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Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

Re: Concept Release on the Appropriate Regulatory Treatment of Event Contracts

Introduction

This comment represents the views of the International Swaps and Derivatives Association (ISDA). ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. ISDA documentation is the standard for OTC derivatives transactions globally. A current list of ISDA's members, as well as other information about ISDA and its activities, is available on our website at www.isda.org.

ISDA is grateful for the opportunity to respond to the Commission's Concept Release. To begin, it is helpful to bear in mind the purposes of the Commodity Exchange Act. As stated in Section 3 (7 U.S.C. 5), broadly speaking the purpose of the law is to promote an effective system of self regulation, deter and prevent abuse of markets and market participants, avoid systemic risk, and promote innovation and competition. All of these purposes are done so in light of the congressional finding that transactions subject to the Act are affected with a national public interest by providing a means to manage and assume price risk, discover prices and disseminating price information through trading in liquid, fair and financially secure trading facilities.

It is likewise worthwhile to consider the broad exemptive authority which Congress gave the Commission in Section 4 of the Act (7 USC 6(c)), and the purposes for which the authority was granted. As noted by the Commission in its Concept Release, 4(c) was created "in order to promote responsible economic or financial innovation and fair competition . . ." Additionally, as noted in the Release, this authority was granted with the intent that the Commission need not make a determination as to whether a particular transaction is otherwise subject to the Act.[1]

Taking these provisions of the Act together, and in light of the statutory scheme as a whole as amended by the Commodity Futures Modernization Act[2], it appears that Congress has placed a priority on creating a flexible regulatory structure capable of adjusting quickly to new developments in the markets. The Commission likewise has

[1] House Conference Report 102-978, 1992 U.S.C.C.A.N. 3214-3215
[2] P.L. 106-580, December 29, 2000

used this authority with an eye towards promoting innovation while at the same time protecting market users; the phenomenal growth of US derivatives markets in the past eight years have demonstrated the wisdom of this approach. Continuing in this vein is likely to yield the most fruitful results when undertaking the present inquiry into event contracts.

Response to Commission Questions

The Public Interest[3]

The Commission asks what public interests are served by event contracts that are designed and traded for information aggregation purposes, and not for risk management or pricing purposes. The Commission also asks how these interests are consistent with the public interest goals, and what variables, etc. could be used to determine the social value of information to the general public.

The existence of event contracts likewise indicates the existence of a market for the information generated and disseminated by such contracts. As the Commission certainly knows information has value in and of itself, and therefore it should be taken for granted that there is a public interest in the creation and dissemination of information regardless of the underlying nature or topic. Stated another way, a public interest exists in allowing information to be created so that a market value can be determined for such information. Given the academic and popular interest[4] in the power of event markets to serve predictive purposes in recent years, there is now sufficient awareness of the nature and purposes of such markets to demonstrate both a demand for this type of information as well as an understanding of its limitations. Given their tendency to help clarify expectations about the likelihood of future events, it would seem that the national interest is served in promoting and not hindering the development of markets to assess the value of individual assessments of probability.

Determining the social value of information is perhaps a task to which the Commission is not ideally suited. Obviously, determining "social value" is not one of the enumerated purposes of the Act. Furthermore it is unlikely that the Commission could develop a metric for determining "social value" that would be less controversial and more transparent than the demand for the information created by such markets. Given the apparent popularity of at least a handful of event markets, both for academic, research and other purposes, it appears such markets are meeting a demand for information which in and of itself demonstrates at least some "social value" of event contracts.

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[3] The responses for each topical heading respond to the topics discussed in the Commission's Release. In order to avoid duplication, the answers respond broadly to the topics as revealed by the header.

[4] The Commission cites some of the more relevant academic work in the Release; see also The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economies, Societies and Nations, James Surowiecki, Random House 2004. For a somewhat less rosy view (and for a historical precedent) see Extraordinary Popular Delusions and the Madness of Crowds, Charles MacKay, Harriman House Ltd., originally published 1841.

Jurisdictional Determinations

As the Commission notes in the Release, the Act grants broad authority over commodity options and futures. The history of regulation of commodity derivative contracts begins with a focus on agricultural commodities, and later, with the creation of the Commodity Futures Trading Commission, was extended to markets for "all other goods and articles . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. 1a(4). This self-referentially broad formulation creates an exhaustive category of potential commodities under the Act,[5] since if a futures contract is to come before the Commission for a jurisdictional determination the underlying commodity presumably will also be the subject of a contract "presently dealt in".

The Commission's jurisdiction over options is also sweeping; Section 4c(b) grants the Commission the power to prohibit options on "any commodity" regulated under the Act.[6] However section 4c(b) grants broader latitude for market participants in that options contracts, if not explicitly prohibited by the Commission, are presumed valid contracts. However, at this juncture it is not necessary for the Commission to engage in an inquiry as to whether a particular event contract is a contract of sale of a commodity for future delivery or an option contract under the Act; indeed, such an inquiry is likely to be counterproductive to the goal of promoting "responsible economic or financial innovation."

Congress gave the CFTC the ability to exempt transactions from the Act without first making a determination as to whether the transaction is subject to the Act. This reflects Congress' understanding that making jurisdictional determinations can have a broad impact across markets and products, and unintended consequences can result from taking an action, even an exemptive one, intended to apply to only one type of transaction. The Commission has historically shared this concern.[7] This prudent policy has allowed markets to operate without fear that seeking exemptive relief may unintentionally cast into doubt other transactions under the Act.

In the Release the Commission discusses the definition and categorization of excluded commodities under the Act. This discussion aptly illustrates why great care must be taken in making jurisdictional determinations. Attempting to identify what interests are

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[5] As the Commission is aware the determination of whether something is a commodity, or even a determination that a particular transaction is a futures contract, does not necessarily mean the Commission has jurisdiction. (See for example Act Section 2).

[6] Of course, options on securities and foreign currency listed on a national securities exchange, and options covered under the "Treasury Amendment," as well as other transactions exempted or excluded under the Act, are treated separately. (See Commodity Exchange Act Sec. 2(c) et. seq.)

[7] So attentive is the Commission to this danger that Rule 140.99, governing requests for exemptive or no action relief, implicitly acknowledges the Commission's care in making such determinations by not requiring petitioners to assert jurisdictional grounds. (Although the Rule does require a petitioner to state whether a proposed transaction is exempt or excluded from trading on a registered entity or exempt board of trade, this requirement can be seen as a factual assertion rather than a legal conclusion).

"price based" or otherwise have "generally accepted and predictable financial, commercial or economic consequences," and differentiating between such contracts from those that "event contracts cover," the Commission runs the risk of instead complicating the question of what types of transactions are excluded from the Act. Though surely this is not the Commission's intent, attempting to draw jurisdictional conclusions with respect to event contracts is fraught with peril and is unnecessary at this juncture. Instead the Commission should follow its time tested and prudent practice, and avoid making jurisdictional determinations. The Commission should focus on a case-by-case basis whether specific event markets, seeking exemptive relief, should be granted such relief, or alternatively grant broad exemptive relief via 4(c) without making a jurisdictional determination.

Legal Implementation

The Commission's discussion of legal implementation asks whether it is appropriate to direct all or certain event contracts onto markets that are regulated differently from traditional DCMs. While creating a new category of market which is regulated differently from full DCM regulation is an attractive approach the Commission should be careful to allow event contract markets to choose this option, or to choose another option such as exemptive relief or even DCM registration. Allowing potential new markets a broad range of choices, rather than forcing any particular regulatory arrangement for the market, is likely to best serve the public's interest in promoting innovation and competition.

The Commission further asks whether it is appropriate to use 4(c) to implement a regulatory scheme for event contracts and markets. As noted above this could be an appropriate route provided the Commission does not undertake jurisdictional determinations which could implicate other product types and markets.

Market Participants

The Commission asks questions with respect to participants in event markets that appear primarily focused on retail customers. Most of these concerns could be addressed as part of any review of a particular event market as part of a request for exemptive relief. Alternatively were the Commission to undertake creating a special category of registration for a particular type of event market, it would do well to draw upon its substantial experience in customer protection in other retail customer contexts. However it is premature to consider such arrangements absent a more detailed review and understanding of what and if any markets were likely to avail themselves of such a regime.

Conclusion

ISDA thanks the Commission for the opportunity to comment on this Release. As noted above, from the perspective of ISDA's members the most important consideration in the event contract discussion is ensuring that jurisdictional determinations are avoided which

could adversely impact other markets and products. To that end ISDA recommends that if the Commission decides to undertake any further action in this area it rely upon the authority given it by Congress to grant exemptive relief without making any determination as to the jurisdictional characteristics of particular types of transactions. Likewise if the Commission decides to consider creating a new type of registered entity for purposes of facilitating the growth of event contract markets the Commission should be clear that such proposal in no way implicates, amends, repeals or affects existing exemptions and exclusions from the Act, nor creates any presumption that any agreement, contract or transaction is not an excluded commodity for purposes of the Act.

Respectfully Submitted,

Greg Zerzan
Counsel and Head of Global Public Policy
ISDA