Update 9/2/23: I have begun moving individual topics into their own relevant thread so that discussions and consensus can be narrowed!

Please see:

1. Reduce Trading Rewards by 45% 2. Adjusting Maker & Taker Fees 3. Introduce a Market Maker Rebate Program 4. Remove DYDX/stkDYDX Trading Fee Discounts 5. Implement a Yearly Reduction in DYDX Emissions & Amend the Distribution of Rewards 6. Introduce Allocations for Trading Rewards Per Market

Note: Sections in this document were written pre-FTX, which may impact certain recommendations. For completeness, I have left these sections unchanged post-FTX (Trading Fees).

Summary:

This proposal provides a range of suggestions and new implementations for the utility, emissions, and alignment of DYDX. As well as covers basic incentive structures, aimed at eliminating inefficiencies within the core functions of dYdX. Ultimately, we believe that with these changes and with the help of the community's feedback, dYdX will become a credibly neutral and sustainable DEX powerhouse.

Introduction:

With V4 nearing and dYdX's subsequent decentralization, a major responsibility is put on stakeholders and the community to ultimately govern and grow dYdX into its hegemony over decentralized derivatives. This document shares Wintermute's beliefs and recommendations for V3 as a large stakeholder and participant in both trading and governance. Importantly, this document is not exhaustive in providing recommendations for all surfaces inherent to V4 and is largely an effort to begin transitioning V3 into a state that will serve as a strong foundation going into V4. Specifically, it focuses on the economics of incentives and mechanisms that will play an integral role in facilitating dYdX's purpose as an exchange in a long-term and sustainable manner.

We will focus our attention on issues, concerns, and recommendations regarding:

- Trading, liquidity provision, and their rewards
- DYDX utility, emissions, and allocation

I'll begin with our proposed changes, followed by their rationale. This is intended to give an overview of all the recommended changes and a basic understanding of how they work together, before moving on to the deeper reasoning behind some components.

Proposed Changes:

Emissions:

1. Gradually reduce the total amount of DYDX emissions (pre-inflation) via community rewards to reach a terminal 2% inflation rate.
2. Reduce Trading Rewards by ~45% to 1,582,192 per epoch.
3. Introduce new allocation weights for the distribution of rewards.

DYDX Utility

:

1. Get rid of Trading Fee Discounts based on DYDX/stkDYDX balance.

Trading Fees & a Market-Making Program:

1. Increase Taker Fees to improve toxic flow and adjust Maker Fees to be more competitive.
2. Introduce a Market Maker Rebate Program.

Trading & Liquidity Provider Rewards

:

1. Introduce allocations of Trading Rewards per market.

After sufficient discussion with the community and dYdX Foundation, we will look to publish governance votes for each recommended change, as applicable (if agreed upon with the community). Importantly, changes surrounding trading fees and discounts are under the control of dYdX Trading and not the community, therefore, their respective governance votes will simply act as a signal on behalf of the community.

Description:

Trading, Liquidity Provision, and their Rewards:

Trading and liquidity provision rewards have been successful in bootstrapping and retaining intended participants on the platform, as well as moulding liquidity expectations. However, it's apparent that the current DYDX emissions schedule and lack of utility have been hurtful to both token holders and the net profit of the protocol. Recent measures to address these issues have helped, but there are other concerns that need to be addressed:

1. The allocation of incentives across an increasing number of markets and products
2. The retention of traders and liquidity providers once regular emissions end

To address both concerns, dYdX requires a scalable and natural way to incentivize users on their platform.

Building a Sustainable Base Incentive Layer

A large proponent of dYdX's overall sustainability is retaining liquidity providers and traders. If we assume DYDX rewards are non-existent, how do we incentivize both market makers and trading participants? We can start by offering fees that are on par or better with competitors and that naturally incentivize MMs.

Maker and Taker Fees:

Note: We have included Binance (BUSD) in our analysis however, don't include it in our analysis discussion given it's not fairly comparative as Binance directly benefits from BUSD usage.

dYdX's current trading fee schedule is highly competitive and significantly cheaper than CEX competitors. This provides a cheap trading environment for traders, however, it also creates an adversarial environment for market makers. Having such low taker fees (e.g. 0.2bps) makes MMs on dYdX susceptible to toxic flow, an issue most market makers have been dealing with for a while now, including ourselves. While latency and infrastructure play a massive part in this, it's also heavily dependent on individual MMs and an issue that is rather hard to solve from the protocol side. Thus, an alternative solution that is quick and easy to implement would be increasing taker fees across all volume bins.

In the case of dYdX, we refer totoxic flow from the latency perspective. Specifically, the price latency with dYdX and other centralized exchanges, coupled with low taker fees, allows aggressive takers to arbitrage market makers on dYdX. This results in market makers becoming out-of-the money nearly immediately.

Figure 1: Comparison of Taker Fees Across Competitors

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Figures 1 and 2 illustrate the base case comparison (ignoring token discounts) of trading fees amongst dYdX and major competitors. Evidently, the current Taker Fee schedule (DYDX_OLD) for dYdX is significantly lower than competitors, except in the case of Binance's BUSD pairs. We'd argue that it's actually too low and that slightly increasing the rates in the Taker Fee schedule (DYDX_NEW) should improve toxic flow due to higher transaction costs and hopefully revenue, assuming users are relatively inelastic at higher yet competitive prices. With the new Taker Fee schedule, dYdX remains highly competitive and in most volume bins it's cheaper than all exchanges if not most.

Figure 2: Comparison of Maker Fees Across Competitors

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dYdX's Maker Fee schedule (DYDX_OLD) is competitive, however, there are volume bins we can improve. As indicated by DYDX_NEW, we propose to reduce Maker Fees for volume bins $0 - $5M and $25M - $100M, making fees in line with BYBIT and FTX respectively. These fee reductions are illustrated in Figure 4.

The new proposed Fee Schedule in Figure 4, provides a more efficient and competitive trading platform for users and should improve toxic flow. Nevertheless, it still fails to incentivize MMs to provide liquidity naturally.

Compared to its competitors, dYdX lacks a separate Market-Making Fee Program. This is arguably a result of the LP rewards program. However, as the number of markets, products, and competitors increases, the average reward per MM is expected to decrease with a fixed reward pool. Therefore, it's imperative for dYdX to introduce a Market-Making Fee Program with rebates to naturally incentivize liquidity and reduce the reliance on rewards.

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The proposed Market-Making Fee Program as shown in Figure 5 consists of 5 tiers based on maker volume as a % of the 30D exchange volume on dYdX. Such a program with these proposed fee tiers is standard across most top-tier CEXs. As a result, MM's rewards are directly proportional to their maker volume and not bound by the size of the reward pool. Furthermore, by introducing a Market-Making Fee Program:

- MMs become more inelastic to changes in the current rewards program given rebates are more predictable and their reward surplus is now larger than before.
- The protocol now has a way to naturally incentivize liquidity, providing increased freedom when altering DYDX rewards.
- The protocol is no longer constrained by an increasing number of markets and products that are intended for V4.
- Obvious liquidity improvements by incentivizing maker volume.

The combination of these proposed changes forms a solid, sustainable base incentive layer on dYdX, albeit, more notably on the liquidity side. But, we are not done yet!

Shifting the role of DYDX:

We believe that a credibly-neutral dYdX is the best dYdX. A decentralized trading venue that is open and inclusive to all new and existing participants arguably has the highest potential long-term.

What does this look like for dYdX?

It involves eliminating cosmetic entry barriers for traders and liquidity providers e.g. "holding DYDX/stkDYDX earns you X", and instead reward any trader (LP) based solely on their trading volume (+ depth, spread, uptime). The first step to achieving this was successfully proposed by Xenophon Labs by eliminating stkDYDX from the Liquidity Provider Rewards Formula, however, there is still one token barrier that exists i.e, Trading Fee Discounts.

Trading Fee Discounts allow holders of DYDX to reduce their cost of trading on dYdX. I'd argue that given 1) dYdX is already one of the cheapest exchanges to trade on, and 2) the volume required to achieve discounted fees isn't particularly high. Therefore,

** the trading fee discount program isn't necessary and removing it will eliminate the cosmetic barrier for traders and simplify user experience**. Specifically, it levels the playing field for traders and LPs irrespective of their DYDX holdings.

Furthermore, trading rewards already act as a rebate based on the fees a user pays, and in a recen[DYDX Holder Questionnaire](#) conducted by the Foundation. They found that only 19% of monthly active users on dYdX hold or stkDYDX and 94% of DYDX/stkDYDX holders are not active traders on the protocol.

To summarise, this change in conjunction with the removal of stkDYDX from LP rewards attempt to maximize protocol revenue via improved liquidity and volume-based metrics. It no longer rewards inefficiencies (stkDYDX/DYDX) and any participant whether that be a trader, LP, or both, is rewarded according to the value they bring to the platform as described above.

Lastly, one major criticism commonly expressed with eliminating stkDYDX/DYDX utility is that it kills protocol alignment and the value of DYDX. I do agree with this, but it's largely justified by the lack of sustainable DYDX value-capture. Hopefully this will change with V4, but it shouldn't be the reason why we keep inefficient mechanisms and based on the survey mentioned above, the argument holds little merit.

Adjusting the Token Incentive Layer:

With a sustainable base incentive layer in place, we can begin to rebuild the current rewards program and address issues resulting in sub-optimal behaviour:

1. Overspending on Trading Rewards
2. Potentially inefficient reward mechanism for Trading Rewards

DYDX Emissions - Present & Future

Before recommending changes to the allocation of DYDX, it's important to understand the current state of emissions. For a quick recap, 50% (500,000,000 DYDX) of the total supply of DYDX is allocated to the community over 5 years, and the remaining 50% to investors, employees, dYdX Trading, etc. More information can be found here. For this proposal, we will restrict our focus to community allocation as it's likely the only thing the DAO can change.

Figure 6 outlines the DYDX communityemissions schedule and the change in emissions with the passing of DIP 14,16, and 17. The excess emissions (1,726,028 DYDX each epoch) are retained in the Rewards Treasury and are accessible by the DAO via on-chain votes. But more importantly, it highlights the DAO's available capital to be spent on V4 necessities e.g. subDAOs, grants, etc.

Figure 6: DYDX Community Emissions Schedule

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Evidently, Trading Rewards are ~44% of all community emissions per epoch, even after its recent 25% reduction. We'd argue this remains excessively high given the current market conditions and dampening of volume across the entire ecosystem. On the other hand, the wind-down of the SSM and LSM has significantly reduced the supply pressure of DYDX as their emissions are now retained within the Rewards Treasury. Therefore, we propose to reduce current Trading Rewards from 2,876,712 DYDX to 1,582,192 DYDX per epoch.

As illustrated in Figure 8, Trading Rewards are reduced by 45% aligning it with the newly proposed emission schedule in Figure 10. The excess DYDX is retained within the Rewards Treasury which can then be used by governance as they see fit.

Furthermore, the current emissions schedule fails to account for the large impending supply shock at the end of the 5-year schedule and disproportionately values stakeholders. Specifically, around 3/8/2026 token holders will be able to vote on enacting an inflation rate with a max bound of 2%. Even if the max inflation rate is approved, stakeholders and the protocol will face a large supply shock. Therefore, we propose a new emissions distribution and choose to reduce emissions yearly over the next 4 years and gradually bring them in line with the maximum 2% inflation rate.

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The new distribution of emissions illustrated in Figure 9 provides an equitable allocation to current stakeholders. Trading Rewards retains the highest share as it's responsible for stimulating trading and platform activity, while Liquidity Providers receive a bump in reward share as moving into V4 they will play an important role in supporting the platform across multiple markets. Lastly, the Community and Rewards Treasury retain a large portion of emissions as it will be responsible for funding subDAOs, grants, growth etc.

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Assuming the community enacts the max 2% inflation rate on the total supply of 1,000,000,000 DYDX, emissions will be reduced to 20,000,000 DYDX per year or 1,534,247 DYDX per epoch.

This is a significant reduction in comparison to the current 85,000,000 DYDX per year or 6,520,548 DYDX per epoch (community emissions). Thus, we have intentionally lined up the final reduction in Figure 9 on 3/8/2026 to be on par with the 2% inflation rate, in order to gradually shift inflation expectations amongst stakeholders. This is achieved by reducing community emissions by 1,246,575.34 DYDX per epoch every year.

However, assuming these changes are implemented on the proposed dates the new total supply would be reduced by ~162,500,000 DYDX (16.25%), impacting the base of which the 2% inflation rate will be calculated.

In the first 2 years, the reduction in emissions is moderate in order to continue facilitating growth efforts. In the last 2 years, the fixed rate of emissions reduction becomes significant, increasing the scarcity of DYDX.

Notably, for the first reduction no change will occur to trading rewards if the above proposal to reduce trading rewards now is approved. If in the case that V4 is not live by the first reduction date, governance can choose to send the excess DYDX to a burn address and ensure that the total supply is being reduced.

Trading Rewards - are they efficient?

The Trading Rewards program is a simple and effective incentive system that rewards users proportional to the amount of fees they pay in a given epoch. Such a mechanism is very efficient from a user's POV as it's essentially a rebate on all trading activity regardless of the market they trade. For example, a user trading in BTC & ETH markets against much tighter spreads receives better execution and the same "fee" as someone trading in a longer tail asset with wider spreads.

This is completely fine if we believe the purpose of trading rewards is to pay users to trade on dYdX according to their regular behaviour. However, if we view Trading Rewards as a mechanism to incentivise trading volume in longer-tail markets or markets in general, it is very inefficient. Other than marginally reducing the transaction cost for longer tail markets, the current trading rewards program fails to directly incentivize trading in these markets. Furthermore, the Liquidity Provider Rewards program is paying LPs to sit there and wait for trading volume in longer tail markets, while Trading Rewards fail to actively drive volume to such markets.

Figure 11:

[Weekly Trading Volume by Market

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Therefore, we propose to introduce market allocations for Trading Rewards similar to what already exists in Liquidity Provider Rewards.

Importantly, I believe that for this to be successful it would require marketing efforts and a clear way for users to identify the amount of DYDX each market is allocated for that epoch (weekly prizes would work better). Each market will have an individual prize pool as opposed to one grand prize pool, and being conscious of not cannibalising ETH & BTC markets which contribute the most to volume and fee. We propose a market split of:

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One concern we have is with the inability to access volume and fees data in real-time and historically. Thus, it's hard to know if we are overpaying or underpaying for volume in certain markets. I assume that with the introduction of a Growth subDAO in V4, this data will be available and a better understanding of optimal allocations can be achieved.

Conclusion:

This proposal introduces a myriad of large and small changes that hopefully form a sustainable foundation going into V4. We began by increasing taker fees to improve toxic flow and decreasing maker fees in certain volume bins to make sure dYdX retains its competitive fee structure. Then, in order to tackle the reliance on DYDX rewards which we propose to reduce over time, we introduce a Market-Maker Rebate Program to naturally incentivize liquidity provision based on maker volume. Next, we chose to eliminate cosmetic entry barriers to rewards such as DYDX Trading Discounts. This intentionally shifts dYdX towards a credibly-neutral DEX that is fully inclusive and rewards metrics that maximize protocol revenue (i.e., volume & liquidity).

With a strong base incentive layer in place, we began tackling an emission schedule that was rather excessive, disproportionately valued stakeholders and had a significant impending supply shock. Thus, we adjusted the distribution of DYDX towards Trading Rewards and constructed an inflation schedule that reduces yearly to meet a 2% max terminal inflation rate. Lastly, we questioned if the current use of Trading Rewards is efficient in stimulating trading volume across longer-tail markets or markets in general. Depending on how the community view the role of Trading Rewards, we argue that creating individual prize pools for each market is a more efficient way to stimulate trading volume. Overall, we believe

that these changes will help accelerate dYdX into its hegemony over the decentralized derivatives space.

Request for Comments:

This proposal introduces a lot of new changes to dYdX and we kindly ask the community and various stakeholders to provide feedback. Once a general consensus is formed around certain changes we will initiate the respective proposal lifecycle for each change. Note, we will work with the dYdX Foundation to ensure the timing of these Snapshots makes sense from a logistics perspective.

We’re really looking forward to hearing from the community! Thank you