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From: rhanson@gmd.edu on behalf of Robin Hanson [rhanson@gmu.edu]

Sent: Sunday, July 06, 2008 11:51 PM

To: secretary

OFC. OF THE SECRETARIAT

Subject: Comment on "Concept Release on the Appropriate Regulatory Treatment of Event Contracts"

COMMENT

I am an event market innovator, having published the first detailed discussions envisioning their widespread application, having designed a widely used trading mechanism (the market scoring rule), and having co-developed the first internal corporate markets (at Xanadu), the first public web markets (the Foresight Exchange), and the aborted-but-pivotal Policy Analysis Market.

As I am less well trained in law than social science, I will not comment on what the C.F.T.C. is legally authorized to do, but only on how various policies correspond to public interest and public opinion. I speak here only for myself and not for any organization with which I may be affiliated.

The degree and type of regulation appropriate for a financial market depends on traders' motives. Long ago most everything beyond direct physical exchange was widely discouraged or prohibited as "gambling" or "speculation." The motives imputed to traders seem to be some combination of mistakes, overconfidence, thrill of action, love of risk, and showing off one's confidence and risk tolerance.

Eventually legal exceptions were carved out for markets where, though speculation was still possible, enough participants had more sympathetic motives to garner public sympathy. Securities markets allowed business managers to hedge ownership, insurance markets allowed hedging of various idiosyncratic risks, and commodities futures markets allowed hedging of various common risks.

It has long been noted approvingly that such speculative markets often have the desirable side effect of inducing people to collect info and to aggregate it into prices. But until recently such info was not considered or accepted as a primary explanation or justification for a market's existence. Given the myriad ways our society now suffers, often dramatically, from failures to aggregate info, I am very optimistic about the long term potential for such markets to offer social value. However, the question remains of how such markets should be regulated today.

Ideally an entire new regulatory regime would be carved out, on par with regimes for securities, insurance, and commodities futures regulation. But who would bother with such an effort before such markets had proven themselves able to realize substantial social value? And how could such markets prove themselves without at least tentative legal spaces in which to experiment? I know of no good reason why the U.S. C.F.T.C. should not provide one of the first such spaces.

Two key issues face a new regulatory regime for info-motivated event markets, especially one carved out of a common-risk-hedging commodities-future regulatory regime:

- How does optimal regulation of info-motivated event markets differ from that of common-risk-hedging markets?
- How can regulators ensure that this new regime is not used as a back door to escape prohibitions on other commodity futures trading, or to escape general prohibitions against gambling?

How Does Optimal Regulation Differ Here?

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On the first question, the largest difference I see, by far, is the appropriate scale. When hedging risks it makes sense to focus first on risks, and hence trades, which are a large fraction of the wealth of the individuals or organizations involved. If risks are common there should be many who trade if any do, and so market volume should be many times individual wealth levels. It makes sense to devote a small fraction of this volume to efforts to avoid foul play. I have heard that it costs on the order of a million dollars to jump the regulatory hoops to gain approval for such markets, and I cannot say that this is not roughly the right magnitude here.

For markets whose main function is to collect info, however, the appropriate scale seems far smaller. To collect info on a topic, those who know or could find out need only be offered a sufficient incentive to bother. In the lab we see substantial effort and price info aggregation when only a few tens of dollars are at stake, and field data seems consistent with this estimate. If most of the social value from info-motivated event markets were concentrated in a few very important topics, it would not matter much if regulatory barriers prevented markets on topics with small info values. But if, as seems plausible, much of the value is found in a long thick tail of smaller topics, then to realize social value it is essential that the entry barriers to creating such markets be reduced to the lowest feasible level.

For example, consider a topic where a social value of one thousand dollars could be realized, if only people were allowed to trade on that topic. It is hard to see how this value could actually be realized if the regulatory cost to create this market were more than a few hundred dollars. If there were a million such topics, the total social value they created would be one billion dollars.

A related difference is when it makes sense to limit participation. If most of a certain kind of risk is held by wealthy individuals or large organizations, then it can make sense to limit participation to such traders. But for info collection it is crucial to allow participation by the sorts of people who could plausibly obtain that info. For a great many topics these people will be spread out in the population, and not easily distinguished from most other people.

How Can We Distinguish When This Regime Should Apply?

On the second question, we seek a reliable way to distinguish markets where the info collected is a strong rationale for its existence, a rationale strong enough to justify overturning the usual public presumption against generic speculation, and strong enough relative to hedging rationales to justify using this new regulatory regime, rather than previous hedging regulatory regimes.

One proposed distinguishing criteria includes the size of an individual trader's stake, and the number of traders. The Iowa Electronic Markets are limited on both of these parameters. Such limits do succeed in preventing large hedging markets from masquerading as event markets. But they do little to prevent generic gambling markets from masquerading as event markets.

Another proposed distinguishing criteria is the form of the organization that hosts the market. It has been proposed that tax-exempt, research, and government organizations be given wider latitude than for-profit businesses. I understand that this matches a common public perception, but honestly it seems mostly wishful thinking to believe that such organizations are substantially more likely to create markets with a stronger info rationale, or to avoid whatever problems one fears with for-profit businesses.

Some have suggested that topics could be used to distinguish the strength of info rationale. Markets on specific sporting events might be presumed to have low info rationale, while markets on public policy or might be presumed to have high info rationale. This approach seems to open the proverbial "can of worms" however, requiring a great and continuing effort to categorize topics.

Perhaps the best approach along these lines would be to inherit some other topic categorization. For example, regulation of free speech makes distinctions between topics where free speech is seen as performing very valuable social functions, giving it a strong legal protection, and topics where it performs less valuable functions, and can thus be more easily regulated. Event markets might be permitted on topics where free speech has a strong legal protection.

In contrast to such weak indicators let me propose a stronger indicator of when a speculative market has a strong info rationale. I am not proposing that only markets which sport this indicator be allowed, but rather that at least these markets be allowed. My proposal is to **permit markets where a sponsor pays to ensure that traders on average do not lose financially from participation**, as this payment creates a strong presumption that this sponsor expected to gain substantial valuable from that info.

It is hard to measure the various benefits that traders may gain from trading, but we can more easily measure the average financial costs that traders suffer. Traders may have to pay fees for permission to trade, to deposit into a system, to check prices and trading history, for each trade, and to withdraw their winnings. In addition, their deposits may not earn competitive risk-adjusted rates of return. Charging at least some of these kinds of fees is essential to the profitability of businesses today that rely primarily on traders' speculative motives. Payment is sometimes in the form of watching certain ads.

If for a particular topic, a sponsor were willing to ensure that traders suffered *none* of these common trading fees, including not selling trader attention to advertisers, that sponsor would have credibly suggested that this market would not exist if the sponsor did not expect the related info to be valuable. If the sponsor furthermore subsidized this market, allowing traders to gain on average by trading against ignorant automated market makers, this would show even more clearly that they valued the resulting info. Such measures would ensure that traders suffered no average financial loss from their participation, though they could still lose on average, such as by wasting too much time dealing with these markets.

Of course we do not expect sponsors to arise to support all topics where info collected by trading would be socially valuable. Businesses would sponsor markets on topics important to them, and charities could collect donations to support markets on topics considered to be more broadly valuable, but we would also expect many coordination failures, where each party prefers that others pay for commonly valuable info. So the case for prohibiting markets that fail this criteria is much weaker than the case for permitting markets that meet this criteria.

It also remains possible that even when a sponsor finds info to be valuable, the social value of that info could be much less than the private value to the sponsor. If we could define identifiable classes of such cases, these could form the basis of exceptions to this general permission.

I have many other opinions about how such markets might be defined and regulated, but I've already gone one for quite a bit here - if you like what you've see so far, you know where to find me to get more.

In Summary

In addition to regulatory regimes for securities, insurance, and commodity futures to hedge common risks, it could make sense to have a distinct regulatory regime for markets whose main rationale is the info that they collect. Such a regime should have a much lower barriers to creating such markets, as much of the soicial value may be distributed in millions of small markets. And while it is hard to determine in general which markets would create high social value, relative to cost, from info collected,

we should presume such high value when a sponsor is willing to pay to ensure that traders suffer no financial cost from their participation.

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