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Received CFTC
Records Section
7/8/08

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

COMMENT

Re: Request for Public Comment on the CFTC's "Concept Release on the Appropriate Regulatory Treatment of Event Contracts"

We, the undersigned, are members the Board of Directors for the Iowa Electronic Markets (IEM), which is the only event market to have received a No-Action Letter from the CFTC. We endorse the idea of the CFTC providing a "safe harbor" for small scale prediction markets in order to foster their development and provide needed research and innovation in information aggregation mechanisms.

Our specific comments on parts of the Concept Release follow.

1. What public interests are served by event contracts that are designed and will principally be traded for information aggregation purposes and not for commercial risk management or pricing purposes?

The public interest that is served by Prediction Markets is primarily due to their role in information aggregation. The public interest is generally better served with more, rather than less, accurate information. The price discovery function of markets is as important in non-traditional markets, such as predicting outbreaks of avian influenza¹, as it is in traditional markets such as orange juice futures. Improved knowledge about the likelihood of a particular event occurring allows decision makers greater latitude in responding optimally. When such markets are conducted under the umbrella of an academic institution, these markets provide research and teaching purposes, both clearly in the public interest.

3. What calculations, analyses, variables, and factors could be used to objectively determine the social value of information to the general public that may be discovered through trading in event contracts? Should this be a factor in determining whether the Commission plays a role in regulating these markets?

Calculation of the value of information is a straight forward exercise that is taught in almost every business school², but it should not be a factor in whether the CFTC should regulate event markets. It is impossible to tell *ex ante* whether any specific event

¹ See the information at <http://fluprediction.uiowa.edu/fluhome/>

² See Pindyck, R S and D. L. Rubinfeld, Microeconomics, 5th ed. 164-165 for a textbook demonstration of how to value improved information.

market will work well enough to draw interested traders. If it does not work trading will dry up.³

4. What characteristics or traits are common to or should be used to identify event contracts and event markets?

The characteristics that can be used to identify event markets useful for information aggregation purposes are (1) a focus on price discovery, and (2) an absence of scale to provide an insurance or hedging motive for trading. Arguably, the IEM has performed well in prediction because the size limitations and the perfectly elastic supply of bundles in those markets make hedging political risk unattractive. In some cases, the existence of specialized information must be considered. For instance, aggregating information about the likely outbreak of flu is more likely to be successful when those with specialized information (doctors, nurses, pharmacists) are included in the trader pool.

8. Given the purposes and history of the Act, would it be appropriate for the Commission to apply any test premised on the economic purpose of certain types of transactions to demarcate the Commission's jurisdiction over particular contracts? If so, what factors could be used to make such a determination?

It would be appropriate for the Commission to apply a test on the economic functions of the information obtained from the operation of the event market. For example, the IEM's markets have primarily had the purpose of teaching and research. It should be obvious that those activities have economic value. Other cases may be different. The Flu markets provide information about whether, and when, to apply prophylaxes to nursing homes. Sales forecasting, as the Hewlett-Packard example showed, would have a direct economic effect on a particular firm.⁴

11. What identifiable factors, statutorily based or otherwise, limit the events and measures that may underlie event contracts when such contracts are treated as Commission-regulated transactions?

Factors that should limit the events where contracts are treated as Commission-regulated transactions must, of necessity, depend upon the nature of the market, especially who is allowed to participate in it. As described in Arrow et. al, it seems likely that there will be three types of market organizers: (i) non-profit organizations, including Universities, colleges and think tanks; (ii) government organizations (e.g., Center for Disease Control, Department of Defense), and (iii) for private businesses and not-for-profits not primarily engaged in research. In some circumstances market enrollment may be restricted to individuals or organizations with special characteristics; in other cases, dissemination of the price and/or trading volume statistics may be restricted. An event like "Will Fidel Castro live past July 1, 2009?" may be of little interest to the first group of markets, but of important interest to the second.

³ See R L Sandor, "Innovation by an Exchange: A Case Study of the Development of the Plywood Futures Contract," *Journal of Law and Economics*, v. 16, n.1, April, 1973, 119-136.

⁴ C R. Plott and K Y Chen, "Information Aggregation Mechanisms: Concept, Design and Implementation For a Sales Forecasting Problem," Caltech Social Science working paper #1131, March 2002.

12. What objective and readily identifiable factors, statutorily based or otherwise, could be used to distinguish event contracts that could appropriately be traded under Commission oversight from transactions that may be viewed as the functional equivalent of gambling?

The distinguishing factor is what the proposing agents plan to do with the information once it is obtained. In conventional gambling, the outcome of a horse race, a card game or a boxing match has no economic value before or after the event occurs.

16. Is it appropriate for the Commission to direct certain or all event contracts onto markets that are regulated differently from and perhaps less stringently than DCMs?

It is appropriate to treat event markets differently than DCMs because their economic function is different. But all event markets should be, up to the question of privacy of information, required to have the same standard for resolution and payoff.

18. Is the issuance of staff no-action relief, such as the relief issued to the IEM, an appropriate or preferable means for establishing regulatory certainty for event contracts and markets?

Though a No-Action Letter may not be sufficiently flexible for all event markets and contracts, in our experience it works well for markets conducted for research and teaching purposes at academic research institutions. Such institutions already have audit functions in place to protect assets and research review in place to protect institutional and social interests. These functions supply similar oversight to that incorporated in regulatory review and we recommend that such oversight be incorporated as part of the no-action relief. For instance, because the IEM is a real-money market, we conform to University of Iowa cash handling procedures and are subject to University of Iowa audit. In addition, our trading rules assure that all trades are 100% cash covered so there is not risk of financial default.

Signed by the IEM Board of Directors,

Joyce Berg, Associate Professor of Accounting, University of Iowa

Thomas Gruca, Professor of Marketing, University of Iowa

Forrest Nelson, Professor of Economics, University of Iowa

George Neumann, Professor of Economic, University of Iowa

Thomas Rietz, Associate Professor Finance, University of Iowa