exchanges need while triggering the conflicts of interest safeguards closer in time to when the potential for conflicts becomes realized.

However, Paradigm opposes both a flat ban on affiliated market making and blanket order-priority subordination at every price level. A flat ban or universal subordination rule would disrupt existing market structures and reduce liquidity in emerging markets, while a volume cap would preserve the affiliate's ability to support those markets and impose meaningful constraints as independent liquidity develops. The volume cap is therefore a workable middle ground: it addresses the Commission's conflict concerns without eliminating a market structure that can serve an important function during a market's (or exchange's) formative stages. Paradigm therefore respectfully urges the Commission to reject a blanket subordination or flat ban in favor of a tailored approach that protects market integrity, preserves incentives to form and fund new exchanges, and allows the affiliate to provide liquidity where the market needs it most.

II. The Mandatory Independent Third-Party RSP Requirement Would Impose Disproportionate Costs on Early-Stage Exchanges

The Proposed Rule would require any DCM with an affiliated market maker to engage the National Futures Association (“*NFA*”) to conduct surveillance of the affiliate, monitor compliance with the DCM's conflicts procedures, and annually certify compliance to both the Commission and the DCM's Board of Directors.⁸ While Paradigm appreciates the Commission's interest in ensuring robust oversight, the mandatory independent third-party RSP requirement would impose costs that are disproportionate to the risks involved, particularly for early-stage exchanges.

To begin, the Commission's own cost estimates are substantial. The Commission estimated that a DCM engaging the NFA as its RSP would face annual NFA fees of \$100,000 to \$150,000; implementation costs of approximately \$500,000; software costs of roughly \$1 million; and cloud computing costs of approximately \$700,000 annually.⁹ These figures alone represent a significant financial burden, and are even more imposing when considering the Commission's acknowledgement that actual costs are likely to scale with the number of services and markets offered by an exchange.¹⁰

Paradigm agrees with the Commission's assessment, and its acknowledgment that the quoted figures represent only a baseline underscores the extent to which a mandatory RSP requirement would stifle innovation and competition. As an initial matter, these costs may simply be prohibitive for an early-stage exchange (especially startups with limited capital and revenue),

⁸ See proposed § 38.852(c)(2), NPRM at 50992.

⁹ See NPRM at 50968-50969, 50981 (Commission cost estimates for NFA engagement, implementation, software, and cloud computing).

¹⁰ *Id.*



foreclosing new market entrants and discouraging competition. But even assuming some exchanges can absorb these costs through the start-up phase, increased compliance costs associated with expanding product offerings will discourage the very innovation and customer service that the Commission should seek to foster. In other words, the mandatory RSP requirement would discourage both new and established exchanges alike from innovating and expanding.

Paradigm also notes an important asymmetry in the Proposed Rule's treatment of affiliated relationships. The Proposed Rule allows DCMs with affiliated FCMs to avoid engaging NFA for certain obligations if they implement robust conflicts procedures and meet other conditions.¹¹ By doing so, the Commission has recognized that, at least in some circumstances, a DCM's own internal procedures can be an adequate substitute for independent third-party oversight. Paradigm sees no principled reason why this same flexibility should not be available to DCMs with affiliated market makers, particularly during a transition period as the industry adapts to the new regulatory framework.

Paradigm therefore urges the Commission to adopt a transition period during which DCMs with affiliated market makers may demonstrate compliance through robust internal procedures, subject to Commission review, before being required to engage an independent third-party RSP. This approach would preserve the Commission's oversight objectives while avoiding the imposition of costs that could prevent the development of new exchanges and markets. And it would also address the asymmetry in the Proposed Rule by ensuring independent examination of affiliated FCMs to the same extent applicable to affiliated market makers without depriving DCMs with affiliated market makers of the flexibility to demonstrate compliance through robust internal procedures or an RSP.¹² In short, the Commission should ensure that DCMs with affiliated market makers have the same option as DCMs with affiliated FCMs by providing them with a choice between engaging with the NFA or implementing robust internal conflicts procedures.

III. The Per-Session Click-Through Disclosure Requirement Should Be Replaced

The Proposed Rule would require DCMs to deliver a per-session notice through the order-entry interface before a customer's first order, delivered in full text (not by hyperlink), disclosing the affiliate market maker's status and the conditions of its participation, including subordination.¹³ Paradigm respectfully submits that this interruptive disclosure regime would impose unnecessary friction on market participants without meaningfully improving the quality of their trading decisions.

The Commission itself considered an alternative regime, under which the DCM would make the relevant disclosures publicly on its website and in its rulebook, and would deliver a notice

¹¹ See NPRM at 50952; proposed §§ 38.604, 38.606.

¹² If the Commission nonetheless adopts a mandatory independent RSP requirement, it should (1) define the independence standard applicable to the third-party RSP; (2) provide that the annual certification is made on a reasonable-assurance basis rather than as a guarantee of compliance; and (3) provide that a DCM is responsible for its RSP's performance under a negligence standard rather than strict liability. See Questions 4, 50, 51.

¹³ See proposed § 38.852(c)(3), NPRM at 50992.



at the time of account opening.¹⁴ The Commission declined to propose this approach, however, reasoning that “information is most salient to a customer at the moment the customer is about to engage in trading activity.”¹⁵ While Paradigm appreciates the Commission’s concern for customer awareness, there is no evidence in the administrative record to support that conclusion and, without such evidence, the per-session click-through requirement goes beyond what is necessary to achieve the Commission’s objective.

Repetitive notices at the start of every session without the ability for traders to opt-out impose real costs for exchanges seeking to build and maintain a user base. Each click that is required before a trader is permitted to execute an order (particularly if the click-through is repetitive and seems unnecessary) creates a disincentive that may cause the trader to abandon the session or even cease using the platform altogether. This is a well-documented aspect of designing digital interfaces, and the Commission should not dismiss it as immaterial, particularly because there is no evidence in the record that per-session notices change trader behavior or improve trading decisions. Nor is there any reason to simply assume that a trader who has been informed of the affiliate’s status at account opening would alter his or her trading strategy based on a repetitive notice delivered at the start of every trading session.

As a result, Paradigm supports the alternative approach that the Commission described. Public website and rulebook disclosure, combined with a prominent notice to the consumer at account opening, will ensure that all customers are aware of the affiliate market maker’s status and the conditions of its participation. This approach strikes a more appropriate balance between transparency and market efficiency, and Paradigm therefore urges the Commission to adopt this alternative in any final rule.

IV. The “Bona Fide Market Making” Framework and the Immediate-Cessation Rule Require Refinement

A. The Distinction Between Bona Fide Market Making and Directional Trading

The Proposed Rule would prohibit an affiliated market maker from taking “directional proprietary positions,” and would instead require that the market maker limit its activity to “bona fide market making.”¹⁶ Paradigm supports the principle that DCM affiliates should not be acting as proprietary trading firms, but the distinction between “bona fide market making” and “directional trading” has long been difficult to define. More importantly, though, the Proposed Rule does not provide clear or even identifiable definitions of these terms in order for market participants to ensure compliance with the regulation.

A market maker that continuously provides two-sided quotes will inevitably build directional positions as it fills customer orders. As a result, determining whether a given position reflects legitimate “market-making” activity or impermissible “directional trading” can only be done through an analysis of intent, which cannot be performed in real time. The subjectivity of

¹⁴ See NPRM at 50954.

¹⁵ *Id.*

¹⁶ See proposed § 38.852(c)(1)(ii)(D), NPRM at 50992.



this determination would therefore create significant uncertainty for both the affiliated market maker and the DCM.

Paradigm therefore urges the Commission to adopt a safe harbor dependent on satisfaction of the quoting limitations established by the relevant DCM. Under this approach, an affiliated market maker that meets its obligations to maintain continuous two-sided quotes and other obligations (*e.g.*, minimum size and maximum spread) would be presumed to be engaged in bona fide market making. And while NFA could be empowered to certify an affiliate's compliance based on other factors or further review of the context of its positions, positions accumulated as a natural consequence of fulfilling those quoting obligations should be deemed not to constitute impermissible directional trading. This safe harbor would provide clarity, reduce the risk of arbitrary enforcement, and allow affiliated market makers to perform their essential liquidity-provision function with confidence.

B. Immediate Cessation Upon Loss of Eligibility

The uncertainty caused by the lack of a clear line between bona fide market making and impermissible directional trading is exacerbated by the fact that, under the Proposed Rule, any firm that runs afoul of the "bona fide market making" requirement must stop trading immediately. Further, the Proposed Rule provides that if NFA fails to provide a certification of compliance, the market maker "will immediately cease to qualify."¹⁷ This immediate-cessation rule lacks the safeguards necessary to prevent disproportionate harm to markets and market participants.

As proposed, the rule provides no cure period, no materiality threshold, and no distinction between a technical lapse and an intentional violation of the conditions of affiliated market making. Even a minor, inadvertent breach such as a momentary gap in quoting caused by a technology glitch would trigger immediate cessation of trading. This strict liability approach is inconsistent with the majority of the Commission's regulations, which generally distinguish between minor and major violations, with the most significant penalties reserved for violations involving intent.

The consequences of immediate cessation are particularly severe where the affiliated market maker serves as a principal source of liquidity. In developing markets, the affiliated market maker may be the only participant providing continuous two-sided quotes, so an abrupt withdrawal of that liquidity would potentially leave customers unable to exit positions at fair prices. In this way, the immediate-cessation rule could harm the very customers it is designed to protect.

Paradigm therefore urges the Commission to eliminate the immediate-cessation rule, and reserve immediate cessation for cases in which the Commission itself initiates an investigation or enforcement action (thereby providing the DCM and market maker with due process rights) or determines that cessation is necessary to protect the public interest. This approach would allow the Commission to react to and stop cases of genuine misconduct, while avoiding potentially harmful and unwarranted disruptions that would result from immediate cessation over technical or immaterial deficiencies.

¹⁷ See NPRM at 50950-50952; Question 50, NPRM at 50954.



V. The Proposed Definition of “Control” Is Overbroad

The Proposed Rule defines an “affiliate principal trading firm” by reference to common “control” with the DCM, and in turn defines “control” as the ability to “direct or cause the direction of management and policies” of the entity.¹⁸ Paradigm is concerned that this definition is substantially broader than the concept of “control” as used elsewhere in the Commission’s regulations, and that it would sweep in a wide range of ordinary investor relationships that do not give rise to the types of conflicts of interest the Proposed Rule is designed to address.

Most definitions of “control” in the Commission’s regulatory framework relate to the ability to direct the *trading of an account*, or the power to make trading decisions on behalf of another person.¹⁹ The Proposed Rule, however, defines “control” as the ability to direct *management and policies*. This is a far broader definition that could capture a wide range of governance arrangements that are standard among investment relationships, particularly in the venture capital and private equity fields through which many early-stage exchanges raise capital.

This broad definition of “control” would create significant uncertainty for early-stage DCMs and their investors. Many investors in early-stage companies (*e.g.*, venture capital funds and strategic investors) hold contractual governance rights that may include board seats, board observer rights, veto rights and consent requirements for certain transactions. Under the Proposed Rule’s definition of “control,” any investor holding such rights could be deemed to “direct or cause the direction of management and policies” of the DCM and therefore be deemed to be under “common control” with the DCM. As a result, any trading firm affiliated with that investor could be classified as an “affiliate principal trading firm” subject to all of the restrictions in the Proposed Rule.

That would be an explosion of the rule to entities far beyond those intended by the Commission, to the detriment of everyone. An investor holding a board seat and customary protective provisions does not exercise the type of operational control over an exchange’s day-to-day operations that would give rise to meaningful conflicts of interest with the exchange’s participants. Under this rule, however, investors may well abandon their board seats or information rights to avoid accidentally being subject to the consequences of this rule.

Paradigm therefore urges the Commission to narrow the definition of “control” in one of three ways:

- First, the Commission could revise the definition to relate to the ability to exercise day-to-day control of the relevant entity, consistent with the prevailing usage of “control” in the Commission’s other regulations. This would focus the Proposed Rule’s restrictions on the relationships that raise legitimate conflicts of interest concerns, rather than capturing governance arrangements that give an investor a role in management and policy decisions.

¹⁸ See proposed § 38.852(a), NPRM at 50991-50992.

¹⁹ See, *e.g.*, 17 C.F.R. § 1.3 (defining “control” in the context of commodity trading advisors and commodity pool operators by reference to the power to direct trading).



- Second, if the Commission retains the “management and policies” formulation, it should expressly acknowledge that customary investor governance rights, including board seats, protective provisions, information rights, and standard consent requirements, do not, standing alone, constitute “control” for purposes of the Proposed Rule.
- Third, the Commission could adopt a bright-line test for affiliation based on voting interest and ownership percentage, informed by the SEC’s approach to ownership and voting limitations for demutualized national securities exchanges. A clear voting-interest and ownership threshold would provide greater certainty to investors and registered entities and avoid the difficulty of applying the subjective “management and policies” formulation.

Each of these approaches would preserve the Commission’s ability to address genuine affiliate relationships while avoiding the unintended consequences that a broad definition of “control” would have on capital formation and corporate governance.

VI. The Capital Independence Condition Is Not Workable

Lastly, the Commission asked whether the capital underlying the affiliated market maker’s trading should be required not to originate from the affiliated DCM.²⁰ Paradigm urges the Commission not to adopt any such requirement. This type of capital independence condition would be impractical to implement, difficult to monitor, and would not meaningfully advance the Commission’s objectives.

Affiliated entities within a common corporate structure share capital in ways that make it difficult, if not impossible, to trace the origin of particular funds used for a specific purpose. For example, an affiliated market maker may receive capital from the same parent entity that funds the DCM, or it may receive capital from investors who also invest in the DCM. It would therefore be impractical for DCMs to monitor and restrict capital that is used for funding an affiliated market maker from “originating from” the DCM.

Moreover, the policy rationale for this capital independence requirement is unclear. The Proposed Rule is designed to address conflicts of interest arising from an affiliated market maker’s privileged position vis-à-vis the exchange, not from the source of its trading capital. Regardless of where the market maker’s capital comes from, the same conflicts-mitigation tools (*e.g.*, disclosure, surveillance, conduct requirements) would be equally necessary and effective. We therefore believe that a capital independence condition would add complexity without corresponding regulatory benefit.

VII. Conclusion

Paradigm commends the Commission for its thoughtful efforts to address the conflicts of interest that may arise in affiliated market structures, while recognizing that affiliated market makers play an important role in the creation and maintenance of new markets. We believe that

²⁰ See Question 48, NPRM at 50954.



the Commission's acknowledgment that "facilitating market structure innovation and competition, subject to appropriate safeguards, advances the Commission's mission" reflects the right approach.

To preserve that balance, however, the final rule should avoid structural constraints that would chill investment in new exchanges and reduce competition. The comments set forth above would allow the Commission to achieve its regulatory objectives while preserving the conditions that new and innovative exchanges need in order to attract capital, become operational, and provide liquidity. If you have further questions regarding our comments to the Proposed Rule, you can contact us at Stefan@Paradigm.xyz.

Sincerely,

/s/ Stefan Schropp

Stefan Schropp
Senior Regulatory Counsel
Paradigm Operations LP

Cc: Joshua Sterling, Milbank LLP

