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Regulatory Proposal: Transparency Framework for Liquidity Provision

To satisfy the Core Principle 9 mandate for "competitive and open" markets, the Commission should move beyond high-level guidance and establish specific reporting requirements for institutional and affiliated market makers. In the thin liquidity environment of most prediction markets, the "who" behind the order book is just as critical as the price.

I. General Institutional Transparency (Independent Makers)

For third-party institutional firms, the focus should be on measuring concentration without compromising proprietary trading data:

- **Category-Level Concentration (HHI):** Mandate the publication of a weekly Herfindahl-Hirschman Index (HHI) score for each contract category (e.g., Sports, Economic Indicators). This provides a standardized metric for whether a market is "highly concentrated" (dominated by one or two firms) or truly competitive.
- **10% Volume or OI Disclosure Threshold:** DCMs should report the aggregate percentage of volume and open interest held by the liquidity providers that meet a 10% threshold both in a significant category on the DCM and the DCM as a whole. This alerts the public and the Commission if a market's health is dependent on a small group of makers. The identities of the makers may be kept confidential and anonymized as “Maker 1,” etc. A significant category is defined as one such as Sports or Crypto, for example, that accounts for more than 10% of total volume or OI on the DCM.
- **Maker vs. Taker Profitability Ratio:** Require a monthly summary showing the aggregate P&L ratio of "Makers" compared to "Takers" both in a significant category on the DCM and the DCM as a whole. A lopsided ratio is a leading indicator of **Adverse Selection**, signaling to retail participants that the "edge" in a specific category may be prohibitively high.

II. Enhanced Disclosure for Affiliated Entities (The "House" Desk)

The presence of a DCM-owned trading arm (e.g., Kalshi Trading) creates an inherent conflict under Core Principle 16. Transparency for these entities must be non-negotiable:

- **Mandatory Identity Attribution:** Any trading entity under common ownership or control with the DCM must be identified by name in all volume and open interest reports. "Anonymized" reporting is insufficient when a conflict of interest is structural.
- **Daily "Affiliate Footprint" Reporting:** DCMs should provide a T+1 report detailing the Affiliated Volume Percentage. If the "House" is the counterparty for 30% of the trades in a significant category, that footprint must be visible to the public.
- **Platform Privilege Disclosure:** DCMs must explicitly disclose if an affiliated maker receives any of the following:
    - Zero-fee or rebated trading tiers not available to the general public and what those arrangements are
    - Direct "cross-connect" or API latency advantages.
    - Incentive stipends for maintaining specific bid-ask spreads.
- **Conflict Audits:** Any affiliate accounting for more than 20% of a category's volume should trigger an automated "Fair Access" audit by the DCM's compliance department, with the results made available to the Commission during annual reviews.

III. Application to the 2026 ANPRM Questions

These recommendations directly address several of the Commission's current inquiries:

- **Impartial Access (Q 2.a):** Transparency into affiliated footprints is the only way to ensure "impartial access." An invisible affiliate with 40% market share is a de facto barrier to entry for other makers.
- **Market Surveillance (Q 2.d):** Publicly reporting the affiliate's footprint allows the broader market to act as a secondary surveillance layer, identifying price distortions that a DCM might overlook when monitoring its own sister company.
- **Public Interest (Q 7):** It is fundamentally contrary to the public interest to allow a vertically integrated exchange to act as the primary "dealer" in its own markets without full, granular disclosure of that activity.

Regulatory Proposal: Mandatory Structural Parity for Affiliated Entities

To satisfy the Core Principle 16 requirements regarding conflicts of interest and the Section 15(b) antitrust mandate, the Commission should move beyond simple disclosure. The "House Desk" (any entity under common ownership with the DCM) must not be permitted to operate under terms more favorable than those available to the most basic retail participant.

I. The "Most Favored Participant" Requirement

The Commission should establish a "Most Favored Participant" (MFP) rule for any DCM utilizing an affiliated trading arm.

- **Zero-Discrimination Standard:** A DCM must be prohibited from granting its affiliated trading arm any fee, rebate, or incentive structure that is not simultaneously and automatically available to **all** market participants, regardless of volume or account tier.
- **Elimination of Volume Hurdles:** If an affiliated maker receives a rebate for providing liquidity, that rebate must be applied to any participant who provides liquidity, starting from the very first contract. This prevents the DCM from "gatekeeping" the best deals behind volume thresholds that only their own desk can easily hit.

II. Prohibition of "Preferential Betterment"

While the House Desk defines the **minimum** standard of fairness, the DCM should remain free to offer *better* terms to independent, third-party makers to attract external liquidity.

- **Asymmetric Terms:** It should be legally permissible—and encouraged—for a DCM to offer superior rebates to independent makers over its own affiliated desk. This serves as a "pro-competitive" corrective measure, helping to offset the structural advantages (such as proximity to exchange leadership) that an affiliate naturally possesses.

III. Technical and Informational Neutrality

The "equal or better" standard must extend to the technical architecture of the exchange.

- **API and Data Parity:** The affiliated desk must utilize the same public API endpoints, documentation, and data feeds as the general public.
- **No "First Look" Privileges:** In an RFQ or Central Limit Order Book (CLOB) environment, the House Desk must never receive an information signal (such as a pending order or a quote request) before it is broadcast to the rest of the market. Any "latency advantage" given to the affiliate would be a per se violation of the antitrust protections intended by the CEA.

IV. Application to 2026 ANPRM Question 39 (Antitrust)

This "Universal Parity" model addresses the core of antitrust law: **Preventing Vertical Foreclosure.**

- **Leveling the Playing Field:** By mandating that the House Desk's terms are the "base model" for everyone, the Commission ensures that the DCM cannot use its monopoly power over the exchange to give its trading arm a predatory pricing advantage.
- **Promoting Market Entry:** When a retail participant or a small-scale developer knows they are getting the exact same "deal" as the exchange's own trading desk, the barrier to entry drops significantly. This creates a more diverse, resilient, and competitive ecosystem, which is exactly what the antitrust provisions of the CEA are designed to protect.

Regulatory Proposal: Standardization of Anonymized RFQ Access

To preserve the integrity of Core Principle 2 (Compliance with Rules), the Commission must address the technical vulnerabilities inherent in Request for Quote (RFQ) systems. Current implementations that expose persistent customer identifiers to liquidity providers facilitate discriminatory access, enabling "soft-blocking" that undermines the requirement for impartial market entry.

I. Prohibition of Persistent Counterparty Identifiers

The exposure of unique Customer IDs via API or manual interfaces creates a non-competitive environment where liquidity providers can cherry-pick counterparties based on historical performance rather than price.

- **Mandatory ID Anonymization:** DCMs must ensure that all counterparty identifiers provided to RFQ quoters are session-specific or rotated at a frequency that prevents long-term tracking. A quoter should see the "size and side" of a trade without the ability to map it to a specific participant's historical P&L.
- **Restriction on Latent Metadata:** Any metadata that could serve as a proxy for identity —including precise geolocation data or specific account-tier indicators—must be stripped from the RFQ broadcast to prevent makers from reverse-engineering a "blocklist" of successful retail traders.

II. Centralized Abuse Reporting System (CARS)

Rather than allowing individual makers to act as judge and jury through shadow-blocking, the Commission should mandate a standardized, transparent reporting framework for identifying and mitigating actual market abuse.

- **Standardized Definition of "Abusive Trading":** The CFTC should codify specific triggers for "abusive" behavior in prediction markets, moving beyond vague "bad faith" clauses. This includes:
    - **Post-Outcome Exploitation:** Attempting to execute trades on contracts where the underlying event has already reached a definitive conclusion but the market remains technically open.
    - **Latency Arbitrage of Oracle Feeds:** Systematic exploitation of known delays between a real-world outcome and the DCM's automated data feed.
- **Aggregated Flagging Mechanism:** Makers should be provided with a formal API endpoint to flag specific transactions for "Technical Abuse Review."
- **DCM-Led Enforcement:** When a user reaches a pre-defined threshold of flags from *multiple independent* makers, the DCM's compliance department must initiate a mandatory audit. This shifts the power of exclusion from the liquidity provider to the exchange's regulatory arm, ensuring that users are penalized for rule-breaking, not for being "too profitable."

III. Due Process and "Fair Access" Protections

To prevent the abuse reporting system from becoming a tool for makers to eliminate sharp competition, the following safeguards are required:

- **Prohibition of "Profit-Based" Flagging:** DCMs must explicitly prohibit the flagging of accounts based solely on a taker's historical win rate or P&L.
- **Transparency of Action:** If a user's access is restricted or terminated based on maker-reported data, the DCM must provide the user with a written summary of the specific abusive behaviors identified, ensuring the participant has a pathway to appeal the decision.

IV. Application to 2026 ANPRM Questions

These measures provide a technical and procedural roadmap for the following inquiries:

- **Impartial Access (Q 2.a):** This proposal eliminates the "private gatekeeping" currently possible in RFQ systems. By removing persistent IDs, the DCM ensures that all participants are judged on the merits of their orders, not their identity.
- **Rule Enforcement (Q 2.b):** Standardizing the definition of abuse allows the Commission to evaluate whether DCMs are enforcing rules consistently across all participants, rather than allowing makers to enforce their own private rules via the API.
- **Prevention of Market Distortion (Q 4.c):** By centralizing the reporting of post-outcome trades, the Commission gains better visibility into the lag-time risks inherent in high-speed event contracts, allowing for more robust surveillance of "past-posting" across the entire industry.

Regulatory Analysis: Distinguishing "Gaming" from Predictive Derivative Markets

The following establishes a rigorous technical and economic boundary between "gaming" (gambling) and "event contracts" (derivatives). The distinction rests on the fundamental difference between static mathematical risk and dynamic informational risk.

I. The "Source of Risk" Test: Static vs. Dynamic Probability

The Commission must distinguish between activities based on how the probability of an outcome is derived.

- **Gaming (Static Probability):** In traditional gambling (slots, roulette, craps), the probability is a mathematical constant defined by the rules of the game. Because the odds are fixed and the risk is artificially generated by the "house," there is no "price" to discover. One cannot "trade" a roulette spin because the fair value is known and unchanging.

- **Event Contracts (Dynamic Probability):** In a sports-based event contract, the probability of "Team A beating Team B" is a variable that fluctuates based on real-world inputs—player health, weather, coaching strategy, and market sentiment. These contracts represent organic risk that exists in the economy regardless of whether a market is offered. The "price" is a reflection of aggregated information, making it a financial instrument rather than a wager.

II. Public Interest: Price Discovery vs. Private Entertainment

To satisfy the public interest requirement, the Commission should evaluate whether the market provides utility beyond the immediate participants.

- **Information Aggregation:** Unlike a casino, where a winning bet provides zero utility to the general public, a liquid market for event contracts produces a "public-good" data point. This price signal serves as a real-time actuarial benchmark for related industries, such as sports broadcasting, event insurance, and corporate sponsorships.
- **Market-Based Odds vs. "The Vig":** In gaming, the "price" (payout) is set by a central authority to ensure a profit margin (the house edge). In an event contract market, the price is set by the intersection of the bid and ask. This transparency eliminates the conflict of interest inherent in "the house" and ensures that participants are transacting at a true market-clearing price.

III. Economic Purpose: Hedging and Risk Transfer

The primary differentiator between gaming and a derivative is the ability for a participant to use the contract to offset an existing commercial "basis risk."

- **Correlation with Real-World Loss:** An event contract allows businesses with exposure to specific outcomes (e.g., a hospitality business in a city hosting a championship) to hedge against the negative economic impact of a team's loss.
- **Artificial vs. Organic Risk:** Gaming creates a new risk for the purpose of entertainment; a sports-based derivative transfers a pre-existing risk from someone who cannot afford to bear it to someone who is willing to take it for a price.

IV. Application to 2026 ANPRM Questions

- **Scope of "Gaming" (Q 19.a):** The Commission should define "gaming" as any activity where the outcome is determined by a closed-loop, Random Number Generator (RNG), or a fixed-odds mathematical system. Activities based on human performance in the physical world should be classified as "commodities" under the CEA due to their inherent price discovery and hedging utility.
- **Distinguishing Contests (Q 19.b):** The distinction between a sports competition and an awards show should depend on the Integrity of the Underlying. A sports competition has a massive, independent regulatory body (e.g., the NFL or NCAA) that ensures a fair outcome. The Commission should favor contracts where the underlying event is managed

by an organization with established anti-corruption and surveillance protocols. Events where those are absent may require additional rules ensuring fair markets.
- **Market Participant Characteristics (Q 19.d):** While critics point to younger demographics as a risk, the Commission must recognize that a regulated DCM is the safest environment for these participants. A transparent, peer-to-peer exchange with segregated funds is a superior public interest outcome compared to pushing this activity to offshore, unregulated sportsbooks where no consumer protections exist.

Regulatory Proposal: Standardization of Market Integrity, Settlement Finality, and Dispute Transparency

To fulfill the mandate of Core Principle 12 (Protection of Market Participants), the Commission must move beyond the current "black box" approach to market adjudication. As prediction markets move from niche political events to high-frequency sports and economic data, the lack of uniformity in how DCMs handle grading errors, marketing-to-rule discrepancies, and market unwinds creates systemic "settlement risk" for participants.

I. The "Plain Language" Supremacy Standard

A recurring point of failure in current markets is the "Technicality Gap"—where a contract title (e.g., "Will Team A win?") implies one outcome while the fine print in the Rulebook allows for a different determination (e.g., ignoring overtime or utilizing a specific, obscure data source).

- **Title-to-Rule Reconciliation:** The Commission should mandate that the "Marketing Title" of a contract serves as the primary interpretive lens. In any instance where a technical Rulebook provision conflicts with the plain-English interpretation of the contract title, the ambiguity must be resolved in favor of the "Reasonable Participant" expectation.
- **Standardized Specification Templates:** DCMs should be required to use a Commission-approved "Summary Box" for every contract, clearly listing the Governing Body (e.g., NBA), the Finality Trigger (e.g., official score at 0:00), and the Source of Truth (e.g., official league feed).

II. The Public Dispute Ledger and "Threshold Adjudication"

Currently, participants report errors through private support tickets, leaving the broader market in the dark about potential grading failures.

- **Mandatory Daily Dispute Report:** DCMs must publish a daily, machine-readable "Market Integrity Report" detailing all participant-submitted disputes regarding contract grading or settlement.

- **Automatic Determination Trigger:** If a dispute is filed by participants representing more than 5% of the Open Interest or 10% of the unique active accounts in a specific contract, the DCM must issue a public Formal Determination Notice within 24 hours. This notice must provide a technical justification for the grading decision, citing specific data points from the Source of Truth.

III. Uniform Protocols for Resettlements and Unwinds

The Commission must define the boundaries of "Settlement Finality" to prevent DCMs from arbitrarily choosing when to "undo" a market.

- **Categorization of Errors:**
    - **Manifest Error (Technical):** If a DCM's own system fails or a data feed provides objectively false information (e.g., reporting a score of 100-0 due to a glitch), an Unwind is permitted, returning all funds to original positions.
    - **Grading Error (Official):** If the governing body of a sport (e.g., the NFL) issues an official stat correction post-settlement, the DCM should be mandated to Resettle the market, provided the correction occurs within a "Finality Window" (e.g., 2 hours post-event).
- **Critique of "Last-Traded Price" (LTP) Settlement:** The current practice of settling broken markets at the LTP is often economically unsound. In a "panic" scenario where a feed is broken, the LTP is usually a distorted price.
    - **Alternative Solution:** Instead of LTP, the Commission should require DCMs to utilize a "Convergence Settlement" for broken contracts. This would settle the contract at the fair value determined by the eventual official outcome, rather than a snapshot of a dysfunctional order book.

IV. Application to 2026 ANPRM Questions

These proposals directly address the technical and procedural requirements found in the following inquiries:

- **Rule Enforcement (Q 2.b):** By standardizing the "Source of Truth" and finality windows, the Commission can objectively measure whether a DCM is enforcing its own rules or making ad-hoc decisions to protect its own liquidity or reputation.
- **Prevention of Market Distortion (Q 4.c):** The Public Dispute Ledger acts as a secondary surveillance layer. It allows the Commission and the public to identify "bad feeds" or manipulation attempts that the DCM's automated systems might miss.
- **Customer Protection (Q 5):** Standardizing the "Plain Language" interpretation prevents DCMs from using "fine-print traps" to settle contracts in a way that disadvantages retail participants who trade based on the contract's title.